Annual Economic Report

2005

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

During the past year-and-a-half the global financial environment remained generally accommodative and the world economy expanded briskly, recording a growth rate of some 5 per cent in 2004 with projected growth of between 4 and 4½ per cent in 2005. While global economic growth moderated somewhat in the second half of 2004 and the first half of 2005, real income still advanced at a fairly rapid pace. The stronger world economy and high international commodity prices contributed to an acceleration in growth on the African continent to a rate which also amounted to around 5 per cent in 2004 – the highest in eight years.

Various tensions and concerns clouded the economic horizon, some of which moved closer to resolution during the year under review. In the United States the authorities gradually raised the target rate for federal funds from around mid-2004, mindful of the harmful side-effects of maintaining unsustainably low short-term interest rates. With global policy interest rates in general at relatively low levels over the past eighteen months, longer-term interest rates in the major markets were also subdued. Credit spreads narrowed, with riskier domestic borrowers and emerging-market countries able to borrow on relatively favourable terms. Under these comparatively liquid circumstances, lending expanded briskly and the prices of shares and especially of houses surged in many parts of the world.

Over the past year-and-a-half the current-account deficits of the United States and some other countries widened further, while current-account surpluses continued to grow in a number of other countries, including some oil-exporting countries and China. In July 2005 the Chinese authorities replaced the eight-year-long peg of the yuan to the US dollar with a system of managed floating and allowed their currency to appreciate somewhat – an important step in the process of reducing some of the imbalances, stresses and strains in the world economy.

The sharp increase in international commodity prices, especially oil prices, contributed to a moderate increase in inflation in most countries since the beginning of 2004. Crude oil prices more than doubled from the beginning of 2004 to August 2005 in the face of strong global demand, geopolitical tensions and concerns regarding possible disruptions of oil production in some countries. While the prices of many other international commodities receded somewhat from their upper turning points in early 2004, prices remained high. Nevertheless, global consumer price inflation picked up very little. In Africa, average consumer price inflation receded from more than 10 per cent in 2003 to a single-digit level in 2004.

The performance of the South African economy in recent times seems to be more solid and consistent than before. In fact, the business cycle has been in an upward phase for 71 months since September 1999, making this the longest upswing in the recorded economic history of South Africa. Real gross domestic product registered twenty-three quarters of uninterrupted increase and rose at an average annualised rate of 3½ per cent over this recovery, signifying an appreciable increase in real production *per capita*. The growth momentum over the past year-and-a-half was sustained by strong domestic expenditure, alongside the stronger world economy and generally favourable terms of trade.

From 3½ per cent in the first half of 2004, real output growth picked up to an annualised rate of 5 per cent in the second half before reverting to 4 per cent in the first half of 2005. The services sector was the mainstay of the economic expansion, maintaining momentum throughout the past year-and-a-half while reflecting the strength of domestic expenditure. Overall mining output also expanded strongly, although gold output continued its secular decline. Strong demand for residential and non-residential buildings, complemented by some infrastructural development projects, underpinned brisk growth in the construction industry.

Manufacturing output rose significantly during 2004, buoyed by robust domestic demand, but lost some momentum in the first half of 2005 as domestic expenditure growth slowed and the relative strength of the external value of the rand weakened the international competitiveness of manufacturers and other producers of tradeables.

Enterprise-surveyed employment outside the agricultural sector responded with some delay to the improvement in domestic output levels and recorded successive increases in each of the five quarters to September 2004. Private-sector job opportunities benefited most from the economic recovery, but there was also a moderate increase in public-sector employment. Although the pick-up in employment was not sustained in the last quarter of 2004 and the first quarter of 2005, on balance 222 000 formal-sector job opportunities were created from the employment trough in June 2003 up to March 2005.

Labour productivity increased by 1,8 per cent in 2004, but picked up in the first quarter of 2005 as employment paused. Wage settlements averaged 6,8 per cent in 2004 and receded to 6 per cent in the first half of 2005, while the cost of labour per unit of production in the formal non-agricultural sector rose by 7,2 per cent in 2004, before moderating to an increase of 5,9 per cent in the year to the first quarter of 2005.

The increase in nominal wages per employee exceeded consumer price inflation by a significant margin in 2004 and early 2005. Together with the improvement in employment levels, higher welfare transfers from government to the household sector and tax relief, it boosted households' real disposable income by a significant margin. Fuelled by rising income levels and lower interest rates, households increased their real final consumption expenditure by 6 per cent in 2004 and at a similar rate in the first half of 2005.

Real general government final consumption expenditure exhibited high growth rates in 2004 and the first half of 2005, as spending on strategic defence equipment and other non-wage goods and services was stepped up. At the same time, fixed capital formation accelerated further, encouraged by rising income and expenditure levels and supported by the enhanced affordability of imported capital goods and lower interest rates. Capital expenditure on residential buildings and transport equipment was particularly buoyant.

Inventory accumulation continued during 2004 alongside rising sales, with carrying costs reduced by lower interest rates. During the first half of 2005 the pace of inventory accumulation slowed down, resulting in a marginal decline in the ratio of inventories to output. The slower pace at which inventories were accumulated explains why growth in real gross domestic expenditure was subdued compared with growth in real domestic final demand during the first half of 2005.

With gross domestic expenditure consistently exceeding gross domestic product over the past two-and-a-half years, the current account of the balance of payments recorded a deficit during each of the past ten completed quarters. Buoyed by rising imports of capital and consumer goods as well as crude oil, the volume of imports rose faster than the volume of exports over this period. During the first half of 2005 the slowdown in aggregate domestic expenditure growth resulted in subdued growth in real imports. This, together with a further increase in real exports, contributed to a narrowing of the current-account deficit. Favourable export prices and a fairly strong external terms of trade contributed to the containment of the current-account deficit: At 3,2 per cent of gross domestic product in 2004 and 3,3 per cent in the first half of 2005, the current-account deficit was modest in comparison with imbalances elsewhere in the world.

Surpluses on the financial account of the balance of payments more than fully covered the deficits on the current account, leading to continued surpluses on the overall balance of payments over the past eighteen months. Apart from significant inflows of capital in the form of portfolio and other capital, large direct investment inflows recently contributed to stronger gold and other foreign-reserve levels.

Bank loans and advances extended to the private sector accelerated vigorously from a twelve-month growth rate of less than 9 per cent in mid-2004 to rates in excess of 22 per cent by mid-2005, supported by rising levels of income and expenditure, relatively low interest rates, strong business and consumer confidence, and the buoyancy of the real-estate and securities markets. Mortgage advances displayed the strongest growth of the various types of credit. With households stepping up their use of credit facilities to a greater extent than companies, household debt rose briskly to 61 per cent of annualised disposable income by mid-2005 – the highest level in six years. With lower interest rates, household debt service cost relative to household income nevertheless remained well contained.

Growth in the broad money supply, M3, picked up during the course of the past year, although not to the same extent as the main credit aggregates. Having fluctuated around 12 per cent for more than two years, by June 2005 twelve-month growth in M3 amounted to 17 per cent while the income velocity of circulation of M3 declined to a record low level in the second quarter of 2005. The strong growth in money supply was a reflection of the brisk increases in nominal income, expenditure and wealth, alongside the increased access to banking services enjoyed by previously unbanked segments of society.

Prices in the real-estate and financial markets attained new record highs over the past year. The yield on long-term bonds fluctuated around a downward trend and reached its lowest level in almost 30 years at the end of February 2005 as the exchange value of the rand appreciated and the prospects for sustained low inflation brightened. The monthly average price level of all classes of shares listed on the JSE Limited increased by 33 per cent from July 2004 to March 2005. Share prices then lost steam for a while and fell back in April alongside weaker global equity markets, but recovered in May and June to set a new record-high closing level on 10 August 2005.

The real-estate market remained buoyant during the past year, but with the probability of further steep declines in mortgage interest costs diminishing, the rate of increase in real-estates prices, which at times exceeded 35 per cent on a year-on-year basis, tapered off in the course of 2004 and in the first seven months of 2005.

Over the past five years the emphasis of fiscal policy gradually shifted from deficit reduction to growth and social development, but without compromising the principles of fiscal sustainability. Exceptionally strong tax collections resulted in a national government deficit before borrowing and debt repayment of only 1,5 per cent of gross domestic product in the 2004/05 fiscal year, or roughly half the amount originally budgeted. The deficit was soundly financed, mostly by issuing government bonds and Treasury bills in the domestic market. At the end of the 2004/05 fiscal year the total government loan debt as a ratio of gross domestic product came to only 36 per cent.

For fiscal 2005/06 it is planned to step up the national government deficit to 3,1 per cent of gross domestic product. With the public sector as a whole committed to enhancing South Africa's infrastructure, planned increases in capital expenditure are also reflected in a two-fold increase of the projected non-financial public-sector borrowing requirement to almost 4 per cent of gross domestic product in 2005/06.

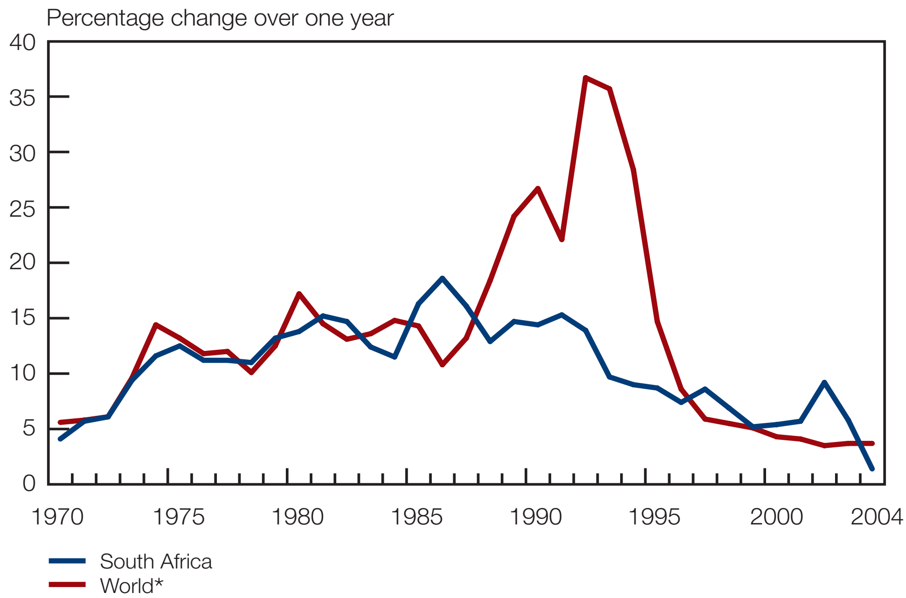
In May 2005 the Reserve Bank introduced a set of modifications to its refinancing system, including the announcement by the Bank prior to the weekly main repurchase auction of an expected range for the daily liquidity requirement in the forthcoming week. Supplementary repurchase transactions are no longer used unless exceptional fluctuations in liquidity are encountered. Standing facilities with the Bank were introduced to help with the absorption of swings in liquidity. These facilities enable banks, at their initiative, to place surplus funds overnight with the Reserve Bank at a rate that is 50 basis points below the main repurchase rate, or to borrow overnight funds at a rate that is 50 basis points above the main repurchase rate through a repurchase mechanism.

During the past year – and in fact on a continuous basis since September 2003 – CPIX inflation remained within the target range of 3 to 6 per cent, while production price inflation consistently fell below CPIX inflation as production prices were influenced more directly by the strength of the exchange value of the rand. These outcomes brought inflation in South Africa in 2004 to a level that was slightly below the world average rate of inflation.

In August 2004 and again in April 2005, the Monetary Policy Committee (MPC) reduced the repurchase rate by 50 basis points, essentially motivated by indications that prospects for future inflation had improved. Other short-term interest rates broadly traced the movements in the repurchase rate.

The responsible economic policies pursued by the authorities and improved prospects for the economy were recognised by three rating agencies who upgraded their rating of South African debt instruments during the course of the past year. This contributed to a further decline of nominal long-term interest rates, to levels previously observed in the late 1970s. Over the past year-and-a-half the variability of short-term and long-term interest rates and of the effective exchange rate of the rand receded appreciably, reinforcing the platform for launching faster growth and development in the coming years.

World and South African consumer prices



* Source: International Monetary Fund

Domestic economic developments

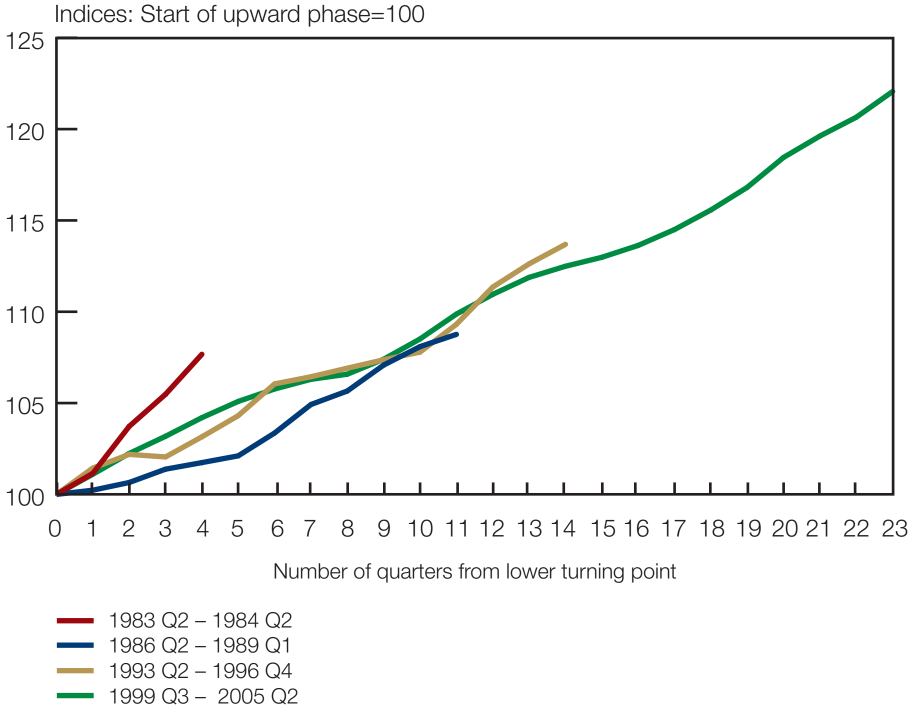
Domestic output[1]

Following an increase of 3½ per cent in 2002, growth in *real gross domestic product* slowed down to 3 per cent in 2003 but thereafter accelerated to 3½ per cent in 2004. These variations in growth reflected fluctuations in the real value added by the primary and secondary sectors of the economy. The real value added by the tertiary sector maintained a fairly steady rate of increase from 2002 to 2004.

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

During the current upward phase of the business cycle – twenty-three quarters of uninterrupted economic expansion, the longest since the end of the Second World War – real gross domestic product rose at an average annualised rate of 3½ per cent, similar to the growth rate attained in the 1993-1996 upswing which lasted fourteen quarters. It is noteworthy that economic growth was sustained for such an extended period at what was for a long time regarded as the economy's potential rate of output growth.

Real gross domestic product during economic recoveries



The pace of real economic growth slowed from an annualised rate of 5 per cent in the second half of 2004 to 4 per cent in the first half of 2005 as growth in the real value added by the primary and the secondary sectors of the economy slackened, while growth in the real value added by the tertiary sector of the economy remained strong at an annualised rate of 4½ per cent in the second half of 2004 and the first half of 2005. For the economy to grow at a rate of about 4 per cent in 2005 as a whole, an annualised rate of increase of about 3½ per cent has to be realised in the second half of 2005.

Growth in the real value added by the *primary sector* accelerated from 1 per cent in 2003 to 3½ per cent in 2004. This was mainly due to a recovery in the real output of the agricultural sector which contracted in 2003 but subsequently recovered somewhat. The growth in the real value added by the mining sector was sustained at a fairly high rate in 2003 and 2004.

Following a decline of 6 per cent in 2003, the real value added by the *agricultural sector* rose by 1 per cent in 2004. The growth in 2004 was mainly supported by an increase in the production of field crops, in particular by maize. Despite a smaller area planted in 2004, the average yield per hectare planted was appreciably higher, boosting the real value added by the agricultural sector. There was also a discernible improvement in the output of horticultural and livestock farming.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

Sectors	2003	2004			2005
	Year	1st half	2nd half	Year	1st half
Primary sector	1	4	6½	3½	5½
Agriculture	-6	7	11	1	5½
Mining	4½	3	5	4	5
Secondary sector	0	4	5½	3	2
Manufacturing	-1	3½	5½	2½	1½
Electricity, gas and water	½	2½	3	2	1½
Construction	5	6	8½	6½	6
Tertiary sector	4	4	4½	4	4½
Commerce	6½	5½	6	6½	5
Transportation and communication	5	6	6½	5½	6
Financial and other services	4	3½	5	4	5½
Non-agricultural sector	*3*	*4*	*5*	*4*	*4*
Total	3	3½	5	3½	4

The expansion in the real value added by the agricultural sector in 2004 was accentuated in the second half of the year when an annualised growth rate of 11 per cent was recorded, up from 7 per cent in the first half of that year. However, growth in real agricultural output petered out to an annualised rate of about 5½ per cent in the first half of 2005. This was mainly on account of subdued non-maize field crop and horticultural production which offset a fair improvement in the fortunes of livestock farmers. The contribution of maize production in the real value added by the agricultural sector during the first half of 2005 stemmed from the harvesting of an ostensibly bumper crop.

The real value added by the *mining sector* increased at roughly the same pace of about 4½ per cent in 2003 and 2004. Growth peaked in the second half of 2004 when it accelerated to 5 per cent, from an annualised rate of 3 per cent in the first half of the year. This strong growth momentum spilled over into the first half of 2005. In 2003 and 2004 the performance of the mining sector was largely sustained by increased diamond, coal and platinum-mining operations. However, the individual contribution of these sectors started to diverge from the second half of 2004 with platinum mining continuing to expand healthily but diamond and coal mining falling behind.

Certain mines faced export capacity constraints as well as increased competition from other global exporters and, more generally, exporters of mining commodities struggled with rising input costs in the face of declining revenues. Nevertheless, real value added by the mining sector expanded in the first half of 2005. The increase in real output originating in the mining sector in the first half of 2005 was concentrated in increases in platinum and "other mining" production. Especially platinum mines continued to benefit from the strong growth in the global demand, both for jewellery and for industrial use. Domestically, brisk production of catalytic converters (both for export and for domestic automobile manufacturing) continued to support the demand for platinum, aligned with international standards for cleaner emission by vehicles. Gold mining continued its secular decline, leaving gold output constrained by rising input costs which in many instances exceeded the market price of gold.

The real value added by the *secondary sector* virtually stagnated in 2003 but recovered at a rate of 3 per cent in 2004 as a result of an improvement in the real output of all three main subsectors which constitute the secondary sector.

Real output originating in the *manufacturing sector* declined by 1 per cent in 2003. This was partly due to a decrease in international competitiveness in export markets as the external value of the rand recovered from the depreciated levels of 2002. However, the setback to manufacturing output was short-lived and real output recovered and increased at a rate of 2½ per cent in 2004. Unlike 2002 when manufacturing output was boosted by the rising output of the export-oriented subsectors, the recovery in 2004 was driven largely by robust domestic demand. This was in spite of the fact that some sectors such as the textile, clothing and footwear manufacturers were adversely affected by import substitution.

The growth in the real value added by the manufacturing sector slowed down in the first half of 2005. Following a rate of increase of 5½ per cent in the second half of 2004, growth slowed to an annualised rate of 1½ per cent in the first half of 2005. Subdued output was particularly evident in the subsectors that manufacture textiles and clothing, basic iron and steel, and wood and wood products. By contrast, vehicle manufacturers performed well as the domestic and global demand for South African manufactured vehicles continued to remain strong.

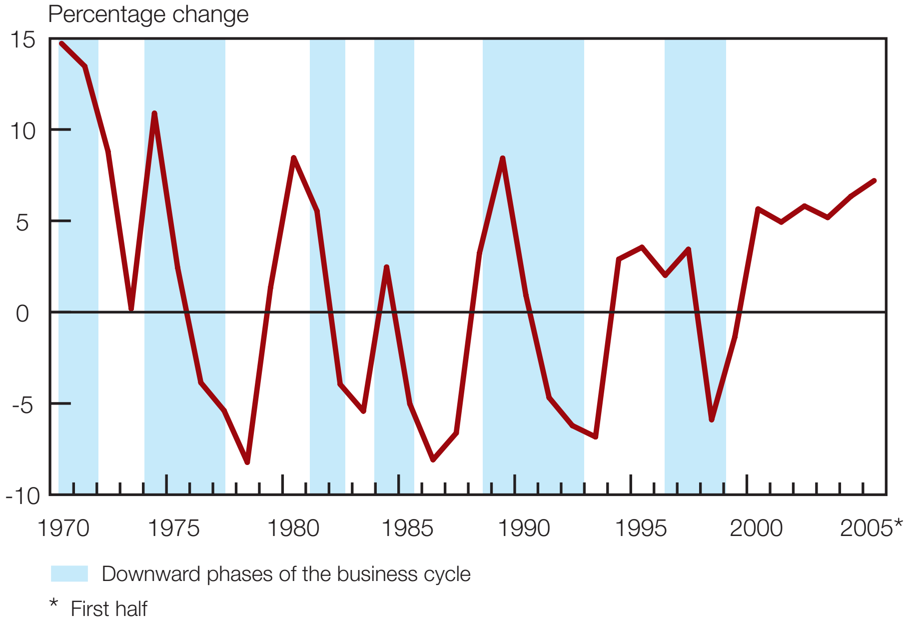
The relatively sluggish growth in the real value added by the manufacturing sector during the first half of 2005 partly reflected levels of the exchange rate of the rand at which some manufacturers apparently found it difficult to remain competitive, either against imports or in the export market. These difficulties were aggravated by a deceleration in real domestic expenditure growth.

The fortunes of the manufacturing sector were reflected in fluctuations in the utilisation of production capacity. Capacity utilisation increased from an average of 81 per cent in 2003 to 85½ per cent in the second quarter of 2004, but receded somewhat to approximately 84½ per cent in early 2005. During the first part of 2005 the lower capacity utilisation rate was probably a reflection of slow growth in output volumes and some additions to production capacity through fixed capital formation.

The growth in the real value added by the sector that supplies *electricity, gas and water* slowed from 2 per cent in 2004 to an annualised rate of 1½ per cent in the first half of 2005. Higher growth in 2004 resulted mainly from growth in the electricity subsector, essentially due to higher volumes of electricity exported as well as an increase in production activities by a number of electricity-intensive production units responding to favourable commodity prices. Real output of the electricity, gas and water sector continued to increase in the first half of 2005, albeit at a slower pace than in the second half of 2004. This slowdown was consistent with the mild temperatures experienced in the early part of the winter and the slowdown in the pace of activity growth in the economy, especially in the manufacturing sector.

Real output growth in the *construction sector* accelerated from 5 per cent in 2003 to 6½ per cent in 2004 – the strongest growth recorded in this sector in fourteen years. In the current upward phase of the business cycle the construction sector recorded an annualised real growth rate of 6 per cent, well above the rate of 2½ per cent recorded in the previous upward phase of 1993-1996. The firm growth can mainly be ascribed to strong demand for residential buildings, sustained growth in the non-residential building subsector and infrastructural developments involving the civil construction industry. Increased activity in the non-residential sector was boosted by the construction of shopping malls. Moreover, the regeneration of inner city areas in some of the major cities contributed to an increase in the real value added by the construction sector.

Real gross value added by the construction sector



The real value added by the *tertiary sector* increased by 4 per cent in 2004 – the same rate attained in 2003 – before accelerating to an annualised rate of 4½ per cent in the first half of 2005, led by higher growth than before in real output of the financial intermediation, insurance, real-estate and business services sector. The tertiary sector, which generates more than two thirds of the value added by the total economy, contributed more than 2½ percentage points to the overall growth rate during the past two years.

Real value added by the *commerce sector* increased sturdily from 2003 to 2004 as the wholesale, retail and motor trade sectors experienced a robust expansion. The real value added in the retail sector reflected robust consumer demand, boosted by high growth in real disposable income, lower interest rates and relatively low inflation. Demand for consumer goods recorded its highest growth rate in nine years as real outlays on durable and semi-durable goods such as furniture, appliances, entertainment goods as well as clothing and footwear increased strongly. The brisk increase in the purchases of these discretionary items was consistent with the general sense of well-being as revealed by the high levels of consumer confidence ascertained by various household surveys. This was also experienced in the motor trade, where the number of new vehicles sold in 2004 approached levels previously seen in the early 1980s.

Growth in the real value added by the commerce sector peaked at 6 per cent in the second half of 2004 before slowing to an annualised rate of 5 per cent in the first half of 2005. Demand for motor vehicles and other consumer goods remained brisk in the first half of 2005 but with slightly less momentum than before. The strong growth in the real value added by the catering and accommodation sector held up well in the first half of 2005.

The communication subsector, particularly cellular phone communication, was the mainstay of growth in the real output originating in the *transport, storage and communication sector* in recent times. The contribution of cellular phones to the value added by the transport, storage and communication sector increased from 19½ per cent in 2003 to 22 per cent in 2004. The further expansion of the cellular phone industry was a result of both upgrades of contracts of existing customers as well as new entrants acquiring cellular phones for the first time.

By contrast to the lively activity in the communication subsector, growth in the real value added by the land-transport subsector lost momentum, plagued by industrial action at some freight companies in the first half of 2005. The real value added by air transport remained broadly unchanged from the second half of 2004 to the first half of 2005. Overall real growth in the transport, storage and communication services sector slowed down to an annualised rate of 6 per cent in the first half of 2005, compared with a rate of 6½ per cent attained in the second half of 2004.

Growth in the real value added by the *financial intermediation, insurance, real-estate and business services sector* accelerated from an annualised rate of 5 per cent in the second half of 2004 to 5½ per cent in the first half of 2005. The stronger growth was primarily driven by buoyant demand in the real-estate sector, especially in the lower and middle range of the property market. This was complemented by improved financial market performance with higher trading volumes registered on the JSE Limited (JSE). Banks, conversely, benefited from stronger revenue flows generated in a low interest rate environment where record vehicle sales and strong gains in property prices were realised in 2003 and 2004. Though still lively, output growth in the banking sector slowed from the second half of 2004 to the first half of 2005.

The real value added by *general government* increased at an annualised rate of 1½ per cent in the first half of 2005, slightly higher than the annual growth rate attained in 2004 as a whole. This was broadly in keeping with moderate increases in employment by all levels of general government.

Following an increase of 3 per cent in 2003, growth in real gross national income picked up further to 5 per cent in 2004. This translated into an acceleration in growth in real gross national income per capita from 1½ per cent in 2003 to 3½ per cent in 2004. The expansion in national income in 2004 was primarily underpinned by reduced net primary income payments to the rest of the world, as dividend and interest payments to non-residents declined from 2003 to 2004. Interest payments on government debt were substantially reduced by the strengthening exchange rate of the rand which lowered the rand value of foreign-currency denominated interest payments. Furthermore the terms of trade improved, although it weakened again in the first half of 2005. Net primary income payments to the rest of the world also edged up in the first half of 2005, contributing to a slowdown in annualised growth in real gross national income to about 2 per cent in the first half of 2005.

Domestic expenditure

Aggregate real gross domestic expenditure increased at an average annualised rate of 4½ per cent in the current upward phase of the business cycle. This is roughly similar to the growth rate registered in the previous upward phase from 1993 to 1996. As during the previous upward phases of the business cycle, real gross domestic expenditure generally increased at a faster pace than real gross domestic product.

Real gross domestic expenditure

Percentage change at seasonally adjusted annualised rates

	2003	2004			2005
Components	Year	1st half	2nd half	Year	1st half
Final consumption expenditure by households	3½	6	6½	6	6
Final consumption expenditure by general government	6½	8	5	7	5½
Gross fixed capital formation	9	11	8½	9½	8½
Change in inventories (R billions)*	9,2	12,3	10,6	11,4	1,6
Gross domestic expenditure	**5½**	**7**	**4½**	**6½**	**3**

* At constant 2000 prices

Growth in real gross domestic expenditure slowed from an annualised rate of 4½ per cent in the second half of 2004 to 3 per cent in the first half of 2005. This was the result of slower growth in real final consumption expenditure by households and real gross fixed capital formation. Although the growth rate in these spending categories slowed down, activity levels were still comparatively high. In addition, the pace of real inventory investment fell from the second half of 2004 to the first half of 2005. By contrast, growth in real final consumption expenditure by general government accelerated from 5 per cent in the second half of 2004 to 5½ per cent in the first half of 2005.

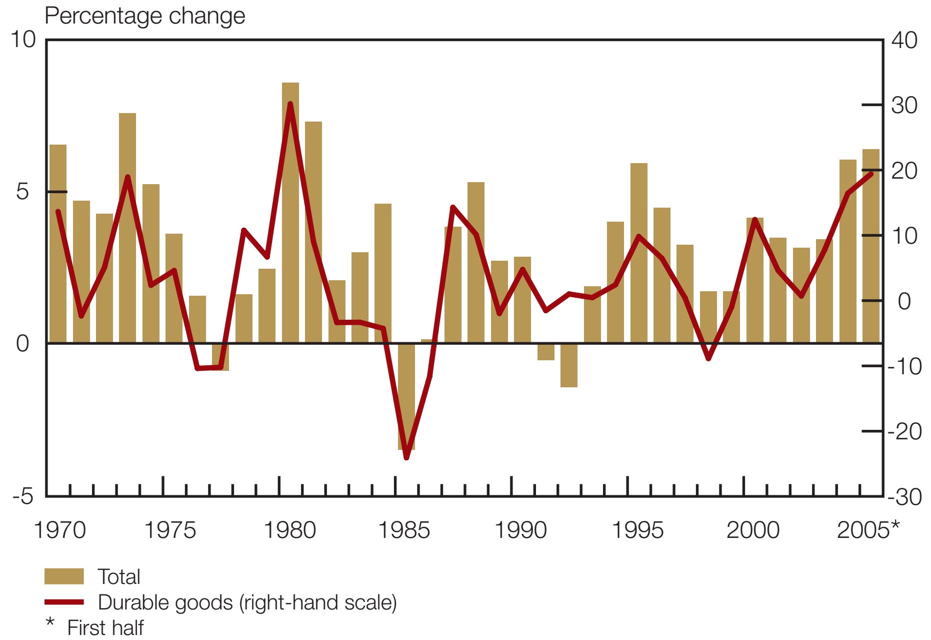
The annualised growth in real gross domestic expenditure decelerated significantly in the second half of 2004 and the first half of 2005, from an exuberant pace in the first half of 2004. The annualised growth in real gross domestic product accordingly exceeded that of real gross domestic expenditure by ½ a percentage point in the second half of 2004 and 1 percentage point in the first half of 2005.

Real final consumption expenditure by households

Final consumption expenditure by households constitutes about 63½ per cent of expenditure on gross domestic product. Growth in real household consumption expenditure accelerated from 3½ per cent in 2003 to 6 per cent in 2004, registering the highest annual growth rate since 1981. In the first half of 2005, growth in real final consumption expenditure by households was just marginally lower at an annualised rate of 6 per cent compared with the 6½ per cent registered in the second half of 2004. Brisk spending on durable and semi-durable goods was primarily responsible for the buoyant growth in 2004 and the first half of 2005. Real outlays on non-durable goods and services were lively but increased at a more sedate pace.

Following an increase at an annualised rate of 13 per cent in the first half of 2004, growth in real expenditure on *durable goods* peaked at 21 per cent in the second half of 2004 before slowing down to 19 per cent in the first half of 2005. The less exuberant expenditure on furniture, household appliances, and recreational goods held back the growth in real durable goods expenditure in the first half of 2005. Household expenditure on transport equipment continued to rise strongly at rates roughly similar to those attained in the second half of 2004. Sales of new and used cars rose further as competition among car dealers spurred demand. The demand for cars was also boosted by a broad sideways movement in motor vehicle prices over the past eighteen months.

Real final consumption expenditure by households

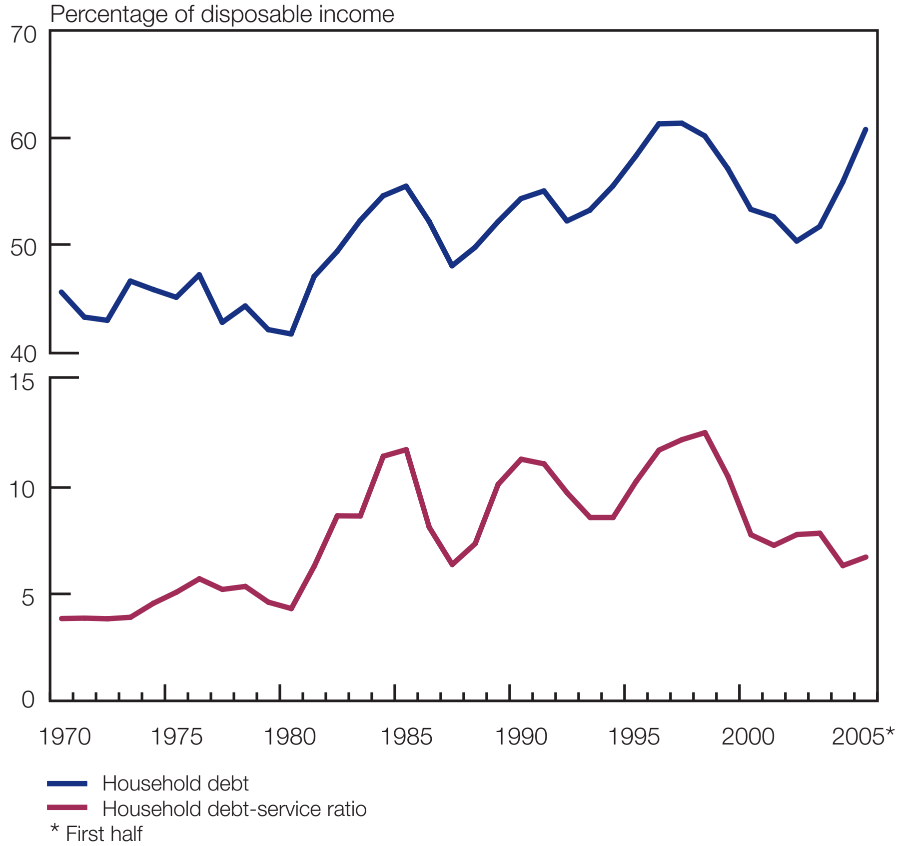


Growth in real spending on *semi-durable goods* remained brisk, recording annualised rates of 13½ per cent in the second half of 2004 and 13 per cent in the first half of 2005. This performance was underpinned by the strong demand for clothing and footwear, and household textiles and furnishings. While households strongly stepped up their spending on durable and semi-durable goods, their expenditure on *non-durable goods and services*, consisting more of household necessities than discretionary items, increased at rather unimpressive rates.

The robust growth of consumer spending was largely based on strong increases in *real household disposable income*. Growth in real household disposable income accelerated from 4 per cent in 2003 to 5½ per cent in 2004. In the first half of 2005, real household disposable income increased at an annualised rate of 5 per cent, slightly below the rate of 6 per cent attained in the second half of 2004. Household disposable income benefited in recent years from tax relief to households in successive national government budgets. In addition, social security and welfare transfers from general government to the household sector increased at high rates ranging from 12 per cent in 2001 to 31 per cent in 2004. The increase was particularly prominent in the case of the child support grant. In 2004 the number of people employed in the economy also increased while the average wage settlement rate remained above the upper limit of the inflation target, all to the benefit of household disposable income.

Besides the strong increase in real household disposable income, the sustained increase in real final consumption expenditure by households took place against the background of continued appreciation in the value of houses, which boosted household wealth, confidence and spending.

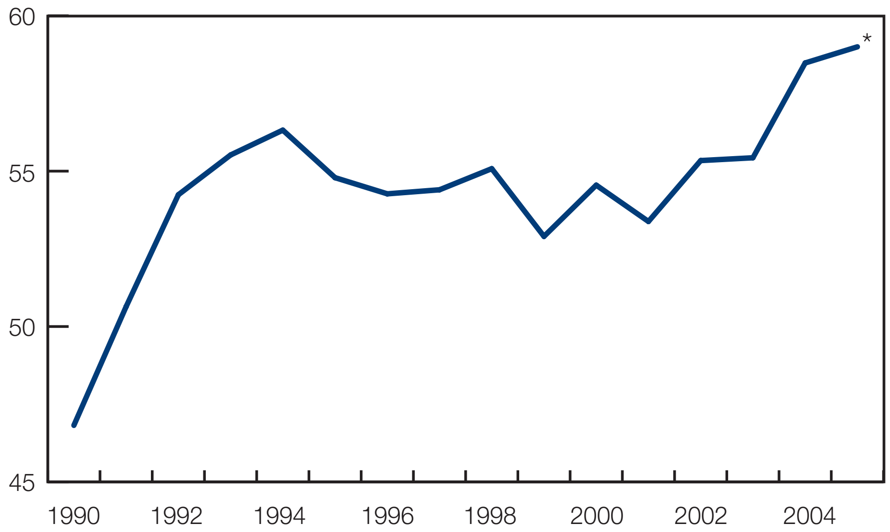
Household debt and debt-service ratio



The record high level of consumer confidence was also partly inspired by lower interest rates which contributed to lower debt servicing costs: Debt servicing cost as a percentage of disposable income slowed down from 8 per cent in 2003 to 6½ per cent in 2004. Despite the increase in total consumer debt, the ratio of debt servicing cost to disposable income remained at 6½ per cent in the first half of 2005.

The steady increase in real disposable income notwithstanding, households incurred debt to finance the acquisition of real estate and durable goods. Accordingly, household debt as percentage of disposable income increased from 51½ per cent in 2003 to 56 per cent in 2004 and 61 per cent in the first half of 2005. However, consistent with the robust activity in the property market, a substantial portion of household debt was collateralised by household real estate, resulting in the ratio of mortgage advances to household debt increasing from 55½ per cent in 2003 to 58½ per cent in 2004 and to 59 per cent in the first half of 2005.

Mortgage advances as percentage of total debt



* First half of 2005

Real final consumption expenditure by general government

Growth in real final consumption expenditure by general government accelerated from 4½ per cent in 2002 to 6½ per cent in 2003 and further to 7 per cent in 2004, receding to a still high rate of 5½ per cent in the first half of 2005. Government spending was boosted by the purchase of four corvettes as part of the government's strategic armaments procurement programme. Excluding the corvettes, the growth in real final consumption expenditure on non-wage goods and services remained very high.

Government expenditure on real compensation of employees was contained at growth rates which has been generally below 1 per cent since 1997, indicative of the drive towards maintaining fiscal discipline. In the process the ratio of compensation of employees to total final consumption expenditure by general government declined from around 70 per cent in 2000 to 58 per cent in 2004 and 57 per cent in the first half of 2005. The bias towards expenditure on non-wage goods and services such as medical supplies and textbooks is consistent with government's policy of improving the general quality of public-sector service delivery. Overall, final consumption expenditure by general government as a percentage of gross domestic product increased from 19 per cent in 2003 to 19½ per cent in 2004, and further to 20 per cent in the first half of 2005.

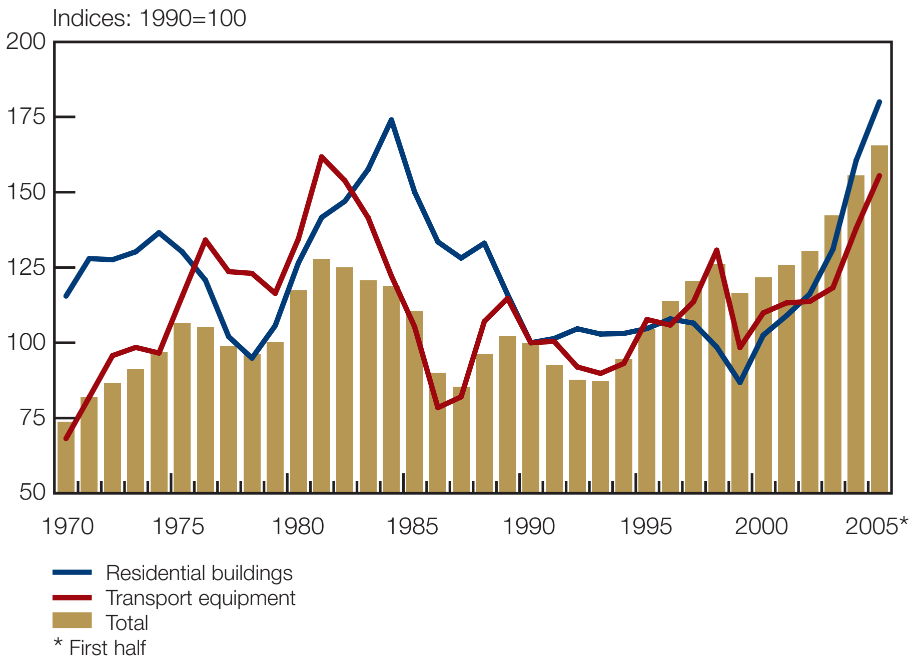
Real gross fixed capital formation

Growth in *real gross fixed capital formation* accelerated from 9 per cent in 2003 to 9½ per cent in 2004. The stronger growth in real gross fixed capital formation could be attributed to distinctly higher growth in real capital outlays by the private sector. At the same time real fixed capital formation by public corporations and general government also rose, albeit at a slower pace than in 2003. Growth in overall real capital outlays peaked in the first half of 2004 when it reached an annualised rate of 11 per cent, but then slowed to 8½ per cent in both the second half of 2004 and the first half of 2005.

As a result of the solid increase in real fixed investment expenditure, the ratio of gross fixed capital formation to gross domestic product increased from 16 per cent in 2003 to 16½ per cent in 2004 and 17 per cent in the first half of 2005.

The slower growth in gross fixed capital formation in the first half of 2005 resulted mainly from subdued real fixed capital outlays by private business enterprises. By contrast, growth in real gross fixed capital formation by public corporations and general government accelerated from the second half of 2004 to the first half of 2005.

Real gross fixed capital formation



Following an increase at an annualised rate of 13½ per cent in the second half of 2004, growth in real gross fixed capital formation by the *private sector* slowed to 4½ per cent in the first half of 2005. This slowdown can be attributed to a decline in capital outlays by the agricultural and mining sectors. Farmers discontinued or in some cases postponed capital expenditure on machinery and equipment as farm income remained under pressure from subdued prices of agricultural commodities, particularly maize. In the mining sector, a number of capital projects were postponed on account of the lower profitability in certain branches of the sector. Although real capital outlays by the private transport sector accelerated in the first half of 2005, it was insufficient to offset the general decline in the other sectors of the economy.

Public corporations stepped up real capital expenditure significantly in the first half of 2005. Following a decline at an annualised rate of 11 per cent in the second half of 2004, real gross fixed capital formation by public corporations increased at a rate of 50 per cent in the first half of 2005. This increase could mainly be attributed to the acquisition of aircraft by South African Airways and additional capital investment by the electricity sector. Projected increases in the demand for energy necessitated the incurrence of costs for re-commissioning mothballed power plants in the electricity sector.

Growth in capital expenditure by *general government* accelerated from an annualised rate of 2 per cent in the second half of 2004 to 5 per cent in the first half of 2005.

Reflecting the government's support for rural development and urban renewal strategies, there was a steady increase in investment in infrastructure and basic services.

An analysis of real gross fixed capital formation by *type of asset* indicates that residential buildings and transport equipment made a significant contribution to growth in capital investment in 2004 and the first half of 2005. Growth in real capital spending on residential buildings accelerated from 6½ per cent in 2002 to 13 per cent in 2003 and 22½ per cent in 2004 – the highest annual growth rate since 1965. Real investment in residential buildings rose by 2½ per cent per annum between 1998 and 2002, when interest rates were relatively high, but accelerated to an average rate of increase of 17½ per cent in the past two years. Factors contributing to the growth in the demand for residential buildings were, among other things:

- the current lower interest rate level and rising aggregate household income;
- returns on property investments overshadowing the returns on other asset classes;
- continued strong demand for property, especially among new entrants into the emerging middle class; and
- the increased popularity of sectional title developments and property in so-called security estates, often for "buy-to-let" purposes.

However, growth in real capital expenditure on residential buildings decelerated significantly from an annualised rate of 36 per cent in the second half of 2004 to 8½ per cent in the first half of 2005 as fears of saturation started to emerge in some areas of the housing market.

Following an increase of just ½ a per cent in 2002, growth in real gross fixed capital formation in transport equipment picked up to 4 per cent in 2003 and 16½ per cent in 2004, and registered an annualised growth rate of 28½ per cent in the first half of 2005. Rising capital investment in commercial vehicles and aircraft was largely responsible for the buoyant increases in the past 18 months.

Change in inventories

Inventory accumulation occurred uninterruptedly for the past six years, broadly coinciding with the upward phase of the business cycle as rising production and sales volumes needed to be supported by higher inventory levels.

The pace of inventory accumulation accelerated slightly in 2004, associated with the lower interest cost of carrying inventories and the appreciation of the exchange value of the rand which reduced the cost of imported goods. An analysis of inventory accumulation by economic activity indicated that the inventory build-up was the strongest in commerce but that it occurred in all the other main sectors of the economy bar mining. The depletion of inventories in the mining sector was largely confined to the gold-mining sector. Gold sales exceeded the declining level of gold production during most of 2004.

Real inventory investment slowed down in the first half of 2005. The slower pace of inventory accumulation in the first half of 2005 was widespread throughout all the main sectors of economic activity. Real inventory investment in the manufacturing sector, for instance, slowed down somewhat as sales were partly satisfied by drawing down inventories while production lagged behind. As a consequence, the ratio of industrial and commercial inventories to non-agricultural gross domestic product slipped from 15½ per cent in the second half of 2004 to marginally below 15½ per cent in the first half of 2005.

Factor income

The growth in *total nominal factor income* accelerated from 6½ per cent in 2003 to 8½ per cent in 2004 as gross operating surpluses recovered from earlier setbacks. Measured over a year, growth in total nominal factor income subsequently slowed down from 10 per cent in the second half of 2004 to 8 per cent in the first half of 2005.

The growth in *gross operating surpluses* accelerated noticeably from an exceptionally low rate of only 3½ per cent in 2003 to 8 per cent in 2004 as economic activity accelerated and profits improved in most sectors. This was followed by a moderate slowdown in the growth in operating surpluses in the first half of 2005. This slowdown was particularly pronounced in the agricultural, mining, manufacturing, construction and commerce sectors; profit margins were compressed as output price increases could not fully compensate for input cost increases.

Growth in *compensation of employees* decelerated from 10 per cent in 2003 to 9 per cent in 2004 and inched below 9 per cent in the first half of 2005. This slowdown in compensation growth and the decline in average wage settlements from 2003 seemed to be a response to the current low inflation rate. Of course, future aggregate compensation changes might be a consequence of employment changes.

Gross saving

The national saving ratio (*gross saving* as a percentage of gross domestic product) declined from a most recent peak of 17 per cent in 2002 to 14½ per cent in 2004 and 13½ per cent in the first half of 2005, bringing the saving ratio to a level previously seen in 1949. The recent weakness in gross saving was confined to the household and corporate sectors while gross saving by general government improved somewhat.

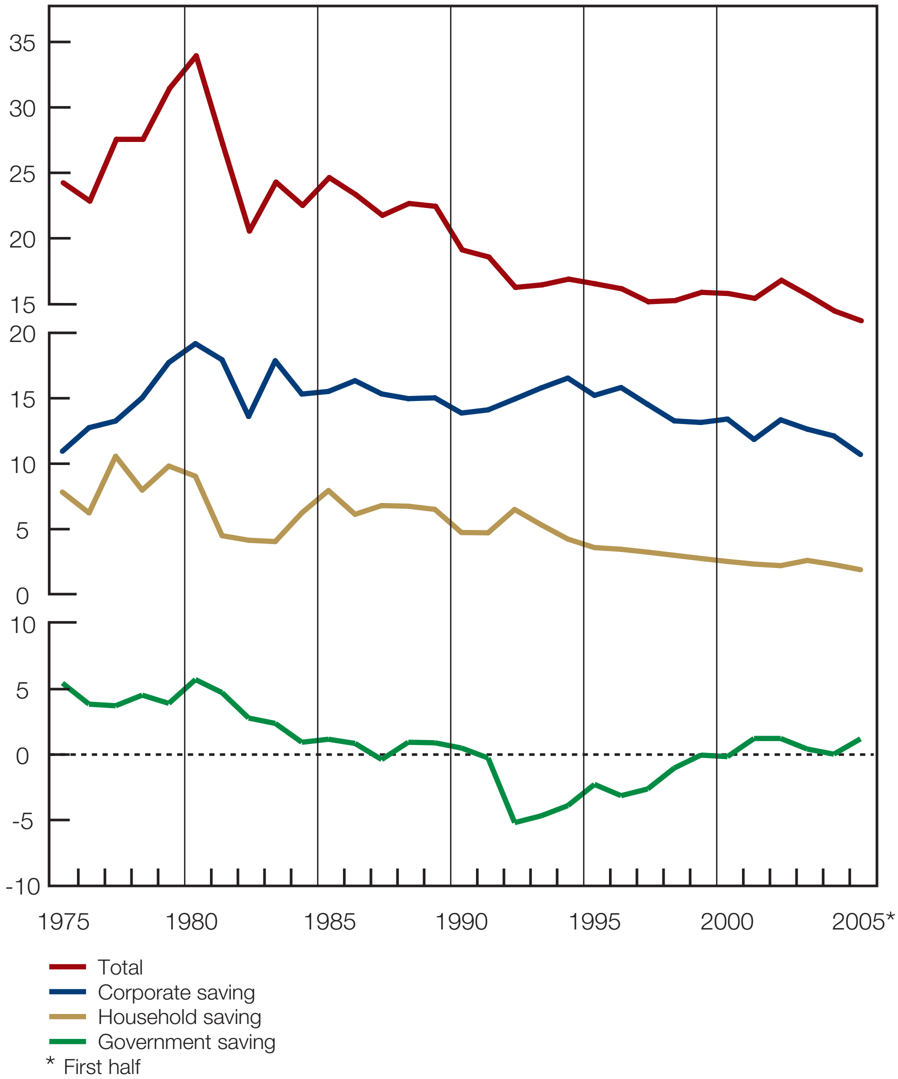
The ratio of gross *household saving* to gross domestic product recovered somewhat from 2 per cent in 2002 to 2½ per cent in 2003 and 2004 but fell back to an average of 2 per cent in the first half of 2005. The growth in households' disposable income lost some momentum relative to that of their final consumption expenditure in the first half of 2005. Households' recent low propensity to save also stemmed from the increase in the net wealth of the household sector. The net wealth of the household sector as a percentage of annual disposable income is estimated to have increased unabatedly from 204 per cent in the first half of 2003 to 234 per cent in the first half of 2005.

The ratio of gross saving by the *corporate sector* to gross domestic product declined from 13½ per cent in 2002 to 12 per cent in 2004 and 10½ per cent in the first half of 2005. The recent weakening in the corporate saving ratio was the result of relatively high dividend payments which coincided with a slowdown in the operating surpluses of incorporated business enterprises.

Gross saving by *general government* averaged ½ a per cent of gross domestic product in the first four years of this decade compared to a dissaving rate of 2½ per cent in the 1990s. The improvement in the general government saving ratio can be credited to higher revenue as a result of more efficient tax collection, and to prudent fiscal policy. However, general government saving subsequently weakened and approached zero in 2004 as recurrent expenditure increased faster than revenue growth.

The deterioration in the national saving ratio implied that South Africa could not fully finance gross capital formation from domestically generated resources. The shortfall of

Gross saving as percentage of gross domestic product



saving increased from R19 billion in 2003 to R44 billion in 2004. The annualised shortfall for the first half of 2005 amounted to R49 billion.

As shown in the accompanying table, there was a shift in the composition of gross saving over the past 25 years. The corporate sector has been the mainstay of national saving and its share of total saving increased to a high point in the 1990s. This share then receded to 81 per cent in the first four years of the current decade. Households

Contribution of each institutional sector to total gross saving
Per cent

	Average for 1980s	Average for 1990s	Average for 2000 – 2004
Household sector..................	25,6	24,9	15,4
Corporate sector....................	66,7	89,1	81,2
General government...............	7,7	-14,0	3,4
Total......................................	**100,0**	**100,0**	**100,0**

were less inclined to save as their net wealth increased in any event, resulting in a sharply lower share in total gross saving since 2000. On the other hand, better fiscal management and higher tax revenue resulted in the elimination of general government's gross dissaving during the first five years of the current decade.

Employment

During the past decade or so the labour market generally created jobs at a lethargic pace. This partly resulted from concerted efforts on the part of industry to stay commercially viable in an increasingly globalised community, often leading to a reduction in employment numbers. In many instances a mismatch between skills on offer and skills demanded inhibited employment, alongside other frictions in the labour market. Still, the continuous expansion in aggregate economic activity which started in September 1999, spurred meaningful advances in the overall level of enterprise-surveyed employment from the third quarter of 2003. This upward trend in the level of employment, however, faltered somewhat in the closing months of 2004 and the first few months of 2005.

According to Statistics South Africa's *Survey of Employment and Earnings* (SEE), the level of enterprise-surveyed formal non-agricultural employment in March 2005 was 3,5 per cent higher or 222 000 persons more than at the trough of the employment cycle in the second quarter of 2003. Stated differently, formal-sector enterprises expanded their employee numbers by around 11 000 persons per month during that period. During the six months to March 2005, however, increases in employment in the services sector were outweighed by decreases in employment numbers in sectors producing internationally tradeable goods, mostly in the mining and manufacturing sectors. Labour paring in these sectors might have been associated with fierce international competition within an environment of growing globalisation and relative rand strength.

Despite job losses occurring in the closing months of 2004, the average level of formal non-agricultural employment rose by 2,0 per cent in that year compared with the preceding year, outperforming employment growth in the overall world economy. According to the *Employment Trends* report of the International Labour Organisation (ILO), global employment grew by 1,7 per cent or 47,7 million jobs in 2004. Robust global economic growth at a rate of 5 per cent in 2004 undoubtedly played a prominent role in shaping this employment outcome.

Considering medium-sized companies in particular, i.e. those employing between 50 and 250 employees, an international survey by Grant Thornton (an international management consultancy) found that 57 per cent of these companies in South Africa expanded employment in 2004. Encouragingly, 51 per cent of companies indicated an intention to further expand their employee complements in 2005, while only 6 per cent indicated an intention to the contrary.

According to Statistics South Africa's bi-annual *Labour Force Survey* the official unemployment rate was 26,5 per cent in March 2005, somewhat higher than the rate of 26,2 per cent recorded in September 2004. According to this household-based survey the overall level of employment rose by around 500 000 persons over the twelve months to March 2005, confirming the employment increases recorded by the SEE during that period.

According to the new *Quarterly Employment Statistics* (QES) publication by Statistics South Africa, based on a sample of 25 000 income-tax-paying employing enterprises in the non-agricultural sector, the job losses experienced in the closing months of 2004 continued in the first quarter of 2005. (The QES findings do not account for seasonal variation and should therefore not be seen as conclusive evidence of a fundamental reversal of the recent upward movement in employment totals as recorded by the SEE.)

As shown in the accompanying table, the increase in the number of private-sector employment opportunities in the year to the first quarter of 2005 was a response to strong domestic expenditure and was most pronounced in the trade, catering and accommodation services sector, followed by the community, social and personal services industry. Employment in the non-gold mining sector, constituting 61 per cent of total mining-sector employment, increased by 5,3 per cent in the four quarters to March 2005. The average level of employment in the mining sector increased by 18,2 per cent in 2004. Strongly rising international commodity prices, most notably in the case of platinum, contributed meaningfully to these increases, but the positive effects of the relatively high level of commodity prices were diluted somewhat by the recovery in the exchange rate of the rand in 2004.

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

Sector	Number	Percentage change
Gold mining	-14 200	-7,5
Non-gold mining	13 800	5,3
Manufacturing	-43 000	-3,4
Electricity supply	1 400	3,3
Construction	15 500	5,8
Trade, catering and accommodation	86 300	6,7
Transport, storage and communication	9 200	5,4
Finance, insurance, real-estate and business services	-44 400	-4,1
Community, social and personal services	36 800	11,2
Total private sector	**61 300**	**1,3**
National, provincial and local government	44 800	3,3
Public-sector enterprises	-5 200	-4,8
Total public sector	**49 800**	**3,2**
Grand total	**111 100**	**1,7**

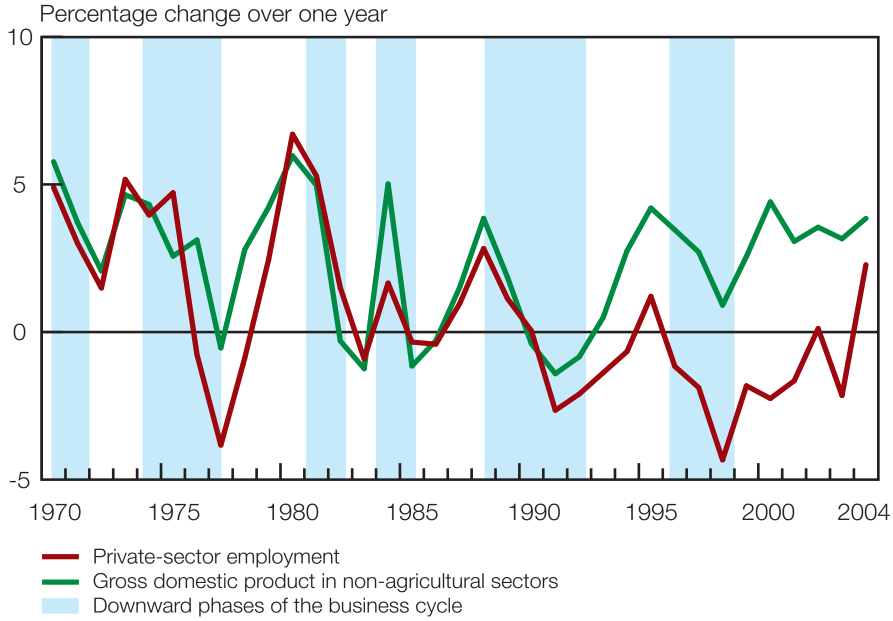
Source: Statistics South Africa, *Survey of Employment and Earnings*

The tourism industry is rapidly developing into an important generator of employment opportunities. The number of foreign tourists visiting South Africa rose from 6,6 million in 2003 to 6,8 million in 2004, or by 2,6 per cent. Consistent with the surge in travel and tourism spending globally, the number of foreign tourists visiting South Africa rose by as much as 10,5 per cent in the year to the first quarter of 2005. According to the World Travel and Tourism Council, job growth in this sector in South Africa is expected to be around 4,7 per cent in 2005, with 1,1 million people being directly and indirectly employed.

Employment in the manufacturing sector, comprising some 25 per cent of total private-sector employment, decreased by 3,4 per cent in the year to the first quarter of 2005 or by 43 000 persons. Notwithstanding strong domestic and foreign demand during 2004, the relative strength of the rand curbed the international competitiveness of the local industry and directed domestic demand away from domestically produced goods, thereby limiting the output and employment-creating capacity of the industry.

During the 1970s and 1980s changes in the level of *private-sector employment* moved broadly in tandem with changes in economic growth as indicated in the graph on the following page. In the past ten years there was a distinct widening of the margin between economic growth and changes in the measured level of employment in the formal sectors of the economy: A given rate of economic growth became associated with a considerably lower rate of formal-sector employment growth than previously. The further absorption of the supply of labour therefore seems to require economic growth rates in excess of those indicated by the historical relationship between growth and job creation during the 1970s and 1980s. However, increased economic growth rates in recent years contributed materially to the improved rate of expansion in the measured level of formal non-agricultural employment.

Private-sector employment and gross domestic product



Employment in the *public sector* has almost consistently expanded during the past two years to March 2005. When measured over a four-quarter period, public-sector employment increased by as much as 3,2 per cent in the first quarter of 2005, or by around 50 000 jobs. The quarter-to-quarter pace of increase in public-sector employment, however, slowed down somewhat in the first quarter of 2005 as employment losses occurred in public-sector enterprises. Job losses in public-sector enterprises and local governments in the year to the first quarter of 2005 were exceeded by gains in employment in national and provincial governments. The average level of staff numbers in the public sector expanded by 1,1 per cent in 2004.

Following a consistent decline in the number of mandays lost due to strikes and other forms of industrial action from 3,9 million in 1994 to 700 000 in 2003, the number of mandays lost rose to 1,1 million in 2004. In spite of the rise, the majority of companies, i.e. 73 per cent, still reported that wage negotiations occurred in a positive and constructive bargaining environment during 2004.

Regardless of improvements recorded in a number of labour market indicators during the past year or so, the ILO identified a number of international labour market challenges in the years ahead. These include the following:

- The HIV/Aids epidemic, estimated to be responsible for the death of around 3,2 million people of working age globally in the course of this year alone, necessitating proactive intervention to mitigate its economic and social effects;

- the trend towards the outsourcing of manufacturing and service-sector jobs, placing strain on existing labour legislation frameworks;
- the termination of certain trade policies opening up the textiles market in particular, leading to increased competition in the textiles market worldwide;
- the development of policies to enhance the employment-creating capacity of the formal economy; and
- the incidence of youth unemployment.

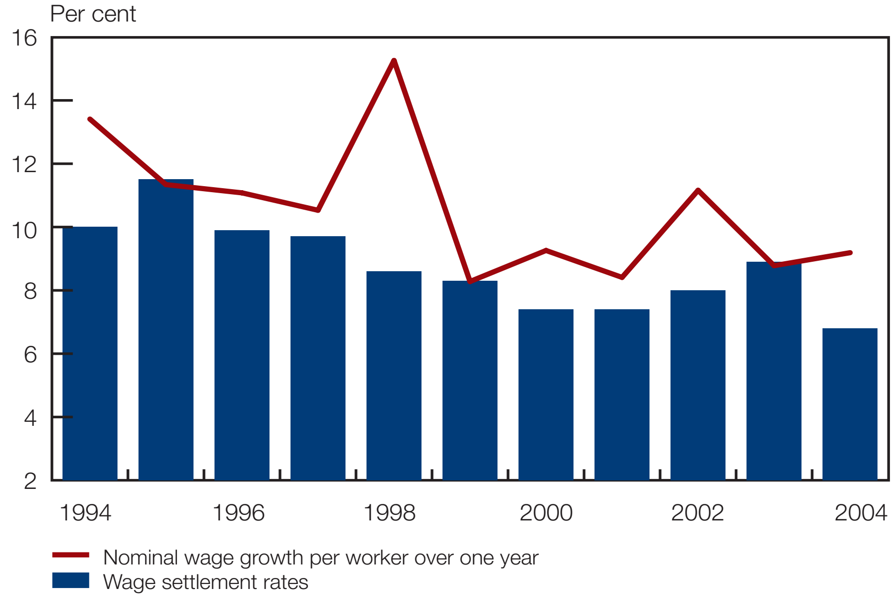
In an effort to address these issues, in particular youth unemployment, the South African government announced an investigation into the efficiency of the labour market. Greater flexibility in appointing and retrenching inexperienced younger workers is likely to be investigated. Further, a comprehensive Public Works Programme was implemented in April 2004. The main thrust of the programme is investment in physical infrastructure while simultaneously creating jobs and providing training opportunities. The programme aims to create more than one million temporary jobs over the next ten years. Recently announced capital projects also bode well for future employment prospects.

Labour cost and productivity

The growth in the *nominal remuneration per worker in the formal non-agricultural sectors* of the economy accelerated from 8,8 per cent in 2003 to 9,2 per cent in 2004. At this rate, nominal wage growth was at a comparatively high level relative to the contemporaneous inflation rate. Factors contributing to the above-inflation increases in average employee remuneration included:
- the fact that in some sectors workers at the lower end of the wage scale were retrenched;
- a worsening of skills shortages in certain specialist areas of the labour market; and
- healthy growth in domestic sales and sales-related bonuses.

Although growth rates in nominal remuneration per worker remained at relatively high levels, a broad downward trend was observed in the past ten years or so, consistent with the moderation in price inflation. Wage moderation has been supported by a decline

Nominal wage growth per worker in the non-agricultural sector and wage settlement rates



in the average wage settlement rate in collective bargaining agreements from a recent high of 11,5 per cent in 1995 to 8,9 per cent in 2003 and 6,8 per cent in 2004, according to Andrew Levy Employment Publications (a private-sector labour consultancy). The average wage settlement rate in the first half of 2005 amounted to 6,0 per cent and is projected to be below the 6,5-per-cent level for the year as a whole.

During the ten-year period to 2004 nominal remuneration growth per worker almost consistently exceeded wage settlement rates – the average differential being 1,7 percentage points. This observation is consistent with the process of so-called "wage drift" which implies that employee pay packages normally rise by more than the wage settlement rate due to the inclusion of additional bonuses and other related increments, and a tendency to gradually create more senior positions. In 2004 when sales and other business targets were generally exceeded, resulting in high bonuses being paid, nominal remuneration growth per worker exceeded the average wage settlement rate by an above-average margin of around 2,4 percentage points.

The general downward adjustment in remuneration increases during the past couple of years is further substantiated by survey results from PE Corporate Services (a human resources management firm) among 900 companies employing around 1,75 million people. According to this survey, average salary increases in April 2005 fell below 7 per cent for the first time in the past twenty years.

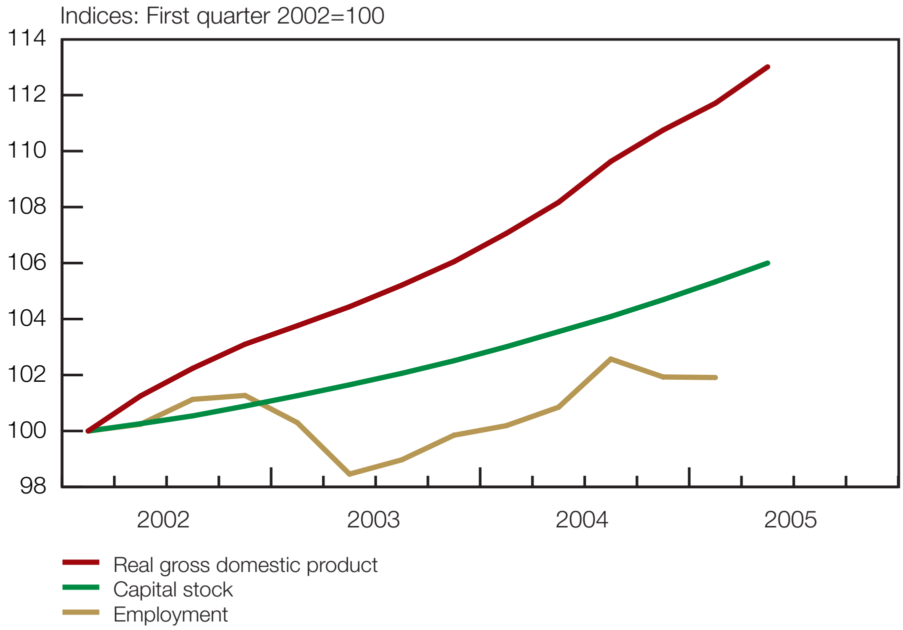
Nominal wage growth per worker in both the public and private sector came to around 9 per cent during 2004. Remuneration growth in the *private sector* during 2004 differed substantially between subsectors. The apparently most generous increases in nominal remuneration per worker occurred in the construction, electricity generation and gold-mining sectors. Average wage increases in excess of 10 per cent in the gold-mining sector in 2004 most plausibly relate to the closure of unprofitable shafts, where workers' wages were the lowest, raising the average remuneration of the remaining workers. However, the rate of increase in nominal remuneration per worker in the non-gold mining sector was meaningfully lower than in gold mining.

Growth in nominal remuneration per worker in the *public sector* remained almost unchanged at around 9 per cent in both 2003 and 2004. At this rate, public-sector wage growth fell below that of preceding years. The highest increases in the public sector in 2004 occurred at local government level and were well in excess of 15 per cent. Employees of public-sector transport, storage and communication enterprises as well as provincial governments received increases of around 9 per cent in 2004. It is promising that, when measured over periods of four quarters, nominal wage growth per worker slowed down meaningfully from a rate in excess of 10 per cent in the fourth quarter of 2004 to around 7 per cent in the first quarter of 2005. This slowdown in nominal wage growth was fairly pervasive as it occurred at all levels of the public sector.

Following meaningful increases in the overall level of employment, *economy-wide labour productivity growth* in the formal non-agricultural sectors of the economy slowed down markedly during the first three quarters of 2004, i.e. from a year-on-year rate of 3,3 per cent in the first quarter to 0,5 per cent in the third quarter. Subsequently, following the decline in the level of formal non-agricultural employment, labour productivity growth picked up to 2,6 per cent in the year to the first quarter of 2005. Irrespective of this, the year-to-year rate of increase in real output per worker in the formal non-agricultural sectors of the economy decelerated from 4,5 per cent in 2003 to 1,8 per cent in 2004. Over the longer term, South African labour productivity growth, at an average annual rate of around 4 per cent since 1996, compares favourably with a global average of 1,8 per cent as estimated by the Conference Board (an international business organisation).

Growth in cumulative real output in the formal non-agricultural sectors of the economy exceeded the increases in labour and capital inputs during the past three years. This signifies an increase in multifactor productivity.

Real gross domestic product, employment and capital stock in the total non-agricultural sector



Contrary to the fairly mundane rates of increase in labour productivity in the economy as a whole, the rate of increase in production per worker in the manufacturing sector picked up meaningfully to 7,4 per cent in the year to the first quarter of 2005, as employment was shed. In 2004 average labour productivity growth in the manufacturing sector was also firm, amounting to almost double that of the economy as a whole.

Lower rates of increase in labour productivity, accompanied by a relatively rapid increase in nominal remuneration per worker, led to an acceleration in the rate of increase in the cost of *labour per unit of production* in the formal non-agricultural sector from 4,1 per cent in 2003 to 7,2 per cent in 2004. Growth in nominal unit labour cost, however, moderated significantly to 5,9 per cent in the year to the first quarter of 2005. Alongside increases in productivity growth, the rate of increase in nominal unit labour cost in the *manufacturing sector* slowed down to 5,4 per cent in the year to the first quarter of 2005 from higher rates of increase in preceding quarters. These generally lower increases in nominal unit labour cost helped to instill discipline in the processes of price and wage formation.

Prices

During the past two years remarkable progress was made in the lowering of South Africa's inflation rate to within the official inflation target range and then with keeping inflation within that range. The year-on-year rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage interest cost (CPIX) remained within the inflation target range of 3 to 6 per cent in twenty-two consecutive months to June 2005.

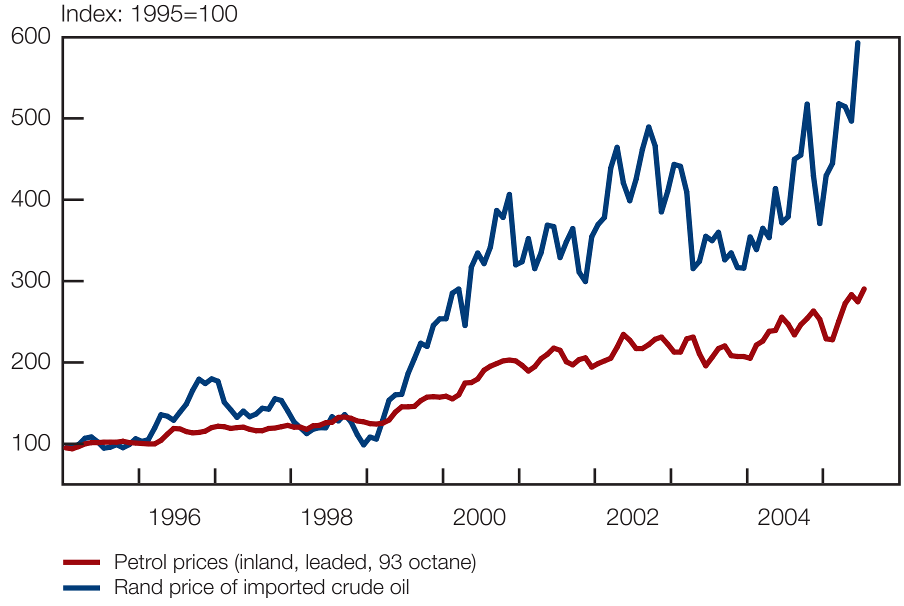
Simultaneously, overall consumer price inflation decelerated markedly from a most recent high of 9,2 per cent in 2002 to 5,8 per cent in 2003 and 1,4 per cent in 2004 – the lowest rate of increase since 1962. While overall consumer price inflation in South Africa consistently exceeded the average inflation of the world economy from 1997 to 2003, domestic inflation fell below the world average of 3,6 per cent in 2004.

While the underlying reason for the recent waning of price inflation could be found in the consistent application of prudent fiscal and monetary policies, more immediate counter-inflationary forces at work included:

- the substantial appreciation in the exchange rate of the rand since the second half of 2002;
- low increases in food prices over an extended period of time; and
- a progressive decline in inflation expectations, inspired by lower actual inflation in a virtuous circle of outcomes and expectations.

Over the past year concerns mounted regarding the inflationary effects of the increase in the price of crude oil. The oil price increase prevented a further moderation of price inflation in South Africa. In fact, year-on-year CPIX inflation accelerated from a most recent low of 3,1 per cent in February 2005 to 3,9 per cent in May. This acceleration in inflation was almost entirely due to the increase in the domestic prices of petrol, which was a result of the higher prices of imported crude oil. Year-on-year CPIX inflation fell to 3,5 per cent in June 2005 as petrol prices fell momentarily in that month, alongside favourably low food inflation. At the production level, the prices in rand of imported mining and quarrying products, mainly consisting of crude oil, increased by as much as 56 per cent in the eighteen months to June 2005.

Crude oil and domestic petrol prices



The strong recovery in global economic activity contributed to the sharp increase in international crude oil prices during 2004 and the first half of 2005. Excess capacity in the Organization of the Petroleum Exporting Countries reached record low levels and actual oil production exceeded output quotas during the past two years, but still oil output had difficulty in keeping up with demand. Consequently, the price of Brent crude oil increased significantly from around US$30 per barrel at the start of 2004 to around

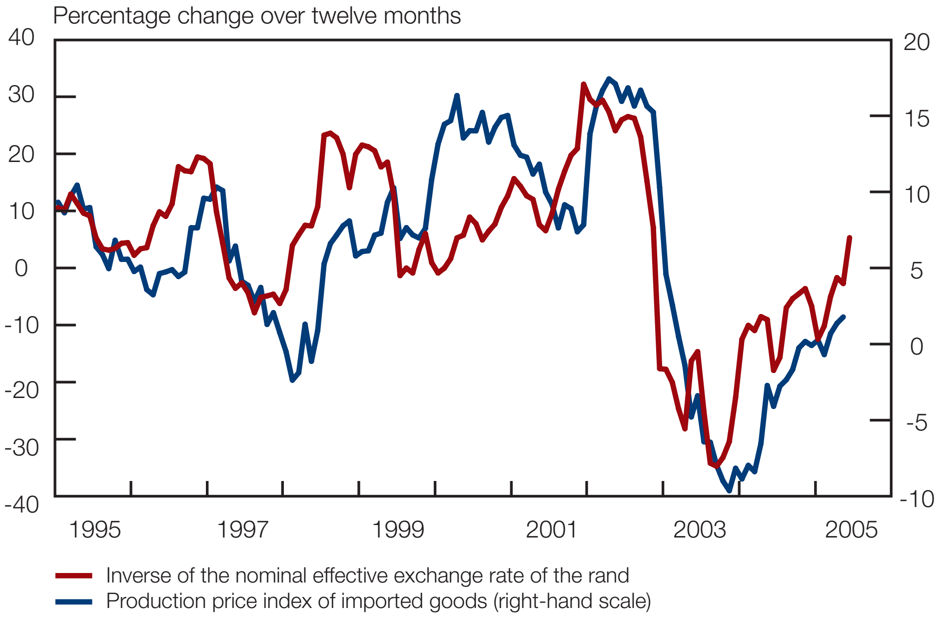
US$60 per barrel most recently. This led to increases in the domestic price of petrol which, for instance, totalled 86 cent per litre from March to June 2005. If petrol prices were omitted from the calculation, year-on-year CPIX inflation would have increased only slightly from 3,1 per cent in February 2005 to 3,3 per cent in June.

The acceleration in the rate of increase in the weighted average production price index of South Africa's main trading-partner countries from a year-on-year rate of 0,9 per cent in March 2004 to around 4 per cent in the opening months of 2005 was also indirectly related to the rise in the prices of crude oil and other commodities.

Exchange rate changes play an important role in the process of price inflation in South Africa. Over and above the direct effect on the price movements of *imported goods* (constituting some 27 per cent of the all-goods production price index), exchange rate changes also influence the degree of price competition in the economy. The appreciation in the exchange rate of the rand since the middle of 2002 was the most important immediate cause of the reduction in the rand prices of imported goods by no less than 11 per cent during the period December 2002 to March 2004. Subsequently, a slower tempo of appreciation of the rand was reflected in a marked deceleration in the rate of *decline* in imported goods prices.

Following the depreciation of the nominal effective exchange rate of the rand in the initial months of 2005, higher crude oil prices and rising trading-partner inflation lifted the level of imported goods prices by 3,4 per cent in the year to June 2005. Notwithstanding the depreciation of the rand, the currency traded in a more settled and less volatile manner during the past year, thereby contributing to a reduction in the volatility of inflation outcomes.

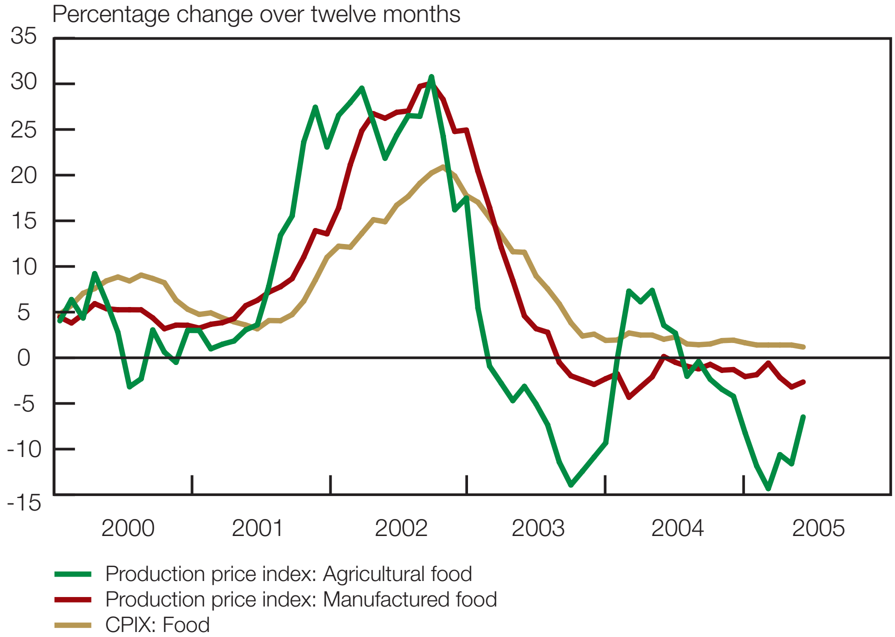
Rand price of a basket of foreign currencies and production prices of imported goods



Partly as a consequence of the decrease in the cost of intermediate inputs, inflation in the prices of *domestically produced goods* decelerated progressively from 13,5 per cent in 2002 to 2,3 per cent in 2004 – the lowest rate of increase since 1968. This slowdown was widely dispersed and lower rates of increase were recorded in almost all subcategories of the all-goods production price index in 2004, with the prices of certain imported goods even declining. Following the rise in the international price of crude oil, the prices of petroleum and coal products rose steeply in 2004 and the first months of 2005. To a large extent, the inflationary effect of these rising energy prices was mitigated by substantial decreases in the prices of agricultural and manufactured food products; these constitute around 22 per cent of the production price index for domestically produced goods. Declines in the production prices of textiles, clothing, footwear, wood and wood products as well as paper and paper products also alleviated upward pressures on production prices in 2004.

The decline in the production prices of food, which acted as the main counterweight against rising energy prices in the past two years or so, occurred at both the farm and factory level. Unlike a pronounced decline of around 17 per cent in the prices of *agricultural* food products from October 2002 to June 2005, the level of manufactured food prices receded by about 5 per cent from its peak in February 2003. Notwithstanding the decline in the production prices of food, the consumer prices of food increased by around 4 per cent during the 28 months to June 2005. Increases in the consumer prices of food coinciding with falling production prices of food were probably a response to robust growth in consumption expenditure.

Food prices



A positive relationship exists between changes in final consumption expenditure by households on food products, and consumer food price changes in excess of increases in the food component of the production price index. It is clear from this relationship that changes in the pace of increase in nominal consumption expenditure by households on food products consistently preceded those in the retail profit margin on food products, as approximated by the excess of the increase in consumer food prices over and above the increase in the production prices of food. Judging from this relationship, it appears that changes in the consumer prices of food products not only result from changes in the production prices of food, but also from demand conditions in the economy.

Substantiating this observation, is the fact that the most recent increases in the consumer prices of food in excess of the increases in the production prices of food were preceded by two quarters by an acceleration in the pace of growth in consumption expenditure by households on food products.

As a result of the interplay between its two main components, *all-goods production price inflation* fell sharply from 14,2 per cent in 2002 to 0,6 per cent in 2004 – the lowest rate of increase in the past 45 years. When measured over periods of twelve months, all-goods production price inflation remained muted, vacillating in a narrow range of 1,1 per cent to 2,5 per cent during the eleven months to June 2005. At a year-on-year rate of 2,3 per cent in June 2005, all-goods production price inflation almost doubled compared to three months earlier, mainly as a result of the steep rise in energy prices. When measured from quarter to quarter and expressed at an annualised rate, all-goods production price inflation accelerated from 1,3 per cent in the first quarter of 2005 to 5,1 per cent in the second quarter.

The inflationary effect of rising energy prices is clearly indicated by a divergence between all-goods production price inflation and production price changes excluding energy price changes. Rising energy prices added as much as 3,4 percentage points to the year-on-year increase in all-goods production prices of 2,3 per cent in June 2005. This implies that non-energy production prices actually decreased by 1,1 per cent in the year to June 2005.

The disinflationary benefits of exchange rate pass-through and muted increases in food prices are clearly indicated by the evolution of *consumer goods price inflation* in the past year or so. The year-on-year CPIX *goods* price inflation receded from 13,4 per cent in October 2002 to around 2 per cent in the early months of 2005 and was 2,0 per cent in June. With very few exceptions, year-on-year CPIX goods price inflation remained below the inflation target range for the twenty-one consecutive months to June 2005. The moderation in CPIX goods price inflation was aided by outright declines in the prices of clothing and footwear, new and used vehicles as well as by little, if any, increase in the prices of furniture and equipment. These declines largely offset the inflationary effect of the rise in the prices of petrol, alcoholic beverages and tobacco products. The quarter-to-quarter pace of increase in CPIX goods prices decelerated meaningfully from 4,4 per cent in the fourth quarter of 2004 to just 0,6 per cent in the first quarter of 2005, reverting again to 4,4 per cent in the second quarter.

Inflation in CPIX components

Percentage change over same period in previous year

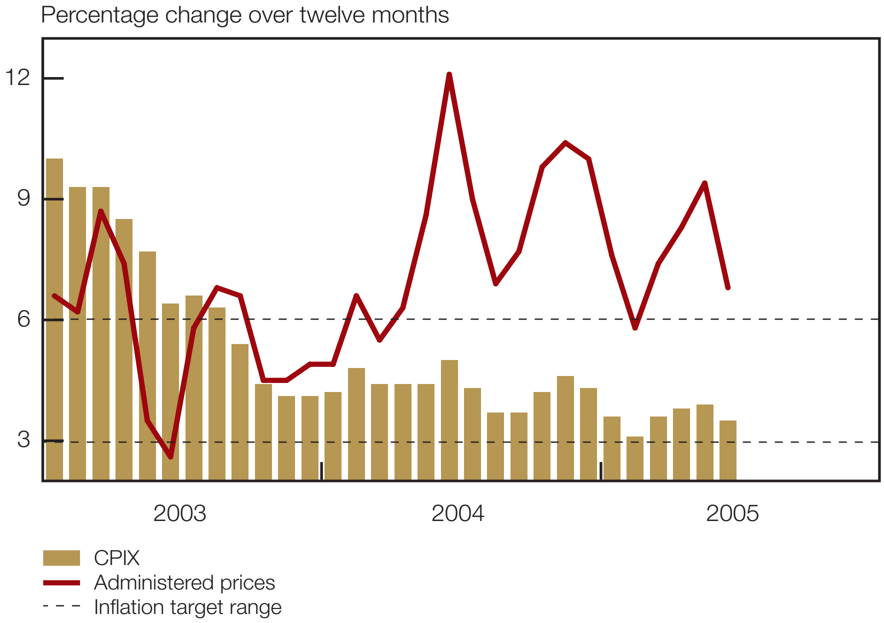
	Weights	June 2005
Alcoholic beverages and tobacco	*3,1*	*7,5*
Services excluding housing and transport	*16,5*	*6,9*
Housing services	*13,4*	*6,4*
Transport running cost	*5,7*	*6,3*
Other goods (not included elsewhere)	17,5	3,2
Transport services	3,9	1,6
Food	26,9	1,1
Furniture and equipment	3,2	-0,9
Vehicles	5,7	-1,2
Clothing and footwear	4,1	-3,0
Total CPIX	100,0	3,5

Italics denote components of which year-on-year increases were higher than the inflation target range of between 3 and 6 per cent for the latest available observation

As the general appreciation of the rand had limited influence on prices in the non-tradeable sector, *CPIX services price inflation* remained at an elevated level relative to CPIX goods price inflation during the past two years or so. Nevertheless, there was a gradual deceleration in CPIX services price inflation from an annual rate of 8,1 per cent in 2003 to 7,0 per cent in 2004 and to 6,4 per cent in the year to June 2005. Over and above the relatively muted increases in transport services prices, there was also a steady deceleration in housing services price inflation since March 2004 which helped to contain services price pressures.

Within the CPIX basket of goods and services, as much as 20,01 per cent of goods and services fell within the definition of administered prices. Since December 2003, year-on-year administered goods and services price inflation outpaced CPIX inflation by a fair margin. Despite the fact that petrol constitutes roughly a quarter of the weight of the CPIX administered price index, thus imparting volatility to administered price changes, year-on-year administered price inflation, on balance, decelerated from 12,1 per cent in June 2004 to 6,8 per cent in June 2005. Fairly sizeable increases in the prices of certain administered goods and services, e.g. water, education, assessment rates and medical services, prevented a further deceleration in administered price inflation.

CPIX and administered prices



Although CPIX inflation remained comfortably within the target range and only four categories showed year-on-year rates of price increase in excess of the upper limit of the inflation target range by June 2005, some factors were still of concern, necessitating continued vigilance in the application of a counter-inflationary policy. These included:

- high and volatile international crude oil prices;
- uncertainty concerning exchange rate developments;
- some salary and wage settlements significantly in excess of the inflation target range;
- increases in certain administered prices in excess of the inflation-target upper limit;
- possible second-round effects of the abovementioned factors; and
- fairly high rates of money supply growth alongside continued buoyancy in domestic demand.

Foreign trade and payments

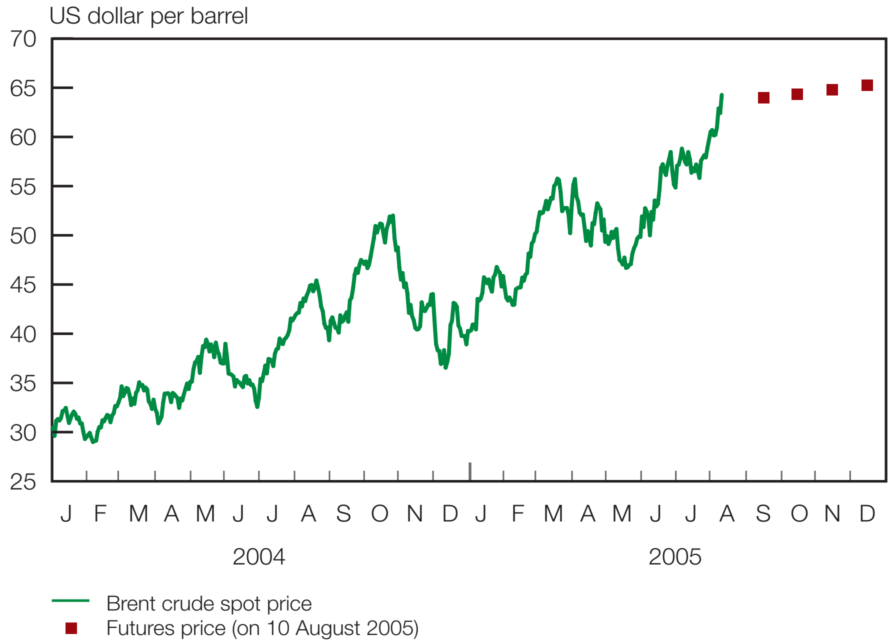
International economic developments

Although global economic growth moderated somewhat in the second half of 2004, world output still advanced at a rapid pace of 5,1 per cent in the year as a whole. Very strong performances continued to be recorded by China and India, but more generally output growth in most emerging-market and developing countries exceeded expectations in 2004. Producers of oil and other commodities enjoyed favourable export prices, buoying their rates of economic growth. Africa registered growth of around 5 per cent in 2004, which was the highest since 1996. Real output growth in the United States of America remained solid in the first half of 2005, alongside a gradual improvement in labour market conditions. However, real economic growth in the euro area, South Africa's largest trading partner, remained generally lacklustre during the past year-and-a-half. Most forecasting agencies expect global real output growth in 2005 to decelerate somewhat to a still robust rate of 4 to 4½ per cent.

The current world economic outlook is still clouded by risks such as global imbalances and high crude oil prices. The current-account deficit of the United States recently widened to levels in excess of 6 per cent of the country's gross domestic product, while large deficits were also registered in Australia and New Zealand. Simultaneously, current-account surpluses have been growing in other countries, especially in Japan, emerging Asia and some oil-exporting countries. In a step which is likely to help towards reducing these global imbalances, China in July 2005 discontinued its exchange rate peg to the US dollar and adopted a policy of managed floating, starting off with the yuan appreciating by 2,1 per cent.

Robust global economic growth has boosted the demand for energy. Crude oil prices have consequently risen to more than double their levels at the beginning of 2004, thereby reaching new record-high levels in nominal terms of US$64 per barrel on 10 August 2005. Geopolitical tensions, adverse weather conditions and threats of oil production disruptions

Brent crude oil prices



in some regions had a substantial impact on oil prices, given the low level of spare production capacity and generally tight conditions in the oil market. Many oil-exporting countries have introduced stabilisation mechanisms to reduce the immediate impact of exceptional oil revenues on potential government expenditure and on their exchange rates.

The considerable increase in the prices of oil and other commodities, alongside relatively accommodative financial policies, resulted in a moderate increase in headline inflation in most countries from early 2004. However, although global inflationary pressures increased somewhat, inflation still remained subdued. The negative impact of the higher oil prices on global growth and inflation was softened because, in real terms, the recent increases were smaller when compared with previous oil-price shocks. There are also signs that the oil intensity of output in most countries declined on a structural basis. Price discipline also benefited from global integration, which curbed the pricing power of producers around the world.

Following a protracted period of exceptionally low short-term interest rates, the monetary authority in the United States started raising the federal funds target rate in mid-2004. The process continued in a stepwise fashion, with the policy target rate raised to 3,50 per cent by August 2005 – the tenth 25-basis-point increase since mid-2004. Monetary policy was also tightened in other countries such as Australia, Brazil, Chile, Hong Kong, India, Mexico, New Zealand, Taiwan and Thailand. By contrast, the central banks of the Czech Republic, Hungary, Israel, Poland, Sweden and the United Kingdom have lowered their official interest rates since the beginning of 2005. The European Central Bank has kept interest rates unchanged since 2003.

In many countries monetary policy was fairly accommodative over the past few years, thereby contributing to buoyant real-estate market conditions. As interest rates edged higher to remove the excessive monetary accommodation, property price growth lost some momentum, at least in certain parts of the world. The continuation of this process might sooner or later begin to weigh down on the growth in household wealth, thus slowing the rampant growth in households' final consumption expenditure.

Policy issues and trade reforms

The process of financial liberalisation continued during the past year with the announcement in the October 2004 *Medium Term Budget Policy Statement* that South African corporates would no longer face exchange control limits on the amount they are permitted to invest abroad, and that they would be allowed to retain foreign dividends offshore. However, all outward investments would still be subject to approval by the authorities; criteria include demonstrated benefit to South Africa.

A number of trade agreements were concluded in 2004 and the first half of 2005, while others were still being negotiated. The Trade, Development and Co-operation Agreement with the European Union was ratified in May 2004, providing for tariff liberalisation which will be complemented by a development assistance programme. The intention is to reduce tariffs to zero on most manufacturing and agricultural products by the calendar year 2012.

The African Growth and Opportunity Act, AGOA, which was enacted by the United States to grant eligible sub-Saharan African countries preferential access to the US market until 2008, was extended to 2015 by amendments signed into law in July 2004.

A preferential trade agreement between Mercosur (comprising Brazil, Argentina, Paraguay, Uruguay, Chile and Bolivia) and the Southern African Customs Union (SACU) was signed in April 2005. Formal trade negotiations with China and India were to commence later in 2005.

Balance on current account[2]

The deficit on the current account of the balance of payments widened abruptly from R38,6 billion in the first half of 2004 to R50,2 billion in the second half. The calendar year 2004 was characterised by a combination of robust domestic demand, in particular the demand for high-value capital goods, together with the strengthening of the exchange value of the rand, which made imports cheaper and exports less competitive. Accordingly, the strong domestic demand and substitution of imported goods for domestically produced goods caused the trade balance to deteriorate significantly, switching into a deficit in the second half of 2004. A fairly solid export performance in the first half of 2005, alongside a moderate increase in merchandise imports, occasioned a slight narrowing of the trade deficit.

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

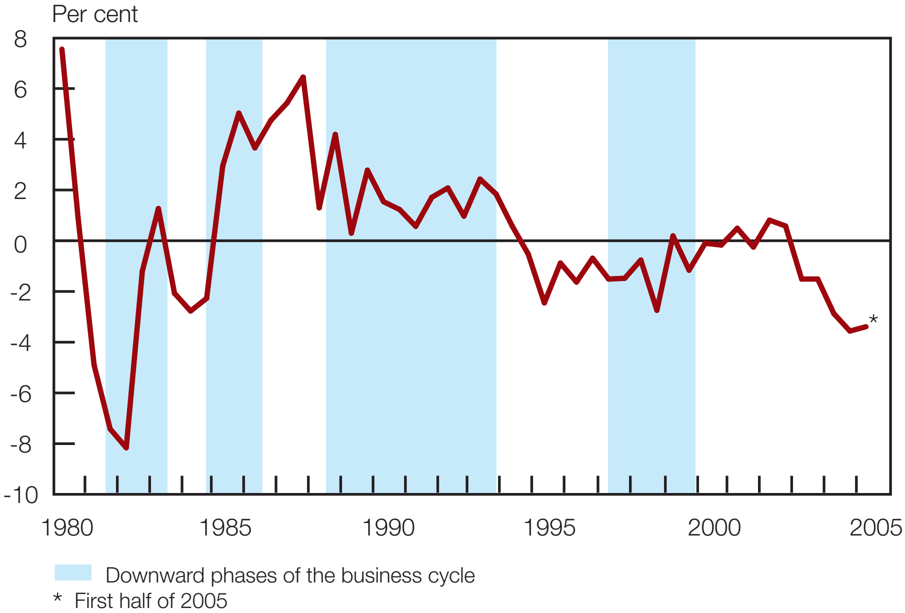
Balance of payments on current account

Seasonally adjusted and annualised
R billions

	2003	2004			2005
Sectors	Year	1st half	2nd half	Year	1st half
Merchandise exports	256,3	269,4	288,5	278,9	308,0
Net gold exports	34,2	33,3	32,3	32,8	27,2
Merchandise imports	-265,0	-298,8	-325,1	-311,9	-338,9
Trade balance	**25,5**	**3,9**	**-4,3**	**-0,2**	**-3,7**
Net services, income and current transfer payments	-44,4	-42,5	-45,9	-44,2	-45,0
Balance on current account	**-18,9**	**-38,6**	**-50,2**	**-44,4**	**-48,7**

The slightly smaller trade deficit together with a marginal contraction of the shortfall on the service, income and current transfer account with the rest of the world in the first half of

Ratio of current-account balance to gross domestic product



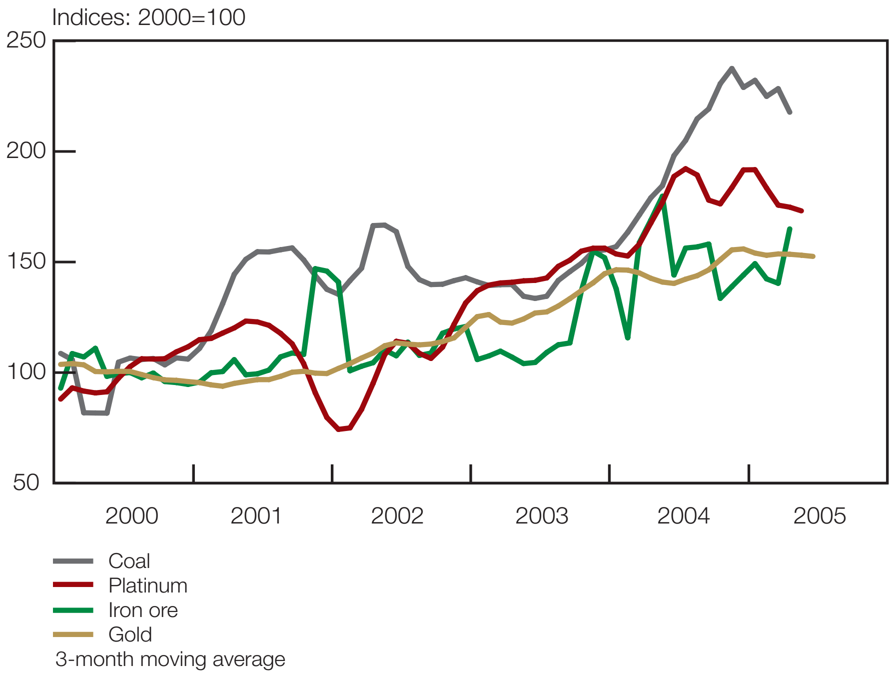
2005 contributed to a contraction of the deficit on the current account over the period. As a ratio of gross domestic product, the current-account deficit decreased from 3,6 per cent in the second half of 2004 to 3,3 per cent in the first half of 2005.

Exports

Underpinned by the relatively high level of international commodity prices and increased foreign demand for South African goods, the value of *merchandise exports* increased by 9 per cent in 2004. Firm growth in export revenues continued in the first half of 2005, when an annualised rate of increase of 14 per cent was registered despite a mild decline in the prices of some export commodities.

Following the earlier surge in international commodity prices, the share of mining products in the value of merchandise exports increased from 45,7 per cent in 2003 to 47,8 per cent in 2004. With certain subsectors of the manufacturing sector experiencing difficulties to remain internationally competitive, the contribution of exported manufactured goods to merchandise exports declined from 40,9 per cent to 38,7 per cent over the same period. In the first half of 2005, the share in total exports of mining products continued to rise, largely due to increasing physical quantities exported which more than offset the impact of commodity prices running out of steam.

Prices of selected commodities in US dollar



Reflecting the strength of the world economy and positive spill-overs from the industrial boom in China and other Asian economies, South Africa's export *volumes* increased by 5½ per cent in 2004 and rose further at a faster annualised pace in the first half of 2005. The physical quantities of exported steel, coal, aluminium and iron ore rose briskly over this period, and were largely responsible for this increase. Over the past eighteen months, growth in the volume of manufactured exports remained muted as producers in some instances turned their attention to supplying the domestic market, attracted by strong aggregate domestic expenditure and more profitable selling prices in the local market. Although the rand *prices* of exported goods increased by 3 per cent in 2004 as a whole, the unit value of exported goods declined in the second half of the year due to lower commodity prices and the impact of the appreciation of the external value of the rand. In the first half of 2005, however, the decline of 1 per cent in dollar-denominated commodity prices was more than fully neutralised by the depreciation of the rand against the dollar, to such an extent that the unit value in rand of overall merchandise exports rose modestly.

For the calendar year 2004 as a whole, net proceeds from *gold exports* declined by 4 per cent. Despite the mining of ore with a higher gold content, higher operating costs and industrial action had a negative impact on the gold-mining industry and certain loss-making operations were shut down. Notwithstanding the decline in the nominal effective exchange rate of the rand, the value of net gold exports contracted by 15½ per cent – or at an annualised rate of 29 per cent – in the first half of 2005. South Africa's gold production declined from 443 tons as recently as 1999, to 376 tons in 2003, 342 tons in 2004 and an annualised level of 300 tons in the six months ending June 2005. While South Africa's gold production declined steadily, supply in the market was supplemented by net official sales by other countries' authorities of about 364 tons of gold between mid-2004 and mid-2005. The reduction in the gold holdings of monetary authorities conformed to the guidelines of the Central Bank Gold Agreement, allowing the European Central Bank and other participating central banks in Europe to sell a maximum of 500 tons of gold per annum from their gold reserves.

The average fixing price of gold on the London market increased from US$364 per fine ounce in 2003 to US$409 per fine ounce in 2004 and subsequently to US$427 in the first half of 2005, having peaked at US$443 per fine ounce in December 2004. The higher dollar price of gold was underpinned by a reduction in the physical supply of bullion, restrained sales from central banks' gold holdings, producer de-hedging practices and – up to early 2005 – a weaker dollar. In view of the solid performance of the rand against the US dollar, the realised rand price of gold per fine ounce decreased by 4½ per cent in 2004. However, it edged higher in the first half of 2005.

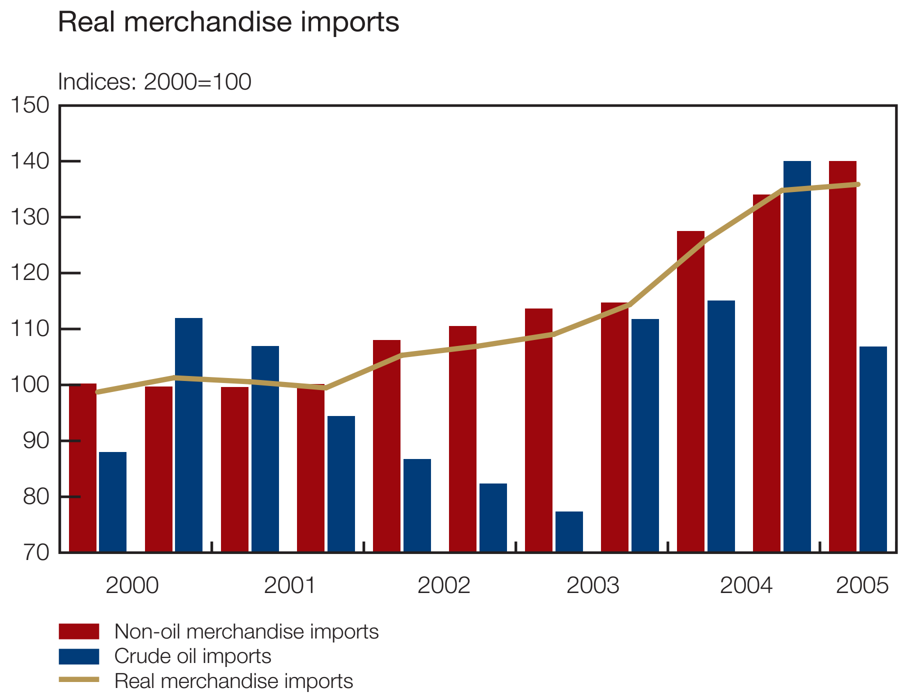
Imports

Mainly on account of strong domestic demand, the physical quantity of imported merchandise increased by no less than 16½ per cent in 2004. The increase was consistent with a lively pace of fixed investment expenditure and higher imports of crude oil. The volume of non-oil merchandise imports rose by 14 per cent in 2004, while the volume of oil imports surged by 39½ per cent. During the first half of 2005, overall import volume growth slowed to an annualised rate of 1½ per cent.

Whereas foreign suppliers satisfied about 20,9 per cent of real aggregate domestic demand in 2003, this share rose considerably to 23,0 per cent in 2004 and maintained this higher ratio of merchandise imports to domestic expenditure in the first half of 2005. Among the immediate reasons for the increasing trend in the import penetration ratio were the purchase of several new aircraft by South African Airways and the acquisition by the South African Navy of four corvettes as part of the government's arms procurement deal. More fundamental forces raising the import penetration ratio included:

- the tendency for expenditure on capital goods and more luxurious consumer goods, both having a high import content, to rise strongly when economic activity and income growth gain momentum;

- the substitution of imported goods for domestically produced goods in response to a decline in the relative prices of imported goods, in turn related to the generally stronger exchange rate of the rand and a shift in supply sources to low-cost producing countries; and



- a change in the composition of exports in favour of certain categories of manufactured goods, which require a higher proportion of imported intermediate goods.

Following a steep decline of 11 per cent in 2003, the rand prices of imported goods increased slightly by ½ a per cent in 2004 as the appreciation of the exchange rate of the rand partly countered the higher international price of crude oil. However, in the first half of 2005 the persistent rise in dollar crude oil prices coincided with the depreciation of the rand against the dollar, leading to an increase in the rand prices of imported goods at an annualised rate of 6½ per cent.

With rising prices reinforcing the growing volumes of imported goods, the value of merchandise imports rose by a substantial 18 per cent in 2004, followed by a further increase at an annualised rate of 8½ per cent in the first half of 2005. Buoyant prices and quantities boosted the value of crude oil imports to almost 12 per cent of total merchandise imports over the past year.

Service, income and current transfer payments

The shortfall on the service, income and current transfer account widened from R42,5 billion in the first half of 2004 to about R45,0 billion in the first half of 2005. However, on an annual basis, the imbalance remained broadly unchanged in 2004 compared with 2003. Interest and dividend payments to the rest of the world declined in 2004, reflecting a decrease in the rand value of South Africa's foreign debt and a decline in the profits of some domestic organisations with substantial foreign shareholding, such as mining houses. Largely owing to the strengthening of the rand, the interest and dividend receipts from the rest of the world decreased marginally in 2004 before increasing in the first half of 2005.

Total receipts for services rendered to non-residents declined in 2004, whereas total service payments to the rest of the world rose marginally on account of higher insurance and freight payments stemming from the higher volume of merchandise imports, especially in the second half of 2004. Despite the appreciation of the exchange value of the rand, which made South Africa a relatively more expensive tourist destination, South Africa benefited to a limited extent from the recovery in international tourism in 2004. According to the World Tourism Organisation, growth was experienced in all regions of the world, with Asia experiencing a 29-per-cent increase in foreign tourists, the Middle East 20 per cent, North and South America 10 per cent, Africa 7 per cent and Europe 4 per cent.

Arrivals of foreign visitors to South Africa

Percentage change

Visitors from	2001	2002	2003	2004	First half of 2005*
Overseas	-1,2	19,5	4,3	0,4	8,5
Africa	-2,4	7,6	0,1	4,2	11,1
Total	**-1,5**	**10,9**	**1,4**	**2,6**	**8,1**

* Compared with first half of 2004

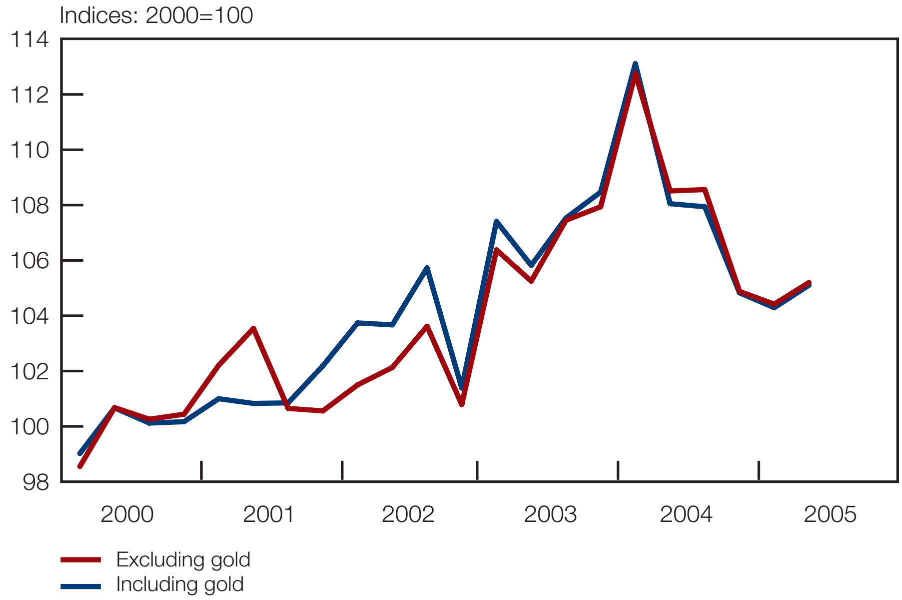
Source: Statistics South Africa; and Reserve Bank estimates for the first half of 2005

Despite an increase in the number of foreign tourists in 2004 and the first half of 2005, nominal growth in travel receipts remained relatively subdued. The hesitant growth in travel receipts could partly be explained by the composition of foreign arrivals: Around 70 per cent of foreign visitors came from Africa, with relatively low spending per capita during their visit, while 30 per cent of foreign visitors came from overseas, typically staying longer and with higher spending per capita. As Europe is the main supplier of overseas visitors to South Africa, the rather weak economic growth in the euro area caused the number of foreign visitors to this country to rise only marginally in 2004. The number of visitors from African countries increased more significantly over the same period, but contributed less towards travel receipts due to their lower spending per capita.

Terms of trade

After having increased in the first half of 2004, South Africa's terms of trade deteriorated in the second half of the year and receded further in the first half of 2005. While the

Terms of trade



modest decline in international commodity prices from the second half of 2004 to the first half of 2005 weighed on the prices of merchandise exports, the increase in the international price of crude oil simultaneously put upward pressure on the prices of imported goods. Overall, the terms of trade rose by 1 per cent in 2004, and declined by 2 per cent in the first half of 2005.

Financial account

The surplus on the financial account (including unrecorded transactions) picked up considerably from 2002, gaining further momentum as it improved from R70,4 billion in 2003 to R96,2 billion in 2004. Portfolio investment flows were predominantly responsible for the financial-account surplus in 2004. During the second half of 2004, portfolio and other investment recorded strong inflows while direct investment registered an outflow. The inflow of surplus savings from the rest of the world was more than sufficient to finance the mounting deficit on the current account of the balance of payments. As a ratio of gross domestic product, the surplus on the financial account amounted to 7,0 per cent in 2004 compared with 5,6 per cent in 2003. In the first half of 2005, the financial account continued to register healthy inflows of portfolio and other investment capital, and recorded a surplus equal to 6,4 per cent of gross domestic product.

Net financial transactions not related to reserves

R billions

	2003	2004			2005
	Year	1st half	2nd half	Year	1st half
Liabilities					
Direct investment	5,4	7,1	-3,3	3,8	3,0
Portfolio investment	7,8	19,2	25,7	44,9	29,6
Other investment	8,9	8,6	4,9	13,5	22,8
Assets					
Direct investment	-4,4	-9,0	-1,4	-10,4	2,8
Portfolio investment	-1,0	-1,5	-4,5	-6,0	1,1
Other investment	26,0	3,2	14,9	18,1	-8,9
Financial transactions*	**70,4**	**42,2**	**54,0**	**96,2**	**46,7**

* Including unrecorded transactions

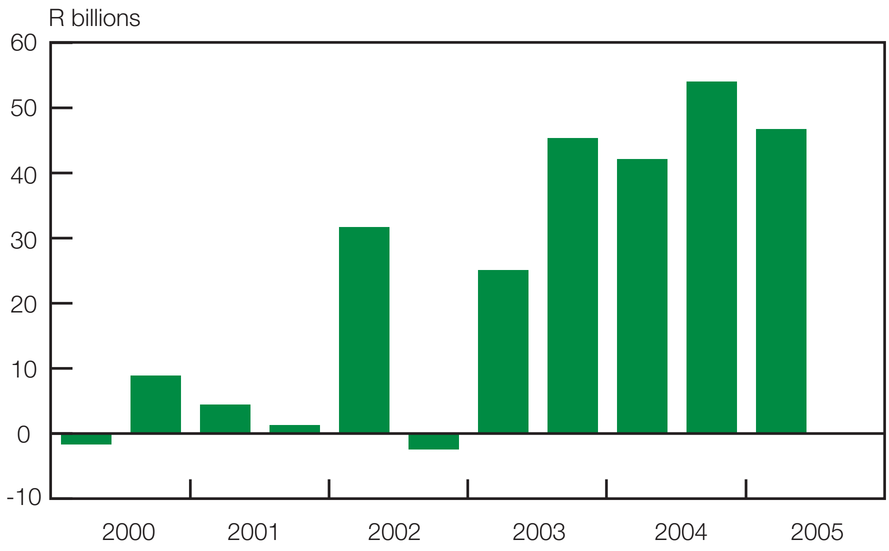
Foreign-owned assets in South Africa

Foreign direct investment into South Africa amounted to R5,4 billion in 2003 and R3,8 billion in 2004. The bulk of the inward direct investment in 2004 was registered in the first quarter, when a non-resident direct investor acquired a 20-per-cent interest in a South African mining company. Over the same period non-resident investors also acquired the entire issued share capital of a domestic exploration company. During the second half of 2004 foreign inward investment turned into an outflow of R3,3 billion when a foreign direct corporate investor sold the remainder of its Telkom shares to a South African entity.

Despite the repayment of other loan capital, the acquisition of South African companies by non-resident investors resulted in an inflow of capital in the first half of 2005. In May 2005, regulatory approval was granted to Barclays Bank plc to acquire a controlling interest in Absa, a domestic bank, in a large-scale foreign direct investment transaction which was ultimately concluded and settled in July.

Generally known for their volatile nature, *portfolio investment liabilities* contracted in the second half of 2003, before recording sizeable inflows of R19,2 billion and R25,7 billion in the first and second half of 2004, respectively. The inflows during 2004 were mainly brought about by an increase in foreign holdings of South African equity, and to a lesser extent fixed-interest securities. Foreign investors were attracted by strong domestic growth, low inflation, rising commodity prices, handsome yields, and prospects of rising bond prices. The National Treasury redeemed a Samurai bond in the first half of 2004 and a euro bond in the second half, but also issued a US$1 billion bond in June 2004. Inflows into portfolio investment liabilities continued in the first half of 2005 as a result of the further accumulation of domestic equity and debt securities by non-resident investors.

Balance on financial account



Including unrecorded transactions

Other foreign investment flows into South Africa declined from R8,6 billion in the first half of 2004 to R4,9 billion in the second half. Inflows during 2004 were generally related to increases in rand and foreign-currency denominated deposits with and short-term loans extended to South African banks by non-residents. In the second half of 2004, the inward movement of other investment capital was partly countered by the redemption of long-term loans by South African public corporations. In the first half of 2005 other investment inflows of R22,8 billion were recorded – almost twice the amount registered in the calendar year 2004 as a whole. Other than an increase in deposits of non-residents with domestic banks, a surge in the volume of merchandise imports probably contributed to an increase in trade financing extended by non-resident trading-partner countries.

South African-owned assets abroad

South African enterprises continued to acquire *direct investment* assets in the rest of the world during 2004. Capital outflows to the value of R9,0 billion and R1,4 billion were registered in the first and second half of 2004, respectively. The sizeable outward movement of capital in the first half of 2004 could mainly be ascribed to the acquisition of a foreign gold-mining company by a South African mining company. In the first half of 2005, the outflow of direct investment capital reverted to an inflow as a South African company disposed of its shareholding in an Australian company.

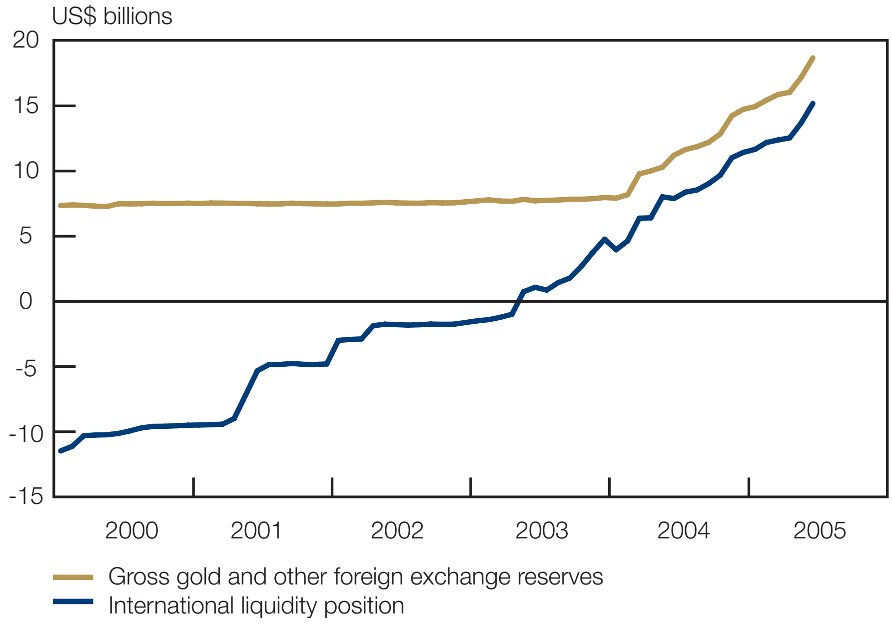
South Africans, predominantly institutional investors, acquired *foreign portfolio investment assets* to the value of R1,5 billion in the first half of 2004 and a further R4,5 billion in the second half. These external investments were partly encouraged by rising asset values on international securities markets. By contrast, an inflow of such funds was recorded in the first half of 2005 when private-sector banks repatriated part of their holdings of foreign debt securities.

Other foreign investment assets declined by R3,2 billion in the first half and R14,9 billion in the second half of 2004, but increased in the first half of 2005. The decrease in other foreign investment assets, particularly in the second half of 2004, could be attributed to a reduction in offshore lending to non-residents as well as a contraction in South African banks' rand-denominated deposits abroad. The outflow of capital in the first half of 2005 emanated largely from an increase in rand-denominated deposits by South African banks with non-resident banks, as well as an increase in loans extended to non-resident banks.

International reserves and liquidity position

Balance-of-payments transactions resulted in significant increases in South Africa's net international reserve position in each of the past three calendar years. The overall balance of payments registered surpluses of R37,1 billion and R51,8 billion in 2002 and 2003, respectively, followed by R52,1 billion in 2004. The sustained healthy overall balance-of-payments position in 2004 was more or less equally distributed between the first and second half of the year, and resulted from sizeable net inflows of portfolio and other investment capital into the South African economy. The mounting deficit on the current account of the balance of payments alongside modest surpluses on the financial account led to further accumulation of net international reserves during the first half of 2005.

Gross gold and foreign exchange reserves and international liquidity position of the Reserve Bank



The gross international reserves of the Reserve Bank more than doubled from US$8,0 billion at the end of 2003 to US$18,7 billion at the end of June 2005 and rose further to US$18,9 billion at the end of July. Over the same period of 19 months the Bank's international liquidity position strengthened from US$4,8 billion to US$15,4 billion. To be fully consistent with the international practice of fair value accounting, the gold holdings of the Bank were, as from March 2005, valued at 100 per cent of the London gold price on the afternoon of the final trading day of the month. Prior to March 2005, gold was valued at 90 per cent of the average of the last ten price fixings of the month on the London bullion market.

As a result of the programme to build up the official reserves, the level of imports of goods and services covered by the Bank's gross international reserves increased from 7 weeks' worth at the end of December 2003 to 10 weeks' worth at the end of December 2004. At the end of June 2005 this ratio equalled 14 weeks' worth.

The liquid foreign assets owned by the private-sector banks in South Africa increased from US$16,9 billion at the end of 2003 to US$18,0 billion at the end of 2004, but declined to US$16,5 billion at the end of June 2005.

Foreign debt

South Africa's total foreign debt rose from US$37,2 billion at the end of 2003 to US$42,3 billion at the end of 2004. The increase in the country's external debt commitments could largely be ascribed to an increase in rand-denominated debt, which rose by US$4,6 billion over the period as non-resident investors increased their deposits with and loans extended to South African banks. Net purchases of domestic bonds by non-resident investors also contributed to the rise in the country's rand-denominated external debt. Foreign currency-denominated debt remained roughly unchanged from 2003 to 2004.

Owing largely to the appreciation of the rand against the US dollar, the value in rand of the country's total foreign debt declined from R247 billion at the end of 2003 to R238 billion at the end of 2004. As a ratio of annual export proceeds, total external debt decreased from 76,3 per cent to 70,7 per cent over the same period. Due to a decline in non-monetary private-sector borrowings maturing in less than twelve months, the *maturity structure* of South Africa's foreign currency-denominated debt improved

Foreign debt of South Africa

US$ billions at end of year

	2000	2001	2002	2003	2004
Foreign currency-denominated debt	**24,9**	**24,0**	**25,0**	**27,4**	**27,9**
Bearer bonds	5,5	6,0	7,8	9,7	9,7
Converted long-term loans	0,2	0,1	0,0	0,0	0,0
Public sector	4,2	3,0	5,0	4,9	4,9
Monetary sector	8,3	8,9	6,3	5,9	7,0
Non-monetary private sector	6,7	6,0	5,9	6,9	6,3
Rand-denominated debt	**12,0**	**6,8**	**7,7**	**9,8**	**14,4**
Bonds	8,3	4,3	4,5	4,2	5,5
Other	3,7	2,5	3,2	5,6	8,9
Total foreign debt	**36,9**	**30,8**	**32,7**	**37,2**	**42,3**

moderately in 2004. The share of short-term foreign-currency debt (i.e. debt with an original maturity of less than one year and long-term foreign-currency debt maturing within the next twelve months) as a percentage of total foreign currency-denominated debt declined from 41,2 per cent at the end of 2003 to 37,5 per cent at the end of 2004. Over the same period South Africa's accumulation of international reserve assets progressed to such an extent that the gross reserves covered 140 per cent of total short-term foreign currency-denominated debt, twice the ratio of 69 per cent at the end of 2003.

In January 2005, the Moody's Investor Agency upgraded South Africa's foreign-currency debt and bank deposits as well as the country's foreign currency-denominated bonds and notes from Baa2 to a Baa1 rating. This put South Africa in the same category as economies such as Malaysia and Thailand, but still somewhat below China and Poland. The Moody's rerating followed an upgrade from stable to positive by Fitch Rating Agency in October 2004. Owing mainly to improved economic stability in the country, the credit rating agency Standard & Poor's upgraded South Africa's long-term foreign currency-denominated debt rating from BBB to BBB+ on 1 August 2005.

Sovereign credit ratings of South Africa's long-term foreign currency-denominated debt

		Moody's		Standard & Poor's		Fitch	
		Rating	Date	Rating	Date	Rating	Date
↑ Lower risk	Investment grade	Aaa		AAA		AAA	
		Aa1		AA+		AA+	
		Aa2		AA		AA	
		Aa3		AA-		AA-	
		A1		A+		A+	
		A2		A		A	
		A3		A-		A-	
		Baa1	11 Jan 2005	BBB+	1 Aug 2005	BBB+	
		Baa2	29 Nov 2001	BBB	7 May 2003	BBB	2 May 2003
		Baa3	30 May 1995	BBB-	25 Feb 2000	BBB-	27 June 2000
Higher risk ↓	Speculative grade	Ba1		BB+	20 Nov 1995	BB+	19 May 2000
		Ba2		BB	3 Oct 1994	BB	22 Sept 1994
		Ba3		BB-		BB-	
		B1		B+		B+	
		B2		B		B	
		B3		B-		B-	
		Caa1		CCC+		CCC+	
		Caa2		CCC		CCC	
		Caa3		CCC-		CCC-	
		Ca		CC		CC	
		C		C		C	
		-		D		D	

Exchange rates

Having already increased by 8,2 per cent in the first half of 2004, the nominal effective exchange rate of the rand, on balance, strengthened further during the remainder of the year, supported by a relatively weaker US dollar, firm commodity prices and positive investor sentiment towards South Africa. Eventually, the rand's trade-weighted external value appreciated by 11,7 per cent in 2004 following an increase of 16,2 per cent in 2003. The announcement by the Bank in August 2004 of a 0,5-percentage-point reduction in the repurchase rate briefly interrupted the steady performance of the rand, as the nominal effective exchange rate of the rand declined by 6,9 per cent from the end of July 2004 to the end of August. However, similar to what occurred in 2003, the interest rate reduction was not accompanied by a lasting depreciation of the rand. The rand appreciated again by 9,9 per cent from the end of August to the end of December 2004.

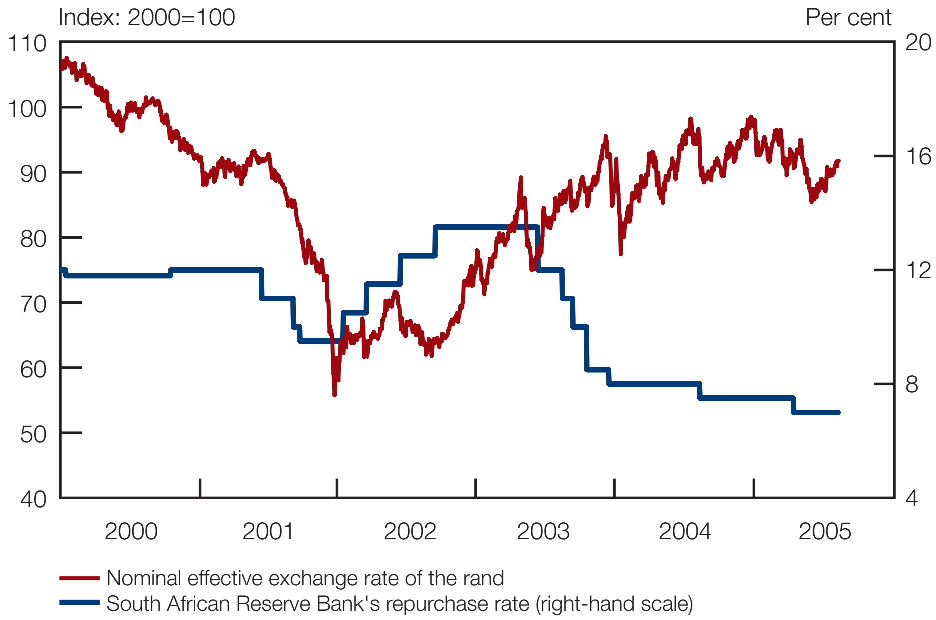
Exchange rates of the rand
Percentage change

	31 Dec 2003 to 30 Jun 2004	30 Jun 2004 to 31 Dec 2004	31 Dec 2004 to 30 Jun 2005
Weighted average............................	8,2	3,2	-9,0
Euro	10,5	-1,1	-4,6
US dollar	6,1	11,3	-15,5
British pound....................................	4,7	4,3	-9,8
Japanese yen	8,0	4,9	-9,1

In the first half of 2005 the nominal effective exchange rate of the rand, on balance, fluctuated downward by 9,0 per cent. Following another reduction by 50 basis points in the repurchase rate of the Bank in mid-April 2005, the nominal effective exchange rate of the rand decreased further by 1,9 per cent up to the end of June 2005. Apart from the interest rate reduction, which was effected against the background of rising global interest rates, the weakening of the rand could probably also be attributed to, among other factors, somewhat lower international prices of key South African export commodities, alongside sizeable deficits on the current account of the balance of payments.

Expectations that large foreign capital inflows arising from foreign direct investment would bring an oversupply of foreign currency to the market contributed to a partial

Nominal effective exchange rate of the rand and South African Reserve Bank's repurchase rate



reversal of the rand's depreciation, but this was, in turn, moderated by the authorities' expression of a preference for a stable and competitive exchange rate of the rand.

The decline in the exchange rate of the domestic currency in the first half of 2005 was not unique to South Africa. Several other emerging-market as well as commodity-currency economies also experienced a degree of currency weakening during this period.

Adjusted for the inflation differential between South Africa and its most important trading-partner countries, the real effective exchange rate of the rand increased by 4½ per cent during the course of 2004, indicating that international competitiveness pressures on South African tradeable-goods producers intensified. In the first six months of 2005, the real effective exchange rate of the rand depreciated by about 8½ per cent.

The average daily turnover in the domestic market for foreign exchange amounted to US$11,3 billion in 2004, but with the increased participation by non-resident investors in the domestic securities market in the first half of 2005, the average daily turnover increased to US$13,8 billion over the six-month period. On a monthly basis it reached a peak of US$15,2 billion in March. Non-residents' share in the activity on the domestic market for foreign exchange increased gradually from 69 per cent in the first half of 2004 to 72 per cent in the second half and further to 74 per cent in the first half of 2005.

Monetary developments and interest rates

Structural and regulatory issues

The South African banking sector remained on a stable and sound financial footing during the past year. Despite a rapid expansion in their balance sheets, banks remained well capitalised, their capital and reserves boosted by higher profitability. At the end of June 2005 there were 37 registered banks in South Africa, as well as 44 representative offices of foreign banks. Five major banking groups continue to dominate and represent about 88 per cent of the total assets of the South African banking sector.

South African private-sector banks, June 2005

	Number	Total assets R billions
Locally controlled banks	13	1 100
Foreign-controlled banks*	6	328
Branches of foreign banks	15	134
Mutual banks	2	1
Total	36	1 563

* Including Absa, although all formalities related to its foreign control had not been concluded at the time

Foreign banks took a keen interest in establishing operations in South Africa. In this regard a major recent development was the acquisition of a majority shareholding in Absa Group Limited by Barclays Bank plc, a bank registered in the United Kingdom. Accordingly, Absa became a subsidiary of Barclays Bank.

Barclays Bank, through its shareholding in Absa Bank, is the first foreign institution to acquire a controlling interest in one of the four big banks in South Africa. Cross-linkages within the newly formed group are also to be strengthened through the acquisition of the ten Barclays sub-Saharan operations by Absa.

Banks utilised various sources of funding to keep their levels of capital adequacy at prudent levels, aligned with the strong growth in their assets. For instance, Calyon Corporate and Investment Bank, through its South African branch, listed a medium-term note programme on the Bond Exchange of South Africa – the first such domestic transaction by a branch of a foreign bank. The notes will be issued in the coming months. Strong profit growth more generally enabled banks to accumulate reserves through retained earnings.

The Office of the Registrar of Banks indicated its full support for the implementation of the new Capital Accord (Basel II) in South Africa. The Office envisages that as from the Basel II implementation date of 1 January 2008 South African banks would no longer be able to use the current Capital Accord, but would have to adopt an appropriate approach from the menu of approaches offered in terms of Basel II. As part of the process of planning and implementing Basel II, the Accord Implementation Forum continued its preparatory work through various subcommittees and task groups.

The National Credit Bill was tabled in Parliament during June 2005. At promulgation the Bill will replace the existing Usury Act of 1968, the Credit Agreements Act of 1980 and the exemption notice issued in terms of the Usury Act which governs micro-lenders. The proposed legislation will apply to all credit transactions and to all credit providers, including banks, retailers, pawnbrokers and micro-lenders. The Bill aims to enhance consumer protection, promote competition and transparency in the credit market, and control over-indebtedness and reckless lending. The Dedicated Banks Bill, intended to increase competition as regards savings accounts and affordable banking services, and the Co-operative Banks Bill, aimed at providing banking services to a broader segment of the population, were released to the public for comment by the National Treasury in 2004 and are scheduled for parliamentary hearings in October 2005.

Compliance with the Financial Sector Charter requirements within the banking sector continued as planned. Broad-based Black Economic Empowerment deals continued during 2004 and the first half of 2005, with several banks and other financial institutions having concluded empowerment deals. The Department of Trade and Industry issued the first phase of the Codes of Good Practice on empowerment deals at the end of June 2005. The codes give guidance on and provide basic principles for the implementation of empowerment deals, and are to be applied in the development, evaluation and monitoring of initiatives, transactions and other implementation mechanisms.

Since its launch on 25 October 2004 as part of the financial sector's commitment to increase access to financial services, the Mzansi bank account – a special low-cost savings and transaction account – is estimated to have brought an additional 4 per cent of the population into the formal banking system. The widespread use of this account by the public is seen as an indicator of success in achieving affordable and accessible banking for the previously unbanked segment of the population in accordance with the objectives of the Financial Sector Charter.

The RSA retail bonds, launched by the National Treasury in May 2004 and accessible through the Post Office infrastructure, performed well and raised around R1,5 billion in funds from approximately 17 000 investors, adding to competition in the market for household savings.

Consistent with the commitment of the Financial Services Charter and New Comprehensive Plan on Sustainable Human Settlements, substantial progress was made with institutional arrangements and mechanisms to increase housing affordability and to improve the efficiency of the low income housing market. A Memorandum of Understanding that will facilitate cooperation between the government and the banking sector was signed at the end of March 2005, contributing towards the goal of mobilising R42 billion in investment funds earmarked for new affordable housing by 31 December 2008.

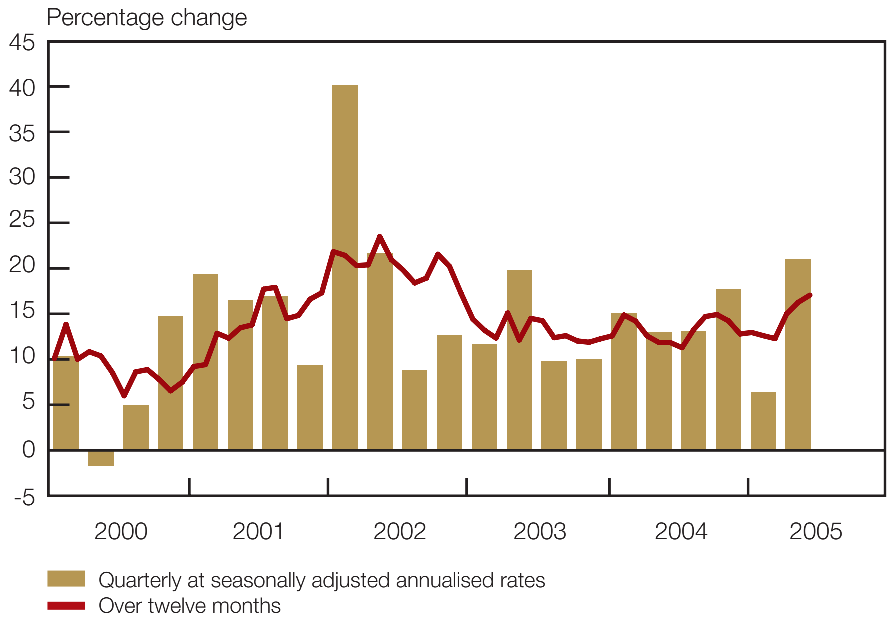
The Public Investment Corporation Act, No 23 of 2004, assented to in December 2004, resulted in the status of the Public Investment Commissioners being changed to that of a corporation as from 1 April 2005. The operations of the Public Investment Corporation will be governed by the Public Finance Management Act, the Companies Act and the Financial Advisary and Intermediary Services (FAIS) Act No 37 of 2002, and ownership remains with the government of South Africa. In tandem with these developments, the institutional coverage of the monetary aggregates was revised and broadened by the inclusion of the now corporatised Public Investment Commissioners in the *private and other domestic parties* category. The Commissioners previously formed part of the government sector. Over and above this, the measurement of the monetary aggregates continued to be affected by disintermediation, restructuring, mergers and acquisitions within the financial sector.

Money supply

During the past year the monetary aggregates continued to be influenced by the comparatively low level of nominal interest rates and strongly positive business and consumer sentiment, which translated into brisk economic activity and a strong transactions demand for money. The wealth effects associated with rising prices of residential real estate and other assets benefited the overall value of corporate and household asset portfolios. A portion of asset portfolios tends to be held in the form of bank deposits, suggesting that wealth effects also contributed to the strong growth in the monetary aggregates. While extraordinary occurrences, such as the redemption of the second tranche of the R150 government bond and bond coupon interest payments at the end of February 2005, caused temporary aberrations, the underlying trend in money supply growth remained firm.

Having recorded a recent high of 23,1 per cent in May 2002, twelve-month growth in the broadly defined money supply (M3) subsequently moderated but remained relatively strong and registered average rates of 13 to 14 per cent in 2003, 2004 and the first half of 2005. The greater stability in M3 growth over the past two years might be a reflection of calmer financial conditions, with inflation lower and more predictable and income and expenditure growth progressing more smoothly than before.

M3



Twelve-month growth in the narrower monetary aggregates recently converged with that of M3, as shown in the accompanying table. As is customarily the case, the narrower aggregates displayed more short-term volatility than M3 over the past two-and-a-half years. The significant reduction in short-term interest rates in 2003, for instance, was reflected in a very low rate of increase in call and overnight deposits and in M1 as the public increasingly preferred other short and medium-term deposits to call and overnight deposits. With quite modest movements in short-term interest rates over the past year, shifts in maturity preferences seemed to have moderated, allowing for a much smaller dispersion in the growth rates of the various aggregates.

Growth in monetary aggregates

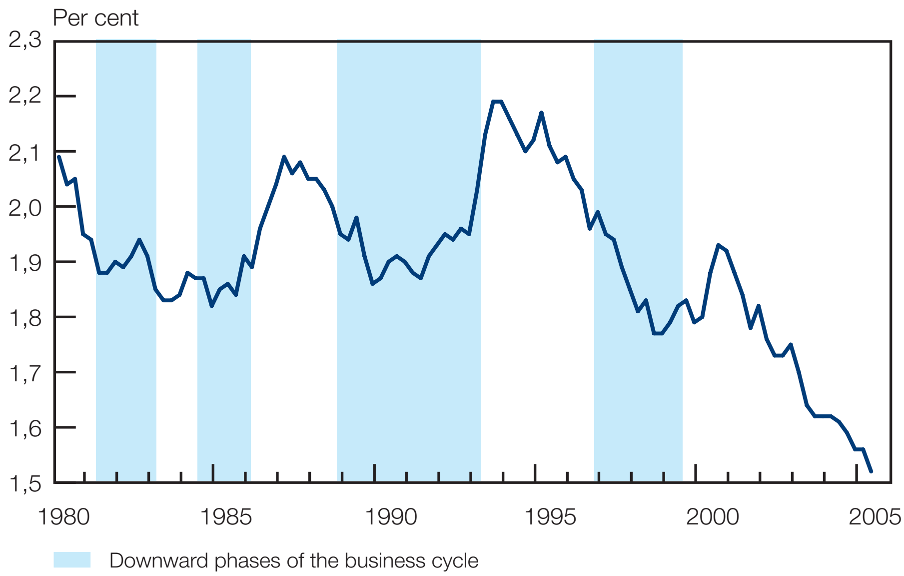
Percentage change over twelve months to end of period

	2003	2004	June 2005
Banknotes and coin in circulation	15,4	15,9	13,4
Cheque and transmission deposits	10,4	10,9	16,1
M1A	11,2	11,6	15,6
Other demand deposits	4,7	4,9	10,8
M1	8,2	8,7	13,5
Other short-term and medium-term deposits	26,0	14,9	21,0
M2	15,9	11,6	17,0
Long-term deposits	-10,3	27,9	17,4
M3	12,9	13,1	17,1

The M3 holdings of the household sector increased by 11,3 per cent over the twelve months to June 2005, alongside rising real disposable income and improved access to the banking sector. Over the same period the corporate sector's holdings of M3 deposits rose by 20,0 per cent, buoyed especially by non-bank financial institutions' strong liquidity preference alongside fluctuating financial asset prices and brisk turnover in the financial markets.

Growth in M3 exceeded growth in nominal gross domestic product throughout 2004 and the first half of 2005. Accordingly, the income velocity of circulation of M3 declined to an all-time low value of 1,52 in the second quarter of 2005. These unprecedentedly low levels of the income velocity of circulation of M3 suggest ample available liquidity in the economy for financing expenditure.

Income velocity of M3



From a structural perspective, several factors contributed to the increase in the level of money supply relative to nominal gross domestic product. These included:

- brisk increases in the market value of residential real-estate and other assets, propelling growth in wealth beyond growth in nominal income;
- higher demand for money arising from exceptional growth in financial market activity, in turn supported by the increase in non-resident participation in the domestic financial markets coupled with the relaxation of exchange controls;
- low inflation and positive real returns on deposit-type investments; and
- improved access to banking services for the previously unbanked segment of the population.

As reflected in the accompanying table, the most important statistical counterpart to the increases in M3 during 2004 and in the first half of 2005 was the strong growth in loans and advances extended to the private sector.

Counterparts of change in M3

R billions

	2004		1st half of 2005	
Net foreign assets		40		18
Net claims on the government sector		-1		-14
Gross claims	*12*		*-17*	
Government deposits (decrease +; increase -)	*-13*		*3*	
Claims on the private sector		113		69
Investments and bills discounted	*-7*		*-13*	
Total loans and advances	*120*		*82*	
Net other assets and liabilities		-45		13
Total change in M3		106		86

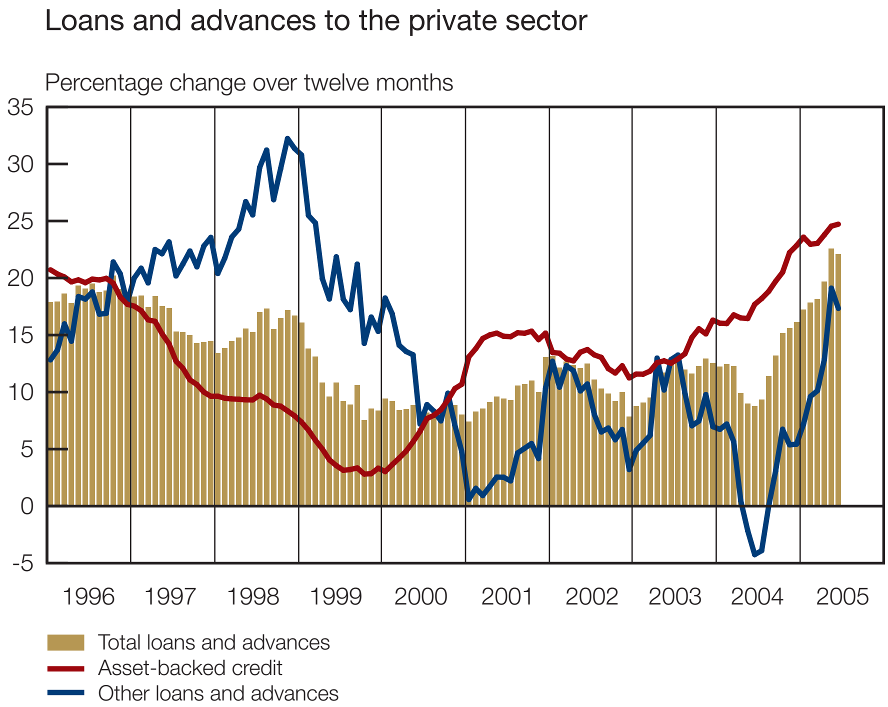
During the first half of 2005, net claims on the government sector were affected by the redemption and coupon interest payments on government bonds at the end of February 2005 to the value of R39,3 billion. The resultant decline in government deposits was later partly reversed by higher-than-expected tax revenue collections.

Credit extension

During the past year the stimulative effect of the current cycle of lower interest rates, favourable lending and borrowing conditions, wealth effects associated with and emanating from buoyant real-estate and financial markets conditions, strong business and consumer confidence and the rebound in the corporate sector's use of bank-intermediated funding gave impetus to the strong growth in total loans and advances extended by monetary institutions to the private sector.

Twelve-month growth in monetary institutions' total loans and advances to the private sector accelerated significantly from single-digit rates recorded during the first half of 2004 to levels above 10 per cent since August 2004, reaching 22,1 per cent in June 2005.

Total loans and advances extended to the private sector increased by R172 billion in the twelve months to June 2005. Asset-backed credit contributed R123 billion to the overall increase in total loans and advances to the private sector.



Underlying growth in *mortgage advances* remained exceptionally strong despite some financial restructuring during the first half of 2005, when one of the reporting banks' mortgage portfolio was absorbed by a non-monetary institution. Growth over twelve months in mortgage advances accelerated significantly to levels which consistently exceeded 20 per cent since September 2004, but which was fairly consistent with the buoyant conditions prevailing in the real-estate market. In turn, this was supported by:

- lower interest rates and generally favourable lending and borrowing conditions;
- an improvement in disposable income on account of brisk economic activity, rising employment and reductions in income taxes;
- growing numbers of first-time home buyers, especially those recently finding employment;
- strong interest in the purchase of second homes and "buy-to-let" property investments, fueled by the healthy capital gains on residential real estate in the recent past; and
- a moderate reduction in the transfer duty payable on fixed property transactions which became effective from 1 March 2005.

Credit aggregates

Component	June 2004 R billions	June 2005 R billions	Change Per cent
Asset-backed credit	499	622	24,6
Instalment sale and leasing finance	137	165	20,4
New passenger cars	*34*	*47*	*38,0*
Other passenger cars	*37*	*44*	*19,0*
*Other goods**	*66*	*76*	*15,0*
Mortgage advances	362	458	26,5
Other loans and advances	278	326	17,3
Total loans and advances	777	948	22,0

* Sum of minibuses, trucks, agricultural machinery and equipment, and other equipment

Strongly positive consumer and business sentiment was also reflected in the strong growth in *instalment sale credit and leasing finance* which is mainly directed at financing expenditure on motor vehicles and other durable goods. Twelve-month growth in this credit category accelerated throughout 2004 and remained at levels around 20 per cent in the first half of 2005. Brisk domestic expenditure, relatively stable prices of new motor vehicles and attractive discounts and other incentives offered to prospective buyers supported strong growth in instalment sale credit and leasing finance provided by monetary institutions.

Other loans and advances contracted by 4,2 per cent over the twelve months to June 2004 but rebounded to a year-on-year growth rate of 17,3 per cent in June 2005 as the corporate sector increased the use of bank-intermediated funding and restructuring resulted in a switch from mortgage financing to other types of advances. Other loans and advances is a volatile credit category, usually dominated by changes in the use of bank-intermediated funding by the corporate sector. Although the issuance of debt securities has grown significantly in the recent past, bank-intermediated funding remains the most important source of funds for the corporate sector. The attractiveness of bank-intermediated funding is enhanced by the relative ease of drawing on facilities or repaying loans and the relative wide dispersion of banks' branch operations.

The corporate sector's use of loans and advances increased by 18,0 per cent or R63 billion over the twelve months to June 2005, mainly reflecting more use of *other loans and advances*, whereas that of the household sector rose by 25 per cent or R108 billion over the same period, reflecting strong growth in asset-backed credit.

Bank loans and advances by sector of economic activity are shown in the accompanying table which indicates that, among the identified sectors, the finance and insurance, and transport and communication industry were responsible for the strongest growth in credit extension over the past year.

Banks' loans and advances by industry

Component	June 2004 R billions	June 2005 R billions	Change Per cent
Agriculture, forestry and fishing	21	22	4,8
Mining	14	17	21,4
Manufacturing	46	45	-2,2
Construction	8	9	12,5
Electricity, gas and water	18	6	-66,7
Trade and accommodation	30	28	-6,7
Transport and communication	15	20	33,3
Finance and insurance	258	399	54,0
of which: Interbank	*66*	*64*	*-3,0*
Real-estate and business services	100	105	5,0
Community, social and personal services	36	35	-2,8
Individuals	366	407	11,2
Other	65	77	18,5
Total	**1 044**	**1 234**	**18,2**

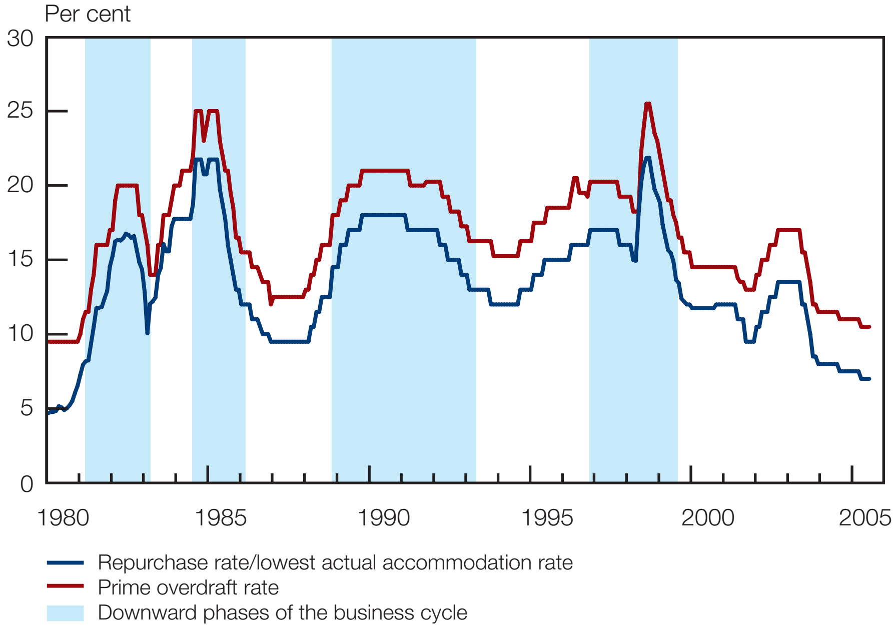
Note: The totals in this table also include advances to non-residents and government as well as interbank loans, unlike the previous table which includes only advances to the domestic private sector

Throughout the period under review, bad debts, non-performing loans and provisions in the banking sector remained at historical low levels – underlining the benefits to banks and their clients of a healthily growing economy, broadly stable macroeconomic conditions and an environment of generally lower interest rates.

Interest rates and yields

Against a backdrop of low inflation, lively economic growth and the appreciation of the external value of the rand, the cycle of declining interest rates that started in June 2003 continued into 2005. The downward movements in short-term interest rates of the past eighteen months were comparatively modest: Of the cumulative decline of 650 basis points in the repurchase rate since June 2003, 550 basis points were effected during 2003, and thereafter 50 basis points in August 2004 and 50 basis points in April 2005. The policy tightening incurred in 2001 was not only completely reversed, but interest rates have receded to their lowest levels since 1980.

Benchmark short-term interest rates



Other money-market interest rates emulated the changes in the repurchase rate as announced by the Monetary Policy Committee (MPC) of the Reserve Bank throughout the interest rate easing cycle.

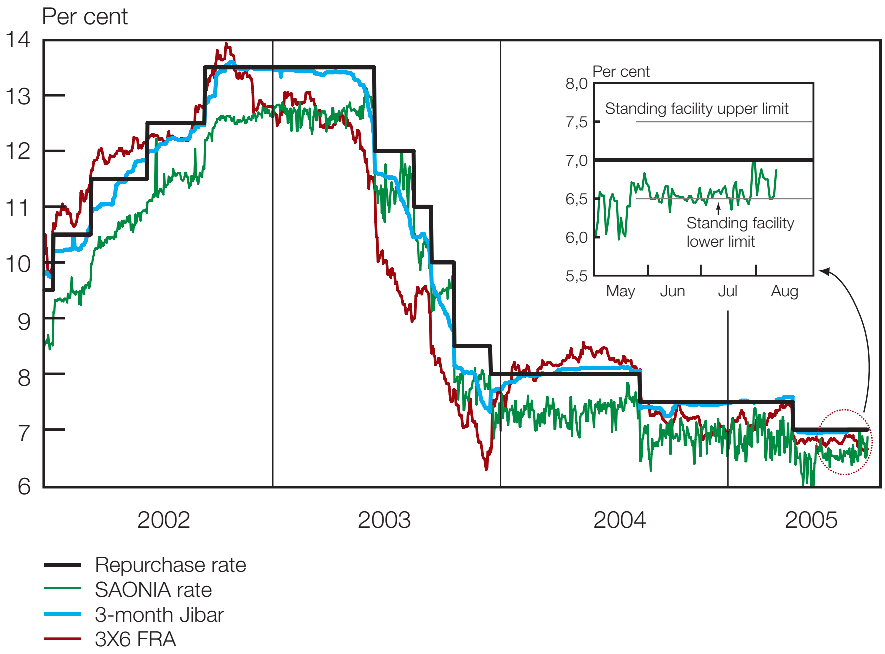
Reserve Bank's repurchase rate

Date effective	Per cent
12 Dec 2003	8,0
13 Aug 2004	7,5
15 Apr 2005	7,0

In the past year, the South African Overnight Interbank Average (SAONIA) rate continued to fluctuate around levels slightly below the repurchase rate. Following the introduction of new money-market operational arrangements on 25 May 2005, the SAONIA rate seemed to have become less volatile, seldom declining below the lower band of the newly-introduced standing facilities available at the Reserve Bank. With the repurchase rate left unchanged at the June and August 2005 meetings of the MPC, the SAONIA rate remained within a narrow range of 6,33 per cent to 6,97 per cent from 25 May to mid-August 2005.

Other money-market interest rates, such as the three-month Johannesburg Interbank Agreed Rate (Jibar) and the rates on Treasury bills, also traced the movements in the repurchase rate. On occasion, such as in early December 2003, they also pre-empted movements in the repurchase rate, although with less-than-perfect foresight. Rates on Treasury bills were also influenced by changes in the banks' demand for liquid assets and in the amounts on offer at the weekly tenders. Over the past twelve months, the aggregate amount offered each week was raised from R2 billion to between R2½ billion and R3 billion.

Money-market interest rates



Mindful of the strong demand for liquid assets and aiming at the structural broadening of the available range of short-term government debt instruments, from 29 April 2005 the National Treasury started issuing 273-day Treasury bills. The accompanying table illustrates the relative importance of and rates on the various maturities of Treasury bills in early August 2005.

Treasury bill tender results, 12 August 2005

Maturity	Amount allotted R millions	Rate Per cent
91 days	2 150	6,72
182 days	300	6,67
273 days	100	6,62

Over the past year, market expectations of future interest rates, as captured in rates on forward rate agreements, were that interest rate movements would be moderate. Views regarding the likely direction of interest rate movements shifted on account of developments in the exchange rate of the rand, oil price, inflation data and the like. By early April 2005, the rates on forward rate agreements suggested that market participants were of the opinion that the interest rate easing cycle had ended and that a tightening cycle was imminent later in 2005. Reacting to the unexpected lowering of the repurchase rate at the April 2005 MPC meeting, rates on forward rate agreements subsequently reflected a fairly neutral view on interest rate prospects for the remainder of the year, but with a mild upward bias in 2006.

Coinciding with reductions in the repurchase rate, the private banks lowered *their prime overdraft rates and predominant rate on mortgage loans* in two steps from 11½ per cent up to early August 2004 to 10½ per cent from mid-April 2005. The current level of the prime overdraft rate is the lowest since January 1981 (see the graph on page 50) and that of the mortgage rate the lowest since September 1975.

In an effort to promote a savings culture among South African citizens, RSA Government Retail Bonds were launched by the National Treasury in May 2004. After a reduction of 75 basis points in January 2005, the rates of interest on these bonds remained unchanged to the end of August. The prevailing interest rates are priced off the government bond yield curve and are changed when the yields on equivalent government bonds move either negatively or positively by more than 50 basis points. Since inception, the rates on these bonds have changed as indicated in the accompanying table.

Interest rates on RSA Government Retail Bonds
Per cent

Date effective	2-year bond	3-year bond	5-year bond
24 May 2004	9,25	9,50	10,00
1 Sep 2004	8,25	8,50	9,00
1 Jan 2005	7,50	7,75	8,25

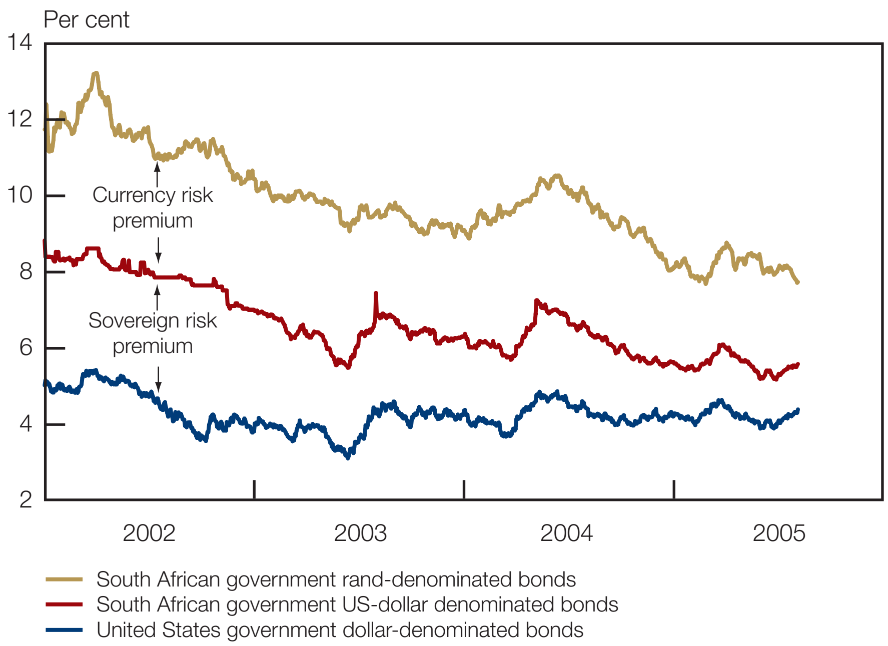
The heightened competition for retail savers' funds introduced by the RSA Government Retail Bonds may explain part of the increase in the *predominant rate on twelve-month fixed deposits* with banks from 6,1 per cent in December 2003 to 7,8 per cent in June 2004. However, the banks lowered these deposit rates in the ensuing months to 6,2 per cent from May 2005; this reduction exceeded the reduction of 100 basis points in the repurchase rate over the same period. In real terms, using historical year-on-year increases in CPIX to adjust nominal rates, the twelve-month fixed deposit rate rendered investors an average real return before tax of 2,7 per cent in the first six months of 2005 as inflation remained subdued. During 2004 the corresponding real return was 2,6 per cent and over the five-year period from January 2000 to December 2004 it averaged 1,9 per cent.

Key administered interest rates have generally remained unchanged since September 2004. The *official rate of interest* applicable to fringe benefit taxation remained at 8,5 per cent to July 2005, following reductions of 50 basis points in both March 2004 and September. The Usury Act's *maximum annual finance charges rates* on money loans and credit and leasing transactions similarly remained unchanged since 17 September 2004, at 20 per cent per annum for amounts of R10 000 or less and 17 per cent per annum for amounts above R10 000, but not exceeding R500 000. In this instance, two reductions of 100 basis points on each occasion were effected earlier in 2004.

The bull run enjoyed by long-term bonds from April 2002 was interrupted in the first half of 2004 when the *daily average yield* on the long-term government bond (code R157, maturing in 2015) increased from 8,88 per cent on 12 January 2004 to a recent high of 10,53 per cent on 15 June. Bond yields increased as a result of, among other things, increased issuance of bonds, fluctuations in the exchange value of the rand, weaker global bond markets, and mounting fears in some quarters that inflation might accelerate. Subsequently the yield on the R157 bond resumed a downward trajectory and reached a record low of 7,69 per cent on 28 February 2005. Yields at these low levels were previously recorded more than thirty years ago. During the second half of 2004 and the first months of 2005, the bull run in the bond market was occasioned by, among other things:

- the appreciation and sustained resilience of the exchange value of the rand;
- subdued inflation in consumer and production prices;
- buoyant tax collections resulting in a smaller budget deficit;
- declining bond yields in international bond markets generally; and
- the upgrade of South Africa's sovereign rating during October from a stable to a positive outlook by Fitch Ratings, as well as an upgrade of South Africa's foreign currency debt by Moody's Investors Service in early January 2005.

Yields on long-term government bonds



The downward momentum in the long-term bond yield slowed after the repurchase rate was kept unchanged at the February 2005 meeting of the MPC and retraced part of this downward movement from early March, increasing to 8,77 per cent on 5 April when persistently high oil prices revived inflation concerns. After falling by almost 50 basis points when the repurchase rate was lowered on 14 April, bond yields again drifted higher to 8,50 per cent on 18 May before easing to 7,93 per cent on 27 June. Alongside broadly unchanged domestic inflation, fluctuating oil prices and a slight pick-up in bond yields in developed markets, long-term bond yields inched higher to 8,17 per cent on 19 July. Since then market-positive inflation data and an upgrade of South Africa's external debt rating by Standard & Poor's resulted in long-term bond yields declining to 7,85 per cent on 11 August.

Mirroring bond yields, the returns offered on investment in the bond market, as measured by the All-Bond Index or ALBI of the Bond Exchange and Actuarial Society, improved markedly during 2004. After declining by 1 per cent from December 2003 to April 2004, the monthly closing value of the index increased by 20½ per cent to February 2005 as the domestic inflation outlook improved. Subsequent returns were less impressive: The index then fell back by 4 per cent to March before improving by 6 per cent to July 2005.

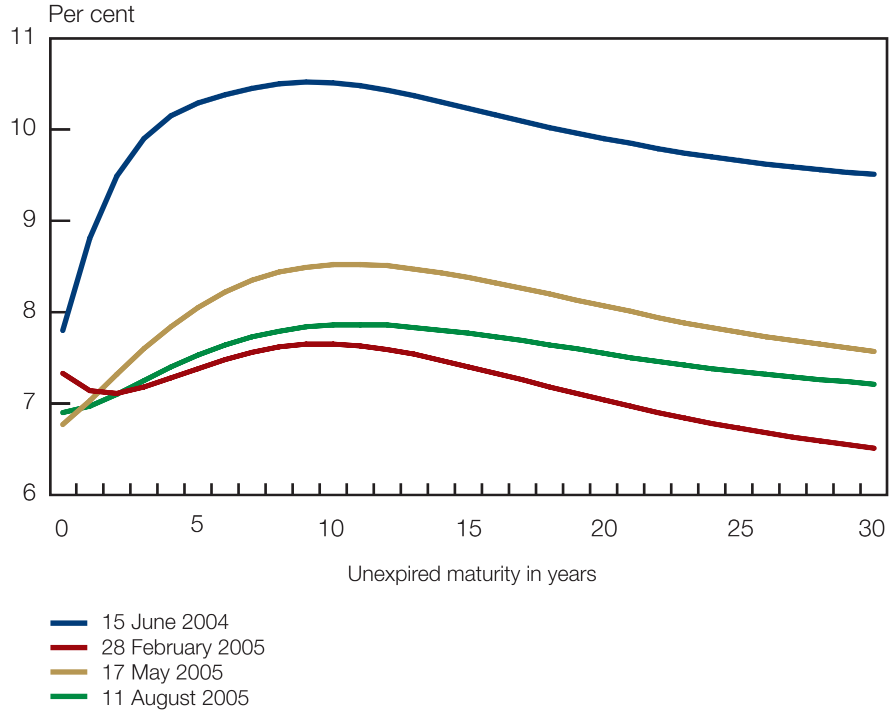
Subdued inflation during 2004 resulted in the *real* or *inflation-adjusted yield on long-term government bonds* (using historical year-on-year increases in CPIX as an indicator of expected future price changes) rising from 4,4 per cent in February 2004 to 5,8 per cent in August, the highest real yield since June 2000. A brisk decline in nominal bond yields brought about a decline in the real yield to 3,9 per cent in December 2004. The real yield then increased and remained relatively stable at a level of around 4,5 per cent in the first six months of 2005 as movements in nominal bond yields broadly matched the movements in the recorded inflation rate over the period.

After edging down by a modest 18 basis points in 2004, the daily average *real yield on government's R189 inflation-linked bond* continued to move lower in 2005, declining markedly from mid-May and reaching a record low of 3,08 per cent at the end of June 2005, 66 basis points lower than at the beginning of the year. The real yield again increased and stood at 3,23 per cent on 11 August. The considerable decrease in yields on inflation-linked bonds during the first half of 2005 widened the gap between yields on conventional bonds and that on inflation-linked bonds and contributed to the recent upward trajectory followed by the *break-even inflation rate.* Subsequent to a sharp decrease from above the 6-per-cent level early in May 2004 to a historical low of 3,66 per cent on 28 February 2005, break-even inflation (a barometer of longer-term inflation expectations) picked up again, reaching 4,56 per cent on 5 April and 4,13 per cent on 11 August.

Responding to the reduction in the repurchase rate in August 2004 and the continued slowing of inflation, the level of the *yield curve* declined substantially from a recent high in June 2004 to record low levels at the end of February 2005. The level of the yield curve moved upwards during March 2005 as the weaker exchange value of the rand and increase in the price of oil stifled expectations of declining inflation. Bond yields across the spectrum of maturities responded to the 14 April 2005 MPC decision to lower the repurchase rate, with a more pronounced decline at the short end of the curve. After moving higher to 17 May alongside a weaker exchange value of the rand, the level of the yield curve again moved lower to 11 August. The slope of the curve also continued to flatten at the short end following the release of better-than-expected inflation figures and the upgrade of South Africa's currency credit rating by Standard & Poor's. The temporary inversion of the curve at the extreme short end was the result of the market pricing in the probability of a rate cut while the focus of the government's issuance programme on longer-term bonds probably contributed to a less downward-sloping longer end of the curve.

South Africa's prudent macroeconomic policies, stable economic growth and substantially stronger foreign exchange position, were recognised by international credit ratings agencies in October 2004 and again in January and August 2005. These re-ratings contributed to a significant decline in the *sovereign risk premium* on South Africa's foreign currency-denominated bonds that are traded in international markets. The differential between the yield on the ten-year South African government US dollar-denominated bond and the yield on United States Federal Government securities of similar maturity declined by 104 basis points from an original differential of 195 basis points at the end of May 2004 to an average differential of 91 basis points in July 2005. The decline in South Africa's sovereign risk premium coincided with a general decline of the yield differentials between emerging markets' sovereign debt and benchmark United States Treasury Bonds. The JP Morgan Emerging Markets Bond Index (EMBI+) declined by 218 basis points from a yield differential of 508 basis points in May 2004 to a record-low differential of 290 basis points in July 2005.

Yield curves



The *currency risk premium* on South African government bonds (measured as the differential between South African government bond yields on rand-denominated debt in the ten-to-twelve-year maturity range issued in the domestic market and dollar-denominated debt issued in the United States market) also declined sharply from 381 basis points in March 2004 to 205 basis points in February 2005. However, the risk premium widened by 102 basis points up to May 2005, before narrowing to July as bond yields in the domestic market declined while the yields on foreign-issued South African bonds increased.

On 14 June 2005, JP Morgan launched its new Government Bond Index-Emerging Markets (GBI-EM+), the first comprehensive global markets index which tracks local currency-denominated bonds issued by governments of emerging-market economies. As a proxy for the tracking of emerging markets globally, the index is expected to provide a benchmark for asset managers. The index currently includes 19 countries from 4 regions. This may ultimately benefit investor interest in South African bonds as seven South African bond issues of different maturities are included, constituting the fourth highest weight of all the countries included in the index.

Financial markets

Structural and regulatory changes in financial markets

Wide-ranging regulatory and legislative reform in the South African financial sector remained focused on modernising the regulatory frameworks, transformation of ownership and staffing of institutions, the promotion of sound business principles and ethics, transparency and accountability. Some of the key developments are discussed below, while others have been dealt with in the section on *Monetary developments and interest rates.*

The verification of client identity by banks and providers of investment services in terms of the Financial Intelligence Centre Act requirements continued according to the set deadlines; the final date – for low-risk clients – is 30 September 2006. Coupled to that was the requirement that financial service providers register with the Financial Services Board, and the emphasis on the accountability of the financial sector in the delivery of financial advice to clients through the Financial Advisory and Intermediary Services Act (FAIS), No 37 of 2002.

At the end of 2004, Parliament passed the Financial Services Ombud Scheme Act, No 37 of 2004. The Act aims at protecting consumers of financial services by expanding and strengthening ombud scheme arrangements designed to resolve complaints resulting from either non-compliance with the provisions of the FAIS Act or where a financial service provider wilfully or negligently rendered an unfair financial service to a client.

During 2004 the National Treasury and the Financial Services Board embarked on a regulatory and policy review of the South African retirement industry. The intention was to update and modernise the current Pension Funds Act, promulgated in 1956, to ensure protection of the interests of members of retirement funds and to enable more people to make adequate provision for retirement while they are still economically active. The envisaged retirement tax reform seeks to contribute to a more consistent and coherent structure and regulation of the broader social security system of South Africa, improve the management of retirement funds and enhance and facilitate adequate retirement savings.

The Securities Services Act, No 36 of 2004, came into operation on 1 February 2005 and replaces the Stock Exchanges Control Act, 1985, the Financial Markets Control Act, 1989, the Custody and Administration of Securities Act, 1992 and the Insider Trading Act, 1998. The objective of the act is to reduce systemic risk and ensure a fair, efficient and secure means of securities trading in South Africa's capital markets, in accordance with international regulatory standards. Under the Act, the JSE Limited (JSE) and the Bond Exchange of South Africa (BESA) will continue to operate as self-regulatory organisations and are obliged to comply with the requirements of the Act with regard to the making of rules and the enforcement thereof.

The Securities Services Act also facilitated the demutualisation of the JSE to become a public unlisted company known as JSE Limited from 1 July 2005. This creates greater flexibility for the JSE in terms of raising capital and creates a more effective market for current rights holders to realise their investment. Demutualisation is an international trend with some of the largest stock exchanges in the world having taken steps in this direction.

Other legislative changes affecting financial markets announced in the Budget of the national government for fiscal 2005/06 include the following:

- A further reduction in the transfer duty rate structure in respect of the acquisition of fixed property, effective from 1 March 2005.

- The domestic interest income tax-exemption threshold was raised from R11 000 to R15 000 for taxpayers under the age of 65, and for taxpayers of age 65 and over it was raised from R16 000 to R22 000, effective from 1 March. The exemption applicable to foreign interest income and dividends was raised from R1 000 to R2 000.

- In order to ensure tax neutrality between companies' debt and equity capital, all financial transaction taxes on the issue of shares will be eliminated, effective from 1 January 2006.

Money market

During the past year the Reserve Bank conducted a review of its money-market operations, which were previously changed in September 2001. As a result, on 25 May 2005, following extensive consultations with market participants, the Bank implemented several changes to its refinancing operations with three aims in view: To streamline the Bank's refinancing operations to make them simpler and more transparent; to encourage the banks to take more responsibility for managing their own individual liquidity needs in the market; and to promote a more active money market in South Africa.

The main changes were the following:

- To assist the banks in tendering, the Bank started announcing its estimate of the average daily market liquidity requirement and the estimated range within which the daily requirement is expected to fluctuate in the coming week, on the Wednesday morning prior to the main weekly repurchase auction. Normally the full amount tendered by each bank would be allotted.

- Whereas previously supplementary square-off tenders at the fixed repurchase rate were frequently conducted, they would henceforth be limited to instances where unexpected developments occurred, giving rise to significant liquidity imbalances. This facility could also be offered towards the end of the reserve maintenance period to assist banks in complying with the averaging of their cash reserves.

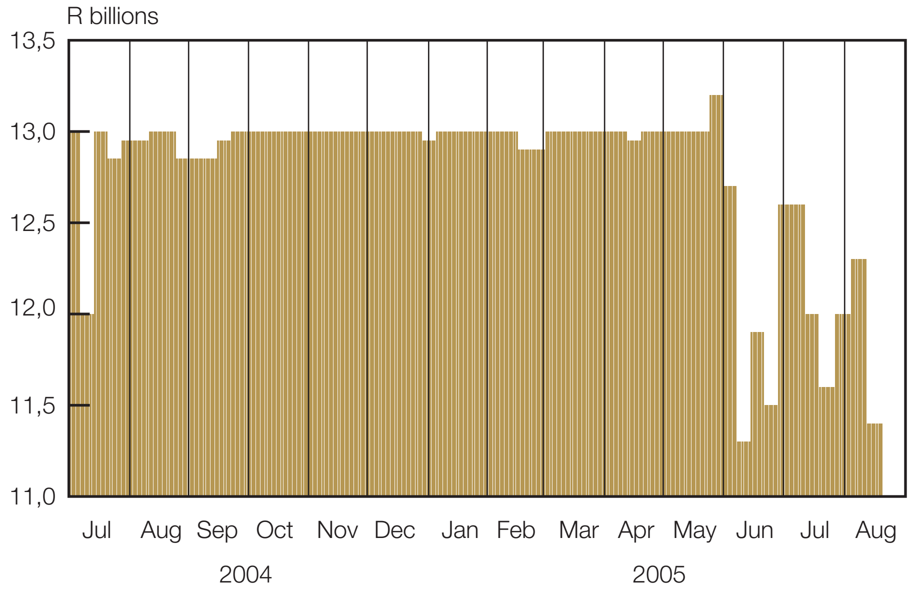
- The rule in terms of which a bank first had to withdraw funds from its cash reserve account before making a deposit was abolished since the supplementary clearing and reverse facilities were phased out as regular features. This was expected to promote more active use of banks' cash reserve balances.

- Standing facilities (previously referred to as final clearing or reverse repurchase tenders) to accommodate banks with short or long liquidity positions were introduced at a spread of 50 basis points above or below the prevailing repurchase rate. The spread was also expected to act as a corridor within which interbank overnight rates would normally vary. These facilities would be available to all banks (both clearing and non-clearing), over and above the weekly main repurchase tenders and access to cash reserves.

- The South African Multiple Option Settlement (SAMOS) system penalty rate at a fixed 500 basis points above the prevailing repurchase rate replaced the marginal lending facility. This facility provides a final but expensive option to bridge banks' temporary liquidity needs, with its high cost encouraging banks to settle their overdrawn positions in the position window period.

However, the central feature of the Bank's operational arrangements – the conduct of repurchase auctions on Wednesdays with a one-week maturity at a repurchase rate fixed at the level announced by the Monetary Policy Committee – remained unchanged. As illustrated in the accompanying graph, the amended operational procedures resulted in variability in the repurchase agreement amounts allotted at the Wednesday auctions. The amounts of repurchase transactions at the weekly main refinancing auctions which, with very few exceptions, had been maintained at a level of R13 billion since 25 September 2003, on occasion in June 2005 receded to as low as R11,3 billion.

Main repurchase accommodation



The most important money-market liquidity flows for 2004 and January to July 2005 are shown in the accompanying table.

Money-market liquidity flows
R billions (easing +, tightening –)

	2004	Jan – Jul 2005
Notes and coin in circulation	-4,2	-0,5
Required cash reserve deposits	-4,9	-1,1
Money-market effect of Reserve Bank's foreign exchange transactions	44,4	27,7
Government deposits with Bank	-0,6	-10,4
Redemption of foreign loans by National Treasury	-10,4	-0,2
Government redemption and interest payments to Bank	-7,3	-10,1
Use of liquidity management instruments*	-11,1	2,1
Outright sales of government bonds	-2,6	0,0
Other items net	-3,3	-6,5
Change in main repurchase amount (decrease +)	**0,0**	**1,0**

* Reserve Bank debentures and reverse repurchase transactions

Following the squaring off of the oversold forward foreign exchange book in February 2004, the Bank continued to increase its foreign exchange reserves through measured buying of foreign exchange from the market, thereby creating rand liquidity. Several mechanisms were utilised to drain the liquidity created. The banks' required cash reserve balances with the Reserve Bank rose considerably in September 2004 as vault cash was no longer allowed as part of qualifying cash reserves; this concluded the phase-out of the vault cash concession which started in September 2001. National Treasury also utilised its rand balances to buy foreign exchange in order to redeem foreign loans, and to make interest and redemption payments on bonds held by the Bank. The level of government deposits with the Bank was also raised.

Furthermore, the outstanding amount of interest-bearing liquidity-draining instruments utilised by the Reserve Bank was also raised and its composition changed over the past 19 months, as shown in the accompanying table. Debentures with a 56-day maturity were first issued on 1 December 2004, and 56-day reverse repurchase transactions were first conducted on 24 March 2005.

Outstanding balances of selected money-market intervention instruments

R billions

End of		Reserve Bank debentures			Reverse repurchase agreements			Total instruments outstanding
		28 days and 91 days	56 days	Total	28 days	56 days	Total	Total
2003:	Dec	3,2	0,0	3,2	5,2	0,0	5,2	8,5
2004:	Jun	5,1	0,0	5,1	10,5	0,0	10,5	15,6
	Jul	9,1	0,0	9,1	12,0	0,0	12,0	21,6
	Aug	9,0	0,0	9,0	11,0	0,0	11,0	20,0
	Sep	7,8	0,0	7,8	9,5	0,0	9,5	17,3
	Oct	8,2	0,0	8,2	10,5	0,0	10,5	18,7
	Nov	9,9	0,0	9,9	11,3	0,0	11,3	21,2
	Dec	8,8	3,1	11,9	7,6	0,0	7,6	19,5
2005:	Jan	12,0	1,2	13,2	11,2	0,0	11,2	24,4
	Feb	12,5	0,0	12,5	7,0	0,0	7,0	19,5
	Mar	10,2	2,8	13,0	5,9	1,3	7,2	20,2
	Apr	6,7	6,2	12,9	4,6	2,5	7,1	20,0
	May	6,1	5,1	11,2	4,7	1,9	6,6	17,8
	Jun	7,3	3,8	11,1	5,3	1,4	6,7	17,8
	Jul	7,5	2,7	10,2	4,0	3,2	7,2	17,4

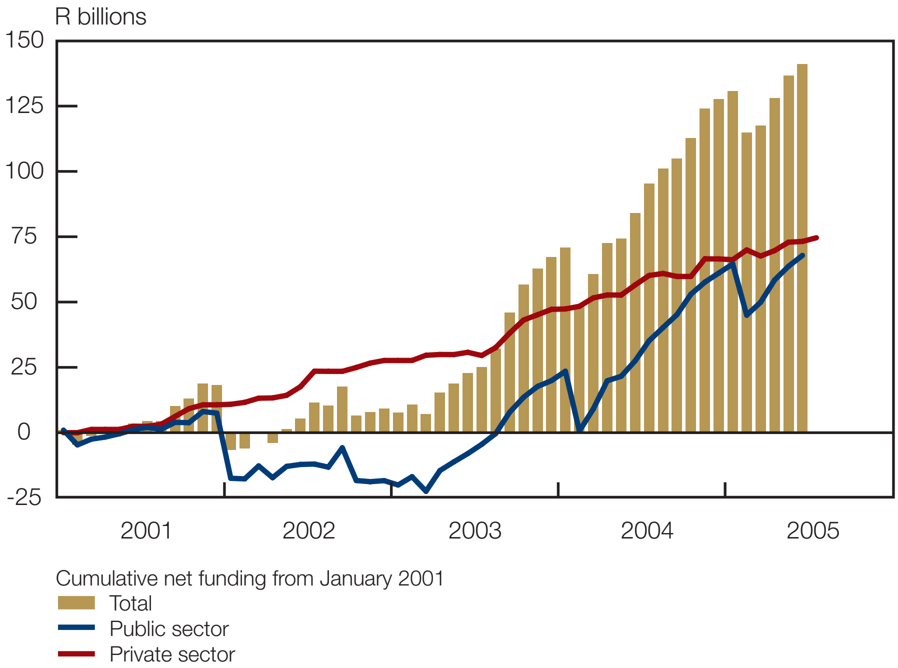
In February and April 2005 the National Treasury issued zero-coupon bonds to the value of R2,5 billion and R4,5 billion, respectively, to the Bank, in order to defray losses which had previously accrued on the Gold and Foreign Exchange Contingency Reserve Account. The zero-coupon bonds issued by the National Treasury were later exchanged for marketable bonds which are used in the conduct of the Bank's open-market operations.

During the past year-and-a-half, the Bank continued to restructure its holdings of interest-bearing government securities by conducting cash-neutral switch auctions and outright sales of government bonds in order to improve the composition of the Bank's portfolio of such bonds. The most significant change in this regard was a set of switch auctions in which the Bank exchanged R3,8 billion in bonds maturing in 2014 for bonds which matured in February 2005.

Bond market

Total net issues of fixed-interest securities by *public-sector borrowers* in the domestic primary bond market amounted to R41 billion in fiscal 2004/05 compared to net issues of R31 billion in fiscal 2003/04. Supported by national government directing its funding strategy more towards the domestic market, sizeable net issues of R52 billion occurred from April 2004 to December. This was reduced by net redemptions of R11 billion in the first quarter of 2005, which included the repayment of the R151 government bond, the second of the three tranches of the R150 government bond. In the second quarter of 2005 net issues amounted to R18 billion.

Funding in the domestic primary bond market



Alongside funding through the existing fixed-interest benchmark bonds, the National Treasury provided for the issuance of three new longer-term bonds in 2005/06. Accordingly, in May 2005 BESA listed the R205 variable coupon bond (maturing in March 2012), the R206 bond with a fixed coupon rate of 7,5 per cent (maturing in January 2014) and the R207 bond with a fixed coupon rate of 7,25 per cent (maturing in January 2020). No new inflation-linked bonds are to be introduced in 2005/06. Since its launch in May 2004 up to the end of July 2005, sales of the RSA Government Retail Bonds have reached R1,52 billion.

Securities of the public sector continued to dominate listings of bonds on BESA. The outstanding nominal value of listed public-sector bonds increased from R432 billion in December 2003 to R473 billion in December 2004. At the end of July 2005 the outstanding nominal value of public-sector bonds listed on the exchange amounted to R485 billion, representing 82 per cent of total bond listings.

National government raised R6,4 billion through the issuance of a US$1 billion ten-year global bond in the international bond markets in June 2004, the only such issue in fiscal 2004/05. Thus far in fiscal 2005/06 revenue overruns enabled National Treasury to cut its net issues of *foreign-currency denominated debt* to below the originally budgeted amount.

In October 2004 the City of Johannesburg announced the launch of a R6 billion six-year funding programme to support its capital investment initiatives. The funding programme includes the issuance of institutional and retail bonds as well as commercial paper, and the utilisation of bank loans. In April 2005 the issuance of an eight-year R700 million bond by the city brought the total nominal value of its bonds in issue to R2,7 billion. The only other municipal bond currently listed on BESA is that of Beacon Bay municipality, with an outstanding nominal value of R1,2 million.

Activity in the corporate bond market continued its rising trend in 2005 as the private sector increasingly sourced funding in the primary bond market. After increasing by R19,3 billion in 2004 the *outstanding nominal value of private-sector loan stock* listed on BESA increased by a further R8 billion in the first seven months of 2005 to reach R86 billion. Asset-backed securitisation and collateral debt obligations – mainly vehicle, credit card and mortgage securitisation – accounted for 56 per cent of the net issues in the first seven months of 2005.

The financing needs of the private sector were furthermore supplemented by the issuance of short-term *commercial paper*. The outstanding nominal value of commercial paper listed on BESA increased by R5,8 billion in 2004 and by a further R3,9 billion in the seven months to July 2005 to reach R20,0 billion. Consistent with the intention to centralise the clearing and settlement of the over-the-counter market, the exchange announced that it facilitated the first electronic settlement of non-listed commercial paper in April 2005. Up to the end of July 177 trades in non-listed instruments were effected through the formal exchange, amounting to R3,4 billion.

Outstanding nominal value of bonds listed on the Bond Exchange of South Africa

	Dec 2003	Dec 2004	Jul 2005	
	R billions	R billions	R billions	Percentage of total
Total securities listed	**500**	**566**	**591**	**100,0**
Public sector	432	473	485	82,1
National government	*364*	*399*	*406*	*68,8*
Local governments	*½*	*2½*	*3*	*0,5*
Public corporations	*67*	*71*	*76*	*12,8*
Private sector	68	93	105	17,9
Bonds	*58*	*78*	*86*	*14,5*
Commercial paper	*10*	*16*	*20*	*3,3*

The value of turnover on BESA of R9,5 trillion in 2004 was 21 per cent less than in 2003. Trading activity in the *domestic secondary bond market* improved somewhat in the second half of 2004, benefiting from the downward movement in bond yields from mid-June and the lowering of the repurchase rate by the Monetary Policy Committee on 13 August. Thus far in 2005 a fair amount of deals were recorded alongside record low bond yields early in the year and a further lowering of the repurchase rate in April. In the seven months to July 2005, turnover exceeded that for the corresponding period in 2004 by 6 per cent. Turnover on BESA has generally been on a declining trend since 2002. The annualised liquidity ratio, measured as the nominal value of bonds traded relative to the nominal value of bonds listed, more than halved from 30,3 in the second quarter of 2002 to 14,1 in the second quarter of 2005.

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, increased markedly from 9 per cent in February 2004 to as high as 17½ per cent in February 2005. In the first seven months of 2005 their participation in the bond market generally exceeded 16 per cent.

On a net basis *non-residents* sold bonds to the value of R4½ billion in the first half of 2004, but this was followed by net purchases of R5 billion in the second half of the year, accelerating to R8 billion in the first seven months of 2005. However, non-residents had been net sellers of South African bonds on a cumulative basis to the amount of R45 billion on a cumulative basis over the period January 2000 to July 2005.

Share market

The total value of equity capital raised in the domestic and international *primary share markets* by companies listed on the JSE increased markedly in 2004 and amounted to R42 billion, nearly double the R23 billion raised in 2003. The resources sector accounted for 62 per cent of the total amount raised in 2004, mainly as a result of the acquisition of complementary businesses by mostly dual-listed companies. While companies in the industrial sector accounted for only 11 per cent of the total capital-raising activity in 2004, they dominated funding activity in the first seven months of 2005, accounting for 58 per cent of the R13 billion raised.

In December 2004 Aquarius Platinum became the first foreign company to list on the JSE utilising the new dispensation that allows for inward bound dual listings of foreign companies. In total 16 new listings of companies occurred on the JSE during 2004 while 39 companies delisted. This was followed by a further 24 delistings and only 8 new listings in the seven months to July 2005, despite the buoyant share market conditions. The reduction in the number of listed companies is partly explained by mergers and acquisitions while a number of smaller, less liquid companies chose to delist as the costs of complying with the JSE's listing requirements reportedly outweighed the benefits of remaining listed. A small number of companies transferred their listing from the main board to the alternative exchange of the JSE for small to medium-sized companies, Alt^{x}.

After a slow start when it opened in October 2003, Alt^{x} gained momentum during 2004 with ten new listings on the exchange. At the end of July 2005 a total of 14 companies were listed on Alt^{x} and their combined market capitalisation amounted to R1,4 billion. This was, however, still only a fraction of the R2 900 billion market capitalisation of companies listed on the main bourse.

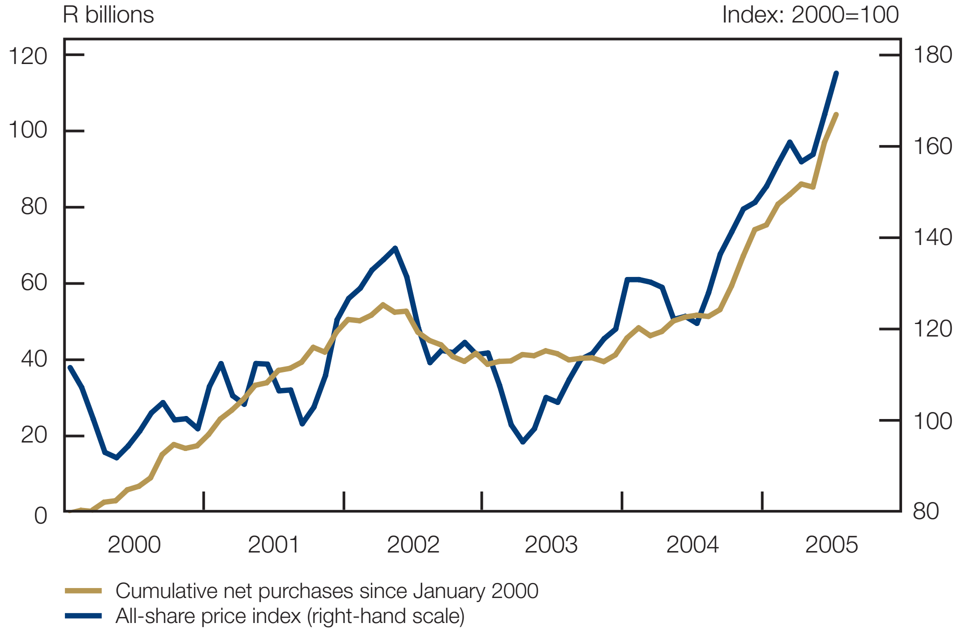
From a recent low in April 2004 the market capitalisation of the JSE increased by 56 per cent to R2,9 trillion in July 2005. The recent growth in market capitalisation exceeded the growth in turnover values, resulting in a decline in market liquidity, measured by turnover as a percentage of market capitalisation, from an average of 50 per cent in 2003 to 49 per cent in 2004 and an annualised 42 per cent in the first seven months of 2005. Turnover in the *secondary share market* nonetheless amounted to a record high of R1,0 trillion in 2004, exceeding turnover in 2003 by 37 per cent. Buoyed by the continued upward trajectory in share prices, trading activity remained brisk in the first seven months of 2005 and amounted to R668 billion, representing an increase of 18 per cent over the turnover in the corresponding period of 2004.

Yield-X, the new interest rate platform of the JSE commenced trading on 28 February 2005. The interest rate exchange is the JSE's fourth electronic clearing and settlement platform, alongside equities, financial futures and agricultural products. The focus of the exchange is on interest rate derivatives with the aim to expand the range of products in the interest rate market, encouraging liquidity and market efficiency. Yield-X operates in a regulated environment overseen by both the JSE and the Financial Services Board. Turnover on this exchange amounted to R5,1 billion up to the end of July 2005.

NewGold bullion debentures, which allow exposure to the rand gold price in units of one hundredth of a fine troy ounce of gold metal, made its debut on 2 November 2004 on the Exchange Traded Funds sector of the JSE. The gold debenture was brought to South Africa by Gold Bullion Securities of London as part of an initiative by the World Gold Council to boost demand for gold. These debentures allow both institutional and retail investors exposure to gold bullion as an investment vehicle. This makes South Africa the third country after Australia and the United States to offer such an investment opportunity in gold bullion through gold debentures. Previously, South Africans primarily invested in gold through Krugerrands, jewellery and gold-mining shares.

Non-residents' holdings of JSE-listed shares increased by R33 billion in 2004 compared with net sales of R0,4 billion in 2003. This was mostly the result of healthy net purchases of shares from October 2004, which resulted in record high net purchases of R21 billion in the fourth quarter of 2004. Non-residents maintained their interest in the share market with further net purchases of R30 billion in the first seven months of 2005. Calculated on a cumulative basis from January 2000 non-residents' net purchases of shares have generally followed the movement in share prices. After accumulating to net purchases of R54 billion in April 2002, this total fell back to a low of R39 billion in January 2003 in concurrence with the sharp decline in share prices. In July 2005 their accumulated net purchases of shares since January 2000 had again accumulated to a high of R104 billion as it accelerated from the second half of 2004 alongside the recovery in the share market.

Cumulative net purchases of shares by non-residents

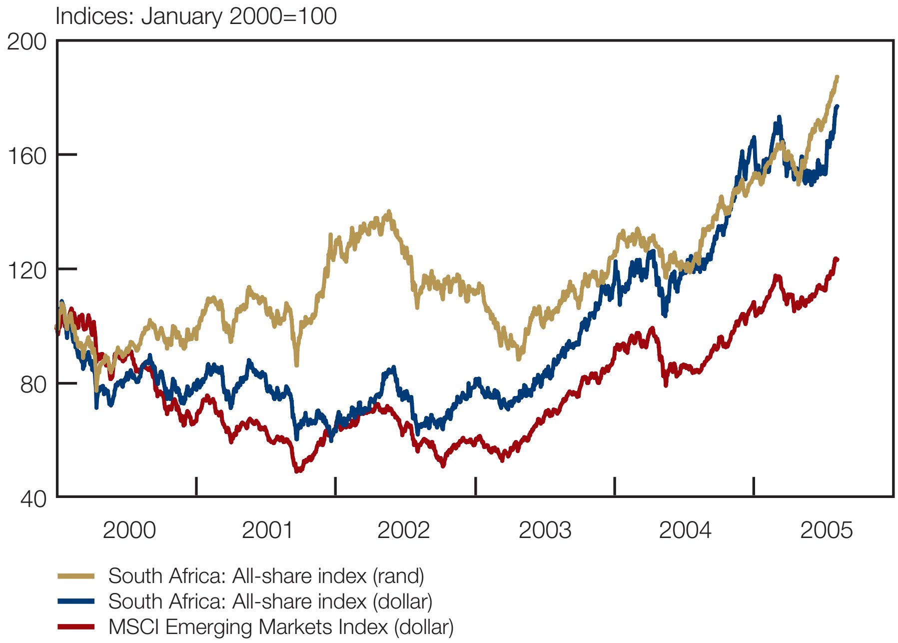


Non-resident participation in the share market, measured as their purchases and sales as a percentage of the total value of purchases and sales on the JSE has, however, moderated from an average of 22 per cent in 2003 to 20 per cent in both 2004 and the first seven months of 2005.

Firm domestic growth, subdued inflation, the more accommodative monetary policy environment and favourable world markets have generally contributed to a bull run in the domestic share market since April 2003. The *daily closing level of the all-share price index* initially posted a gain of 52 per cent from 25 April 2003 to 3 March 2004 before declining to May 2004, following the downward trend of international equity markets in the wake of weaker commodity prices, the higher oil price and rising international interest rates. The all-share index then rebounded from July 2004, reaching consecutive new record highs towards the end of the year and remaining buoyant in the first months of 2005. A new all-time high was reached on 10 August 2005, representing an increase of 61 per cent from the recent low recorded on 18 May 2004.

Emerging markets globally have experienced bull market conditions since April 2003 and the movements displayed by South African share prices broadly matched and exceeded the developments in these markets. After a brief interruption in the first months of 2004 the Morgan Stanley Capital International (MSCI) Emerging Markets Index, which measures the equity market performance in global emerging markets, increased by 49 per cent from 17 May 2004 to a then record high on 28 February 2005. South African share prices, expressed in US-dollar terms, followed a similar upward path and increased by 67 per cent from 14 May 2004 to a new high on 9 March 2005, but fell thereafter when the rand depreciated. Since then the dollar index of South African share prices rebounded from mid-July to reach new all-time highs in August. The MSCI index also fell back from the end of February 2005 although it improved to new record highs in August, increasing by 18 per cent from 18 April to 11 August and recording a somewhat less pronounced increase when compared to the increase of 20 per cent in the equivalent South African all-share dollar index over the same period.

Share prices



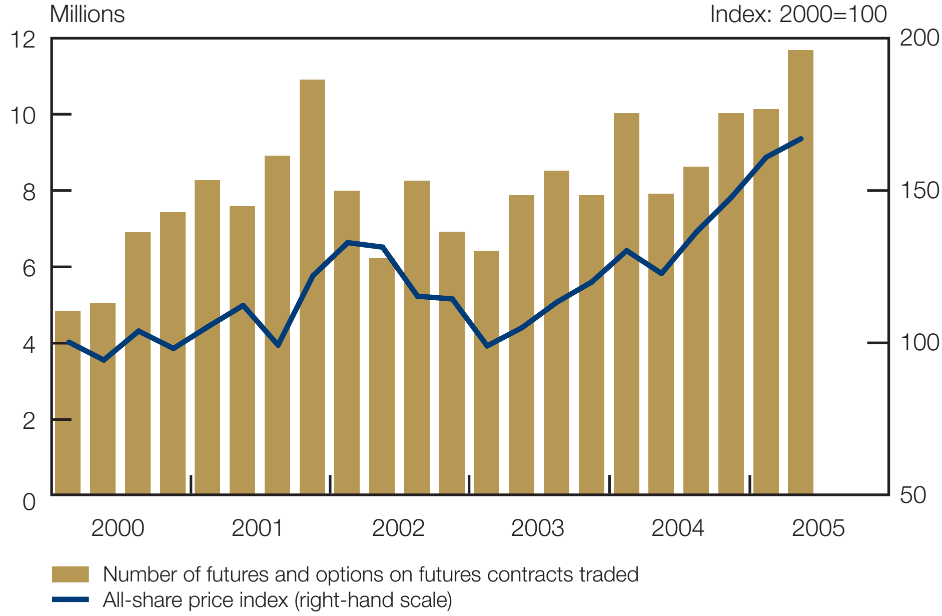
After the sharp increases recorded during the second half of 2004 the rise in domestic share prices lost some momentum during the first half of 2005 as share markets globally became apprehensive of the high energy prices and their expected impact on global growth. Industrial shares, which had increased by 40 per cent from 18 May 2004 to the end of December, subsequently recorded a more subdued increase of 17 per cent to 11 August 2005. Financial shares also recorded more modest gains of 18 per cent thus far in 2005 when compared to gains of 47 per cent recorded during the second half of 2004. By contrast, the resources sector gained a further 37 per cent from the end of 2004 to 11 August, benefiting from improvements in commodity prices and the depreciation of the exchange value of the rand. During 2004 the price index of the resources sector had increased by only 10 per cent from 18 May to the end of December as the resilient exchange value of the rand had an unfavourable impact on the profitability of companies in this sector.

Rising share prices resulted in a decline in the *dividend yield* on all classes of shares from a high of 4,6 per cent in April 2003 to 2,8 per cent in February 2004. The dividend yield then fluctuated with a slight downward bias and came to 2,6 per cent in July 2005 as the increase in share prices exceeded the growth in dividends declared. At the same time the *price-earnings ratio* for all classes of shares on balance decreased from 15,0 in February 2004 to 14,8 in July 2005.

Market for derivatives

The total number of *futures and options on futures contracts* traded on the Financial Derivatives Division of the JSE increased by 19 per cent from 30,7 million contracts in 2003 to a record high of 36,6 million contracts in 2004. Trading volumes followed the recovery in the underlying share market and increased significantly in the second half of 2004. The buoyancy continued into 2005 and the total number of trades in the seven months to July, at 25,1 million, exceeded the total number of contracts traded in the corresponding period of 2004 by 24 per cent.

Financial derivatives



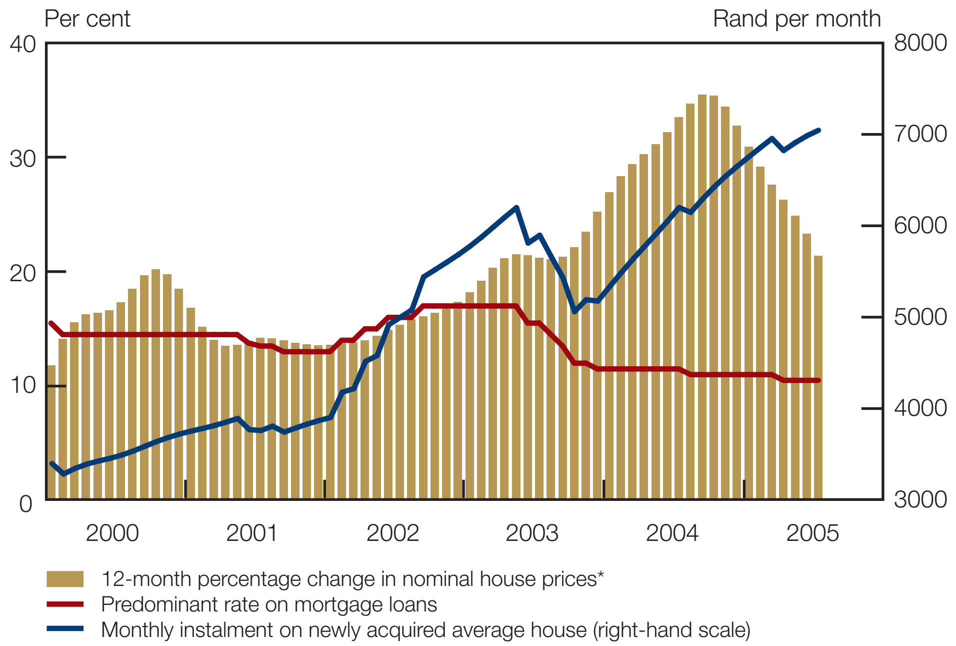
Subsequent to a decline of 70 per cent in 2003 in the number of warrants traded on the JSE, trade volumes were maintained at 5,8 billion contracts in 2004. Trading activity regained momentum in 2005 with the 5,1 billion contracts traded in the first seven months exceeding trade in the corresponding period of 2004 by 49 per cent. The number of warrants listed on the JSE continued to increase steadily from 297 in January 2004 to 358 in July 2005 as the higher trade volumes and rising share prices probably contributed to the renewed interest in the market.

The significant decline in most grain prices, and in particular that of maize, since February 2004 ultimately influenced trade in commodity derivative instruments during 2004 and the first months of 2005. The spot price of white maize as quoted by the JSE Agricultural Products Division declined, on balance, by more than two thirds from a recent high of R1 518 per ton on 2 February 2004 to as low as R471 per ton on 25 February 2005 due to a generous surplus from the previous season, the harvest of the biggest crop in over a decade and the strength of the exchange value of the rand during the period. Subsequently, a weaker exchange value of the rand contributed to maize prices increasing moderately to an average of R606 per ton in July 2005. The number of *commodity futures contracts and options* on such contracts traded on the Agricultural Products Division of the JSE decreased by 18 per cent from 2,3 million contacts in 2003 to 1,9 million contracts in 2004. Turnover remained subdued in 2005, with 16 per cent fewer contracts traded in the first seven months than in the corresponding period of 2004.

Real-estate market

The *real-estate market* remained buoyant in the first months of 2005, alongside strong house price increases in many parts of the world. Nevertheless, the pace of price increases in South Africa seems to have moderated in recent months. The year-on-year rate of increase in *residential property prices*, as measured by Absa, accelerated almost uninterruptedly from January 2002 and exceeded 35 per cent in September 2004, before slowing to 21 per cent in July 2005. The month-on-month rate of increase in house prices also slowed from a most recent high of 3,0 per cent in January 2004 to 0,9 per cent in July 2005.

House prices and mortgage costs



* Source: Absa

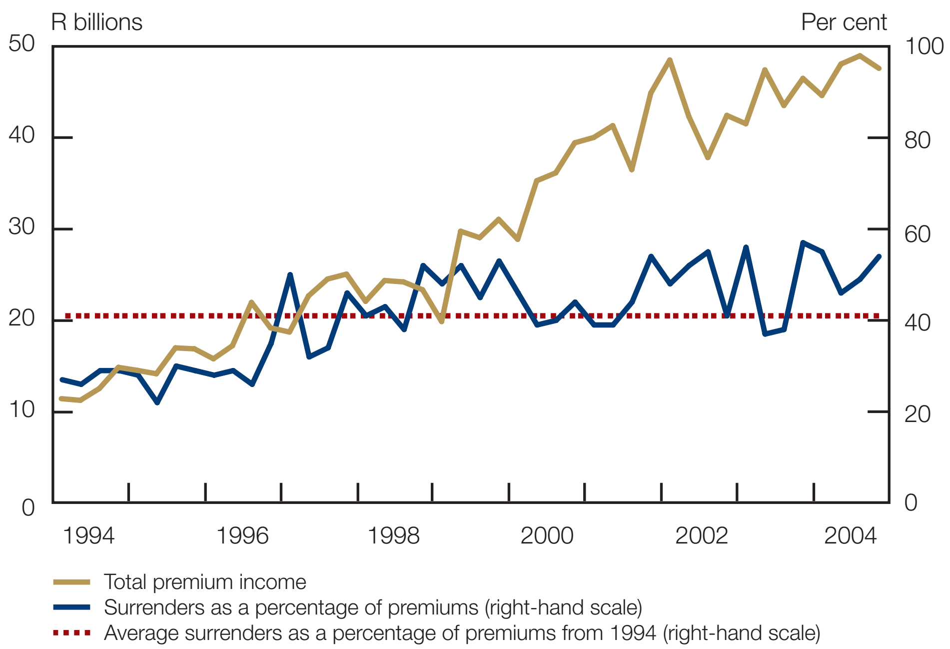
Rising house prices resulted in an increase of 54 per cent in the value of *transfer duty paid* in 2004 and a further increase of 30 per cent in the first six months of 2005 when compared with the same period in 2004. The increase occurred despite the adjustment of transfer duty brackets and the raising of the transfer duty exemption threshold on various occasions by the national government.

While the lowering of interest rates since June 2003 has benefited existing home-owners through reductions in their required mortgage repayments, the rise in house prices has resulted in progressively higher mortgage repayments required for newly acquired property. Mortgage repayments, calculated by using the predominant mortgage rate on a 100-per-cent bond at current house prices in the 80m^2 to 400m^2 size-range, have been rising since November 2003: Notwithstanding the reductions in interest rates, the monthly mortgage instalment of R7 045 on a newly purchased property would be R1 984 more in July 2005 than the instalment on a similar property in October 2003. The fact that continuously higher gross monthly household income is required of potential buyers to finance the repayment on property may partly explain the recent slower rate of increase in property prices.

Non-bank financial intermediaries

Improving domestic bond and equity market conditions generally benefited the investment performance of non-bank financial intermediaries during the course of 2004. After rising by 6 per cent from the end of 2002 to the end of 2003, the total assets of South African long-term insurers increased by a further 15 per cent to December 2004. The long-term insurers also enjoyed an upswing in premiums received during 2004. Premiums received increased by almost 7 per cent in 2004, slightly higher than the growth of 4,6 per cent recorded in 2003, against the background of a continued demand for risk protection and retirement preserving products, and regulatory changes which placed greater emphasis on the conduct and deliverance of sound advice by financial consultants and intermediaries.

Long-term insurers: Premium income and surrenders



Fixed-interest securities form an important component of the assets of long-term insurers as these securities deliver stable cash flows over time. However, long-term insurers' holdings of such securities fell somewhat from 17 per cent of total assets in the first quarter of 2003 to 13 per cent in the fourth quarter of 2004, mainly due to the enhanced returns offered by the share market. Over the same period holdings of shares increased from 42 per cent to 48 per cent of total assets.

The improvement in asset values failed to improve investor confidence as demonstrated by the increase in policy surrenders. Surrenders have grown steadily in nominal terms from R14 billion in 1994 to R97 billion in 2004. Calculated as a percentage of premiums received by long-term insurers, surrenders have increased from an average of 38 per cent in the period 1994 to 1996 to an average of around 49 per cent from 2002 to 2004. The level of surrenders remains a cause for concern to the industry and recent suggestions by the Life Office Association and other role players in the industry, such as reforming upfront costs and commissions on early policy terminations, as well as converting traditional policies to new generation products, are aimed at improving investor confidence and reducing surrenders.

Public finance

Fiscal policy

The Minister of Finance presented the Budget to Parliament on 23 February 2005 against a background of solid domestic macroeconomic performance and a supportive international environment. Sound fiscal policies and a conservative debt management approach over several years contributed to lower debt service costs and provided a platform for a more expansionary fiscal stance. Accordingly, resources would be redirected towards areas of priority, making the Budget more supportive of the poor and more geared towards developing both human and physical capital – indispensable preconditions for long-term growth and sustainable development.

In order to enhance the participation of the poor in economic growth, for the next decade government's development policy will centre around four aspects: Strengthening the capacity to save and undertake capital accumulation; increasing the pace of investment in modern transport, communication, water and energy networks; aligning further education and training to the requirements of the workplace; and addressing barriers to small business development and job creation.

Government reconfirmed its commitment to maintaining a balance between spending on income support and social development, on the one hand, and supporting growth on the other, thereby adhering to its overall social and economic priorities. With a larger proportion of spending on social services going to the poorest 40 per cent of households, the gap between rich and poor is expected to narrow. The social development strategy will entail the enhancement of education and health services, transforming townships into sustainable communities, addressing rural development challenges and crime-reducing initiatives through effective policing and a thorough criminal justice system.

Over the past five years the emphasis of fiscal policy gradually shifted from deficit reduction to growth support, but without compromising the principles of fiscal sustainability. A significantly larger deficit was projected for 2005/06, to be followed by a slight further increment in the deficit in the subsequent two years. At the same time the Budget would continue to support economic growth through moderate tax relief to both companies and individuals, keeping the overall tax burden at around 25 per cent of gross domestic product.

In order to attain this goal, in recent years the South African tax system has been thoroughly modernised. Far-reaching reforms to the income tax structure and administration have resulted in improvements in tax compliance and tax morality. These reforms and an upswing in economic activity led to strong growth in tax collections, enabling the government to reduce its budget deficit while spending more on service delivery. Government also encouraged domestic development and growth through revenue-related measures – e.g. by providing tax relief to individual and corporate taxpayers, and introducing tax incentives which encourage capital formation, job creation and enhanced international competitiveness of the business sector.

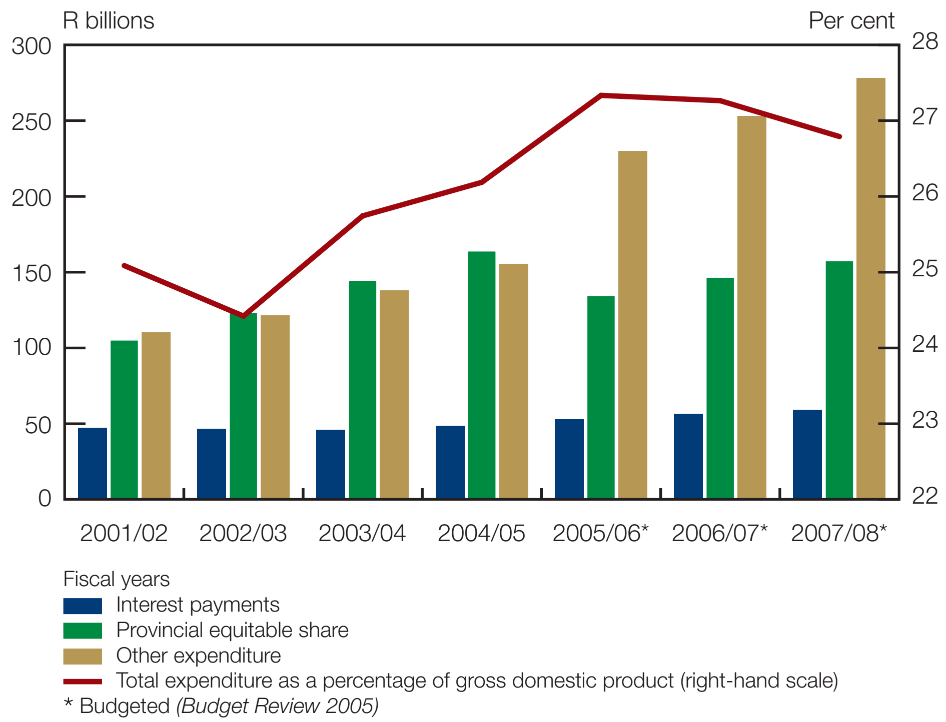
Against the backdrop of an affordable and sustainable budget deficit, South Africa's public debt has stabilised as a percentage of gross domestic product. As part of the public debt management strategy, an increase in foreign currency-denominated debt as a portion of total government loan debt is foreseen, as well as the restructuring of the maturity profile of loan debt and the introduction of new funding instruments. Government reaffirmed its intention to actively manage its debt portfolio with the aim of minimising the risk and cost of funding, and to ensure a liquid market for trading in government securities. Fiscal prudence has led to declining interest costs, which enhanced government's flexibility in conducting fiscal policy, allowing it to contemplate higher levels of social spending without imposing a higher tax burden on the economy or increasing its borrowing requirement to unsustainable levels.

National government expenditure

National government expenditure in fiscal 2004/05 amounted to R368 billion, implying an increase in the ratio of national government expenditure to gross domestic product from 25,7 per cent in fiscal 2003/04 to 26,2 per cent in fiscal 2004/05. The increase in this ratio in recent years bears testimony to the easier fiscal policy stance adopted by government from 2001.

The year-on-year rate of increase in national government expenditure declined from 12,8 per cent in fiscal 2003/04 to 12,0 per cent in fiscal 2004/05 – close to the original budget projection of 12,2 per cent. The rate of increase in national government expenditure in fiscal 2004/05 was higher than the average year-on-year rate of increase of 9,0 per cent in the five fiscal years preceding 2003/04.

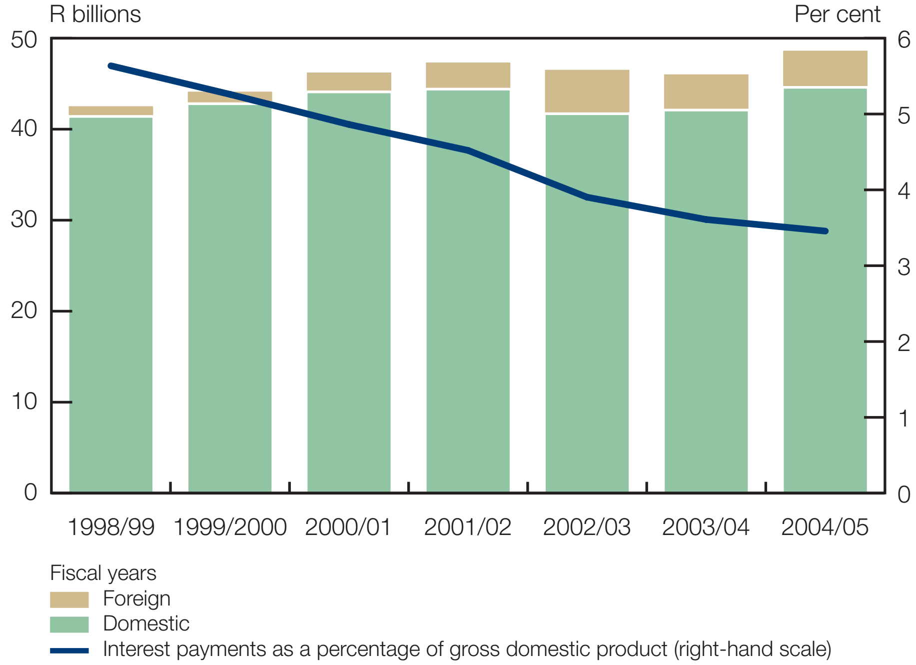
Total expenditure by national government



The marginally lower-than-budgeted expenditure in 2004/05 can partly be attributed to lower interest payments on national government debt. Interest payments increased by 5,6 per cent to amount to R48,7 billion in fiscal 2004/05. The growth in interest payments was lower than the originally budgeted increase of 8,9 per cent. The strengthening of the exchange value of the rand, together with lower domestic interest rates, contributed towards the saving on interest payments, as did a smaller deficit that needed to be financed.

In fiscal 2004/05, interest payments as a ratio of gross domestic product amounted to 3,5 per cent – well below the 5,6-per-cent level recorded as recently as fiscal 1998/99. Interest payments as a ratio of gross domestic product were originally budgeted to amount to 3,8 per cent in fiscal 2004/05.

Interest payments by national government



Non-interest recurrent expenditure, mainly consisting of transfers to provincial governments, amounted to R314 billion in fiscal 2004/05 which was 12,9 per cent more than a year earlier. Nationally collected revenue transferred to provinces as their equitable share constituted more than half of this amount in 2004/05. These transfers are projected to decrease over the medium term, due to a shift in social grants transfers from provinces to the National Department of Social Development. The *Budget Review 2005* announced that a National Social Security Agency is being established, bringing a shift in social grant funding from the provincial to the national sphere.

Government consumption expenditure was budgeted to continue rising steadily alongside increased investment spending. *Real* non-interest expenditure increased by about 9,0 per cent in fiscal 2004/05 and is expected to increase at an average annual rate of 5,5 per cent over the three-year budget period. Non-interest spending plans allow for expanded access to social services, improving the livelihood of the poor and raising the efficiency of public-service delivery. The 2005 Budget provided for increased allocations to improve the conditions of employment, enhance pay progression, and provide for career-pathing and performance-related remuneration of public servants. This was especially geared towards police, teachers and social workers.

Expenditure on capital assets as a proportion of total spending remained at a low level in 2004/05 and amounted to 1,6 per cent of total national government spending, virtually the same as in the previous fiscal year. Other tiers within the public sector are expected to play a much larger role in reducing backlogs in economic infrastructure, involving areas such as transport and logistics infrastructure, electricity generation, and telecommunication. Nevertheless, the year-on-year rate of increase in payments for capital assets at national government level was 18,6 per cent in fiscal 2004/05.

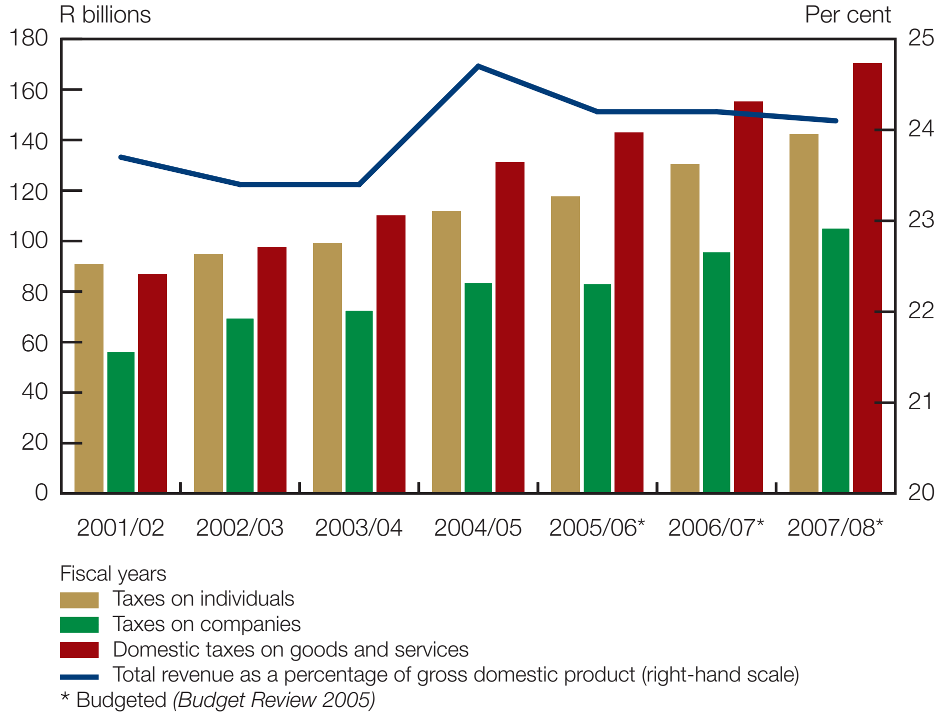
Total national government expenditure was estimated to amount to R418 billion in fiscal 2005/06, representing a year-on-year rate of increase of 13,5 per cent. It was estimated that national government expenditure will increase at an average annual rate of 10,4 per cent over the medium term. As a ratio of estimated gross domestic product, national government expenditure is estimated to be kept at around 27 per cent over the three-year period.

National government revenue

The *Statement of National Revenue, Expenditure and Borrowing* indicates that unaudited national government revenue amounted to R347 billion in fiscal 2004/05 and that it increased at a year-on-year rate of 16,2 per cent – substantially higher than the originally budgeted rate of increase of 9,4 per cent.

The rate of increase in national government revenue in fiscal 2004/05 was substantially higher than the 7,2-per-cent increase recorded in the previous fiscal year, and also appreciably higher than the average year-on-year rate of increase of 11,2 per cent in the five fiscal years preceding 2003/04. The contribution made by broadening the tax base and pursuing greater efficiency in tax collections is evident from the pick-up in the inflation-adjusted rate of increase in government revenue from an average of

Major components of national government revenue



3,0 per cent in the fiscal years 1999/2000 to 2003/04, to no less than 12,1 per cent in fiscal 2004/05.

As indicated in the accompanying table, almost all categories of revenue outperformed the original budget estimates. Taxes on income, profits and capital gains rose at a higher rate than the originally budgeted growth rate, mainly as a result of a strong increase in company income tax collections. Taxes on property continued to reflect the robust trading activity in the real-estate market. Domestic taxes on goods and services also grew strongly, indicating the continued buoyancy in consumer spending. The strong growth in taxes on international trade and transactions reflected rising imports, in turn related to buoyant domestic expenditure and the relative strength of the exchange value of the rand.

National government revenue in fiscal 2004/05

Revenue source	Originally budgeted 2004/05		Preliminary outcome 2004/05	
	Originally budgeted R billions	Percentage change*	Actual R billions	Percentage change*
Taxes on income, profits and capital gains	189,2	10,0	195,6	13,7
Payroll taxes	4,3	10,4	4,4	14,0
Taxes on property	6,9	2,4	9,0	34,4
Domestic taxes on goods and services	121,5	10,3	131,3	19,2
Taxes on international trade and transactions	10,5	24,5	13,3	58,5
Other revenue	7,9	6,2	7,0	-6,7
Less: SACU** payments	13,3	37,1	13,3	37,1
Total revenue	**327,0**	**9,4**	**347,3**	**16,2**

* Fiscal 2003/04 to fiscal 2004/05
** Southern African Customs Union

The *Budget Review 2004* provided for a sharp increase in transfers to the SACU partners – Botswana, Lesotho, Namibia and Swaziland – which came into effect from April 2004, thereby leaving less funds accruing to the South African government. SACU payments are budgeted to decrease somewhat in fiscal 2005/06 due to the introduction of a new formula.

The total revenue of national government is estimated to amount to R370 billion in fiscal 2005/06, representing a year-on-year rate of increase of 6,5 per cent. It was estimated that national government revenue will increase at an average annual growth rate of 8,6 per cent over the current three-year planning horizon. The strong growth in revenue created room for some tax relief, budgeted to amount to R9,4 billion in fiscal 2005/06. The tax framework for the medium term aims to reinforce the current momentum of growth in the South African economy, while contributing to broader participation and small business development.

National government revenue as a ratio of gross domestic product amounted to 24,7 per cent in fiscal 2004/05, compared with 23,4 per cent in the previous two fiscal years. Around these levels, government is confident that sustainable development can proceed without being hampered by excessive taxation. Accordingly, national government revenue is estimated to average 24,2 per cent of gross domestic product over the current three-year budget cycle.

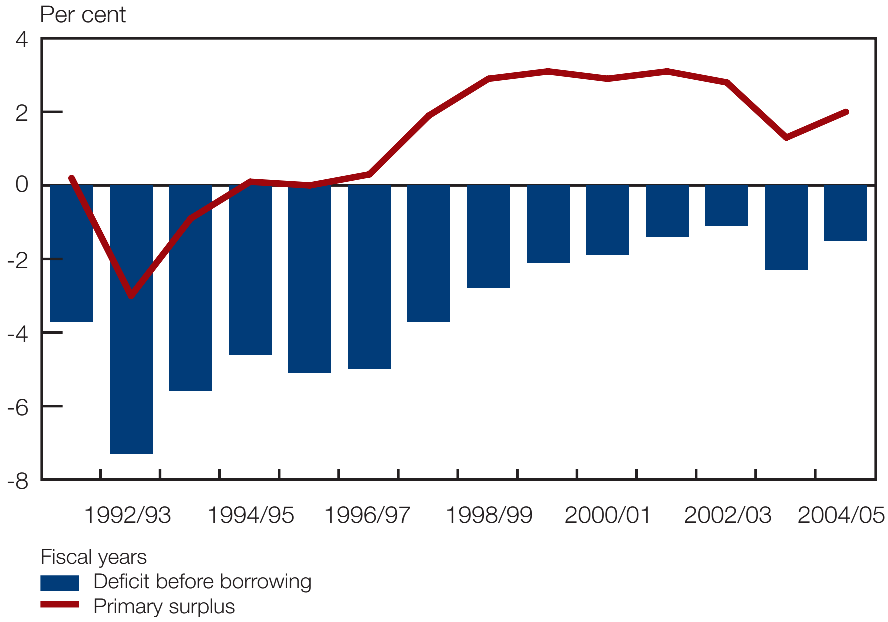
National government deficit

The net result of the higher-than-budgeted revenue and lower-than-budgeted expenditure in fiscal 2004/05 was a cash book deficit of R20,8 billion, roughly half the originally budgeted amount of R41,9 billion. The national government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 1,5 per cent in fiscal 2004/05 compared with a ratio of 2,3 per cent recorded in the previous fiscal year. The deficit ratio recorded in fiscal 2004/05 is also well below the originally budgeted ratio of 3,1 per cent.

The fiscal policy stance in the past five years has shifted emphasis from lowering the deficit to supporting economic growth without jeopardising long-term fiscal sustainability. From its exceptionally low level in 2004/05, the deficit is expected to rise and be maintained at a level of around 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) remains at levels consistent with fiscal sustainability. It reached a surplus of 2 per cent of gross domestic product in fiscal 2004/05, higher than the 1,3 per cent recorded in the previous fiscal year. A decrease to 0,3 per cent is envisaged for fiscal 2005/06 and fiscal 2006/07, after which it is expected to rise slightly to 0,5 per cent in fiscal 2007/08.

National government balances as a percentage of gross domestic product

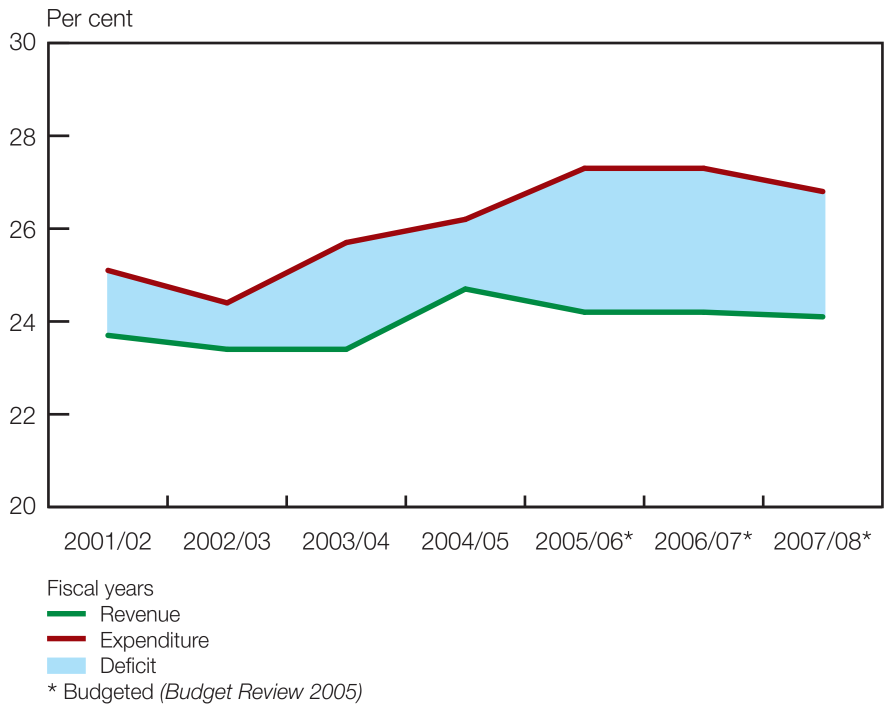


Financing of national government deficit

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-flow deficit amounted to R15,9 billion in fiscal 2004/05. A year earlier, the cash-flow deficit stood at R28,4 billion.

National government's net borrowing requirement in fiscal 2004/05 was affected by extraordinary payments and receipts. Included among extraordinary *payments* were the payments made by the National Treasury to the South African Reserve Bank in April 2004 and February 2005 of R7,0 billion and R2,5 billion, respectively. These were partial payments for the liability resulting from foreign exchange losses in years past, which by law accrue to the Gold and Foreign Exchange Contingency Reserve Account. Government also incurred a cost of R1,3 billion on the revaluation of foreign loans at redemption in fiscal 2004/05. Although the extraordinary *receipts* were originally budgeted to amount to R2,7 billion in fiscal 2004/05 – mainly proceeds expected to be derived from the restructuring of state assets – only R29 *million* was collected from this source.

National government finances as a percentage of gross domestic product



These extraordinary transactions increased the net borrowing requirement of the national government to R27,0 billion in fiscal 2004/05, compared with a net borrowing requirement of R32,4 billion recorded a year earlier. The greater part of national government's net borrowing requirement in fiscal 2004/05 was financed through the issuance of bonds in the domestic capital market, as indicated in the table on the following page.

Domestic long-term funding in fiscal 2004/05 was obtained at an average rate of 9,2 per cent per annum. Domestic short-term instruments were sold at an average rate of 7,5 per cent per annum. These yields can be compared with the budget assumptions of 9,0 per cent and 9,9 per cent, respectively.

The National Treasury launched new fixed-income bonds in May and August 2004, coded R203 and R204, respectively. From May 2004 to March 2005 these bonds raised R19,6 billion for the National Revenue Fund. In May 2004, the National Treasury launched the RSA Government Retail Bond, which yielded a total of R1,3 billion from May 2004 to March 2005.

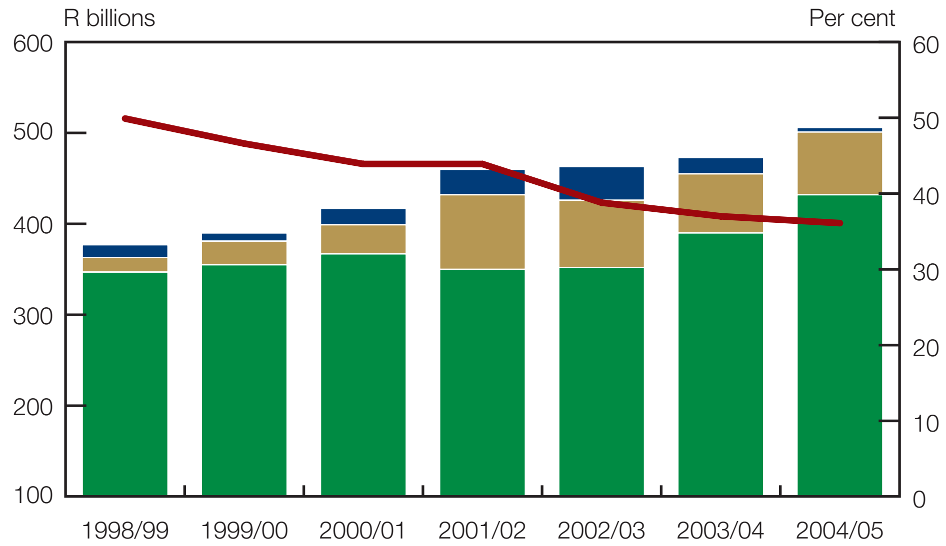
National government financing in fiscal 2004/05
R billions

Item or instrument	Originally budgeted	Actual
Deficit	**41,9**	**15,9***
Plus: Extraordinary payments	7,0	9,8
Cost on revaluation of foreign loans at redemption	2,2	1,3
Less: Extraordinary receipts	2,7	0,0
Net borrowing requirement	**48,4**	**27,0**
Treasury bills	6,0	6,2
Domestic government bonds	34,3	33,2
Foreign bonds and loans	8,1	5,8
Changes in available cash balances**	0,0	-18,2
Total net financing	**48,4**	**27,0**

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

Net issues of foreign bonds and drawings on foreign loans amounted to R5,8 billion during fiscal 2004/05. In June 2004, the National Treasury issued a 10-year global bond yielding R6,4 billion. Net foreign funding also included amounts drawn on the export credit facility which had been arranged for the financing of the Strategic Defence Procurement Programme to the amount of R3,4 billion.

Total national government debt



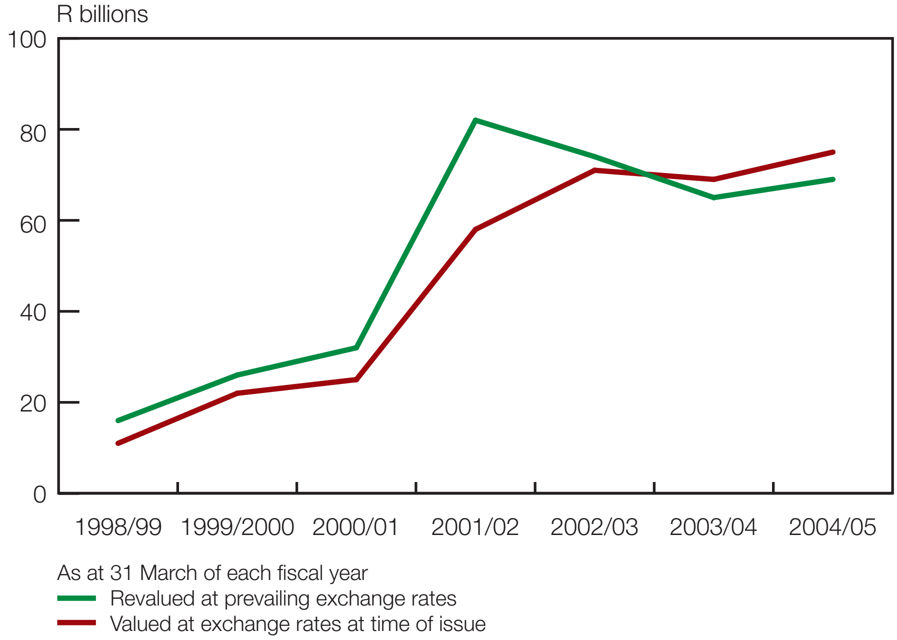
As at 31 March of each fiscal year
Gold and Foreign Exchange Contingency Reserve Account
Foreign debt
Domestic debt
Total debt as a percentage of gross domestic product (right-hand scale)

The average maturity of the foreign marketable bonds of national government decreased slightly from 79 months at the end of March 2004 to 78 months at the end of March 2005, while the maturity of domestic marketable bonds increased slightly from 98 months to 99 months over the same period.

The financial activities of national government resulted in an increase in government's bank balances from R12,7 billion at the end of March 2004 to R30,9 billion at the end of March 2005.

The net borrowing requirement of the national government, together with the discount on new government bonds issued, led to an increase in the total loan debt of national government from R455,1 billion at the end of March 2004 to R501,7 billion at the end of March 2005. The share of foreign loans in the total loan debt decreased slightly from 14,2 per cent at the end of March 2004 to 13,8 per cent at the end of March 2005. Since fiscal 2003/04, foreign debt revalued at prevailing exchange rates has been lower than the rand value of foreign debt as at the time of incurring the debt. This stood in contrast to the four fiscal years preceding 2003/04, and reflected the effect of the strengthening exchange rate of the rand on the outstanding value of foreign bonds and loans in rand terms.

Total foreign debt of national government



It was also announced that the balance on the Gold and Foreign Exchange Contingency Reserve Account amounted to R5,3 billion on 31 March 2005 compared with R18,0 billion a year earlier. These transactions brought the total debt of national government to R507,0 billion at the end of March 2005 compared with R473,1 billion

Gold and Foreign Exchange Contingency Reserve Account
R billions

Date	
Balance as at 31 March 2004	18,0
Minus payment by Treasury, 1 April 2004	-7,0
Minus payment by Treasury, 25 February 2005	-2,5
Minus forward cover and revaluation profits, 2004/05	-3,2
Balance as at 31 March 2005	5,3

at the end of March 2004. As a ratio of gross domestic product, total national government debt decreased from 37,0 per cent at the end of March 2004 to 36,1 per cent at the end of March 2005. Government-guaranteed debt also declined from R79,6 billion at the end of March 2004 to R73,9 billion at the end of March 2005.

General government finance

The borrowing requirement of the consolidated general government shrank from a high of 9,0 per cent of gross domestic product recorded in fiscal 1993/94 to 2,4 per cent in fiscal 2004/05. Over the course of the next three fiscal years, the borrowing requirement is projected to average 3,2 per cent of gross domestic product. This increase reflects the priority which government assigns to the expansion of investment and other spending in order to meet developmental objectives within a sound and sustainable budget framework.

An analysis of the *Provincial Revenue Fund Statements* indicates that provincial governments recorded a cash *surplus* of R2,3 billion in fiscal 2004/05 compared with a cash deficit of R2,2 billion in fiscal 2003/04. This can be attributed to increased saving as well as underspending by provincial governments relative to budget allocations.

The increase in local government allocations, as stated in the *Budget Review 2005*, reaffirms government's commitment to support local governments to improve delivery of municipal services, specifically water and electricity to poor households, and to maintain and extend municipal infrastructure. Preliminary local government statistics indicate that

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

Spending category	Percentage of total expenditure		Average growth 2004/05 – 2007/08 Per cent
	2004/05[1]	2007/08[1]	
General government services and unallocatable expenditure	**6,7**	**7,6**	**14,6**
Protection services	**16,3**	**15,5**	**8,2**
Defence and intelligence	5,7	4,9	4,4
Public order and safety[2]	10,5	10,6	10,2
Community and social services	**51,8**	**51,8**	**9,7**
Education	19,6	18,7	8,1
Health	11,0	10,9	9,4
Social security and welfare	16,3	16,9	11,2
Housing and community services[3]	5,0	5,3	11,6
Economic services	**12,7**	**13,5**	**12,2**
Fuel and energy	0,6	0,6	10,3
Agriculture, forestry and fishing	1,9	2,4	18,9
Mining, manufacturing and construction	0,4	0,5	12,7
Transport and communication	4,6	4,8	11,4
Other economic services[4]	5,1	5,2	10,5
Interest	**12,5**	**11,5**	**6,7**
Total	**100,0**	**100,0**	**9,7**

1 *Budget Review 2005*, adjusted for comparability
2 Including police, prisons and justice
3 Including recreation and culture as well as sport services
4 Including water schemes, tourism, labour, environmental protection and related services

their combined cash deficit for fiscal 2004/05 amounted to R8,6 billion, significantly more than the deficit of R5,1 billion recorded a year earlier. The financial position of some local governments continued to be adversely affected by non-payment for services rendered.

The deficit of the consolidated central government (i.e. national government, extra-budgetary institutions and social security funds) declined from R28,6 billion in fiscal 2003/04 to R26,7 billion in fiscal 2004/05, mainly due to the revenue overrun of national government.

As indicated in the table on the previous page, spending on community and social services remains the most important and largest functional category of government spending and is projected to amount to 51,8 per cent of the projected expenditure by consolidated national and provincial governments and social security funds in fiscal 2007/08. Spending on these services lays the foundation for future growth through human capital development and provides direct support to the poor. This type of spending is expected to increase at an average annual rate of 9,7 per cent over the three-year budget cycle.

The increase in the spending allocated to public order and safety indicates government's commitment to improving safety and security for all citizens. Interest as a percentage of total expenditure is expected to decline, thus making more funds available to be spent on other essential services.

The increase in general government services can mainly be attributed to the inclusion of a contingency reserve which is planned to rise from R2,0 billion in fiscal 2005/06 to R8,0 billion in fiscal 2007/08. The contingency reserve provides for unforeseen and unavoidable spending in all functional areas.

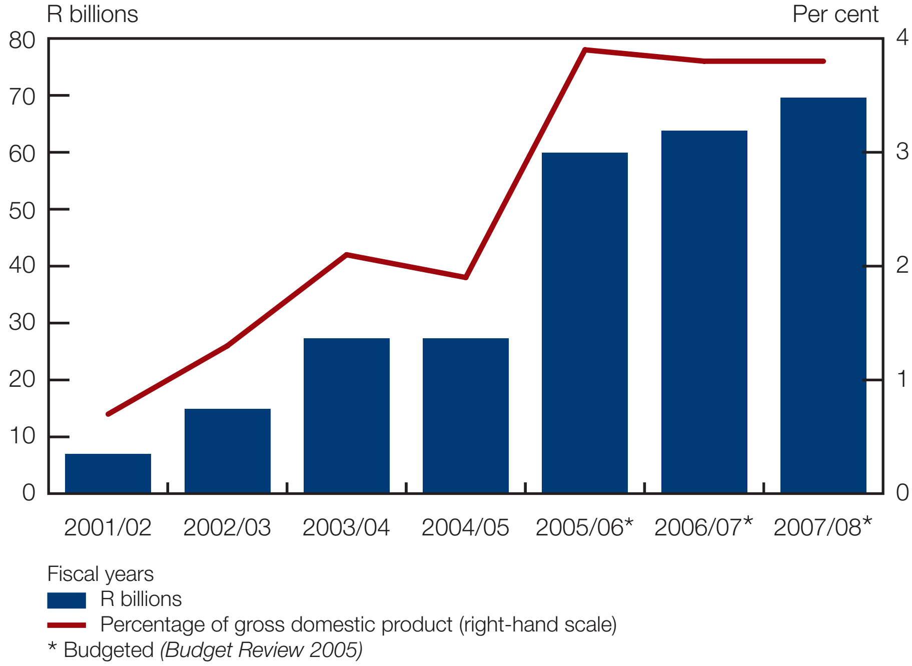
Non-financial public-sector borrowing requirement

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) remained virtually the same as in the previous fiscal year, amounting to R27,3 billion in fiscal 2004/05. The revenue overrun of national government in 2004/05, together with a decrease in the financial *surplus* of extra-budgetary institutions and social security funds and the turnaround in the financial position of provincial governments from a deficit to a surplus, contributed to this healthy state of affairs. The non-financial public-sector enterprises and corporations recorded a lower surplus in fiscal 2004/05 compared with the previous fiscal year, essentially as a result of higher capital expenditure which included the acquisition of aircraft by South African Airways.

It is expected that investments by state enterprises will require significant additional borrowing. Eskom's five-year infrastructure investment plan involves expenditure of R110 billion of which R56 billion is to be invested over the medium term, while Transnet's capital formation will amount to R50 billion in total, including R30 billion which is to be invested during the three-year budget period.

As a ratio of gross domestic product, the borrowing requirement amounted to 1,9 per cent in fiscal 2004/05, compared with 2,1 per cent in the previous fiscal year. Medium-term estimates contained in the *Budget Review 2005* indicate that the borrowing requirement of the public sector will average 3,8 per cent of the estimated gross domestic product from 2005/06 to 2007/08.

Non-financial public-sector borrowing requirement



National government finance in the April-June quarter of fiscal 2005/06

National government revenue rose strongly in the first quarter of fiscal 2005/06, resulting in a cash-flow deficit of R8,2 billion compared with R11,7 billion in the same period of the previous fiscal year. After taking into account the extraordinary payments and the cost on revaluation of foreign loans at redemption, the net borrowing requirement amounted to R12,7 billion in the period April to June 2005. During the quarter the National Treasury issued 273-day Treasury bills for the first time, and also launched a new variable-rate bond redeemable in 2012 and a new fixed-coupon bond maturing in 2020.

National government financing in fiscal 2005/06
R billions

Item or instrument	Originally budgeted 2005/06	Actual April – June 2005
Deficit	**48,0**	**8,2***
Plus: Extraordinary payments	7,0	4,5
Cost on revaluation of foreign loans at redemption	0,7	0,0
Less: Extraordinary receipts	1,0	0,0
Net borrowing requirement	**54,7**	**12,7**
Treasury bills	5,0	8,3
Domestic government bonds	26,3	17,2
Foreign bonds and loans	12,8	0,2
Change in available cash balances**	10,6	-13,0
Total net financing	**54,7**	**12,7**

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