Annual Economic Report

2007

South African Reserve Bank

Annual Economic Report

2007

South African Reserve Bank

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-seventh ordinary general meeting to be held on 20 September 2007. The review also forms part of the South African Reserve Bank's report to Parliament in terms of section 31 of the South African Reserve Bank Act No 90 of 1989.

Enquiries relating to this Report should be addressed to:
The Executive General Manager and Chief Economist
Research Department
South African Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27-12-3133668/3676

http://www.reservebank.co.za/aer

ISSN 0081-2528

Contents

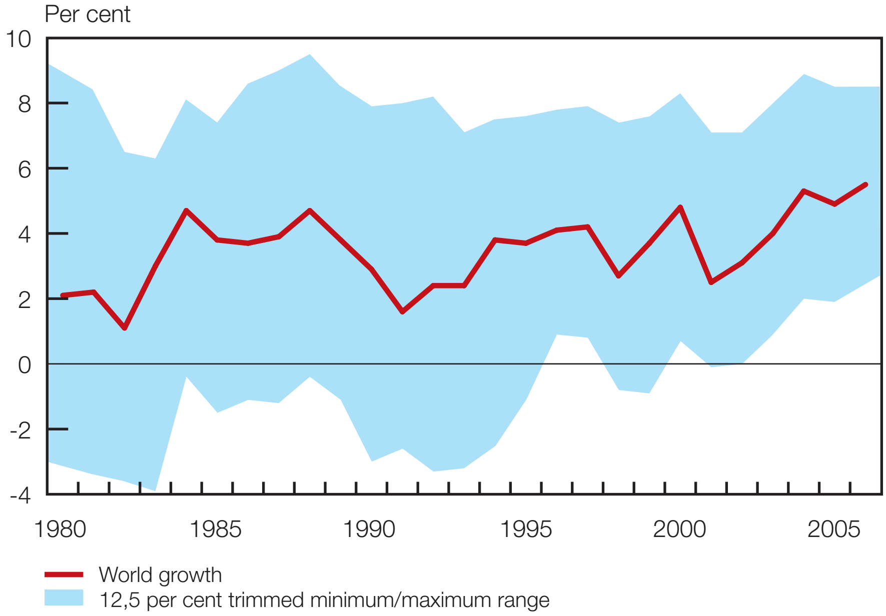
Annual Economic Report 2007

Introduction	1
Domestic economic developments	6
Domestic output	6
Domestic expenditure	11
Factor income	17
Gross saving	19
Business cycle developments	21
Employment	22
Labour cost and productivity	24
Prices	25
Foreign trade and payments	29
International economic developments	29
Policy issues and trade reforms	32
Exports	33
Imports	36
Net service, income and current transfer payments	37
Terms of trade	38
Financial account	38
Foreign debt	42
International reserves and liquidity position	43
Exchange rates	44
Monetary developments and interest rates	46
Structural and regulatory issues	46
Money supply	49
Credit extension	51
Interest rates and yields	54
Financial markets	59
Structural and regulatory changes in financial markets	59
Money market	61
Bond market	63
Share market	66
Market for exchange-traded derivatives	68
Real-estate market	69
Non-bank financial intermediaries	70
Public finance	71
Fiscal policy	71
National government expenditure	71
National government revenue	72
National government deficit	74
Financing of national government deficit	75
General government finance	77
Non-financial public-sector borrowing requirement	79

Introduction

The global economic setting continued to be favourable during the past year. World economic growth was strong in 2006 and is expected to broadly retain its momentum in 2007. At the same time, individual country growth rates have gradually become more uniform with fewer outliers as economic policy frameworks have become more focused on sustainability and soundness. The fact that aggregate growth was more consistent also contributed to individual countries' economic stability, as did the continued strength of commodity prices.

World growth in real gross domestic product and range of growth rates for individual countries



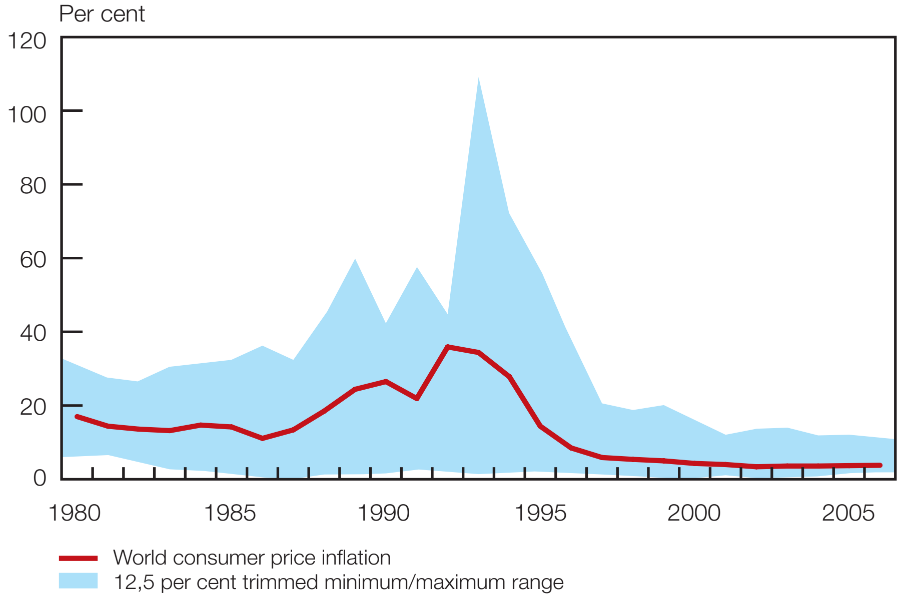
For each year, countries were ranked by growth rate. The 12,5 per cent of countries at the top and 12,5 per cent at the bottom were excluded as outliers; the range shown relates to the growth rates of the 75 per cent of countries in the middle of the distribution.

Source: IMF *World Economic Outlook Database*, April 2007, and own calculations

A broadly similar observation may be made with regard to inflation: In recent years global average inflation has reached fairly low levels, while the dispersion of individual country inflation rates has also narrowed considerably, with the exception of a small number of outliers.

Although consumer price inflation remained moderate in most parts of the world over the past year, the prices of commodities remained high and capacity pressures intensified. A sustained increase in oil prices not only impacted directly on inflation, but also encouraged the diversion of agricultural products to the production of bio-fuels, thereby contributing to an acceleration in food price inflation. Under these circumstances, quite a number of central banks tightened their monetary policies further in order to contain inflation.

World consumer price inflation and range of inflation rates for individual countries



The same methodology was used as with the real economic growth rates.

Source: IMF *World Economic Outlook Database*, April 2007, and own calculations

A number of risks remained in the background. Global current-account imbalances continued, but during the past year the United States (US) dollar depreciated significantly against most major currencies, probably contributing to the containment of the deficit on the US current account. Risk premia imbedded in the prices of financial assets rose from very low levels, with a number of events triggering an enhanced awareness of risk among market participants and resulting in a rather abrupt repricing of risk. Probably the most important events of this kind were the turbulence in emerging markets in May 2006 which strengthened international investors' preference for investment in the more mature markets; the fall in share prices in China in February 2007 and the resulting correction in numerous markets; and the strains developing around the risky "sub-prime" segment of the mortgage market in the US, which led to a loss of confidence in counterparties and culminated in a reduction of liquidity in the credit markets and a sharp decline in global share prices in August 2007. Although the effect of the first two events soon petered out, it remains to be seen how the most recent disruption will impact on wealth, confidence, expenditure and economic activity in general. In a number of economies central banks viewed the turbulence to be severe enough to warrant injections of liquidity into the financial markets.

Africa again recorded a robust rate of economic expansion in 2006, registering a real growth rate of roughly 5½ per cent for the third successive year. Against a background of favourable commodity prices, sustained global growth, debt relief, improved economic policies and a stronger emphasis on infrastructural development, it is projected that the economic upswing will maintain its solid momentum in 2007.

Replicating the global growth trajectory, real economic growth in South Africa came to approximately 5 per cent in each year from 2004 to 2006 and broadly retained this momentum in the first half of 2007. This solid performance seems likely to sustain the current economic upswing which started in September 1999. Having persisted for approximately 8 years, the upswing is twice the length of the previous longest expansionary phase of the business cycle. It has also contributed to a favourable reassessment of the country's potential growth rate.

Viewed from the production side, the most consistent growth in the economy over the past year and a half was recorded in the services sector. Telecommunication services continued to expand briskly, bolstered by improvements in technology and price reductions in some areas. Lively conditions in the financial and real-estate markets continued, accompanied by strong demand for credit and banking services, while the trade sector benefited from strong domestic expenditure.

By contrast, the primary sector recorded a disappointing real growth performance during the period under review. Agricultural output was impeded by erratic climatic conditions. Mining production was lacklustre, notwithstanding favourable prices for the sector's products as strong international prices were amplified by the weaker exchange value of the rand from May 2006. The weak response of production volumes in mining to favourable prices not only reflected the inevitable depletion of ore bodies in some areas, but also logistical and environmental constraints as well as interruptions on account of maintenance and industrial action.

Production in the secondary sector expanded apace in the past 18 months as the construction industry, in particular, recorded double-digit rates of real growth, responding to the infrastructure drive and buoyant demand for residential and non-residential buildings. This also translated into strong demand for manufactured products used by the construction industry. However, the robust performance extended to most manufacturing subsectors, benefiting from brisk local sales and exports which were reinforced by the more competitive exchange value of the rand during the past year. Capacity utilisation in manufacturing remained high.

Growth in real domestic expenditure outpaced that in real domestic production over the past year and a half, as has been the case since 2002. All the components of domestic final demand continued to expand strongly over the past 18 months. Real final consumption expenditure by households rose briskly, supported by rising levels of employment and disposable income. A slight moderation set in during the first half of 2007, partly on account of the increases in interest rates from June 2006. Nevertheless, this did not prevent the ratio of household debt to disposable income from scaling new heights. However, despite some individual households overextending themselves, the aggregate household balance sheet remained sound as rising prices of houses and shares bolstered the value of the household sector's assets.

Real final consumption expenditure by general government continued to rise as government expanded its staff complement and stepped up service delivery. Among the final expenditure components, the strongest growth over the past year and a half was recorded by gross fixed capital formation. From 2006 this expenditure component accelerated to a double-digit rate of real growth, and in the first half of 2007 this had raised the ratio of fixed capital formation to gross domestic product to more than 20 per cent – the first time since 1989. While the strongest increases were attributable to public corporations, and especially to the electricity utility's investment programme, general government and the private sector also stepped up their capital expenditure considerably.

Buoyant domestic expenditure resulted in high imports. Despite a further improvement in the terms of trade, driven by buoyant prices of export commodities, the deficit on the current account of the balance of payments widened to 6,5 per cent of gross domestic product in 2006 – the highest since 1975 – and registered a broadly similar ratio in the first half of 2007. Merchandise imports rose across all categories – consumer, capital and intermediate goods – while payments for services also increased. Income payments to non-residents in the form of dividends and interest rose strongly, consistent with solid company profits and non-residents' growing investment into South Africa.

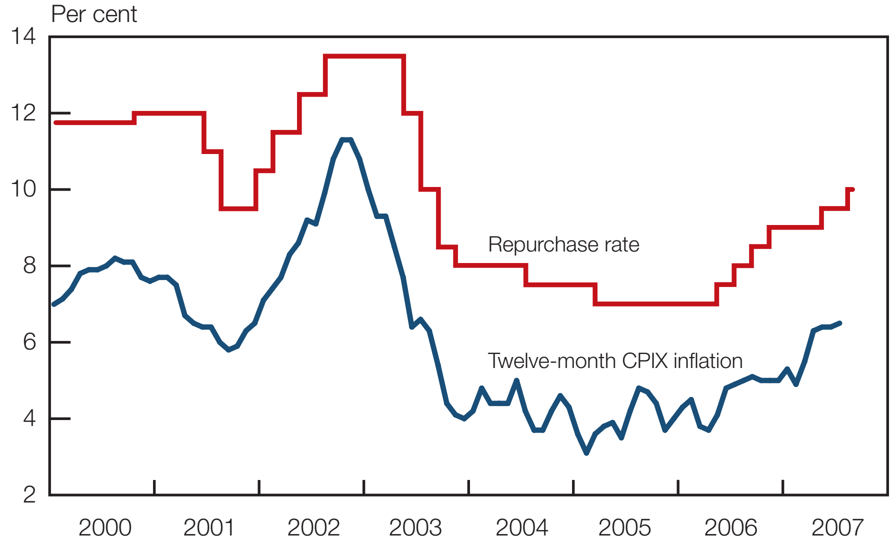
The deficit on the current account of the balance of payments continued to be more than fully financed by net financial inflows from abroad. Most important among these were portfolio inflows. In 2006 non-residents stepped up their holdings of both South African shares and bonds, while in the first half of 2007 their focus was on shares, consistent with the sustained growth in company profits and share prices.

With the overall balance of payments remaining in surplus during the past year and a half, the South African Reserve Bank (the Bank) increased its gold and foreign exchange reserves to a level of almost US$30 billion at the end of August 2007. The Bank's international liquidity position, an indicator of exposure to currency risk, which had amounted to a negative US$23 billion at its worst point during the Southeast Asian crisis of the late 1990s, improved to a positive value of US$23 billion by early 2007 and came to US$27,4 billion by the end of August 2007. The exchange value of the rand depreciated significantly from the second week in May 2006 as international investors' enthusiasm for emerging-market exposure dwindled, but from around August 2006 started to move within a relatively stable trading range at nominal levels against a basket of currencies that were around 15 to 20 per cent lower than before the decline in May.

Consistent with the growing economy, employment continued to trend higher during the period under review. Average wage settlements accelerated somewhat, from around 6,2 per cent in 2005 and 6,5 per cent in 2006 to 6,8 per cent in the first half of 2007. Government employees received an increase of 7,5 per cent in mid-2007 following protracted negotiations and industrial action. The most recent settlements were concluded against the background of significantly higher realised inflation, increasing shortages of skilled and semi-skilled workers, and strong growth in company profits.

Twelve-month CPIX inflation remained within the target band of 3 to 6 per cent from September 2003 to March 2007 – a period of more than 3½ years, which was helpful in moderating inflation expectations. However, the exchange rate depreciation from May 2006 as well as rising energy and food prices bolstered inflation. In an environment of

CPIX inflation and repurchase rate



high capacity utilisation, strong expenditure growth and buoyant credit extension, the risks of these temporary forces becoming entrenched in an ongoing inflation spiral were significant, and prompted the Monetary Policy Committee (MPC) of the Bank to tighten policy. This was done in a gradual fashion, with increases of 50 basis points at each of the June, August, October and December 2006 meetings of the MPC. After a respite at the first two MPC meetings of 2007, the repurchase rate was again raised by 50 basis points on each occasion at the June and August 2007 meetings. Other money-market interest rates moved higher alongside the repurchase rate.

In the domestic bond market, yields moved lower from September 2006 as the earlier downward trend of the exchange rate made room for a sideways movement, crude oil prices receded and it became clear that government would need to borrow little if anything in the bond market in the near term. However, rising oil prices, accelerating inflation and increases in short-term interest rates resulted in a significant increase in bond rates from late February 2007. Share prices, on balance, performed very well during the past year and a half, setting successive record highs. The jitters in international financial markets during August 2007, which were mainly related to some investors' exposure to high-risk mortgage loans in the US, nevertheless spilled over into a significant decline in South African share prices.

The National Credit Act came into full effect on 1 June 2007, providing for enhanced transparency, fairness and responsibility in the extension of credit. While in some instances it is likely to result in more rigorous processes in the screening of credit applications, possibly leading to longer processing times and higher rejection rates, it is too early to quantify the impact of the new regulatory environment on credit extension. However, the most rapid increases in bank credit extension over the past year were in loans and advances to companies – a category which falls outside the scope of the new Act. Strong fixed capital formation and inventory investment, mergers, acquisitions, empowerment deals and participation in the financial markets in general bolstered the demand for credit by the corporate sector. While the tempo of increase in bank loans and advances to the household sector slowed during the past year, this still remained at high levels, with mortgage advances in particular maintaining strong momentum. This was consistent with the buoyancy of the real-estate market, where house prices maintained double-digit rates of increase over twelve-month periods. Banks continued to securitise some of their assets; if these were added back, it would have resulted in moderately higher rates of increase in loans and advances than in the conventional aggregates measured on the banks' balance sheets.

Strongly rising income and expenditure, lively financial market activity as well as increases in asset prices and wealth supported growth in the broad money supply, M3. Higher rates of interest on M3 deposits and precautionary motives in the light of asset price volatility may also have raised the demand for money. As before, the increase in M3 was mainly concentrated in the deposit holdings of companies rather than households.

The national government recorded a fiscal surplus in 2006/07 as its strong revenue growth continued, and projected another surplus for 2007/08. For the public sector as a whole, a small deficit was projected as capital expenditure was set to increase significantly. Fiscal prudence and low levels of both government and external debt contributed to the decision during June and July 2007 of two ratings agencies to revise South Africa's foreign-currency ratings outlook from stable to positive.

Domestic economic developments

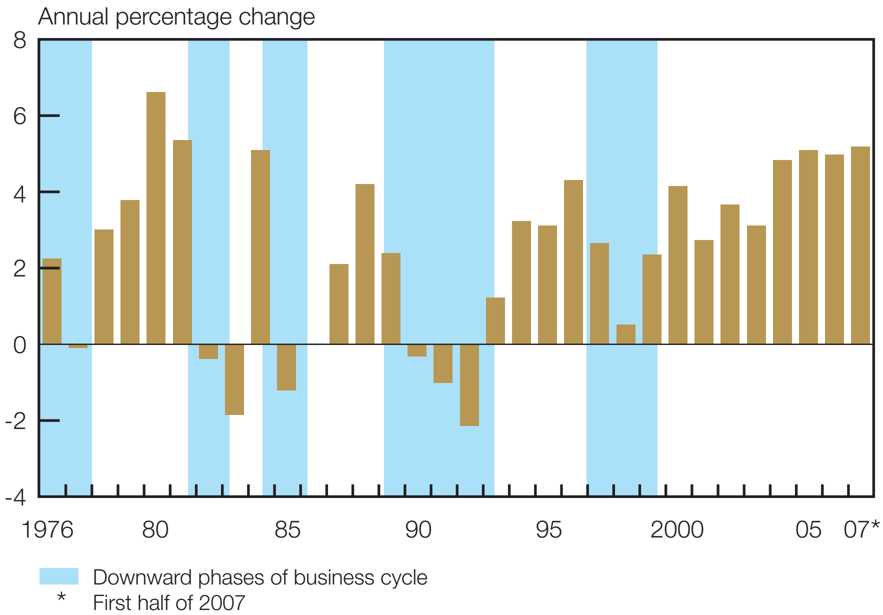
Domestic output[1]

1 Unless stated to the contrary, quarterly and half-yearly growth rates referred to in this section are based on seasonally adjusted data.

The economic upswing in South Africa continued in the first half of 2007 and completed thirty-one quarters of uninterrupted expansion in real gross domestic product at an average annualised rate of 4¼ per cent. To date, this has been the longest upswing on record. The performance of the domestic economy was enhanced by the sustained expansion of global economic activity.

Following an increase of 4 per cent in 2005, the real value added by the *agricultural sector* contracted by 13 per cent in 2006, the largest annual decline since 1996. This contraction was mainly due to lower production of field crops – in response to declining prices in the preceding year, the area planted with maize and wheat was significantly smaller in 2006. In addition, the average maize yield per hectare planted decreased from 3,6 tons in 2005 to 3,4 tons in 2006. In the first half of 2007 agricultural production was held back by erratic rainfall, but nevertheless increased slightly from a low base in 2006.

Real gross domestic product



The agricultural sector's share of gross domestic product declined from 4½ per cent in 1990 to 2¾ per cent in the first half of 2007. This could, among other things, be ascribed to the deterioration in the terms of trade (i.e. output prices relative to input prices) of the agricultural sector. Between 1990 and 2005 the terms of trade weakened by 18,0 per cent from 1,10 to 0,90 before strengthening again to 1,01 in 2006.

Although South Africa is the world's largest producer of gold and platinum and one of the leading producers of base metals and coal, the contribution of the mining sector to South Africa's gross domestic product continued to decline. In the first half of 2007 the mining sector's share in total nominal value added amounted to 8 per cent, compared with an average share of 13¾ per cent in the 1980s.

Real gross domestic product

Percentage change at seasonally adjusted annualised rates

	2005	2006			2007
Sectors	Year	1st half	2nd half	Year	1st half
Primary sector	3	-6¾	-3½	-4½	-1¼
Agriculture	4	-17¼	-17½	-13	3¼
Mining	2½	-2	2	-¾	-3
Secondary sector	5½	5	7	5¾	6¼
Manufacturing	5	3½	6	4¾	4½
Electricity, gas and water	2½	4¼	1¾	3	3
Construction	12	13½	15¾	13¾	18¼
Tertiary sector	5¼	6½	5¼	6	5¼
Commerce	6½	6½	6	6¾	5
Transport and communication	5½	5¼	5½	5½	5¾
Financial and other services	5½	11	6½	8¼	6½
Non-agricultural sector	*5*	*5½*	*5½*	*5½*	*5*
Total	5	5	5	5	5

This diminished share – despite the high prices of mining products in the past year – can partly be ascribed to the fact that South Africa's gold production continued its secular decline, falling from 395 tons in 2002 to 275 tons in 2006, the lowest level of domestic gold production since 1922. The sharp increase in the gold price from the beginning of 2006 allowed gold-mining companies to mine ore with a lower gold content, which impacted adversely on the real value added by the gold-mining industry.

Logistical and environmental constraints and the depletion of some of the richest ore bodies contributed to lustreless production volumes in a number of mining subsectors. By contrast, production of platinum group metals trended higher over the past number of years, its value having exceeded that of gold since 2001. In 2006, South Africa produced 78 per cent of the global platinum supply.

After real value added by the *mining sector* rose by 2½ per cent in 2005, it contracted by a ¾ per cent in 2006. In the second half of 2006 real value added by the mining sector increased as platinum production surged. The demand for platinum was mainly underpinned by growth in the demand for catalytic converters. However, in the first half of 2007 the real value added by the mining industry contracted again as platinum production was adversely affected by work stoppages and the temporary closure of a smelter.

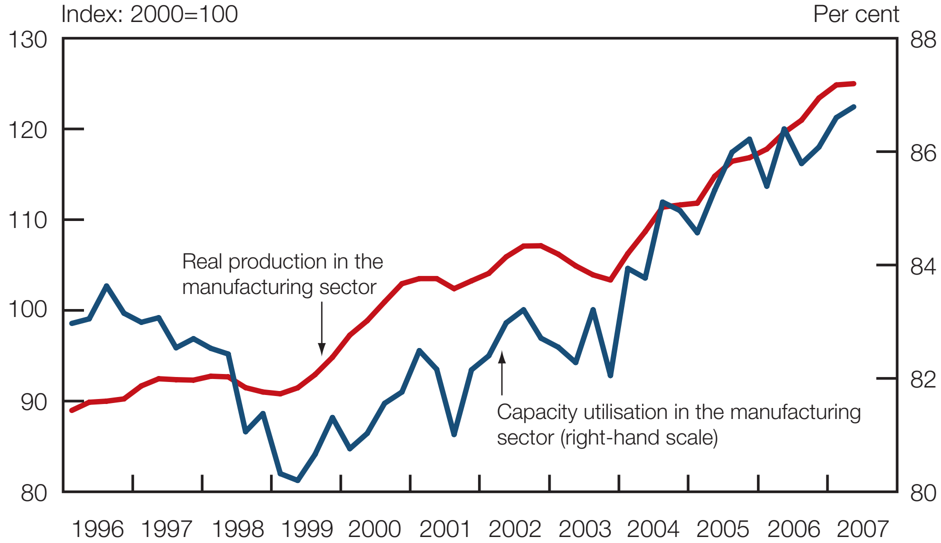
Following a decline in the first half of 2006, real value added by the coal-mining industry increased in the second half of 2006. Production advanced further in the first half of 2007 partly due to growing demand for electricity. In addition, South Africa's coal exports benefited from congestion in ports of other coal-exporting countries, thereby diverting demand to South Africa. Likewise, the real value added by the diamond-mining industry increased in the first half of 2007.

The growth rate in real value added by the *secondary sector* accelerated steadily from 5½ per cent in 2005 to 5¾ per cent in 2006 and to 6¼ per cent in the first half of 2007. This resulted from higher growth in the real output by all three main subsectors constituting the secondary sector, especially in the manufacturing and construction sectors.

In the *manufacturing sector*, which accounts for about 18 per cent of gross domestic product, real output continued to increase at a pace of nearly 5 per cent in 2006. This was the third consecutive year, starting in 2004, that growth in real value added by the manufacturing sector amounted to approximately 5 per cent. The contribution came mainly from the basic metals and transport equipment subsectors. This was broadly in keeping with the increase recorded in the volume of exports of basic metals and transport equipment in 2006. In addition, the sustained increases in the real value added by the manufacturing sector throughout 2006 reflected the high levels of domestic demand over this period.

In the second half of 2006 growth in real value added by the manufacturing sector accelerated to an annualised rate of 6 per cent, almost double the growth rate of 3½ per cent recorded in the first half of 2006. This acceleration could partly be linked to the robust demand for intermediate and capital goods related to building and construction activity as infrastructure development gained momentum. Furthermore, from mid-May 2006, a more competitive external value of the rand supported export-oriented sectors and bolstered the demand for domestically produced manufactured goods. The subsectors of manufacturing that benefited particularly from these developments were those involved in the production of iron and steel, wood products, glass and electrical equipment, as well as non-metallic minerals, including cement production.

Real production and capacity utilisation in manufacturing

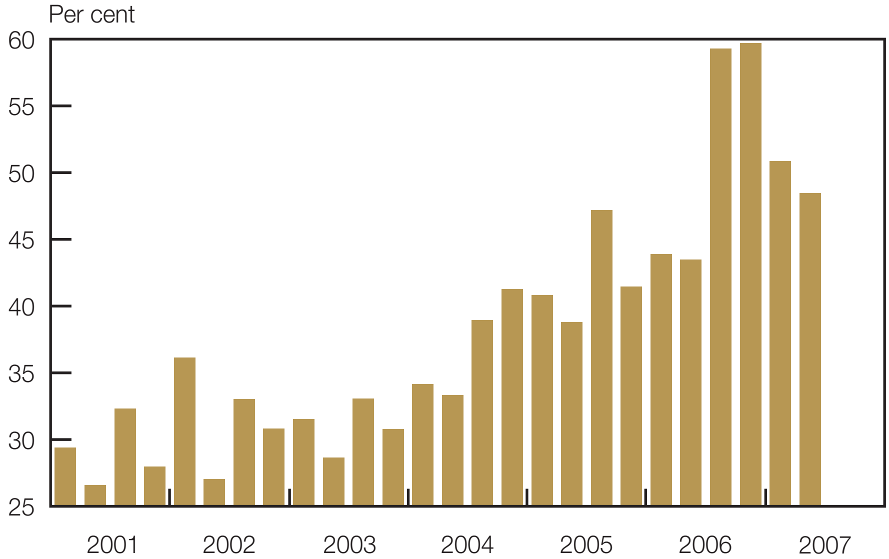


Seasonally adjusted

However, in the first half of 2007 the growth in real value added by the manufacturing sector lost some momentum as the higher interest rates started to filter through to the economy, alongside the effect of a slightly stronger rand and rising input costs. Nonetheless, manufacturing activity continued to be supported by the solid growth in construction activity. Other manufacturing subsectors that reported strong growth in the first half of 2007 included the manufacturing of radios and television sets, and the furniture industry. By contrast, the local textile and clothing industry continued to experience a subdued performance. The import penetration ratio trended higher to the end of 2006, but declined somewhat in the first half of 2007.

Growth in real value added by the sector supplying *electricity, gas and water* accelerated from 2½ per cent in 2005 to 3 per cent in the first half of 2007, the same rate attained in 2006. Expanded capacity was commissioned, including two open-cycle gas-turbine power stations in the Western Cape, to ensure that the availability of electricity was adequate to meet the peak demand in the 2007 winter.

Manufacturing of textiles and clothing: Import penetration



The continued buoyancy in the *construction sector* was reflected in a steady acceleration in real output. The real value added by this sector expanded at double-digit growth rates from the first quarter of 2004, surging by 12 per cent in 2005, 13¾ per cent in 2006 and further at an annualised rate of 18¼ per cent in the first half of 2007. This increasing activity has directly increased the share of the construction sector in the economy's gross value added from 2½ per cent in 2004 to 3 per cent in the first half of 2007, a trend that will probably continue as demand for construction and civil engineering services expands. The sustained growth in the real value added by the construction sector was mainly related to lively conditions in the non-residential building sector and infrastructural developments undertaken by the civil construction industry.

Having risen by 6½ per cent in 2005 and 6¾ per cent in 2006, real value added by the *commerce sector* slowed in the first half of 2007. The slower growth in the first half of 2007 was mainly confined to the motor trade subsector and to a lesser extent the retail sector, reflecting the tapering off of the exceptionally brisk pace of growth in demand for new motor vehicles, and durable and semi-durable consumer goods.

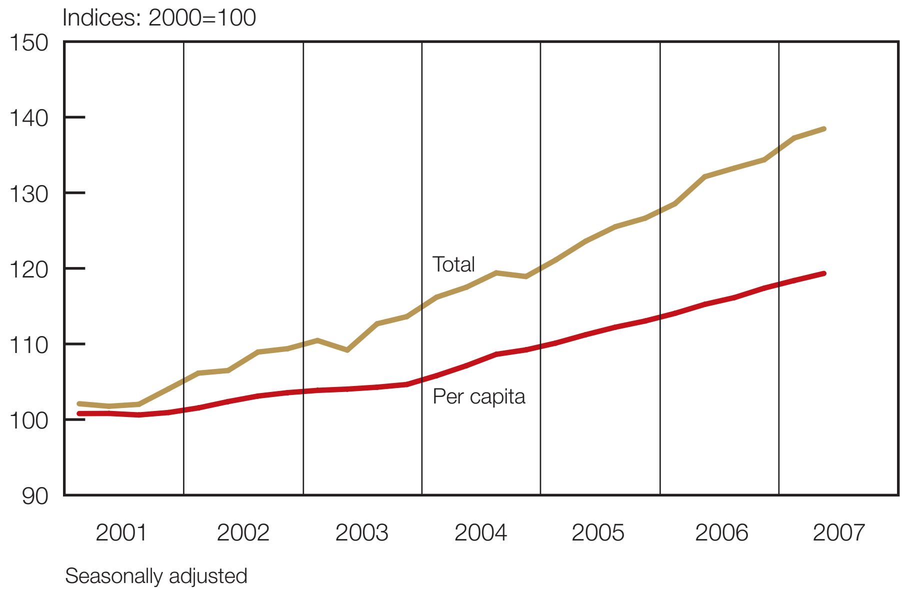
Growth in real value added by the *transport, storage and communication services sector* fluctuated between 4¾ per cent in 2004 and 5½ per cent in 2006. This trend continued into the first half of 2007 with annualised growth amounting to 5¾ per cent. The communication subsector preserved its status as the main contributor to growth in real value added by the transport, storage and communication sector. This was a reflection of continued growth in especially the telecommunication industry, as use of cellular telephones continued to expand alongside strong growth in internet services driven by broadband technology. Price reductions in some areas also contributed to the brisk expansion.

Growth momentum in real value added by the *finance, insurance, real-estate and business services sector* accelerated from 5½ per cent in 2005 to 8¼ per cent in 2006. Activity slowed again in the first half of 2007, recording an annualised rate of real growth of 6½ per cent. After the exceptional performances of the banks, securities dealers and the business services sector lifted the growth rate of the sector in 2006, the slower growth in the first half of 2007 was mainly concentrated in the activity of banks and business services providers.

Real value added by *general government* increased slightly from 3¼ per cent in the second half of 2006 to 4 per cent in the first half of 2007 as more employees were appointed in several areas. A moderate setback to production of government services arose from a public-sector strike in June 2007.

The growth in *real gross national income* accelerated from 5¼ per cent in 2005 to an annualised rate of around 6 per cent in both 2006 and the first half of 2007, outperforming growth in gross domestic product by a notable margin. Although net primary income payments to the rest of the world increased, the effect was more than neutralised by the improvement in the terms of trade in 2006 and the first half of 2007. The higher net primary income payments to the rest of the world were mainly on account of a substantial rise in net dividend payments to non-resident investors, together with an increase in net interest paid to foreign portfolio investors in the domestic securities markets and to foreign creditors. Real gross national income per capita increased at a rate of 4¾ per cent in the first half of 2007, marginally lower than the 5 per cent recorded in 2006. This was mainly due to accelerated growth in gross national income while growth in the population continued to taper off.

Real gross national income



Domestic expenditure

Aggregate *real gross domestic expenditure* recorded an average annualised growth rate of 5½ per cent during the current upward phase of the business cycle. As during the previous upward phases, this rate of growth was higher than the average annualised growth rate recorded by real gross domestic product over the period.

Real gross domestic expenditure

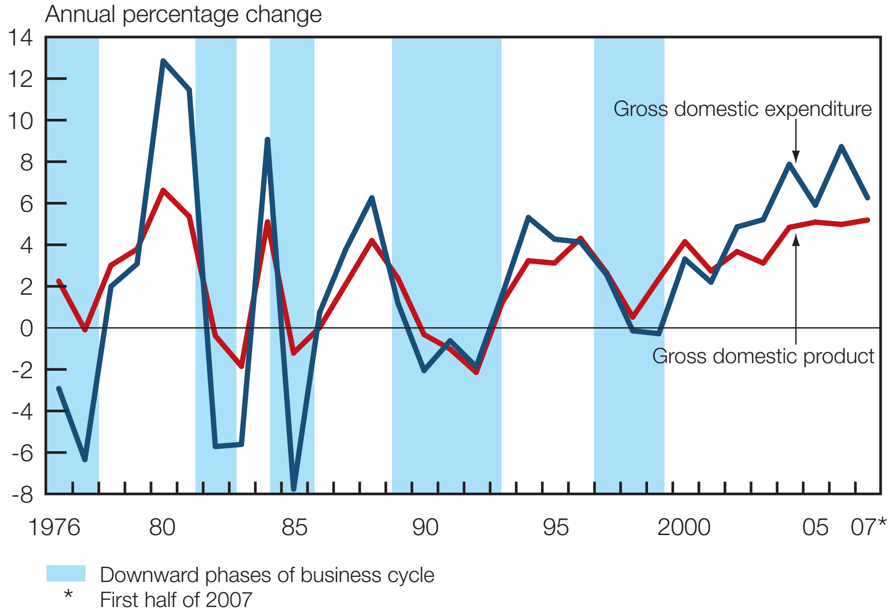
Percentage change at seasonally adjusted annualised rates

	2005	2006			2007
Components	Year	1st half	2nd half	Year	1st half
Final consumption expenditure by households	6½	7¾	7¾	7¼	7
Final consumption expenditure by general government	5¼	5½	2½	5½	7
Gross fixed capital formation	9½	12¾	14¼	12¾	18½
Change in inventories (R billions)*	8,8	16,1	15,4	15,8	11,1
Gross domestic expenditure	6	11	6	8¾	6¼

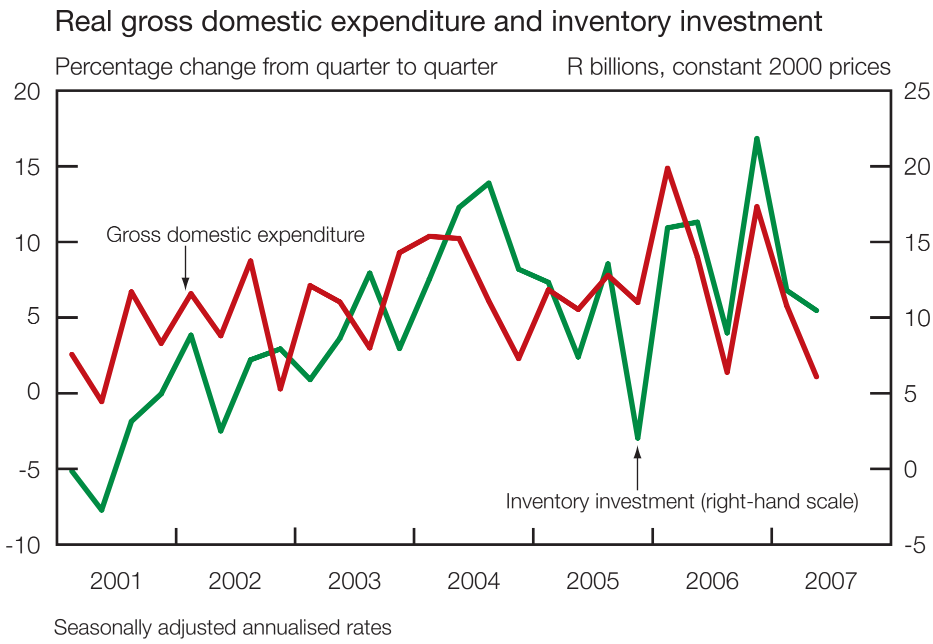
* At constant 2000 prices

Growth in real gross domestic expenditure slowed from 8¾ per cent in 2006 to 6¼ per cent in the first half of 2007. The buoyant spending was fuelled by sturdy aggregate real final demand and strong inventory accumulation over this period. Brisk spending by households coupled with robust growth in real gross fixed investment was mainly responsible for the increase in final demand. Mainly as a result of the higher level of crude oil imports in 2006, real inventory investment increased strongly.

Real gross domestic product and expenditure



* First half of 2007



Real final consumption expenditure by households

With quarter-to-quarter growth rates ranging between 7½ per cent and 8¼ per cent during 2006, annual growth in *real final consumption expenditure by households* amounted to a robust 7¼ per cent for the year 2006, the highest annual growth since 1981. Compared with a growth rate of 7¾ per cent in the second half of 2006, real household spending increased at a marginally lower but still brisk annualised growth rate of 7 per cent in the first half of 2007. The strong performance in real household expenditure from 2004 was mainly due to consumer spending on durable and semi-durable goods. Real outlays on non-durable goods and services increased at a steady pace during this period.

Real final consumption expenditure by households

Percentage change at seasonally adjusted annualised rates

	2005	2006			2007
Components	Year	1st half	2nd half	Year	1st half
Durable goods	18¾	19	8¾	15½	3¼
Semi-durable goods	16½	20½	20¼	18½	16
Non-durable goods	4¾	5	5	4¾	5¾
Services	2½	3	5¾	3½	5¾
Total	6½	7¾	7¾	7¼	7

Growth in real household expenditure on *durable goods* slowed from 18¾ per cent in 2005 to 15½ per cent in 2006 and 3¼ per cent in the first half of 2007. The recent deceleration in spending on durable goods resulted from a reduction in purchases of personal transport equipment, especially new motor cars. Coming from a high base in 2006, the slower pace of real expenditure on new motor cars in the first half of 2007 can partly be ascribed to the lagged impact of past interest rate increases, high household debt levels and the increase in the prices of new motor cars. In addition, delays due to teething problems experienced with the new e-Natis vehicle registration system and more rigorous screening of financing applications in the wake of the full implementation of the National Credit Act (NCA) on 1 June 2007 may have influenced spending on personal transport equipment.

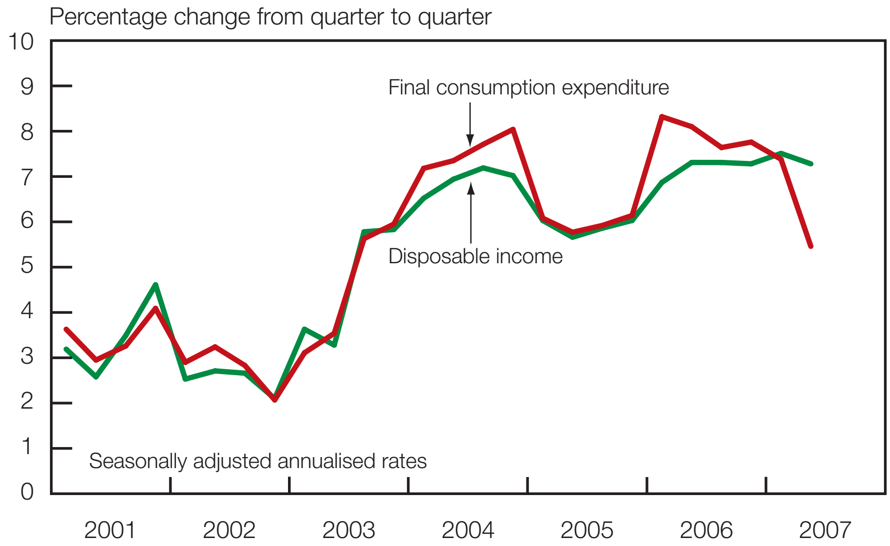
Growth in real expenditure on *semi-durable goods* accelerated from 16½ per cent in 2005 to 18½ per cent in 2006 before slowing to 16 per cent in the first half of 2007. The slower rate of increase in the first half of 2007 could mainly be attributed to less exuberant spending on clothing and footwear as well as on household textiles, furnishings and glassware.

While growth in household expenditure on discretionary consumer goods such as new motor vehicles and durable and semi-durable goods started to lose momentum in the first half of 2007, spending on more essential *non-durable goods* and *services* increased steadily throughout 2006 and the first half of 2007, despite higher food and fuel prices over this period.

The buoyant consumer spending throughout 2006 was boosted by an exceptionally high level of consumer confidence. This was supported by rising employment and real disposable income as well as an increase in household wealth, inspired by buoyant real-estate values and share prices.

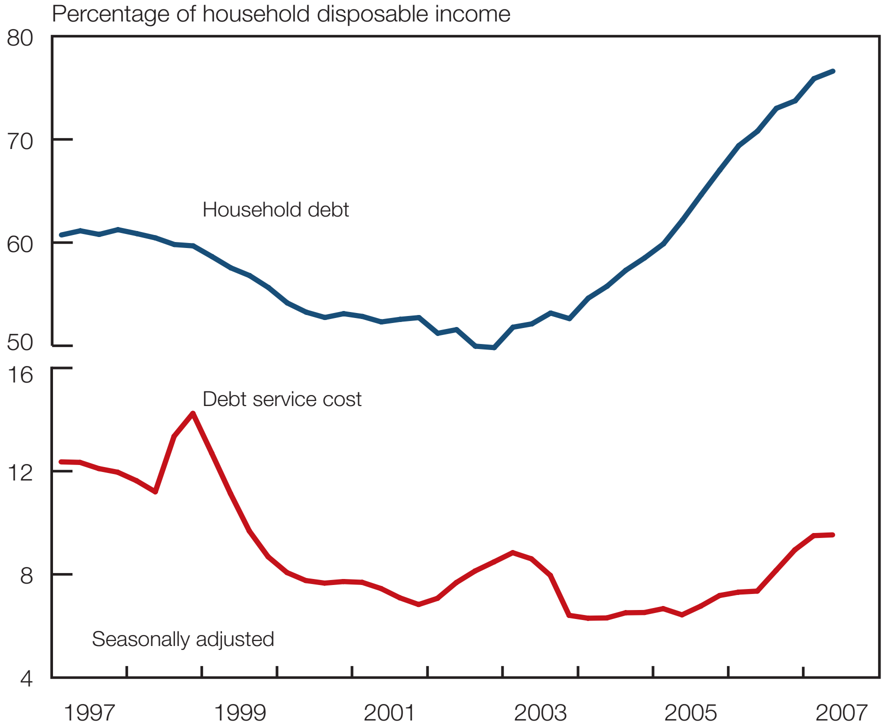
Growth in *real disposable income* of households accelerated from 6¼ per cent in 2005 to 6¾ per cent in 2006 and further to an annualised rate of 7½ per cent in the first half of 2007. These increases initially resulted from personal income tax cuts, relatively low inflation and increased social grants. In addition, there was an increase in employment, while wage settlements that generally exceeded the upper limit of the inflation target range also underpinned income growth.

Real final consumption expenditure and disposable income of households



Since the end of 2003, real disposable income of households has increased at a slightly lower rate than real household consumption expenditure. Households resorted to credit facilities to support their levels of consumption and property acquisition. Accordingly, the ratio of total *household debt* as a percentage of disposable income increased from 63½ per cent in 2005 to 71¾ per cent in 2006 and to a new record high of 76½ per cent by mid-2007. Larger outstanding household debt, together with upward adjustments in lending interest rates since June 2006, led to an increase in debt service cost. As percentage of disposable income of households, *debt service cost* increased progressively from 6¾ per cent in 2005 to 8 per cent in 2006 and 9½ per cent in the first half of 2007. The debt service cost of 9½ per cent of disposable income in the first half of 2007 remained fairly tame compared with the ratio of more than 14¼ per cent recorded towards the end of 1998, but exceeded the more recent highs set in late 2002 and early 2003.

Household debt and debt service ratios



Real final consumption expenditure by general government

The growth in real final consumption expenditure by *general government* increased marginally from 5¼ per cent in 2005 to 5½ per cent in 2006. After increasing at a rate of only 2½ per cent in the second half of 2006, real spending by general government accelerated to an annualised rate of 7 per cent in the first half of 2007. This faster growth was particularly evident in increases in real outlays on non-wage goods and services and partly reflected the purchase of a submarine in the first quarter of 2007. Increases in compensation of employees continued at a slightly faster pace in the first half of 2007. Should the acquisition of armaments be excluded, growth in real final consumption expenditure by the government remained at around 5 per cent in both 2005 and 2006.

The share of compensation of government employees in total consumption expenditure by general government decreased from about 57¾ per cent in 2005 to 56¼ per cent in 2006 and receded further to 55½ per cent in the first half of 2007. Growth in expenditure on real compensation of employees moderated from 3½ per cent in 2005 to 3 per cent in 2006 before edging higher to 3½ per cent in the first half of 2007.

Overall, final consumption expenditure by general government as a percentage of gross domestic product declined marginally from 19½ per cent in 2006 to 19¼ per cent in the first half of 2007.

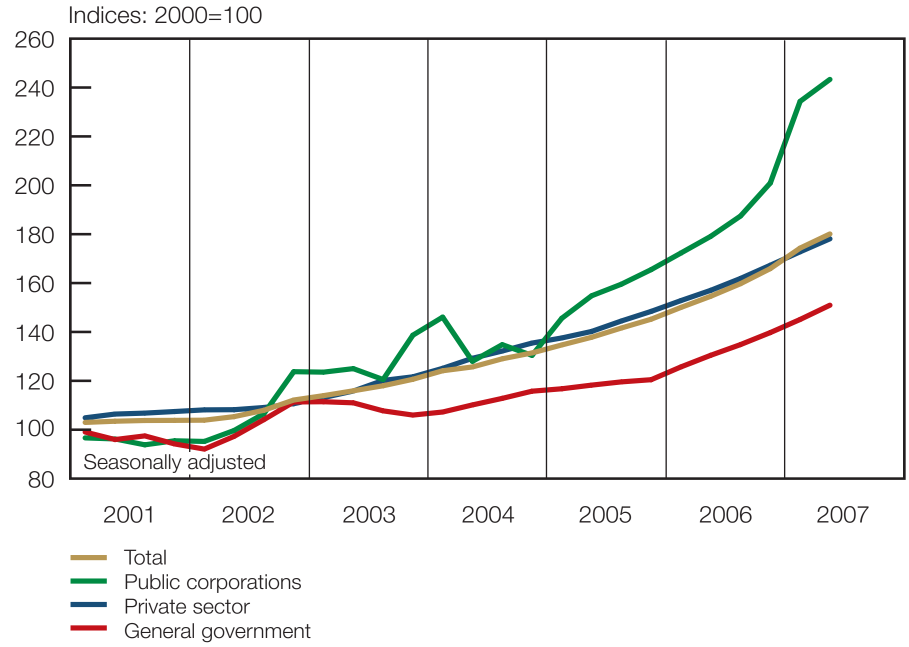
Real gross fixed capital formation

Brisk economic activity and high rates of capacity utilisation bolstered capital expenditure. Subsequent to growth rates of 9 and 9½ per cent in 2004 and 2005, respectively, *real gross fixed capital formation* increased at a rate of 12¾ per cent in 2006. After recording a growth rate of 14¼ per cent in the second half of 2006, growth in real gross fixed capital formation surged to an annualised rate of 18½ per cent in the first half of 2007. This significant increase in the growth of real gross fixed capital formation resulted from increased activity in all three institutional sectors, namely the private sector, public corporations and general government.

The higher growth in real capital outlays lifted the ratio of gross fixed capital formation to gross domestic product from 17 per cent in 2005 to 18¾ per cent in 2006 and further to 20¾ per cent in the first half of 2007, the highest ratio since 1989. Consequently, real fixed investment expenditure's contribution to the growth in real gross domestic expenditure increased to 3¼ percentage points in the first half of 2007, up from 2½ percentage points recorded in the second half of 2006.

Growth in real gross fixed capital formation by the *private sector* accelerated from an annualised rate of 9¼ per cent in 2005 to 12 per cent in 2006. Following an increase of 13 per cent in the second half of 2006, growth in real capital expenditure by the private sector edged higher to 13¾ per cent in the first half of 2007. This increase was evident throughout all sectors of the economy but particularly mining, manufacturing, construction, transport and communication.

Real gross fixed capital formation by institutional sector



Real fixed investment in the *mining sector* picked up substantially throughout 2006, having previously receded in 2004 and 2005 on account of factors such as the strengthening of the rand, logistical frictions and high input cost increases experienced in those years. Capital outlays in the mining sector over the past 18 months were dominated by investment in platinum mines following the sustained high level of precious metal prices. Capital investment by the gold-mining sector also rebounded in 2006. In addition, iron-ore mining projects featured prominently in the capital expenditure undertaken in the mining sector in 2006 and the first half of 2007.

Growth in real capital investment by the *manufacturing sector* slowed from an annualised rate of 10¾ per cent in 2005 to 8 per cent in 2006, but accelerated again to a rate of about 10 per cent in the first half of 2007. This acceleration was more pronounced in the steel and motor manufacturing industries. Increased capital investment by the steel manufacturers reflected the upgrading of plants in anticipation of the surge in construction activity. The motor manufacturing industry expanded capacity to increase production for the export market, and in many other manufacturing subsectors capital expenditure progressed briskly. There was strong pressure on manufacturers to expand, since their utilisation of production capacity rose from 86 per cent in the second half of 2006 to 86¾ per cent in the first half of 2007 – much higher than the average of 81¾ per cent over the past ten years.

The momentum of real gross fixed capital formation in the *construction sector* was maintained, consistent with the on-going building and infrastructural development projects. Logistical and technological imperatives were reflected in strong investment in the *transport, storage and communication sector*, with all modes of transport gearing up for further increases in activity and the communication subsector maintaining strong momentum in its expansion of network capacity. By early 2007 real fixed capital formation in both the construction and the transport and communication sectors had doubled compared with its level in 2000.

Public corporations stepped up capital expenditure significantly from 2005. Following an increase at a rate of 16 per cent in 2005, growth in real gross fixed capital formation by the public corporations accelerated to 18¼ per cent in 2006 and an annualised rate of no less than 51¼ per cent in the first half of 2007. This most recent increase resulted mainly from expenditure on electricity and transport infrastructure. The electricity sector increased real capital outlays by speeding up the construction of gas-turbine plants to meet the ongoing power demand. In addition to projects to boost capacity, Eskom is engaged in extensive refurbishment at several power stations. The transport sector continued with the expansion of ports and rolling stock to relieve congestion at harbours and alleviate rail transport bottlenecks. The upgrading of terminal buildings at airports is aimed at accommodating the rise in air traffic and the increased number of passengers.

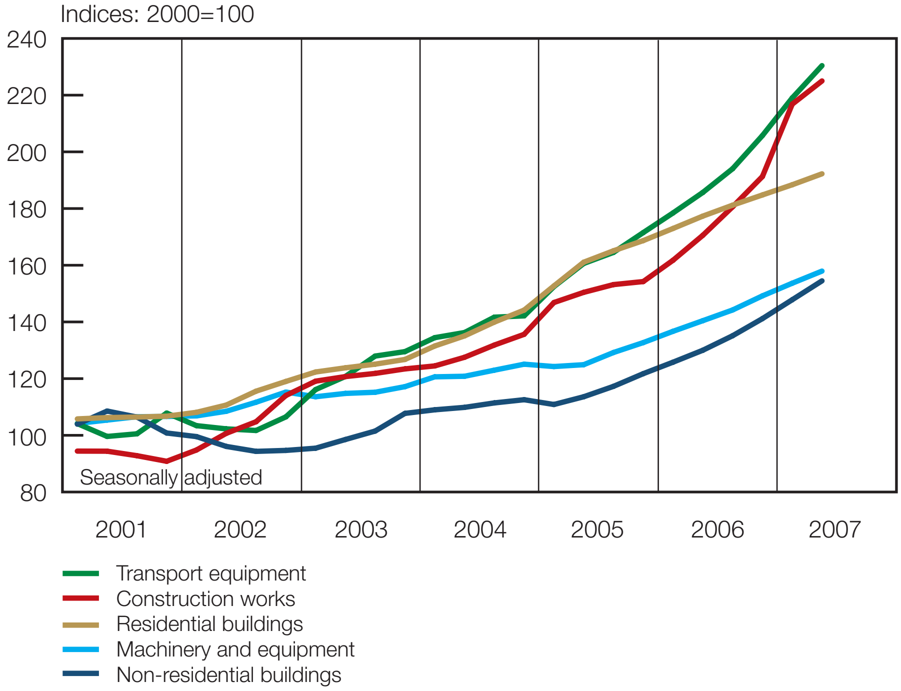
Capital expenditure by *general government* increased briskly at annualised rates of 15 per cent in the second half of 2006 and 16¼ per cent in the first half of 2007, as the upgrading and development of infrastructure gained further momentum. The revamping and refurbishment of stadiums by municipalities are underway in preparation for the 2010 FIFA World Cup.

An analysis of real gross fixed capital formation by *type of asset* indicates that real outlays on *construction works* and *transport equipment* outperformed capital investment on other types of assets in the first half of 2007. Real capital expenditure on construction works increased at an annualised rate of 25¼ per cent in the second half of 2006 before accelerating to a rate of 41 per cent in the first half of 2007. Civil construction activity remained particularly robust, underpinned by expenditure related to the Gautrain project and the 2010 FIFA World Cup.

There has been robust expenditure on commercial vehicles, needed to facilitate the transport needs of a bustling economy. This has lifted the annualised growth of real capital expenditure on transport equipment from 20½ per cent in the second half of 2006 to 26½ per cent in the first half of 2007. Investment in *residential buildings* rose at a more sedate pace from the second half of 2005 as the affordability of housing was reduced by higher prices and building costs as well as increased interest rates on borrowing.

Robust growth in real capital outlays on *non-residential buildings* was recorded in the first half of 2007, with the addition of shopping space being complemented by the expansion of industrial buildings. Real capital outlays on *machinery and equipment* also continued to trend higher as producers modernised and expanded their production capacity.

Real fixed capital formation by type of asset



Change in inventories

Real inventory investment increased from R8,8 billion in 2005 to R15,8 billion in 2006 before slowing to R11,1 billion in the first half of 2007. The slower pace of inventory accumulation in the first half of 2007 was widespread throughout the main sectors of the economy. However, it was more pronounced in the mining sector where inventories were actually reduced. The slower pace of inventory accumulation in the manufacturing sector partly resulted from lower volumes of crude oil imports. Real inventory investment increased in the total trade sector, despite a slower build-up of inventories of agricultural stocks-in-trade. From late 2006, stock levels in the motor trade sector gradually increased from earlier low levels, with the decline in the sales of motor vehicles allowing for inventory restocking. In the construction sector, real inventories continued to increase moderately.

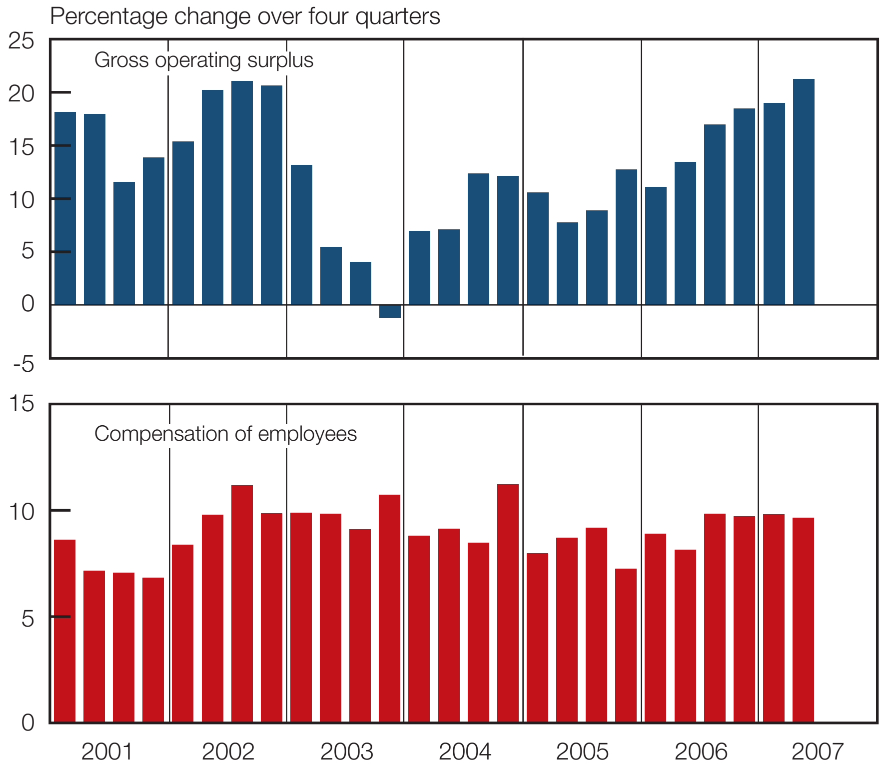
The level of industrial and commercial inventories relative to non-agricultural gross domestic product remained at 14½ per cent in both the second half of 2006 and the first half of 2007.

Factor income

The growth over one year in *total nominal factor income* amounted to 12 per cent in 2006 following more benign growth of between 7½ per cent and 9½ per cent in the preceding three years. This positive trend continued as growth in nominal factor income accelerated to 15 per cent in the first half of 2007. This was the result of substantially stronger growth recorded in the gross operating surplus of business enterprises and a sustained increase in compensation of employees.

Year-on-year growth in the *total compensation of employees* receded from an average rate of 18¼ per cent in the 1980s and 12¼ per cent in the 1990s to an average of 9 per cent in the first six years of the current decade. In the most recent years the growth in the compensation of employees slowed from 10 per cent in 2003 to 8¼ per cent in 2005. However, it regained momentum and increased by 9¼ per cent in 2006 and 9¾ per cent in the first half of 2007. The stronger growth was broad-based and due to, among other things, sustained expansion in employment levels in most sectors of the economy; higher wage settlements against the backdrop of higher consumer prices; and the lack of skilled workers, in particular in the construction sector that was operating close to full capacity. The growth in compensation of employees in this sector outstripped the growth recorded in the rest of the economy, averaging a year-on-year rate of increase of 15 per cent since 2005.

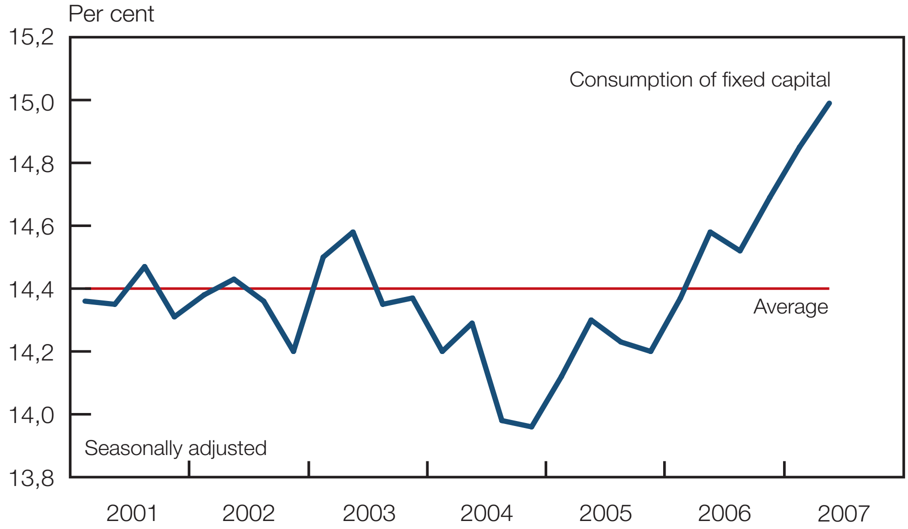
Gross operating surplus and compensation of employees



After slowing between 2003 and 2005, the year-on-year growth in *gross operating surpluses* accelerated to 15 per cent in 2006 and 20¼ per cent in the first half of 2007 compared with the same period in 2006. With the exception of the trade, finance and mining subsectors which recorded slower growth in the first half of 2007, all economic sectors experienced buoyant increases in their operating surpluses. Consequently, the share of the gross operating surplus in total factor income rose to an all-time high of 52¼ per cent in the first half of 2007, compared with 50½ per cent in 2006 and an average of about 43½ per cent in both the 1980s and 1990s. In the first half of 2007, notable increases in this ratio were evident in the sectors agriculture, mining, construction, as well as electricity, gas and water.

Notwithstanding the strong increases in the gross operating surplus of enterprises, the availability of capital to fund expansion of production capacity might be adversely affected by the need to replace obsolete capital equipment. Due to the recent strong surge in fixed capital formation, the share of consumption of fixed capital in factor income increased from 14 per cent in the beginning of 2005 to 15 per cent in the first half of 2007. The much-needed expansion of fixed capital formation to put the South African economy on a sustained higher growth path has to be financed proportionally more by surplus savings, either attracted from the rest of the world or generated by domestic savers.

Consumption of fixed capital as a percentage of total factor income



Gross saving

Gross *saving as a percentage of gross domestic product* increased from 13½ per cent in the first half of 2006 to 15¼ per cent in the first half of 2007 following the improved saving performances of the domestic institutional sectors. However, the latter ratio still fell short of the most recent high of 17 per cent recorded in 2002.

The downward trend in the saving ratio of the *corporate sector* that started in the middle of 2003 appeared to have levelled off in the first half of 2007. The corporate saving ratio declined from 14¼ per cent of gross domestic product in the second half of 2003 to 10 per cent in the first half of 2006 before improving to 10¾ per cent in the first half of 2007. Stronger growth in corporate earnings as measured by gross operating surpluses improved the corporate saving ratio in the first half of 2007.

Between 2002 and 2006 the declining saving ratio of the corporate sector resulted from a number of factors. Firstly, growth in operating surpluses slowed to an average of only 10 per cent per year between 2003 and 2006 as the exchange rate of the rand appreciated and inflation decelerated. Secondly, dividend payments increased at a strong average annual rate of 14½ per cent per year in the period 2003 to 2006, lowering the saving ratio of the corporate sector. Thirdly, growth in tax payments outstripped growth in gross operating surpluses, particularly in 2005 and 2006. The payment of taxes as a ratio of gross operating surpluses increased from 14 per cent in 2000 to 23 per cent and 25½ per cent in 2005 and 2006, respectively.

The gross saving ratio of the *household sector* levelled out in the first half of 2007 after a prolonged decline from the second half of 1992. The saving ratio declined from 6¾ per cent in the second half of 1992 to 1½ per cent in both the second half of 2006 and the first half of 2007. The bottoming-out of the saving ratio in the first six months of 2007 resulted from a slowdown in the growth of households' final consumption expenditure, while their disposable income maintained a robust pace of increase.

As shown in the accompanying table, there was a shift in the composition of gross saving over the past 26 years. The corporate sector has been and remains the mainstay of the pool of domestic saving available to finance gross capital formation. Nearly 90 per cent of all capital formation in the 1990s was financed by the corporate sector, following a reduction in domestic saving in the 1980s to redeem South Africa's foreign debt commitments brought about by the financial sanctions imposed on the country during that period.

Contribution of the institutional sectors to the financing of gross capital formation

Per cent

	Average for 1980s	Average for 1990s	Average, 2000 to 2006
Household sector	28,0	25,5	12,4
Corporate sector	71,6	89,3	72,4
General government	7,5	-14,4	4,9
Total: Domestic sectors	107,1	100,4	89,7
Foreign sector	-7,1	-0,4	10,3
Gross capital formation	100,0	100,0	100,0

Towards the end of the 1990s the household sector's propensity to save deteriorated sharply as its net wealth increased substantially. Consequently, households' contribution to the financing of gross capital formation declined from an average of 28 per cent in the 1980s to only 12½ per cent between 2000 and 2006.

Household net wealth, i.e. the difference between households' total assets and household debt, expressed as a ratio of disposable income, increased only slightly from 236 per cent in 1995 to 241 per cent in 2001. This ratio subsequently declined to 223 per cent in 2002 when growth in household debt outstripped growth in household assets mainly due to the strong upward movement of interest rates. However, the ratio of net wealth relative to disposable income increased strongly from the low recorded in 2002 to 298 per cent in 2006 and further to 317 per cent in the first half of 2007 – nearly surpassing the highest point reached in 1984. This strong increase in the net wealth ratio mainly reflected the substantial growth in the market value of residential buildings and investment in equities.

Changes in the composition of the household balance sheet are shown in the table on the opposite page. Although the value of residential buildings as a ratio of total assets remained at about 25 per cent, the share of residential buildings in total fixed assets increased from 53½ per cent in 1980 to 83¾ per cent in 2006. However, other capital goods declined in importance. Mortgage advances increased considerably relative to most other balance sheet items during the period under review, and by 2006 constituted

61 per cent of total household debt. An analysis of household financial assets indicates that the share of deposits held with banks declined, whereas equity holdings increased. Asset accumulation and appreciation kept the households' overall balance sheet in a fairly robust condition notwithstanding the increased levels of indebtedness.

Composition of the household balance sheet, 1980 to 2006

Components	Household assets and liabilities as percentage of total assets				Compound annual growth over period 1980 to 2006
	1980	1990	2000	2006	Per cent
Fixed assets	47,8	34,6	26,1	29,9	12,6
Residential buildings	25,5	21,6	18,8	25,1	14,6
Other capital goods*	22,3	13,0	7,3	4,8	8,2
Financial assets	52,2	65,4	73,9	70,1	16,0
Notes and coin	0,9	0,9	0,8	0,7	13,4
Deposits with banks and Postbank	15,5	13,7	9,7	7,6	11,6
Shares	17,6	19,9	23,2	32,7	17,5
Other**	18,2	30,9	40,2	29,1	16,8
Total assets	**100,0**	**100,0**	**100,0**	**100,0**	**14,7**
Mortgage advances***	6,4	8,0	9,2	10,5	16,8
Instalment sale and leasing finance	2,5	3,0	2,5	2,8	15,3
Personal and credit card loans	1,7	4,1	3,2	2,5	16,5
Open accounts in trade sector	0,7	0,6	0,8	0,5	13,3
Bank credit to unincorporated businesses	0,9	1,3	1,2	0,6	12,7
Total liabilities	**12,2**	**17,0**	**16,9**	**16,9**	**16,2**
Net worth	87,8	83,0	83,1	83,1	14,5
Total liabilities and net worth	**100,0**	**100,0**	**100,0**	**100,0**	**14,7**

* Unincorporated businesses and non-profit institutions serving households
** Consist of interest in pension funds and life insurers, funds with participation mortgage schemes and deposits with the Public Investment Corporation
*** Including residential mortgage securitisation and loans granted by pension funds

Individual items may not add to totals due to rounding

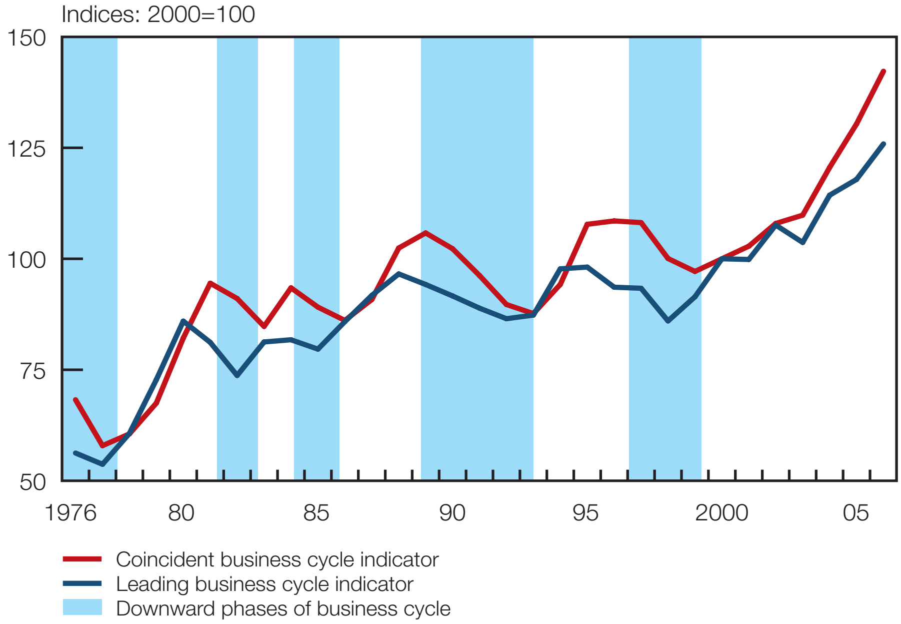
Better fiscal management and strong growth in tax revenue resulted in the elimination of *general government's* gross dissaving in the first six years of the current decade. The gross disposable income of general government at current prices increased on average by 14¼ per cent per year compared with an average rate of growth in recurrent expenditure of 12 per cent per year from 2000 to 2006.

From 2003 capital formation has consistently exceeded domestic saving, with the shortfall tending to widen alongside the acceleration in capital spending. This shortfall was financed by foreign saving, with such saving contributing 10½ per cent to the capital outlays made over the period 2000 to date, compared with an outflow of domestic saving in the 1980s as well as the 1990s.

Business cycle developments

The domestic economy has enjoyed the longest upward phase of the business cycle in the post-World War II period, commencing in September 1999 and tentatively extending into its 96th month in August 2007. At eight years, the duration of the current upswing so far is more than twice that of the previous longest upward phase, which covered the 44 months from September 1961 to April 1965. The extraordinary length of the current upswing is at least partly related to the fact that it coincided with a structural improvement in South Africa's rate of economic growth. In turn, this improved resilience of the domestic economy resulted from factors such as the more open and liberalised economic environment; stable and sound monetary and fiscal policies and management; the strength of the world economy and sustained commodity price boom; and robust consumer and investment demand alongside higher income levels and healthy consumer and business confidence. The robust trajectories of the composite business cycle indicators are shown in the accompanying graph.

Business cycle indicators



Employment

In the past three years growth in employment has responded positively to the growth momentum in the domestic economy. Overall employment levels rose from 10,4 million in September 1999 to 12,8 million in September 2006. Almost all economic sectors recorded consistent growth in employment from 2003 following subdued labour market conditions in the preceding years.

The September 2006 *Labour Force Survey* (LFS) conducted by Statistics South Africa (Stats SA) estimated total employment at 12,8 million people, or an increase of 4,1 per cent compared with a year earlier. This included employment of 1,1 million persons in the agriculture, hunting, forestry and fishing industry. The LFS indicates that agricultural employment consistently fell since September 2002, picking up slightly in September 2006. Much of this employment includes seasonal employment related to the planting cycle. The construction sector showed strong employment growth in support of activity in the infrastructure and residential sectors. In fact, the construction sector almost doubled its employment levels in the four years to September 2006.

The LFS furthermore estimated that the the economically active population continued to rise considerably as new entrants in the form of school leavers and migrants entered the labour market. The official unemployment rate accordingly remained high, although it receded from 29,4 per cent in March 2003 to 25,5 per cent in September 2006.

Labour force survey

	September					
	2001	2002	2003	2004	2005	2006
Total employment (millions)	11,18	11,30	11,42	11,64	12,30	12,80
Employment in the formal non-agricultural sectors (millions)	7,03	7,18	7,37	7,69	7,99	8,38
Unemployment rate (per cent)	29,40	30,40	28,00	26,20	26,70	25,50

Source: Statistics South Africa, *Labour Force Survey,* September 2006

In December 2006 Stats SA introduced an expanded *Quarterly Employment Survey* in an effort to improve the quarterly coverage of employment levels in the economy. This effort resulted in the inclusion of an additional 750 000 persons in the quarterly surveyed formal non-agricultural employment series from June 2006. This shift can be attributed to the legislative changes which extended the definition of the formal sector, growth arising from small businesses entering the formal work space and greater compliance with administrative and registration requirements by employers. In essence it involved moving workers who were previously only counted every six months through household surveys to being counted both through the household surveys and through quarterly employer surveys.

In March 2007 employment in the formal non-agricultural sector of the economy stood at 8,2 million employees, roughly 2,9 per cent more than in the corresponding period of 2006 after correcting for the break in coverage mentioned above.

Total enterprise-surveyed formal non-agricultural employment

	Thousands		
Sector	March 2006	March 2007	Percentage change
Mining and quarrying	446	481	7,9
Gold mining	154	167	8,0
Non-gold mining	292	315	7,8
Manufacturing	1,329	1,323	-0,4
Electricity supply	52	53	2,9
Construction	469	474	1,1
Trade, catering and accommodation	1,667	1,722	3,3
Transport, storage and communication	245	255	4,2
Finance, insurance, real-estate and business services	1,714	1,817	6,0
Community, social and personal services	435	399	-8,3
Total private sector	**6,357**	**6,525**	**2,6**
National, provincial and local government	1,445	1,501	3,9
Public-sector enterprises	223	232	3,9
Total public sector	**1,668**	**1,733**	**3,9**
Grand total	**8,026**	**8,259**	**2,9**

Employment in the private sector increased by 2,6 per cent in the year to March 2007. In the public sector employment growth took place at a stronger pace, with national and provincial government as well as public corporations accounting for an increase of 3,9 per cent over the year to March 2007. Government's response to development challenges partly entailed an increase in budget allocations to raise public sector personnel levels in relevant areas such as health and education as well as security.

Employment growth in the mining industry has been broad-based, occurring in both the gold and non-gold mining subsectors during the year under review. The sustained high levels of commodity prices and depreciation of the rand helped to strengthen employment creation in the industry as new production capacity was developed and some marginal mining operations were revived to take advantage of the exceptionally high gold price.

While manufacturing production expanded further during the year under review, this was not accompanied by an increase in formal-sector employment in manufacturing.

A surge in public and private-sector fixed investment gave rise to further employment gains in the construction industry, following years of negative employment growth. The infrastructure investment programmes identified by government indicated in the Medium Term Expenditure Framework for 2007 to 2010 amounting to R415 billion are aimed at addressing structural economic and social infrastructure bottlenecks, thereby supporting economic growth. The buoyant construction of residential and non-residential buildings further supported employment growth in the building industry in recent years. Surveys confirm that confidence levels in the building and construction industries are high.

Robust domestic demand bolstered employment in the trade, catering and accommodation services sector as well as in finance, insurance, real-estate and business services. These industries responded positively to the upturn in investment spending, robust consumer spending and lively demand for credit.

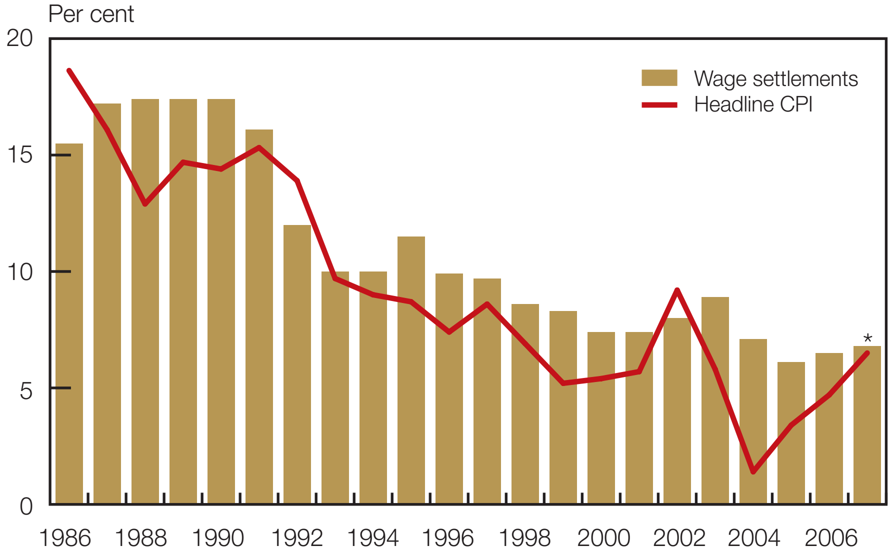
Employment in the electricity, gas and water supply industry also rose as part of the process to meet the increased electricity demand as well as to upgrade existing electricity-generating and transmission facilities.

Labour cost and productivity

According to Andrew Levy Employment Publications average wage settlements amounted to 6,5 per cent in 2006, rising to 6,8 per cent in the first half of 2007. Settlements so far in the third quarter of 2007 have generally amounted to 7,5 per cent or more; 7,5 per cent was also the minimum settlement reached in the public sector after protracted industrial action. Intensified industrial action alongside demands for wage settlements well above inflation have led to the loss of an estimated 11,5 million mandays in the first half of 2007. Higher wage settlements are likely to push consumer price inflation upward unless productivity growth accelerates concurrently.

Growth in nominal remuneration per worker amounted to 7,5 per cent in 2006, receding to a year-on-year rate of 4,6 per cent in the first quarter of 2007. Year-on-year increases in average nominal remuneration per worker in the first quarter of 2007 were most pronounced in the manufacturing, construction, electricity as well as community, social and personal services sectors.

Wage settlement rates and headline inflation



* First half of 2007
Source: Andrew Levy Employment Publications

Economy-wide labour productivity growth is estimated to have receded from 4 per cent in 2005 to 2,4 per cent in 2006. In the first quarter of 2007, year-on-year labour productivity growth amounted to 2,4 per cent.

Following a rise in nominal wage growth and a moderation in labour productivity growth, growth in nominal unit labour cost in the formal non-agricultural sectors of the economy accelerated to 4,9 per cent in 2006. The nominal unit labour cost increase then decelerated to 2,2 per cent over the four-quarter period to March 2007.

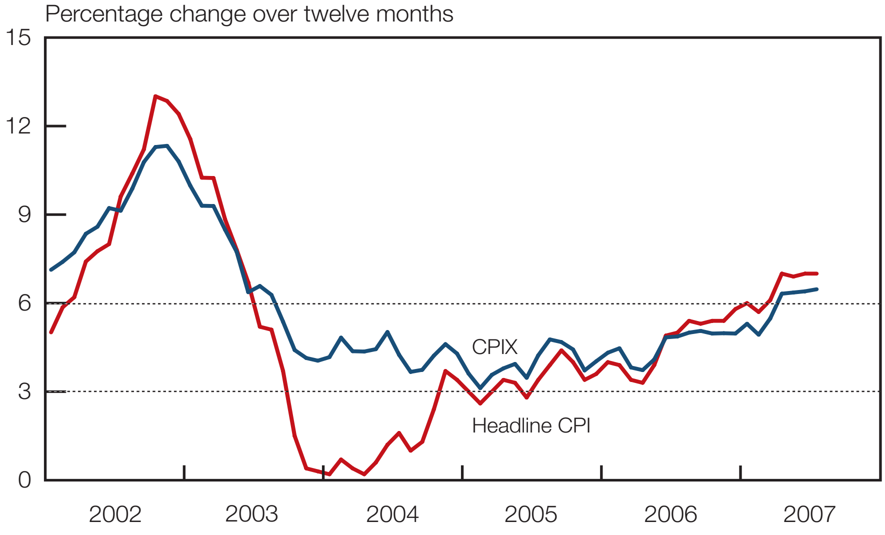
Prices

Inflationary forces intensified considerably during the past year. Previously, price pressures had been well-behaved and twelve-month CPIX inflation had decelerated to within the inflation target range of 3 to 6 per cent from September 2003. It remained within the target range for 43 successive months, reflecting factors such as a well-behaved exchange rate and sound monetary and fiscal policies. Inflation expectations also broadly converged around these levels.

From early 2006, however, prices began to rise in response to various economic shocks and factors such as escalating international crude oil prices, increases in food prices, the continued commodity price boom and the significant depreciation of the external value of the rand from May 2006. As this process gained momentum, production price inflation picked up to double-digit rates, consumer goods prices accelerated and even the prices of consumer services began to respond as so-called second-round effects permeated the web of prices. By April 2007 CPIX inflation breached the upper boundary of the inflation target range.

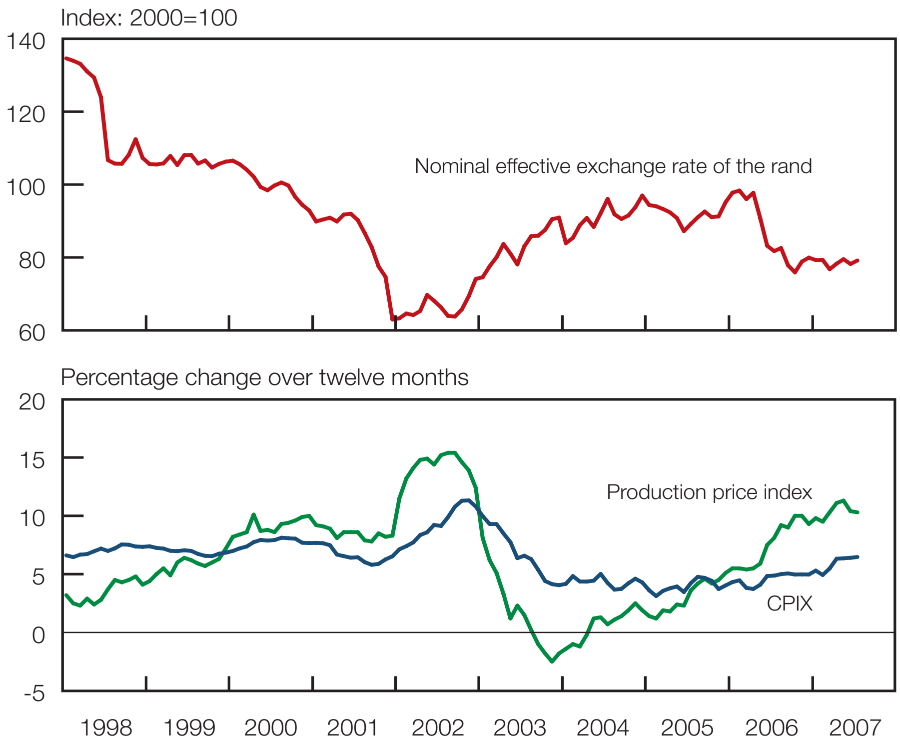
Year-on-year all-goods production price inflation accelerated from 5,3 per cent in March 2006 to 11,3 per cent in May 2007 and 10,3 per cent in July. This acceleration resulted from widespread increases in the prices of both domestically produced goods and imported goods.

Consumer price inflation



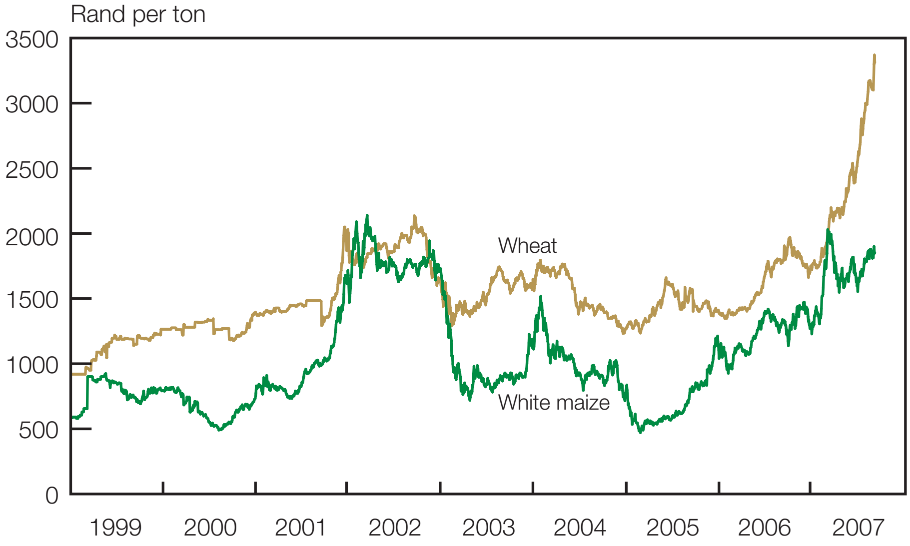
The production prices of imported goods are affected by inflation in South Africa's trading-partner countries and changes in commodity prices and in the exchange value of the domestic currency. While trading-partner inflation was fairly well-behaved, in the past year and a half the exchange rate of the rand depreciated significantly, leading to increases in the imported goods production price index. The most prominent increases were those in the prices of food, basic metals and petroleum. The twelve-month rate of increase in imported goods production prices accelerated from 4,7 per cent in May 2006 to 11,7 per cent one year later, moderating to 9,2 per cent in July 2007. Domestic production prices of goods tracked the production prices of imported goods fairly closely, confirming the importance of cost-push, import-parity and export-parity considerations in the price formation process.

Exchange rate and inflation



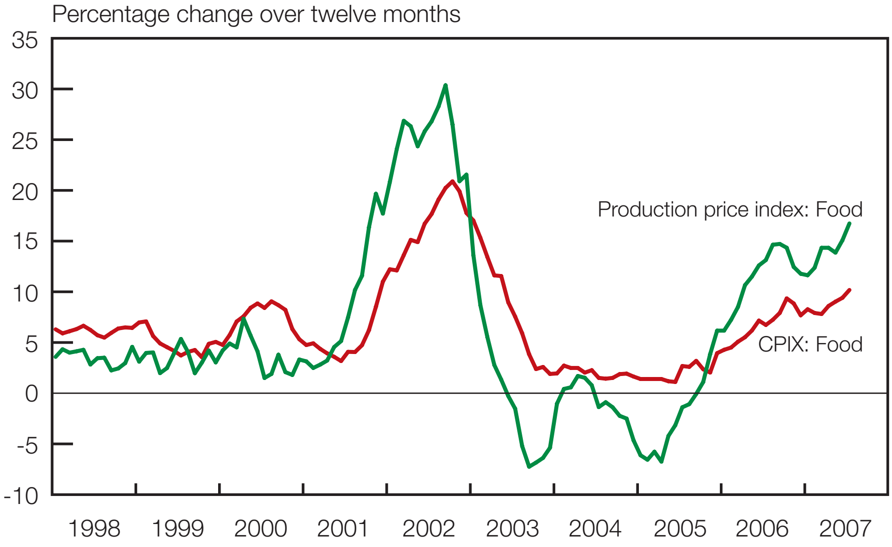
Domestic agricultural food product prices increased sharply over the past eighteen months following unfavourable weather conditions and rising international prices alongside the competing demand for agricultural output to be diverted to bio-fuel production. The production price inflation of agricultural food products accelerated from a year-on-year rate of 0,4 per cent in August 2005 to 23,5 per cent a year later. Thereafter it moderated to 15,2 per cent in June 2007, but again accelerated to 19,0 per cent in July. Nevertheless, by June 2007 grain spot prices stood at levels which were 70 per cent higher than two years earlier.

Grain spot prices



Food price inflation at the manufacturing level accelerated from a year-on-year rate of 1,3 per cent in December 2005 to 11,9 per cent in October 2006 as fresh meat prices in particular advanced strongly. As the pace of meat price increases moderated, the production price inflation of manufactured food decelerated somewhat to February 2007, before picking up to 15,1 per cent in July due to price increases in especially wheat products.

Food price inflation



CPIX inflation amounted to 3,9 per cent in 2005, rising to 4,9 per cent in 2006. Over the same period, CPIX goods price inflation accelerated from 3,1 per cent to 5,0 per cent while CPIX services price inflation decelerated from 5,6 per cent to 4,0 per cent. Year-on-year CPIX inflation accelerated from a rate of 3,7 per cent in April 2006 to 6,4 per cent in both May and June 2007, edging up further to 6,5 per cent in July.

Within the CPIX goods category, components that contributed to the rise in CPIX inflation were mainly food and transport running cost, which includes petrol. Year-on-year food price inflation accelerated from 2,1 per cent in November 2005 to 9,3 per cent in October 2006 driven mainly by rising meat prices. In the following five months food price inflation subsided as meat price inflation hesitated, but thereafter began accelerating again and amounted to 10,2 per cent in July 2007.

A weaker rand and rising international crude oil and petroleum product prices fanned petrol price inflation. The Gauteng pump price of unleaded 93 octane petrol, on balance, rose from R5,39 per litre in March 2006 to R7,11 per litre in June 2007, but subsequently decreased to R6,78 in September.

CPIX services price inflation amounted to 5,6 per cent in 2005 and 4,0 per cent in 2006. Year-on-year inflation in the prices of services accelerated from 3,3 per cent in June 2006 to 5,7 per cent in July 2007. In the services category the most important drivers of inflation included homeowners' cost, domestic workers' wages, and education.

The accompanying table shows the rates of price inflation for the major categories of goods and services, ranging from a double-digit rate of increase for transport running cost to negative inflation for clothing and footwear. Although food clearly contributed considerably to the acceleration in CPIX inflation over the past year, the measures of underlying inflation obtained by excluding items such as fuel, food or administered prices also picked up significantly over this period, suggesting that more widespread and deep-seated inflationary forces were at work.

Inflation in the components of CPIX

Percentage change over twelve months

	Weights	March 2007	July 2007
Transport running cost	5,7	8,2	6,4
Alcoholic beverages and tobacco	3,1	7,5	10,2
Food and soft drinks	26,9	7,6	9,9
Housing services	13,4	5,8	6,7
Services excluding housing and transport	16,5	5,0	*5,5*
Goods not included elsewhere	17,5	5,3	*5,8*
Transport services	3,9	4,2	*3,4*
Furniture and equipment	3,2	0,1	0,2
Vehicles	5,7	-0,1	0,8
Clothing and footwear	4,1	-8,7	-7,4
Total CPIX	**100,0**	**5,5**	**6,5**

Italics denote year-on-year increases within the inflation target range of 3 to 6 per cent for July 2007

Inflation expectations[2] deteriorated notably from around May 2007. This is confirmed by regular surveys of inflation expectations among analysts as well as by breakeven inflation rates calculated from bond market data.

2 As surveyed by the Bureau for Economic Research, University of Stellenbosch.

Foreign trade and payments

International economic developments

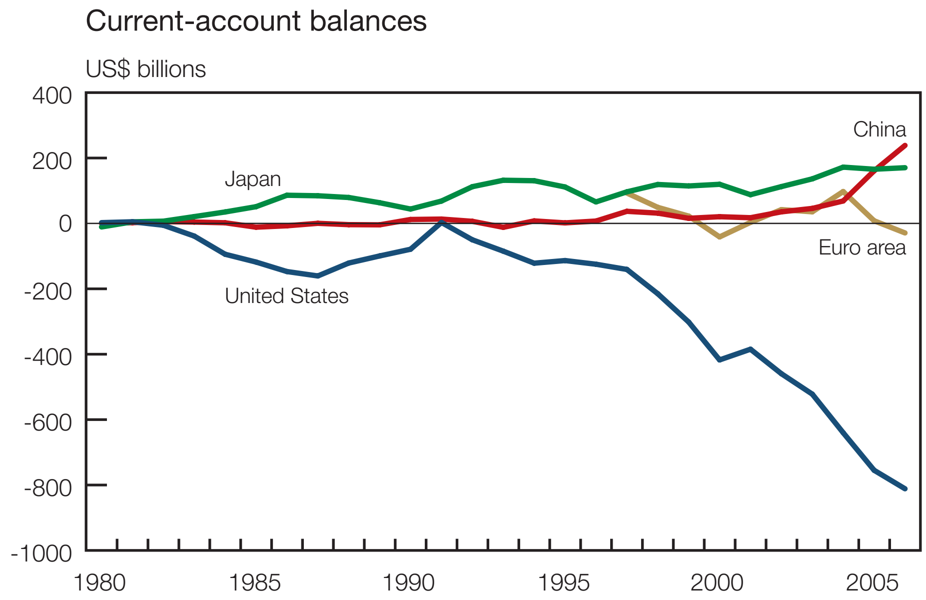
The global economy has continued to expand rapidly and grew at a remarkable pace of 5,4 per cent in 2006 – the fastest pace in almost three decades – from 4,9 per cent in 2005.[3] The performance of the global economy in the recent past was notable with growth rates above 4 per cent in the past four years. The strength of the world economy in 2006 was underpinned by a broad-based expansion in advanced economies as well as rapid growth in emerging-market and developing countries, led by China and India. Global economic growth remained strong in the first half of 2007, supported by robust domestic demand in major countries.

3 IMF World Economic Outlook, April 2007 and July 2007 Update.

After expanding briskly in the first half of 2006, real economic growth in the US fell below its potential rate due to a decline in residential construction and difficulties in the sub-prime mortgage market. Output growth again rebounded during the second quarter of 2007 as a result of improved external trade and fixed business investment. Following a moderate expansion in 2005, economic activity in the euro area gained strength during 2006 and maintained relatively strong momentum in the first quarter of 2007. A recovery in employment growth led to a decline in the unemployment rate to its lowest level since 1993. Euro area output growth, however, moderated in the second quarter of 2007. Real growth in Japan showed a modest, but sustained recovery in 2006. In the final quarter of 2006 the economy expanded at its fastest pace in three years. The Japanese economy remained strong in the first quarter of 2007, but slowed more than expected in the second quarter, partly reflecting a moderation in the growth of private consumption and exports as well as a contraction in private investment.

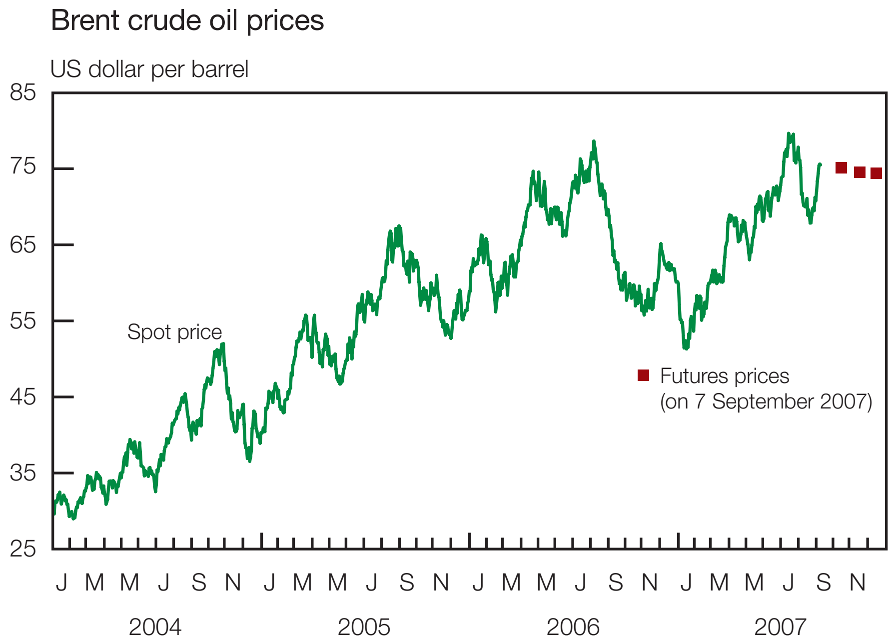
Real output growth remained strong in emerging-market countries in 2006 and the early part of 2007, amid high prices for most commodities, low inflation, buoyant financial markets and strong gains in trade. The emerging Asian region continued to outperform the emerging European and Latin American regions. Notwithstanding tightening measures introduced by the authorities, large fast-growing emerging-market economies such as China and India experienced accelerating economic growth in 2006, providing further strong impetus to the global growth momentum. Economic growth in Africa[3] amounted to 5,5 per cent in 2006, registering the third successive year of expansion at around this rate. Growth was bolstered by the continued global economic expansion, improved macroeconomic policies, debt relief and sustained demand for fuel and non-fuel commodities. Economic activity is projected to accelerate further in 2007 to 6,4 per cent as new oil fields and mines come on stream, aid flows increase and oil-importing economies benefit from robust foreign demand for non-fuel commodities.

Global current-account imbalances remained sizeable during 2006. The US current-account deficit of US$812 billion, or 6,2 per cent of gross domestic product, was matched by surpluses in oil-exporting countries, emerging Asia (especially China) and Japan. However, concerns about a disorderly unwinding have been alleviated somewhat after current-account positions as a percentage of gross domestic product stabilised in 2006. Multilateral consultations between the US, China, the euro area, Japan and Saudi Arabia were held during 2006 under the auspices of the International Monetary Fund to discuss global imbalances and the policies needed to reduce them while sustaining strong global growth. In April 2007 the participants presented policy plans towards resolving imbalances and sustaining firm growth.



Source: IMF *World Economic Outlook Database*, April 2007

Robust global demand has contributed in recent years to the sharp rise in the prices of commodities, especially fuel and metal. While metal prices continued to surge in 2006, oil markets were characterised by sharp oil price volatility – registering only a moderate rise for the year as a whole. Food prices have also been increasing globally, particularly since 2006, reflecting supply shocks and higher international maize and wheat prices amid historically low global stocks and higher demand from the bio-fuels industry. Crude oil prices increased sharply in the first half of 2006 to levels of around US$79 per barrel in August 2006, underpinned by supply setbacks and geopolitical tensions. Oil prices subsequently started to decline significantly as the easing of geopolitical tensions in the Middle East as well as high levels of US crude and fuel stocks soothed supply concerns.



This prompted the Organization of the Petroleum Exporting Countries (OPEC) in October 2006 and again in December to announce reductions in actual production. After falling substantially in the fourth quarter of 2006, crude oil prices declined further to around US$52 per barrel in mid-January 2007 in response to unusually mild temperatures in North America and Europe and historically high inventories of petroleum products. Crude oil prices have increased since February, reaching new record-high levels approaching US$80 per barrel in July. High prices have been underpinned by OPEC cutbacks, a rebound in US demand in the first quarter of 2007 amid cold weather, tight US fuel supplies and the resurgence of geopolitical tensions in Nigeria and the Middle East. The oil price briefly declined to levels of below US$68 per barrel at the end of August, but subsequently increased above US$75 per barrel in the first week of September amid a series of US refinery interruptions, hurricane-related concerns and large declines in US crude inventories.

Rising crude oil prices exerted upward pressure on global inflation and caused many central banks to tighten monetary policy during 2006. The US Federal Open Market Committee has kept the target for the federal funds rate unchanged since June 2006, but reduced its discount rate by 50 basis points in August 2007. The monetary tightening in several other countries coupled with oil price declines after August 2006, however, moderated global inflationary pressures. Headline inflation again started to increase in 2007 and core inflation began to move up in some countries in response to sustained global economic growth, high levels of capacity utilisation, tight labour markets, substantial increases in food prices and strong domestic demand. Inflation remains benign in major emerging-market economies considering the strong pace of economic growth. The inflationary environment in some of the major emerging-market countries such as Brazil, China, the Czech Republic, Korea, Poland and Russia, however, worsened notably in the past few months.

Most advanced countries and some emerging-market economies therefore further tightened monetary policy during 2007. Since January 2007, monetary policy has been tightened in Canada, Chile, China, the Czech Republic, Denmark, the euro area, India, Japan, Mexico, New Zealand, Poland, South Korea, Sweden, Switzerland, Taiwan and the United Kingdom. By contrast, Brazil, Chile, Hungary, Israel and Thailand lowered policy rates. The central banks of China, India and Korea have also started to increase the required reserve ratio since the second half of 2006 to absorb excess liquidity.

Selected key central bank policy interest rates

Country	1 Jan 2006	7 Sep 2007	Latest change (Percentage points)	
United States	4,25	5,25	29 Jun 2006	(+0,25)
Japan	0,00	0,50	21 Feb 2007	(+0,25)
Euro area	2,25	4,00	13 Jun 2007	(+0,25)
United Kingdom	4,50	5,75	5 Jul 2007	(+0,25)
Canada	3,25	4,50	10 Jul 2007	(+0,25)
Australia	5,50	6,50	8 Aug 2007	(+0,25)
New Zealand	7,25	8,25	26 Jul 2007	(+0,25)
China	5,58	7,02	22 Aug 2007	(+0,18)
India	6,25	7,75	30 Mar 2007	(+0,25)
South Korea	3,75	5,00	9 Aug 2007	(+0,25)
Thailand	4,00	3,25	18 Jul 2007	(-0,25)
Brazil	18,00	11,25	6 Sep 2007	(-0,25)
Mexico	8,25	7,25	27 April 2007	(+0,25)
Chile	4,50	5,50	9 Aug 2007	(+0,25)

Source: Various national central banks

Policy issues and trade reforms

The Minister of Finance, in his 2007 *Budget Review*, reconfirmed the government's commitment to the gradual liberalisation of exchange controls. The solid performance of the South African economy over the past few years paved the way for further relaxation of such controls. In an effort to further enable South African companies to expand their strategic international partnerships, the Minister announced that the required shareholding threshold for foreign direct investment outside Africa would be lowered from 50 per cent to 25 per cent. In an effort to deepen the country's financial markets and increase liquidity in the domestic market for foreign exchange, the JSE Limited was given a mandate to establish a rand currency futures market. Furthermore, South African companies involved in international trade would be allowed to operate a single customer foreign currency (CFC) account for trade in goods and services, a step aimed at reducing the transaction cost associated with multiple CFC accounts.

A reappraisal of some of the country's existing trade agreements and subsequent negotiations resulted in, among other things, an agreement between South Africa and the European Union to reduce the duties levied on vehicle imports in both directions in phases, starting from December 2006. To allow the domestic clothing and textile industry time to adjust to the fierce winds of international competition, the Department of Trade and Industry announced the implementation of quotas on clothing and textile imports from China from January 2007. South Africa's initiative to boost its own economic growth rate via the Accelerated and Shared Growth Initiative for South Africa (AsgiSA), and its participation in the New Partnership for Africa's Development (NEPAD), have resulted in numerous co-operative agreements and projects.

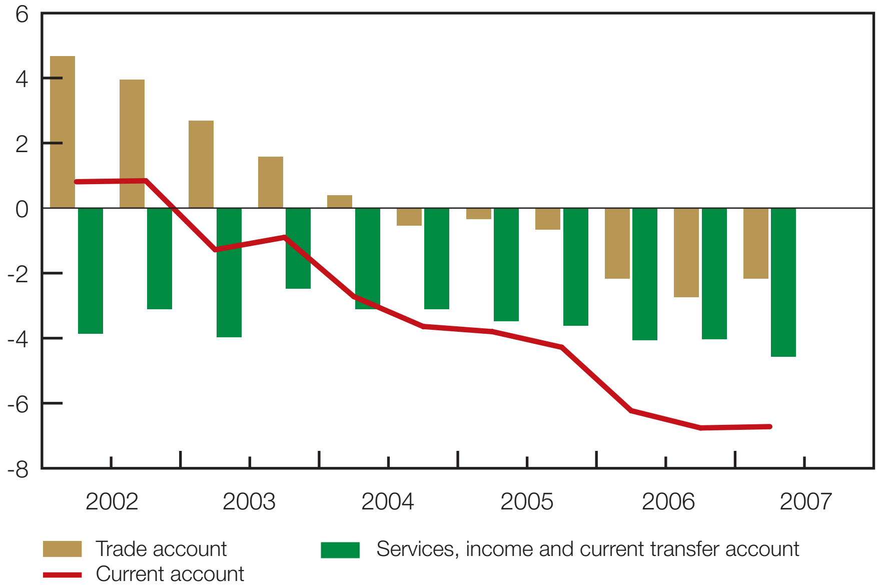
The Doha Development Round of World Trade Organization negotiations continued during the year under review, but issues such as the reduction of farm subsidies by developed countries and the opening up of agricultural and industrial markets could not be resolved conclusively.

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

	2005	2006			2007
	Year	1st half	2nd half	Year	1st half
Merchandise exports	325,1	347,9	449,1	398,5	480,9
Net gold exports	27,0	31,5	39,4	35,5	36,8
Merchandise imports	-359,8	-415,4	-537,7	-476,5	-558,8
Trade balance	**-7,7**	**-36,0**	**-49,2**	**-42,5**	**-41,1**
Net services, income and current transfers	-54,6	-67,3	-72,3	-69,9	-86,7
Balance on current account	**-62,3**	**-103,3**	**-121,5**	**-112,4**	**-127,8**
As percentage of gross domestic product	*-4,0*	*-6,2*	*-6,8*	*-6,5*	*-6,7*

As the current upward phase of the business cycle which commenced in 1999 gained momentum, a surge in gross fixed capital formation and an almost simultaneous deterioration in the balance on the current account of the balance of payments set in from 2003. Consistent with the sustained strong domestic demand and the country's relatively high import propensity, the volume of merchandise imports increased at a much faster pace than that of merchandise exports during the past four years. Accordingly, the country's trade shortfall with the rest of the world widened, causing the deficit on South Africa's current account to rise to 6,5 per cent of gross domestic product in 2006 and 6,8 per cent in the second half of that year. Although the trade deficit narrowed somewhat in the first half of 2007, this was more than neutralised by a widening of the shortfall on the net service, income and current transfer account with non-residents, resulting in a further sizeable deficit on the current account in the first six months of 2007.

Components of the current account as percentage of gross domestic product

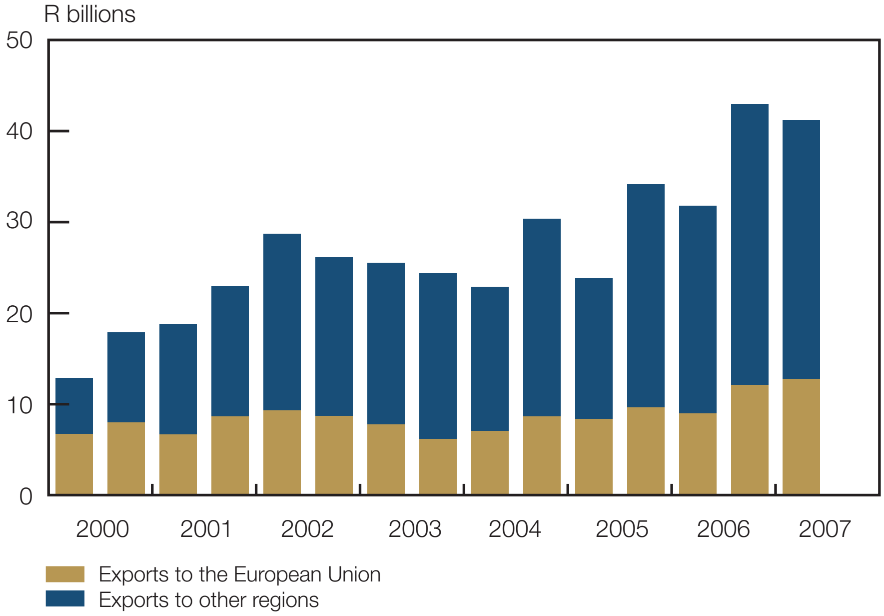


Exports

The continued expansion in global economic activity together with the depreciation of the rand in the middle quarters of 2006 bolstered South Africa's export earnings. The value of merchandise exports surged by no less than 29 per cent from the first to the second half of 2006 and advanced by a further 7 per cent in the first half of 2007. The modest growth in export revenue in the first half of 2007 was due to a more subdued rate of increase in both the volume and price of merchandise exports. The overall volume of goods exported increased by 2 per cent in the first half of 2007 following a rise of 14½ per cent in the second half of 2006.

Manufacturing export receipts rose considerably during the second half of 2006, with most subcategories recording firm increases. Exports of vehicles and transport equipment, for instance, rose substantially during this period, but edged lower in the first half of 2007 despite a continued increase in the exports of vehicles and automotive components such as catalytic converters, engines, axles, silencers and exhausts to the European Union. However, an increase in exports of goods in other manufacturing subcategories like machinery and electrical equipment and chemical products raised total manufactured exports somewhat during the first half of 2007.

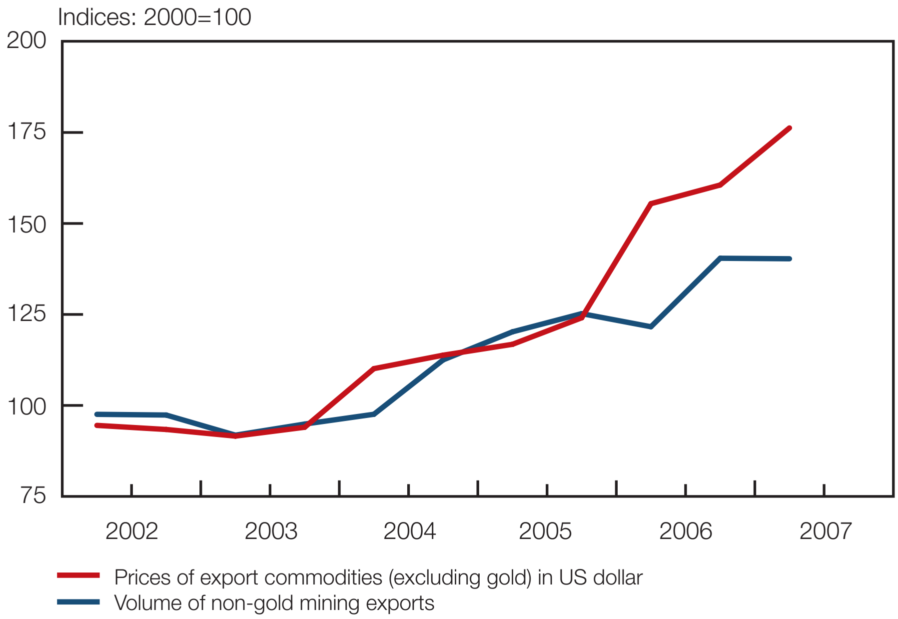
Exports of vehicles and transport equipment



The perennial growth in the economies of China and India contributed to strong international demand for domestically produced mining products. The volume of mining exports rose by 15½ per cent from the first half of 2006 to the second half before moving sideways in the first half of 2007. Non-gold mining products accounted for roughly 52 per cent of the total value of merchandise exports in the first half of 2007.

The increase in the average unit price of merchandise exports amounted to 13 per cent in the second half of 2006, slowing to 5 per cent in the first half of 2007. Export prices continued to benefit from a persistent upward trend in international commodity prices

South Africa's export commodity prices and volume of mining exports

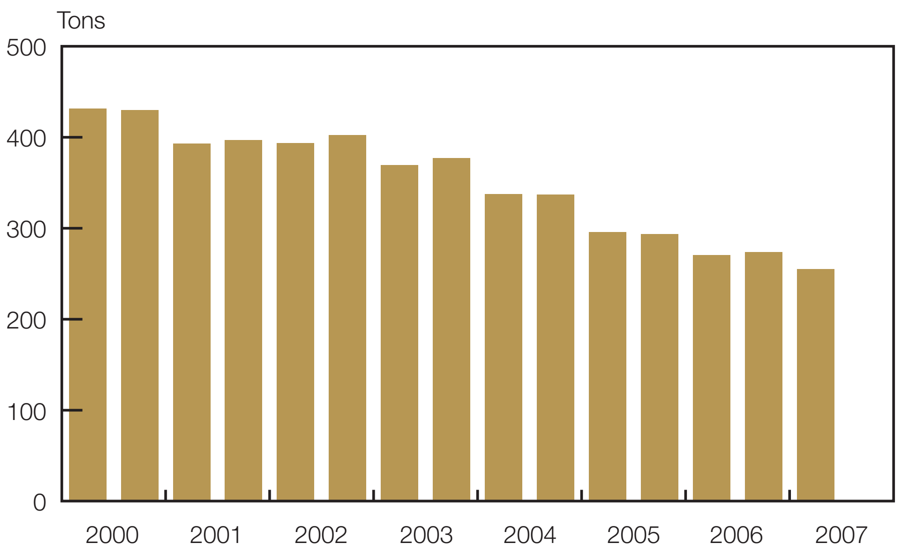


alongside the depreciation of the rand from May 2006. Boosted by China's rapidly expanding economy and concomitant demand for industrial commodities, metal and minerals commodity prices trended higher. Over the past eighteen months, the US dollar prices of South African export commodities accordingly jumped by almost 36 per cent.

In tandem with the downward trend in international gold production, South Africa's gold production contracted further in 2006 and the first half of 2007. The decline in domestic production could be ascribed to the higher costs incurred as a result of mining at deep underground levels, local strikes and labour cost which increased more than the inflation rate. Notwithstanding the decline in production, South Africa remained the world's largest gold producer in 2006, albeit by a small margin. Australia lost its second position to become the world's fourth largest producer after the US and China. The volume of South Africa's net gold exports contracted by 9 per cent in 2006 and further by 11 per cent in the first half of 2007. An increase of 1,5 per cent in the amount of ore mined was not sufficient to offset a decline of 9,3 per cent in the average grade, which fell from 5,15 grams per ton in 2005 to 4,67 grams per ton in 2006.

The average London fixing price of gold increased by 36 per cent to US$604 per fine ounce in 2006 and further by 6½ per cent from the second half of 2006 to the first half of 2007. The surge in the price of gold was driven by, among other things, the global demand and supply imbalances for gold, US economic fundamentals, high energy and commodity prices, geopolitical tension and higher prices of crude oil. In June 2007, however, the increase in the gold price was briefly disrupted by concerns regarding future gold sales by central banks. In the third year of the five-year Central Banks Gold Agreement, the European Central Bank and the Bank of Spain sold 37 and 80 tons of gold, respectively. In total about 1 500 tons of gold have been sold since the signing of the agreement in September 2005. The decline in the volume of net gold exports was completely offset by an increase of 44½ per cent in the average realised rand price in 2006, resulting in higher net gold export revenues for the year. By contrast, the increase by 5 per cent in the rand price of gold in the first half of 2007 was not sufficient to counter the decline in export volumes.

Gold production

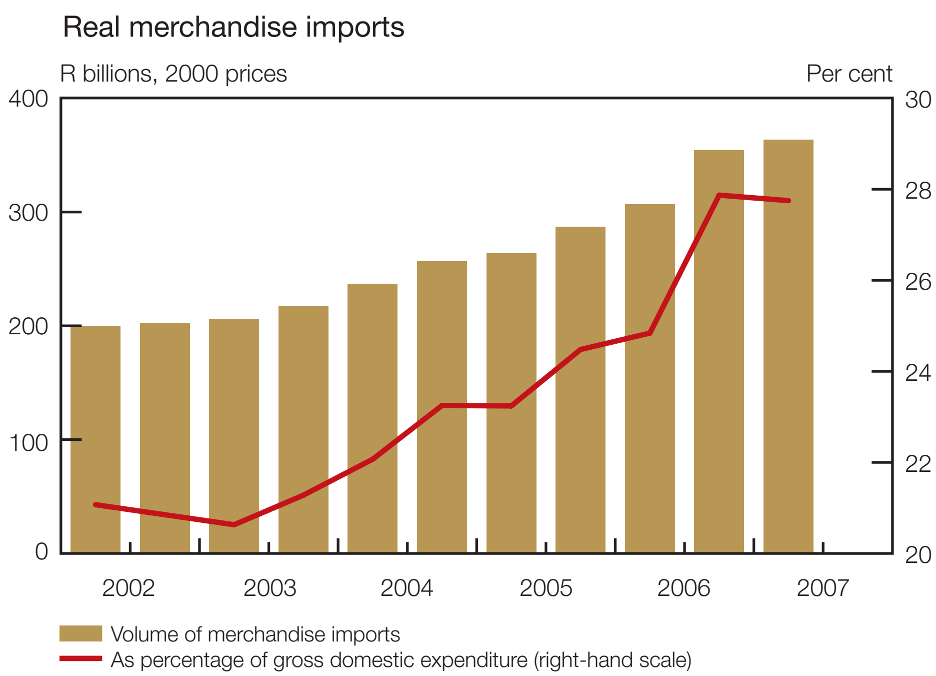


Annualised data

Imports

Persistent vibrant domestic demand led to an increase in the demand for imported capital, intermediate and consumer goods. The higher value of imported goods in 2006 and the first half of 2007 was concentrated in the subcategories for mineral products, machinery and electrical equipment, and vehicle and transport equipment as various infrastructural projects gained momentum.

The value of merchandise imports rose by no less than 29½ per cent in the second half of 2006 compared with the first half. In volume terms the increase was 15½ per cent, while import prices rose by 12 per cent over the same period. By contrast, both the value and volume of merchandise imports rose at subdued rates in the first half of 2007.



The country's import penetration ratio accordingly increased from 25 per cent in the first half of 2006 to 28 per cent in the second half, moving sideways in the first half of 2007.

Although the value and volume of crude oil imports display considerable short-term variability, the value of crude oil imports comprised 12½ per cent of the total value of merchandise imports during the first half of 2007, a magnitude almost similar to that of 2006. However, in an effort to adequately meet the rising domestic demand for petroleum products and ease the strain on domestic refining capacity, South African oil companies stepped up the importation of refined oil products such as petrol and diesel.

The volatility in the international price of crude oil weighed heavily on the overall price of merchandise imports. The steep increase in the international price of crude oil alongside the depreciation of the external value of the rand caused the rand price of merchandise imports to rise sharply in the second half of 2006. The mild decline in the price of oil and broad sideways movement of the exchange value of the rand in the first half of 2007 helped to moderate the increase in the rand price of such goods over this period.

Net service, income and current transfer payments

The deficit on the net service, income and current transfer account widened by R15 billion to R70 billion in 2006 and further to an annualised R87 billion in the first half of 2007. After deteriorating from 3,5 per cent of gross domestic product in 2005 as a whole to 4,1 per cent in the first half of 2006, the deficit remained broadly unchanged in the second half of 2006, before widening to 4,6 per cent during the first half of 2007. As reflected in the accompanying table, the widening of the deficit in 2006 could be ascribed to a larger net deficit for services which escalated by half a percentage point. Contrary to this relatively sharp movement, the larger deficit during the first half of 2007 reflected higher net dividend payments to non-residents.

Balances: Components of services, income and current transfer account

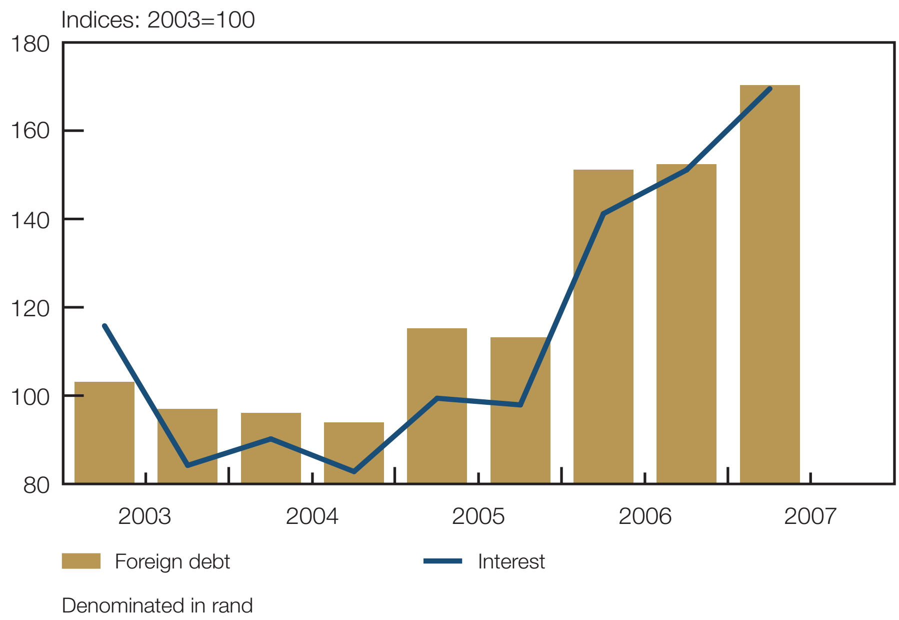
Percentage of gross domestic product

	2005	2006	2007*	Average 1999 – 2003	Average 2004 – 2007
Net services payments	-0,4	-0,9	-0,9	-0,3	-0,6
Net interest payments.............................	-0,3	-0,3	-0,3	-1,1	-0,3
Net dividend payments	-1,6	-1,6	-2,2	-1,3	-1,7
Net other income payments....................	-0,1	-0,1	-0,1	-0,2	-0,1
Net current transfer payments	-1,1	-1,1	-1,1	-0,6	-1,0
Total deficit	**-3,5**	**-4,0**	**-4,6**	**-3,6**	**-3,8**

Deficit -, surplus +
* First half of 2007

The level of gross interest payments to non-resident investors and creditors escalated noticeably by about 48 per cent in 2006 followed by more moderate growth of about 12 per cent in the first half of 2007 when compared with the second half of 2006. A combination of higher international interest rates and a persistent increase in foreign debt exposure contributed towards these elevated levels of interest payments. However, interest receipts,

Foreign debt and interest paid

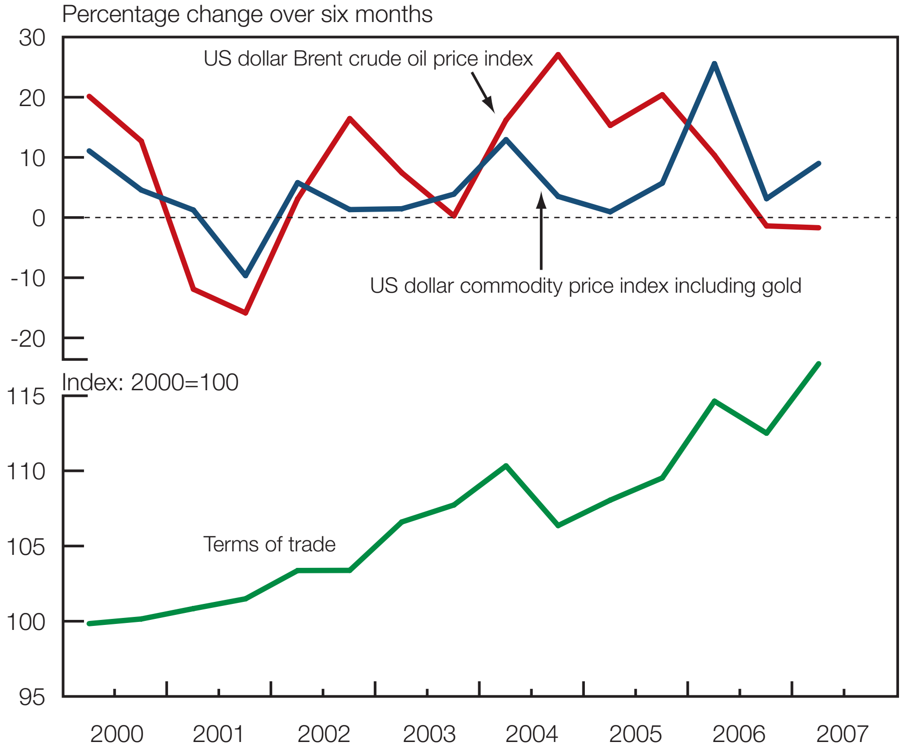


resulting mainly from higher foreign exchange holdings by the South African monetary sector, prevented the deficit on net interest payments from deteriorating further over the period. Net dividend payments as percentage of gross domestic product remained broadly unchanged at about 1,6 per cent throughout 2006 before escalating to more than 2 per cent in the first half of 2007. The sizeable dividend payments experienced throughout 2006 and 2007 partially reflected the continued strong profit conditions in the economy.

Terms of trade

A rapid, commodities-led increase in export prices relative to import prices resulted in an improvement in South Africa's terms of trade in the first half of 2006. In the second half of 2006, the terms of trade deteriorated moderately, but improved visibly during the first half of 2007.

Commodity price indices and terms of trade



Financial account

Sustained robust economic growth, high commodity prices and an abundance of international liquidity have resulted in the longest period of uninterrupted net inflows of capital into South Africa since the early 1970s – nine consecutive half-year periods of capital inflows on the financial account, beginning in 2003. Over this period the country's well-developed capital markets played a significant role in attracting foreign financial flows as portfolio investment into South Africa recorded the largest inflows of the three functional categories in the financial account culminating in an inflow of R79,5 billion (including unrecorded transactions) in 2006.

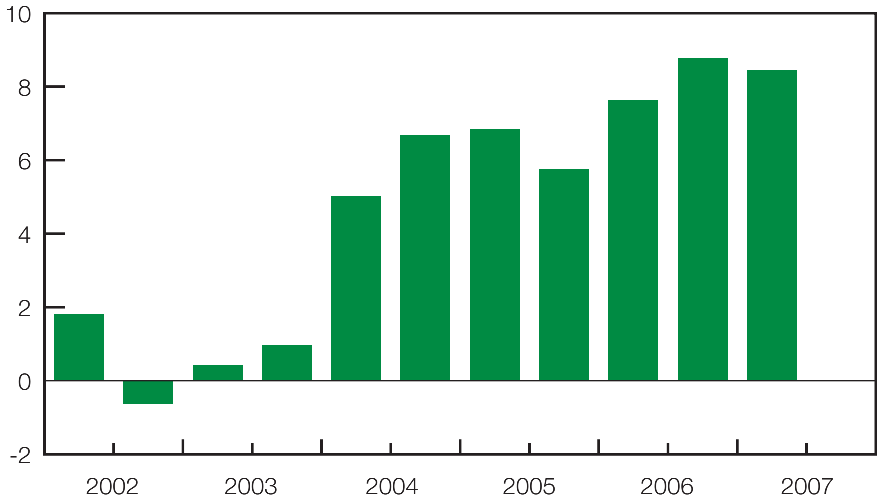
Net financial transactions not related to reserves
R billions

	2005	2006			2007
	Year	1st half	2nd half	Year	1st half
Liabilities					
Direct investment	42,4	12,2	-15,1	-2,9	15,8
Portfolio investment	36,1	88,9	55,4	144,3	66,5
Other investment	30,8	44,0	18,4	62,4	22,1
Assets					
Direct investment	-6,0	-11,3	-33,9	-45,2	-9,3
Portfolio investment	-6,0	-6,7	-7,0	-13,7	-10,8
Other investment	-22,3	-60,9	17,8	-43,1	-7,3
*Financial transactions**	*96,5*	*62,6*	*79,4*	*142,0*	*79,5*

* Including unrecorded transactions

While portfolio investment inflows have been mainly responsible for the financial account surplus since 2004, prospects for inward direct investment flows were also improving as interest from private equity entities escalated during 2006. The inflow of other investment capital, mainly in the form of loans and deposits, also contributed to the financing of the shortfall on the current account of the balance of payments. As a ratio of gross domestic product, the surplus on the financial account amounted to 8,2 per cent in 2006 compared with 6,3 per cent in 2005. During the first half of 2007, this ratio increased to 8,5 per cent.

Net financial transactions not related to reserves as percentage of gross domestic product



Foreign-owned assets in South Africa

Foreign direct investment into South Africa increased significantly during 2006 as foreign direct investment companies expanded their equity stakes in South African telecommunications, tyre, sugar and steel manufacturing companies. A number of foreign disinvestment transactions occurred during the second half of 2006 in the gold-mining industry when foreign direct investment entities sold their shareholding to domestic groups. This resulted in a reduction in direct investment liabilities for 2006 as a whole. As some of the transactions involving private equity funds have been concluded while others are in the process of being finalised, the outflow changed to an inflow during the first half of 2007. The acquisition of South African companies by private equity funds was focused on several sectors. In some instances the acquisition was structured in such a way that the acquisition price was partly paid through a direct investment inflow and partly through borrowing in the domestic and foreign financial markets.

Portfolio investment into South Africa recorded inflows on a half-yearly basis from the start of 2004. The performance of emerging-market stock markets, as illustrated in the accompanying table, has attracted investors from developed markets in search of higher yields. South Africa has performed admirably with a five-year rate of return in the stock market, second only to Russia. The country's stable political environment and prudent government policies and regulations bolstered investors' confidence. While the largest inflow of capital into South Africa was in the form of equity securities, South Africa also benefited from inflows into its developed domestic debt markets during 2006 and the first half of 2007. As a result of the favourable fiscal position of the central government, a net outflow of capital related to bonds was recorded during 2006, as government redeemed bonds held by international investors. The issuance of international bonds by parastatals and private-sector companies in foreign markets over the past eighteen months was also subdued.

Performance of selected emerging-market countries' stock markets

Per cent

	Five-year annualised returns (Dec 2000 to Dec 2006)	2006 returns	Five-year standard deviation as of 31 December 2006
Russia	50,3	63,9	29,5
South Africa	39,7	21,4	23,8
Brazil	38,0	49,0	38,2
India	37,7	48,8	23,3
Mexico	29,5	43,2	20,4
Korea	28,7	15,0	24,0
China	28,4	85,0	21,1
Malaysia	16,8	40,1	15,3
Israel	10,9	-4,0	20,9
Taiwan	9,9	22,2	22,6

Top ten countries by weight in S&P/IFCI Index

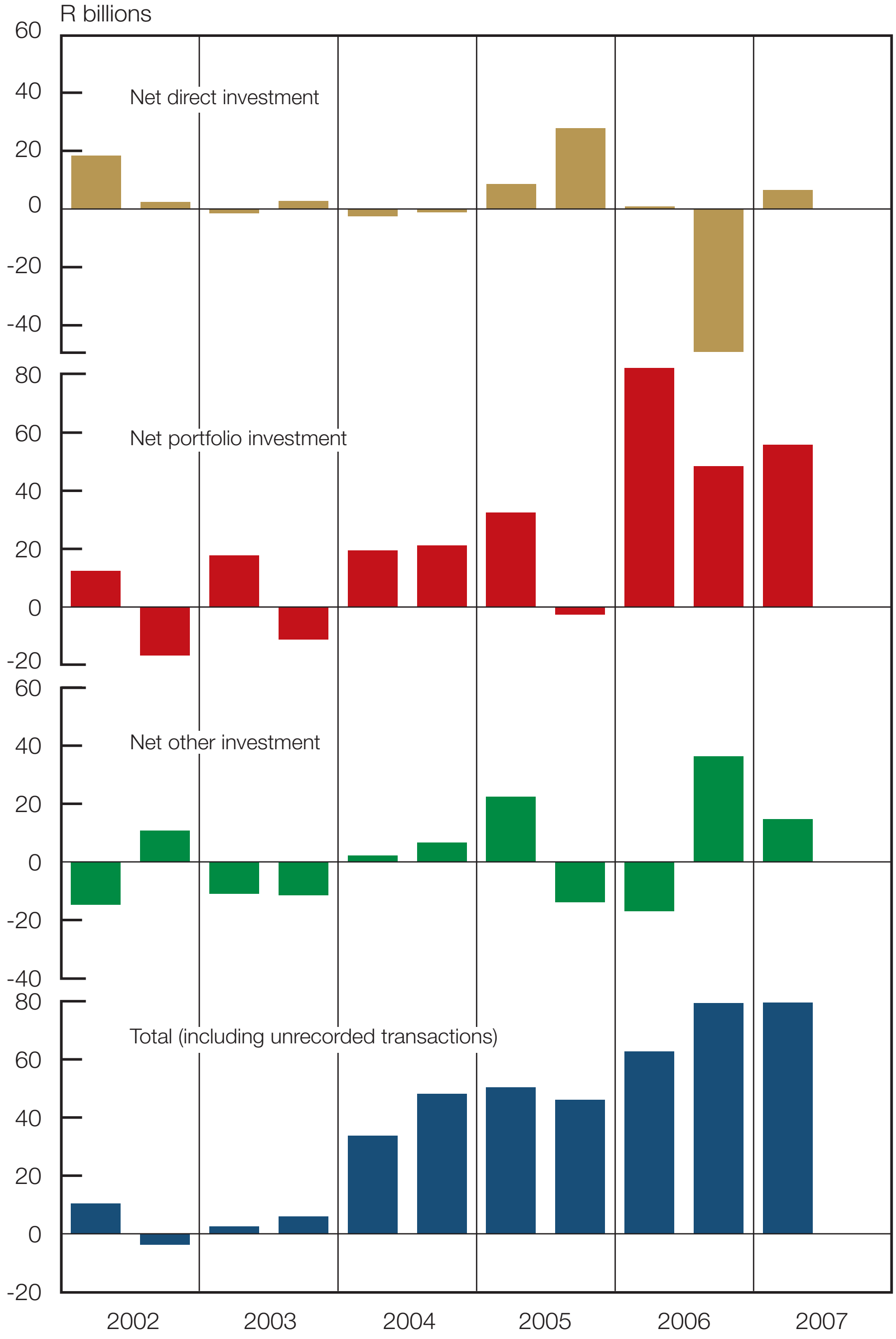
Source: Standard & Poor's

Other foreign investment into South Africa recorded its largest ever inflow in any calendar year during 2006. These inflows were in the form of both long and short-term loans drawn upon by mainly the private and banking sectors. Non-residents' rand and foreign-currency denominated deposits with the South African banking sector also increased, consistent with the positive interest rate differential between South Africa and the developed countries. The inflow of capital into this category continued at a more subdued pace during the first half of 2007.

South African-owned assets abroad

The reduction of the threshold in the foreign shareholding for direct investment outside Africa should encourage the geographical growth and diversification of South African enterprises. Outflows of capital for the acquisition of *foreign direct investment* assets from the rest of the world were recorded during 2006 and the first half of 2007. The largest transaction in 2006 involved the acquisition by a South African telecommunications company of an enterprise in the Middle East. The acquisition of *foreign portfolio investment assets* by predominantly South African institutional and, to a lesser extent, individual investors progressed at a steady pace during 2006 and the first half of 2007 against the background of low volatility in the international markets.

Balance of payments: Financial account



Other foreign investment assets increased significantly during 2006, but declined in the first half of 2007. The increase in other foreign investment assets in the first half of 2006 could mainly be attributed to an increase in the offshore foreign-currency deposits of South African banks. During the first half of 2007 the South African banks reduced their foreign-currency denominated deposits with offshore banks, resulting in an inflow of capital.

Foreign debt

South Africa's total outstanding debt increased by US$10,8 billion from the end of 2005 to the end of 2006, before declining by US$1,6 billion during the first quarter of 2007. The substantial acceleration in the accumulation of foreign debt during 2006 was aligned with the robust growth in domestic demand and to a large extent reflected the increase in the *other investment liabilities* category on the financial account of the balance of payments. Private-sector companies made use of loans and trade credit to finance their purchases of fixed capital assets and inventories, while non-resident investors raised their foreign-currency deposits with the domestic monetary sector. Non-residents may have become more risk-averse, resulting in subdued growth in such deposits during the first quarter of 2007. Loans extended to local firms also declined over the period. The rand-denominated debt also decreased in the first quarter of 2007 as some rand-denominated government bonds in the hands of non-residents were redeemed.

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

	2002	2003	2004	2005	2006	2007*
Foreign-currency denominated debt...	25,0	27,4	27,9	28,1	35,8	34,9
Bearer bonds	7,8	9,7	9,7	9,1	10,5	10,3
Public sector	5,0	4,9	4,9	4,6	5,2	5,2
Monetary sector	6,3	5,9	7,0	7,9	10,3	10,7
Non-monetary private sector	5,9	6,9	6,3	6,5	9,8	8,7
Rand-denominated debt	9,0	11,9	17,1	20,3	23,4	22,7
Bonds	4,5	4,2	5,8	6,3	7,5	6,1
Other	4,5	7,7	11,3	14,0	15,9	16,6
Total foreign debt	34,0	39,3	45,0	48,4	59,2	57,6

* First quarter

Owing to the increase in the debt levels and the depreciation of the rand against the currencies of South Africa's main trading-partner countries, the country's total foreign debt, measured in rand, increased by R106 billion from a level of R306 billion at the end of 2005 to R412 billion at the end of 2006. As a ratio of gross domestic product, South Africa's total external debt increased from 20,0 per cent to 23,2 per cent over the same period. The increase in this ratio was still slower than that recorded in the years prior to 2003.

After declining for three consecutive years, the ratio of foreign debt to exports of goods and services rose marginally from the end of 2005 to the end of 2006. The sustained growth in imports of goods and services in an environment of subdued savings encouraged local companies to utilise the borrowing facilities at their disposal. Many other emerging-market countries' ratios improved, roughly in accordance with their current-account surpluses and in some instances reflecting debt relief.

Ratio of foreign debt to exports of goods and services: Emerging-market and developing countries
Per cent at end of period

	2001	2002	2003	2004	2005	2006
Africa	183,5	183,8	158,8	130,6	94,5	68,7
South Africa	**81,4**	**87,6**	**79,3**	**73,7**	**68,0**	**72,1**
Central and eastern Europe	123,9	129,0	126,4	119,6	111,9	110,6
Commonwealth of Independent States	114,1	111,8	107,0	92,5	86,3	79,5
Developing Asia	97,6	86,4	74,7	62,5	53,2	48,2
Middle East	65,1	62,9	54,8	48,6	40,5	40,5
Western hemisphere	192,4	188,9	178,6	148,0	116,0	94,6

Source: IMF *World Economic Outlook*, April 2007

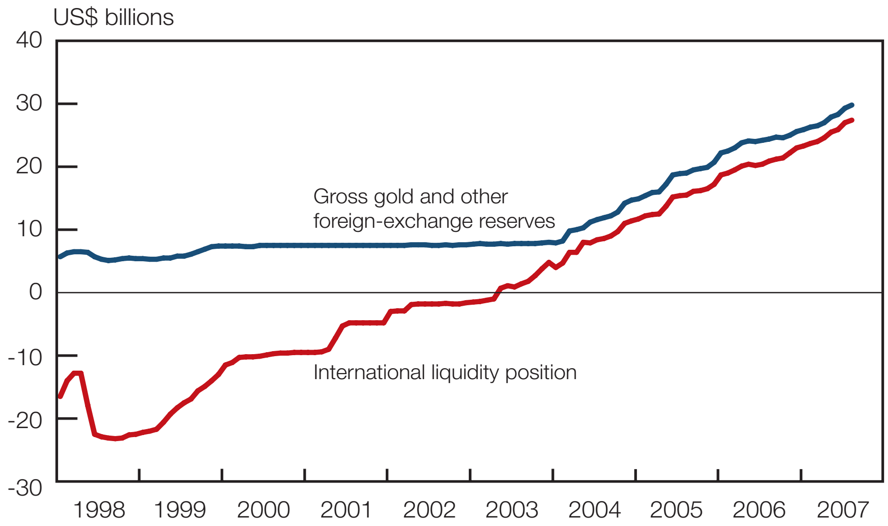
South Africa's short-term, foreign-currency denominated debt (i.e. debt with an original maturity of less than one year and other foreign-currency denominated debt maturing within twelve months) amounted to 47,6 per cent of total foreign-currency denominated debt at the end of 2006, compared with 41,3 per cent at the end of 2005. This deterioration in the maturity structure of South Africa's foreign-currency denominated debt was mainly due to an increase in the monetary and private sectors' short-term debt.

During June and July 2007, Moody's and Fitch rating agencies revised South Africa's foreign-currency ratings outlook from stable to positive. A positive outlook was assigned to the government's foreign-currency debt as well as to the foreign-currency bank deposits. The revised ratings were based on South Africa's track record of political stability, sound government finances, strengthening external liquidity and a healthy financial system.

International reserves and liquidity position

South Africa's net international reserves increased by R29,8 billion in 2006 as the financial account of the balance of payments continued to more than fully finance the growing deficit on the current account. The accumulation of reserves in 2006 was evenly spread over the first and second half of the year, partially reflecting the stable financial

Gross reserves and international liquidity position of the South African Reserve Bank



conditions in the country. The accumulation of foreign reserves continued into the first half of 2007 when a further R19,0-billion improvement in the international reserves position was recorded.

The gross international reserves position of the Bank improved from US$20,7 billion at the end of 2005 to US$25,6 billion at the end of 2006 and further to US$29,8 billion at the end of August 2007. Although a sizeable build-up of gross reserves occurred during 2006, the ratio of foreign-exchange reserves of the Bank to the current-account deficit deteriorated from 2,1 in 2005 to 1,6 in 2006 and remained unchanged at the end of June 2007. The level of imports of goods and services covered by gross official international reserves decreased to 12 weeks' worth at the end of December 2006. However, at the end of June 2007 this ratio increased again to 13½ weeks' worth.

The international liquidity position of the Bank also continued its gradual improvement from US$17,2 billion at the end of December 2005 to US$23,0 billion at the end of December 2006 and further to US$27,4 billion at the end of August 2007.

Exchange rates

A reassessment of risks in and returns associated with investment in emerging markets by international investors, a sharp fall in global commodity prices, a recovery in the US dollar and a rise in global interest rates resulted in downward pressure on emerging-market currencies from early May 2006. The nominal effective exchange rate of the rand, which had held steady in the first four months of 2006, depreciated considerably over the subsequent two months and, on balance, decreased by 15,4 per cent in the first half of 2006, thereafter declining only marginally during the remainder of the year. The roughly unchanged level of the rand against a basket of currencies during the second half of 2006 resulted from opposing forces of uncertainty among market participants. News about the rising deficit on the current account of the balance of payments was countered by reports of attractive opportunities in and high-profile inflows of funds into South Africa.

Exchange rates of the rand

Percentage change

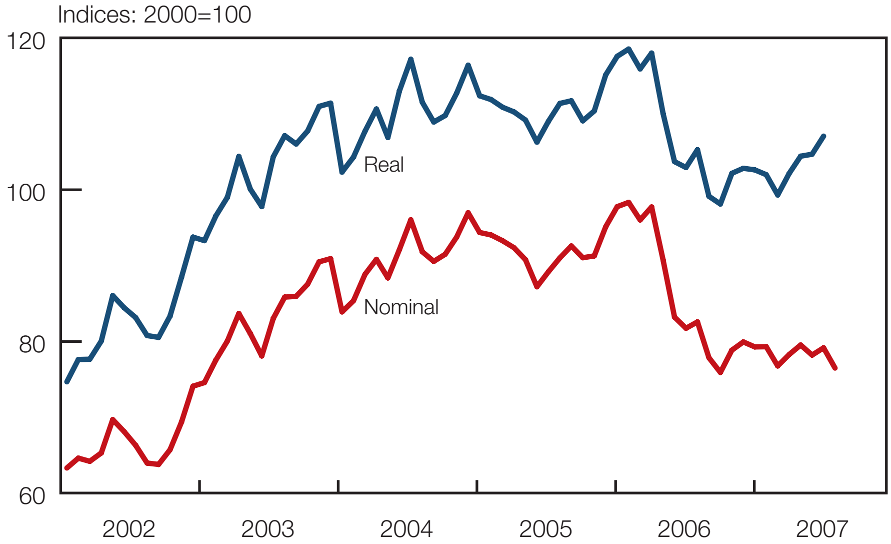
	30 Dec 2005 to 30 Jun 2006	30 Jun 2006 to 29 Dec 2006	29 Dec 2006 to 29 Jun 2007	29 Jun 2007 to 31 Aug 2007
Weighted average*	**-15,4**	**-0,1**	**-2,7**	**-1,5**
Euro	-17,4	-1,2	-3,8	-1,6
US dollar	-11,5	2,4	-1,7	-0,2
British pound	-16,5	-4,5	-3,6	-0,8
Japanese yen	-13,4	6,1	2,0	-6,0

* Against a basket of 13 currencies

Further volatility in stock markets and continued nervousness regarding the current-account deficit put some downward pressure on the exchange rate of the rand during the first half of 2007, but this was largely countered by a renewed surge in commodity prices and positive sentiment surrounding large foreign capital inflows from private equity investors.

On balance, these developments enhanced the relative competitiveness of South African exporters. The real effective exchange rate of the rand declined by 7 per cent in the nineteen months to July 2007, although the bulk of the decline was concentrated around May and June 2006.

Effective exchange rates of the rand



The attractiveness of trading and investment in South African equity and debt securities was also reflected in an increase in the average daily turnover in the domestic market for foreign exchange from US$13,3 billion in 2005 to US$14,2 billion in 2006, and further to US$15,7 billion in the first half of 2007. The share of non-residents in the activity in the domestic market for foreign exchange increased to 77,0 per cent in the first half of 2007 from 73,1 per cent in 2006, alongside their continued acquisition of domestic portfolio assets.

Monetary developments and interest rates

Structural and regulatory issues

The favourable macroeconomic environment continued to underpin the financial performance of South African banks during the past year. Asset growth in the banking sector remained strong, notwithstanding increases in lending rates and the securitisation of assets. Buoyant demand for bank-intermediated credit from both the household and corporate sectors contributed positively to banks' profitability. Overall, the banking system remained generally stable and in compliance with regulatory guidelines, with the ratio of non-performing to total loans remaining below its long-term average.

At the end of July 2007, there were 35 registered banks in South Africa as well as 43 representative offices of foreign banks. Four major banking groups continued to dominate, representing about 84 per cent of the total assets of the South African banking sector.

Size of the South African private banking sector

	July 2006		July 2007	
	Number of institutions	Total assets R billions	Number of institutions	Total assets R billions
Locally controlled banks	14	1 753	14	2 185
Foreign controlled banks	5	8	5	9
Mutual banks	2	1	2	1
South African branches of foreign banks	14	178	14	167
Total registered banks	**35**	**1 940**	**35**	**2 362**

Over the past twelve months banks continued to diversify their sources of funding through, for instance, increased asset securitisation and the issuance of notes and bonds for reasons such as re-capitalising and positioning for further balance sheet expansion. Over the year to July 2007, banks raised net funding to the amount of R56,6 billion in the primary bond market. Of this amount R13,8 billion was raised through conventional loan stock listings while the securitisation of assets and issuance of commercial paper amounted to R26,9 billion and R15,8 billion, respectively. While the securitisation of bank assets has generally accelerated in the South African market over the past eighteen months, some domestic banks more recently also sourced funding in the international financial markets.

In order to entrench their positions as market leaders and tap into the emerging pool of new borrowers, banks have continuously improved their banking products and services through the efficient use of technology and the formation of partnerships with non-bank financial service companies and retailers.

Banks continued to make progress towards the final preparations for the Basel II capital-adequacy framework due to be implemented in January 2008. The draft Banks Amendment Bill was released for public comment in February 2007 and is expected to be finalised later this year. The objectives of the Bill are to facilitate the implementation of Basel II and to align the Banks Act with changes in supervisory policy, market developments and practical considerations. The proposed amendments to the regulations relating to banks and to the exemption notice relating to securitisation schemes, which are intended to replace the current regulations relating to banks, were also released for public comment in April 2007.

Under the ambit of the proposed co-operative banks legislation, one business association established a co-operative bank during the past year with the aim of providing financial services, primarily to the co-operative movements and other selected customer segments such as small business operators, through an established country-wide network.

In November 2006, the Financial Sector Charter Council released its first annual report on transformation in the financial sector for the year 2005. According to the report, the sector was on track to meet its black ownership target of 25 per cent by 2008 and at the end of 2005 had almost reached its R50-billion target set for funding major empowerment deals envisaged for 2008. In addition, the R5-billion target set for financing small and medium-sized black enterprises by the year 2008, had already been exceeded in 2005.

Through partnerships with various stakeholders, including national and international development agencies, banks have made a considerable contribution to the building of affordable housing and provision of finance to the lower income market. Consistent with the Memorandum of Understanding between the banks and the National Department of Housing, an amount exceeding R30 billion out of the R42 billion pledged had already been spent. The banks have been successful in broadening access to financial services to people earning low incomes. It is estimated that over 3 million Mzansi accounts have been opened and the functionalities of the account have been improved as well.

The Competition Commission enquiry into competition in banking and the national payment system commenced during the past year with the release of the terms of reference outlining responsibilities and functions. The enquiry had received submissions from various stakeholders, including members of the public, and it is anticipated that the final report will be handed over to the Competition Commissioner later this year.

September 2006 marked a final deadline for banks to have established and verified the identity of all clients in terms of the Financial Intelligence Centre Act (FICA) 2001, including those considered to be of low risk. Amendments to the Act being formulated were aimed at, among other factors, enhancing the Centre's own monitoring powers and providing for the conduct of inspections, especially in those instances where there were no other supervisory bodies.

In response to public concerns relating to the commitment of banks in terms of the provision of access to credit as envisaged in the Financial Sector Charter and regulatory concerns relating to reckless lending, all major lending banks unveiled a voluntary Code of Conduct on Credit Extension. The Code contains useful provisions to protect customers, not only from excessive offers of credit but also from inexplicable denial of credit by a bank representative. All important provisions relating to the Code are expected to be incorporated in a revised Code of Banking Practice.

The final phase of the implementation of the NCA was reached on 1 June 2007 when the Act's remaining stipulations came into effect. In the context and spirit of the Act, the four associations representing members who provide in excess of 95 per cent of private-sector credit extended to consumers in South Africa – namely the Banking Association South Africa, Consumer Credit Association, Furniture Traders Association and Micro Finance South Africa – signed a Memorandum of Understanding. They thereby committed themselves to co-operate in assessing the viability of a possible industry-driven set of voluntary arrangements which could in future give relief to overindebted consumers, through an industry-assisted voluntary debt mediation process. It is still too early to quantify the impact of the Act on the demand for credit, a question which may be further complicated by the coincident impact of changes in the monetary policy stance.

On 1 June 2007 the NCA replaced the Usury Act, the Credit Agreements Act and the Exemption Notice to the Usury Act, the latter being specifically applicable to micro-lenders. The NCA controls and regulates all credit agreements and therefore governs the credit-extension activities of institutions engaging in the provision of credit. Insurers and pension funds providing loans, such as policy loans (except where the credit is utilised to maintain the payment of premiums on a policy) and direct housing loans are required to register as credit providers and must ensure that all loans issued comply with the detailed requirements of the NCA.

Maximum interest rates as set by the NCA apply to all new credit agreements entered into from 1 June 2007 onwards, while credit agreements entered into prior to this date remain subject to the Usury Act interest rate limits.

The maximum interest rates in terms of the NCA are calculated as stated in the accompanying table:

National Credit Act maximum interest rates

Category	Rate formula Per cent per annum	Maximum rate* Per cent
Mortgage agreements	(RR x 2,2) + 5	27
Credit facilities	(RR x 2,2) + 10	32
Unsecured credit transactions	(RR x 2,2) + 20	42
Developmental credit agreements:		
For the development of a small business	(RR x 2,2) + 20	42
For low-income housing (unsecured)	(RR x 2,2) + 20	42
Short-term credit transactions	5% per month	60
Other credit agreements	(RR x 2,2) + 10	32
Incidental credit agreements	2% per month	24

RR refers to the repurchase rate as set by the SARB

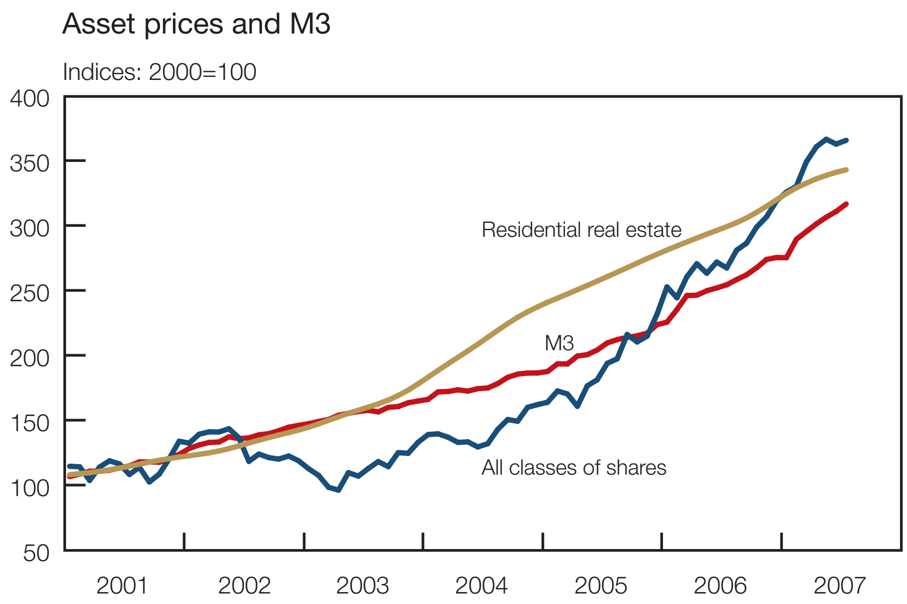
* Annual interest rate based on the current repurchase rate of 10,0 per cent

The maximum finance charge rates as stipulated by the Usury Act and applicable to credit agreements entered into prior to 1 June 2007 were changed on 5 March 2007. For transactions of R10 000 or less, the maximum rate is now calculated as the repurchase rate plus one third thereof, plus 11 percentage points and is currently 24 per cent. For transactions exceeding R10 000 it is the repurchase rate plus one third thereof, plus 8 percentage points and is currently 21 per cent. Rates are rounded down to the closest whole number.

The Usury Act interest rates will henceforth change seven days after a change in the repurchase rate, while changes in the NCA interest rates will be effective on the day of the change in the repurchase rate.

Money supply

Growth in the broadly defined money supply (M3) increased towards the end of 2005 and remained at relatively high levels during 2006 and the first half of 2007. Growth over twelve-month periods averaged 23 per cent in 2006 and remained at similar levels in the first seven months of 2007.



Twelve-month growth in the narrower monetary aggregates displayed more short-term volatility when compared to M3 during the period under review. The monetary policy tightening and the associated increase in money-market interest rates from June 2006 have been reflected in a notable acceleration in the growth rate of deposits with a term to maturity of more than six months.

Growth in monetary aggregates

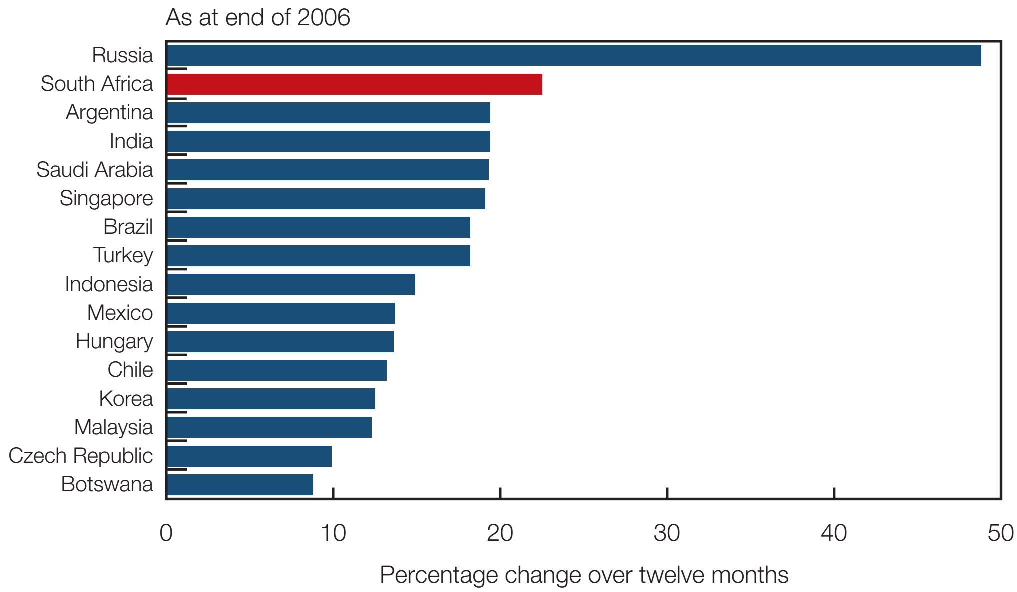
Percentage change over twelve months to end of period

Monetary aggregates	2005	2006	July 2007
Banknotes and coin in circulation	11,1	15,0	7,1
Cheque and transmission deposits	21,0	15,9	19,3
M1A	**19,4**	**15,8**	**17,5**
Other demand deposits	19,2	26,8	12,5
M1	**19,3**	**20,4**	**15,1**
Other short and medium-term deposits*	15,9	19,7	29,4
M2	**17,7**	**20,1**	**21,6**
Long-term deposits**	44,2	39,8	41,0
M3	**20,5**	**22,5**	**24,5**

* Unexpired maturities of more than one day up to six months
** Unexpired maturities of more than six months

An important reason for the robust growth in M3 was the strong increases in income and expenditure. At the same time, wealth effects emanating from rising prices of financial and non-financial assets (as depicted in the graph on page 49) also supported growth in money supply. In turn, the increases in money supply probably also rendered support to asset prices. Exceptionally buoyant increases in trading in the South African financial markets may also partly explain why recent growth in money supply in South Africa exceeded that of most other emerging-market countries.

Growth in broad money supply in selected emerging-market countries



Source: *Emerging Markets Economic Outlook*, Oxford Economics

Over the past three years, a notable seasonal occurrence has been the redemption of government bonds and coupon interest payments at the end of each February, which served to bolster the short-term growth in M3 on a purely seasonal basis.

The M3 holdings of the corporate sector contributed a record R230 billion, or 75 per cent, to the overall increase in money supply over the twelve months to July 2007. Within the corporate sector, the non-bank financial companies accounted for 62 per cent of the increase, which could be partly attributed to the speculative and precautionary motives for holding monetary assets in an environment characterised by robust activity in the financial markets. The household sector's deposit holdings contributed R75 billion to the overall increase in M3 from July 2006 to July 2007. This sector continued to benefit from, among other things, rising disposable income, in turn related to wage adjustments which exceeded inflation, and the recent significant gains in employment creation.

Over the past year, growth in M3 exceeded growth in nominal gross domestic product. Accordingly, the income velocity of circulation of M3 declined from 1,40 in the third quarter of 2006 to 1,30 in the second quarter of 2007, suggesting the availability of ample liquidity in the economy.

The counterparts of change in M3 are presented in the accompanying table. A substantial part of the increase in M3 during 2006 and the first seven months of 2007 was statistically explained by the increase in banks' claims on the private sector, mainly reflecting strong growth in total loans and advances.

Counterparts of change in M3

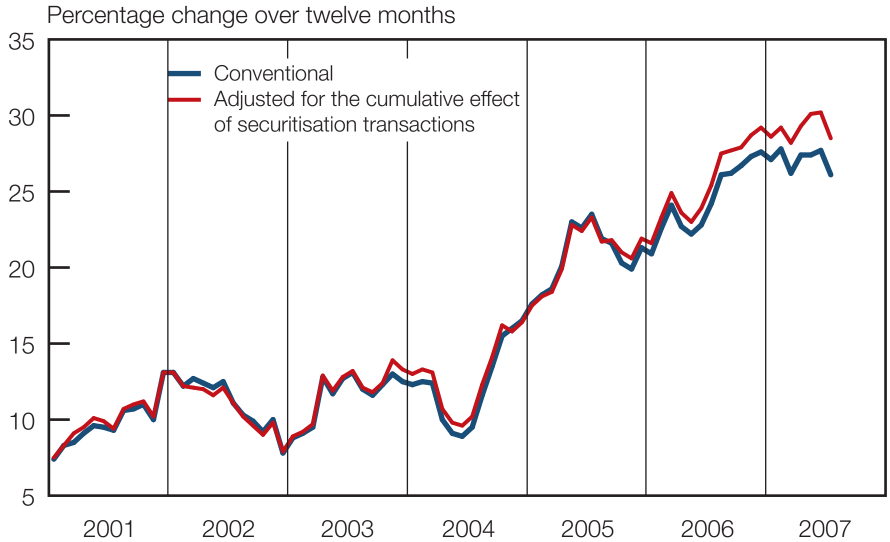
R billions

	2005	2006	Seven months to July 2007
Net foreign assets	48,8	58,0	1,4
Net claims on government sector	-41,9	-30,2	19,5
Claims on private sector	186,0	294,7	171,1
Net other assets and liabilities	-5,9	-74,3	-10,1
Total change in M3	**187,0**	**248,2**	**202,2**

Credit extension

Total loans and advances extended to the domestic private sector continued to grow at a brisk pace during the past year, despite the successive increases in domestic lending interest rates from June 2006. The current phase of rapid credit expansion was stimulated in part by the significant monetary policy easing which started in 2003, in turn made possible by an exceptional slowdown in inflation. More broadly, the major factors that have contributed to the rising demand for credit from the start of the upward credit cycle in 2004 are the firm domestic output and expenditure, the relatively low level of debt servicing costs, improvements in disposable income as well as strong positive wealth effects. These initial conditions also stimulated demand for houses, leading to robust trading conditions and escalating prices in the residential real-estate sector. The resultant higher house prices, in turn, had a major impact in elevating mortgage advances.

Total loans and advances extended to private sector



Growth over twelve months in loans and advances has consistently exceeded 26 per cent since August 2006. However, non-performing loans as a percentage of total loans have remained low during early 2007, prolonging the environment conducive to the extension of credit by the banks. In the past eighteen months, the cumulative securitisation of instalment sale and mortgage advances amounted to R38,8 billion, influencing the level of the standard measure of banks' total loans and advances. Consequently, a notable divergence developed between the twelve-month growth rates of the standard measure and the measure adjusted for the cumulative effect of securitisation transactions. However, the robust growth in loans and advances was restrained to some extent by the delays in vehicle registrations due to the introduction of a new electronic vehicle registration system in May 2007. The implementation of the NCA on 1 June 2007 could also have somewhat speeded up the extension of credit prior to that date and the more rigorous process for screening loan applications introduced by the Act could possibly, with a lag, dampen growth in advances to the household sector to some extent.

Banks' loans and advances increased by a record R315 billion in the twelve months to July 2007. During this period all credit categories increased significantly; asset-backed credit contributed R186 billion while other loans and advances increased by R129 billion.

Credit aggregates

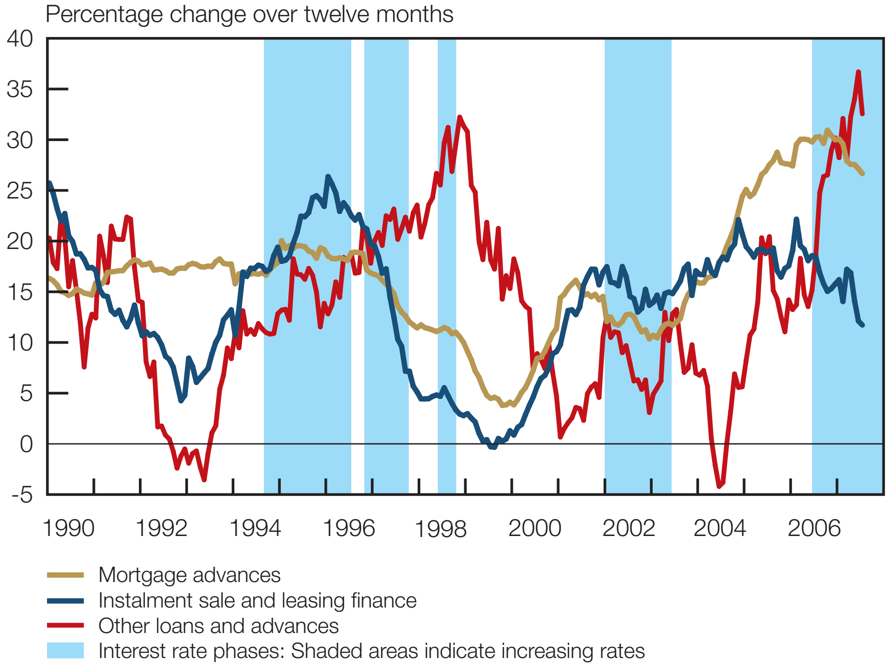
Component	July 2006 R billions	July 2007 R billions	Change Per cent
Asset-backed credit	810	996	23,0
Instalment sale and leasing	198	221	11,7
Of which: New passenger cars	*64*	*66*	*3,2*
Other passenger cars	*49*	*48*	*-1,6*
Other assets financed	*85*	*107*	*25,9*
Mortgage advances	612	775	26,7
Other loans and advances	395	523	32,6
Total loans and advances	**1 205**	**1 519**	**26,1**

Mortgage advances contributed 52 per cent to the overall increase in loans and advances, despite mortgage book securitisations to the value of R13,8 billion over the past year. Having remained around 30 per cent throughout 2006, twelve-month growth in mortgage advances edged lower to 26,7 per cent in July 2007. However, adjusted for the cumulative effect of securitisation transactions, growth remained around 31 per cent in the twelve months to July 2007. Record-high increases were also registered on a month-on-month basis.

The brisk growth in mortgage advances continued to reflect the relatively affordable borrowing costs and a higher level of activity in the real-estate market. Growth in this credit category also benefited from the entry and expansion of mortgage originators. Efficiency gains were also made associated with the granting of pre-approval certificates and online and telephonic applications.

Instalment sale credit and leasing finance grew at less robust rates of between 12 and 18 per cent during the past twelve months, reflecting the combined impact of continued securitisation transactions, higher interest rates and a possible shift away from the

Growth in the main categories of loans and advances



financing of durable goods through instalment sale credit to the use of other types of credit such as equity withdrawn from mortgage facilities, overdrafts and credit card advances. This was also supported by disintermediation where other sources of funding were utilised, such as internal funds, funding through non-bank financial companies offering attractive finance packages, the issuance of financial instruments in the capital markets by companies, as well as cash sales and improved terms on trade credit. Adjusted for the cumulative effect of securitisation transactions, growth remained above 20 per cent in the twelve months to July 2007.

Twelve-month growth in *other loans and advances* accelerated, on balance, from 18,6 per cent in July 2006 to 33,0 per cent in July 2007. Within other loans and advances, general loans contributed 74 per cent to the overall increase, while overdraft facilities accounted for 14 per cent and credit card advances for 13 per cent. The growth in the credit card market was supported, among other things, by telemarketing and internet campaigns which allowed experienced issuers to market products more efficiently and grow rapidly. Growth in this market also coincided with a rise in joint card ventures between private banks and non-financial companies.

The household sector accounted for the greater part of the demand for bank loans and advances in the first half of 2006, when credit extension was strongly influenced by consumption expenditure and the acquisition of real estate. From the second half of 2006, the corporate sector accounted for the bulk of the increase in bank credit extended to the private sector. The elevated demand for credit by the corporate sector was largely driven by rising capital formation and corporate restructuring activity. The household sector's use of bank loans and advances rose by R145 billion or 21,8 per cent over the twelve months to July 2007, whereas the corporate sector's use of such advances increased by R169,7 billion and twelve-month growth accelerated to 31,6 per cent over the same period.

Bank loans and advances by industry are shown in the accompanying table, indicating that over the past year, the strongest growth was registered in the amount of credit extended to the mining; electricity, gas and water; and transport and communication sectors.

Banks' loans and advances by industry

Component	June 2006 R billions	June 2007 R billions	Change Per cent
Agriculture, forestry and fishing	26	31	19,2
Mining	16	29	70,6
Manufacturing	61	79	29,5
Construction	16	20	25,0
Electricity, gas and water	6	13	116,7
Trade and accommodation	37	57	54,1
Transport and communication	26	59	126,9
Finance and insurance	470	453	-3,6
Of which: Interbank	*106*	*101*	*-4,7*
Real-estate and business services	144	180	25,0
Community, social and personal services	40	40	0,0
Individuals	699	871	24,6
Other	73	103	41,1
Total	1 616	1 935	19,8

Interest rates and yields

During 2006 inflationary forces and risks intensified, causing the Monetary Policy Committee (MPC) of the Bank to tighten policy. The MPC increased the repurchase rate by 50 basis points at a time at four successive meetings, starting in June 2006, in order to keep the monetary policy stance consistent with the achievement of the inflation target. At the February and April 2007 meetings the policy rate was kept on hold, following a more favourable assessment of the outlook for inflation, but in June sufficient evidence of a deterioration in inflation prospects had accumulated to prompt a further increase of 50 basis points in the repurchase rate. High international oil prices, accelerating food price inflation, sustained strong consumer demand and credit growth, most recent inflation outcomes slightly above earlier expectations and signs of acceleration in underlying inflation beyond fuel and food only contributed to this decision. Similar considerations led the MPC to raise the repurchase rate in August 2007, again by 50 basis points.

Repurchase rate of the Bank

Date effective	Per cent
15 Apr 2005	7,0
8 Jun 2006	7,5
4 Aug 2006	8,0
13 Oct 2006	8,5
8 Dec 2006	9,0
8 Jun 2007	9,5
17 Aug 2007	10,0

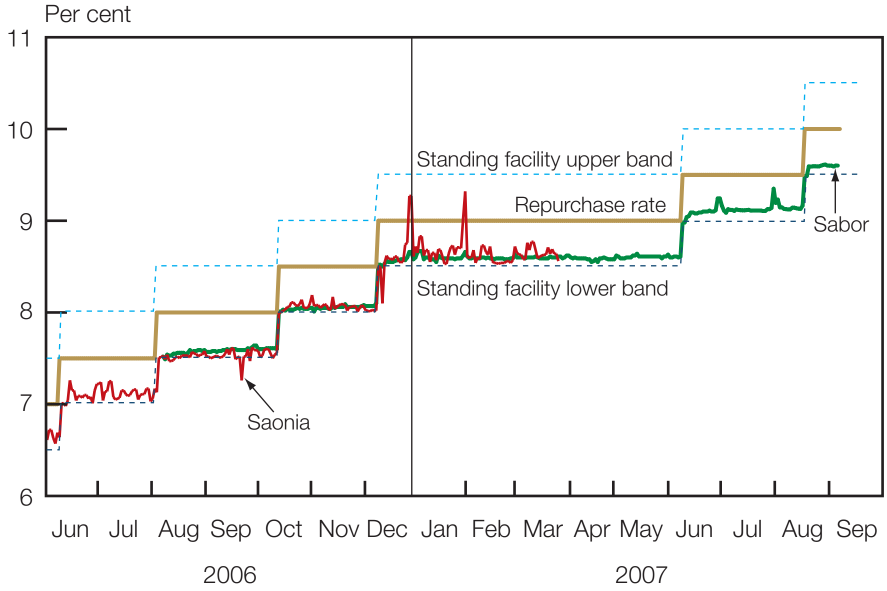
The current upward phase in interest rates has been characterised by consistent changes of 50 basis points at a time in the repurchase rate. In the previous upward interest rate cycle, starting from January 2002, the repurchase rate was raised by

100 basis points at a time. In the subsequent downward phase from June 2003, the adjustments in the repurchase rate fluctuated between 50 and 150 basis points per change, although since December 2003 the MPC has not changed the policy rate by any other magnitude than 50 basis points.

From 27 March 2007, the Bank replaced its previously used overnight interbank rates with new, less volatile benchmark call rates in order to improve the functioning of the domestic money market. The South African Benchmark Overnight Rate on deposits (Sabor) replaced the South African Overnight Interbank Average (Saonia) and the Saonia+, while the Overnight Foreign Exchange rate (Overnight FX rate) replaced both the Foreign Exchange Forward rate and the Carry rate. Calculation and dissemination of the previously used rates have been discontinued.

Since inception on 27 March 2007, the Sabor and the Overnight FX rates have displayed limited fluctuation. The Sabor, for instance, fluctuated in a narrow range of between 8,55 per cent and 8,64 per cent and adjusted to 9,24 per cent on 30 June 2007, following the June 2007 repurchase rate increase – while consistently remaining within the limits set by the standing facility ranges. Subsequently, the rate adjusted upward to 9,6 per cent on 5 September in line with the increase in the repurchase rate in August 2007. The accompanying graph depicts the overnight rates following a test period which started on 7 August 2006.

Benchmark overnight rates and repurchase rate



Other money-market interest rates such as the Johannesburg Interbank Agreed Rate (Jibar) and rates on Treasury bills also reflected the increases in the repurchase rate. However, the tender rate on 91-day Treasury bills deviated somewhat from the repurchase rate and trended downward between February and March 2007. This was consistent with the increase in demand for the instrument following the February redemption and coupon payments on government bonds, which intensified the dearth of liquid assets. The rate then moved sideways before trending upward again around mid-May 2007, reflecting expectations of future increases in the repurchase rate and the Bank's decision to start accepting the bonds of certain public utilities as collateral from 23 May 2007, which eased demand for Treasury bills.

During the second half of 2006, rates on forward rate agreements (FRAs) continued to closely emulate rand exchange rate movements and indicated market participants' expectations of increases in interest rates in response to increasing inflationary pressures. This upward movement continued until the end of January 2007, before stabilising somewhat. From May 2007, FRA rates resumed their upward trend, thereby discounting the imminent increase in the Bank's repurchase rate in June 2007, following the release of unfavourable production and consumer price inflation data. Subsequent to the 8 June 2007 MPC decision, FRA rates continued to indicate expectations of further increases in money-market interest rates and the view was maintained up to mid-August, when the MPC decided to raise the repurchase rate by a further 50 basis points.

Private banks increased their prime overdraft rate and predominant rate on mortgage loans by 50 basis points following each of the four successive increases in the repurchase rate from June to December 2006. After remaining at this level for the first five months of 2007, these rates were increased by a further 50 basis points in June and another 50 basis points in August to reach 13,50 per cent, following the latest increases in the repurchase rate.

The predominant rate on twelve-month fixed deposits with banks increased from 6,2 per cent in April 2006 to 9,5 per cent in August 2007, broadly reflecting steady returns on cash as an asset class. Using historical year-on-year increases in CPIX to adjust nominal rates, the twelve-month fixed deposit rate yielded an average real return before tax of 2,6 per cent in the first seven months of 2007, only slightly higher than the average of 2,3 per cent recorded in 2006.

Interest rates on the RSA Government Retail Bonds as priced off the government bond yield curve are changed when the yields on equivalent government bonds move by more than 50 basis points. The accompanying table depicts how these rates have changed since July 2006.

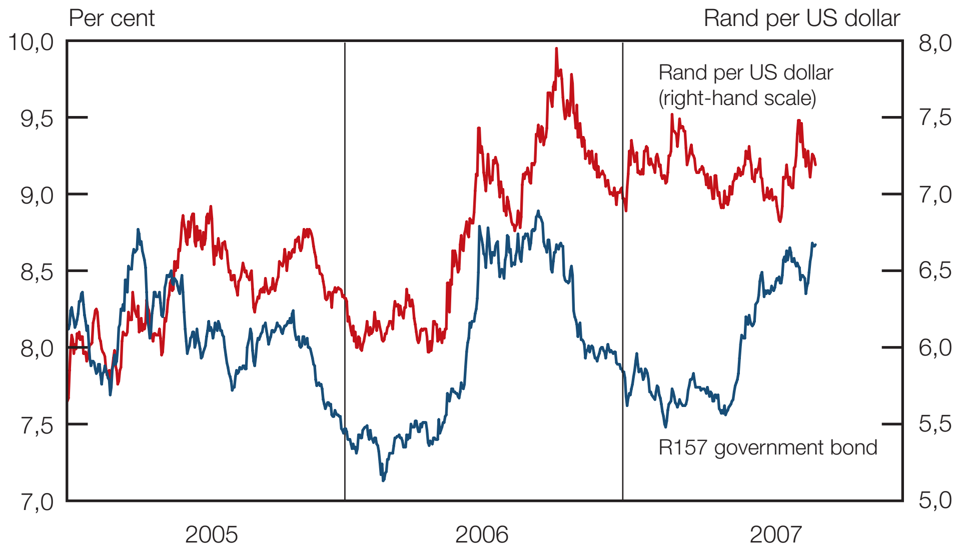
Interest rates on RSA Government Retail Bonds

Per cent

Effective from	2-year bond	3-year bond	5-year bond
1 Jul 2006	8,00	8,25	8,50
1 Aug 2006	8,50	8,75	9,00
1 Mar 2007	8,50	8,75	8,00
1 Jul 2007	9,00	8,75	8,50
1 Sep 2007	9,25	9,25	8,75

The daily average yield on the R157 government bond (maturing in 2015) increased from 7,13 per cent on 20 February 2006 to 8,89 per cent on 11 September, in line with the high international price of crude oil and the steep depreciation in the exchange value of the rand from early May 2006, which exacerbated the risks to the domestic inflation outlook. Towards the end of 2006, however, a moderation in domestic inflation expectations, some appreciation in the exchange value of the rand and projections of a lower supply of government bonds resulted in yields declining at the intermediate and longer-term maturities, with the R157 yield declining to 7,48 per cent on 23 February 2007.

Long-term bond yield and exchange value of the rand

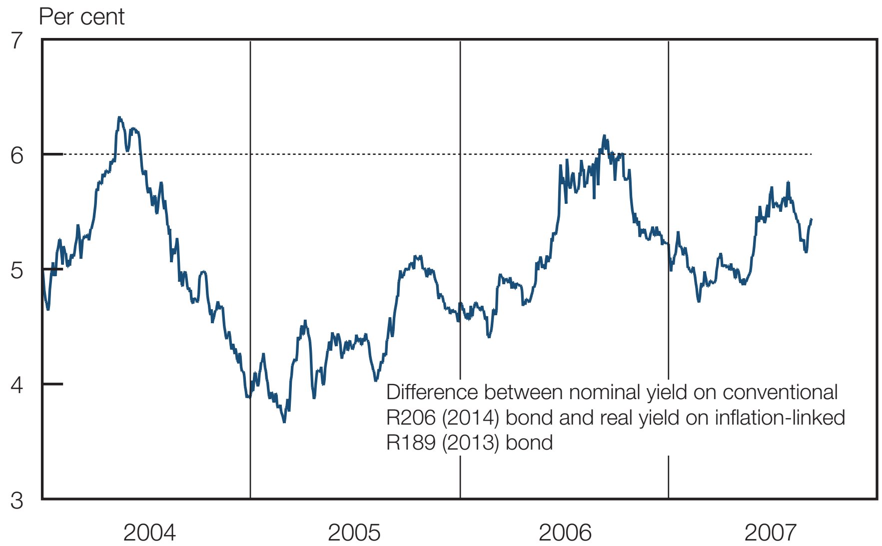


From the low level at the end of February 2007, bond yields reacted to successive releases of higher-than-expected inflation data, pushing the level of the yield curve across all maturities higher to August. The yield on the R157 bond increased to 8,67 per cent on 7 September.

From a recent high of 8,92 per cent on 11 September 2006, the daily average yield on the R206 conventional government bond (maturing 2014) fluctuated downwards to 7,51 per cent on 23 February 2007, while the real yield on the R189 inflation-linked government bond (maturing 2013) increased slightly from 2,58 per cent to 2,68 per cent over the same period. Accordingly, the break-even inflation rate[4] declined from 6,17 per cent on 11 September 2006 to 4,71 per cent on 23 February 2007, before increasing to 5,72 per cent on 29 June as the conventional bond yield increased significantly. The break-even inflation rate reached 5,45 per cent on 7 September 2007.

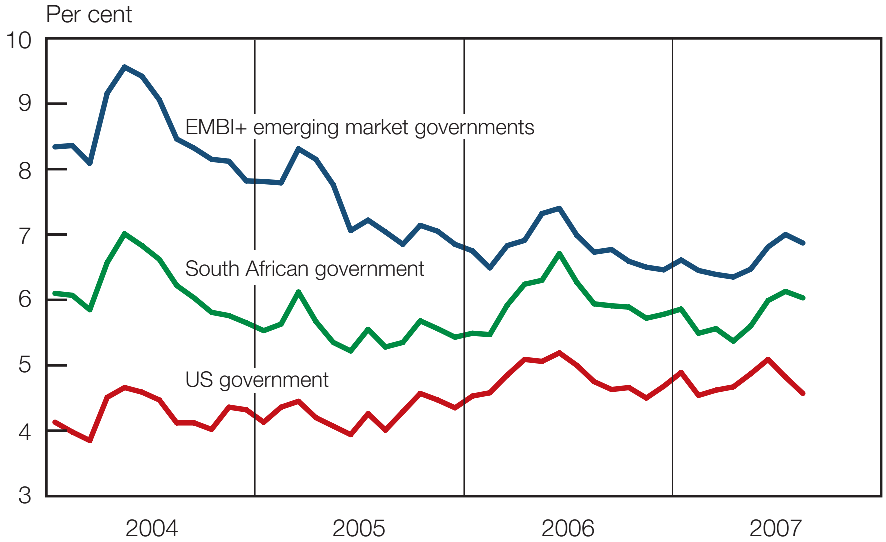
4 As proxied by the difference between the nominal yield on conventional government bonds and the real yield on inflation-linked government bonds within the six-year maturity range.

Break-even inflation rate



Internationally, risk premia on bonds remained relatively low although an increase was observed from June 2007. Within the emerging-market grouping, the sovereign risk premia on US dollar-denominated South African government bonds remained relatively low over the past year, as illustrated in the accompanying graph.

US dollar-denominated bond yields



5 Calculated as the yield differential between the seven-year South African government US dollar-denominated bond and US securities of similar maturity.

The yield differential between sovereign debt of emerging and advanced economies, as measured by the JP Morgan Emerging Markets Bond Index (EMBI+), narrowed from 221 basis points in June 2006 to a record low of 153 basis points in May 2007, before widening to 223 basis points in August. This general contraction of emerging-market bond spreads benefited the sovereign risk premium[5] on South Africa's foreign-currency denominated bonds trading in international markets, which declined from an average of 115 basis points in July 2006 to 67 basis points in May 2007, before widening to 125 basis points in August. These narrow premia were partly related to the South African government's sound financial position and its ability to redeem rather than issue bonds.

Financial markets

Structural and regulatory changes in financial markets

By the end of 2006 the required majority of nine SADC[6] Member States had signed the SADC Protocol on Finance and Investment which is seen as the first step towards harmonising financial services within the region. The Protocol deals with a range of matters aimed at strengthening investment and trade linkages as well as regional co-operation to enhance the attractiveness of the region as an investment destination. It encompasses matters pertaining to stock exchanges, regional financial and capital markets, the regulation and supervision of non-bank financial services as well as issues relating to anti-money laundering initiatives.

6 *Southern African Development Community.*

The Exchange Control Rulings were amended in October 2006 to provide for inward listings of interest-bearing securities on the Bond Exchange of South Africa (BESA) by non-resident issuers. The amendment allows non-resident entities to raise capital in South Africa on condition that only non-derivative debt instruments denominated in rand may be listed. The permissible foreign portfolio investment allowances of South African institutional investors were changed to provide for an additional five per cent of total retail assets for investment in African inward-listed instruments. South African private individuals are allowed to invest in inward-listed instruments without restriction.

In the 2007/08 Budget, government granted the JSE Limited (JSE) approval to trade currency futures. The JSE's interest rate exchange, Yield-X, started trading in rand/US dollar currency futures on 18 June 2007, with the expectation that other currency contracts will follow. Yield-X directives pertaining to educational qualifications of members, minimum values for reported transactions and client registration were amended to provide for the trading of currency futures. The introduction of these derivatives on Yield-X is likely to boost participation and liquidity in this market. Currency futures in a transparent market will probably find favour with investors in their quest for instruments to hedge or take on board currency exposures, given the fairly high historical volatility of the rand.

South African pension funds and long-term insurers may trade currency futures subject to the 15-per-cent foreign allocation allowance, while asset managers and registered collective investment schemes can participate subject to the 25-per-cent foreign allocation limits. No limits are applicable to resident individuals and foreigners. Domestic companies and trusts are prohibited from trading without exchange control approval from the South African Reserve Bank.

From 1 March 2007, the Retirement Fund Tax on interest and rental income was abolished. The tax rules applicable to lump sum amounts withdrawn from retirement funds have also been streamlined and simplified. In a bid to standardise the tax treatment of contributions to pension, provident and retirement annuity funds and to also simplify matters and reduce costs, regulatory requirements contained in the Income Tax Act and related regulatory notes will be moved to the Pension Funds Act.

Amendments to legislation include the Corporate Laws Amendment Act of 2006, which sought to amend the Companies Act of 1973 and the Close Corporation Act of 1984. The amendments included inserting new definitions, broadening the Minister's powers of delegation, making a distinction between public interest and limited interest companies and making further provisions regarding financial assistance for the purchase of a company's shares. However, subsequent to these amendments, a total overhaul of the corporate landscape was introduced through the Companies Bill of 2007. The objective of the Bill is a comprehensive modernisation of company law, aligning South Africa with international standards. The Companies Bill is expected to replace the Companies Act of 1973 in its entirety and provide for the possible future repeal of the Close Corporation Act of 1984.

Further proposals to legislative amendments were the Transnet Pension Fund Amendment Bill of 2006 and the Pension Funds Amendment Bill of 2007. The former seeks *inter alia* to redefine some aspects of the Act and rename the institution concerned to the Transport Pension Fund. The Pension Funds Amendment Bill seeks, among other things, to clarify and redefine certain aspects of the Act as well as the powers and functions of the Pension Funds Adjudicator. The regulatory powers of the Registrar of Pension Funds will also be extended. This Bill is one of several reforms and developments needed to pave the way for the proposed Social Security Scheme as announced by the Minister of Finance in the 2007/08 Budget.

Following the signing of the Statement of Intent[7] in December 2005 by the Life Offices' Association of South Africa and the Minister of Finance, the National Treasury issued a retirement fund reform discussion paper[8] on contractual savings in the life insurance industry in March 2006. A second draft of the retirement fund reform paper was released in February 2007, proposing a national savings scheme. This may see the introduction of a multi-pillar system consisting of social assistance grants, mandatory participation in a national social security system up to an agreed earnings threshold and supplementary voluntary savings for individuals.

7 Designed to, among other things, set minimum standards for benefits in the event of early termination of retirement annuities and endowment policies; and pledge the commitment to examine other issues impacting on cost, including commission structures, disclosure standards and consumer education. A new generation of products which promote fair charges, easy access and decent terms were launched in 2006.

8 Issued by the National Treasury on 30 March 2006 to reflect on issues that impact on the ability of the industry to deliver products that are cheap, fair and appropriate.

Other relevant legislative changes affecting financial markets announced in the national Budget for fiscal 2007/08 included the raising of the annual domestic interest income-tax exemption threshold from R16 500 to R18 000 for taxpayers under the age of 65 and from R24 500 to R26 000 for taxpayers aged 65 and over, effective from 1 March 2007. The exemption applicable to foreign interest income and dividends was raised from R2 500 to R3 000.

Reforms to the system of secondary tax on companies were also announced including renaming it as a dividend tax at company level, broadening the definition of the tax base, reducing the tax rate from 12,5 per cent to 10 per cent, and eventually moving formal legal liability for the dividend tax from the company paying the dividend to the shareholder receiving it.

Profits realised on the sale of shares can be taxed either as ordinary income or as capital gains, depending on circumstances and facts. In order to provide fair treatment, effective from 1 October 2007, all shares disposed of after three years will be subjected to capital gains tax.

Previously, foreign companies earning South African sourced income were taxed at a rate of 29 per cent, but a higher tax rate of 34 per cent applied if the foreign company generated the income through a South African branch or agency. This 34-per-cent tax rate will now apply regardless of whether or not a foreign company maintains a local branch or agency.

An important aspect of black economic empowerment (BEE) transactions is the ability of BEE partners to raise financing. A number of amendments to the Income Tax Act were proposed to ensure that BEE and similar restructurings do not encounter undue additional tax costs.

Money market

During the past thirteen months to July 2007, the amount of accommodation provided at the weekly main refinancing tenders fluctuated between R10,7 billion and R14,7 billion. Although modest, these variations were larger than those prior to the implementation of the changes to the Bank's operational procedures on 25 May 2005. The average daily liquidity requirement of private-sector banks varied between R9,3 billion and R15,9 billion during the period under review – occasionally breaching the liquidity range due to volatility in the daily note and coin flows.

Apart from the weekly main repurchase tender, operations in the money market on the initiative of the banks included the use of banks' cash reserve accounts with the Bank – withdrawing or depositing funds for short periods while still having to comply with the statutory cash reserve requirements on a monthly average basis – and, on occasion, the utilisation of standing facilities in order to square off their end-of-day positions.

The statistical counterparts impacting on money-market liquidity over the period under review are shown in the table below.

Money-market liquidity flows

R billions (easing +, tightening -)

	Jul – Dec 2006	Jan – Jul 2007
Notes and coin in circulation	-9,7	4,7
Redemption of foreign loans by National Treasury	-2,0	-6,1
Cash reserve balances	-7,1	-5,0
Money-market effect of SARB's foreign-exchange transactions	17,3	35,6
Government deposits with SARB	-5,1	-12,3
SARB holdings of government bonds	-0,3	-0,1
Use of liquidity management instruments	3,8	-10,7
Reverse repurchase transactions	1,4	-5,3
SARB debentures	2,4	-5,4
Other items net	4,0	-6,8
Banks' liquidity requirement	**0,9**	**-0,7**

* SARB debentures and reverse repurchase transactions

The Bank continued to increase its foreign-exchange reserves by purchasing foreign exchange from the market, thereby adding rand liquidity to the amount of R52,9 billion in the thirteen months to July 2007. The proceeds from the Bank's creaming-off operations involving measured buying of foreign exchange from the market were used not only to build up the gross foreign-exchange reserves, but also to repay foreign loan facilities. This included the prepayment of US$1 billion on a 3-year US$1 billion syndicated term loan entered into in 2004. The expansionary effect of the Bank's purchases of foreign currency on the money market was partly neutralised by increases in notes and coin in circulation outside the Bank, banks' cash reserve holdings and a considerable build-up in government deposits with the Bank.

The outstanding amount of interest-bearing liquidity-draining instruments utilised by the Bank, i.e. reverse repurchase agreements and SARB debentures, on balance, receded during the second half of 2006. This decrease partly reflected a sizeable reduction in SARB debentures made available to the market, with issues of two-month debentures in particular being curtailed as market participants became cautious ahead of expected increases in interest rates. SARB debentures and repurchase agreements rebounded in the first seven months of 2007, as shown in the accompanying table.

Outstanding balances of selected money-market sterilisation instruments

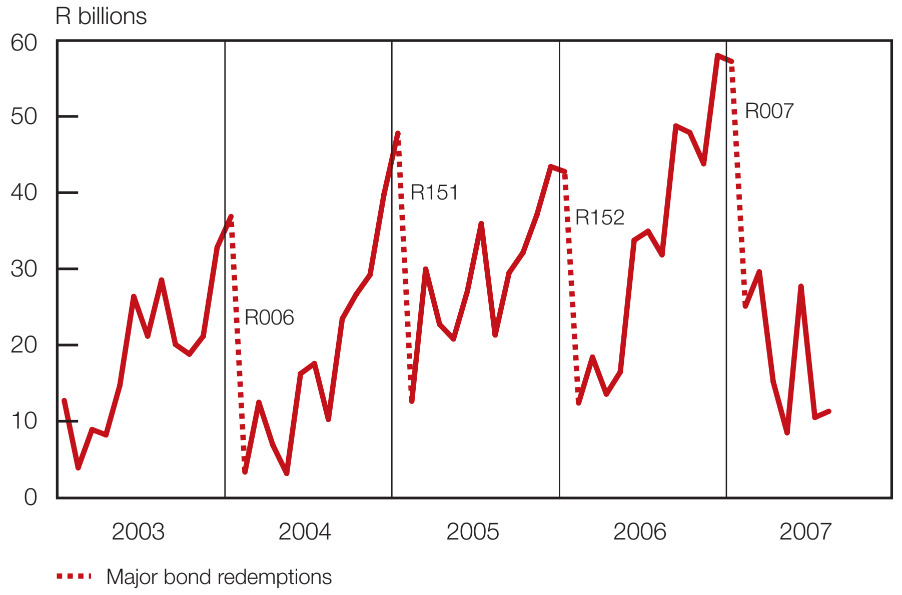
R billions

End of		SARB debentures	Reverse repurchase agreements	Government deposits with SARB*
2006:	Jun	5,4	2,0	36,8
	Jul	5,7	2,3	36,5
	Aug	5,0	2,0	36,6
	Sep	4,3	3,0	36,8
	Oct	2,8	2,8	36,9
	Nov	3,5	2,3	37,1
	Dec	3,0	0,6	42,4
2007:	Jan	4,9	2,0	43,7
	Feb	4,9	2,8	45,6
	Mar	4,9	3,1	45,9
	Apr	6,9	3,1	48,8
	May	8,7	4,8	49,3
	Jun	8,3	5,3	49,5
	Jul	8,4	5,9	54,7

* Mainly comprising the Paymaster General and National Treasury special deposit account with SARB

Government continued to accumulate substantial cash balances in its tax and loan accounts with private banks, partly in order to effect coupon interest payments on government bonds and capital redemption payments on the first tranche of the R194 government bond – namely the R007. At the end of February 2007, for example, coupon interest and redemption payments on such bonds amounting to R34,2 billion were made to private-sector parties. The graph below shows the impact on government deposits of these and similar payments on the three tranches of the R150 government bond in 2004, 2005 and 2006.

Government deposits in the tax and loan accounts



During the first half of 2006, the Bank's portfolio of government bonds remained unchanged at R7,7 billion, but declined to R7,5 billion following the redemption of the R007 government bond and remained at this level until the end of July 2007.

During May 2007 the Bank expanded the pool of liquid assets accepted as collateral in the refinancing system to include bonds from the All Bond Index (Albi) excluding those issued by commercial banks. The bonds added are detailed in the table below.

List of eligible collateral
Rand denominated

Assets previously and still included as eligible collateral	Assets which have been added as from 23 May 2007
Government bonds	Development Bank of Southern Africa (DV07)
Land Bank bills	Eskom Holdings Limited (ES09, E170, ES33)
Separate trading of registered interest and principal of securities (STRIPS)	SA National Roads Agency (SZ25)
SARB debentures	Transnet Limited (T011)
Treasury bills	Trans-Caledon Tunnel Authority (WS03, WS04)

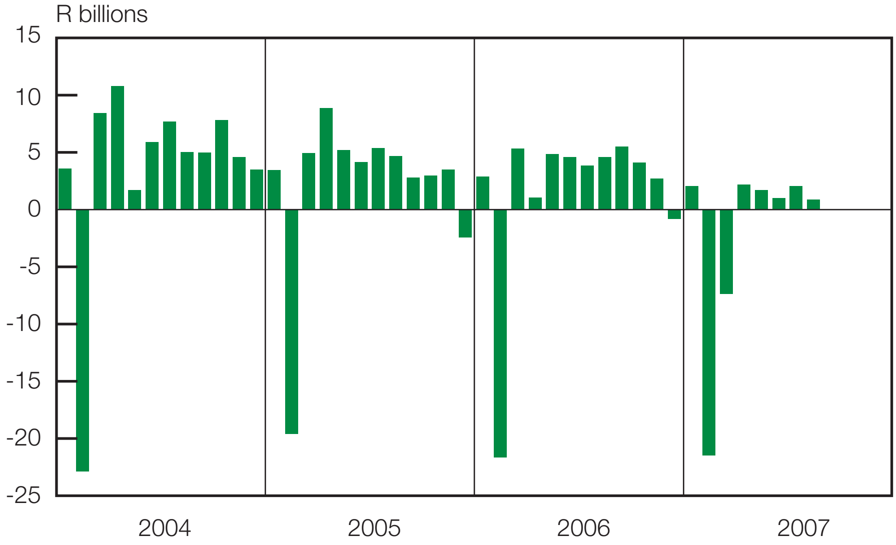
Bond market

The national government raised R2,3 billion through retail bonds from their launch in May 2004 to the end of July 2007. This is evidence that many small to medium investors understand and find the retail bond market a useful investment vehicle. Recent developments in the retail bond market suggest further scope for such issues. A major private bank issued three-year and five-year retail deposit notes in February and September 2006. Although the notes are dual-listed on the JSE and BESA, they only trade on the JSE. At the end of August the outstanding nominal value of these instruments on BESA amounted to R650 million and the corresponding turnover on the JSE amounted to R232 million in the first eight months of 2007.

The City of Johannesburg launched the country's first municipal retail bonds in August 2007. The bonds, which will only be available to South African residents, will help to fund the city's expenditure programmes. A minimum investment amount of R1 000 will be accepted for the two-year, three-year and five-year municipal bonds. The bonds will be listed and traded on the JSE main board and issues up to R1 billion have been authorised.

The weekly auctioned amount of government bonds nearly halved from an average of R800 million in April 2006 to R450 million in August 2007. Total net issues of fixed-interest securities by public-sector borrowers in the domestic primary bond market reversed from net issues of R17,0 billion in 2006 to net redemptions of R19,0 billion in the first eight months of 2007. This included the redemption of the R007 government bond – the first of three tranches of the R194 government bond to be repaid. The capital redemption value of this bond amounted to R24,1 billion, and coupon payments on these and other outstanding government bonds put a further R10,1 billion in cash in the hands of investors. The remaining two tranches of the R194 bond, namely the R195 and the R196, mature in 2008 and 2009, respectively. In the February 2007 Budget of national government, an amount of R9,0 billion was projected to be redeemed in fiscal 2007/08 through net redemptions of domestic fixed-income bonds.

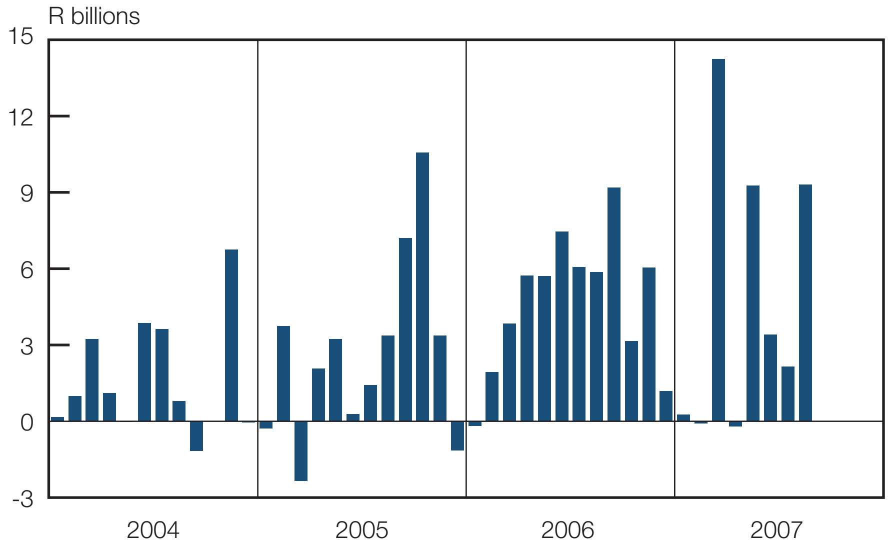
Public-sector funding in bond market



Govex was the first exchange traded fund to be listed on BESA in May 2007, giving investors the opportunity to trade the performance of the BESA Government Bond Index (GOVI). Govex units take the form of debentures, can be exchanged for the underlying bonds, and pay coupons which are automatically reinvested in the fund.

Private-sector funding activity in the domestic primary bond market became more pronounced than that of government as the supply of government bonds was reduced. Total net bond issues by the private sector averaged 31 per cent of total net bond issues in the first eight months of 2007. The outstanding nominal value of private-sector loan stock listed on BESA rose by R56,0 billion in 2006 and by a further R38,3 billion in the first eight months of 2007 to reach R204 billion at the end of August, with securitisation accounting for 43 per cent of this amount.

Private-sector funding in bond market



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 R13,8 billion in 2006 and by a further R6,6 billion in the first eight months of 2007. The total outstanding nominal value of debt listed on BESA increased by R27,4 billion in the first eight months of 2007 to R748 billion at the end of August, and the total market capitalisation on BESA of R819 billion exceeded this value indicating that, on balance, the majority of bonds traded at a premium.

Both the domestic public and private sector issued foreign-currency denominated debt in the international bond markets as a way of funding in 2006 and the first seven months of 2007. After raising R5,5 billion in April 2006 in the international bond markets, national government raised a further R7,1 billion in May 2007 through the issuance of a US$1-billion fifteen-year bond at a coupon rate of 5,875 per cent. Public corporations raised R3,8 billion in 2006, but were passive during the first seven months of 2007. Private-sector borrowers raised R4,5 billion in 2006, followed by approximately R31,9 billion in the first seven months of 2007.

Non-resident issuer interest in rand-denominated bonds in the international bond markets remained buoyant in the first eight months of 2007. The net issuance of rand-denominated bonds in the European bond markets amounted to R9,7 billion in the first eight months of 2007, compared with R5,0 billion recorded in 2006 as a whole. With residents having been passive since March 1999, a South African resident issued rand-denominated bonds in these offshore markets in April 2007, raising an amount of R0,9 billion.

In addition to issuance in the European bond markets, the issuance of rand-denominated bonds by foreign borrowers in the Japanese Uridashi market also accelerated during the first eight months of 2007. Following net issues of R4,8 billion in 2006, the nominal value of rand-denominated bonds issued by non-residents in the Uridashi market amounted to R8,3 billion in the first eight months of 2007.

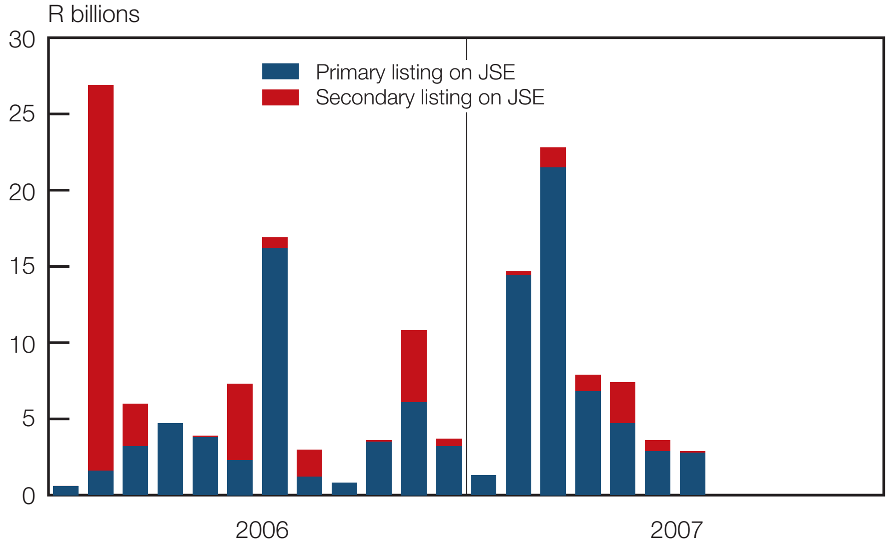
The value of bonds traded on BESA amounted to a record high R13,6 trillion in 2006, exceeding turnover of R9,8 trillion in 2005 by 39 per cent, as trading activity in the secondary bond market was boosted by, among other things, a high number of trades and record-high net purchases of bonds by non-residents. Turnover of R11,1 trillion was recorded in the first eight months of 2007, 25 per cent more than in the corresponding period of 2006. From a daily average of R44,6 billion in December 2006, turnover increased to a record-high daily average of R73,6 billion in July 2007, contributing towards an average of around R65,8 billion in value traded per day in the first eight months of 2007. The annualised liquidity ratio, measured as the nominal value of bonds traded relative to the nominal value of bonds listed, was 18,8 in the first eight months of 2007 compared with 15,9 for 2006 as a whole.

Non-residents recorded net purchases of bonds of R34,1 billion in 2006, with 78 per cent of total net purchases occurring in the second half of the year. In the first eight months of 2007, non-residents recorded net purchases of R16,1 billion, compared with net purchases of R21,5 billion recorded in the corresponding period of 2006. This included record-high net sales of R9,1 billion in July 2007 and record-high net purchases of R20,6 billion in August. Non-resident participation in trading on BESA remained around 19 per cent from October 2006 to August 2007, alongside higher domestic inflation and a subdued supply of South African government bonds.

Share market

The total value of equity capital raised in the domestic and international primary share markets by companies listed on the JSE amounted to R87,8 billion in 2006. The amount raised was almost equally distributed between companies with primary listings and companies with secondary listings on the JSE. Equity financing amounted to R60,6 billion in the first seven months of 2007, mainly raised by resources sector companies with primary listings on the JSE.

Total capital raised by companies listed on the JSE



For the first time since 1998, new listings exceeded de-listings in 2006 as the increasing confidence in the equity market contributed to 37 new listings of companies on the JSE while the number of de-listings amounted to 24. In the first seven months of 2007, however, only 22 new listings were recorded compared with 33 de-listings. The increase in de-listings during 2007 was mainly due to suspensions and the acceleration of private equity buyouts.

The upward trend in share prices ensured that trading activity in the secondary share market remained brisk in 2006 and in the first eight months of 2007. The value of turnover of R2,1 trillion in 2006 was 66 per cent higher than the turnover of R1,3 trillion recorded in 2005. Turnover amounted to R1,9 trillion in total (or on average R10,8 billion per day) in the eight months to August 2007, representing an increase of 32 per cent over the turnover in the corresponding period of 2006.

The total market capitalisation of the JSE at month-ends increased by 41 per cent from R4,1 trillion in May 2006 to an all-time high of R5,8 trillion in March 2007, before declining to R5,6 trillion in August. Market liquidity, measured by expressing turnover as a percentage of market capitalisation, increased slightly from an average of 49 per cent in 2006 to an annualised 51 per cent in the first eight months of 2007.

The number of companies listed on Alt^{X}, the JSE's bourse for small to medium-sized companies, more than doubled from 23 at the end of July 2006 to 57 at the end of August 2007. After previous attempts by the JSE to host small, developing companies through the development capital market (DCM) and venture capital market (VCM) had been impaired due to attracting some poor-quality companies, Alt^x seems to have been more successful in capturing small and developing companies of acceptable quality during its nearly four years of existence. The combined market capitalisation of all the companies listed on Alt^x also increased from R3,2 billion in August 2006 to a record high of R21,4 billion in August 2007. Turnover on Alt^x amounted to R3,5 billion in the first eight months of 2007, almost three times the R1,2 billion traded in the whole of 2006.

Non-residents' interest in shares listed on the JSE has continued unabated since September 2006. Non-residents posted record-high net purchases of shares to the value of R73,7 billion in 2006. Their participation in the share market averaged 21 per cent in both 2006 and the first eight months of 2007. Non-residents continued to accumulate JSE-listed shares in the first eight months of 2007 with net purchases of R64,7 billion, more than the R53,7 billion in the corresponding period of 2006.

The JSE all-share price index declined by 17 per cent from 11 May 2006 to 13 June in response to weaker global equity markets, negative sentiment towards emerging markets, lower commodity prices and the increase in the domestic repurchase rate in June. From a recent low on 13 June 2006, the all-share price index increased by 47 per cent to a then record high on 26 February 2007, alongside stronger global equity markets and robust growth in commodity prices. Subsequently, the all-share price index declined by 7 per cent to 5 March 2007 as a global market sell-off was triggered by a sharp decline in Chinese equity prices which recorded their biggest one-day loss in recent history after the tightening of regulations by the Chinese government. Share prices on the JSE then rebounded sharply and erased their earlier losses, surpassing previous highs and increasing by 20 per cent to an all-time high on 13 July. Share prices then fell considerably, triggered by concerns and some defaults related to the risky "sub-prime" segment of the US mortgage market which led to a loss of confidence in counterparties and a sharp decline in global share prices. Prices on the JSE declined by 13 per cent to 17 August, but recovered by 9 per cent in the three weeks to 7 September 2007.

Share prices

The generally robust performance of the JSE has been supported by unprecedented economic growth as fuelled by an increase in local infrastructure spending, strong growth in corporate earnings as well as continued strong purchases of equities by foreign investors. In the first eight months of 2007, the resources sector, boosted by high commodity prices, outperformed the other main sectors, increasing by 22 per cent. Industrial shares increased by 14 per cent, while financial shares recorded a gain of only 4 per cent as these share prices were probably adversely affected by the implementation of the new NCA on 1 June 2007 as well as by the increase in the repurchase rate.

In US dollar terms, the all-share price index of the JSE and the Morgan Stanley Capital International (MSCI) Emerging Market index have outperformed both the MSCI World index and the FTSE All World index in 2006 and in the first eight months of 2007. In the eight months to August 2007, the MSCI Emerging Markets index increased by 19 per cent followed by the all-share price index which rose by 13 per cent, with the FTSE All World index and the MSCI World index increasing by 6 per cent and 7 per cent, respectively.

The strong rise in share prices took the price-earnings ratio of all classes of shares from 15,7 in June 2006 to 17,3 in January 2007 – its highest level since 1998. However, the price-earnings ratio then declined to 14,3 in August. Conversely, the dividend yield on all classes of shares decreased from 2,5 per cent in June 2006 to 2,1 per cent in June 2007 as the increase in share prices exceeded the growth in dividends declared before increasing to 2,5 per cent in August. The earnings yield on all classes of shares decreased from 6,5 per cent in March 2006 to 5,8 per cent in January 2007, before increasing to 7,0 per cent in August.

Market for exchange-traded derivatives

The bullish underlying share market conditions buoyed trading activity in the derivatives market during 2006 and the first eight months of 2007. The total number of futures and options on futures contracts traded on the Financial Derivatives Division of the JSE rose fervently during this period, contributing towards record-high turnover.

Similarly, trading in commodity futures and options on the Agricultural Products Division of the JSE rose sharply as high local grain prices stimulated trading activity during 2006 and in the first eight months of 2007. Local grain prices increased on account of tight supply conditions in the market.

Turnover in warrants traded on the JSE increased by more than half in 2006, as the robust conditions in the share market spilled over into this market. Subsequently, turnover in warrants lost momentum in the eight months to August 2007, as the number of contracts traded amounted to 7 billion compared with 19 billion in the same period of 2006. The actual number of warrants listed fluctuated widely from 355 in January 2006 to 426 in June, before declining to 401 in August 2007.

Turnover in derivatives on the JSE

			Change over one year	
	2006 R billion	Jan – Aug 2007 R billion	2006 Per cent	Jan – Aug 2007 Per cent
Financial futures and options on futures	2 996	2 783	93	53
Warrants	7	2	72	-68
Agricultural commodity futures and options	165	180	68	90
Interest rate derivatives	32	28	162	40

Trading activity on Yield-X increased briskly and more than doubled during 2006, remaining lively in the first eight months of 2007. On 18 June 2007, currency futures were introduced on Yield-X. With only rand/dollar contracts traded, these accounted for 81 per cent of the total number of futures contracts traded on Yield-X from June 2007 to August. Derivative instruments listed and trading on BESA registered turnover of R4,7 billion during 2006, while trade remained lacklustre in the first eight months of 2007 when turnover amounted to R0,6 billion.

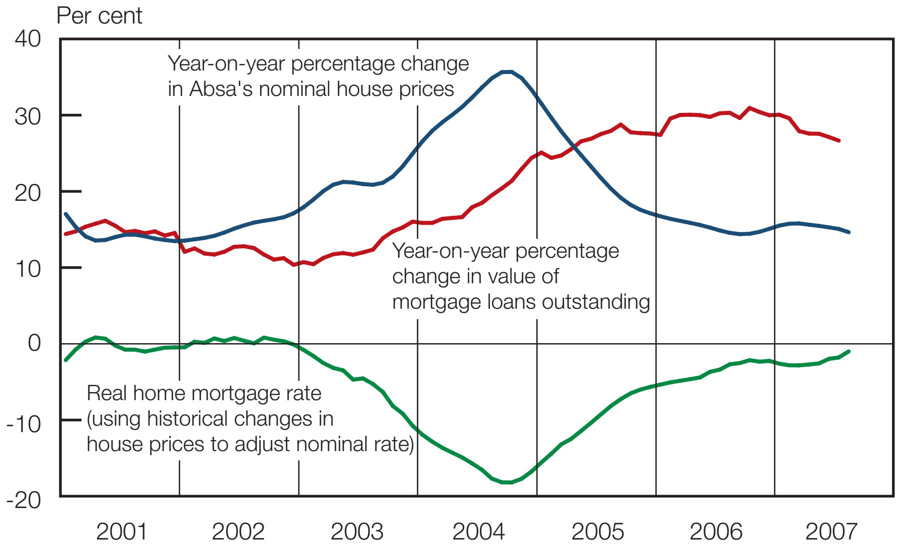
Real-estate market

Following a slight pause towards the end of 2006, the rate of increase in real-estate prices resumed its downward trend in the second quarter of 2007. The year-on-year growth rate of average residential property prices in the middle segment of the market, as measured by Absa, declined from its recent high of 35,7 per cent in October 2004 to 14,4 per cent in September 2006. The deceleration was in response to reduced affordability on account of the high levels of house prices and increasing cost of mortgage finance, alongside strong building activity which added to the supply of housing. Nevertheless, the historical twelve-month tempo of house price increases continued to exceed nominal mortgage interest rates. Subsequently, the year-on-year growth rate in house prices reaccelerated somewhat to 15,8 per cent in March 2007, before edging lower to 14,6 per cent in August.

The month-on-month increase in house prices slowed to 0,7 per cent in August 2007. The full implementation of the NCA from 1 June 2007 could slow the process of loan approvals in some instances.

Listed property performed well, with the prices of such shares increasing by 65 per cent from 17 July 2006 to 21 May 2007, as strong property fundamentals continue to feed into a solid property market outlook. The listed property index then hesitated and shed 7 per cent to 7 September, but on balance still outperformed the all-share price index over the past year.

House prices, mortgage borrowing and real interest rates



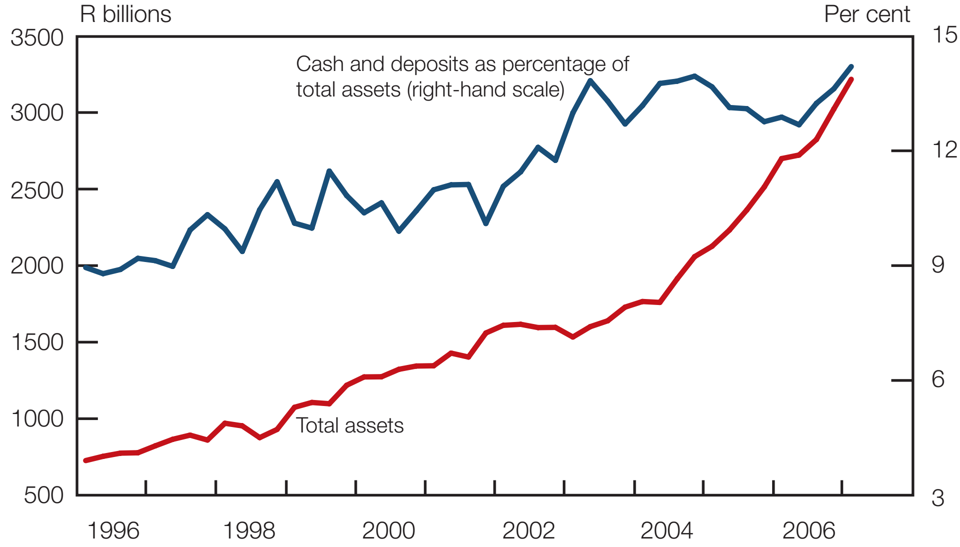
Non-bank financial intermediaries

The total net inflow[9] of funds into non-bank financial institutions[10] more than doubled from R34 billion in 1999 to R79 billion in 2006. However, by far the greatest contributor to the increase in the value of assets owned by these institutions was the remarkable increase in asset prices over the past six years. Despite strong increases in share prices, there are indications that non-bank financial intermediaries have recently adopted more defensive strategies and have increased the portion of assets held in the form of cash and deposits with banks.

9 Net sales of units by unit trusts plus premiums received by insurers plus contributions into pension and provident funds less administration costs.

10 Unit trusts, long-term insurers, as well as official and private pension and provident funds.

Total assets of selected non-bank financial institutions at market value



Public finance

Fiscal policy

The sustained robust economic upswing, alongside prudent fiscal policy management, culminated in the announcement of the first ever main budget surplus in more than three decades by the Minister of Finance when he presented the Budget to Parliament in February 2007. This fiscal outcome provided scope for the repeal of taxes on retirement funds and further moderate tax relief. The Budget projected a positive economic outlook, with real economic growth projected to average approximately 5 per cent per annum over the medium-term period to the fiscal year 2009/10, supported by enhanced public and private investment programmes, as well as benign global economic conditions.

To realise its developmental goals, government would foster a climate conducive to robust and sustained investment in productive capacity, while removing barriers to growth. The infrastructure programme involving both government and the public corporations was seen as crucial for the modernisation of the economy and enhancement of competitiveness. Fiscal policy would sustain economic growth through government savings and prioritising spending programmes which would bolster export capacity in the long run, mindful that in the short run the rising investment and associated increase in imports were likely to result in a fairly large deficit on the current account of the balance of payments.

The Budget proposed further reforms to the social security system aimed at reducing households' vulnerability through enhanced income security and savings. The working South African population would be required to contribute to a basic savings and social insurance scheme while retaining the existing system of social grants. The introduction of a wage subsidy was under consideration as an avenue to help promote job creation. The changes were expected to be implemented in 2010 and in the meantime proposals would be tabled for public consultation.

The improvement in the main budget balance reflected the sustained growth in revenue under favourable economic conditions, together with the progressive effects of deficit reduction and lower debt service costs. At its prudent current and projected levels, the budget balance provided a stable platform for government to increase investment and to respond appropriately in the event of adverse economic conditions.

National government expenditure

National government expenditure in 2006/07 came in below the original budget projection for the fourth consecutive year and amounted to R471 billion. The marginally lower-than-budgeted expenditure outcome was largely due to underspending by national government departments. Subsequently, the unaudited outcome was R5,8 billion less than the Adjusted Budget of R476 billion. As a ratio of gross domestic product, expenditure remained virtually unchanged at 26,3 per cent when compared with the previous fiscal year.

The rate of growth in government expenditure amounted to 12,9 per cent in fiscal 2006/07, slightly lower than the rate recorded in fiscal 2005/06. Real growth in government spending and in non-interest expenditure amounted to 8,0 and 9,5 per cent, respectively, for the year under review, well above the economy's real growth rate. This underlined government's growth-oriented approach, assigning higher priority to expenditure on social assistance and the enhancement of basic infrastructure and services.

During 2006/07 transfers and subsidies to businesses, households, foreign countries and other levels of general government increased more than originally budgeted for. These transfers included funds earmarked for large capital investment projects of provincial and local government, as well as social grant transfers to households. To enable local governments to continue to meet their obligations after the abolishment of the regional services council levies, national government made an additional transfer to them.

Increased revenue on account of strong economic growth, sound economic policy and prudent debt management enabled government to lower the borrowing requirement. Interest payments on government debt were broadly in line with budget expectations and continued on a subdued trajectory with an outcome of R52,2 billion, or an increase of 2,6 per cent, in fiscal 2006/07. The subdued debt service costs freed resources for channelling towards more productive expenditure.

Government spending continued to be guided by its objectives of accelerated growth, job creation and poverty alleviation. Growth in payments for capital assets was consistent with budget expectations, which reflected government's commitment to accelerate economic growth. Capital spending was projected to accelerate further to boost growth and development and to ensure a successful 2010 FIFA World Cup through infrastructure investment in stadiums and public transport.

Total government expenditure was estimated to amount to R534 billion in fiscal 2007/08, representing a year-on-year rate of increase of 13,5 per cent. This included an additional amount of R13,3 billion allocated to the 2010 FIFA World Cup, bringing the total contribution from national government to R17,4 billion. It was estimated that national government expenditure would increase at an average annual rate of 11,4 per cent over the three-year budget period and would remain at around 27,5 per cent of gross domestic product.

National government revenue

National government revenue in fiscal 2006/07 amounted to R481 billion or R34,6 billion more than the original budget estimate. The increase of 17,0 per cent was significantly more than the 8,6 per cent originally envisaged in the 2006 Budget. However, the highest historical excess revenue collected remains that of fiscal 2005/06, when it amounted to R41,3 billion.

National government revenue in fiscal 2006/07

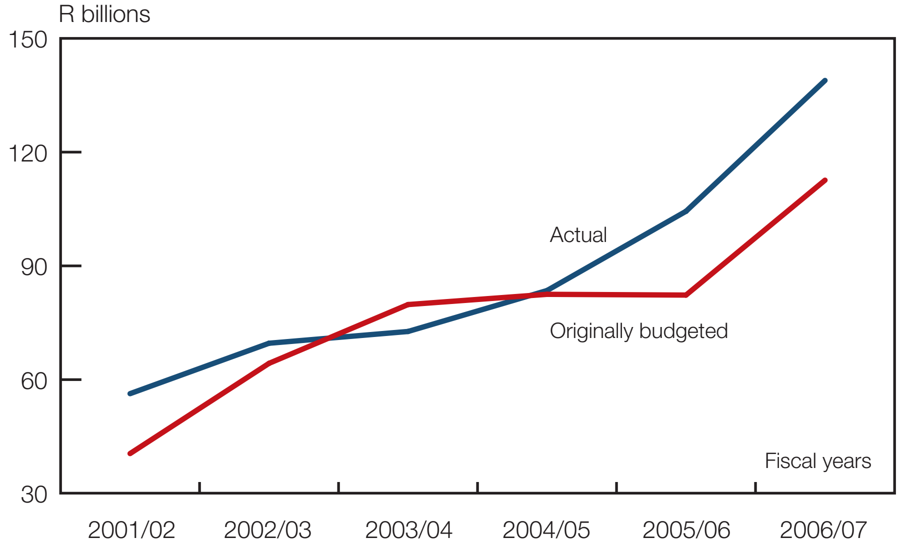
R billions

Revenue source	Originally budgeted		Preliminary outcome	
	R billions	Percentage change*	R billions	Percentage change*
Taxes on income, profits and capital gains	245,8	6,5	279,6	21,2
Payroll taxes	5,6	14,9	5,9	21,0
Taxes on property	8,9	-19,9	10,3	-7,2
Domestic taxes on goods and services	171,7	14,0	174,5	15,8
Taxes on international trade and transactions	23,6	29,7	24,0	32,0
Other revenue	10,5	8,7	11,7	21,6
Less: SACU** payments	19,7	39,6	25,2	78,1
Total revenue	446,4	8,6	480,9	17,0

* Fiscal 2005/06 to fiscal 2006/07
** Southern African Customs Union

As indicated in the table on the opposite page, all the major categories of revenue outperformed the original budget projections. The main drivers of the robust revenue performance were the stronger-than-expected economic growth driven mainly by domestic demand and investment by both the public and private sectors, higher-than-anticipated corporate profits, increased pay-as-you-earn collections and structural changes in the tax policy that have significantly broadened the tax base. Healthy revenue trends contributed to an increase in the ratio of tax collections to gross domestic product.

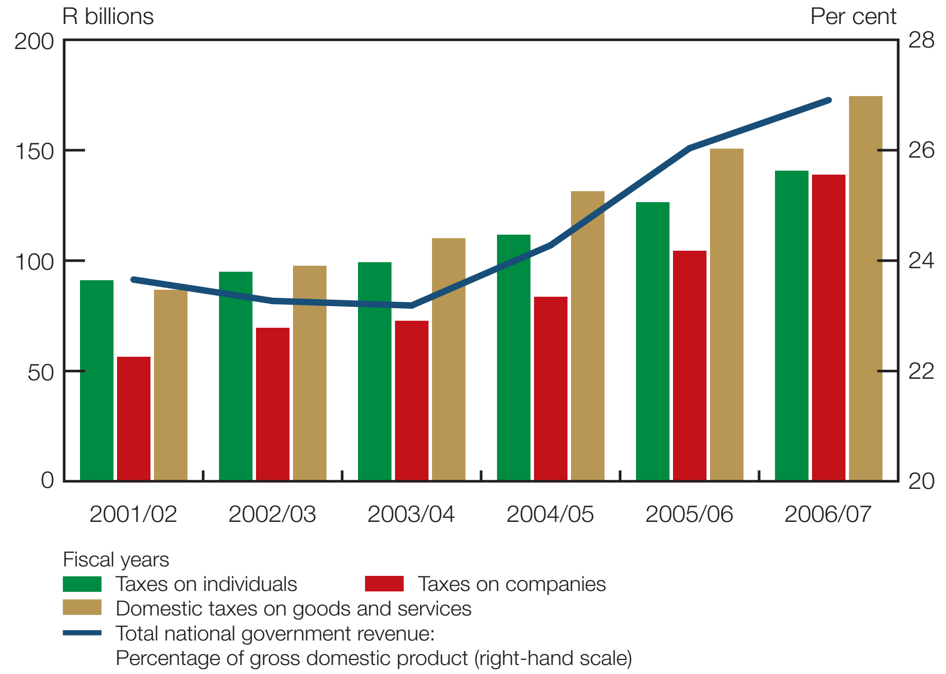
Corporate income tax collections



Most of the revenue overrun came from tax payments by the corporate sector, with the contribution of company taxes to total revenue reaching approximately 29 per cent in fiscal 2006/07 – against a 10-year average of 20 per cent. The upward trend can partly be explained by the buoyancy in corporate profits as evidenced by the growth in the share of the gross operating surplus in national income, and by improved tax compliance. The profitability of companies was also bolstered by high commodity prices and strong domestic demand. The increased profitability of private business enterprises was also supported by higher investment spending, aimed at replacing the existing capital stock and expanding productive capacity. With multipliers and accelerators amplifying the elevated investment spending, production began to accelerate significantly in the latest three years, leading to higher profits. Consequently, corporate income tax exceeded budgetary projections in the latest three fiscal years and by considerable margins in the latest two years, as shown in the graph. In fiscal 2003/04 the actual tax collections had still fallen short of original budget projections as the profit margins of companies in the manufacturing and mining sector narrowed due to the strong recovery in the exchange value of the rand and weaker foreign demand.

Domestic taxes on goods and services also grew strongly in the past fiscal year as buoyant consumer spending bolstered value-added tax collections. The strong demand for imported goods resulted in robust growth in taxes on international trade and transactions. Only taxes on property contracted after the threshold property values, below which no transfer duties are payable, were raised in February 2006. However, the contraction in this category was still less than originally projected.

Major components of national government revenue



An expanding tax base, a growing economy and a decade of sound fiscal policies have given the South African government the fiscal space to substantially step up spending on services and infrastructure and initiate momentous social security reforms.

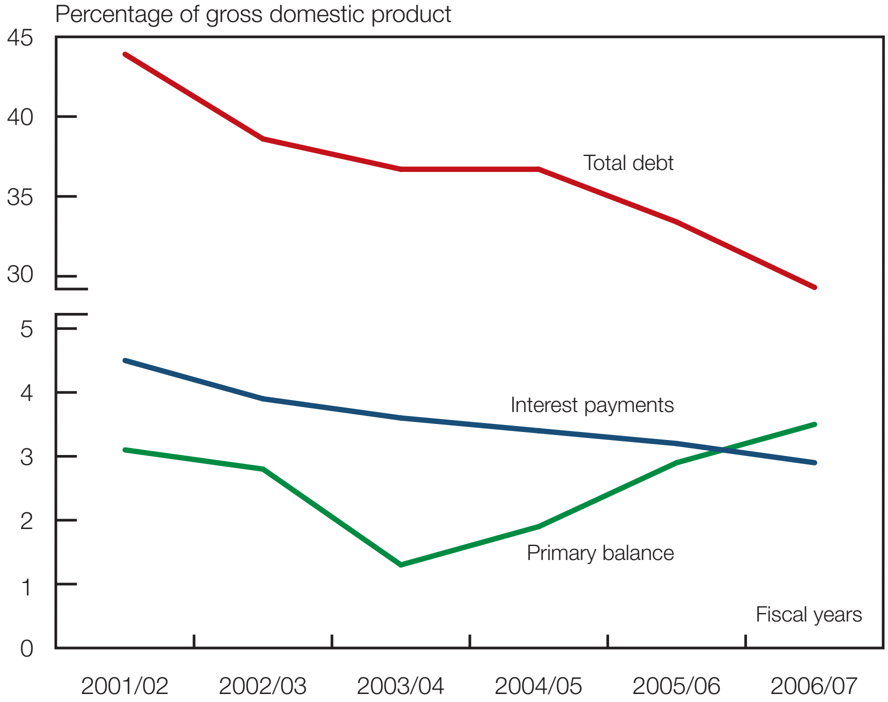
The total revenue of national government was estimated to amount to R545 billion in fiscal 2007/08, representing a year-on-year rate of increase of 13,2 per cent. It was estimated that national government revenue as a ratio of gross domestic product would average 27,6 per cent over the medium term after taking into account the effects of the February 2007 tax proposals.

National government deficit

The net result of the higher-than-budgeted revenue and lower-than-budgeted expenditure in fiscal 2006/07 was a cash book *surplus* of R10,4 billion, compared with a *deficit* of R5,6 billion recorded a year earlier. This surplus – the first ever recorded at national government level – stood in contrast to the originally budgeted deficit of R26,4 billion. As a ratio of gross domestic product, the national government surplus before borrowing and debt repayment amounted to 0,6 per cent in fiscal 2006/07, compared with a deficit ratio of 0,4 per cent recorded in the previous fiscal year. Accordingly, more domestic financial sector resources are available for utilisation elsewhere in the public and private sector.

Consistent with government's borrowing and debt sustainability strategy, the debt of national government as a ratio of gross domestic product receded substantially, contributing to lower interest costs. As a result, the *primary balance* (i.e. the deficit recalculated by excluding interest payments from total expenditure) reached a surplus of 3,5 per cent of gross domestic product in fiscal 2006/07, higher than the 2,9 per cent surplus recorded in the previous fiscal year. The primary surplus showed that government revenue could comfortably cover non-interest expenditure, and provided further confirmation of the sustainability of the government's finances.

National government debt sustainability indicators



According to the *Budget Review 2007*, the budget balance as a ratio of gross domestic product was expected to reach a surplus of 0,6 per cent in fiscal 2007/08 and revert to a deficit of 0,4 per cent by fiscal 2009/10. The budget surplus represents a considerable strengthening of public finances, providing significant fiscal space to accommodate future policy priorities and to respond to shifts in economic conditions.

The projected surplus in 2007/08 provides reassurance that government could continue to meet its commitments without fear that potential economic risks or cyclical shifts could lead to excessive budget deficits or a curtailment of expenditure programmes.

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), national government recorded a cash-flow *surplus* of R14,0 billion in fiscal 2006/07. This can be compared with a cash-flow *deficit* of R1,0 billion recorded in the previous fiscal year.

National government's net surplus in fiscal 2006/07 was influenced by extraordinary transactions as well as the cost on revaluation of foreign debt at redemption. Extraordinary payments essentially consisted of a payment of R3,8 billion relating to the Saambou Bank liability. Extraordinary receipts included premiums of R0,9 billion for bonds issued and also special dividends of R828 million from Telkom as well as R668 million from the Airports Company of South Africa. Foreign-exchange amnesty proceeds to the amount of R365 million were received in fiscal 2006/07. The abolition of the Lebowa Trust resulted in extraordinary receipts to the amount of R467 million. A transfer of R200 million was made from the Agricultural Debt Account to the National Revenue Fund.

Financing of national government in fiscal 2006/07
R billions

Item or instrument	Originally budgeted	Actual
Budget balance	**26,4**	**-14,0***
Plus: Extraordinary payments	0,0	4,2
Cost on revaluation of foreign debt at redemption	1,4	1,8
Less: Extraordinary receipts	0,2	2,5
Net borrowing requirement**	**27,6**	**-10,5**
Treasury bills	5,8	5,3
Domestic government bonds	10,2	-0,6
Foreign bonds and loans	3,8	1,9
Change in available cash balances***	7,8	-17,1
Total net financing	**27,6**	**-10,5**

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

The extraordinary transactions and cost on revaluation of foreign debt at redemption resulted in a surplus of R10,5 billion in fiscal 2006/07, compared with a net borrowing requirement of R1,5 billion recorded in the previous fiscal year. The surplus contributed to an increase of R17,1 billion in cash balances of national government. Simultaneously, national government borrowed less than originally budgeted in both the domestic and foreign capital markets. Both long-term and short-term domestic funding in fiscal 2006/07 were obtained at an average interest rate of 7,9 per cent per annum.

The National Treasury introduced two new fixed-income bonds in 2006/07. During the period under review, net issues of foreign bonds and drawings on foreign loans amounted to only half of the originally budgeted amount. In April 2006, a new foreign bond maturing in 2016 was issued, which yielded R5,5 billion. This was, however, partly offset by the redemption of a foreign bond to the amount of R3,3 billion in May 2006. Net foreign funding included R3,7 billion drawn on the export credit facility which had been arranged for the financing of the Strategic Defence Procurement Programme.

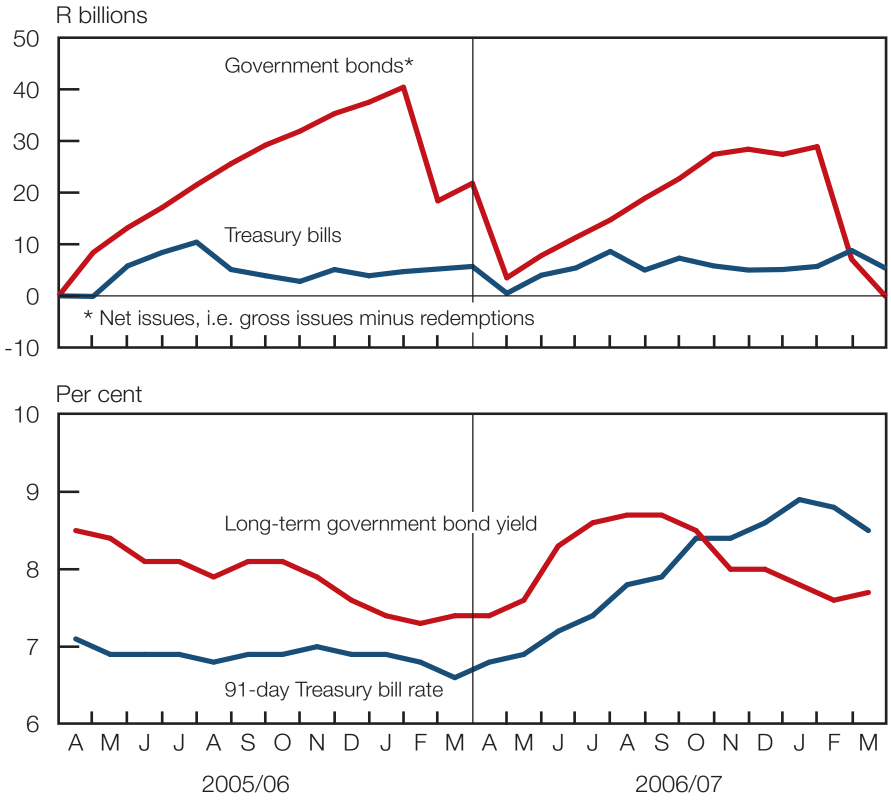
On balance, government's bank balances increased from R58,2 billion at the end of March 2006 to R75,3 billion at the end of March 2007.

The issuance of debt instruments, the discount on new government bonds issued and the revaluation of foreign debt at a depreciated exchange value of the rand, led to an increase in the loan debt of national government from R528 billion at the end of March 2006 to R552 billion at the end of March 2007. As a ratio of gross domestic product, total loan debt decreased from 33,5 per cent at the end of March 2006 to 30,9 per cent at the end of March 2007, significantly less than the 41,2 per cent recorded in fiscal 2001/02.

In the period from fiscal 2001/02 until 2005/06, the proportion of foreign debt to total loan debt was declining as government relied less on foreign funding. However, this ratio increased from 12,6 per cent at the end of March 2006 to 15,0 per cent in March 2007, following the depreciation of the exchange value of the rand which pushed up the rand value of foreign debt.

The surplus on the Gold and Foreign Exchange Contingency Reserve Account amounted to R28,5 billion at the end of March 2007, compared with R1,8 billion at the end of March 2006. Government-guaranteed debt declined from R67,9 billion at the end of March 2006 to R66,5 billion at the end of March 2007.

Cumulative financing of national government



General government finance

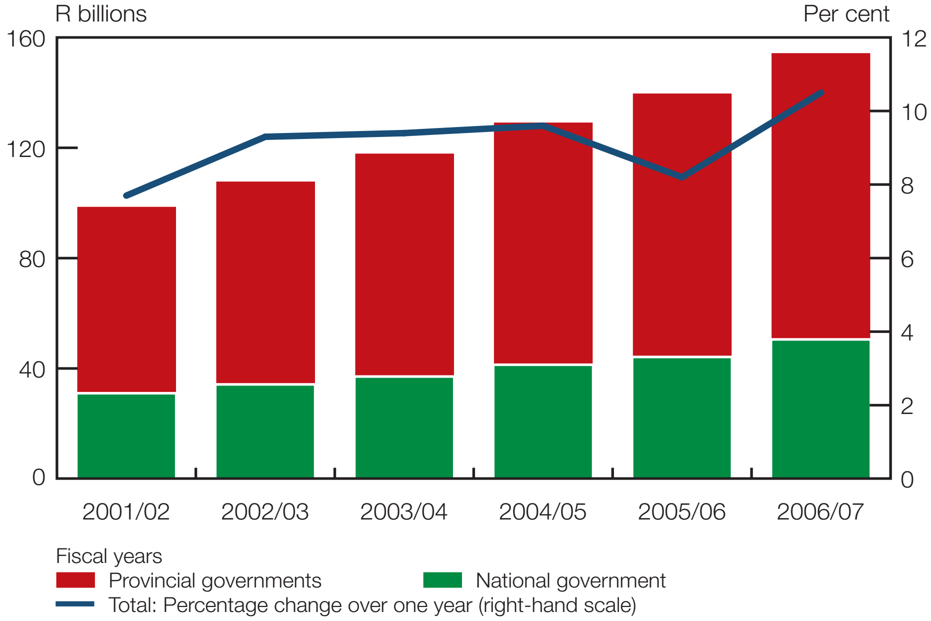
For the first time ever, the consolidated general government (i.e. central, provincial and local governments) recorded a cash surplus in fiscal 2006/07. This positive financial state of affairs could mainly be attributed to the strengthening of the main budget balance and the cash surpluses of the extra-budgetary institutions and social security funds. However, over the medium term the consolidated general government was projected to record an average borrowing requirement of 0,1 per cent of estimated gross domestic product.

Compensation of employees remained the largest component of current expenditure by government, accounting for about a third of total spending at general government level. For national and provincial governments this category of spending recorded a real increase of approximately 5 per cent in fiscal 2006/07. The average increase for the past three fiscal years was approximately at the same level. Recent increases in government's wage bill were still based on the three-year wage settlement signed in 2004. The three-year wage agreement contributed to the stabilisation of personnel costs, whereby remuneration adjustments were linked to inflation, while at the same time allowing for moderate real wage increases. A new agreement was negotiated in mid-2007, but not without some industrial action by government employees.

Over the medium term, the government wage bill is expected to grow at an average rate of 8,8 per cent per annum and to amount to R230 billion in 2009/10. The government has prioritised the expansion of employment in priority areas such as healthcare, justice and policing; real wage increases for specific categories of professionals; and personnel reforms such as the introduction of the Government Employees' Medical Scheme.

Provincial governments were allocated an additional R4,3 billion infrastructure grant in 2007/08, bringing spending on this grant to R21,0 billion over the next three years – which is in conformity with the improved spending capacity and need to address infrastructure backlogs.

Compensation of government employees



The transfer of social assistance administration and payment functions from national and provincial social development departments to the newly established South African Social Security Agency (SASSA), was effected in fiscal 2006/07. The agency was established to centralise the grants payment system, promoting greater efficiency and improved service delivery.

The estimated cash deficit of local government amounted to R7,6 billion in fiscal 2006/07, compared with a deficit of R9,9 billion recorded a year earlier. This narrowing of the cash deficit resulted partly from an increase in grants received and a moderate improvement in revenue collection. The increase in local government's share of nationally raised revenue, as stated in the *Budget Review 2007*, largely relates to allocations to cities hosting the 2010 FIFA World Cup to construct and refurbish stadiums, and to rehabilitate and upgrade transport and other municipal infrastructure in the vicinity of the stadiums.

The most important and largest broad functional category of government spending is expenditure on community and social services, as shown in the table on the opposite page. This category consistently amounts to more than half of the expenditure by consolidated national, provincial and social security funds. This type of spending was expected to increase at an average annual rate of 11,4 per cent over the medium term, with housing and community services clearly a priority area.

Functional classification of expenditure: Consolidated national, provincial and social security funds

Spending category	Percentage of total expenditure 2006/07[1]	2009/10[1]	Average growth 2006/07 – 2009/10 Per cent
Protection services	**15,7**	**15,1**	**9,5**
Defence and intelligence	5,4	4,7	6,5
Public order and safety[2]	10,3	10,3	10,9
Community and social services	**53,6**	**54,2**	**11,4**
Education	19,2	19,1	10,8
Health	11,0	10,8	10,2
Social security and welfare	16,5	15,9	9,8
Housing and community services[3]	6,9	8,3	18,3
Economic services	**14,2**	**15,3**	**13,7**
Fuel and energy	0,8	0,6	4,8
Agriculture, forestry and fishing	2,1	2,0	9,8
Mining, manufacturing and construction	0,6	0,4	-3,0
Transport and communication	5,8	6,6	16,3
Other economic services[4]	5,0	5,7	15,9
State debt cost[5]	**10,6**	**7,5**	**-0,8**
General government services and unallocatable expenditure	**5,9**	**8,0**	**22,9**
Total	**100,0**	**100,0**	**11,0**

1 *Budget Review 2007*, 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, multi-purpose projects and related services
5 Including interest, management cost and the cost of raising loans

Other priorities to receive more attention over the medium term include transport and communication as well as other economic services. Debt service costs as a share of total expenditure would continue to decline, freeing additional resources for productive expenditure and essential services.

Non-financial public-sector borrowing requirement

The non-financial public sector[11] recorded a virtually balanced budget in fiscal 2006/07. This was significantly different from the cash surplus recorded in the previous fiscal year and fell below the revised surplus of 0,7 per cent of gross domestic product projected in the *Budget Review 2007*. The increase in net investment in infrastructure by non-financial public-sector enterprises and corporations led to a turnaround in their finances, from a cash surplus recorded in the previous fiscal year to a deficit in 2006/07.

11 The consolidated central, provincial and local governments, and non-financial public enterprises and corporations.

Medium-term estimates contained in the *Budget Review 2007* indicated that the borrowing requirement of the public sector would increase to an average of 1,0 per cent of gross domestic product from 2007/08 to 2009/10.

Capital expenditure at all levels of government was forecast to accelerate and would be partly financed in the capital markets. Government expanded partnerships with the private sector through mutually beneficial contractual arrangements over the past decade, recognising that the private sector has a comparative advantage in delivering certain services. Agreements for six public-private partnership (PPP) projects were finalised in 2006/07, with a further two expected in the first half of 2007/08.