# Quarterly Bulletin

September 2006

South African Reserve Bank

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No 241



South African Reserve Bank

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http://www.reservebank.co.za/quarterlybulletin ISSN 0038-2620

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Quarterly Economic Review

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## Introduction

Robust growth in global economic activity was sustained during the first half of 2006, notwithstanding exceptionally high prices of crude oil and other commodities and the further tightening of monetary policy in a number of major economies. While global inflation picked up somewhat during this period, the removal of monetary policy stimulation, fierce competition in the ever-expanding tradeables sector and the discipline in price and wage expectations instilled by a protracted period of low inflation contributed to the containment of the inflation momentum.

From around May 2006 global investors became significantly more wary of the relatively low risk premia attached to investment in emerging markets, demanding higher returns in those markets or preferring to channel funds to the more mature markets where interest rates had risen to more attractive levels. This triggered a decline in share and bond prices and a depreciation of currencies in a number of developing countries, with those countries running sizeable current-account deficits generally more severely affected than the others.

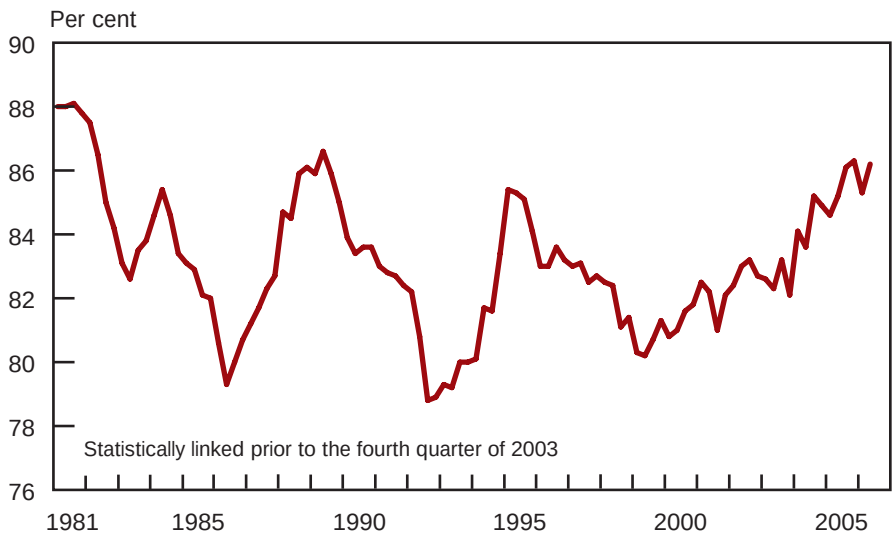
South Africa counted among the countries whose financial-asset prices and exchange rates declined on account of the reassessment of risk and reward in emerging-market economies, reinforced by a retraction in international commodity prices from their previous highs. From mid-May to mid-June 2006 the South African all-share price index, the prices of long-term bonds and the exchange value of the rand all declined significantly. However, over the subsequent three months share market sentiment improved again. Share prices eventually rose to new record highs by early September, buoyed by the robust economy, appealing prospects for some commodities and vigorous growth in company profits.

Despite the volatility in the financial markets from May 2006, the growth rate of the South African economy was not only sustained but accelerated significantly in the second quarter of the year. The annualised rate of growth in real gross domestic product rose to virtually 5 per cent in the second quarter, bolstered by substantially stronger growth in the secondary sector. In manufacturing, for instance, the real value added expanded at a stronger pace than before as real domestic final demand continued to surge, alongside a more competitive external value of the rand in the latter half of the second quarter. Capacity utilisation in the manufacturing sector accordingly rose to comparatively high levels. Growth in the construction sector continued apace in both the first and the second quarters of 2006. Only the agricultural sector registered a contraction in real value added during the second quarter, partly due to the significantly smaller maize crop which was also harvested comparatively late.

Domestic expenditure continued on its robust expansion path, with all the components of domestic final demand registering strong increases in the second quarter of 2006. The household sector's real disposable income was buoyed by rising employment and wage levels, higher transfers from government to households, and some tax relief to individuals. As household disposable income continued to increase in an environment of relatively subdued interest rates, real final consumption expenditure by households rose briskly, led by purchases of durable and semi-durable consumer goods. This was accompanied by rising debt levels. Household debt relative to disposable income

reached a new record high in each successive quarter from mid-2005, with debt mainly incurred in order to acquire fixed property and consumer durables. The cost of servicing the debt relative to household income started to edge higher as the amount of debt outstanding increased, with the interest rate on such debt also starting to rise somewhat in the second quarter of 2006.

Utilisation of production capacity in manufacturing




Real final consumption expenditure by general government rose strongly in the second quarter of 2006, mainly reflecting the acquisition of high-value military equipment as part of the defence procurement programme. Simultaneously, real gross fixed capital formation increased briskly, lifting the ratio of gross fixed capital formation to gross domestic product to 18½ per cent. Four years earlier this ratio stood at less than 15 per cent, but investment responded well as the expansion in economic activity continued to become the longest upswing in the business cycle history of the country. In the second quarter of 2006 solid increases in capital expenditure were recorded by all three institutional sectors, i.e. private business enterprises, public corporations and general government. Real inventory levels also rose strongly in manufacturing as well as in the wholesale, retail and motor trade sector, consistent with the general buoyancy of demand in the economy.

With domestic demand recording robust increases, imports rose strongly in the second quarter of 2006. Exports also increased significantly during this period, with both the volume and price of exported goods bolstered by the strength of the world economy. The trade deficit nevertheless widened in the second quarter. However, net service and income payments to non-residents declined, mainly on account of higher dividend and interest receipts by South African investors on their offshore investments as well as increased expenditure by foreign tourists. This was sufficient to result in a slight reduction in the deficit on the current account of the balance of payments, to 6,1 per cent of gross domestic product in the second quarter.

The deficit on the current account continued to be financed by capital inflows, which came in a variety of forms. Inward portfolio investment, which was exceptionally strong in the first quarter of 2006, moderated somewhat in the second quarter but remained high. The second-quarter inflow again mainly consisted of share purchases by non-residents. Foreign direct investment activity continued, with a non-resident investor acquiring shares in a domestic tyre manufacturing company and South African news distribution and

petro-chemical companies stepping up their holdings of foreign direct investment assets. Non-residents also increased their deposits with South African banks during the second quarter of 2006.

The overall balance of payments recorded a smaller surplus in the second quarter of 2006 than in the first as the South African Reserve Bank (the Bank) moderated its net purchases of foreign currency in the market. In July and August the Bank, sensitive to market conditions, continued to exercise caution in acquiring foreign exchange from the market. The gross gold and foreign exchange reserves, which rose from US$23,0 billion at the end of March 2006 to US$24,0 billion at the end of June, accordingly inched higher to US$24,4 billion at the end of August.

From mid-May 2006 the exchange value of the rand depreciated significantly alongside the currencies of several other emerging-market economies. The depreciation was largely sustained over the ensuing months, with the nominal effective exchange rate of the rand at the end of August some 15 per cent lower than at the beginning of May. This, together with high oil prices in the international markets, rising food prices and strong domestic demand conditions contributed to an acceleration in inflation. Production price inflation, in particular, accelerated strongly from the second quarter of 2006. CPIX inflation also picked up significantly but remained well within the target area of 3 to 6 per cent, its sensitivity to movements in the prices of goods at the production level moderated by the more subdued behaviour of services prices. Wage settlements edged slightly higher in the first half of 2006 compared with those in 2005.

The deterioration in the short-term outlook for inflation was acknowledged by the Monetary Policy Committee of the Bank. After a period of 14 months of an unchanged monetary policy stance during which nominal short-term interest rates were maintained at their lowest levels since 1980, policy was tightened in order to ensure conformity of inflation with the target range over the medium term. The repurchase rate was raised from 7 per cent to 7½ per cent in early June 2006 and to 8 per cent in early August. Other money-market interest rates moved higher, both in anticipation of and in reaction to increases in the repurchase rate.

The relatively low interest rate levels, buoyant income and expenditure, lively conditions in the financial markets and generally rising trend in asset prices created conditions conducive to sustained brisk increases in money supply and in banks' credit extension. Growth in the money supply was exceptionally strong during the second quarter of 2006, dragging the income velocity of circulation of M3 to another record low. At the same time, banks' loans and advances recorded vigorous increases, with mortgage advances in particular displaying strong momentum. This supported activity and prices in the real-estate market, which in turn reinforced the demand for and supply of mortgage finance. While the pace of increase in average house prices decelerated, these prices continued to rise at double-digit year-on-year rates. In the luxury market, however, strong buyer resistance developed, resulting in muted price increases.

Government finances continued to be supportive of a disciplined monetary policy environment. The robust increases in the tax revenue of the national government which had been recorded in fiscal 2005/06 were broadly maintained in the first four months of fiscal 2006/07, consistent with the buoyant performance of the economy. With government expenditure rising more strongly than revenue during the period April to July 2006, the deficit widened somewhat in comparison with the same period of the previous fiscal year, but nevertheless remained well contained. The deficit was readily financed, mainly by issuing bonds and Treasury bills in the domestic financial market but also to a limited extent through recourse to the international capital market.

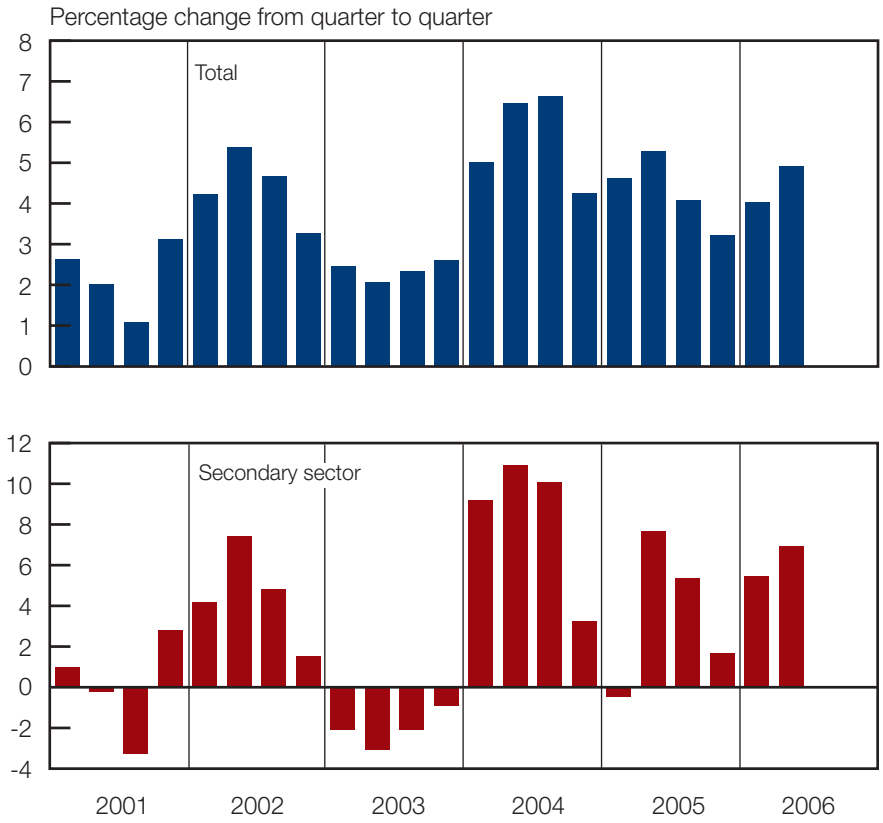
## Domestic economic developments

### Domestic output[1]

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

Growth in South Africa's *real gross domestic product* accelerated from an annualised rate of 4 per cent in the first quarter of 2006 to almost 5 per cent in the second quarter. This acceleration mainly reflected substantially stronger growth in the real value added by the secondary sector, supported by a further vigorous increase in the real value added by the tertiary sector. A decline in the real production of the primary sector was comfortably offset by the increase in real value added by the other sectors over the period. Excluding agriculture, real gross domestic product increased at an annualised rate of 5¾ per cent during the second quarter of 2006.

Real gross domestic product




Seasonally adjusted annualised rates

When comparing the first two quarters of 2006 with the corresponding two quarters of 2005, total real gross domestic product increased at a rate of 4 per cent, falling short of the almost 5-per-cent growth attained in the year 2005 as a whole.

The real value added by the *primary sector* declined at an annualised rate of 8½ per cent in the second quarter of 2006. This was mainly due to a sharp decline in the real output of the agricultural sector which more than offset the positive growth rate recorded in the mining sector.

Following a decline of 18¾ per cent in the first quarter of 2006, the real value added by the *agricultural sector* receded further at an annualised rate of 33 per cent in the second

quarter. This sharp contraction can be attributed to a significantly smaller maize crop which was also harvested comparatively late.

## Real gross domestic product

Percentage change at seasonally adjusted annualised rates

| | 2005 | | | | | 2006 | |
|---|---|---|---|---|---|---|---|
| Sectors | 1st qr | 2nd qr | 3rd qr | 4th qr | Year | 1st qr | 2nd qr |
| Primary sector ..... | 8¾ | 2¼ | ¼ | -2¾ | 3¼ | -9 | -8½ |
| Agriculture..... | 6½ | 3 | 10¼ | 4 | 5½ | -18¾ | -33 |
| Mining ..... | 9½ | 2 | -3½ | -5½ | 2½ | -4½ | 3 |
| Secondary sector ..... | -½ | 7¾ | 5½ | 1¾ | 4½ | 5½ | 7 |
| Manufacturing ..... | -2¼ | 8 | 5½ | -¼ | 4 | 4¼ | 6 |
| Tertiary sector ..... | 6 | 4½ | 4¼ | 5 | 5¼ | 5¼ | 5½ |
| *Non-agricultural sector ..* | *4¾* | *5* | *4* | *3¼* | *5* | *4½* | *5¾* |
| Total ..... | 4½ | 5¼ | 4 | 3¼ | 5 | 4 | 5 |

In contrast with the decline in the agricultural sector, the real value added in the *mining sector* rebounded in the second quarter of 2006. Subsequent to three successive quarters of negative growth, real output in the mining sector advanced at an annualised rate of 3 per cent in the second quarter. The expansion can mainly be attributed to vibrant activity in the platinum-mining sector, with the production of platinum group metals benefiting from favourable global demand and record-high prices. Growth in the real output of the "other mining" sector also improved substantially during the second quarter of 2006, mainly on account of better prospects as sustained high commodity prices enhanced these mines' profitability. High input costs continued to adversely affect the gold-mining sector, with output contracting in the first two quarters of 2006.

Growth in the real value added by the *secondary sector* accelerated in the second quarter of 2006. Following a moderate growth rate of 1¾ per cent in the fourth quarter of 2005, the real value added by the secondary sector expanded at brisk annualised rates of 5½ per cent and 7 per cent in the first and second quarters of 2006, respectively. Increased production in the second quarter of 2006 was the result of firm growth in all three subsectors constituting the secondary sector.

Growth in the real value added by the *manufacturing sector* accelerated from an annualised rate of 4¼ per cent in the first quarter of 2006 to 6 per cent in the second quarter. All major manufacturing subsectors recorded positive growth rates as real domestic final demand continued to surge, alongside a more competitive external value of the rand in the latter half of the second quarter. Exceptionally strong growth rates were recorded in several subsectors, including the export-oriented sector that manufactures basic iron and steel products. The buoyant activity in the manufacturing sector took place against the backdrop of a high level of business confidence. The utilisation of production capacity in the manufacturing sector rebounded to a level of 86¼ per cent in the second quarter of 2006.

The real value added by the sector that supplies *electricity, gas and water* increased at an annualised rate of 3½ per cent in the first quarter of 2006, rising to 4 per cent in the second quarter. High electricity demand was buoyed by the strong performance of the real economy, while several cold spells in the past quarter also increased the demand from the household sector. Exports of electricity to neighbouring countries were marginally lower in the second quarter of 2006 compared with the first quarter.

The robust activity in the *construction sector* continued unabatedly in the first half of 2006 as the real value added by the construction sector rose at annualised rates of 13¾ per cent in the first quarter and 14 per cent in the second quarter. In the second quarter construction activity was boosted by sustained fairly strong demand for residential units, augmented by projects for retail and office space. In addition, there was a solid increase in construction projects such as the maintenance of provincial roads and the construction of dams.

The pace of growth in real value added by the *tertiary sector* increased marginally from 5¼ per cent in the first quarter of 2006 to 5½ per cent in the second quarter. This firm growth was underpinned by increased activity in the trade and transport, storage and communication sectors. Despite losing some momentum in the second quarter of 2006, growth in the finance, insurance, real-estate and business services sector remained fairly brisk.

Growth in the real value added by the *trade sector* accelerated from an annualised rate of 5 per cent in the first quarter of 2006 to 6 per cent in the second quarter. This can mainly be attributed to a substantial increase in the real output of the retail subsector. This subsector benefited from strong consumer demand and concomitant high levels of consumer confidence. Real household consumption expenditure on consumer semi-durables such as clothing and footwear was particularly robust during this period. In addition, the real outlays on new motor vehicles remained strong, boosting the real value added by the motor trade subsector.

The real value added by the *transport, storage and communication sector* increased at an annualised rate of 5 per cent in the first quarter of 2006, rising to 5½ per cent in the second quarter. This resulted mainly from an increase in the real value added by the land transport as well as the communication subsectors. In the land transport subsector activity was mainly centred on freight transport, where the growth in transport more than offset the decline in the real value added by rail transport.

Growth in the real value added by the *finance, insurance, real-estate and business services sector* edged lower from an annualised rate of 8¾ per cent in the first quarter of 2006 to 8½ per cent in the second quarter. Although quarter-to-quarter growth in the real value added by banks slowed in the second quarter, it remained high.

The real value added by *general government* continued to rise in the second quarter of 2006 at an annualised rate of 1½ per cent, marginally above the pace registered in the first quarter. In the *personal services* sector real production maintained real rates of increase of 3½ per cent in both the first and second quarters of 2006.

## Domestic expenditure

Growth in aggregate *real gross domestic expenditure* slowed from an annualised rate of 14½ per cent in the first quarter of 2006 to 7½ per cent in the second quarter. The slower rate of expenditure mainly resulted from a considerably smaller increment to the pace of inventory accumulation during the second quarter. Nevertheless, real growth in all the final demand components – final consumption expenditure by households and general government, and gross fixed capital formation – accelerated in the second quarter of 2006.

## Real gross domestic expenditure

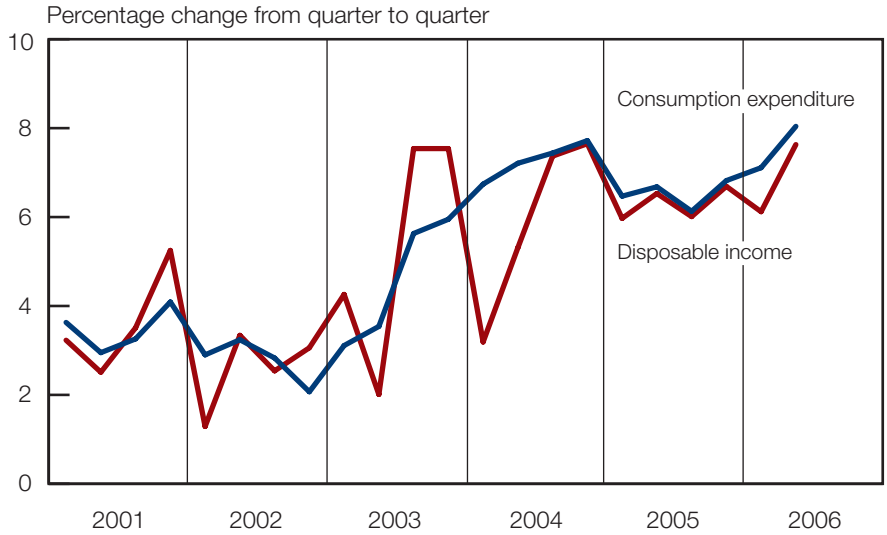
Percentage change at seasonally adjusted annualised rates

| Components | 2005 | | | | | 2006 | |
|---|---|---|---|---|---|---|---|
| | 1st qr | 2nd qr | 3rd qr | 4th qr | Year | 1st qr | 2nd qr |
| Final consumption expenditure by households | 6½ | 6¾ | 6 | 6¾ | 7 | 7 | 8 |
| Final consumption expenditure by general government | ¾ | 6 | 5½ | 14¾ | 5½ | -2¼ | 16 |
| Gross fixed capital formation | 10¾ | 5½ | 8¼ | 8½ | 9¼ | 10¾ | 11¼ |
| Change in inventories (R billions)* | 12,3 | 6,1 | 13,3 | 2,3 | 8,5 | 12,9 | 14,9 |
| **Gross domestic expenditure** | **7** | **5¾** | **7¼** | **3¾** | **6** | **14½** | **7½** |

* At constant 2000 prices

*Real final consumption expenditure by households* expanded robustly in the second quarter of 2006. Having increased at an annualised rate of 7 per cent during the first quarter of 2006, growth accelerated to 8 per cent in the second quarter – the highest quarter-to-quarter growth rate to be recorded since the first quarter of 1995. The buoyant household expenditure reflected exceptionally high consumer confidence, the relatively low level of interest rates, a decline in the price of some semi-durable goods such as clothing and footwear, and a further improvement in the real disposable income of households. The pace of growth in real disposable income of households increased from 6 per cent in the first quarter of 2006 to 7½ per cent in the second quarter. Household income benefited from an increase in salaries and wages and from the tax reduction announced in the 2006/07 Budget. Government transfers to the household sector also increased in the second quarter.

### Real household consumption expenditure and disposable income




Seasonally adjusted annualised rates

With growth in real household consumption exceeding growth in real disposable income, household saving inched lower in the second quarter and household debt continued to rise. Household debt as a percentage of disposable income amounted to

69¾ per cent in the second quarter of 2006, an increase of 1 percentage point compared with revised data for the first quarter.

The faster growth in real household expenditure during the second quarter of 2006 was broadly based, occurring in all the major spending categories except services.

Household debt and debt service ratios


Annualised growth in real household expenditure on *durable goods* increased from 13¼ per cent in the first quarter of 2006 to 15 per cent in the second quarter. Households stepped up expenditure on personal transport equipment, in particular new cars. The introduction of new models together with attractive deals continued to encourage customers to purchase motor vehicles. The growth in spending on durable goods was also supported by higher outlays on recreational and entertainment goods.

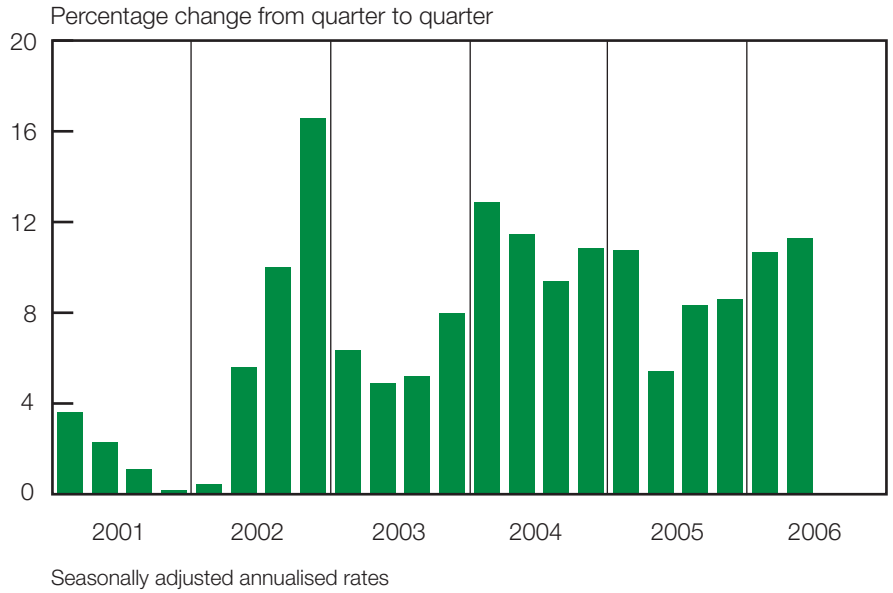
The major contributor to the growth in real final consumption expenditure by households during the second quarter was real expenditure on *semi-durable goods,* where growth accelerated from an annualised rate of 17¾ per cent in the first quarter of 2006 to 24½ per cent in the second quarter. This was mainly a result of strong demand for clothing and footwear, household textiles and furnishing, as well as recreational and entertainment goods. Prices of some of these items declined from the first to the second quarter, making them more attractive to consumers.

Demand for household fuel and power, reinforced by the winter months, was mainly responsible for growth in household expenditure on *non-durable goods*. Households also stepped up spending on food, beverages and tobacco. Demand for petroleum products also rose, with the expanding vehicle fleet and rising income levels offsetting the impact of higher fuel prices.

Following a decline of 2¼ per cent recorded in the first quarter of 2006, *real final consumption expenditure by general government* increased at an annualised rate of 16 per cent in the second quarter. This strong increase mainly reflected expenditure on non-wage goods and services, including the acquisition of aircraft as part of the defence procurement programme. Consequently, real final consumption expenditure by general government as a ratio of gross domestic product edged higher from 20¼ per cent in the first quarter of 2006 to 21 per cent in the second quarter.

Growth in *real gross fixed capital formation* increased further from 10¾ per cent in the first quarter of 2006 to about 11¼ per cent in the second quarter. This lifted the ratio of gross fixed capital formation to gross domestic product from 18 per cent to 18½ per cent over the same period. Solid increases in real outlays on capital goods were recorded by all three institutional sectors, i.e. private business enterprises, public corporations and general government.

Real gross fixed capital formation




In the *private sector*, growth in real gross fixed capital formation edged marginally lower from an annualised rate of 11½ per cent in the first quarter of 2006 to 11¼ per cent in the second quarter. Nevertheless, during the second quarter of the year robust capital expenditure was evident in most sectors of the economy, reflecting high levels of business confidence. In the mining and construction sectors rising investment mainly reflected the continuation of existing projects. Mining companies' appetite for investment improved as their incomes were enhanced by higher commodity prices. Real investment in non-residential buildings such as shopping centres and office space continued apace in the second quarter of 2006, but at the same time the demand for residential buildings began to wane somewhat.

Public corporations stepped up expenditure on machinery and other equipment essential for the efficient provision of services. This was especially evident in the country's electricity utility. As a result, growth in real fixed capital outlays by *public corporations* accelerated from an annualised rate of 19¼ per cent in the first quarter of 2006 to 22¼ per cent in the second quarter.

Real capital formation by *general government* expanded somewhat in the second quarter of 2006. On the provincial level expenditure was stepped up in areas such as the upgrading of rural roads, thereby improving the much-needed economic infrastructure.

*Real inventory accumulation* increased from R12,9 billion in the first quarter of 2006 to R14,9 billion in the second quarter. As in the first quarter, most inventory investment occurred in the manufacturing sector, *inter alia* as petroleum refineries built up stock levels, thereby raising oil imports during the second quarter. In addition, there was a build-up of inventories in the wholesale, retail and motor trade sector as domestic demand continued to expand. Inventories contributed just ¾ of a percentage point to growth in real gross domestic expenditure in the second quarter of 2006, down from 3¾ percentage points in the first quarter.

## Factor income

The growth in *total nominal factor income*, measured over one year, decelerated from 11¼ per cent in the first quarter of 2006 to 11 per cent in the second quarter. The marginally weaker rate was due to slower growth in gross operating surpluses of business enterprises while compensation of employees maintained approximately the same growth rate as in the first quarter of 2006.

The year-on-year increase in *compensation of employees* was broadly sustained at a rate of 9 per cent in the second quarter of 2006 after recording a rate of 9¼ per cent in the first quarter. An analysis of compensation of employees by sector indicates that while an acceleration was recorded in the electricity, trade and transport sectors, this was neutralised by lower growth in compensation of employees in the construction and financial sectors.

The growth over four quarters in *operating surpluses* in the economy remained strong, edging only slightly lower from 13½ per cent in the first quarter of 2006 to 12¾ per cent in the second quarter. Lower growth was recorded in the operating surpluses of the mining, manufacturing and construction sectors, while operating surpluses in the agriculture sector declined. In contrast, sectors which experienced strong growth in their operating surpluses in the second quarter of 2006 included the electricity, trade and finance sectors.

## Gross saving

The national saving ratio, i.e. the ratio of total *gross saving to gross domestic product*, increased moderately from 13 per cent in the first quarter of 2006 to 13¾ per cent in the second quarter. The improvement in the saving ratio can mainly be attributed to an improvement in the saving performance of the corporate sector which more than offset the weaker savings originating from the household sector and general government. Notwithstanding the recent improvement in the saving ratio, the average ratio for the first six months of 2006 came to 13½ per cent compared to 14 per cent recorded in 2005. The low level of gross domestic saving recorded in the second quarter of 2006 implies that almost 31 per cent of South Africa's capital formation was financed by foreign capital.

Gross saving by the *corporate sector* as percentage of gross domestic product increased from 10 per cent in the first quarter of 2006 to 11¾ per cent in the second quarter. This improvement was mainly on account of lower but still strong growth in the gross operating surpluses of business enterprises, boosted by the robust levels of economic activity and weakness of the rand against the currencies of South Africa's major trading partners. The level of saving was also supported by the tapering off of

dividend payments in the second quarter of 2006. The year-on-year growth in dividend payments amounted to 7¾ per cent in the second quarter of 2006, much lower than the rates of between 22¾ per cent and 25¼ per cent recorded in the previous three quarters. Tax payments increased by 28¼ per cent in the second quarter of 2006, compared to higher rates for most of 2005. Corporate tax payments for the calendar year 2005 increased by 31 per cent.

The gross saving ratio of the *household sector* declined further from 1¾ per cent of gross domestic product in the first quarter of 2006 to 1½ per cent in the second quarter. Notwithstanding strong growth in real disposable income of households amounting to an annualised growth rate of 7½ per cent in the second quarter of 2006, consumption expenditure increased at a stronger pace, putting strain on the pool of household saving. The ratio of household saving to gross domestic product came to an average of 1½ per cent during the first six months of 2006, compared to levels of 2 per cent and 1¾ per cent for 2004 and 2005, respectively.

The gross saving by *general government* as a percentage of gross domestic product weakened from 1½ per cent in the first quarter of 2006 to ½ a per cent in the second quarter – slightly lower than the rate recorded in calendar year 2005. The weakening of the saving ratio was the net result of strong increases in current income being offset by even stronger recurrent expenditure. While the current income of general government increased by 16 per cent in the year to the second quarter of 2006, current expenditure increased by 21 per cent.

## Employment

According to the latest *Quarterly Employment Statistics* survey by Statistics South Africa, the level of *enterprise-surveyed employment* in the formal non-agricultural sectors of the economy increased further in the three months to March 2006, albeit at a slower pace than in the three preceding quarters. Job losses in a number of sectors caused the overall level of private-sector employment to fall somewhat in the first quarter of 2006, while public-sector employment increased further.

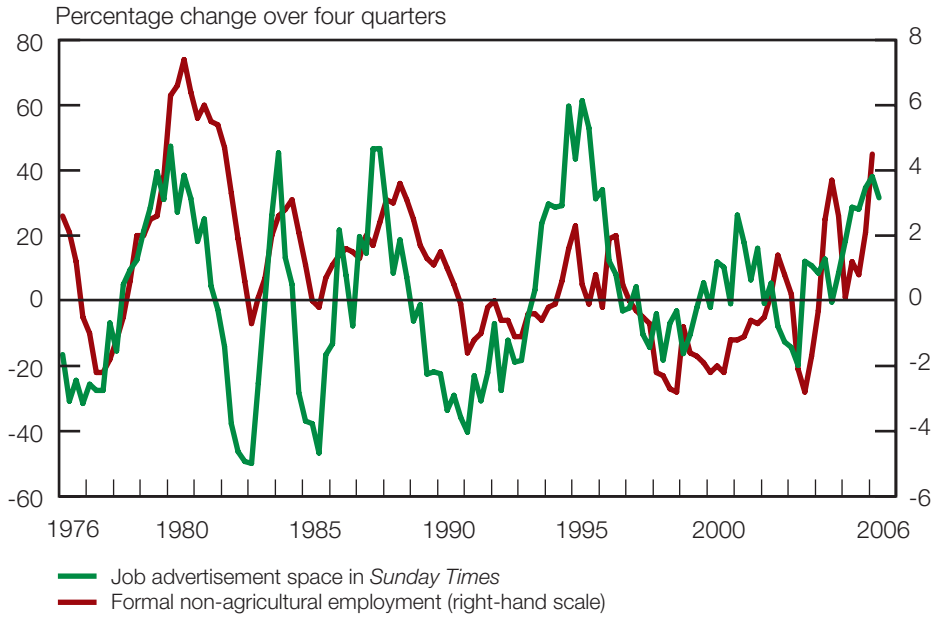
Consistent with the lower interest rate environment and concomitant high confidence levels in the economy, activity in the construction sector surged, leading to meaningful increases in employment in this sector. Employment in the construction sector increased by around 22 per cent in 2005 and by almost 7 per cent in the three months to March 2006. The latest business survey of the Bureau for Economic Research conducted in the building and construction industry confirms that overall building activity continued at a comparatively lively pace in the second quarter of 2006, despite early indications of a moderation in demand in the residential sector.

Employment in the transport, storage and communication sector expanded significantly during 2005, although some employment losses occurred during the closing months of the year and in the three months to March 2006. Sturdy increases in the community, social and personal services sector also transpired in 2005, although some job losses occurred during recent months. Consistent with the robust increases in consumer demand, employment in the trade, catering and accommodation services sector rose meaningfully in 2005 while also moderating somewhat during the three months to March 2006. Due to further retrenchments of employees in the labour-intensive gold-mining sector during the past year, the aggregate level of private-sector employment in 2005 was only marginally higher than in the preceding year.

Employment numbers in the *public sector* increased consistently in 2003 and 2004, picking up more decisively in 2005 as national departments, in particular, expanded their employee complements. By contrast, employment in the public-sector transport, storage and communication sector contracted. In contrast to the private sector where employment losses occurred, public-sector employment increased by 1,2 per cent in the three months to March 2006, the eighth consecutive quarter of increase.

Indications are that labour market conditions remained conducive to further employment gains in the second quarter of 2006. The volume of job advertisement space in the print media, which has historically been fairly well correlated with formal non-agricultural employment, rose by as much as 32 per cent in the year to the second quarter of 2006. At the same time, business confidence according to the Rand Merchant Bank/BER Business Confidence Index declined slightly in the second quarter of 2006 but consistently remained at relatively high levels, unlike those seen in the past thirty years. According to the Investec Purchasing Managers Index survey conducted in August 2006 the level of employment in the manufacturing sector is expected to expand further in the near future.

Job advertisement space in the print media and formal non-agricultural employment




According to the *Wage Settlement Survey* by Andrew Levy Employment Publications, the percentage of companies indicating that they had retrenched workers declined substantially from 37 per cent during the three-year period up to 2003, to only 14,8 per cent during 2005. This is a significant reduction and is consistent with other indications of employment growth in the economy. Within this environment of improved job prospects, the number of mandays lost rose from around 700 000 in the first half of 2005 to 1,6 million in the first half of 2006, thereby exceeding the first-half totals for the past ten years. This increase in the number of mandays lost was due to widespread and prolonged strike action in the transport and security sectors.

## Labour cost and productivity

The rate of increase in *nominal remuneration per worker* amounted to 7,2 per cent in 2005, meaningfully lower than in preceding years. Over the year to the first quarter of 2006 the increase in nominal remuneration per worker came to 7,3 per cent. Higher rates of increase in average nominal remuneration per worker were fairly pervasive, since nominal wage growth accelerated in both the private and public sectors over the quarter to March 2006. Nominal wage growth per worker in the private sector outpaced that in the public sector in the first quarter of 2006.

According to Andrew Levy Employment Publications, the average level of *wage settlements* in collective bargaining agreements rose from 6 per cent in the first half of 2005 to 6,2 per cent in the first half of 2006. Settlements in the first half of 2006 ranged from 4 per cent in the transport sector to 7,5 per cent in the building and construction sector, while the average minimum monthly wage per worker remained broadly unchanged over this period.

The pace of increase in nominal remuneration per worker in the *public sector* slowed to 6,8 per cent in 2005 and to 6,0 per cent in the year to the first quarter of 2006. Despite this slowdown, growth in nominal remuneration per worker showed a marked acceleration at national department level. In contrast with previous quarters, remuneration increases at provincial level were well contained in the year to March 2006.

Similar to the slowdown in nominal wage growth in the public sector, nominal wage growth per worker in the *private sector* fell from 9,1 per cent in 2004 to 7,1 per cent in 2005. Mainly driven by rates of increase of around 15 per cent in the construction, non-gold mining as well as transport, storage and communication sectors, growth in nominal wages per worker accelerated again to reach 8,1 per cent in the year to the first quarter of 2006.

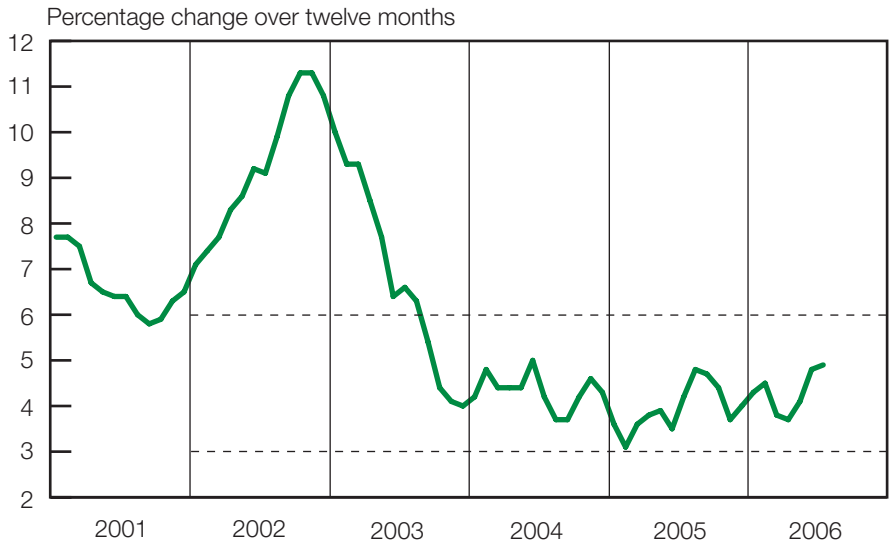
Consistent with the increases in the overall level of employment, year-on-year *economy-wide labour productivity growth* slowed considerably in the course of 2005, amounting to 2,1 per cent in the fourth quarter of that year. Notwithstanding this slowdown, average labour productivity growth for 2005 as a whole still outpaced that of the preceding year by a considerable margin. Labour productivity in the first quarter of 2006 was marginally lower when compared with the same period in the previous year. Production per worker in the *manufacturing sector* increased by 5,0 per cent in 2005, slightly lower than in the preceding year, but nevertheless meaningfully higher than for the economy as a whole. Labour productivity growth in the manufacturing sector, however, slowed to 2,7 per cent in the year to the first quarter of 2006.

The acceleration in the rate of increase in average nominal remuneration per worker, combined with the deceleration in labour productivity growth, caused the rate of increase in *nominal unit labour cost in the formal non-agricultural sector* to pick up markedly from a level well below the inflation target range to one which exceeds the target range by a fair margin. At 7,6 per cent in the first quarter of 2006, the year-on-year increase in nominal unit labour cost was the highest since the fourth quarter of 2004. This development is attributed in part to a decline in labour productivity over the year to the first quarter of 2006, as quarterly surveyed employment growth outpaced output growth. Save for the marked drop in employment and remuneration numbers in the first quarter of 2005, establishing a low base value for year-on-year calculations, nominal unit labour cost growth would have been more contained in the first quarter of 2006.

## Prices

Price pressures in the domestic economy have mounted in recent months primarily due to consistent increases in the international price of crude oil, accelerating food price inflation and sustained strong consumer demand in general. The depreciation of the exchange rate of the rand from the middle of May 2006 has also adversely affected the inflation outlook. Year-on-year CPIX inflation, however, continued to fluctuate within the inflation target range of between 3 and 6 per cent.

CPIX




Following the depreciation of the rand since the middle of May 2006, the average level of the prices of *imported goods* started to pick up and by July prices had risen by 8,2 per cent over the year. When measured from quarter to quarter and expressed at an annualised rate, imported goods prices rose by more than 10 per cent in the second quarter of 2006. Declines in the prices in a number of imported goods categories, coupled with well-contained increases in the majority of the other categories, were largely countered by a consistent rise in energy prices. Excluding energy prices, imported goods prices rose by 3,9 per cent in the year to July 2006. In addition to higher energy prices, basic metal prices also increased briskly, consistent with the general rise in international commodity prices.

Production price inflation in South Africa's main trading-partner countries also responded to increased energy costs as the monthly average spot price of Brent crude oil, for example, rose from around US$55 per barrel in November 2005 to approximately US$74 per barrel in July 2006. As a result, year-on-year increases in the composite wholesale price index of South Africa's main trading-partner countries accelerated from 3,7 per cent in March 2006 to 5,1 per cent in June with indications of a further acceleration in July.

In addition to the direct cost-raising effects of increased imported goods prices, steep increases in the prices of mining products, non-ferrous basic metals, products of petroleum and coal, agricultural food products, electrical machinery, fresh meat as well as alcoholic drinks, propelled *domestically produced goods price inflation* to a higher level in recent months. In the year to July 2006 the production prices of mining products

excluding coal rose by 37,2 per cent, non-ferrous basic metals by 29,5 per cent and products of petroleum and coal by 24,9 per cent, all of these strongly influenced by developments in export parity or import parity prices. Agricultural food prices also increased by 21,5 per cent over the period. Year-on-year inflation in the production prices of domestically produced goods accordingly more than quadrupled from about 2 per cent in the first half of 2005 to 8,1 per cent in July 2006. At this rate, domestically produced goods price inflation fell below imported goods price inflation, reversing the order which had applied in the preceding two months.

Disconcerting was the doubling in the quarter-to-quarter pace of increase in domestically produced goods prices to a rate slightly in excess of 10 per cent in the second quarter of 2006. This rate was restrained by the prices of textiles, clothing and footwear, which remained broadly unchanged in that quarter compared to the preceding quarter. Higher rates of increase were, however, recorded in all the "other goods" categories.

## Production prices

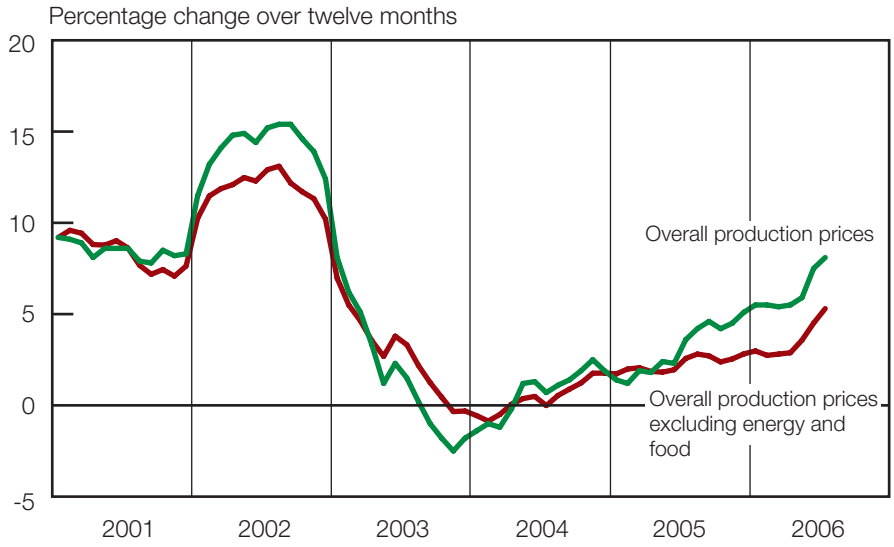
Quarter-to-quarter percentage changes at annualised rates

| Period | | Domestically produced goods | Imported goods | Overall production prices |
|---|---|---|---|---|
| 2004: | 1st qr | 5,2 | -3,2 | 2,9 |
| | 2nd qr | 4,8 | 5,0 | 4,9 |
| | 3rd qr | 1,3 | -3,9 | 0,6 |
| | 4th qr | 0,5 | 2,2 | 0,9 |
| | **Year** | **2,3** | **-3,9** | **0,6** |
| 2005: | 1st qr | 1,5 | -2,7 | 0,6 |
| | 2nd qr | 5,2 | 14,1 | 6,6 |
| | 3rd qr | 6,6 | 11,7 | 8,5 |
| | 4th qr | 3,2 | 1,7 | 2,8 |
| | **Year** | **2,9** | **3,6** | **3,1** |
| 2006: | 1st qr | 5,6 | -0,1 | 4,2 |
| | 2nd qr | 10,6 | 10,8 | 10,7 |

With both domestically produced goods and imported goods price inflation accelerating, the year-on-year rate of increase in the *all-goods production price index* more than doubled to 8,1 per cent over the twelve months to July 2006. When all-goods production price inflation is stripped of the effect of the current main inflation drivers, i.e. energy and food prices, an increase of 5,3 per cent was recorded in the year to July 2006. However, this latter rate of increase was double the rate of increase registered in the closing months of 2005, indicating that underlying production price pressures were also picking up.

Year-on-year CPIX *inflation* amounted to 4,9 per cent in July 2006, compared with 3,7 per cent three months earlier. The upward trend in CPIX inflation was not only attributable to petrol price increases, as the indicator which excludes petrol also rose to 3,9 per cent in July 2006 – the highest rate of increase since June 2004. Food price inflation, which has been increasing steadily since late 2005, as well as higher prices of alcoholic beverages and tobacco products, contributed significantly to this upward trend in consumer price inflation. Consistent with the acceleration in year-on-year CPIX inflation, the quarter-to-quarter rate of increase picked up markedly to an annualised 5,1 per cent in the second quarter of 2006.

## Production prices




*CPIX goods price inflation* not only fluctuated considerably during the past two-and-a-half years due to the monthly changes in petrol prices, but moved to a higher level from around the middle of 2005. Measured over twelve months, CPIX goods price inflation more than tripled to 5,7 per cent in July 2006 despite the fact that as much as one fifth (by weight) of the goods categories still registered price declines in July 2006. In particular, declines were recorded in the categories for furniture and equipment, clothing and footwear as well as new and used vehicles.

Over the same period, significant increases in the prices of meat, fish and vegetables contributed to rising food prices. The prices of grain products have not fully responded to the sizeable increase in maize prices since the latter part of 2005, although some upward pressure is evident. Year-on-year increases in the category for *other goods*, constituting around 27 per cent of the CPIX goods basket, leveled off at around 2,5 per cent during the first half of 2006 but rose to 3,9 per cent in July. The quarter-to-quarter pace of increase in CPIX goods prices accelerated consistently from the fourth quarter of 2005, and by the second quarter of 2006 amounted to an annualised rate of 5,7 per cent.

## Inflation in CPIX components

Percentage change over twelve months

| | Weights | July 2006 |
|---|---|---|
| Transport running cost | 5,7 | 19,3 |
| Alcoholic beverages and tobacco | 3,1 | 7,0 |
| Food | 26,9 | 6,7 |
| *Services excluding housing and transport* | 16,5 | *4,3* |
| *Other goods (not included elsewhere)* | 17,5 | *3,9* |
| *Transport services* | 3,9 | *3,4* |
| Housing service | 13,4 | 2,6 |
| Vehicles | 5,7 | -1,0 |
| Furniture and equipment | 3,2 | -2,0 |
| Clothing and footwear | 4,1 | -7,6 |
| **Total CPIX** | **100,0** | **4,9** |

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

As opposed to the variability and upward trend in CPIX goods price inflation, *CPIX services price inflation* has been decelerating almost unabatedly since the closing months of 2003. The slowdown in services price inflation to 3,5 per cent in July 2006 mainly emanated from a moderation in the rate of increase in domestic workers' wages and medical services, as well as absolute declines in communication costs. This rate is almost three times less than what had been recorded in the opening months of 2004. Following a faster pace of increase in all services price categories, the quarter-to-quarter CPIX services price inflation rate accelerated to an annualised 3,9 per cent in the second quarter of 2006.

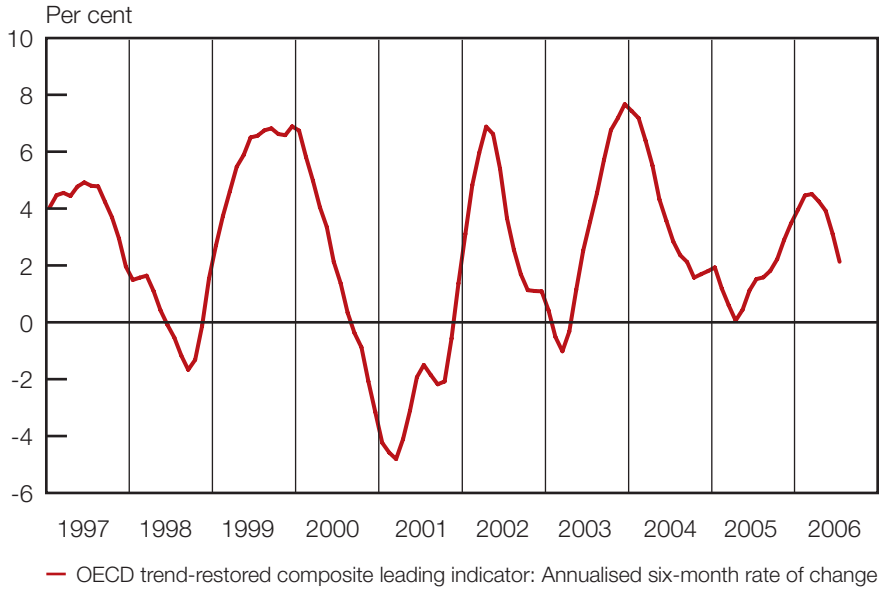
Inflation in the prices of administered goods and services, being inclusive of petrol prices, fluctuated considerably during the past two-and-a-half years as petrol prices changed from month to month. Administered price inflation picked up to 8,9 per cent in the year to July 2006. Noteworthy is the fact that when petrol prices are excluded from the calculation, administered price inflation has been receding consistently since July 2005, and amounted to only 3,1 per cent in the year to June 2006, but picked up to 4,3 per cent in July.

# Foreign trade and payments

## International economic developments

Following exceptional strength in 2004, global economic growth moderated slightly, maintaining a still robust rate of expansion in 2005 and the first half of 2006. The six-month rate of change of the composite leading indicator of the Organisation for Economic Co-operation and Development (OECD), however, suggests weaker growth in the OECD area towards the end of the year, having peaked in March 2006. This indicator provides early signals (leading by six to nine months) of turning points in economic activity.

OECD: Composite leading indicator

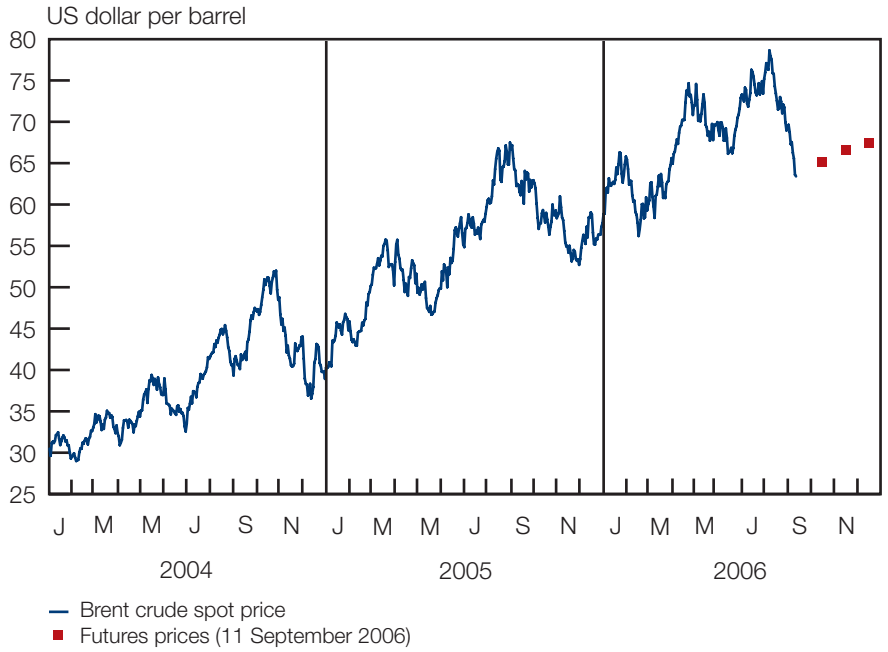



After rebounding strongly in the first quarter of 2006, economic growth in the United States (US) moderated substantially in the second quarter as the slowdown in the housing market, high crude oil prices and the effects of monetary policy tightening made themselves felt. Real economic growth in Japan decelerated during the first two quarters of 2006, whereas economic growth in the euro area regained momentum and became more broadly based as world trade continued to expand. Real output growth in China, Indonesia and the Philippines accelerated in the second quarter of 2006, but slowed in most of the other major Asian emerging-market countries. Rapid Chinese economic growth in the second quarter was supported by a rising trade surplus and brisk investment growth. The pace of economic activity in Chile and Venezuela regained momentum in the second quarter of 2006, but moderated in several other major Latin American emerging-market economies. Real output growth in Africa is expected to continue growing at a relatively robust pace during 2006.

Brent crude oil prices remained volatile and increased from an average of US$62 per barrel in the first quarter of 2006 to US$70 per barrel in the second quarter, before reaching new record-high levels approaching US$80 per barrel in early August 2006. The high crude oil prices reflected strong global demand, disruptions in oil supply such as the recent shutdown of the largest US oil field due to pipeline problems in Alaska, limited excess oil

production capacity, geopolitical tensions and the current hurricane season. Brent crude oil prices, however, declined below US$64 per barrel in early September 2006 following the easing of geopolitical tensions, the end of the US summer driving season and indications that the temporary shutdown of the Alaska oil field would only affect about half of the output. Futures prices suggest that by early September market participants expected Brent crude oil prices to be around US$66 per barrel in the fourth quarter of 2006.

Brent crude oil prices




Inflationary pressures increased in several countries, partly reflecting rising energy prices. As a result, central banks around the globe continued to tighten monetary policy in recent months. The Bank of Japan ended its quantitative easing monetary policy in March 2006 and increased the uncollateralised overnight call rate by 25 basis points in July. The Bank of England raised the official Bank rate in early August 2006 by 25 basis points to 4,75 per cent in order to bring inflation back to the target in the medium term. The European Central Bank also increased its key interest rate by 25 basis points in August to 3,0 per cent, the fourth increase since the end of 2005, in an effort to curb inflation. Monetary policy was also tightened in recent months in other countries, including Australia, Canada, Chile, China, the Czech Republic, Denmark, Hong Kong, Hungary, India, Israel, Malaysia, South Korea, Sweden, Switzerland, Taiwan, Thailand and Turkey. After increasing its target for the federal funds rate at seventeen consecutive meetings, the US Federal Open Market Committee (FOMC) kept it unchanged in August at 5,25 per cent. However, the central banks of Brazil, Indonesia, Mexico, Poland and Russia recently lowered interest rates.

## Current account[2]

As could be expected when gross domestic expenditure increases briskly, the value of merchandise imports continued to rise at a vibrant pace in the second quarter of 2006. The increased expenditure on foreign-produced goods was only partly matched by an increase in export earnings, and South Africa's trade deficit accordingly widened to R44,4 billion in the second quarter of 2006. However, owing to lower net service, income

*2 Unless stated to the contrary, the current-account flows referred to in this section are seasonally adjusted and annualised.*

and current transfer payments to non-residents, the deficit on the current account of the balance of payments narrowed marginally to R101,7 billion in the second quarter of 2006. As percentage of gross domestic product, the current-account deficit declined from 6,4 per cent in the first quarter of 2006 to 6,1 per cent in the second quarter.

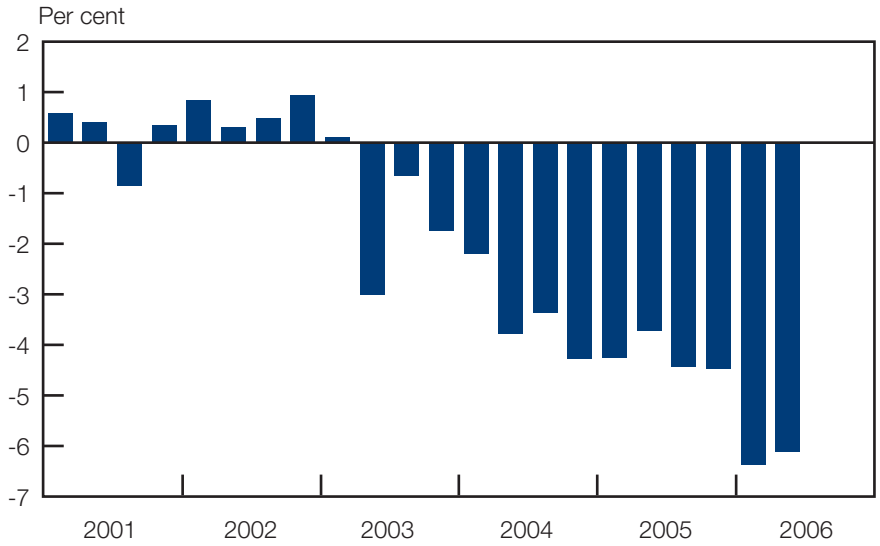
## Balance of payments on current account

Seasonally adjusted and annualised
R billions

| | 2005 | | | | | 2006 | |
|---|---|---|---|---|---|---|---|
| | 1st qr | 2nd qr | 3rd qr | 4th qr | Year | 1st qr | 2nd qr |
| Merchandise exports | 281,1 | 326,7 | 337,3 | 337,6 | 320,7 | 322,5 | 362,8 |
| Net gold exports | 24,9 | 25,9 | 26,0 | 31,3 | 27,0 | 29,3 | 33,7 |
| Merchandise imports | -319,0 | -356,8 | -384,0 | -378,9 | -359,7 | -388,3 | -440,9 |
| **Trade balance** | **-13,0** | **-4,2** | **-20,7** | **-10,0** | **-12,0** | **-36,5** | **-44,4** |
| Net service, income and current transfer payments | -49,2 | -51,0 | -47,7 | -61,6 | -52,4 | -66,6 | -57,3 |
| **Balance on current account** | **-62,2** | **-55,2** | **-68,4** | **-71,6** | **-64,4** | **-103,1** | **-101,7** |

The contraction in the value of merchandise *exports* in the first quarter of 2006 was reversed in the second quarter when export proceeds rose by 12,5 per cent on account of regained vigour in the physical quantity of merchandise exports as well as higher rand prices of exported goods. Pronounced increases in the value of manufactured and mining exports were recorded over the period. Increased demand for South African exports alongside the improved competitive position of South African producers had an expansionary effect on the volume of exported goods. Having declined for two consecutive quarters, the volume of merchandise exports increased by 6½ per cent in the second quarter of 2006 as the export sales of manufactured goods and mining products advanced. By contrast, the volume of gold exports dropped by 3½ per cent in the second quarter of 2006, continuing its longer-term trend.

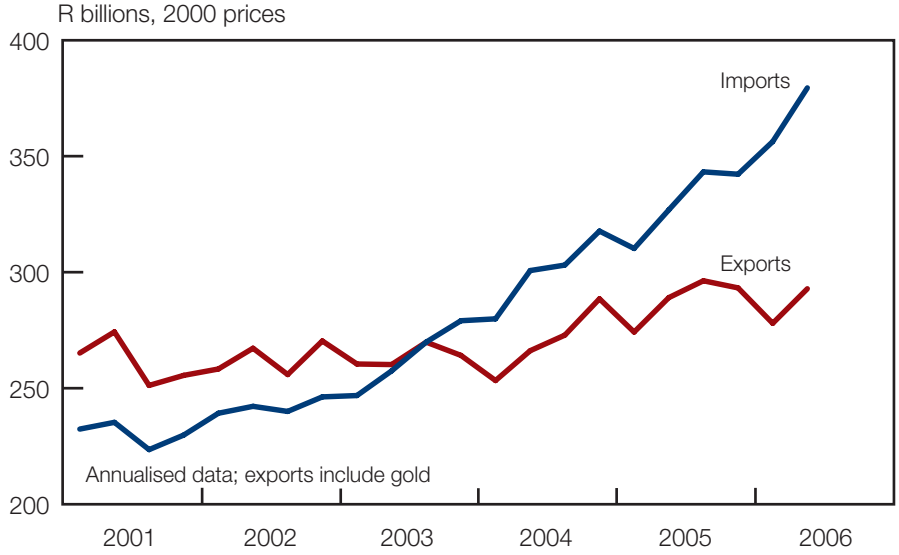
Ratio of current-account balance to gross domestic product



Apart from the depreciation of the rand from the middle of May 2006, the average rand price of merchandise exports also benefited from higher international commodity prices during the second quarter – overall, the unit price of exports rose by 6 per cent over the period. In US dollar terms, commodity prices advanced by 12 per cent during the period. The average realised price of gold exports rose by 19 per cent from the first to the second quarter of 2006 while the price of gold on the London market increased from US$554 per fine ounce to US$628 per fine ounce, or by 13,4 per cent, over the same period.

The volume of *imported goods*, which had increased by 3½ per cent in the first quarter of 2006, advanced by almost 9 per cent in the second quarter. In part, the higher physical quantity of imports could be attributed to the importation of crude oil and refined petroleum products in an effort to meet the anticipated demand during a period in which a major refinery will undergo maintenance. The physical quantity of non-oil imports, however, also rose solidly by 7 per cent as the infrastructural investment began to gain momentum.

Real imports and exports of goods and services




Steadily rising output prices in South Africa's main trading-partner countries, higher international crude oil prices and a decline in the external value of the rand in the latter part of the second quarter of 2006 gave rise to an increase of 4,2 per cent in import prices in the second quarter. The combined effect of higher import volumes and prices caused the value of merchandise imports to increase by 13½ per cent to R440,9 billion in the second quarter. The value of crude oil imports relative to the total value of imported goods rose from 12½ per cent in the first quarter of 2006 to almost 15½ per cent in the second quarter.

The negative imbalance on the service, income and current transfer account with the rest of the world narrowed from R66,6 billion in the first quarter of 2006 to R57,3 billion in the second quarter. Higher dividend and interest receipts by South African investors on their offshore investments contributed substantially to the improvement in the external account. In addition, foreign tourists also spent more on travel-related services in South Africa. The increase in service receipts was almost sufficient to offset the negative effect of increased interest payments related to the country's larger foreign-debt exposure.

As the international prices of South African export commodities rose by more than international crude oil prices, a further increase in South Africa's terms of trade was registered in the second quarter of 2006.

## Financial account

Risk aversion towards emerging-market economies in general in the latter part of the second quarter of 2006 contributed to the shrinking of the surplus on South Africa's financial account with the rest of the world. Primarily on account of net inward portfolio flows in the first half of the second quarter of 2006, the financial account of the balance of payments recorded capital inflows to the tune of R30,5 billion in the second quarter. Over the same period, direct and other investment recorded an outflow on a net basis. The surplus on the financial account (including unrecorded transactions) as a percentage of gross domestic product accordingly declined to 7,4 per cent in the second quarter of 2006.

### Net financial transactions not related to reserves

R billions

| | 2005 | | | | | 2006 | |
|---|---|---|---|---|---|---|---|
| | 1st qr | 2nd qr | 3rd qr | 4th qr | Year | 1st qr | 2nd qr |
| Change in liabilities | | | | | | | |
| Direct investment | 1,4 | 1,4 | 32,2 | 5,7 | 40,7 | 8,4 | 3,2 |
| Portfolio investment | 7,8 | 25,3 | 7,3 | -4,1 | 36,3 | 52,8 | 35,9 |
| Other investment | 22,3 | -2,4 | 1,9 | 0,3 | 22,1 | 20,3 | 23,5 |
| Change in assets | | | | | | | |
| Direct investment | -0,6 | 3,2 | -1,7 | -1,3 | -0,4 | 1,8 | -8,7 |
| Portfolio investment | 2,3 | -1,5 | -3,2 | -3,4 | -5,8 | -3,0 | -3,3 |
| Other investment | -6,3 | 0,7 | -26,4 | 9,2 | -22,8 | -33,8 | -36,0 |
| Total financial transactions* | 16,3 | 35,1 | 24,2 | 22,8 | 98,4 | 33,4 | 30,5 |

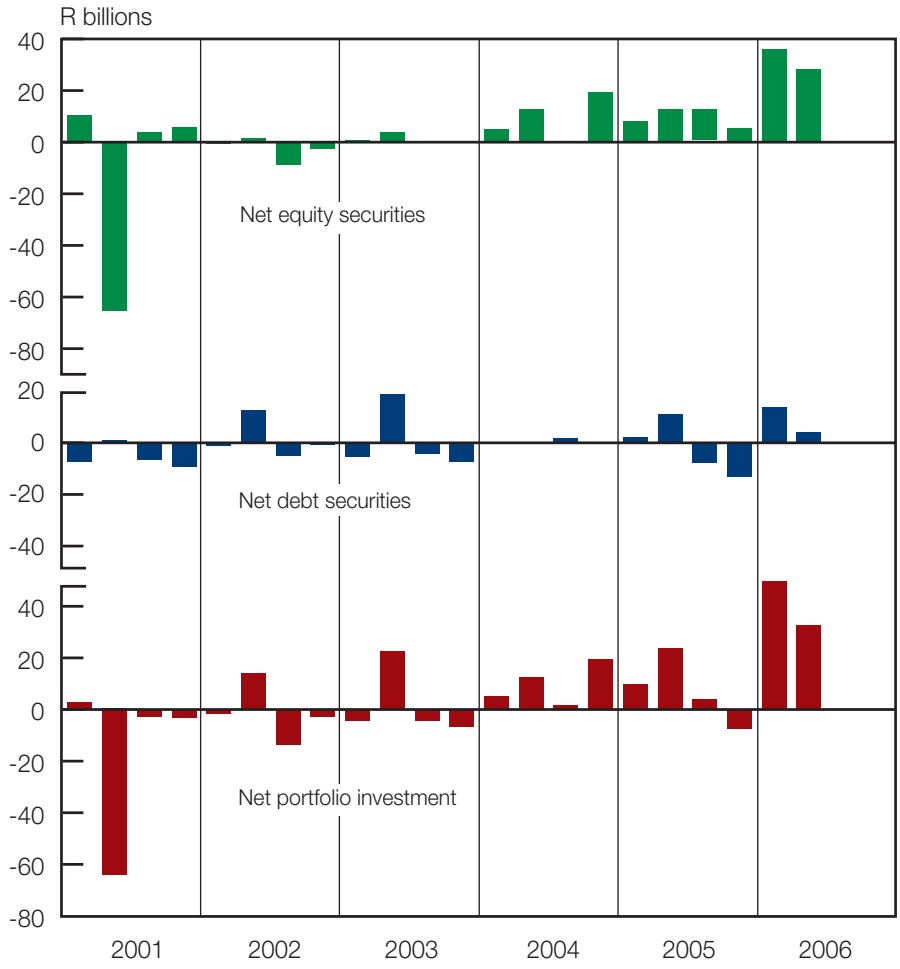
* Including unrecorded transactions

### Foreign-owned assets in South Africa

*Foreign direct investment* into South Africa recorded an inflow of R3,2 billion in the second quarter of 2006. This inflow of capital reflected a non-resident direct investor's acquisition of shares in a domestic tyre manufacturing company as well as an increase in loan capital obtained from parent companies abroad. At the same time, foreign investors sold their shareholding in a domestic diamond mining company to a domestic empowerment entity, partly offsetting the inflow of capital over the period.

*Foreign portfolio investors* continued to accumulate South African securities in May and June 2006 despite the change in sentiment towards investment in emerging markets, including South Africa. In total, non-resident investors acquired securities to the value of R35,9 billion in the second quarter of 2006 – smaller than the record capital inflow of R52,8 billion which was registered in the first quarter. The net purchases of equity and debt securities through the JSE Limited (JSE) and the Bond Exchange of South Africa (BESA) in the second quarter of 2006 was supplemented by a €750 million international bond issue by the National Treasury. The proceeds were partly utilised to redeem a €500 million international bond issue which matured in May 2006. In July 2006, non-resident investors were net sellers of South African equity securities and net purchasers of bonds.

Net portfolio investment flows




*Other foreign investment* into South Africa registered an inflow of R23,5 billion in the second quarter of 2006 compared with an inflow of R20,3 billion in the first quarter. The steady inflow of capital during the second quarter mainly reflected a further increase in non-resident rand and foreign-currency denominated deposits with South African banks. The maturity of the bulk of these deposits was less than one year.

## South African-owned assets abroad

*Direct investment* by South African entities abroad reverted from an inflow to an outflow in the second quarter of 2006 when, among others, a South African news distribution company, a healthcare company and a petro-chemical company increased their holdings of foreign direct investment assets. This outflow was partially countered by the sale of a South African insurance company's foreign subsidiary. On a net basis, the outflow of capital amounted to R8,7 billion in the second quarter of 2006 compared with a capital inflow of R1,8 billion in the first quarter.

*Outward portfolio investment* increased from R3 billion in the first quarter of 2006 to R3,3 billion in the second quarter. South African institutional investors, and to a lesser degree individual investors, continued to broaden and diversify their holdings of foreign

assets in terms of the dispensation granted under the prudential regulations of exchange control.

*Other outward investment* amounted to R36,0 billion in the second quarter of 2006 compared to an increase of R33,8 billion in the first quarter of 2006. The outflow of capital in the second quarter mainly took the form of increased foreign-currency deposits with and loans and advances extended to foreign banks.

## International reserves and liquidity

South Africa's overall balance of payments recorded a surplus of R3,4 billion in the second quarter of 2006 – significantly less than the surplus of R11,6 billion registered in the first quarter.

The value of the gross gold and other foreign reserves of the South African Reserve Bank rose from US$23,0 billion at the end of March 2006 to US$24,0 billion at the end of June. By August, the Bank's gross international reserves had increased further to US$24,4 billion. The outstanding amount of short-term credit facilities utilised by the Bank remained roughly unchanged at US$3,5 billion from the end of July 2004 to the end of July 2006. The level of import cover (i.e. the value of gross international reserves relative to the value of imports of goods and services) increased from 14 weeks at the end of March 2006 to 15 weeks at the end of June. This ratio has more than doubled since the end of 2003.

The Bank's international liquidity position improved from US$17,2 billion at the end of December 2005 to US$19,5 billion at the end of March 2006 and US$20,2 billion at the end of June, rising marginally further to US$20,9 billion at the end of August.

## Foreign debt

As a result of South Africa's net borrowing in offshore markets, the country's foreign-currency denominated debt rose from US$28,4 billion at the end of 2005 to US$30 billion at the end of March 2006. Simultaneously, the country's rand-denominated debt rose markedly from US$18,1 billion to US$23,4 billion. South Africa's total outstanding foreign debt accordingly increased from US$46,5 billion at the end of December 2005 to US$53,4 billion at the end of March 2006.

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

| | 2005 | | | | 2006 |
|---|---|---|---|---|---|
| | 1st qr | 2nd qr | 3rd qr | 4rd qr | 1st qr |
| **Foreign-currency denominated debt** | **28,8** | **28,3** | **28,3** | **28,4** | **30,0** |
| Bearer bonds | 9,4 | 9,1 | 9,8 | 9,5 | 10,4 |
| Public sector | 4,6 | 4,5 | 4,6 | 4,6 | 4,5 |
| Monetary sector | 8,1 | 8,1 | 7,5 | 7,8 | 8,6 |
| Non-monetary private sector | 6,7 | 6,6 | 6,4 | 6,5 | 6,5 |
| **Rand-denominated debt** | **17,3** | **17,1** | **17,9** | **18,1** | **23,4** |
| Bonds | 5,7 | 6,6 | 6,0 | 6,3 | 6,6 |
| Other | 11,6 | 10,5 | 11,9 | 11,8 | 16,8 |
| **Total foreign debt** | **46,1** | **45,4** | **46,2** | **46,5** | **53,4** |

Foreign-currency denominated debt rose in the first quarter of 2006 due to international bond issues by South African private-sector companies as well as a South African parastatal. In addition, non-resident investors also increased their foreign-currency deposits with South African banks.

The country's rand-denominated debt increased during the first quarter of 2006 as a direct investment enterprise acquired loan finance from a direct investor abroad. An increase in rand-denominated deposits with and foreign loans extended to South African banks also contributed to the higher level of rand-denominated debt.

Measured in rand, South Africa's total foreign debt increased from R294 billion at the end of 2005 to R331 billion at the end of March 2006.

## Exchange rates

During the second quarter of 2006, increasingly attractive interest rates in some of the mature markets kindled negative sentiment and risk aversion among international investors towards the emerging-market economies. This also affected South Africa, with the nominal effective exchange rate of the rand declining by no less than 16,2 per cent from the end of March 2006 to the end of June 2006 – the largest quarterly decline that has been recorded since the depreciation of 24 per cent in the fourth quarter of 2001.

### Exchange rates of the rand

Percentage change

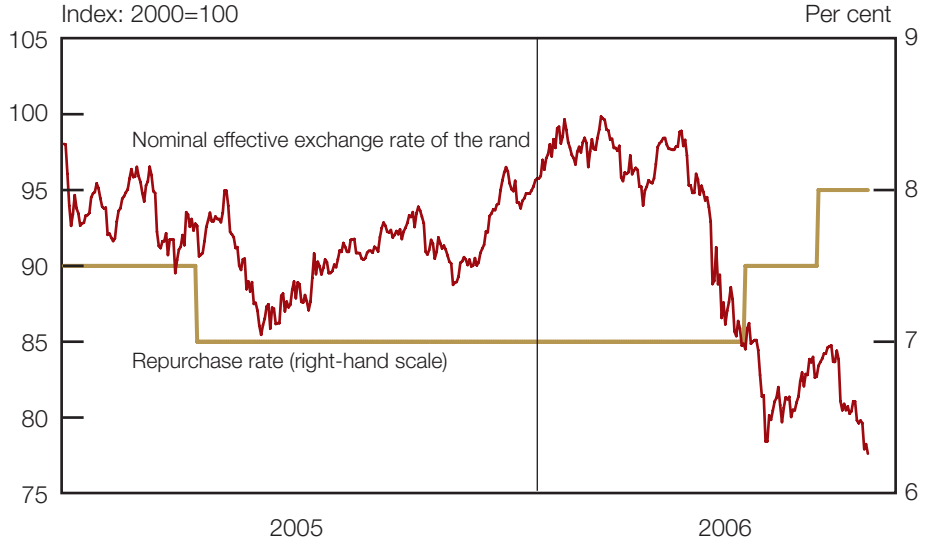
| | 30 Sep 2005 to 30 Dec 2005 | 30 Dec 2005 to 31 Mar 2006 | 31 Mar 2006 to 30 Jun 2006 | 30 Jun 2006 to 31 Aug 2006 |
|---|---|---|---|---|
| Weighted average* | 2,0 | 1,0 | -16,2 | 0,0 |
| Euro | 2,1 | -0,2 | -17,2 | -0,2 |
| US dollar | 0,8 | 2,0 | -13,2 | 0,9 |
| British pound | 2,6 | 1,3 | -17,6 | -3,1 |
| Japanese yen | 4,3 | 2,2 | -15,2 | 3,1 |

* Against a basket of 13 currencies

The adjustment in the exchange rate of the rand mainly took place in May and June 2006, and by raising the risk of inflation exceeding the upper limit of the target range, it contributed to the tightening of monetary policy in June and August. Apart from the sell-off in emerging-market currencies, especially those countries with sizeable current-account deficits, the decline in the exchange value of the rand in the second quarter of 2006 could also be attributed to rising interest rates in developed economies and a decline in commodity prices. In July and August 2006, the weighted average exchange rate of the rand on balance remained unchanged despite higher commodity prices, a weaker US dollar and non-resident investors' increased demand for domestic bonds.

South African exporters of goods and services became more competitive in the second quarter of 2006 as the real effective exchange rate of the rand declined by approximately 10,5 per cent, whereas an increase of 0,7 per cent was registered in the first quarter.

Nominal effective exchange rate of the rand and the repurchase rate




Partly reflecting the heightened volatility in some emerging-market economies, the average daily turnover in the domestic market for foreign exchange increased from US$13,0 billion in the first quarter of 2006 to US$14,8 billion in the second quarter. The average daily turnover for the month of June reached a new record high of US$15,8 billion, eclipsing the monthly turnover of US$15,2 billion registered during March 2005. Non-resident participation in the domestic market for foreign exchange as percentage of total turnover increased further from 72 per cent in the first quarter of 2006 to 74 per cent in the second quarter.

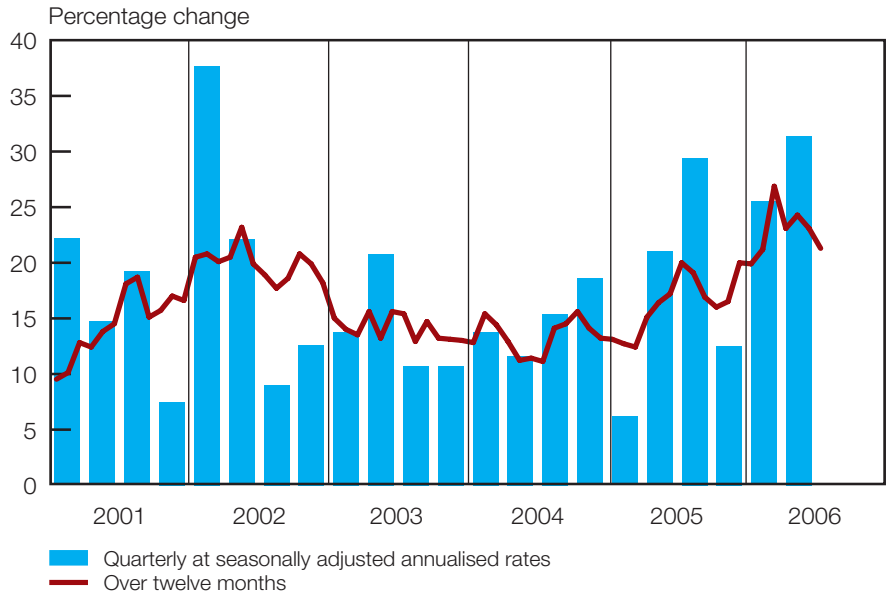
# Monetary developments, interest rates and financial markets

## Money supply[3]

Growth in broadly defined money supply was exceptionally strong in the second quarter of 2006, exceeding the brisk pace of growth in nominal gross domestic income. Apart from continued strength in income and expenditure, other factors bolstering growth in the monetary aggregates included positive wealth effects accruing to companies and the household sector on account of the value of financial assets and real estate, as well as the reinforcement of the speculative motive for holding deposits which resulted from the volatility in financial markets starting in May 2006.

*3 The quarter-to-quarter growth rates referred to in this section are seasonally adjusted and annualised.*

### Growth in M3




The annualised quarter-to-quarter growth in the broad monetary aggregate (M3) accelerated from 25,6 per cent in the first quarter of 2006 to 31,4 per cent in the second quarter. The acceleration in M3 was also evident in its twelve-month growth as it rose above 20 per cent from February 2006, registering a growth rate of 21,2 per cent in July.

### Monetary aggregates

Per cent at seasonally adjusted annualised rates

| | Quarter-to-quarter growth | |
|---|---|---|
| | 1st qr 2006 | 2nd qr 2006 |
| M1A | 22,4 | 19,3 |
| M1 | 12,8 | 31,6 |
| M2 | 17,6 | 25,8 |
| M3 | 25,5 | 31,4 |

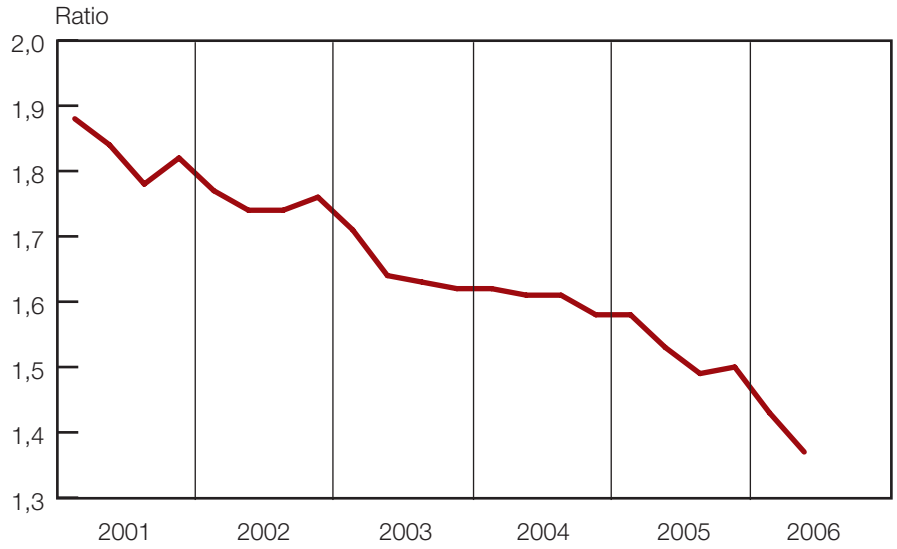
The quarterly growth in the narrower monetary aggregates, M1 and M2, accelerated significantly in the second quarter of 2006. Growth in M1A also remained relatively

strong over the same period, partly reflecting the strong liquidity preference of the domestic non-bank private sector for transactional and precautionary purposes.

The increase in M3 during the second quarter of 2006 was concentrated in deposits with maturities of less than 32 days, while deposits with maturities beyond six months also rose over the same period. Analysed by institutional sector, companies' bank deposit holdings continued to increase robustly in the second quarter of 2006 and accounted for most of the increase in M3. The household sector contributed a smaller share to the overall increase in M3 alongside rising levels of disposable income.

The quarter-to-quarter seasonally adjusted and annualised growth in M3 exceeded growth in nominal gross domestic product by 19,2 percentage points in the second quarter of 2006. Accordingly, the income velocity of circulation of M3 declined from 1,43 in the first quarter of 2006 to a record low of 1,37 in the second quarter.

Income velocity of circulation of M3




The statistical counterparts of changes in M3 are presented in the accompanying table. Banks' claims on the private sector again recorded the strongest increase among the M3 counterparts during the second quarter of 2006, as a result of the rapid growth in total loans and advances. Net foreign assets also rose considerably as foreign assets of the monetary sector continued to increase during the second quarter of 2006.

## Counterparts of change in M3

R billions

| | 1st qr 2006 | 2nd qr 2006 |
|---|---|---|
| Net foreign assets | 37,6 | 29,0 |
| Net claims on the government sector | 0,5 | -13,6 |
| Claims on the private sector | 77,5 | 52,0 |
| Net other assets and liabilities | -9,9 | -38,0 |
| **Total change in M3** | **105,7** | **29,4** |

Net claims on the government sector decreased as government deposits rose considerably, partly reflecting high corporate tax collections during the second quarter of 2006.

## Credit extension

Robust growth in total loans and advances[4] extended to the private sector continued during the second quarter of 2006, underpinned by the continued strong domestic expenditure and income, and generally positive wealth effects. Despite the increase in short-term interest rates in June 2006, the level of interest rates and debt servicing costs remained relatively low. Non-performing loans remained at low levels.

*4 Total loans and advances to the domestic private sector consist of instalment sale credit, leasing finance, mortgage advances, overdrafts, credit card and general advances. The first three categories are referred to as asset-backed credit, while the last three categories together are referred to as other loans and advances.*

The quarter-to-quarter annualised growth in total loans and advances continued at a brisk rate of 26,4 per cent in the second quarter of 2006. Growth over twelve months remained around 23,0 per cent during the second quarter of 2006 and amounted to 24,6 per cent in July. Mortgage advances dominated the overall increase in loans and advances extended to the private sector during the second quarter of 2006, despite a securitisation transaction by one of the reporting banks.

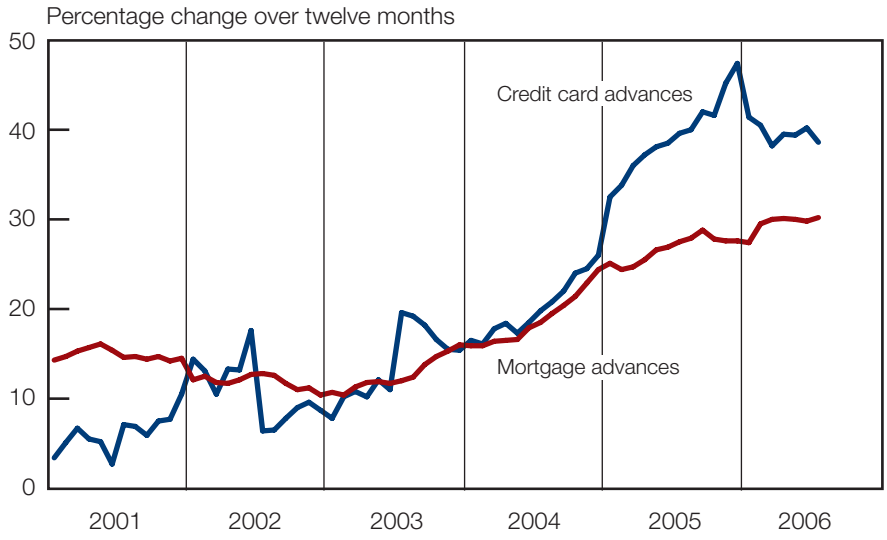
Banks' total loans and advances rose by R44,8 billion in the second quarter of 2006. The contribution to the increase by type of credit is reflected in the accompanying table.

### Quarterly changes in credit aggregates
R billions

| | 1st qr 2006 | 2nd qr 2006 |
|---|---|---|
| Asset-backed credit | 40,9 | 44,8 |
| Mortgage advances | 33,0 | 36,7 |
| Instalment sale credit and leasing finance | 7,9 | 8,1 |
| Other loans and advances | 35,4 | -0,1 |
| Overdrafts | 11,6 | 4,4 |
| Credit card advances | 2,7 | 2,2 |
| General advances | 15,5 | -6,5 |
| **Total loans and advances** | **76,3** | **44,7** |

Growth in *mortgage advances* continued at a robust pace in the second quarter of 2006 despite the securitisation of residential mortgages to the value of R3,0 billion by one of the reporting banks. The firm growth in this credit category was consistent with the

### Mortgage and credit card advances



sustained buoyant conditions in the property market, in turn partly related to the favourable adjustments to transfer duty thresholds announced in February. This might have been temporarily reinforced by the increase in mortgage registrations following the backlog that resulted from the public holidays in April 2006. Twelve-month growth remained around 30,0 per cent in the four months ending July 2006.

Twelve-month growth in *instalment sale credit and leasing finance*, which is mainly intended for financing expenditure on motor vehicles and other durable goods, remained relatively strong despite stock shortages experienced by some motor vehicle manufacturers, and fluctuated in a narrow range between 18 ½ and 19 ½ per cent during the second quarter of 2006. This largely reflected brisk expenditure on durables, in turn partly influenced by attractive incentives offered to prospective buyers alongside technological advances in the products available and fear that prices might rise in future on account of the depreciation of the exchange value of the rand which started in May 2006.

*Other loans and advances*, which are mainly dominated by the corporate sector's fairly uneven use of overdrafts and general loans, increased only marginally in the second quarter of 2006 as the use of bank-intermediated credit abated somewhat. Growth over twelve months in this aggregate accelerated from 18,9 per cent in March 2006 to 19,6 per cent in July. However, twelve-month growth in credit card advances remained exceptionally strong, amounting to 38,6 per cent in July 2006.

The household sector's use of bank loans and advances rose by R32,8 billion in the second quarter of 2006, while that of the corporate sector increased by only R12,0 billion.

The National Credit Act was promulgated on 10 March 2006, and governs all consumer credit. A brief overview of the Act and its likely impact on consumers and the way credit providers conduct business are provided in the accompanying box.

## Box: The National Credit Act

The National Credit Act, No 34 of 2005 (the Act), became effective on 1 June 2006. At the same time the office of the National Credit Regulator and the National Consumer Tribunal were established. The Act replaces the Usury Act of 1968, the Credit Agreements Act of 1980 and the exemption notice issued in terms of the Usury Act[1]. The Act sets a framework for every type of credit transaction, i.e. micro loans, home loans, overdrafts, furniture finance, etc. The objectives of the Act are to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers[2].

The Act is being implemented in three phases: Most of the Act's administrative provisions came into effect on 1 June, 2006; the National Consumer Tribunal as well as measures to protect the consumer against unfair practices by credit bureaus came into effect on 1 September, 2006; and the new and improved consumer rights will be implemented on 1 June 2007. This box provides an overview of the Act, in particular the highlights of Chapter 4 which deals with consumer credit policy by looking at its impact on consumers[3] and the way credit providers conduct business.

Chapter 4 of the Act outlines the consumer credit policy[4]. Part of Chapter 4 deals with consumer rights. Among the rights afforded to the consumer is the right to apply for credit. Protection against discrimination in respect of credit is provided for and, on request from the consumer, the credit provider must provide the dominant reason(s) for credit being refused. The consumer has the right to information in plain and understandable language; to receive documents through mechanisms such as facsimile and e-mail; and to rescind a credit agreement. The consumer may access his or her credit record without charge; be advised by the credit provider before any adverse information concerning the person is reported to a credit bureau; and may challenge the accuracy of the records and information. Consumers will be entitled to a free copy of their credit records once every year and will have enough time to shop around for the best deal before taking up any credit. The

Act requires that quotation documents on any proposed credit transaction be provided and must be valid for five working days.

The Act prohibits, except if pre-arranged with the consumer, credit providers from marketing or selling credit at home or work. Advertising practices that are misleading, fraudulent or deceptive are prohibited. Credit providers are required to verify the indebtedness of prospective clients before providing credit, with failure to do so resulting in money owed to them being forfeited. Credit providers are also required to follow the strict laws aimed at preventing *over-indebtedness and reckless lending*[5].

The Act allows consumers to apply to a debt counsellor to be declared over-indebted and have their debts restructured. If a debt counsellor concludes that a consumer is over-indebted, the debt counsellor may issue a proposal recommending that the Magistrate's Court either declare one or more of the consumer's credit agreements reckless or re-arrange such agreement(s) by extending the repayment period, postpone payment, or both, to suit all the parties involved. During this process, the consumer may not enter into any further credit agreement other than a consolidation agreement.

Chapter 5 of the Act allows the Minister of Trade and Industry, after consulting the National Credit Regulator, to prescribe the maximum interest rate and maximum transaction fees applicable to each subsector of the consumer credit market. This may close loopholes used by money lenders to charge exorbitant interest and fees.

1 The Usury Act governed money-lending transactions, The Credit Agreements Act governed instalment sale agreements and the exemption notice issued in terms of the Usury Act exempted microlenders from the maximum interest rate imposed on banks.

2 For details of the Act, refer to Government Gazette No 28619 of 15 March 2006.

3 The Act gives credit guarantors the same status and protection as it does credit consumers.

4 The Consumer credit policy is divided into four parts which deal, firstly, with consumer rights, secondly with confidentiality, personal information and consumer credit records, thirdly with credit-marketing practices, and fourthly with over-indebtedness and reckless credit.

5 A consumer is *over-indebted* if the preponderance of available information at the time that a determination is made indicated that the particular consumer is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party. On the other hand, a credit agreement is reckless if, at the time that the agreement was made, or at the time when the credit amount approved was increased, the credit provider failed to conduct an assessment as prescribed by the Act; or, having conducted an assessment as required by the Act, the credit provider entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that the consumer did not generally understand or appreciate his or her risks, costs or obligations under the proposed credit agreement, or entered into a credit agreement that would make the consumer over-indebted.

*V Mashiane and N Gumata*

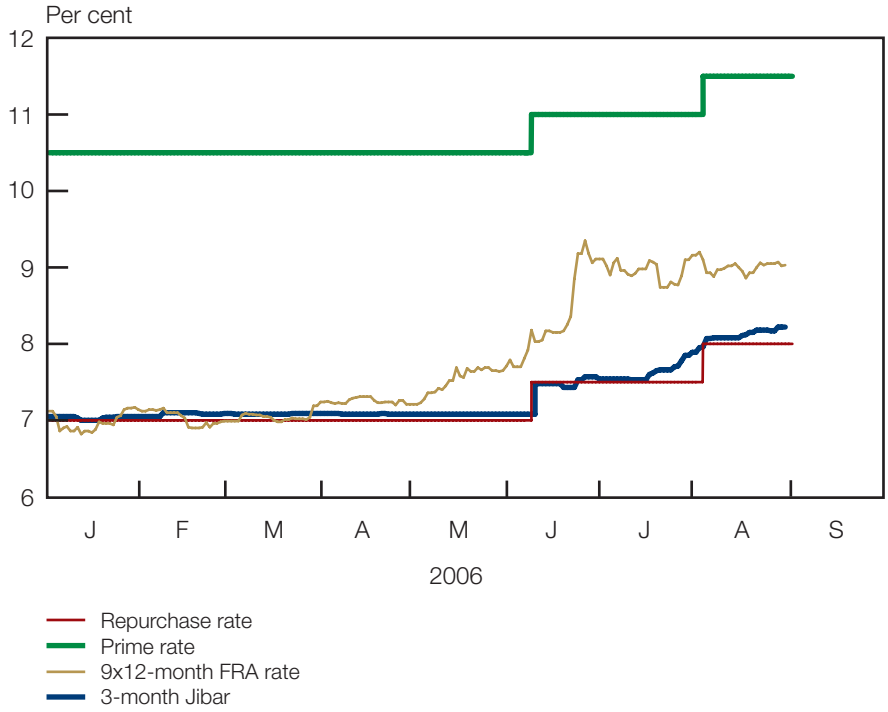
## Interest rates and yields

Following a 50-basis-point increase in the repurchase rate at its June 2006 meeting, the Monetary Policy Committee (MPC) raised the repurchase rate by a further 50 basis points to 8,00 per cent in August 2006. This was in response to a deterioration in the risks to the inflation outlook brought about by the weaker exchange rate of the rand, uncertainties regarding oil prices, exceptionally strong growth in household consumption and continued widening of the current-account deficit. The August 2006 MPC statement discussing the developments underlying the decision at that time is reproduced in full elsewhere in this *Bulletin.*

From the end of March 2006, rates on forward rate agreements (FRAs) began to reflect the possibility of an increase in the repurchase rate, following a significant rise in global and domestic bond yields, oil price uncertainties and the effects thereof on inflation. Following the June 2006 repurchase rate increase, FRA rates rose further, reflecting strong expectations that the repurchase rate would be raised again. On 26 June 2006, the 3x6-month FRA and 9x12-month FRA rates peaked at 8,31 per cent and 9,35 per cent, respectively, reflecting market participants' conviction that sizeable further increases in the repurchase rate were imminent.

The private-sector banks followed the repurchase rate increases, raising the *prime overdraft rate* and *predominant rate on mortgage loans* by 50 basis points on each occasion in June and August to an eventual level of 11,50 per cent.

Money-market rates




Other money-market interest rates also trended higher from around April 2006, partly in anticipation of and partly in response to increases in the repurchase rate. The increases were more pronounced in respect of longer-term maturities, as shown in the accompanying table.

Money-market rates
Per cent

| | 3-month Treasury bills | 3-month Jibar | 6-month Jibar | 12-month Jibar |
|---|---|---|---|---|
| 30 Apr 2006 | 6,74 | 7,08 | 7,23 | 7,44 |
| 30 Jun 2006 | 7,19 | 7,53 | 7,78 | 8,56 |
| Change Apr-Jun (bps) | +45 | +45 | +55 | +112 |
| 30 Aug 2006 | 7,71 | 8,24 | 8,55 | 8,86 |
| Change Jun – Aug (bps) | +52 | +71 | +77 | +30 |

The *predominant rate on twelve-month fixed deposits* of the private-sector banks initially declined from 6,5 per cent in November 2005 to 6,2 per cent in February 2006, but started increasing from May and eventually reached a level of 7,6 per cent in August. Due to the increase in inflation in recent months, the twelve-month fixed deposit rate, adjusted for historical year-on-year increases in CPIX, rendered investors an average *real*

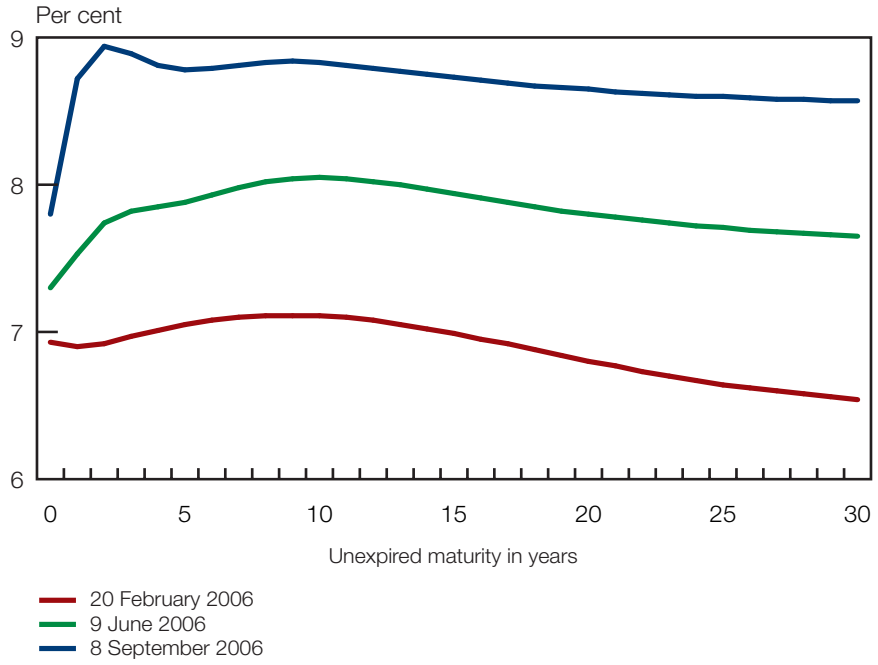
return before tax of only 2,0 per cent in the first seven months of 2006, somewhat less than the average real return of 2,3 per cent recorded in 2005.

Following an across-the-board reduction of 25 basis points in March 2006, the rates of interest on *government retail bonds* were increased by 75 basis points in July and by a further 50 basis points from 1 August. The latest increase brought the rates of interest on these bonds to 9,00 per cent on the 5-year bond, 8,75 per cent on the 3-year bond and 8,50 per cent on the 2-year bond.

Long-term bond yields displayed an upward bias from the end of February 2006 as persistently high oil prices revived inflation concerns. The upward movement accelerated from mid-May, alongside the depreciation of the exchange value of the rand and global risk aversion towards emerging markets. The *daily average yield* on the long-term R157 government bond (maturing in 2015) initially increased at a moderate pace from a 36-year low of 7,13 per cent on 20 February 2006 to 7,40 per cent at the end of April, before gathering momentum and increasing to a high of 8,79 per cent on 26 June. The steep upward trajectory in domestic bond yields from early May 2006 to the end of June contrasted with somewhat less pronounced fluctuations in bond yields in the major international financial centres during this period. The upward momentum in domestic long-term bond yields started to even out towards the end of June and continued to fluctuate in a narrow range alongside improvements in the exchange value of the rand, the tighter monetary policy stance and renewed investor interest in emerging markets. Bond yields declined to a low of 8,45 per cent on 27 July, fluctuating higher to 8,86 per cent on 8 September.

From a low and slightly inverted level on 20 February 2006, the level of the yield curve moved upward and steepened at the short end in the months that followed as bond yields with longer outstanding maturities rose in response to inflation concerns and fluctuations in the exchange value of the rand. Some flattening of the yield curve occurred when yields at the short end of the curve increased in accordance with the tightening of the monetary policy stance in June and early August 2006.

Yield curves

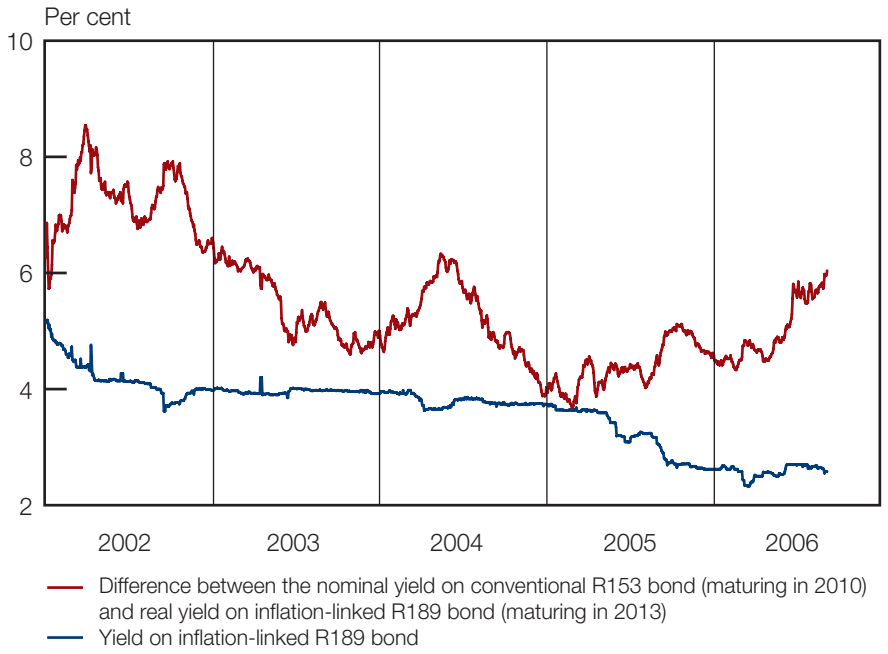


Alongside the increase in the repurchase rate in early August the *yield gap* between the 10-year segment and the extreme short end of the curve narrowed from a positive 171 basis points on 6 July 2006 to 90 basis points at the end of August. The gap between the 10-year segment and the extreme long end of the curve remained inverted, although it narrowed somewhat from a negative 50 basis points on 6 July to 26 basis points at the end of August as bond yields over the intermediate and longer ends of the curve evened out. In general, the flattening of the curve at the long end may be an indication that market participants expect inflation to be contained by the adoption of a tighter monetary policy stance.

In July 2006 the National Treasury issued a new long-term conventional bond, the R209, with a coupon rate of 6,25 per cent and a maturity date in 2036. Previously the longest conventional government bond was the R186 with a maturity date of 21 December 2026. The second of the two new bond issues envisaged in the 2006 Budget, the R208 bond, with a coupon rate of 6,75 per cent and a maturity date in 2021, made its debut during the month of August.

The monthly average *real yield* on the R189 inflation-linked government bond (maturing in 2013) reached a record low of 2,36 per cent in March 2006, before edging higher to 2,65 per cent in August. Nevertheless, the gap between the nominal yield on conventional bonds and the real yield on inflation-linked government bonds widened from March 2006, reflecting the risks posed to the domestic inflation outlook by the consistently high price of crude oil, the depreciation of the value of the rand and inflation figures which started to come out at the high end of market expectations. The *break-even inflation rate* in the four-to-seven-year maturity range fluctuated higher from a recent low of 4,3 per cent on 21 February 2006 to a level slightly above 6 per cent on 8 September.

Break-even inflation rate




Nervousness in financial markets resulted in global investors critically reassessing investments in emerging markets towards the middle of 2006. The yield differential above United States government bonds of the JP Morgan Emerging Markets Bond

Index (EMBI+), which tracks total returns for external-currency denominated debt instruments of the emerging markets, increased from a low of 178 basis points in April 2006 to 221 basis points in June, before improving to 194 basis points in August. Similarly, the *sovereign risk premium* on South Africa's foreign-currency denominated bonds increased consistently from an all-time low monthly average of 68 basis points in February 2006 to 115 basis points in July. The differential between yields on South African government US-dollar denominated bonds maturing in 2014 and yields on United States Federal Government securities of similar maturity again narrowed by 16 basis points in August as investor confidence in emerging markets was partly restored.

The *currency risk premium* on South African government bonds[5] also widened, from 116 basis points in April 2006 to 274 basis points in August. In July and August the widening of the risk premium occurred mainly when the yields on foreign-issued South African bonds decreased significantly alongside their foreign counterparts, while bond yields in the domestic market fluctuated moderately higher during this period.

*5 Measured as the differential between South African government bond yields on rand-denominated debt in the nine-to-eleven-year maturity range issued in the domestic market and dollar-denominated debt issued in the United States market.*

## Money market

During the second quarter of 2006 and in the first (two) months of the third quarter, the estimated highest and lowest limits of the daily liquidity range varied between R13,9 billion and R10,7 billion, respectively. Meanwhile, the actual daily liquidity requirement of the private-sector banks fluctuated between R14,2 billion and R11,1 billion – occasionally breaching the liquidity range due to volatility in the daily note and coin flows. The amount of accommodation provided at the weekly main refinancing tenders fluctuated between R11,6 billion and R13,2 billion during the period under review. In order to square off end-of-day positions banks primarily utilised their cash reserve accounts with the Bank and only occasionally utilised the standing facilities.

The statistical counterparts of the money-market liquidity flows from April to August 2006 are summarised in the accompanying table.

### Money-market liquidity flows

R billions (easing +, tightening -)

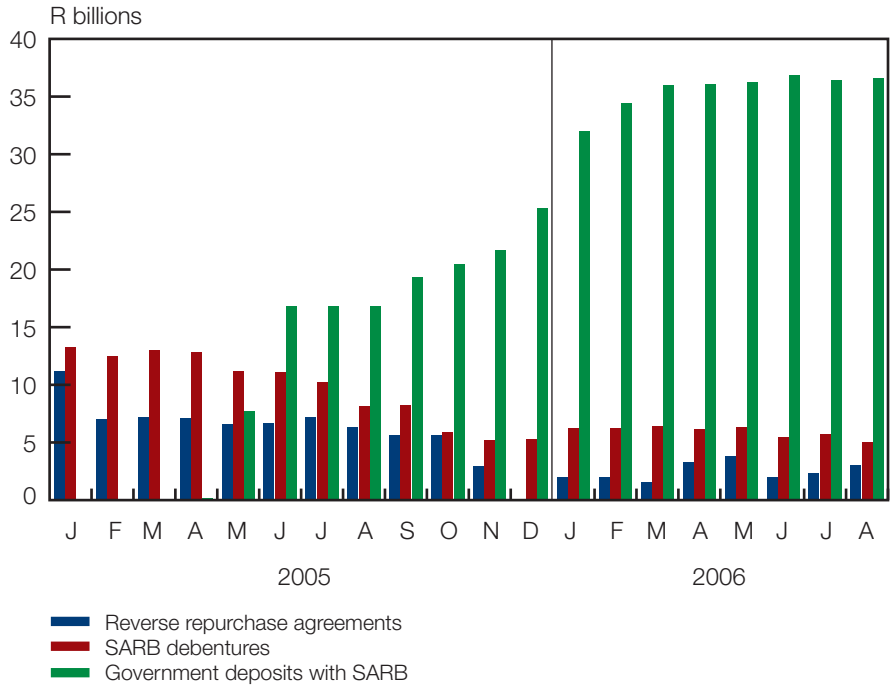
| | Apr – Jun 2006 | Jul – Aug 2006 |
|---|---|---|
| Notes and coin in circulation | -1,0 | 1,3 |
| Required cash reserve deposits | -1,2 | -0,4 |
| Money-market effect of foreign exchange transactions of the SARB | 4,1 | 3,2 |
| Government deposits with SARB | -0,8 | 0,2 |
| Use of liquidity management instruments* | 0,5 | -0,6 |
| Other items net | -1,2 | -4,1 |
| **Banks' liquidity requirement (decrease +, increase -)** | **0,4** | **-0,4** |

* South African Reserve Bank debentures and reverse repurchase transactions

Net foreign exchange purchases from the market by the Bank added liquidity to the tune of R4,1 billion in the three months to June 2006, slowing to R3,2 billion in the two months to the end of August. Banks' cash reserve holdings had a contractionary effect over the same two periods. The government increased its deposits with the Bank in the second quarter, thereby siphoning off some liquidity, while rising notes and coin in circulation assisted in sterilising some of the liquidity created during the period under review.

The Bank also utilised other interest-bearing instruments, such as long-term reverse repurchase agreements and South African Reserve Bank debentures, to drain liquidity. The balance outstanding of these instruments increased by R0,6 billion from the end of June 2006 to August. The accompanying graph illustrates the developments in money-market intervention instruments utilised.

Liquidity-draining operations: Outstanding balances




The Bank's holdings of government bonds declined from R9,7 billion at the end of February to R7,7 billion at the end of August 2006.

## Bond market

Funding by *public-sector borrowers* through the net issuance of fixed-interest securities in the domestic primary bond market amounted to R7,2 billion from January to August 2006, considerably less than the R17,0 billion raised in the corresponding period of 2005. The issuance of fixed-income bonds may be expected to remain low, due to the exceptionally high tax collections by the government. In the February 2006 Budget a net amount of only R8,7 billion was projected to be raised by national government in fiscal 2006/07 through domestic long-term issuance.

Fund raising activity by public and private-sector borrowers in the *international bond markets* picked up in the first months of 2006. Two private-sector companies entered the international markets in January and February 2006. In addition, Eskom issued a €500 million seven-year bond in March, followed by a €750 million ten-year bond issued by the National Treasury. Although no new borrowing activity occurred in the subsequent months to July, the R12,1 billion raised by public and private-sector borrowers in the seven months to July exceeded the R8,9 billion raised in the international bond markets in the whole of 2005.

In contrast to the recent decrease in the domestic funding activity of the public sector, the private sector increasingly sourced funding in the primary bond market. The *outstanding nominal value of private-sector loan stock* listed on BESA increased by R31,5 billion in 2005 and by a further R36,4 billion in the first eight months of 2006. This brought the total outstanding nominal value of listed private-sector loan stock to R146 billion.

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 R7,6 billion in the first eight months of 2006 to reach R33,9 billion. Introduced in April 2005, the electronic settlement of non-listed commercial paper on BESA recorded 505 trades to the value of R9,3 billion up to December 2005. A further 690 trades to the value of R10,6 billion were effected in the subsequent months to August 2006.

*Turnover on* BESA remained buoyant during the first eight months of 2006 amid heightened volatility in bond yields. The R8,8 trillion turnover in the first eight months of 2006 was 33 per cent more than in the corresponding period of 2005. The value of turnover improved steadily from an average daily turnover of around R39 billion in 2005 to set a new record of R67 billion in value traded per day in June 2006. Subsequently, the average daily turnover fell to R56 billion in July and R58 billion in August.

The South African Hedge Fund Index, created by BESA and Clade Investment Management, was launched on 15 August 2006. The purpose of the index is to provide a credible measure of the hedge fund sector's performance and at the same time to enable comparison of hedge funds with other asset managers.

Non-resident investors again showed keen interest in the South African secondary bond market from February 2006 to August after they had been net sellers of bonds from July 2005 to January 2006. Net sales of bonds of R21,3 billion in the second half of 2005 were followed by net purchases of R7,7 billion in the first half of 2006. This amount was surpassed by record-high net purchases of R11,8 billion in the month of July, with further net purchases of R2,0 billion recorded in August. From the beginning of 2006 to the end of August, non-residents' cumulative net purchases of bonds amounted to R21,5 billion, with most of their transactions being concluded in government bonds.

Coinciding with the global risk aversion towards emerging markets, non-resident interest in issuing rand-denominated bonds in the *European bond markets* waned in the first seven months of 2006, before improving in August. After net issuance of R6,5 billion in 2005, net issues amounted to R2,8 billion in the eight months to August 2006.

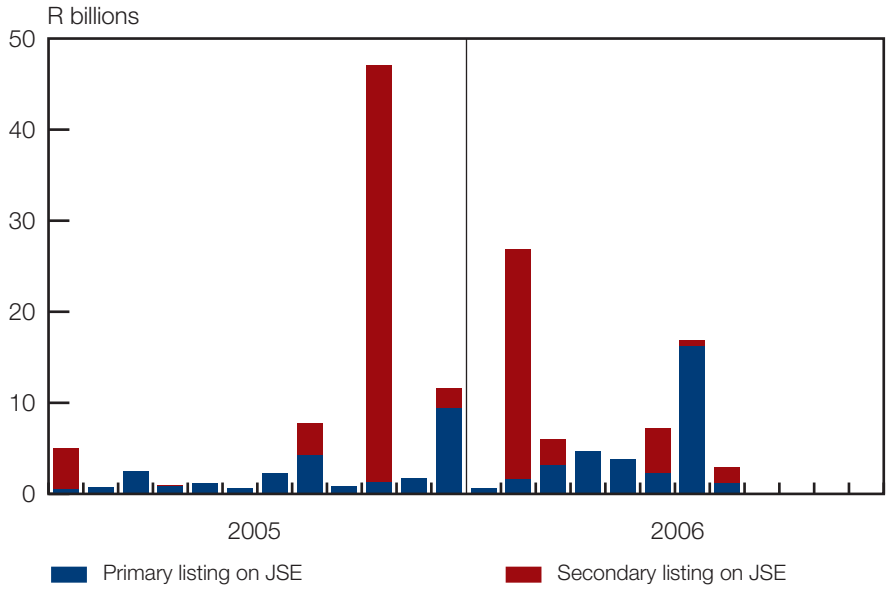
In addition to the reduced issuance in the European bond markets, the issuance of rand-denominated bonds by foreign borrowers in the *Japanese Uridashi market* also slowed during 2006. Rand-denominated bonds were first issued in this market in July 2004. The total nominal value of issues for the year 2005 amounted to R8,8 billion, followed by issues of R2,5 billion in the eight months to August 2006.

## Share market

The total value of equity capital raised in the domestic and international *primary share markets* amounted to R69 billion for the eight months to August 2006, or just more than three times the amount raised in the corresponding period of 2005. Of this amount R33 billion was raised by companies with primary listings on the JSE, while companies with primary listings on foreign bourses and secondary listings on the JSE raised

R36 billion. Companies acquiring complimentary businesses accounted for 65 per cent of the total capital raising activity thus far in 2006.

Total capital raised by companies listed on the JSE




The daily average turnover in the *secondary share market* reached a record high of R10,7 billion per day in June 2006, before declining to R7,6 billion in August as the repositioning which followed the volatility in share prices started to subside and as non-residents' interest in the domestic share market waned. The value of turnover in the first eight months of 2006 was nevertheless 85 per cent higher than in the corresponding period of 2005. Market liquidity, measured by the annualised turnover as a percentage of market capitalisation, increased from 38 per cent in December 2005 to a record high of 65 per cent in June 2006, before declining to 45 per cent in August.

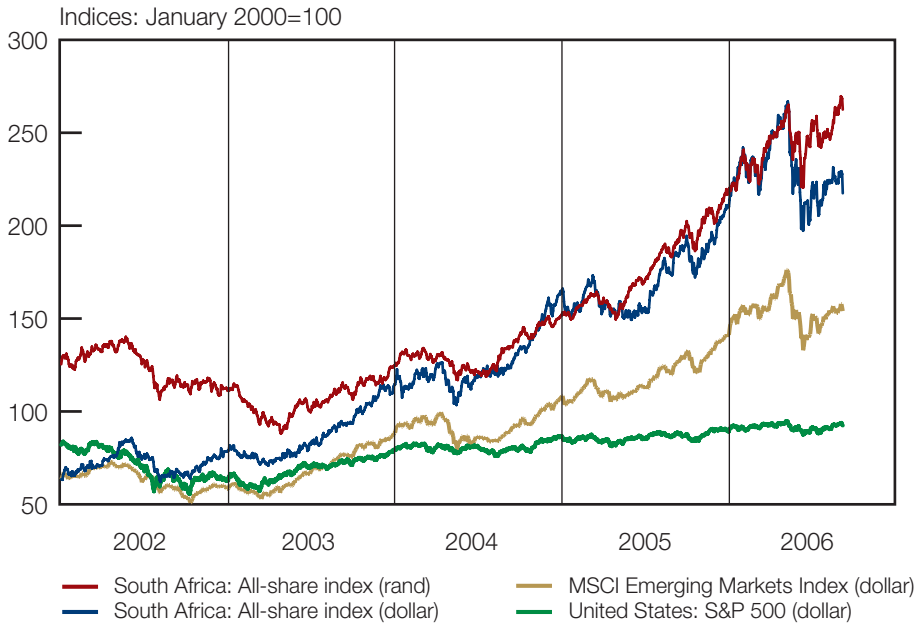
*Alt*$^{x}$, the JSE's bourse for small to medium-sized companies, continued on its growth path with the number of companies listed on Alt$^{x}$ increasing by eight in the first eight months of 2006 to reach 23 at the end of August. The combined market capitalisation of all companies listed on Alt$^{x}$ increased from R1,9 billion in December 2005 to R4,0 billion in July 2006 before declining to R3,2 billion in August. Turnover on Alt$^{x}$ amounted to R541 million in the eight months to August 2006, an increase of 357 per cent over the R118 million recorded in the corresponding period of 2005.

Non-residents' cumulative net purchases of shares in the South African share market of R56,5 billion just in the first half of 2006 already exceeded net purchases of R50,2 billion recorded in the year 2005 as a whole. Record high net purchases of R32,8 billion in the first quarter of 2006 were followed by still high net purchases of R23,7 billion in the second quarter. However, in July and August buying interest waned and net sales of R2,8 billion were recorded. From the beginning of 2006 to the end of August, non-residents' cumulative net purchases of shares amounted to R53,7 billion.

The strong upward movement in share prices of emerging markets from the second half of 2005 was interrupted in May 2006 when investors globally reassessed their exposure towards emerging markets. The Morgan Stanley Capital International (MSCI) Emerging

Markets Index, which measures the equity market performance in the global emerging markets, decreased by 25 per cent from an all-time high on 8 May 2006 to 13 June. South African share prices, expressed in dollar terms, recorded a decrease of similar magnitude over the same period. In the subsequent three months both the MSCI Index and the South African all-share index recovered a sizeable part of their earlier losses. From 13 June 2006 to 8 September the MSCI Index improved by 16 per cent, and the equivalent South African all-share dollar index by 9 per cent, although both indices remained well below the all-time highs attained in May. The impact of the risk aversion towards emerging markets is evident when comparing both indices to the Standard and Poor's 500 composite index of the United States stock market, which declined by a more subdued 8 per cent from 8 May to 13 June before recovering by 6 per cent to 8 September.

Share prices




In rand terms, the *daily closing level of the all-share price index* declined by 17 per cent from its then record high on 11 May 2006 to 13 June. During this period the prices of resources shares declined by 21 per cent, while industrial shares declined by 15 per cent and financial shares by 12 per cent. The subsequent recovery in the all-share index to new record highs in early September was assisted by a recovery in commodity prices which supported demand for resources shares. Industrial and financial shares recorded less pronounced increases over the period as market players assessed the future impact of inflation and monetary policy tightening on the profitability of companies. For example, the share prices of general retailers, a subcategory of the industrial sector, reached its peak on 8 May 2006 and recorded a decline of 30 per cent to 27 June as it not only followed the rest of the share market lower, but also responded negatively to the increase in the repurchase rate in early June. The share price index of general retailers recovered somewhat to early September although it remained well below its record levels attained in May. On 8 September 2006 the daily all-share price index was 18 per cent higher than its recent low in June, supported by increases of 26 per cent in resources shares, 15 per cent in industrial shares, and 9 per cent in financial shares.

The *dividend yield* on all classes of shares increased from a low of 2,3 per cent in April 2006 to 2,5 per cent in August. In 2005 the dividend yield averaged around 2,7 per cent. The dividend yield has been on a declining trend since early 2003 – the start of the bull market trend in share prices – as share prices rose more briskly than historical dividends declared. The JSE launched the FTSE/JSE Dividend Plus Index in August 2006. The yield-weighted index measures the performance of higher yielding instruments within the FTSE/JSE Top 40 and FTSE/JSE Mid Cap indices.

The *price-earnings ratio* of all classes of shares receded to 15,7 in August 2006, from a recent high of 16,5 in April 2006. The current level of the price-earnings ratio significantly exceeded the average of 14,4 recorded in 2005 as well as its long-term average of 13,7, calculated over the period from 1990 to date.

## Market for exchange-traded derivatives

The financial derivatives market on the JSE remained buoyant in 2006, although activity started to slow from June when nervousness in financial markets affected both the share and bond markets. Nevertheless, turnover values in the financial and interest rate derivative markets in the first eight months of 2006 still exceeded trade in the same period in 2005 by a substantial margin. Turnover in commodity futures and options grew comparatively slowly, although trade in these contracts increased significantly from April 2006 to August as maize prices, on balance, rose by 21 per cent from a low of R1 061 per ton on 19 April 2006 to R1 280 per ton at the end of August. Turnover in the market for exchange-traded derivatives is indicated in the accompanying table.

### Derivatives turnover, January to August 2006

| | Turnover | Change over one year |
|---|---|---|
| | R billions | Per cent |
| Financial futures and options on futures | 1 817 | 123 |
| Warrants | 6 | 168 |
| Agricultural commodity futures and options | 95 | 71 |
| Interest rate derivatives | 20 | 208* |

* February to August 2006 compared with February to August 2005

## Real-estate market

Increases in residential real-estate prices continued to slow during the course of 2006. The year-on-year rate of increase in the prices of residential property in the middle segment of the market, as measured by Absa, decelerated uninterruptedly from 35,5 per cent in September 2004 to 13,6 per cent in August 2006. The month-on-month rate of increase in house prices fell below one per cent in March 2006 and declined to only 0,8 per cent in August, the lowest growth rate in just over five years. At the same time, banks' mortgage advances continued to grow apace. The bulk of the mortgage advances granted continued to be in respect of existing buildings, with less than 10 per cent of the total amount granted in the first half of 2006 flowing to the construction of new buildings.

Analysing the different price categories, the year-on-year rate of increase of property prices in the luxury market segment declined to below 10 per cent from the second quarter of 2005, and continued to slow further in the first half of 2006. The year-on-year rate of increase in residential property prices in the affordable houses category remained at a high level in 2005, before decelerating significantly in the second quarter of 2006. Progressively higher monthly repayments on new mortgage bonds, due to rising house prices and an increase in mortgage rates from June 2006, together with the prolonged period during which growth in property prices has exceeded growth in remuneration, may partly explain the slowdown in growth of property prices.

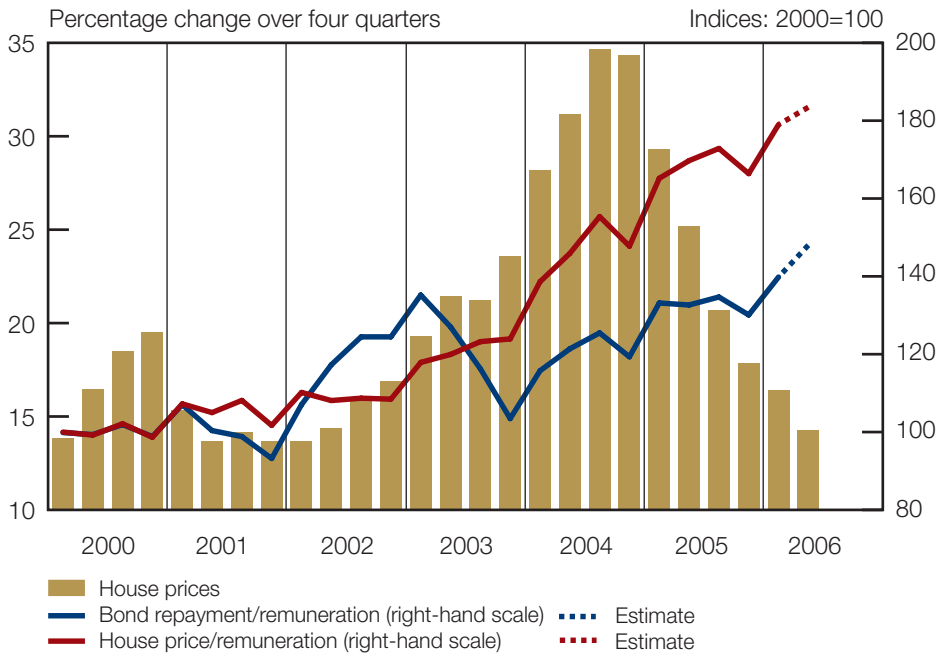
## House price changes in different price classes

Percentage change over four quarters

| Period | September 2004 | March 2006 | June 2006 |
|---|---|---|---|
| Affordable (40m² to 79m², below R193 000) | 21,1 | 10,5 | 6,8 |
| Middle segment (80m² to 400m², below R2,6 million) | 34,7 | 16,4 | 14,3 |
| Small (80m² to 140m²) | 39,0 | 15,2 | 16,7 |
| Medium (141m² to 220m²) | 37,4 | 16,2 | 15,3 |
| Large (221m² to 400m²) | 32,2 | 18,8 | 12,4 |
| Luxury segment (between R2,6 million and R9,5 million) | 21,9 | 7,9 | 7,7 |

Source: Absa

## House prices and affordability



## Non-bank financial intermediaries

Non-bank financial institutions fulfil their intermediary role as they re-allocate funds from units that are in search of investments to units that are in need of funds. This is mainly done through prudent investment in the financial markets, mostly on behalf of households. A large part of non-bank financial intermediaries' assets are generally vulnerable to price fluctuations in the financial markets: Over 77 per cent of non-bank financial intermediaries' assets are currently held in the form of shares and securities other than shares. The total assets of the consolidated non-bank financial intermediaries increased significantly over the year to the end of the first quarter of 2006, rising by 24 per cent as share prices, in particular, trended strongly upward. Almost 70 per cent of liabilities are insurance technical reserves or claims by members against these institutions.

### Non-bank financial intermediaries*

| End of | Assets | | | | | Liabilities | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Securities other than shares | | Shares and other equity | Other assets | Total assets/ liabilities | Shares and other equity | Insurance technical reserves | | Other liabilities |
| | General government | Other | | | | | Pension | Other | |
| | Percentage of total assets | | | | R billions | Percentage of total liabilities | | | |
| 2001: 01 | 16,3 | 9,8 | 46,8 | 27,1 | 1 590 | 16,9 | 49,7 | 27,0 | 6,5 |
| 02 | 16,8 | 9,5 | 47,9 | 25,8 | 1 682 | 17,7 | 49,2 | 27,1 | 6,0 |
| 03 | 17,5 | 9,0 | 46,8 | 26,6 | 1 660 | 18,1 | 49,4 | 26,5 | 6,1 |
| 04 | 16,5 | 8,6 | 50,3 | 24,7 | 1 830 | 19,6 | 47,3 | 27,0 | 6,1 |
| 2002: 01 | 15,4 | 8,9 | 50,1 | 25,6 | 1 867 | 19,7 | 47,3 | 26,9 | 6,1 |
| 02 | 15,8 | 9,2 | 49,1 | 26,0 | 1 880 | 20,2 | 47,5 | 26,3 | 6,0 |
| 03 | 17,1 | 10,2 | 47,3 | 25,4 | 1 853 | 20,6 | 47,3 | 25,6 | 6,5 |
| 04 | 17,2 | 9,8 | 47,7 | 25,3 | 1 832 | 20,6 | 47,9 | 25,6 | 6,0 |
| 2003: 01 | 17,7 | 10,6 | 45,6 | 26,1 | 1 775 | 20,8 | 48,0 | 24,7 | 6,6 |
| 02 | 17,1 | 10,5 | 45,7 | 26,7 | 1 848 | 21,0 | 47,7 | 25,1 | 6,2 |
| 03 | 17,6 | 11,1 | 45,9 | 25,4 | 1 906 | 21,3 | 47,2 | 25,3 | 6,2 |
| 04 | 17,1 | 10,2 | 47,7 | 25,0 | 2 000 | 21,8 | 46,7 | 25,5 | 6,0 |
| 2004: 01 | 17,4 | 10,6 | 47,0 | 25,1 | 2 058 | 22,4 | 46,4 | 24,9 | 6,3 |
| 02 | 17,1 | 10,7 | 46,6 | 25,6 | 2 071 | 22,8 | 46,2 | 24,4 | 6,5 |
| 03 | 16,4 | 11,0 | 48,2 | 24,4 | 2 199 | 23,4 | 46,1 | 24,2 | 6,3 |
| 04 | 16,3 | 9,8 | 49,0 | 24,9 | 2 325 | 24,0 | 46,0 | 23,7 | 6,3 |
| 2005: 01 | 16,2 | 9,3 | 49,7 | 24,8 | 2 414 | 24,4 | 44,6 | 24,6 | 6,4 |
| 02 | 15,7 | 9,8 | 50,6 | 23,8 | 2 523 | 25,0 | 44,2 | 24,7 | 6,1 |
| 03 | 15,6 | 10,0 | 51,8 | 22,6 | 2 687 | 26,2 | 43,4 | 24,7 | 5,7 |
| 04 | 14,9 | 9,6 | 51,9 | 23,7 | 2 813 | 25,9 | 43,0 | 24,9 | 6,2 |
| 2006: 01 | 14,6 | 10,0 | 52,5 | 22,9 | 2 988 | 26,3 | 42,3 | 25,0 | 6,4 |

* Consist of unit trusts, Public Investment Corporation, long and short-term insurers, public and private pension funds, participation bond schemes, and finance and trust companies.

# Public finance

## Non-financial public-sector borrowing requirement[6]

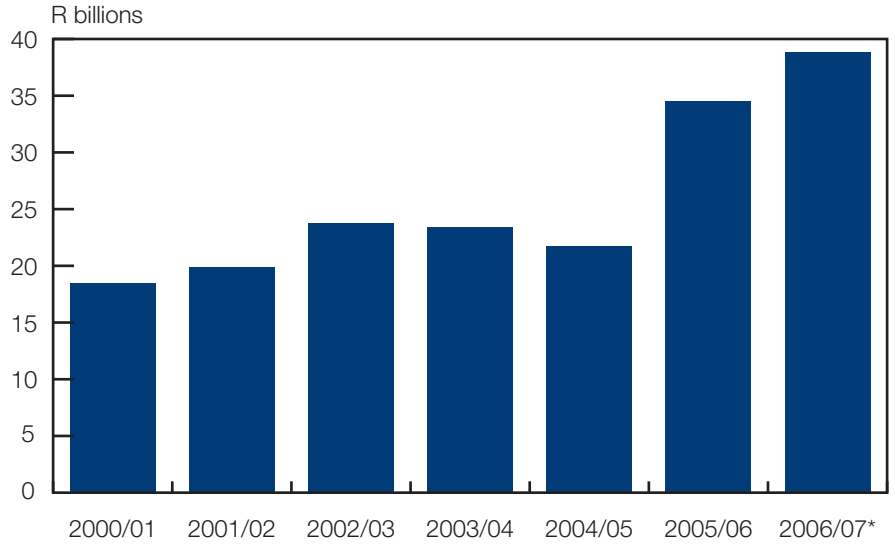
The *non-financial public sector* recorded a cash *surplus* of R10,4 billion in the April-June quarter of 2006/07 compared with a surplus of R11,7 billion in the April-June quarter of 2005/06. As a ratio of gross domestic product the surplus amounted to 2,5 per cent in the quarter under review, compared to a surplus of 3,2 per cent recorded in the same period a year earlier. In 2005/06 as a whole the first surplus ever was recorded amounting to 0,6 per cent of gross domestic product.

*6 Calculated as the cash deficit of the consolidated central government, provincial governments, local governments and non-financial public enterprises and corporations.*

Total net investment in non-financial assets by the non-financial public sector amounted to R16,0 billion from April to June 2006, which was significantly higher than in the corresponding quarter of the previous fiscal year when such investment came to R10,9 billion. Infrastructure programmes involve not only the various levels of general government, but the public sector at large. Spending on infrastructure by the public sector is expected to amount to R372 billion over the next three years.

The net cash flow from operating activities of the *non-financial public sector enterprises and corporations* amounted to R10,6 billion in the first quarter of fiscal 2006/07, compared to R11,8 billion in the same period a year earlier. Total net investment in non-financial assets amounted to R6,8 billion from April to June 2006, compared to an investment amount of R4,8 billion in the corresponding quarter of the previous fiscal year, an increase of no less than 43 per cent. The combined financial activities of the non-financial public enterprises and corporations resulted in a decrease in the surplus from R7,0 billion in the first three months of fiscal 2005/06 to R3,8 billion in the same period of the current fiscal year.

Investment in non-financial assets by non-financial public-sector enterprises and corporations




Fiscal years
* April-June 2006, annualised data

The *national government* finances have benefited from continuing buoyant economic conditions, with cash receipts arising from tax collections and other operating activities increasing by 17,1 per cent in the first quarter of fiscal 2006/07 when compared with the same quarter in fiscal 2005/06. Cash payments for operating activities by national government recorded a year-on-year increase of 7,4 per cent during the period under review. Combining the net cash flow from operating activities with the net investment in non-financial assets, a cash deficit of R4,0 billion was registered from April to June 2006, compared with a cash deficit of R12,1 billion recorded in the corresponding period a year earlier. In both these periods the cash deficit was financed mainly through the issuance of domestic debt instruments.

Preliminary data of the *extra-budgetary institutions* indicated a cash surplus amounting to R2,2 billion in the April-June quarter of 2006 compared with a surplus of R5,2 billion recorded in the same period a year earlier. The *social security funds* recorded a cash surplus of R0,1 billion in the April-June quarter of 2006, which was slightly lower than the surplus of R0,8 billion recorded in the same period of the previous fiscal year. Included in the finances of social security funds is the data of the newly established South African Social Security Agency (SASSA). This agency will be responsible for administering the social assistance grants in all provinces.

An analysis of the *Provincial Revenue Fund Statements* indicates that a cash *surplus* of R10,6 billion was recorded in the April-June quarter of 2006, which was less than the cash surplus of R11,6 billion recorded in the same quarter of the previous fiscal year. The main source of provincial governments' cash receipts – grants received from national government – amounted to R47,4 billion, which was 17,1 per cent less than in the corresponding period of the previous fiscal year. The decrease was due to the shift in the financing conduit for social security transfers from provinces to the newly established SASSA.

The cash surplus of the provincial governments in the period April to June 2006 was reflected in an increase in deposits on the provincial investment accounts with the Corporation for Public Deposits. In contrast to this increase, the provincial governments' deposits with banks decreased from R8,4 billion at the end of March 2006 to R7,7 billion at the end of June 2006. At the same time their overall indebtedness to banks also decreased to a negligible amount between the same dates.

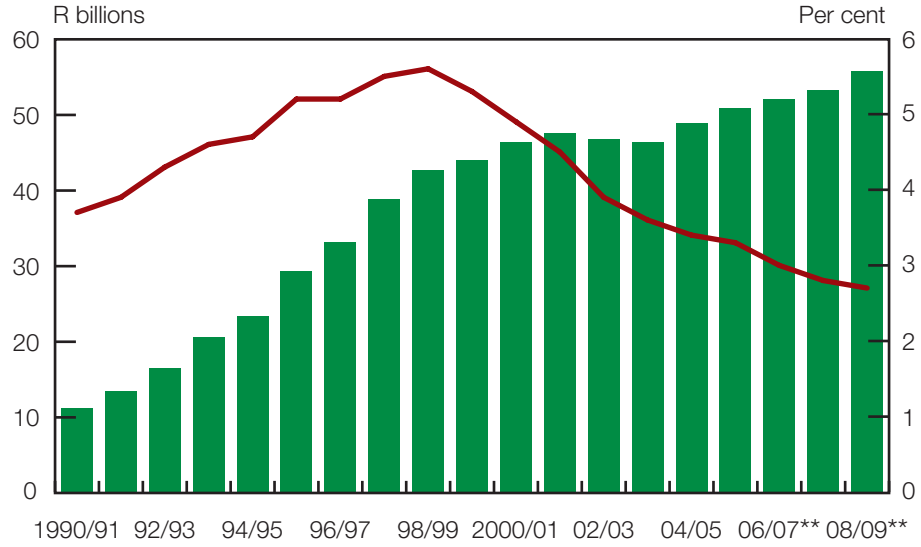
The cash deficit of *local governments* in the April-June quarter of 2006 was estimated at R2,3 billion, which was higher than the deficit of R0,9 billion recorded in the same quarter of the previous fiscal year. The increase in the deficit of local governments can mainly be attributed to a significant increase in the net investment in non-financial assets.

## Budget comparable analysis of national government finance

National government expenditure in the first quarter of fiscal 2006/07 fell short of the pro rata budgetary projections. Amounting to R107,6 billion, expenditure in this quarter rose by 10,2 per cent when compared with the same period of the previous fiscal year, similar to the average yearly increase of 10,1 per cent in the same period during the five years prior to fiscal 2005/06. Adjusted for cash flows, expenditure amounted to R106,2 billion, representing an increase of 9,7 per cent when compared with the same period in the previous fiscal year. The *Budget Review 2006* projected that national government expenditure would increase at a rate of 13,4 per cent for the current fiscal year as a whole.

Interest payments by national government during the first quarter of fiscal 2006/07 amounted to R8,0 billion, which represented a year-on-year rate of increase of 11,3 per cent when compared to the April-June quarter of the previous fiscal year. The higher interest payments could be ascribed to an increase in the funding volume as well as greater reliance on instruments paying interest. The original budget projections indicated that interest payments would increase at a rate of only 2,2 per cent for the full fiscal year 2006/07, contained through appropriate borrowing strategies, a favourable interest rate environment and a limited size of the borrowing requirement of government. The *Budget Review 2006* projected that debt service cost would continue to decline as a ratio of gross domestic product, from 3,0 per cent in fiscal 2006/07 to 2,7 per cent of estimated gross domestic product in fiscal 2008/09.

National government state debt cost *




Fiscal years
* Includes interest, management cost and the cost of raising loans
** *Budget Review 2006* estimates
R billions
Percentage of gross domestic product (right-hand scale)

During the first quarter of the current fiscal year, the equitable share of nationally raised revenue transferred to provinces increased at a year-on-year rate of 11,9 per cent when compared to the same quarter in fiscal 2005/06. Payments for capital assets amounted to R0,6 billion in the April-June quarter of 2006 – a decrease of 1,0 per cent from the corresponding period of the previous fiscal year – as some lags were encountered in stepping up capital expenditure. In the *Budget Review 2006* it was projected that this category of government spending would amount to R6,0 billion in fiscal 2006/07 as a whole.

The strong economic growth together with soaring prices of export commodities were evident in the national government revenue collections in the first quarter of fiscal 2006/07, which increased at a year-on-year rate of 15,7 per cent to amount to R104,3 billion. This rate of increase was higher than the average growth rate of 14,2 per cent recorded in the same period during the five years prior to fiscal 2005/06. The *Budget Review 2006* projected that national government revenue would increase by 8,6 per cent in fiscal 2006/07.

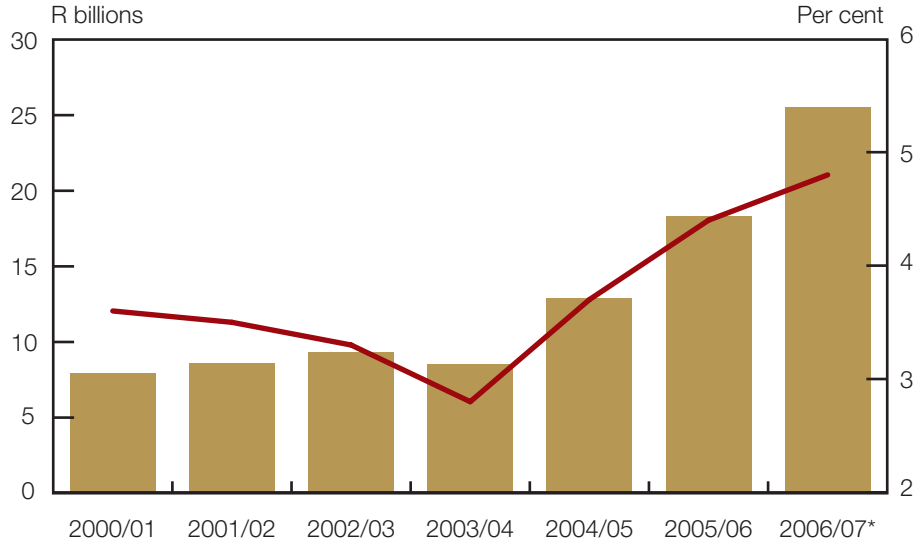
## National government revenue in fiscal 2006/07

| Revenue source | Originally budgeted | | Actual Apr-Jun 2006 | |
|---|---|---|---|---|
| | R billions | Percentage change Full year | R billions | Percentage change* |
| Taxes on income, profits and capital gains | 245,8 | 6,5 | 61,3 | 15,9 |
| Payroll taxes | 5,6 | 14,6 | 1,2 | 4,7 |
| Taxes on property | 8,9 | -19,9 | 2,6 | 2,9 |
| Domestic taxes on goods and services | 171,7 | 13,9 | 37,6 | 17,9 |
| Taxes on international trade and transactions | 23,6 | 29,6 | 4,8 | 40,8 |
| Other revenue | 10,5 | 10,8 | 1,7 | 30,4 |
| *Less:* SACU** payments | 19,7 | 39,6 | 4,9 | 62,3 |
| **Total revenue** | **446,4** | **8,6** | **104,3** | **15,7** |

* April-June 2005 to April-June 2006
** Southern African Customs Union

As shown in the table above, tax collections from income, profits and capital gains increased robustly as companies benefited from the broad-based increase in economic activity, leading to higher profit and taxation levels – especially in the trade and financial sectors. The sluggish behaviour of taxes on property primarily signalled the effect of the reduction in transfer duties as announced in the 2006 Budget, although the slowdown in real-estate prices and turnover probably also played a role. Domestic taxes on goods and services continued to outpace the original budget projections, indicative of strong domestic demand. This increase was mainly driven by strong collections from the largest component of this tax category, i.e. value-added tax, which is largely determined by final consumption expenditure by households. Taxes on international trade and transactions showed the strongest increase among the components of national government revenue, which was consistent with the brisk increase in imports to meet strong domestic demand.

### Customs duties collected by national government




Fiscal years
* April-June 2006, annualised data
R billions
Percentage of total revenue (right-hand scale)

Transfers to the other SACU member countries – Botswana, Lesotho, Namibia and Swaziland – were projected to increase substantially in fiscal 2006/07. This is due to the higher-than-projected customs duties and increased imports from South Africa by other members of the customs union in the previous fiscal year.

Netting national government's revenue and expenditure from April to June 2006 results in a *cash book* deficit before borrowing and debt repayment of R3,3 billion, compared with a R7,5 billion deficit recorded in the same period of the previous fiscal year. As a ratio of gross domestic product, the deficit amounted to 0,8 per cent in the first three months of the current fiscal year, compared with 2,0 per cent in the same period of fiscal 2005/06.

The *cash-flow* deficit before borrowing and debt repayment in the first quarter of fiscal 2006/07 amounted to R4,6 billion, compared with a deficit of R8,2 billion recorded in the corresponding period of the previous fiscal year. After taking into account the revaluation cost incurred when foreign bonds and loans mature, the net borrowing requirement of national government for the period under review amounted to R5,0 billion compared with a borrowing requirement of R12,7 billion in the same period of the previous fiscal year.

As indicated in the accompanying table, the greater part of the net borrowing requirement of national government in the first quarter of fiscal 2006/07 was financed through the issuance of debt instruments in the domestic capital market. Domestic long-term funding was obtained at an average rate of 7,6 per cent per annum, while domestic short-term instruments, i.e. Treasury bills, were sold at rates marginally below those on government bonds. This reflected the positive yield gap between bonds and Treasury bills. The average maturity of the domestic marketable bonds of national government in issue decreased slightly from 98 months at the end of March 2006 to 97 months at the end of June.

## Financing of national government deficit

R billions

| Item or instrument | Originally budgeted Fiscal 2006/07 | Actual Apr-Jun 2006 | Actual Apr-Jun 2005 |
|---|---|---|---|
| **Deficit** | **26,4** | **4,6*** | **8,2*** |
| *Plus:* Extraordinary payments | 0,0 | 0,0 | 4,5 |
| Cost on revaluation of maturing foreign debt | 1,4 | 0,4 | 0,0 |
| *Less:* Extraordinary receipts | 0,2 | 0,0 | 0,0 |
| **Net borrowing requirement** | **27,6** | **5,0** | **12,7** |
| Treasury bills | 5,8 | 5,4 | 8,3 |
| Domestic government bonds | 10,2 | 11,2 | 17,2 |
| Foreign bonds and loans | 3,8 | 2,5 | 0,2 |
| Change in available cash balances** | 7,8 | -14,1 | -13,0 |
| **Total net financing** | **27,6** | **5,0** | **12,7** |

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

Net issues of foreign bonds and use of loans amounted to R2,5 billion during the first quarter of 2006/07. A new foreign bond which matures in 2016 was issued in April 2006 and yielded R5,5 billion to the National Revenue Fund. This was, however, partly offset by the redemption of a foreign bond to the amount of R3,3 billion in May 2006. The average maturity of the foreign marketable bonds of national government increased from 68 months at the end of March 2006 to 75 months at the end of June 2006.

The financial activities of national government resulted in a further increase in government's bank balances from R58,2 billion at the end of March 2006 to R72,3 billion at the end of June 2006, continuing the rising trend which prevailed in fiscal 2005/06. At the same time, however, total loan debt of national government increased by a larger absolute amount, from R528 billion at the end of March 2006 to R561 billion at the end of June. Foreign debt as a proportion of total loan debt increased from 12,6 per cent to 14,6 per cent between the above-mentioned dates. Total national government loan debt as a ratio of gross domestic product amounted to 34,9 per cent at the end of June 2006 compared to 33,8 per cent at the end of March 2006.

Government-guaranteed debt declined from R70,5 billion at the end of December 2005 to R67,9 billion at the end of March 2006.

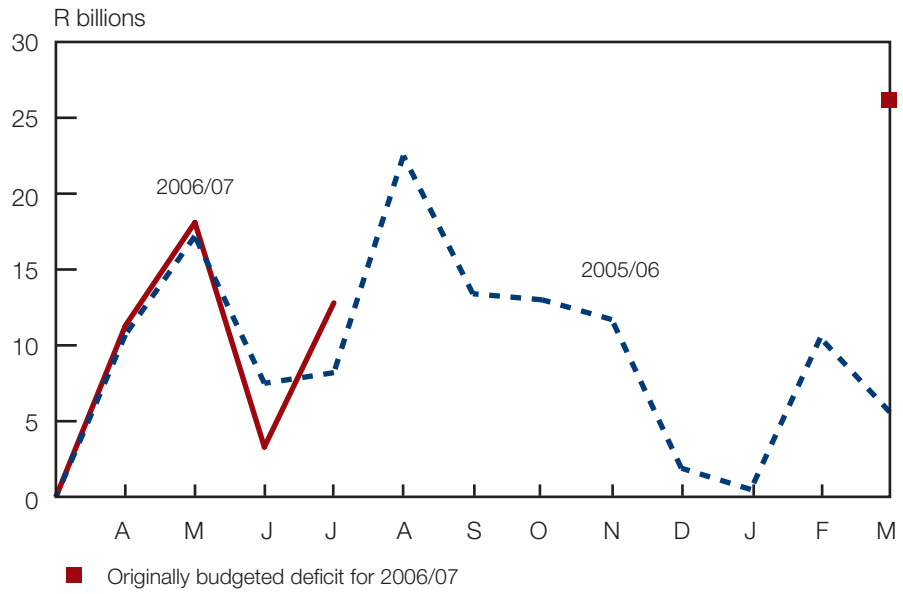
## National government finance in July 2006

National government expenditure in July 2006 amounted to R38,8 billion, bringing the cumulative expenditure in the first four months of fiscal 2006/07 to R146,4 billion which was 16,4 per cent more than in the same period of the previous fiscal year.

Revenue amounted to R29,3 billion in July 2006 and to R133,6 billion in the first four months of fiscal 2006/07, representing a year-on-year rate of increase of 13,7 per cent. Taxes on income, profits and capital gains increased by 16,0 per cent in the first four months of fiscal 2006/07 compared with the corresponding period a year earlier. As a component of this category of revenue, corporate income tax collections continued to grow strongly at a year-on-year rate of 26,8 per cent. All the other categories of revenue also reflected strong growth when compared with the originally budgeted revenue.

The net result of national government's revenue and expenditure in the first four months of fiscal 2006/07 was a *cash book* deficit of R12,8 billion compared with R8,2 billion in

Cumulative deficit of national government



the same period of the previous fiscal year. The deficit before borrowing and debt repayment, adjusted for cash flows, amounted to R12,5 billion. Extraordinary receipts include special dividends paid by Telkom to the amount of R0,8 billion as well as Limpopo Minerals Trust proceeds amounting to R0,5 billion in July 2006. This resulted in a net borrowing requirement of R11,6 billion, which was mainly financed by issuing government bonds and Treasury bills in the domestic market.

## Financing of national government deficit

R billions

| Item or instrument | Originally budgeted Fiscal 2006/07 | Actual Apr – Jul 2006 | Actual Apr – Jul 2005 |
|---|---|---|---|
| **Deficit** | **26,4** | **12,5*** | **9,2*** |
| *Plus:* Extraordinary payments | 0,0 | 0,0 | 4,5 |
| Cost on revaluation of maturing foreign debt | 1,4 | 0,4 | 0,0 |
| *Less:* Extraordinary receipts | 0,2 | 1,3 | 2,2 |
| **Net borrowing requirement** | **27,6** | **11,6** | **11,5** |
| Treasury bills | 5,8 | 8,6 | 10,4 |
| Domestic government bonds | 10,2 | 14,5 | 21,6 |
| Foreign bonds and loans | 3,8 | 3,4 | 1,4 |
| Change in available cash balances** | 7,8 | -14,9 | -21,9 |
| **Total net financing** | **27,6** | **11,6** | **11,5** |

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

# Statement of the Monetary Policy Committee

3 August 2006

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

## Introduction

Domestic inflation is on an upward trend, with food price inflation adding to the pressures emanating from persistent petrol price increases. Household consumption spending has continued to grow at a strong pace and consumer confidence remains high. This has been reflected in strong credit extension and preliminary indications are that the deficit on the current account of the balance of payments might have remained high in the second quarter. These factors, combined with a general depreciation of the rand, have resulted in a further deterioration in the inflation outlook.

In the recent past there has been considerable volatility in international financial markets in general, and in emerging markets in particular. These developments have centered around the uncertainty about the future path of interest rates globally. However, the latest developments appear to suggest that some calm may be returning to the financial markets, as evidenced by the narrowing spreads on emerging-market debt.

## Recent inflation developments

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) increased at a year-on-year rate of 4,8 per cent in June, compared to 3,7 per cent in April and 4,2 per cent in May. This upward trend is not only attributable to petrol price increases. If petrol prices were excluded, CPIX would have measured 3,5 per cent and 3,8 per cent in May and June, respectively. This latter figure is the highest rate of increase of this measure since June 2004. Food price inflation has also made a significant contribution to this upward trend.

Prices of petrol and diesel increased at year-on-year rates of 13,2 per cent and 22,7 per cent in May and June, respectively. Food price inflation has been increasing steadily since late 2005. In November last year, year-on-year food price increases measured 2,0 per cent. In each subsequent month food price inflation increased, and measured 7,2 per cent in June. Significant increases in the prices of meat, fish and vegetables have been the major contributors to this trend. Grain product prices have not fully responded to the sizeable increase in maize prices since the latter part of last year although some upward pressure is evident. In June, the grain products inflation component of CPIX measured 3,8 per cent compared to 0,2 per cent in January 2006.

Most of the other CPIX categories continue to exhibit low rates of price increases, while the categories of clothing and footwear, and furniture and equipment have shown persistent price declines. Services price inflation has declined continuously in the past few months and measured 3,3 per cent year on year in June 2006. Administered prices excluding petrol are predominantly services and therefore have exhibited a similar trend but at marginally lower rates of increase.

Indications of possible consumer price pressures come from production price inflation which increased at a year-on-year rate of 7,6 per cent in June, compared to 5,5 per cent and 6,3 per cent in April and May, respectively. Although food and energy were

important drivers of these increases, the pressure was more broad based. If food and energy were excluded, production price inflation would have measured 4,5 per cent in June, compared to 2,9 per cent in April, and 3,6 per cent in May of this year. Some of the upward pressure in June can be attributed to the change to winter electricity tariffs.

## The outlook for inflation

Since the previous meeting of the Monetary Policy Committee (the MPC), the inflation forecast of the Bank has deteriorated moderately. The most recent central forecast of the Bank projects inflation to peak above the 6-per-cent level and to remain outside the target range for the first two quarters of 2007. Thereafter, based on the current assumptions, CPIX inflation is projected to decline slowly to reach a level marginally above 5 per cent by the end of 2008.

It seems to us that the use of the forecast in monetary policy decisions needs to be further explained. The MPC does not use the forecast in a mechanical way as the basis for policy making. The forecast provides a broad guide to possible inflation outcomes, but the MPC relies on its judgement about possible future developments. No model can adequately capture all the relevant dynamic processes in any economy. It is worth emphasising that the model outcomes are also dependent on the assumptions that are fed into it. Furthermore, the MPC takes a view of the risks to the forecast.

The exchange rate has exhibited considerable volatility, and has been fluctuating between levels of around R6,70 and R7,50 to the US dollar since the June MPC meeting. The behaviour of the rand was initially related to increased global risk aversion, combined with concerns relating to domestic balance-of-payments imbalances. More recently, expectations that the monetary policy tightening cycle globally may be at or near its peak have prompted an appreciation of the rand to current levels of around R6,90. On a trade-weighted basis, the rand has depreciated by about 14 per cent since the beginning of the year, and by 2,5 per cent since the previous MPC meeting. Some pass-through from the exchange rate to prices can be expected, particularly to domestic petrol prices, which have increased by a cumulative R0,56 in July and August. Exchange rate movements accounted for about R0,44 of this adjustment. The prospects for the rand going forward, and the associated risks to inflation, depend to some extent on the global interest rate trend.

In previous statements the MPC expressed concerns about the expanding deficit on the current account of the balance of payments. Current-account deficits are a reflection of higher domestic expenditure and are not in themselves inflationary. There is, however, a possible risk to the exchange rate if the deficits are perceived to be unsustainable, particularly if the deficits are reflecting higher consumption expenditure. The recent exchange rate reaction to the higher deficit is indicative of this, but it is also part of the macroeconomic adjustment process. In order for the exchange rate to play its part in this process, it is important that the exchange rate changes are not simply offset by higher inflation.

The current-account deficit is expected to be adequately financed through capital inflows, although the focus of non-residents has shifted from the equity market towards the domestic bond market. In July, non-residents became net sellers of shares to the value of R2 billion, while non-resident net bond purchases totalled R11,8 billion in the same month, compared to net sales of R1,3 billion in June.

Household consumption expenditure, which grew at an annualised rate of 7 per cent in the first quarter of this year, shows few signs of abating. The FNB/BER Consumer

Confidence Index declined marginally in the second quarter of 2006, but nevertheless remains close to historically high levels. Motor vehicle sales continue to exhibit strong growth. New vehicle sales grew by 20,8 per cent in the year to July.

This higher consumer demand has been underpinned by low nominal interest rates, rising real incomes, and wealth effects arising from strong asset price growth. The residential property market remains buoyant, although the rate of increase in house prices has declined somewhat during 2006. According to the Absa House Price Index, house prices recorded year-on-year increases of 13,6 per cent in June. Prices on the JSE Securities Exchange have been somewhat volatile with the Alsi fluctuating between 18 380 and a high of 21 592.

Growth in credit extension to the private sector reflects the growth in consumer expenditure and higher property prices. Growth over twelve months in total loans and advances accelerated from 22,5 per cent in May 2006 to 23,2 per cent in June. Asset-backed credit growth, which accounts for a significant part of the increase in total loans and advances, has remained around 27 per cent since February 2006.

Until recently, wage developments presented a benign picture. During 2005, unit labour cost in the formal non-agricultural sector increased by 3,4 per cent, providing further evidence that wage pressures were well contained. However, in the first quarter of 2006, nominal unit labour cost increased by 7,6 per cent compared to the same quarter of the previous year, and up from an increase of 2,6 per cent in the fourth quarter of 2005. This development is attributed in part to a decline in labour productivity in the first quarter of 2006 compared to the first quarter last year, as employment outpaced output growth. It is too early to tell if this represents a reversal of the previous trend, but as a significant number of wage negotiations are concluded in the third quarter, these developments will be closely monitored. Wage settlement surveys conducted by Andrew Levy Employment Publications show that settlements have averaged 6,2 per cent in the first half of 2006, compared to 6,3 per cent in 2005 as a whole.

Preliminary indications are that economic growth, although still robust, continues to show some moderation compared to the 4,9 per cent achieved in 2005, and consequently poses little threat to the inflation outlook. The RMB/BER Business Confidence Index declined in the second quarter, although it remains at a high level. Manufacturing output growth has shown some signs of sustaining the first quarter recovery after the subdued levels in the second half of 2005. The physical volume of manufacturing production increased by 4,4 per cent on a year-on-year basis in May, while the Investec/BER Purchasing Managers Index has increased for six consecutive months, with the measure for July indicating a strongly positive outlook for the sector. Mining production, however, remains under pressure. Total mining production decreased by 6,8 per cent year on year in May although in the past three months mining production increased by 5,4 per cent compared to the previous three months, mainly as a result of increased platinum group metals production.

International factors also pose a risk to the inflation and interest rate outlook. International oil price developments remain a significant source of concern. In mid-June the price of Brent crude oil had declined to levels of around US$66 per barrel as a result of higher reported inventories. However, by the end of June, oil prices had risen to levels of around US$75 per barrel as a result of strong demand pressures, supply constraints and rising geopolitical tensions. In July the price of Brent crude oil averaged almost US$74 per barrel, compared to US$68 per barrel in June.

Despite the relatively subdued global inflation environment, inflationary pressures have begun to emerge in a number of countries. This has prompted further tightening of monetary policy by several central banks in the past few months.

## Monetary policy stance

The MPC remains concerned about the longer-term threats to the inflation outlook and has therefore decided that a further adjustment to the repo rate would be prudent. Accordingly, the repo rate is increased by 50 basis points to 8,0 per cent per annum with immediate effect. The MPC will, as is always the case, remain vigilant in order to ensure that CPIX inflation stays within the inflation target range.

# Notes to tables

## National financial account – Tables S-44 to S-45

Henceforth, only annual national financial account data will be published in the regular statistical tables of the *Quarterly Bulletin*. Quarterly data tables will be published once a year as an addendum to the *Note on flows of funds* in the March *Bulletin*.

The quarterly national financial accounts for 2004 may be found on pages S-44 to S-51 of the March and June 2006 *Quarterly Bulletins*.

## Production, distribution and accumulation accounts of South Africa by main institutional sector – Tables S-125 to S-130

Six new tables are introduced with this issue of the *Quarterly Bulletin*, presenting production, distribution and accumulation accounts by institutional sector in a new format and with an enhanced level of detail. This development was prompted by the System of National Accounts (SNA), a set of guidelines that provides a comprehensive conceptual and accounting framework for compiling a macroeconomic database suitable for analysing and evaluating economic performance. The latest version of the SNA, released in 1993, describes a coherent, consistent and integrated set of macroeconomic accounts in the context of a set of internationally agreed concepts, definitions, classifications and accounting rules. The detailed integrated economic accounts introduced by the 1993 SNA are at the centre of the accounting framework.

South Africa's national accounts are broadly consistent with the principles, guidelines and recommendations contained in the 1993 SNA. Research to expand the scope of South Africa's national accounts within the framework provided by the SNA is ongoing. The compilation and dissemination of the production, distribution and accumulation accounts for institutional sectors in South Africa in the format and level of detail contained in the six new tables is a further step to expand the scope of the country's national accounts. This expansion and integration of institutional sectors were reviewed in an article titled "The integrated economic accounts of South Africa", published in the September 2004 *Quarterly Bulletin*, and in a supplement to the June 2005 *Bulletin*.

Following further work on the institutional sector accounts, their development has reached the stage where they can be introduced on a permanent basis in the *Quarterly Bulletin*. Institutional units are grouped into institutional sectors on the basis of their principal functions, behaviour and objectives. The resident institutional sectors which are distinguished are the *financial corporations* (S-125), *non-financial corporations* (S-126), *general government* (S-127), and *households and non-profit institutions serving households* (S-128). Together they constitute the *total domestic economy* (S-129). The *rest of the world* (S-130) is also distinguished through an account grouping together all transactions between resident institutional units of South Africa and resident units from the rest of the world. The relevant tables have annual frequency. In addition, a limited number of key series are presented with quarterly frequency in Table S-131.

The information disseminated in the new tables is more comprehensive than the national accounts information previously published, and provides for a better understanding of the economic interaction between the institutional sectors. Notably, the financial and non-financial corporate sectors are now shown separately, whereas previously only an aggregate table for the entire corporate sector was presented. The previous table on *current income and expenditure of incorporated business enterprises* is replaced by these two tables. The previous tables on *current income and expenditure of general government* and *current income and expenditure of households* are replaced by their expanded counterparts.