Quarterly economic review

Introduction

Despite the evident advantages over the longer term of global capital mobility for economies with capital shortages, the growing integration of international capital markets entails the risk that capital flows may dry up from time to time or be reversed as market sentiment changes. The international ramifications of the Asian financial crisis bear testimony to the far-reaching disruption that can be unleashed by sudden changes in investors' sentiment.

The current international financial crisis erupted in July 1997 in Thailand when the pegging of the Thai baht to the US dollar was abandoned. Capital withdrawals – causing the exchange rate and financial asset prices in Thailand to decline sharply – elicited a policy response that was meant to restore financial stability, but this response also slowed down economic activity in the Thai economy. Doubts arose about the sustainability of exchange rate arrangements elsewhere and spillover effects were soon felt in other Asian countries, notably Indonesia, Korea, Malaysia and the Philippines. Growth in Japan also turned negative in late 1997 and remained negative in the first half of 1998.

The turmoil in Asian financial markets and the recession in Japan contributed to a slowdown in global economic growth in the second half of 1997 and in 1998. Financial markets became even more unsettled in 1998 when the Russian government announced a number of emergency measures which included the depreciation of the rouble and a unilateral restructuring of external and domestic debt. Capital flows continued to be redirected to the advanced economies of the world, aggravating the external financing difficulties of emerging-market economies, such as Brazil, where sharp increases in interest rates were required to stem the drain on international reserves. Commodity prices continued to fall in 1998, in part as a result of reduced demand in Japan and the other Asian countries affected by the crisis. This led to significant declines in the export earnings of commodity-producing countries and further increases in the external financing needs of these economies.

The growth inhibiting problems of the developing economies, for instance over-valued exchange rates, low commodity prices, weak financial systems, and unsustainable fiscal and balance-of-payments deficits, have been identified as the reasons for the loss of confidence in emerging markets. South Africa – where macroeconomic stability is not in doubt and the financial system is fundamentally sound – could not escape the spillover effects of the Asian crisis. Some of the reasons why Asian contagion affected monetary and economic conditions in South Africa were the low domestic savings ratio, the inability to attract sustained inflows of foreign direct investment, the high ratio of short-term external debt to international reserves, the paucity of international reserves and falling commodity prices. The principal elements that transmitted the crisis to South Africa were heavy selling of fixed-interest securities by non-resident portfolio investors which caused an unavoidable rise, of 725 basis points from June to August 1998, in bank lending rates. This had the potential to limit economic activity in the short run.

The real gross domestic product, which had been growing at a subdued pace prior to the onset of the crisis, declined abruptly in the third quarter when business confidence was negatively influenced by the international financial turmoil and export demand was curtailed by the recession in Asia. Apart from the services sectors, where the telecommunications and financial services sectors contributed to positive growth in output, fairly steep rates of decline were recorded in the real value added by the other sectors of economic activity. More specifically, production in the manufacturing sector declined sharply as domestic consumer demand for durable goods declined and the international economy slowed down. Mining output also contracted in the third quarter, partly because of the weak export demand for commodities, whereas agricultural output shrank as a result of a much smaller maize crop.

The decline in the third quarter notwithstanding, year-on-year output growth in gross domestic product during the first three quarters of 1998 was still positive at about ½ per cent. Largely because of the low base established in the third quarter, projections point to growth of less than ½ per cent for the whole of 1998. This growth rate is considerably lower than had been expected generally at the beginning of 1998. It also implies a sharp decline in the real income per capita of the South African population in 1998.

In sharp contrast to the decline in real gross domestic production, growth in real gross domestic expenditure accelerated in the third quarter of 1998. All the components of gross final demand, i.e. private consumption, government consumption and fixed investment, continued to increase, but at a slower pace than in the second quarter. The year-on-year growth of real government consumption expenditure and fixed capital expenditure, especially in the public sector, nevertheless persisted at high levels. Household expenditure on non-durable goods and services maintained a sturdy pace, but deep cuts were made in the purchases of durable and semi-durable household goods. The principal reason for the acceleration in real gross domestic expenditure was the decline in inventory holdings during the third quarter of 1998, which was considerably smaller than the decline recorded in the second quarter. Expectations of weak growth in demand, the high carrying cost of inventories and ongoing improvements in cost-management techniques prompted manufacturers and traders to further economise on their inventory holdings.

Overall growth in factor remuneration slowed down in the third quarter. As is typical during periods of slack economic activity, the growth in gross operating surpluses slowed down more than the growth in labour remuneration, thus raising labour's share in the overall value of production. Corporate saving relative to gross domestic product declined in the process. Together with very modest household savings and increased dissaving by general government, lower corporate saving contributed to a further deterioration in the domestic savings ratio.

Economic growth without job creation has been a troubling aspect of the South African economy over the past two to three years. A small increase in aggregate employment occurred in the second quarter of 1998, but overall employment in 1998 was still well below the levels attained in 1996. The weak employment growth notwithstanding, nominal remuneration per worker continued to increase in 1998 along with a sharp rise in wage-related strikes and work stoppages.

Rising nominal labour remuneration usually leads to higher inflation through cost-induced price pressures, which are reinforced by the aggregate demand pressures arising from the increased spending power of employed workers. However, domestically generated inflation in the first half of 1998 was contained by solid increases in labour productivity and some absorption of production costs by domestic producers. Nonetheless, the rise in the general price level accelerated as the depreciation of the rand raised prices and these effects were passed through the price formation processes. The increases in mortgage interest rates also pushed the consumer price index higher.

The high level of domestic expenditure and efforts by importers to pre-empt expected increases in import prices following the depreciation of the rand, led to a sharp upward movement in merchandise imports and a concomitant widening of the deficit on the current account of the balance of payments. At the same time, the value of merchandise exports and net gold exports improved too, but to a lesser extent than the increase in the value of merchandise imports. Together with a decline in net service payments to the rest of the world, the growth in export earnings contained the deficit on the current account of the balance of payments to approximately 2½ per cent of gross domestic product in the third quarter of 1998.

For the first time since the fourth quarter of 1996, the country experienced an outflow of capital during the third quarter of 1998. Both long- and short-term capital moved out of the country. To a large extent these outflows were related to the turbulence in the international financial markets which prompted non-residents to sell South African fixed-interest securities, and the weakening of the rand which caused an increase in the use of domestic, instead of foreign credit sources for trade financing. Foreign trade financing of international transactions was effectively discouraged by the high cost of forward cover.

The rand came under downward pressure from May to August 1998 as the international financial situation was affected by the troubles in emerging markets and the unilateral debt restructuring in Russia. Policy steps taken by the Reserve Bank, particularly those that permitted interest rates to rise along with market pressures and the decision that the exchange rate of the rand should find its own level, brought some stability back to the domestic foreign-exchange market. In fact, confidence was restored to such an extent that the rand appreciated by almost 14 per cent from 28 August 1998 to 25 November.

The growth in the broad and the narrower monetary aggregates, and in total domestic credit extension as well, showed signs of abating towards the end of the third quarter of 1998. For the whole of the quarter, monetary and credit growth was still strong and definitely not consistent with the objective of low inflation in the long run. Furthermore, the possibility that past rapid money growth could impact on future inflation continued to lurk in the background, compelling the Reserve Bank to maintain a cautious position regarding the easing of monetary policy. The tightening of monetary conditions following the destabilisation of the domestic securities markets, unavoidably led to higher interest rates and contributed to the decline in aggregate output in the third quarter. The slowdown in the growth in output was part of the inescapable adjustment process that was necessary for the restoration of financial stability.

Money market interest rates firmed until the middle of September because of the unsettled state of international financial markets, the weakness of the rand and renewed fears of inflation at that time. A gradual decline followed, which was endorsed by the Reserve Bank around the middle of October. The Bank then reduced the daily underprovision of liquidity to the banks and later began to provide the full amount of the banks' daily liquidity needs. The repurchase rate of the Reserve Bank started to decline and on 24 November 1998 was some 200 basis points lower than on 13 October. This decline in the cost of funding allowed the banks to lower their prime overdraft rates on two occasions by one percentage point at a time.

The raising of funds by the public sector in the primary bond market was lower in the first half of the current fiscal year than in the first half of the previous fiscal year. Private-sector companies, in turn, raised only a small amount of new capital in the primary debt market, focusing almost entirely on bank credit extension and the primary market for equity capital to meet their financing requirements.

The South African financial markets underwent a period of major adjustment from May to August 1998 when emerging markets around the world were under pressure and the stability of the global financial system was questioned at times. The adjustment process was triggered by the net selling of fixed-interest securities by non-resident investors from May 1998. Yields on long-term government bonds, which had been drifting downwards in the first four months of the year, rose strongly to their highest average monthly level ever – exceeding the averages registered in December 1985 after the announcement of the foreign-debt standstill. As has occurred in other emerging markets, equity values declined sharply – the average price level of all classes of shares in September 1998 was some 39 per cent lower than in May. Bond and share prices then recovered somewhat in October and November. Nonetheless, the dollar value of South African listed shares declined by 26 per cent between December 1997 and October 1998. Non-resident investors, however, continued to increase their equity holdings in listed companies during the first ten months of 1998, ostensibly in complete disregard of the decline in asset values.

The overall public-sector borrowing requirement, in absolute value and relative to gross domestic product, declined in the first half of fiscal 1998/99 in comparison with the same period in the previous fiscal year. Similarly, the deficit before borrowing and debt repayment on the Exchequer account as a ratio of gross domestic product, decreased from the first half of fiscal 1997/98 to the first half of fiscal 1998/99.

The Minister of Finance increased the projected deficit on the national government's budget for the current fiscal year from 3,5 per cent of gross domestic product to 3,9 per cent when the Adjustments Budget was submitted to Parliament on 2 November 1998. This increase does not signal a deviation from government's deficit reduction programme. As spelt out in the Medium Term Expenditure Framework, government remains firmly committed to containing the budget deficit to 3 per cent of gross domestic product, but one fiscal year later than originally envisaged.

Domestic economic developments

Domestic output [1)]

South Africa's real gross domestic product declined in the third quarter of 1998. After having increased at a seasonally adjusted and annualised quarter-to-quarter rate of ½ per cent in each of the four successive quarters up to the second quarter of 1998, real value added declined at a rate of about 2½ per cent in the third quarter. The level of gross domestic product in the first three quarters of 1998 was still about ½ per cent more than in the corresponding period of the previous year. However, for 1998 as a whole, economic growth is projected to fall below ½ per cent.

Agricultural output declined substantially in the third quarter of 1998 when the full impact of the smaller than expected maize crop was felt. Currently maize production in the 1997/98 production year is estimated at 7,6 million tons or about 25 per cent less than the previous season's crop of 10,1 million tons. If the agricultural sector is excluded, the real output of the other sectors still declined at a seasonally adjusted and annualised rate of about 1½ per cent in the third quarter of 1998 compared with steady, virtually unchanged output levels in the first two quarters of the year.

1) Minor revisions were made to the national accounts data and incorporated in this issue of the *Quarterly Bulletin*. These revisions are based on more detailed or more appropriate data that have been made available during 1998. More comprehensive revisions are envisaged in the first half of 1999 when most benchmark estimates will be evaluated afresh

Total real output in the *mining sector*, which had contracted at seasonally adjusted and annualised rates of 4½ per cent in the first quarter of 1998 and ½ per cent in the second quarter, declined further at an annualised rate of 2 per cent in the third quarter. The downward trend in mining output was evident in most of the major subsectors, such as gold and coal. Mining products were adversely affected by weak international demand, particularly from the depressed economies in Asia, and a severe slump in commodity prices.

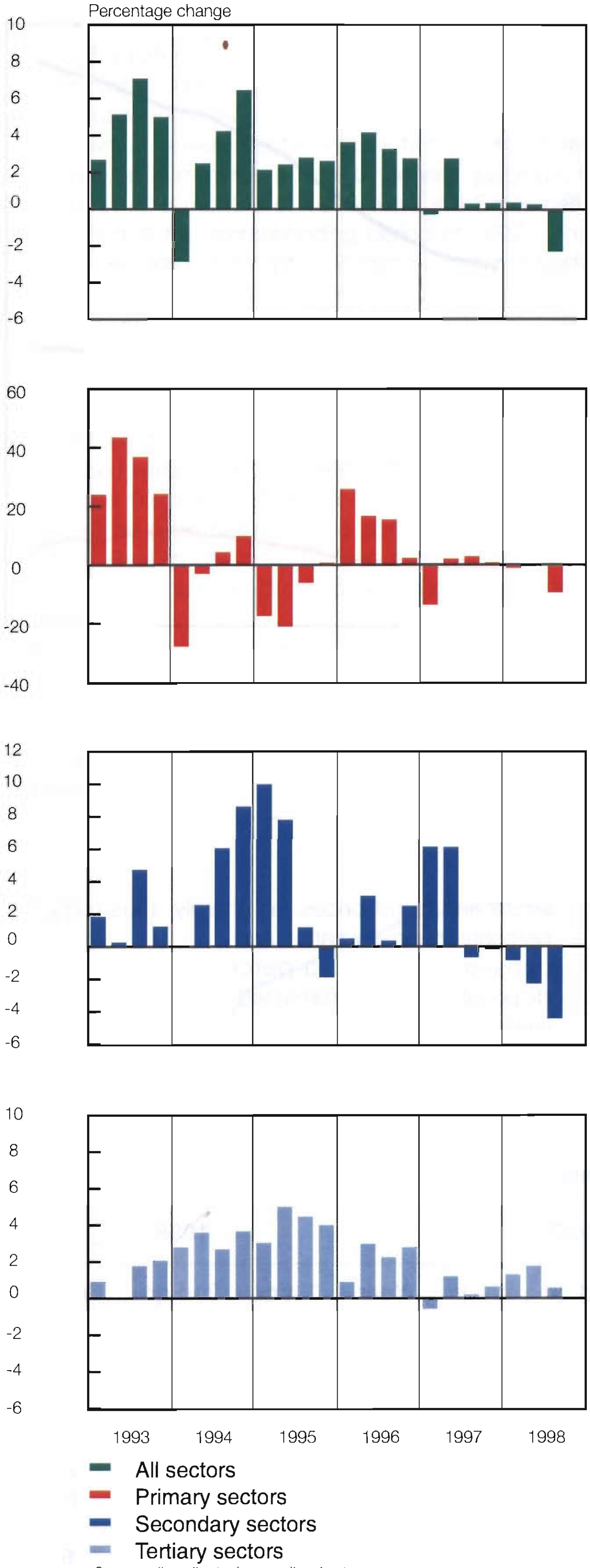
The real output of the *manufacturing industry*, which accounted for 24 per cent of total gross domestic product in 1997, declined at a seasonally adjusted and annualised rate of 5 per cent in the third quarter of 1998, following somewhat more moderate declines of 1½ per cent in the first quarter and 3 per cent in the second quarter. The weakness of manufacturing production is explained by sharp increases in the number of workdays lost because of strikes and other forms of labour unrest, the slowdown in the growth of aggregate final demand, weak growth in export demand, particularly from the Far East, and steadily diminishing activity in the primary sectors. The rate of capacity utilisation in manufacturing declined to 80½ per cent in the first half of 1998. As recently as 1995 the capacity utilisation rate had been 83½ per cent.

In the *other secondary sectors*, the real value added by the sector supplying electricity, gas and water declined slightly in the third quarter of 1998 because the unusually mild winter had reduced the demand for electricity for heating purposes in South Africa and the neighbouring countries and there was also a decline in the industrial consumption of electricity. In addition, real value added by the construction sector declined as the general slowdown in building

Table 1. Real gross domestic product
Percentage change at seasonally adjusted and annualised rates

Sectors	1997					1998		
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Primary sectors	-13½	2	3	1	½	-1	0	-9½
Agriculture	-31	-5	-½	0	-1	5	1½	-19½
Mining	1½	7	5	1½	1	-4½	-½	-2
Secondary sectors	6	6	-½	0	3	-1	-2½	-4½
Manufacturing	7	6½	-1	-½	3½	-1½	-3	-5
Tertiary sectors	-½	1	0	½	1	1½	1½	½
Commerce	-2	2	-1½	-½	½	1½	1½	-½
Transport, storage and communication	½	4½	3	2½	2½	1	2½	1½
Financial and other services	2	2	1	1½	2½	3	3½	1
Total	**-½**	**2½**	**½**	**½**	**1½**	**½**	**½**	**-2½**

Growth in real gross domestic product



Seasonally adjusted annualised rates

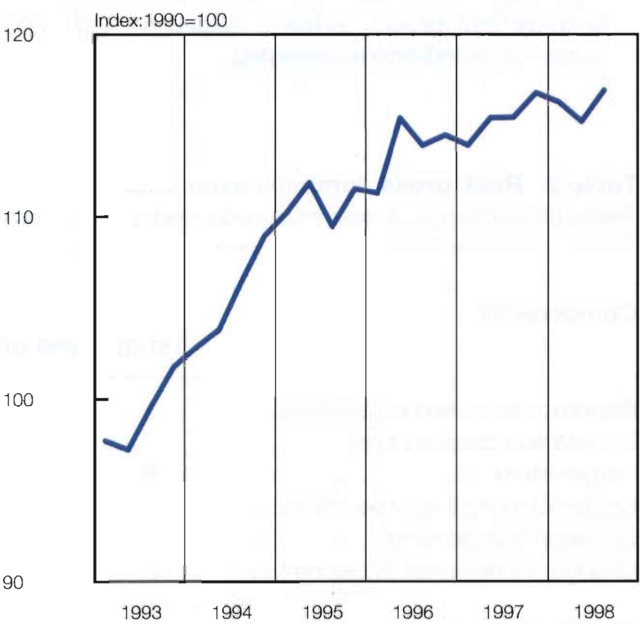
and construction activities was aggravated by the relatively high level of mortgage interest rates.

The real value added by the *tertiary sectors* continued to increase in the third quarter of 1998, albeit at an annualised rate of ½ per cent which was significantly lower than the growth of 1½ per cent in the second quarter. The subdued mood in the business sector and among consumers slowed the rate of increase in real value added by most of the various types of tertiary activities. Nevertheless, the growth in real value added by the transport, storage and communications sector was boosted by the expansion of the telecommunications network. The relatively high levels of activity in the equity, bond and other financial markets supported further growth in the sector for finance, insurance, real estate and business services, although growth slowed to lower levels than what had previously been experienced. By contrast, real value added by the motor trade declined in the third quarter of 1998 as the greater financial burden of financing high-value consumer durables began to have an adverse influence on motorcar sales.

Domestic expenditure

After *aggregate real gross domestic expenditure* had declined in the first two quarters of 1998, it rose firmly at a seasonally adjusted and annualised rate of 6 per cent in the third quarter. Since domestic spending grew decidedly faster than domestic output, net foreign trade in goods and services made a further negative

Real gross domestic expenditure



Seasonally adjusted

contribution to the growth of gross domestic product: imports rose whereas exports declined. Whereas quarter-to-quarter growth in gross domestic expenditure accelerated in the third quarter of 1998, the growth in gross final demand slowed modestly, implying a smaller inventory disinvestment in the third quarter than in the second quarter.

Real private consumption expenditure grew at a seasonally adjusted and annualised rate of ½ per cent in the third quarter of 1998, compared with 1½ per cent in the second quarter. Much of the slowdown is accounted for by a fall in the expenditure on durables, particularly purchases of new motor vehicles, which declined at an annualised rate of 21 per cent. For the three quarters to the end of September 1998, total expenditure on transport equipment by households was about 13 per cent lower than in the corresponding period of 1997. Real outlays on furniture and household appliances declined at a rate of 9 per cent in the third quarter of 1998, while expenditure on semi-durable goods also declined slightly.

Consumption expenditure is determined less by temporary changes in income than by changes in people's expectations about income over their lifetime. Nevertheless, changes in current income will affect consumption as they have an influence on future income and consumer confidence. The value of household wealth is an indication of permanent investment income, because it represents expectations of future income from financial assets. By contrast, outstanding debt reduces the amount of wealth that can be devoted to household consumption. All three of these forces worked against strong increases in consumption expenditure in the third quarter:

- aggregate household real income grew slowly as employment growth virtually stagnated and consumer price inflation accelerated;
- share and bond prices fell sharply, thus reducing personal financial wealth; and
- consumer debt as a percentage of personal disposable income remained at the relatively high level of about 66 per cent.

Real private consumption expenditure

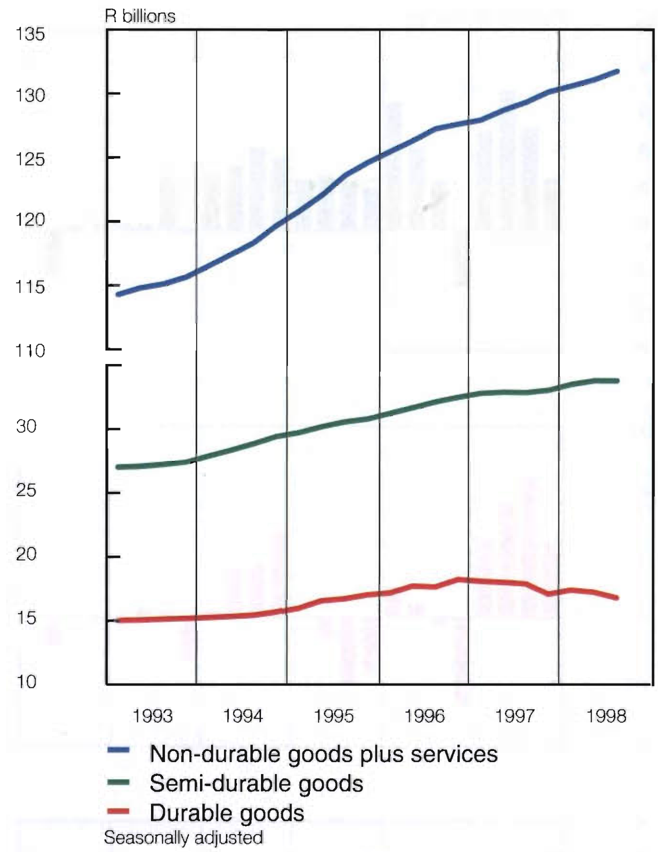


Table 2. Real gross domestic expenditure
Percentage change at seasonally adjusted and annualised rates

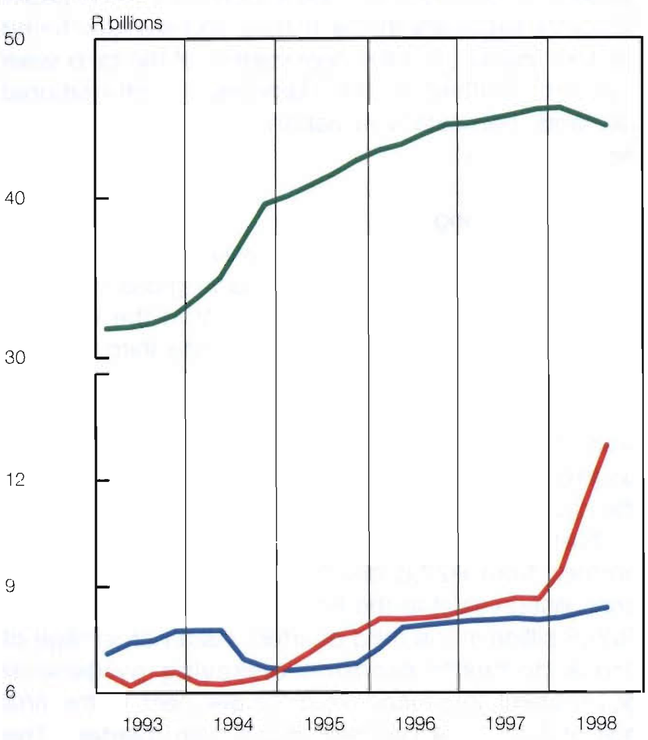
Components	1997					1998		
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Private consumption expenditure....	1	1½	1	½	2	2½	1½	½
Government consumption expenditure..................................	6	7½	9	11½	7	3	2½	2
Gross domestic fixed investment	2	3	3	1½	3½	6	9½	8
Domestic final demand	2½	3	3	3	3½	3½	3	2½
Change in inventories (R billions)*....	-2,7	-2,3	-4,4	-3,0	-3,1	-8,7	-8,8	-6,7
Gross domestic expenditure........	**-2**	**5½**	**0**	**4½**	**1½**	**-1½**	**-3½**	**6**

* Constant 1990 prices, annualised

The annualised growth in *real consumption expenditure by general government* slowed down progressively from 3 per cent in the first quarter of 1998 to 2½ per cent in the second quarter and about 2 per cent in the third quarter. Spending containment by provincial governments and limited growth in real personnel remuneration were the main factors responsible for this slowdown in government consumption expenditure. However, the current real outlays by general government in the first nine months of 1998 were still 6 per cent higher than in the corresponding period of 1997. The increase in real consumption expenditure by general government was 7 per cent in the calendar year 1997.

The upward trend in *real gross domestic fixed investment* which was established during the third quarter of 1993 was maintained in the third quarter of 1998. Current estimates suggest that increases in total real gross domestic fixed capital formation, at annualised rates, of 6 per cent in the first quarter of 1998 and 9½ per cent in the second quarter were followed by a further rise of 8 per cent in the third quarter. Real gross domestic fixed capital formation in the first three quarters of 1998 was some 5 per cent higher than in the first three quarters of 1997. In the whole of 1997 growth in real gross domestic fixed investment was 3½ per cent. The sustained high increases in capital formation throughout the first three quarters of 1998 were brought about by an expansion of public-sector fixed investment. Real gross domestic fixed investment by the private sector has declined since the second quarter of 1998.

Components of real gross domestic fixed investment



Seasonally adjusted annualised rates

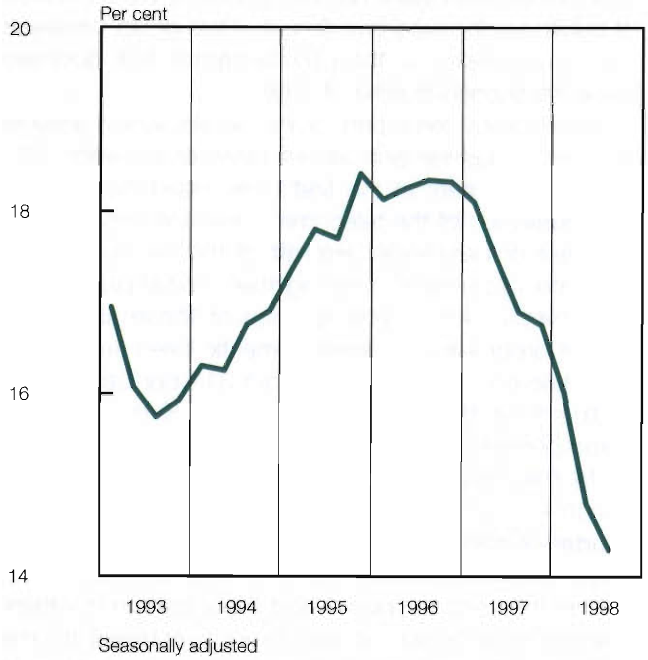
Real capital formation by the *public sector* grew at quarter-to-quarter annualised rates of between 22½ and 52½ per cent in the first three quarters of 1998. The expansion of the telecommunications network and the fleet of passenger aircraft of the national airline featured prominently among the capital projects of parastatals. As a consequence of these and other capital programmes, gross domestic fixed investment by public corporations was about 31½ per cent higher in the first three quarters of 1998 than in the corresponding period of 1997.

In the *private sector, real gross domestic fixed investment* began to loose momentum during the first quarter of 1998 when it grew at an annualised rate of only ½ per cent, followed by declines at rates of 4½ per cent in the second quarter and 5 per cent in the third. Year-on-year growth in real fixed investment by the private sector was accordingly reduced to ½ per cent in the first three quarters of 1998 compared with 3 per cent in the whole of 1997. A classification of capital spending in the private sector by type of economic activity indicates that capital spending declined in the agricultural, manufacturing and financial services sectors. However, increases in capital spending were still reported by the mining and commercial sectors during the third quarter of 1998.

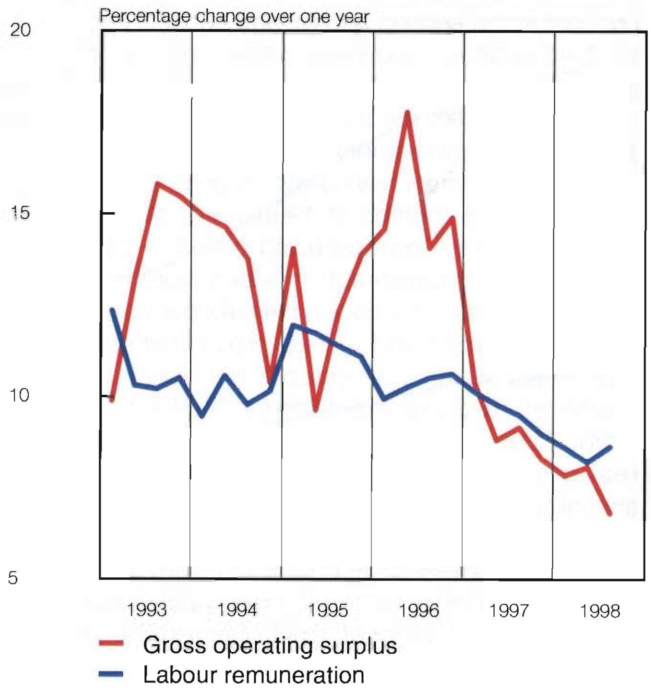
The absolute decline in *inventory investment* since the first quarter of 1997 became more pronounced from the beginning of 1998. Expressed at constant 1990 prices, inventories declined at an average annualised rate of R8,8 billion in the first two quarters of 1998 and by about R6,7 billion in the third quarter. The decline in inventory levels in the third quarter of 1998 by a smaller amount than in the first two quarters had the effect of raising overall growth in gross domestic expenditure by about 3 percentage points.

Apart from an increase in inventory holdings in the sector transport, storage and communication and some unplanned inventory build-up in the motor trade, the overall level of industrial and commercial inventories declined in the third quarter of 1998, although less markedly than in the first half of the year. Improved inventory management techniques have helped manufacturers and traders to reduce their desired level of inventories as a proportion of production since the beginning of the current decade. The desired inventory level is negatively affected by borrowing costs, and short-term interest rates have moved sharply higher. As a consequence, the level of commercial and industrial inventories relative to production declined to

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



Gross operating surplus and labour remuneration



a low level of 14½ per cent in the third quarter of 1998. Some improvement in inventory management techniques might also have occurred.

Factor income

The growth over four quarters in total nominal factor income at market prices decelerated from an average increase of about 9 per cent in the first two quarters of 1998 to 8 per cent in the third quarter. The slower growth in factor income could be ascribed to weaker growth in the operating surpluses of business enterprises which was partially offset by somewhat stronger growth in total labour remuneration. The year-on-year growth in *aggregate labour remuneration* amounted to 8½ per cent in the first three quarters of 1998, which was higher than the corresponding growth of 7½ per cent in total nominal operating surpluses. As aggregate employment in the formal sectors of the economy was considerably lower in the first half of 1998 than in the first half of 1997, the growth in total labour remuneration should be attributed to rising salaries and higher wages per worker.

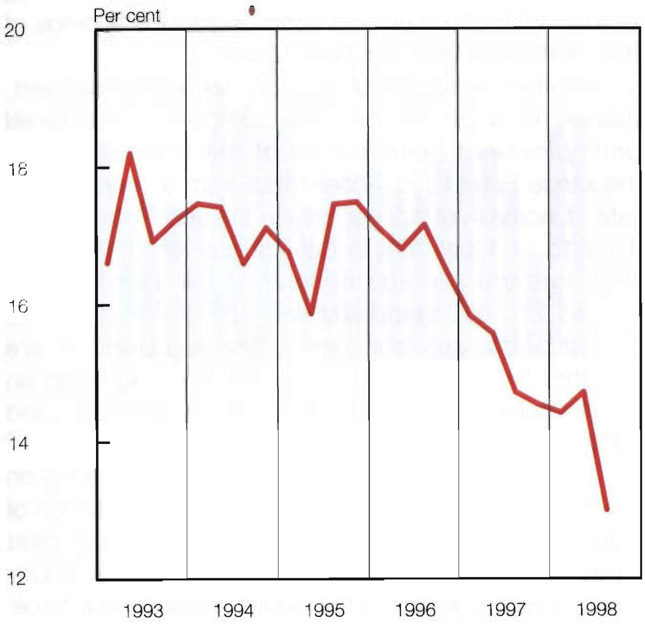
Growth in the nominal *gross operating surpluses* of business enterprises, measured over periods of four quarters, slowed down slightly from an average of 8 per cent in the first half of 1998 to 7 per cent in the third quarter. This weaker growth was mainly due to a deterioration in the gross income of farmers and a general slowdown in profit growth in all the major sectors of the economy. Initial increases in the profitability of exporters in the mining and manufacturing sectors arising from the depreciation of the rand were more than offset by the slackness in international demand, particularly in Japan and other Southeast Asian countries.

Domestic saving

The national propensity to save weakened further and the ratio of gross domestic saving to gross domestic product declined from 14½ per cent in the first two quarters of 1998 to 13 per cent in the third quarter. This low savings ratio, which is insufficient for the investment and development needs of the economy, was the result of increased dissaving by general government and weaker, though still positive, saving by the private sector.

Net *dissaving* by general government deteriorated from R22,0 billion (seasonally adjusted and annualised value) in the first two quarters of 1998 to R25,5 billion in the third quarter. As a percentage of gross domestic product, dissaving by general government increased from 3½ per cent in the first half of 1998 to 4 per cent in the third quarter. The weakening in the savings performance of general government was primarily due to further increases in consumption expenditure and higher interest payments, which together increased faster than tax receipts.

Gross domestic saving as percentage of gross domestic product



Seasonally adjusted

The corporate sector's net saving came under pressure in the third quarter of 1998 as operating surpluses slowed down, or even declined, for example in the primary sectors of the economy. Consequently, net corporate saving declined from 4½ per cent of gross domestic product in the first two quarters of 1998 to 3½ per cent in the third quarter. Household saving was equally constrained by a desire to maintain consumption habits against the backdrop of rising debt-servicing costs and a slowdown in real income growth. As a percentage of gross domestic product, household savings declined slightly from the first two quarters of 1998 to a marginally lower level in the third quarter.

Employment

Positive growth in aggregate real gross domestic product since 1996 has not been successful in lifting the employment-creating capacity of the South African economy. In fact, the level of *overall employment in the formal non-agricultural sectors* of the economy declined persistently from one quarter to the next during 1996 and 1997. A further decline in total employment occurred in the first quarter of 1998, but this was followed by a marginal increase at a seasonally adjusted and annualised rate of 1,1 per cent in the second quarter. (The second quarter of 1998 is the latest period for which information has been released by Statistics South Africa.)

The increase in formal non-agricultural employment from the end of the first quarter of 1998 to the end of the second quarter was not uniformly distributed across all sectors of the economy. Of the eight main sectors identified by Statistics South Africa, increases were registered in five, namely

- construction;
- wholesale, retail and motor trade;
- catering and accommodation services;
- transport, storage and communication; and
- community, social and personal services.

These increases were partially offset by declines in employment in

- mining and quarrying;
- manufacturing; and
- electricity generation.

The decline in employment in the formal sectors of the economy over the past two to three years was essentially the result of steps taken by domestic *private-sector* producers who faced strong demands for higher real wages in an increasingly competitive international environment. Employers facing such demands can typically adjust their employment practices in three different ways:

(i) Accept the demands for higher real wages. This reaction will almost invariably lead to growing numbers of loss-making businesses and might also induce employers to increase output prices in an attempt to restore profitability. In a disinflationary international environment, this could lead to a continuous loss of competitiveness and declining profitability until firms are forced to close down.

(ii) Resist the demand for higher remuneration of employees to maintain or restore and improve profitability, thereby preserving existing jobs and possibly creating new employment opportunities.

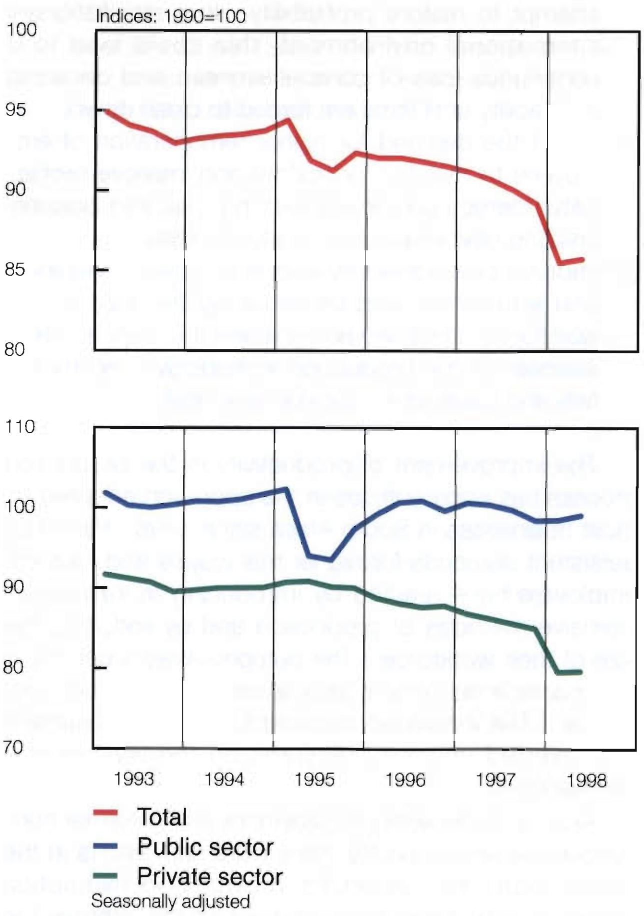
(iii) Improve productivity by investing in new machinery and equipment and by reducing the size of the workforce. This would increase the capital intensiveness of the production technology used by the firm and lower its labour intensiveness.

The improvement of productivity in the production process has apparently been the approach adopted by most businesses in South Africa since 1996. Faced by persistent demands for higher real wages and salaries, employers have reacted by introducing more capital-intensive methods of production and by reducing the size of their workforce. The outcome was a decline in aggregate employment and a rise in production per worker. The increased demand for capital investment also exerted upward pressures on the level of real interest rates.

Alongside declining employment in the formal non-agricultural private sector there were also efforts in the *public sector* to contain the growth in consumption expenditure by general government and to improve the efficiency of public-service delivery. As a result, employment in the public sector generally declined from the third quarter of 1996 – a trend that was consistent with government's intentions as enunciated in various public policy statements, including GEAR. Nonetheless, the ratio of employment by public authorities to total employment in the formal non-agricultural sectors increased from 34,1 per cent in the second quarter of 1996 to 36,0 per cent in the second quarter of 1998.

The final results of the *1996 Population Census* were released by Statistics South Africa on 20 October 1998. The census provides benchmark values for various key dimensions of the South African population. Of the total population of 40,6 million in 1996, 13,8 million were found to be economically active. Those without work numbered 4,7 million, equivalent to 33,9 per cent of the economically active population. This unemployment rate is consistent with the "wide definition" of unemployment according to which those who had not taken active steps to find work are also counted as part of the economically active population. *Official unemployment* as a percentage of the economically active population, which is based on the premise that potential workers must have taken active steps to find employment before being included in the economically active population, was estimated at 21,6 per cent according to the findings of the *1996 October Household Survey.*

Non-agricultural employment



Another indicator of changes in unemployment, namely changes in the *total number of registered unemployment beneficiaries* of the Unemployment Insurance Fund (UIF), accelerated from a year-on-year rate of increase of 1,2 per cent in the second quarter of 1997 to 14,1 per cent in the first quarter of 1998. At that time the average number of UIF beneficiaries totalled 273 000 compared with 239 000 in the same period of the previous year. New registrations are reported to be at their highest level ever, signalling an inordinately high level of job losses in late 1997 and early 1998.

The Employment Equity Bill of 1997 was placed on the statute book on 16 October 1998 as Act No. 55 of 1998. The purpose of the Act is to redress past inequities and to increase the representation of previously disadvantaged groups in the South African labour force. In terms of this Act, employers who have more than 50 workers, shall

- consult employees about an employment equity plan;
- prepare a profile of the plan;
- implement the plan; and
- report annually to the Department of Labour regarding the plan.

Compliance with the Employment Equity Act will be monitored by a part-time commission, labour inspectors, the Labour Court, the Commission for Conciliation, Mediation and Arbitration and the director-general of the Department of Labour.

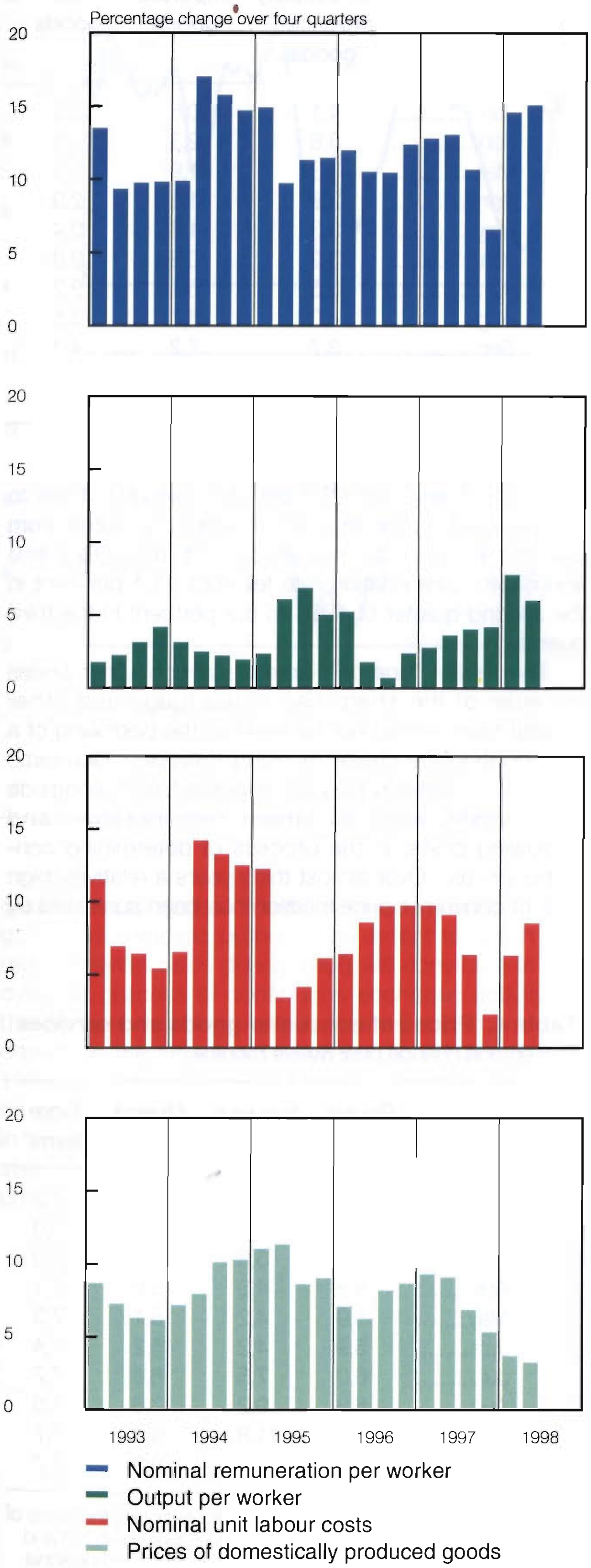
The Presidential Jobs Summit was held on 30 October 1998. The intention with this Summit was to bring government, the business community and the organised labour movement together to seek ways of improving the employment-creating capacity of the economy. Consensus was reached on a wide range of job-creating programmes, including

- the introduction of youth brigades to promote youth employment;
- the refocusing of special employment programmes to target marginalised communities;
- proposals on housing provision which included new financial mechanisms to finance low-cost housing;
- tourism initiatives;
- measures to address skills development; and
- the consolidation of existing projects into a more coherent whole.

Labour costs and productivity

Price increases, which may be equated with inflation in the short run, depend critically upon developments in the labour market and, in particular, on the behaviour

Non-agricultural labour productivity, remuneration per worker, unit labour costs, and production prices



of unit labour costs. After more than two years of below-potential economic growth and generally declining employment, the upward pressure on labour costs was so strong that the average remuneration per worker was still rising faster than output prices. This growth in the nominal remuneration of employees contributed to persistently rising private consumption expenditure and aggregate gross domestic demand. If price pressures and an acceleration of inflation are to be avoided in this context, aggregate demand growth has to be reduced through other means, such as a more restrictive monetary policy, to a path consistent with low and stable inflation.

The rate of increase over four quarters in *nominal remuneration per worker in the formal non-agricultural sectors* of the economy exceeded the increase in output prices by a fair margin in the first half of 1998. However, the potential inflationary impact of these cost increases was partly counteracted by the strong *productivity* increases that were reflected in rising output volumes per employed worker. Moreover, nominal labour cost increases were not fully neutralised by productivity increases, causing nominal unit labour costs to rise faster than output prices (as indicated by the increase over one year in the price index of domestically produced goods) in the first half of 1998.

Labour market conditions were indeed turbulent in the first three quarters of 1998. The number of mandays lost due to strikes and work stoppages rose sharply from 310 000 in the first three quarters of 1997 to 1,85 million in the corresponding period in 1998. Wage disputes caused 98,5 per cent of the total number of strikes in the nine months to September 1998 – the highest level recorded over an eight-year period.

Inflation

The downward cycle in the year-on-year increase in prices from the beginning of 1997, both at the producer and consumer level, came to an end in the second quarter of 1998. Over the six months to September 1998 the growth in production prices accelerated appreciably as the rand depreciated. The consumer price index, in turn, was strongly influenced by a sharp rise in the prices of consumer services, notably interest rates on mortgage bonds.

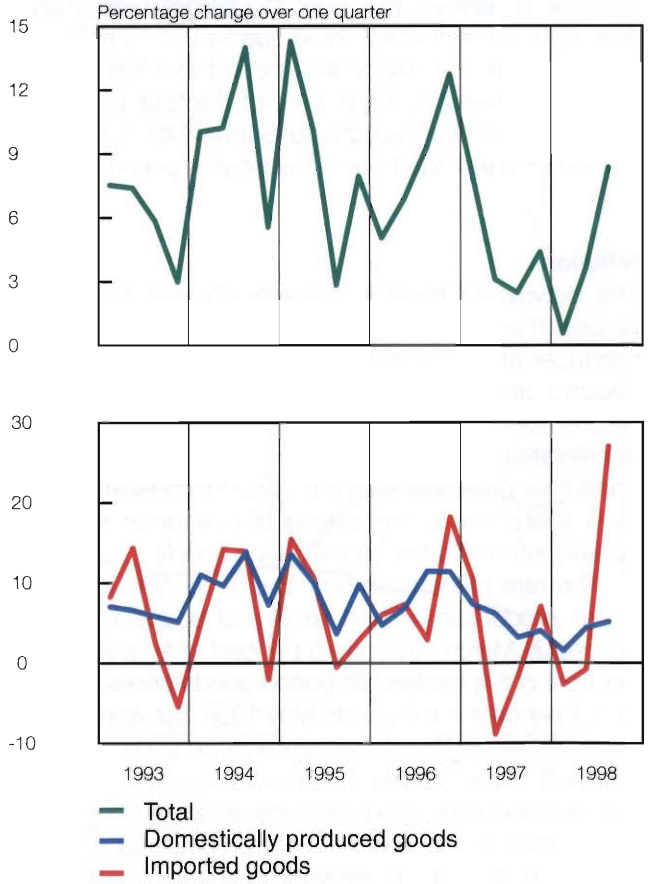
The rate of increase over twelve months in the *all-goods production price index* almost doubled from 2,3 per cent in March 1998 to 4,5 per cent in August and 4,3 per cent in September. Imported goods prices declined by 1,1 per cent in the year to May 1998, but were 7,8 per cent higher in October than a year earlier. When measured from quarter to quarter and at seasonally adjusted and annualised rates, the acceleration in prices of imported goods was far more pronounced – a price rise of 0,8 per cent in the second quarter of 1998 was followed by an increase of 26,9 per cent in the third quarter.

The pass-through from the depreciation of the rand and the attendant imported goods price increases to the prices of domestically produced goods was rather weak in the third quarter of 1998. The year-on-year increase in the prices of *domestically produced goods* accelerated only moderately from 3,2 per cent in June 1998 to 4,0 per cent in August and 3,8 per cent in October. Taking into consideration the relatively strong increases in nominal unit labour costs and the rise in the prices of imported intermediate goods, some acceleration of the increase in the production price index can reasonably be expected. Alternatively, cost increases will have to be absorbed by domestic producers.

The *overall consumer price index,* inclusive of mortgage interest payments, rose by 9,1 per cent in the twelve months to September 1998 compared with 5,0 per cent in April. Services price increases over twelve months have been higher than goods price increases since July 1998, largely because of the strong rise in interest payments on mortgage bonds. Therefore, when *core inflation* is considered, the acceleration of year-on-year price increases was more subdued. It rose from 6,9 per cent in March 1998 to 7,7 per cent in September. Indeed, measured from quarter to quarter the seasonally adjusted and annualised core inflation rate fell from 11,1 per cent in the second quarter of 1998 to 6,2 per cent in the third quarter.

The recent "one-off" increase in consumer prices because of the sharp rise in mortgage and other interest rates should not be seen as the beginning of a new continuous phase of rising inflation. Domestic demand conditions play an important role alongside input costs, such as labour remuneration and borrowing costs, in the process of determining consumer prices. Over almost thirty years a relatively high level of consumer price inflation has been sustained by

Production price index



Seasonally adjusted annual rates

Table 3. Production price indices

Percentage change over twelve months

	Domestically produced goods	Imported goods	All goods
1998: Jan	4,1	-0,5	3,2
Feb	3,6	-2,3	2,5
Mar	3,3	-1,9	2,3
Apr	3,2	1,3	2,9
May	3,3	-1,1	2,4
Jun	3,2	0,9	2,8
Jul	3,5	5,1	3,7
Aug	4,0	6,7	4,5
Sep	3,7	7,2	4,3
Oct	3,8	7,8	4,5

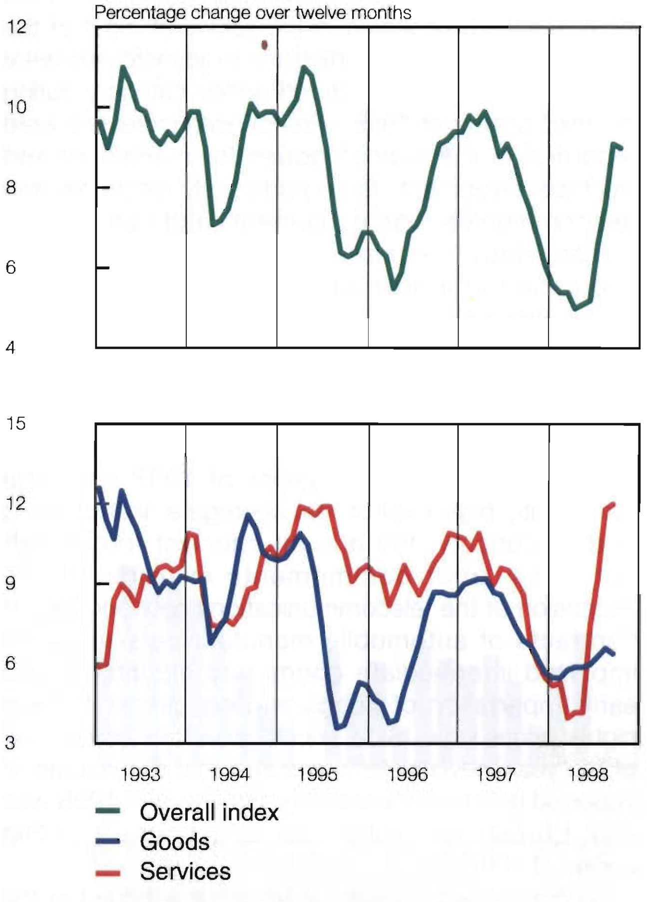
Table 4. Prices of consumer goods and services

Percentage change over twelve months

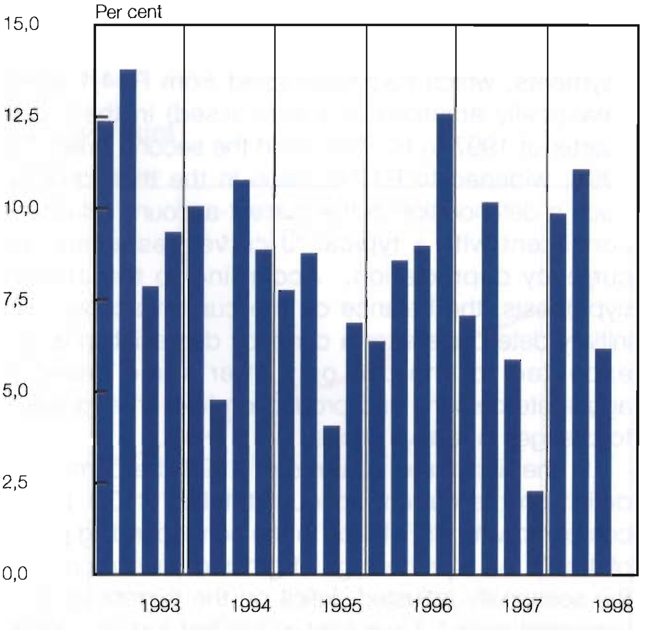
	Goods	Services	Overall	Core items*
1998: Jan	5,7	5,5	5,6	7,2
Feb	5,5	5,2	5,4	7,0
Mar	5,5	5,3	5,4	6,9
Apr	5,8	4,0	5,0	7,1
May	5,9	4,2	5,1	7,3
Jun	5,9	4,2	5,2	7,4
Jul	6,0	7,5	6,6	7,2
Aug	6,3	9,2	7,6	7,6
Sep	6,6	11,8	9,1	7,7
Oct	6,4	12,0	9,0	7,7

* Change in the overall consumer price index excluding the prices of fresh and frozen meat and fish, and of vegetables, fresh fruit and nuts; interest rates on mortgage bonds, overdrafts and personal loans; value-added tax and property taxes

Consumer prices



Core inflation



Quarter-to-quarter changes at seasonally adjusted annualised rates

growth in aggregate domestic demand in excess of the growth in domestic output. The extent to which the rise in interest rates during 1998 will contribute in the dynamic process of continuous economic activity to the dampening of growth in domestic demand will determine the slowdown in inflation in the first half of 1999. The slowing effect of weaker growth in demand on observed inflation will be reinforced by slowdowns in the rate of increase in the consumer price index, stemming from reductions in interest rates and the unwinding of the effects of the rand's depreciation.

Foreign trade and payments

Current account

The deficit on the current account of the balance of payments, which had contracted from R14,1 billion (seasonally adjusted and annualised) in the fourth quarter of 1997 to R5,7 billion in the second quarter of 1998, widened to R17,8 billion in the third quarter. Such a deterioration in the current-account balance is consistent with a typical "J-curve" response to a currency depreciation. According to the J-curve hypothesis, the balance on the current account will initially deteriorate after a currency depreciation and is expected to improve only after some delay as aggregate demand and production take time to adjust to changes in relative prices.

In the first three quarters of 1998 the cumulative deficit on the current account totalled R10,1 billion, compared with R5,7 billion in the corresponding period of 1997. As a percentage of gross domestic product, the seasonally adjusted deficit on the current account increased from 1,1 per cent in the first half of 1998 to 2,7 per cent in the third quarter.

A sharp rise in the value of merchandise imports was the main factor responsible for the deterioration in the balance on the current account in the third quarter of 1998. Part of the rise in the value of imports during the third quarter of 1998 was due to the declining exchange rate which increased the prices in rand of imported goods. The value of exports also rose as a consequence of the depreciation of the rand, but this rise could not fully offset the increase in import values. Net service and transfer payments to the rest of the world declined moderately in the third quarter of 1998, preventing an even greater deterioration in the current-account balance.

The value of *merchandise imports* (seasonally adjusted and annualised) which had shown limited growth from the third quarter of 1997 to the second quarter of 1998, rose exceptionally strongly from R134,7 billion in the second quarter of 1998 to R163,0 billion in the third quarter, i.e. by 21 per cent. Firm increases were observed in the values of most of the import categories, but particularly large increases were registered in the manufactured goods category during the third quarter of 1998. Pronounced increases were recorded in the subcategories for machinery and electrical equipment, more particularly electronic and telecommunications equipment, and vehicle and transportation equipment which included the acquisition of a new passenger aircraft by South African Airways.

The physical quantity of goods imported rose by 6½ per cent from the second to the third quarter of 1998. The factors primarily responsible for the rise in the volume of merchandise imports between the second and the third quarter of 1998 were the persistently high level of real aggregate final demand in the economy, the one-off effect of the aircraft purchase, prior commitments in terms of the expansion of the telecommunications network, export contracts of automobile manufacturers requiring imported intermediate goods and equipment and early importation of goods and equipment to beat higher prices later. Slow import growth in the first half of the year, nevertheless, ensured that the volume of imported goods in the first three quarters of 1998 was only 1,8 per cent higher than in the corresponding period of 1997.

Import price increases were rather subdued in the first half of 1998 as inflation was kept at low levels in trading-partner countries and international oil prices remained depressed. These disinflationary forces were countered, but only modestly so, by a mild depreciation of the rand by about 4 per cent in the first four and a half months of 1998. In the third quarter of 1998, however, the full impact of the sharp decline in the nominal effective exchange rate of the rand between the middle of May and 6 July was felt; import

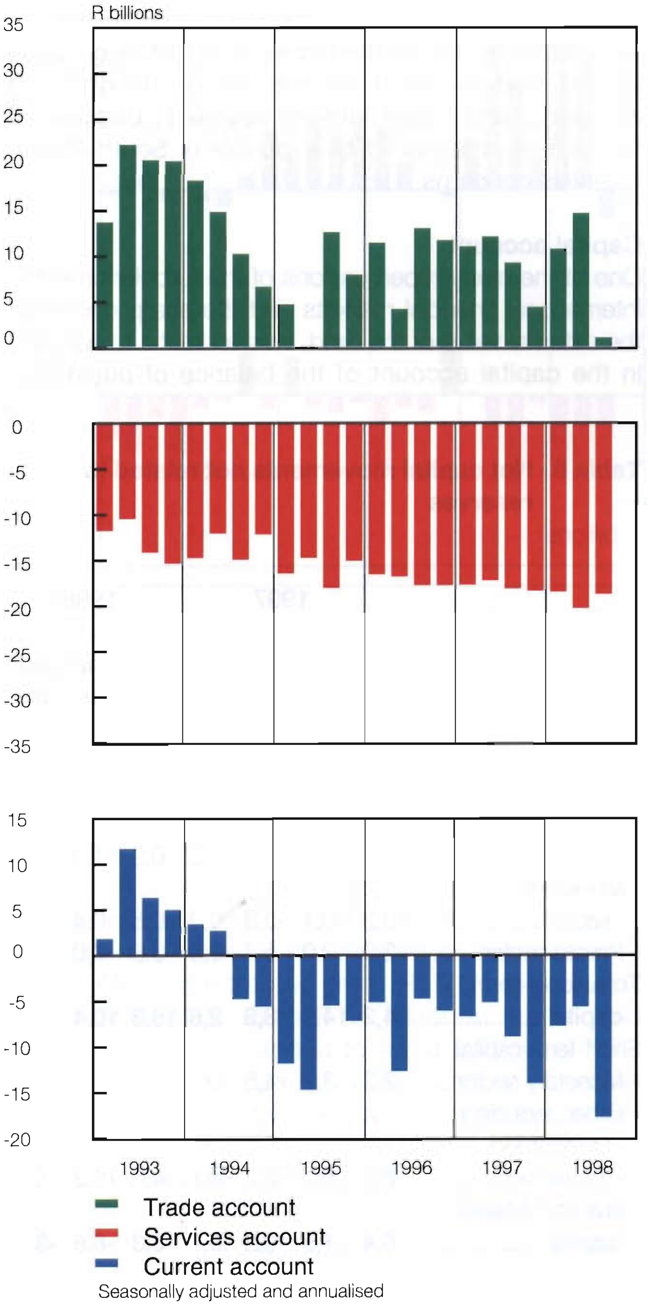
Table 5. Balance of payments on current account
Seasonally adjusted and annualised
R billions

	1997				1998		
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr	3rd qr
Merchandise exports	107,7	115,9	115,3	117,6	124,2	126,3	137,1
Net gold exports	26,8	24,7	26,0	25,7	25,5	23,0	26,9
Merchandise imports	-123,6	-128,6	-132,1	-139,0	-139,1	-134,7	-163,0
Net service and transfer payments	-17,7	-17,3	-18,2	-18,4	-18,5	-20,3	-18,8
Balance	**-6,8**	**-5,3**	**-9,0**	**-14,1**	**-7,9**	**-5,7**	**-17,8**

prices accordingly rose on average by 13½ per cent from the second to the third quarter.

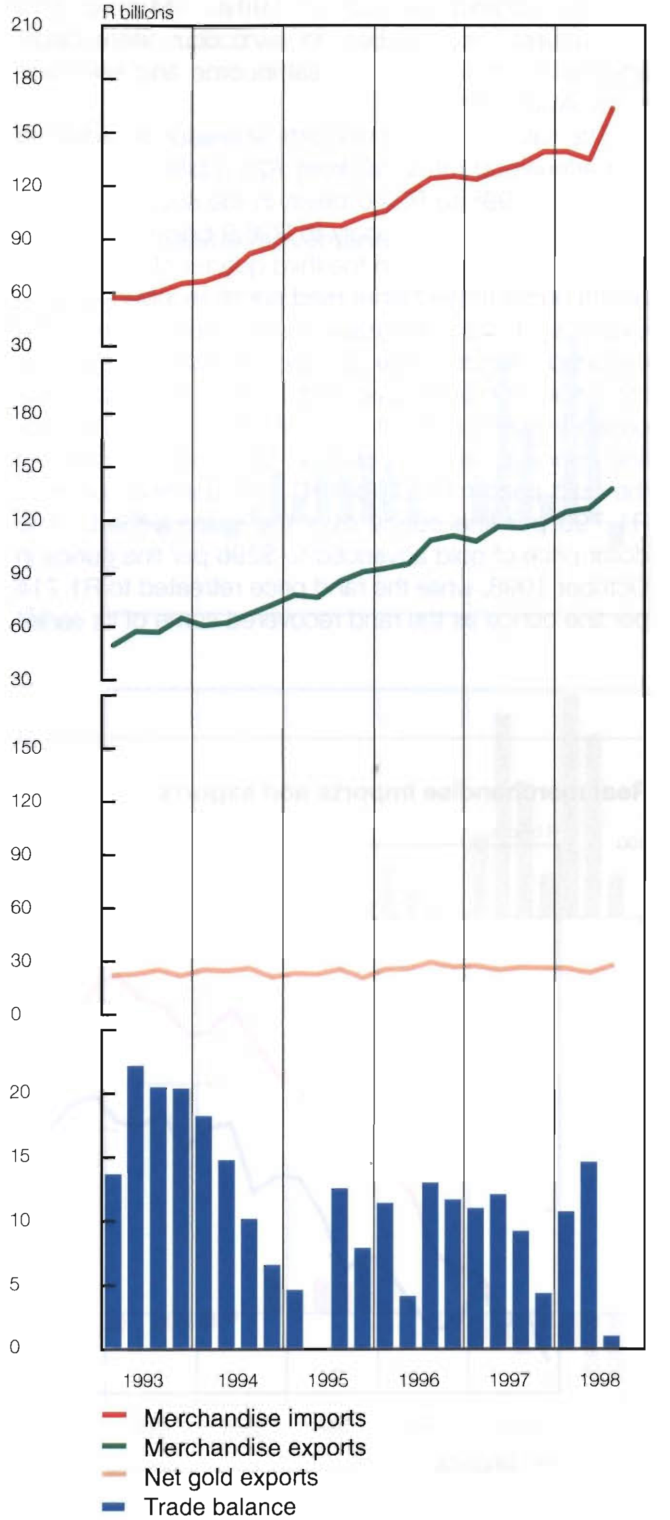
The value of *merchandise exports* rose from a seasonally adjusted and annualised value of R126,3 billion in the second quarter of 1998 to R137,1 billion in the third quarter. This represents a quarter-to-quarter increase of 8½ per cent. The *prices of export products,* many of which are determined in foreign currency, benefited from the depreciation of the rand. Not surprisingly, the average rand prices of goods exported from South Africa rose by 12½ per cent from the second to the third quarter of 1998.

Current account



Seasonally adjusted and annualised

Trade account



Seasonally adjusted and annualised

The *volume of merchandise exports* declined by some 3½ per cent in the third quarter of 1998. The weak economic conditions in countries in Asia had a strong contractionary effect on growth in overall real exports. The share of exports destined for Asian countries as a percentage of total merchandise exports accordingly shrank from 30 per cent in the first three quarters of 1997 to 24 per cent in the corresponding period of 1998. Mining and agricultural commodities, in particular, were badly affected by the decline in real income and spending in the Asian economies.

The value of *net gold exports* at seasonally adjusted and annualised rates, fell from R25,5 billion in the first quarter of 1998 to R23,0 billion in the second quarter, but then recovered strongly to R26,9 billion in the third quarter. The increase in the third quarter of 1998 could be attributed to the higher rand prices received for gold exports and an increase in the volume of gold exported. Although the average fixing price of gold on the London market declined from US$300 per fine ounce in the second quarter of 1998 to US$288 per fine ounce in the third quarter, the rand equivalent of the gold price moved from R1 551 per fine ounce to R1 790 per fine ounce over the same period. The dollar price of gold advanced to $296 per fine ounce in October 1998, while the rand price retreated to R1 714 per fine ounce as the rand recovered some of its earlier losses against the dollar. More or less unchanged gold output and the selling of gold that had been accumulated over previous quarters caused a rise of 5½ per cent in the physical quantity of gold exports from the second to the third quarter of 1998.

Net service and transfer payments to non-residents (seasonally adjusted and annualised), which had increased to R20,3 billion in the second quarter, declined to R18,8 billion in the third quarter. This improvement in the deficit on the services account was caused by an increase of R2,1 billion in services receipts which was higher than the rise of R0,6 billion in service payments. More specifically, increases were recorded in service receipts from passenger fares and investment income on outward investments recently made by South African individuals and corporates. The mild increase in payments for services were due to the higher level of foreign trade and the associated payments for freight and insurance, and higher interest payments because of the increased foreign-debt exposure of South African business concerns.

Capital account

One of the many repercussions of the turbulence in the international financial markets and the sharp decline in the external value of the rand, was a drastic turnaround in the capital account of the balance of payments.

Real merchandise imports and exports

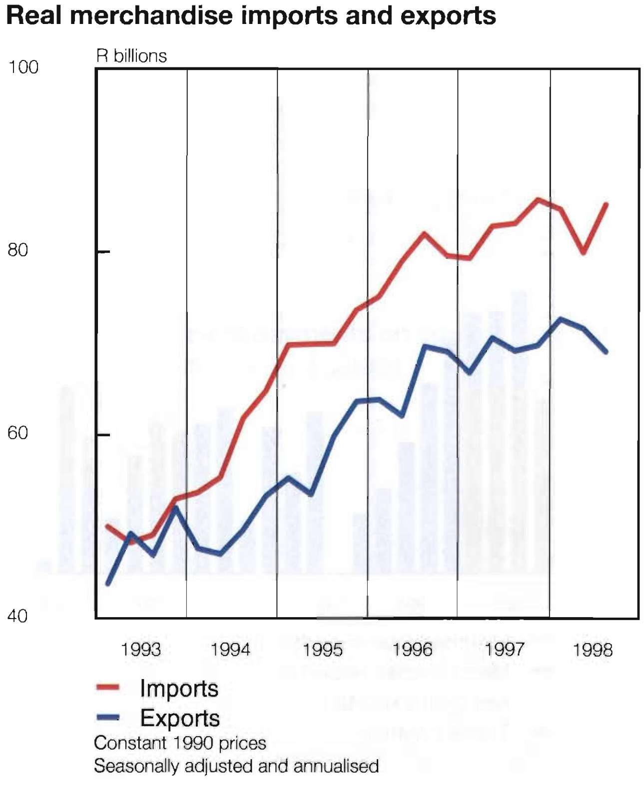
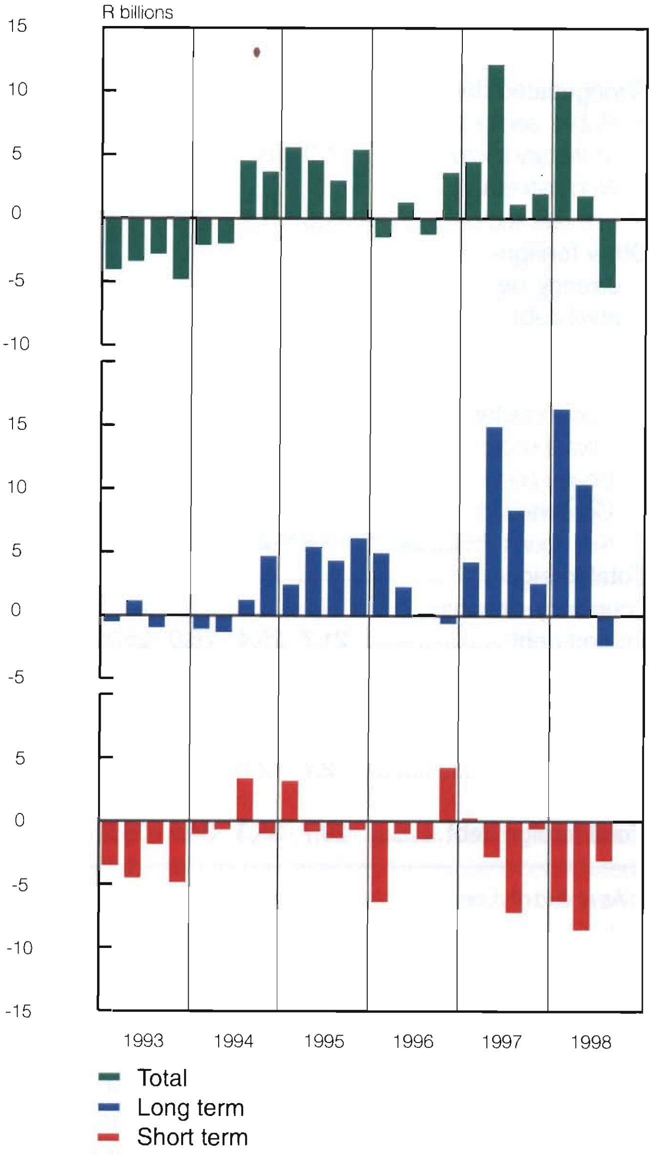


Table 6. Net capital movements not related to reserves

R billions

	1997				1998		
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr	3rd qr
Long-term capital							
Public authorities	1,0	12,2	2,1	-2,5	6,2	1,9	-4,7
Public corporations	1,4	4,8	0,8	-0,2	0,9	1,9	0,3
Monetary sector	-0,2	-0,1	-0,3	-0,2	-0,6	-0,4	-3,9
Private sector	2,0	-2,0	5,7	5,5	9,8	7,0	6,0
Total long-term capital	**4,2**	**14,9**	**8,3**	**2,6**	**16,3**	**10,4**	**-2,3**
Short-term capital							
Monetary sector ...	2,3	3,3	-4,5	0,0	-1,7	1,7	1,9
Other, including unrecorded transactions........	-2,7	-5,2	-2,3	-0,7	-4,6	-10,3	-5,0
Total short-term capital	**-0,4**	**-1,9**	**-6,8**	**-0,7**	**-6,3**	**-8,6**	**-3,1**
Total capital..........	**3,8**	**13,0**	**1,5**	**1,9**	**10,0**	**1,8**	**-5,4**

Net capital movements (not related to reserves)

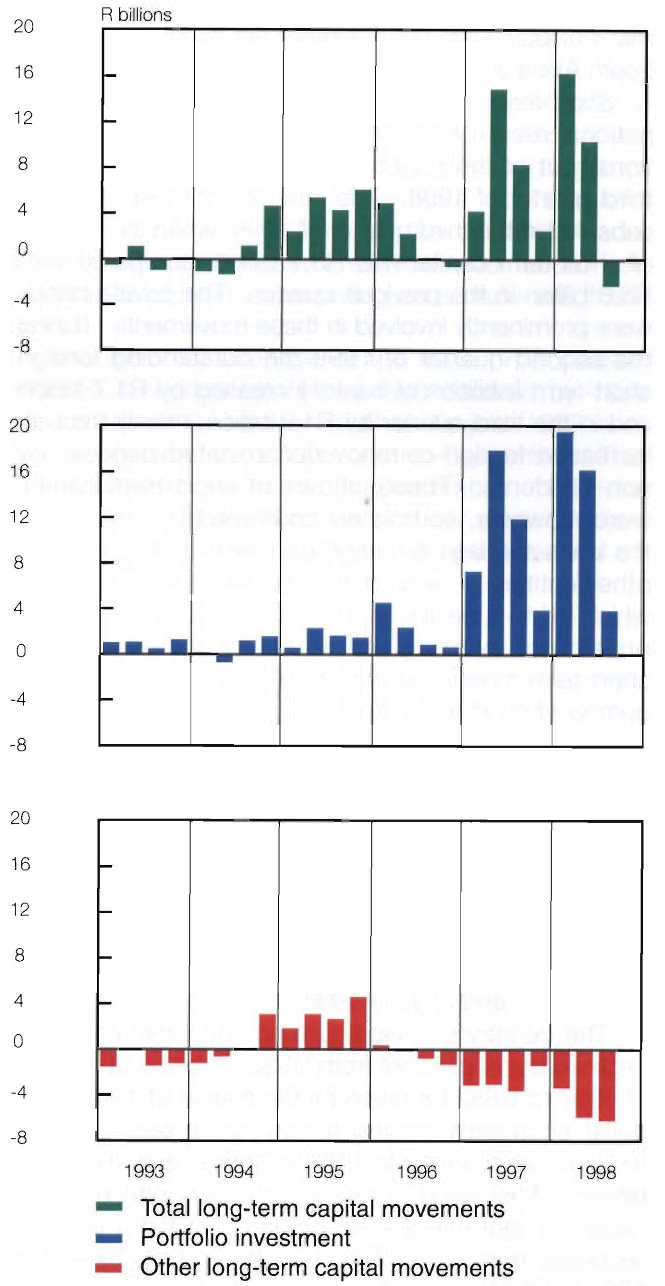


As international perceptions of investment in emerging markets turned negative, the net inward movement of capital not related to reserves into South Africa contracted from R10,0 billion in the first quarter of 1998 to R1,8 billion in the second quarter and then changed to a net outflow of R5,4 billion in the third quarter. This outflow of capital was accounted for by outflows of long- and short-term capital.

The net movements of *long-term capital* showed an abrupt reversal: inflows of long-term capital of R16,3 billion in the first quarter of 1998 and R10,4 billion in the second quarter were followed by a net outflow of R2,3 billion in the third quarter. The net outflows in the third quarter of 1998 were essentially confined to the public sector and the monetary sector, whereas the non-bank private sector still experienced a relatively strong inflow of long-term capital.

The outflow of long-term capital from the *public sector* was predominantly in the form of net sales by non-resident investors of long-term bonds of the South African government, to the value of R14,9 billion in the third quarter. Public corporations obtained net external funding during the third quarter, although on a far more limited scale than the reduction of non-resident holdings of long-term

Long-term capital movements



government securities. These flows were dominated by the financing arrangements for the acquisition of the new passenger aircraft by South African Airways.

The *monetary sector* experienced a net outflow of long-term capital amounting to R3,9 billion in the third quarter. This came mainly from the acquisition of offshore assets by locally domiciled banks.

The movement of international long-term capital to the *domestic private sector* declined from a net amount of R7,0 billion in the second quarter of 1998 to R6,0 billion in the third quarter. The main forces behind the net inflow of long-term capital to the non-bank private sector were a substantial amount of foreign direct investment into the country and continuing purchases by non-resident investors of equity through the Johannesburg Stock Exchange. The nervousness among international investors about the quality of investment in emerging markets obviously did not deter equity investments in South Africa during the third quarter of 1998.

Short-term capital movements (not related to international reserves but including unrecorded transactions) out of the country continued unabated in the third quarter of 1998. The intensity of these outflows subsided in the third quarter of 1998 when the outflow of short-term capital was R3,1 billion, compared with R8,6 billion in the previous quarter. The private banks were prominently involved in these movements: during the second quarter of 1998 the outstanding foreign short-term liabilities of banks increased by R1,7 billion and in the third quarter by R1,9 billion, mainly through increased foreign-currency denominated deposits by non-residents. These inflows of short-term capital were, however, completely countered by changes in the leads and lags in foreign payments and receipts by other entities in view of the weakening of the rand, which led to a decline in the short-term liabilities of the private non-banking sector and an increase in the short-term foreign assets of these institutions, i.e. an outflow of short-term capital.

Foreign debt

South Africa's total outstanding foreign debt declined from US$39,2 billion at the end of December 1997 to US$38,8 billion at the end of June 1998. Owing to the sharp depreciation of the rand against the dollar in the first half of 1998, the rand value of total external debt rose from R190,8 billion at the end of 1997 to R228,9 billion at the end of June 1998.

The country's foreign-currency denominated debt declined by 1½ per cent from US$25,2 billion at the end of 1997 to US$24,8 billion by the middle of 1998. The dollar equivalent of rand-denominated debt, in turn, remained unchanged at US$14,0 billion over the same period. Measured in rands, however, non-resident investors increased their holdings of fixed-interest securities from R50,6 billion at the end of December 1997 to R59,9 billion at the end of June 1998.

Foreign debt as a percentage of gross domestic product increased marginally from 30,4 per cent at the end of 1997 to 30,9 per cent at the end of June 1998. Short-term foreign-currency denominated debt with an unexpired maturity of less than 12 months constituted about 55,9 per cent of total foreign-currency-denominated debt at the end of June 1998. The comparable ratio at the end of December 1997 was marginally higher at 56,0 per cent.

Table 7. Foreign debt of South Africa
US$ billions at end of year

	1994	1995	1996	1997	1998*
Renegotiated debt	**3,4**	**3,0**	**2,7**	**2,5**	**2,3**
Public sector	0,8	1,1	1,3	1,2	1,2
Monetary sector	1,0	0,7	0,3	0,2	0,1
Non-monetary private sector	1,6	1,2	1,1	1,1	1,0
Other foreign-currency-denominated debt	**18,3**	**22,4**	**23,3**	**22,7**	**22,5**
Public sector	3,4	4,5	4,7	4,2	3,5
Monetary sector	3,9	4,9	6,6	7,5	8,4
Non-monetary private sector	4,5	6,3	5,9	5,7	5,4
Bearer bonds and notes	2,7	3,8	4,0	4,0	4,2
Converted long-term loans	3,8	2,9	2,1	1,3	1,0
Total foreign-currency-denominated debt	**21,7**	**25,4**	**26,0**	**25,2**	**24,8**
Rand-denominated debt	**8,0**	**9,9**	**8,5**	**14,0**	**14,0**
Bonds	5,3	7,3	6,3	10,4	10,2
Other	2,7	2,6	2,2	3,6	3,8
Total foreign debt	**29,7**	**35,3**	**34,5**	**39,2**	**38,8**

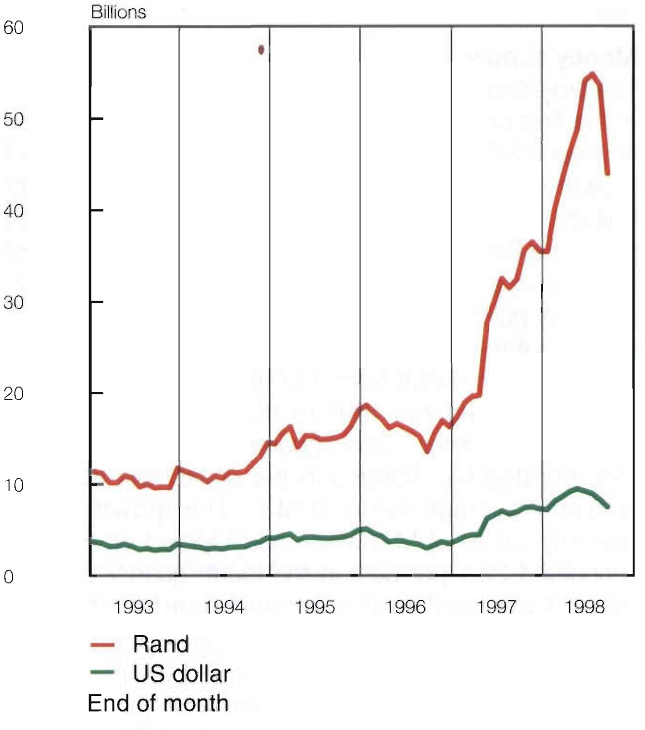
* As at end of June

Foreign reserves

The joint effect of deficits on the current and the capital accounts of the balance of payments had been a decline of R11,3 billion in the country's *net gold and other foreign reserves* during the third quarter of 1998. This meant that the change in the country's net gold and other foreign reserves amounted to a decline of R3,6 billion in the first three quarters of 1998. This decline contrasts with a buildup in the net gold and other foreign reserves amounting to R10,9 billion in 1997. In October 1998, the net gold and other foreign reserves of the Reserve Bank rose by R0,5 billion.

South Africa's *gross gold and other foreign reserves*, which had increased by R18,6 billion in the first half of 1998, declined by R10,1 billion in the third quarter. At the

Total gross international reserves



end of September 1998 total gross foreign reserves amounted to R44,0 billion of which 14 per cent constituted gold holdings. Included in the foreign-currency holdings at the end of September 1998 was an amount of R18,4 billion obtained through short-term borrowing in order to supplement gross international reserves.

The gross foreign reserves of the country at the end of September 1998 were equal to the value of imports of goods and services for a period of 10½ weeks, compared with almost 15 weeks at the end of June. The net oversold open position in foreign currency of the Reserve Bank remained virtually unchanged at about US$23,2 billion from August to October 1998, but then declined slightly in November.

Exchange rates

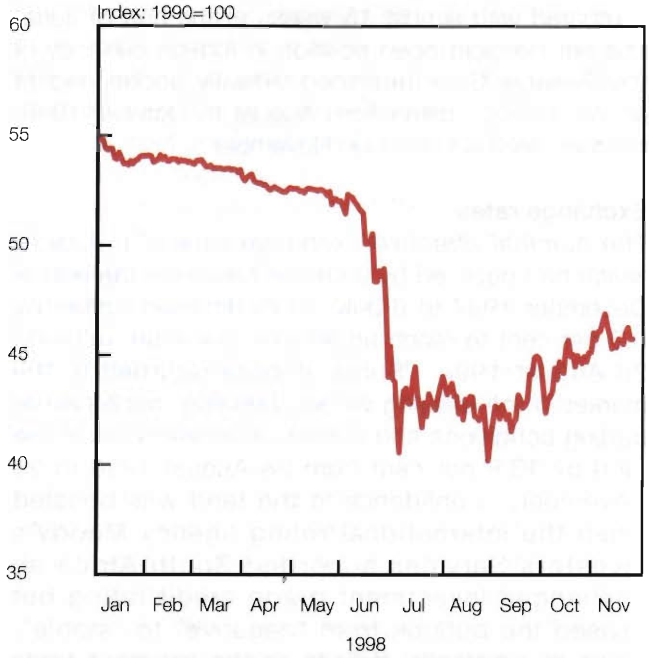
The *nominal effective exchange rate of the rand,* which had declined by 25,8 per cent from the end of December 1997 to 6 July 1998, declined further by 0,9 per cent to reach an all-time low index value on 28 August 1998. Some stability returned to the market in the ensuing weeks, bringing much calmer trading conditions and a gradual appreciation of the rand by 13,8 per cent from 28 August 1998 to 25 November. Confidence in the rand was boosted when the international rating agency Moody's Investors Services accorded South Africa an unchanged investment grade credit rating but revised the outlook from "negative" to "stable". News of substantial deficits on the country's trade account during October and November could not stop the rand from appreciating on a trade-weighted basis.

The monthly average of the *inflation-adjusted effective exchange rate* of the rand declined by 18,7 per cent from December 1997 to August 1998 and then appreciated by 1,3 per cent to September. The overall depreciation from December 1997 to September 1998 amounted to 17,6 per cent. The improvement in the international competitiveness of

Table 8. Exchange rates of the rand
Percentage change

	22 May 1998 to 6 Jul 1998	6 Jul 1998 to 28 Aug 1998	28 Aug 1998 to 25 Nov 1998	31 Dec 1997 to 25 Nov 1998
Weighted average	-22,7	-0,9	13,8	-16,3
US dollar	-23,2	-0,7	17,1	-14,5
British pound	-23,6	-1,7	17,0	-14,6
German mark	-21,0	-1,6	11,2	-18,6
Japanese yen	-20,5	1,2	-1,2	-20,5
Netherlands guilder	-21,0	-1,6	11,1	-18,5
Italian lira	-21,0	-1,4	11,4	-18,0
Emerging markets				
Indonesian rupiah	3,3	-25,7	-19,5	11,2
Malaysian ringgit	-15,2	0,4	5,2	-16,2
Philippines peso	-17,7	5,9	4,6	-16,7
Singaporean dollar	-19,7	3,3	7,7	-16,5
Taiwanese dollar	-21,4	0,5	9,2	-15,0

Nominal effective exchange rate of the rand



domestic producers implied by the real depreciation of the rand may contribute to a future recovery in the economy, provided that domestic cost increases can be sufficiently contained to sustain the gains in competitiveness.

As indicated in Table 8 the rand has recently also appreciated against a number of Asian currencies. Since the end of 1997, however, the rand has depreciated against most of the Asian currencies and thus regained some of the competitive ability that had been forfeited when these currencies depreciated so strongly in the second half of 1997.

The net average daily turnover in the market for foreign exchange, which had increased sharply from US$3,8 billion in the first quarter of 1998 to US$10,9 billion in the second quarter when the turmoil in the South African financial markets erupted, declined again to US$9,8 billion in the third quarter of 1998. The gradual return of stability to the market was marked by a decline in average net daily turnover from a high of US$13,4 billion in June 1998 to US$10,1 billion in July, US$9,7 billion in August and US$9,5 billion in September.

Monetary developments, interest rates and financial markets

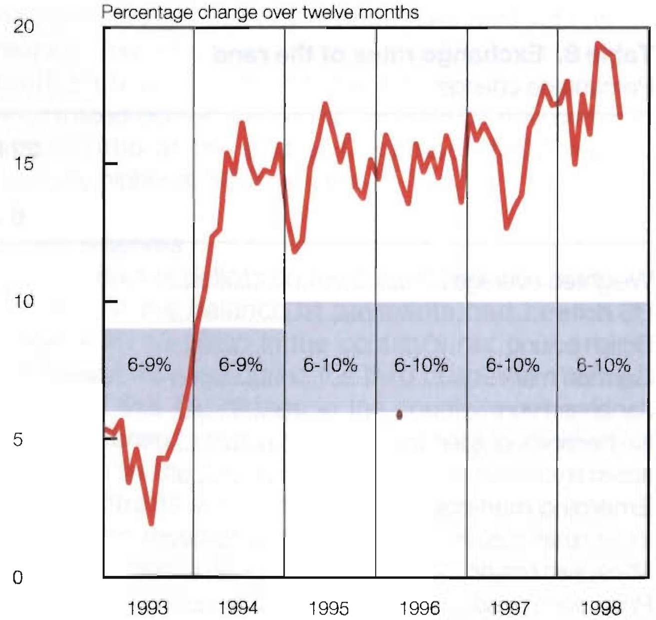
Money supply

The *broadly defined money supply (M3)* expanded rapidly in the first nine months of 1998, fluctuating in a range between 15,0 per cent and 19,4 per cent. These annual growth rates were substantially higher than the upper limit of the guideline range of between 6 and 10 per cent which the Reserve Bank has indicated as one of a set of indicators that would be monitored to guide decisions on monetary policy.

The year-on-year growth in M3 seemed to have slackened somewhat from 19,4 per cent at the end of the second quarter of 1998 to 16,7 per cent at the end of the third quarter. This apparent slowdown was not corroborated by changes in the seasonally adjusted quarterly average value of M3. The growth in the quarterly values of M3, which had tapered off from an annualised 23,1 per cent in the fourth quarter of 1997 to 14,3 per cent in the second quarter of 1998, accelerated sharply to 18,8 per cent in the third quarter. The possibility that this and past rapid money growth could feed through into higher future inflation, continues to pose a threat to consistently lower inflation. Broad money growth will need to decline further to remain consistent with the objective of low and stable inflation.

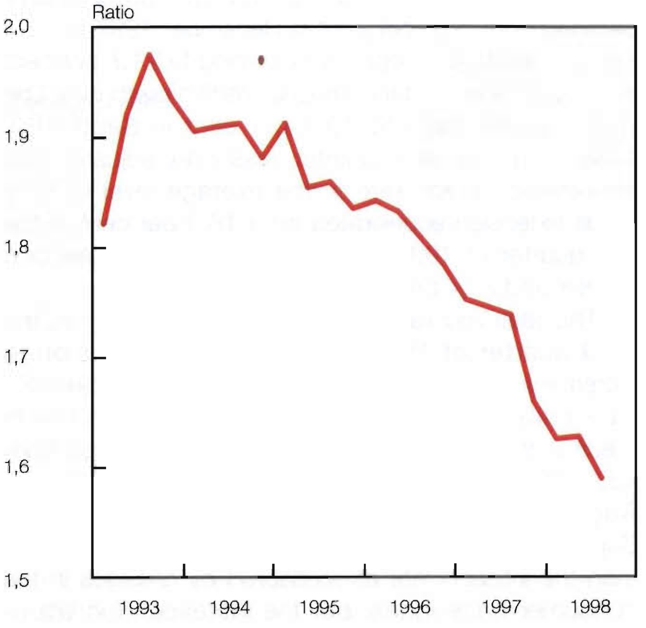
The increase in the money supply exceeded the growth in the nominal gross domestic product for the

M3 money supply



Shaded areas indicate the money growth guideline ranges

Income velocity of M3



twentieth consecutive quarter during the third quarter of 1998. As a result, the income velocity of M3 approached the nadir that was recorded in 1965. The more recent decline in aggregate income velocity has largely been accounted for by the international financial crisis which prompted a sizeable shift in asset preference from long-dated fixed-interest assets and equity investments to short-dated liquid assets, including depository-type investments with banks.

Evidence of the strong liquidity preference of the non-bank private sector during the first three quarters of 1998 is presented in Table 9. The changes in the components of M3 clearly reveal an increased preference for the holding of shorter-term deposits at the expense of longer-term deposits.

Other demand deposits were highly popular in the second and third quarters of 1998, whereas *cheque and transmission* deposits also increased consistently over the first nine months of the year. The combined increases in these two categories of deposits amounted to 136 per cent of the overall increase in M3 in the second and third quarters of 1998. By contrast, other short- and medium-term deposits and long-term deposits declined in the second and third quarters of 1998 by an amount that was equal to 37 per cent of the overall increase in M3. These shifts in the composition of M3 reflected the non-bank private sector's increased preference for liquid assets against the backdrop of falling share prices and rising bond yields, and also the monetary sector's funding strategies which were directed at shortening the maturities of its deposit liabilities during a time of highly uncertain interest rate movements.

Table 9. Quarterly changes in notes, coin and bank deposits of the private sector

R billions

	1998		
	1st qr	2nd qr	3rd qr
Notes and coin in circulation	-0,5	0,3	-0,2
Cheque and transmission deposits..................................	2,1	5,0	0,7
Other demand deposits	2,1	21,2	15,8
Other short- and medium-term deposits..................................	4,1	-3,3	-5,8
Long-term deposits..................	5,3	-1,1	-1,3

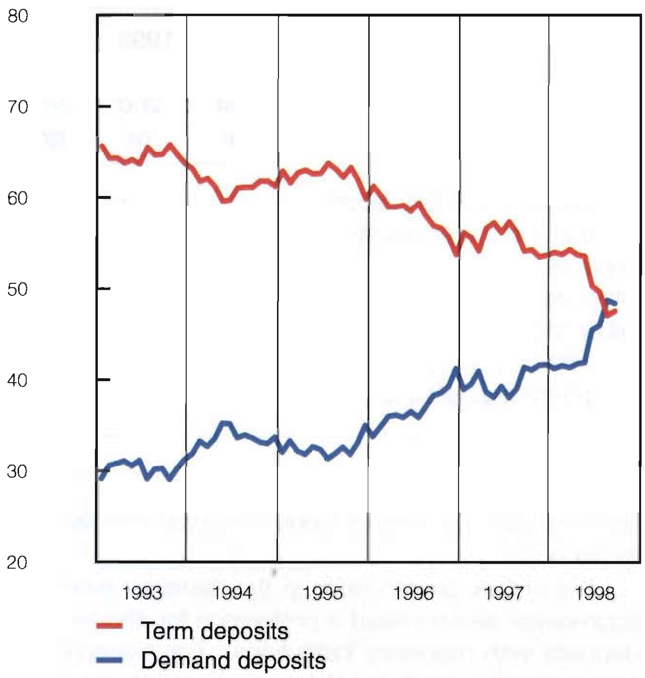
The annual growth rates in the narrower monetary aggregates also revealed a preference for shorter-term deposits with monetary institutions. For example, the twelve-month growth in M1 has continuously outpaced the growth in M3 since April 1998 – the growth differential in favour of M1 was more than 24 percentage points in August (see Table 10).

The *main counterpart* (in a statistical or accounting sense) of the R9,2 billion increase in M3 in the third quarter of 1998 was an increase in the monetary sector's claims on the private and the government sectors. The absolute value of the increase in each of these credit aggregates was, however, substantially reduced from that of the second quarter. In addition, the moderating influence of the slowdown in domestic credit extension on overall monetary growth in the third quarter of 1998 was reinforced by a continued decline in the net foreign assets of the monetary sector. In the third quarter of 1998, deficits arising from the Reserve

Table 10. Twelve-month growth rates in M1 and M3

Period	M1	M3
1998: Jan	22,9	17,2
Feb............................	22,8	18,0
Mar............................	14,7	15,0
Apr	25,2	17,5
May	26,0	16,1
Jun	35,3	19,4
Jul	40,6	19,1
Aug	43,7	18,9
Sep	33,6	16,7

Demand and term deposits as percentage of M3



Bank's involvement in the forward foreign-exchange market were an important accounting counterpart of the increase in M3. (See table 11).

Table 11. Accounting counterparts of changes in M3

R billions

	1998		
	1st qr	2nd qr	3rd qr
Net foreign assets	5,8	-5,0	-15,9
Net claims on government sector	-2,5	11,8	5,1
Gross claims	-1,2	4,4	6,6
Deposits (+ decrease, - increase)	-1,3	7,4	-1,5
Claims on private sector	17,3	23,5	8,3
Net other assets	-7,5	-8,2	11,7
Total change in M3	**13,1**	**22,1**	**9,2**

Credit extension

The rate of increase over twelve months in *total domestic credit extension* by the monetary sector declined from 16,6 per cent in December 1997 to 14,3 per cent in March, before accelerating to 21,7 per cent in August 1998. Total domestic credit growth over one year then fell back to 19,3 per cent in September 1998. The quarter-to-quarter seasonally adjusted and annualised growth rate in the average level of total credit extension accelerated from 16,0 per cent in the first quarter of 1998 to 24,1 per cent in the second quarter and 23,4 per cent in the third quarter.

The relatively rapid rate of credit extension in the third quarter of 1998 was mainly the result of an increase in the growth of credit extended to the *non-bank private sector.* The twelve-month growth rate in credit extended to the private sector accelerated from 13,3 per cent in January 1998 to 17,5 per cent in August; it then receded to 15,3 per cent in September. These annual growth rates were higher than the inflation rate as measured by changes in the consumer price index, but the increase in inflation-adjusted credit extension over twelve months has recently decelerated from 10,3 per cent in June 1998 to 5,8 per cent in September 1998.

An analysis of monetary institutions' claims on the private sector by *type of credit* shows that the growth in credit extended to the private sector in the third quarter consisted mainly of *overdrafts and other loans*

Credit extension by monetary institutions

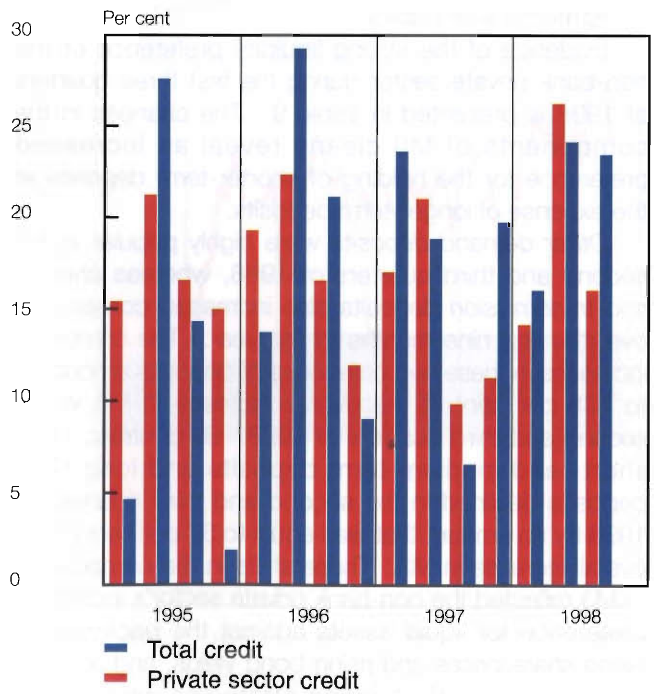
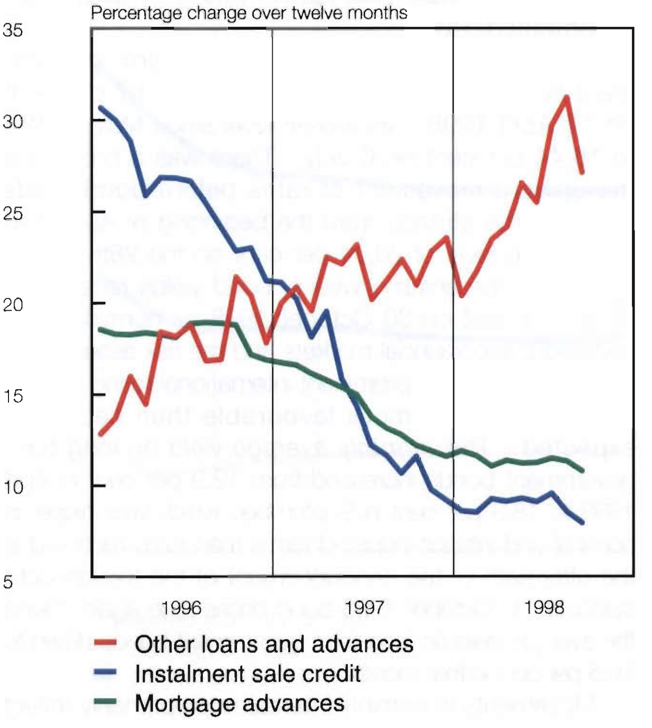


Table 12. Increase in credit extension to the private sector by main type of credit

R billions

Type of credit	1998 1st qr	1998 2nd qr	1998 3rd qr
Bills discounted	-0,2	1,8	-0,7
Instalment sales	0,9	1,1	0,0
Investments	1,3	1,4	-3,3
Leasing finance	-0,8	0,6	0,0
Mortgage advances	5,1	5,2	4,2
Other loans and advances	11,1	13,4	8,1
Total	**17,4**	**23,5**	**8,3**

Components of credit extended to the private sector



and advances. Increased demand for working capital by the corporate sector and some borrowing by companies to tide them over a period of relatively slack demand in the economy, were prominent forces behind the rise in the corporate demand for credit. This was reinforced by an increase in the demand for credit arising from the many speculative opportunities that arose during a period of heightened volatility in the securities markets. The weakness of the exchange rate of the rand also caused a substantial switching of trade financing from foreign to domestic sources of credit.

The growth over twelve months in *mortgage advances* remained at levels below 12 per cent in the first nine months of 1998, reaching 10,7 per cent in September. The high and rising level of nominal mortgage interest rates had an adverse impact on the affordability of housing. New mortgage advances granted were curtailed severely and were 32,0 per cent lower in September 1998 than in September 1997. Under the new bank supervisory regulations which came into effect on 1 October, an increase in the risk weighting was assigned to new mortgage loans which exceeded 80 per cent of the value of the property collateralised. Some banks reacted to this step by raising their rates on new home loans which exceeded this limit.

The growth over twelve months in *instalment sales credit* subsided from rates of higher than 20 per cent at the beginning of 1997 to 7,9 per cent in September 1998. Similarly, *leasing finance*, which had increased by 0,5 per cent in the twelve months to September 1997, declined by 4,3 per cent in the twelve months to September 1998. Waning consumer confidence and perceptions of declining wealth, along with high levels of interest rates, prevented individuals from servicing higher levels of collateralised borrowing. *Investments* declined by R3,3 billion in the third quarter of 1998 as a result of corporate restructurings during which equity investments were transferred to non-bank entities.

In contrast to corporate sector credit, personal sector credit growth has shown clear signs of slowing. Perceptions of declining personal wealth as share and bond prices declined and consumer confidence waned, led to reductions in the increase in credit extended to households from R5,2 billion in the second quarter of 1998 to R2,2 billion in the third quarter. In terms of percentage changes, the growth over twelve months in credit extension to households at 7,4 per cent in September 1998 was well below the growth of 25,9 per cent in credit extended to the corporate sector during the same period.

Interest rates and yields

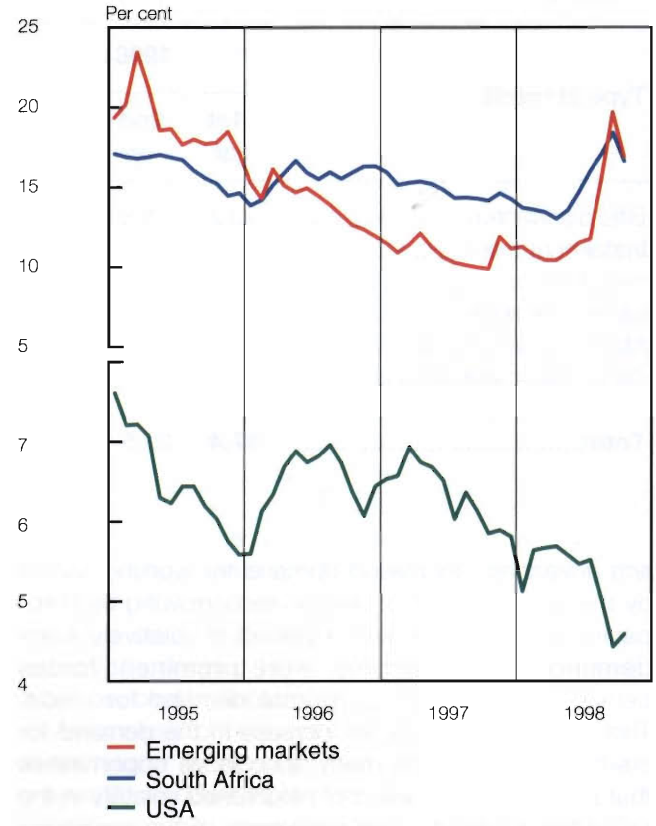
Bond yields, which had declined steadily from January 1997 to April 1998, increased strongly in the ensuing months, especially when non-resident investors began to reduce their holdings of fixed-interest securities issued by the South African government and other parastatals. This sudden reversal of foreign investment flows was a consequence of the reassessment by global market investors of the risk associated with investing in emerging-market economies, following the financial difficulties encountered in a number of countries in Asia and the Russian Federation. The fall in bond prices gained momentum as monetary conditions were tightened in order to stabilise the South African financial markets and after the Russian government announced a unilateral restructuring of all rouble-denominated debt.

The *daily average yield on long-term government bonds* increased from a low of 12,67 per cent on 17 April 1998 – its lowest level since May 1994 – to 16,44 per cent on 6 July. There was a brief lull in the upward movement of rates before bond yields began to rise strongly from the beginning of August to an average level of 20,09 per cent on the 28th of that month. In the ensuing weeks, bond yields receded to 15,66 per cent on 30 October 1998 as normality was restored in the financial markets and the risk assessment of South Africa by a prominent international rating agency turned out to be more favourable than had been expected. The *monthly average yield* on long-term government bonds increased from 12,9 per cent in April 1998 to 18,3 per cent in September, which was higher in nominal and inflation-adjusted terms than rates recorded in the aftermath of the announcement of the foreign-debt standstill. In October 1998 bond prices rose again, taking the average yield on long-term government bonds down to 16,5 per cent in that month.

Movements in nominal interest rates primarily reflect changes in expected real interest rates and changing expectations of inflation. Measures of expected consumer price inflation in 1998, derived from the forecasts of 27 professional economists have increased, on average, by about 1 percentage point since May. Average consumer price inflation in 1999 is expected to be about half a percentage point higher than the expected inflation in 1998. The upward adjustment in inflation expectations was smaller than the net rise in the average monthly yield on long-term government bonds between April and October 1998, implying an increase in real yields of between 2 and 2½ percentage points. Making use of actually observed inflation rates as an indication of inflation expectations, the average inflation-adjusted yield on long-term government bonds increased from 6,2 per cent in the sixteen months to April 1998 to 8,3 per cent in the period from May to October 1998 – an increase of slightly more than 2 percentage points. This rise in real interest rates may reflect concerns about a possible deterioration in the domestic savings rate, as reflected in the widening deficit on the current account of the balance of payments and also the reversal of international capital movements from inflows to the country to outflows from the country.

South Africa's classification, by foreign portfolio managers, as an emerging market resulted in a closer correspondence between the movement of domestic bond yields and those of other emerging markets (see accompanying graph). As a consequence, the interest rate differential between government debt in South

Nominal yield on long-term government bonds



Daily average yield on long-term government bonds

Africa and in the United States widened appreciably. The differential in September 1998 of about 1 390 basis points translates into an inflation-adjusted differential of 560 basis points, which is considerably higher than the 330 basis points recorded in April 1998.

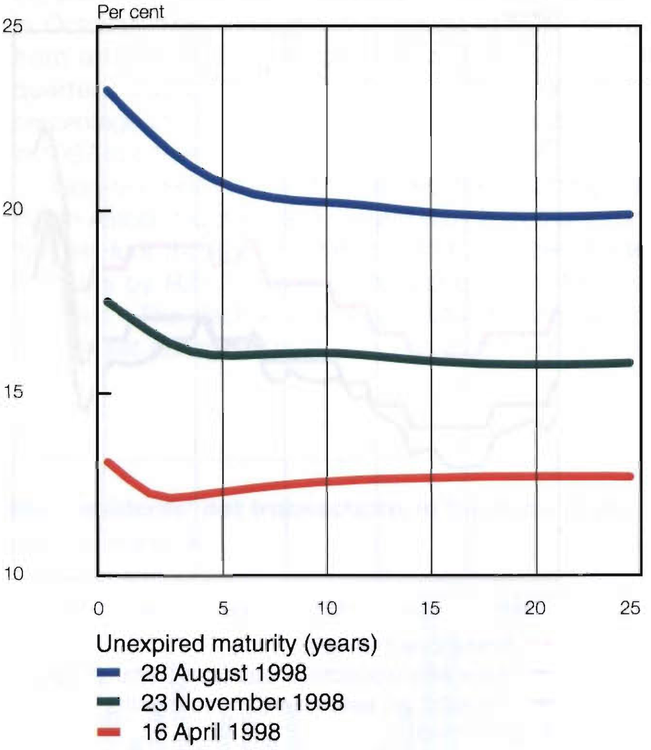
At the beginning of the turmoil in the domestic financial markets, the repurchase rate of the Reserve Bank rose from 14,79 per cent on 11 May 1998 through periods of high volatility to settle at a level of 21,86 per cent from 1 September to 13 October 1998. When some stability returned to the international financial markets and the Reserve Bank began providing an increased portion of the daily liquidity needs of the banks, the repurchase rate entered a period of gradual decline from 14 October 1998 to reach a level of 19,86 per cent on 24 November.

Prior to the beginning of the decline in the Reserve Bank's repurchase rate, other money market rates were already signalling an easing in money market conditions. For example, the rate on bankers' acceptances with a maturity of three months peaked on 28 August at a level of 21,60 per cent. This interest rate level was maintained until 16 September, when it began to decline gradually, i.e. almost a month ahead of the first decline in the Reserve Bank's repurchase rate. By 24 November 1998 the rate on bankers' acceptances with a maturity of three months had declined by 368 basis points to 17,92 per cent. The tender rate on Treasury bills with a maturity of three months followed a trend similar to that of bankers' acceptances, falling by 480 basis points from a high point of 22,30 per cent on 11 September 1998 to 17,50 per cent on 24 November. The rate on interbank call deposits reached a peak of 21,50 per cent on 1 September 1998 and was at 18,25 per cent on 24 November.

The first tender for Reserve Bank *debentures* was held on 16 September 1998. The interest rate established on that date was 21,31 per cent. It declined subsequently in accordance with other interest rate movements to 18,80 per cent on 24 November 1998.

The *yield curve* changed drastically from 16 April 1998 to 28 August as the slope of the curve changed from a slight to a fairly steep inversion over maturities of less than three years, and the overall level of interest rates and yields shifted higher. The increased inversion at the short end of the curve was a reflection of the unavoidable tightening of domestic monetary conditions since May 1998. The flat slope of the curve over maturities of longer than three years probably signalled uncertainty about the future direction of financial policies and expectations of higher future inflation. The yield curve drifted lower towards the end of October to a level midway between that of April and August 1998 as the international financial markets stabilised and domestic short-term rates began to move lower. Towards the end of October non-resident investors increased their holdings of fixed-interest securities, thus lending further support to the downward movement of interest rates.

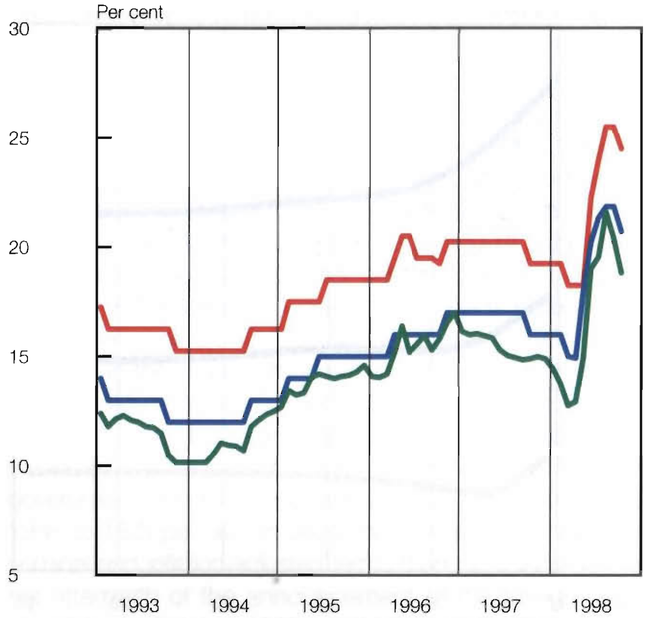
Yield curves



Following the increases in the average repurchase rate, the banks raised their *prime overdraft rates* from 18,25 per cent to 20,25 per cent on 10 June 1998 and to 22,25 per cent at the end of that month. Further increases during July and August 1998 took the prime overdraft rates of the banks to 24 per cent at the end of July and 25,5 per cent at the end of August. In reaction to the general downward movement in money market interest rates from the middle of September 1998 and the decline in the Reserve Bank's repurchase rate from 14 October, the banks lowered their prime overdraft rates by one percentage point at a time to 24,50 per cent on 19 October and 23,50 per cent on 9 November.

The *predominant rate on mortgage loans* by banks had been increased by six percentage points – in three steps of two percentage points per month – from 18 per cent in June 1998 to 24 per cent in September. From 1 October 1998 some banks also added a penalty interest margin to new home loans exceeding 80 per cent of the property value. This step was the result of the increase in the capital adequacy requirement on such mortgage loans granted by banks. The banks followed the general downward movement of interest rates by lowering the predominant rate on mortgage loans by about half a

Interest rates*



Prime overdraft rate
Bank rate/repurchase rate from 9 March 1998
Bankers' acceptances of three months
*End of month

percentage point in mid-October and by three-quarters of a percentage point on 9 November 1998. These steps noticeably increased the dispersion of mortgage interest rates charged by individual banks.

The *predominant retail rate on twelve-month fixed deposits* with banks displayed a pattern broadly similar to that of mortgage rates and was increased by four percentage points – in two steps of two percentage points at a time – from 12,5 per cent in June 1998 to 16,5 per cent in August. The *standard interest rate* applicable to loans granted from the State Revenue Fund was raised in five steps from 13 per cent in May 1998 to 18,5 per cent on 1 October, but was then lowered to 16,5 per cent on 1 November. The *maximum permissible finance charges rates*, as laid down in terms of the Usury Act, were raised by four percentage points on 21 August 1998 to 33 per cent per annum in respect of money lending, credit and leasing transactions of more than R6 000 but less than R500 000, and 36 per cent for amounts of up to R6 000.

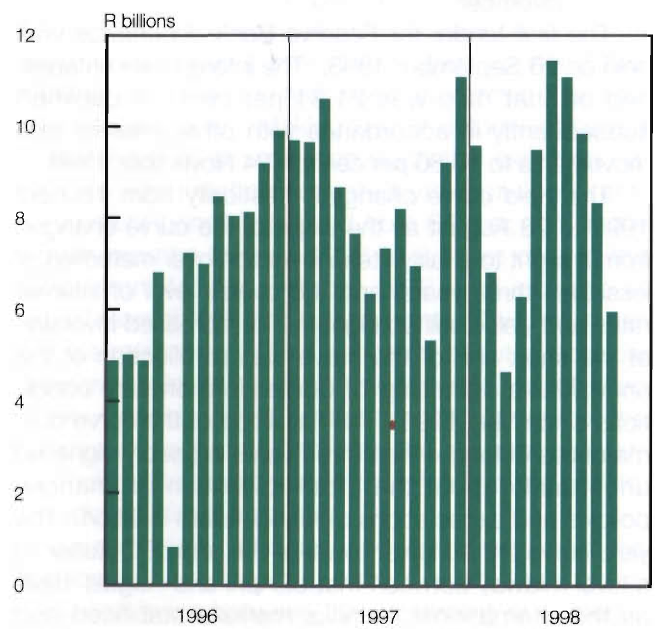
Money market

Money market conditions tightened considerably in the second quarter of 1998 and remained tight for the greater part of the third quarter. The monthly average liquidity provided by the Reserve Bank peaked at R11,4 billion in June 1998 and then gradually declined to R8,3 billion in September and R6,0 billion in October. The daily outstanding amount of repurchase transactions between the Reserve Bank and private banks reached an upper turning point of R15,1 billion on 26 May 1998 and then declined, on balance, to a low of R5,3 billion on 15 October.

The easing in money market conditions during the third quarter of 1998 was mainly related to deficits arising from the Reserve Bank's transactions in the forward foreign exchange market. In total, a net amount of R6,6 billion was added to money market liquidity through the Bank's foreign-exchange activities in the third quarter of 1998, following a contractionary impact of R12,7 billion in the second quarter.

The *Reserve Bank's operations* in the money market during the third quarter of 1998 were aimed at stabilising domestic monetary conditions against the backdrop of unsettled international financial markets. To this end, the Bank adopted a cautious approach and, through the daily auction system, provided less liquidity than the estimated requirement for the day. Only when it became apparent that the global markets were regaining stability, was the Bank prepared to relax its vigilance against potential financial instability. The daily underprovision of liquidity was kept at between R500 million and R100 million in August 1998 and was reduced to R100 million during most of September. On 14 October 1998 the daily underprovision was reduced from R100 million to R50 million and from 16 October the liquidity requirement has been fully met.

Total liquidity provided by Reserve Bank



Monthly average of daily values

In the statement issued to announce the Reserve Bank's repurchase system for providing liquidity to the private banks, it was anticipated that the Bank would, at some stage, issue its own debentures as a supplementary facility for banking institutions to place short-term funds. The Reserve Bank debentures were conceived to be acceptable financial instruments for the purpose of regular repurchase transactions between the Reserve Bank and the banking sector.

In light of recent increases in money market liquidity and the continuing unsettled conditions in the international financial markets, the Bank regarded it as an opportune moment to start issuing the first Reserve Bank debentures in order to establish a role for this paper in the system of liquidity provision. With the introduction of the debentures, the Bank clarified the point that, at that juncture, the intention was not to raise short-term money market interest rates, but to provide an additional investment facility for surplus short-term funds.

Transferable debentures to the amount of R200 million (issued in multiples of R5 million) were offered for the first time on 16 September 1998. The maturity of the debentures currently in issue is 30 days and a tender is allocated on a yield basis in ascending order of bids received. The tender is open to bids from banks and the public at large, subject to a minimum amount of R5 million. The cumulative outstanding amount of Reserve Bank debentures was R2,0 billion on 24 November 1998.

Bond market

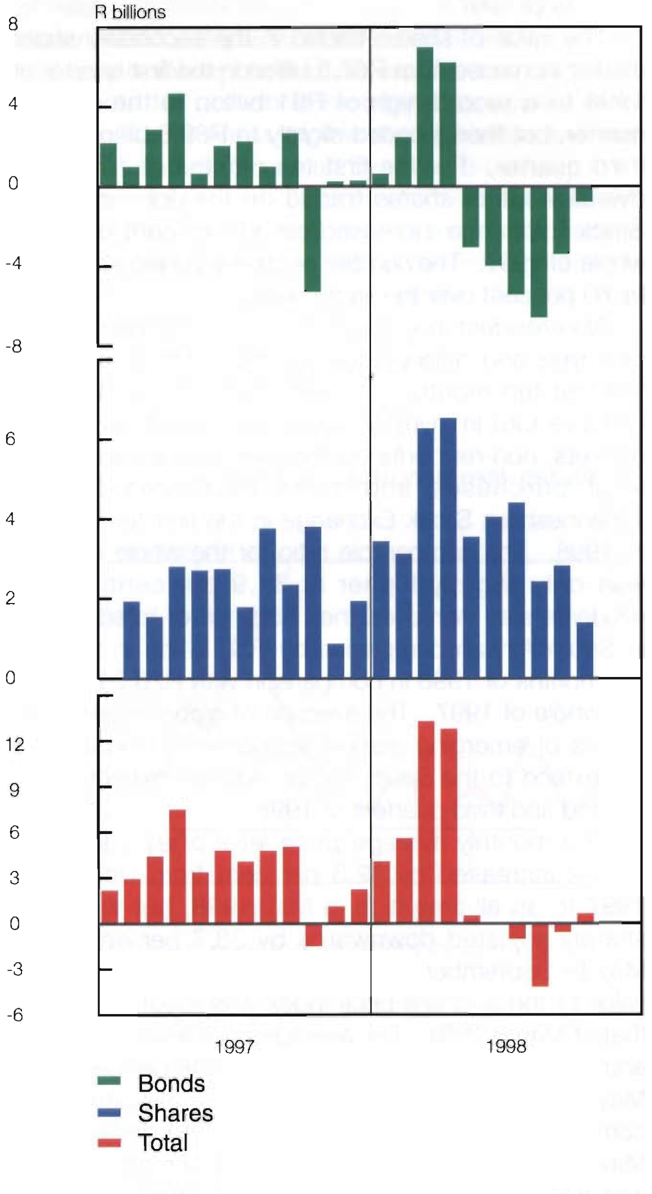
Net *new borrowing by public-sector entities in the domestic primary bond market* decreased from R5,6 billion in the second quarter of 1998 to R3,0 billion in the third quarter. The total amount of funds raised by the public sector accordingly came to R8,5 billion in the first half of the current fiscal year, compared with a net amount of R9,3 billion in the corresponding period of fiscal 1997/98. Government bonds with a nominal value of R20,7 billion were auctioned and allotted from the beginning of April 1998 to October, leaving R10,3 billion of the budgeted amount still to be funded in the remaining five months of fiscal 1998/99.

During the first nine months of 1998 *listed private-sector borrowers* raised only R30 million in the domestic capital market through the issuance of *preference shares and debentures*. The deterioration in investor sentiment towards emerging markets and the high cost of borrowing for South African entities in offshore markets were reflected in the complete lack of capital-raising activity in the *international primary bond market*. Government and other domestic borrowers abstained from issuing *foreign-currency denominated bonds* in the first ten months of 1998 and no new funds have been raised through *rand-denominated bonds* by South African issuers in the *eurorand market* since April 1998.

Activity in the *secondary bond market* was buoyant during the first three quarters of 1998. The value of bonds traded on the Bond Exchange increased from R1,7 trillion in the first quarter of 1998 to R2,5 trillion in the second quarter and R2,6 trillion in the third quarter. In October 1998 the turnover receded to R644 billion from a monthly average of R877 billion in the third quarter. Turnover of repurchase transactions as a percentage of total turnover increased from 54 per cent in 1997 to 61 per cent in the first ten months of 1998.

Non-resident investors increased their holdings of South African fixed-interest securities by R16,3 billion in the first four months of 1998, but then reduced these holdings by R23,1 billion in the period from May to October. The decline in foreign investors' interest in this market during the past year was also reflected in a

Non-residents' net transactions in the secondary capital markets



decline in the gross transactions value of non-residents' purchases and sales of bonds from R895 billion in the second quarter of 1998 to R805 billion in the third quarter. Measured as a percentage of total sales and purchases, non-residents' transactions in bonds declined from a high of 20 per cent in April 1998 to 15 per cent in October.

Share market

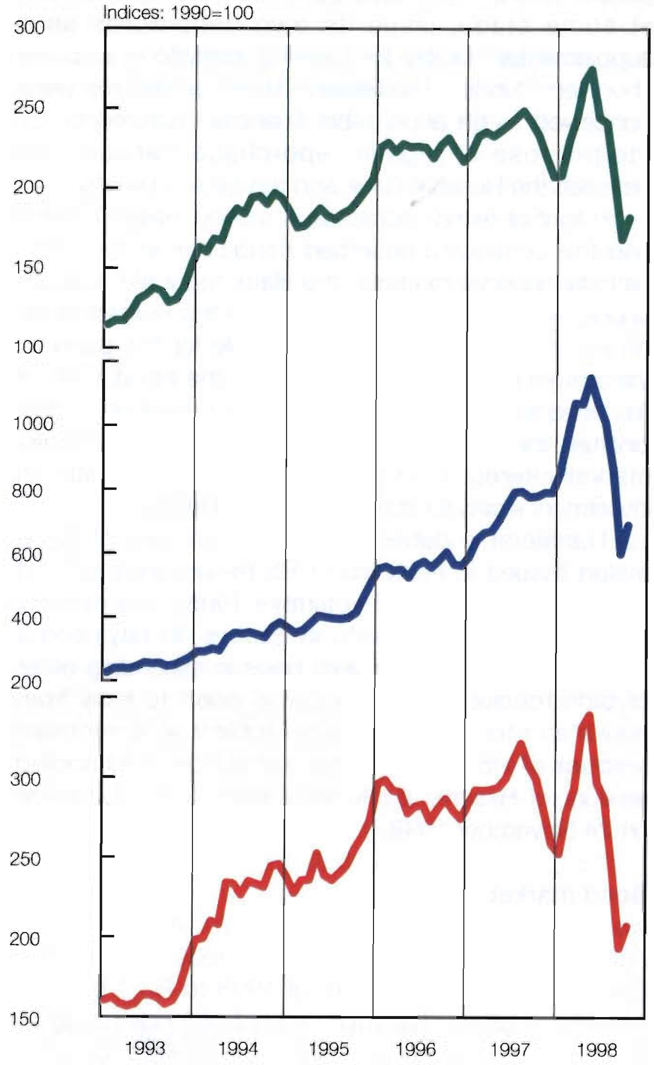
Capital-raising activities by private-sector companies during 1998 continued to reflect a preference for equity financing rather than debt accumulation, probably because of the high cost of debt relative to that of equity capital. The value of *capital raised in the primary share market* by companies listed on the Johannesburg Stock Exchange increased from R9,3 billion in the first quarter of 1998 to R20,3 billion in the second quarter and R25,9 billion in the third quarter. This represents a rise of 41,3 per cent in the first three quarters of 1998 in comparison with the first three quarters of 1997.

The value of shares traded in the *secondary share market* increased from R67,5 billion in the first quarter of 1998 to a record high of R91 billion in the second quarter, but then receded slightly to R89,6 billion in the third quarter. For the first ten months of 1998, the overall *value of shares* traded on the Johannesburg Stock Exchange increased by 33 per cent over the whole of 1997. The *number of shares* traded increased by 60 per cent over the same period.

Non-resident investors remained active participants as buyers and sellers in the secondary share market in the first ten months of 1998. Notwithstanding the negative turn in investor sentiment towards emerging markets, non-residents contributed 29 per cent of the total purchases and sales of shares on the Johannesburg Stock Exchange in the first ten months of 1998. The comparable ratio for the whole of 1997 was only slightly higher at 31,9 per cent. Non-residents also increased their holdings of listed shares in South African companies by R38 billion in the first ten months of 1998 in comparison with R26,2 billion in the whole of 1997. The aversion of global investors to assets of emerging market economies obviously did not extend to the South African equities market in the second and third quarters of 1998.

The monthly *average price level of all classes of shares* increased by 32,3 per cent from December 1997 to an all-time high in May 1998, but was then sharply adjusted downwards by 38,7 per cent from May to September. In September 1998 the average value of the all-share price index was roughly equal to that of March 1994. The average price level of *banking and insurance company shares* fell by 48 per cent from May to September 1998 and that of industrial and commercial shares by 43 per cent. The decline from May to September 1998 in the prices of mining shares was less severe than in the prices of other classes of shares: the prices of gold-mining shares fell by 14,2 per cent and those of non-gold mining shares by 10,8 per cent.

Average monthly share prices



In October 1998 the average price level of all classes of shares recovered by 8 per cent. Despite this increase and the recent strengthening in the exchange rate of the rand, the value of share prices in terms of US dollars has declined, on balance, by approximately 26 per cent from December 1997 to October 1998.

As indicated in Table 13 the yields and price ratios on shares mirrored the broad trend in share prices during the first ten months of 1998. The monthly average *dividend yield* on all classes of shares increased from 2,1 per cent in May to 3,5 per cent in

Table 13. Yields and price ratios

	Dividend yield Per cent	Earnings yield* Per cent	Price-earnings ratio*
1998: Jan	2,7	7,6	13,1
Feb	2,4	6,9	14,4
Mar	2,3	6,5	15,3
Apr	2,2	5,9	16,8
May	2,1	5,9	16,9
Jun	2,3	6,8	14,7
Jul	2,4	6,8	14,7
Aug	2,8	8,2	12,2
Sep	3,5	10,2	9,8
Oct	3,3	9,6	10,4

* Excluding gold-mining shares

September, but then decreased to 3,3 per cent in October. The monthly average *earnings yield* (gold-mining shares excluded) increased likewise from 5,9 per cent in May 1998 to 10,2 per cent in September, but then declined to 9,6 per cent in October. The *price-earnings ratio* of all shares, apart from gold-mining companies, declined from 16,9 in May 1998 to 9,8 in September, before rising to 10,4 in October.

Market for derivatives

Emerging-market contagion and price volatility in the underlying domestic financial markets led to increased activity in the *formal derivatives market*. Trading volumes in *equity and interest rate futures contracts* rose by 48 per cent in the first ten months of 1998 compared with the corresponding period of 1997. The number of equity and interest rate futures and options on futures contracts traded increased from a quarterly average of 2,9 million in 1997 to an all-time high of 4,8 million in the first quarter of 1998, receding to 3,6 million and 3,8 million contracts in the second and third quarters, which were still relatively high. *Non-resident participation* in futures and options on futures contracts, measured as a percentage of open interest, also increased from 24 per cent in 1997 to 29 per cent in the first ten months of 1998.

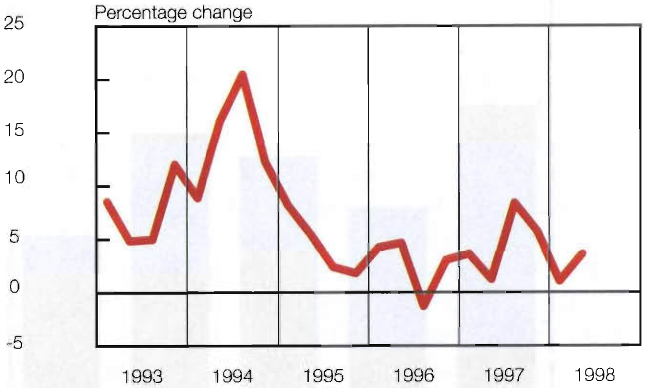
After having risen strongly in the second quarter of 1998, the trade in *equity options contracts* subsided in the third quarter and October. The number of equity options contracts traded increased from 50 450 in the first quarter of 1998 to 60 370 in the second quarter, but then declined to 38 390 in the third quarter. In October 1998, the number of equity options contracts traded declined significantly compared with the monthly average during the third quarter. In contrast to the trade in equity options contracts, the number of trades conducted in *warrants* increased rapidly from 269 million in the second quarter of 1998 to 415 million in the third quarter – an increase of 54 per cent. When reasonably stable conditions returned to the share market in October 1998, the monthly number of warrants traded fell to 97 million, compared with an average monthly number of 139 million in the third quarter.

Trading in *commodity futures contracts and options* on such contracts in the first ten months of 1998 totalled 68 749 contracts and was more than five times the number traded in the corresponding period of the previous year. The proximate cause for this rapid increase was the termination of centralised marketing arrangements for a number of agricultural commodities and the move towards an increasingly deregulated system of marketing. Trade in *maize commodity futures contracts* overwhelmingly dominated the trade in commodity futures contracts and accounted for 98 per cent of all trade transactions concluded in the first ten months of 1998.

Real-estate market

Property is an important investment asset and a store of value. In much the same way that share prices are determined by expected future profits and dividends, real-estate values depend on expected rental values. Prospects for growth in rental values appear to be bleak in South Africa as the average value per real-estate transaction increased by only 3,3 per cent in the first eight months of 1998 compared with the first eight months of 1997. The total value of real-estate transactions increased by 3,6 per cent in the first eight months of 1998 and the number of real estate transactions by 0,2 per cent.

Change in value per transaction in real-estate market



Change over four quarters in value per transaction

Public Finance

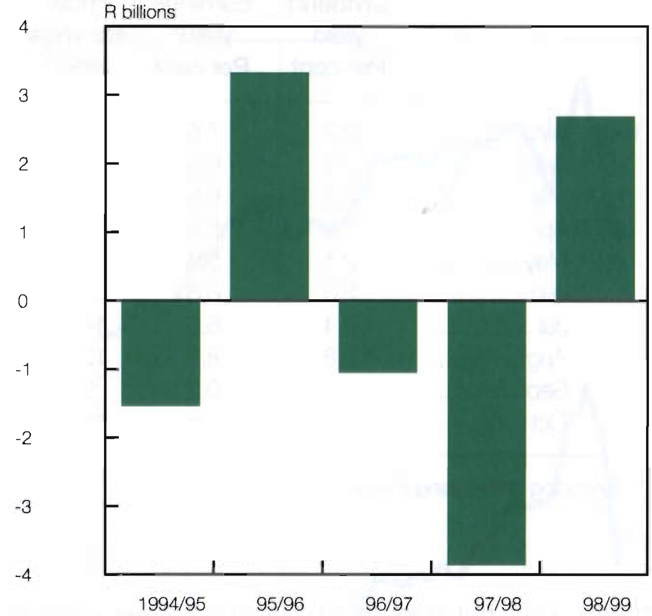
Public-sector borrowing requirement

The *public-sector borrowing requirement* (i.e. the deficit before borrowing and debt repayment of the consolidated central government, provincial governments, local authorities and non-financial public business enterprises) declined by R4,1 billion from R22,1 billion in the first half of fiscal 1997/98 to R18,0 billion in the first half of fiscal 1998/99. This lowered the public-sector borrowing requirement as a ratio of gross domestic product from 7,5 per cent in the first half of fiscal 1997/98 to 5,6 per cent in the first half of fiscal 1998/99.

The decrease in the public-sector borrowing requirement in the first half of 1998/99 could be attributed to a turnaround in the finances of the provincial governments, from a shortfall of R3,9 billion in the first half of fiscal 1997/98 to a surplus of R2,7 billion in the first half of fiscal 1998/99. However, in fiscal 1998/99 the aggregated financial balance of provincial governments changed from a surplus of R3,8 billion in the April-June quarter to a deficit of R1,1 billion in the July-September quarter. The borrowing requirement of the main budget and that of local authorities widened from the first half of fiscal 1997/98 to the first half of fiscal 1998/99.

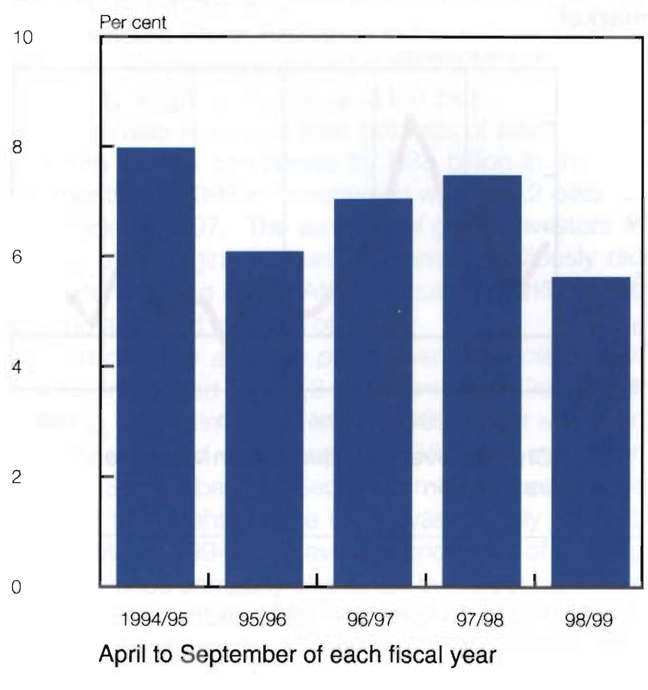
At the level of the *general government* (i.e. the total public sector excluding the non-financial business enterprises) the improvement in the borrowing requirement was the outcome of a slowdown in the growth of current and capital expenditure and a marginal strengthening of growth in revenue. The year-on-year rate of increase in current expenditure declined strongly from 8,7 per cent in the first half of fiscal 1997/98 to 2,3 per cent in the first half of fiscal 1998/99. Over the same period, the growth in capital expenditure by general government fell from 30,9 per cent to 10,7 per cent. Mainly on account of firm growth in non-tax revenue, the rate of increase in general government revenue accelerated from 8,9 per cent in the first half of fiscal 1997/98 to 9,5 per cent in the first half of fiscal 1998/99.

Deficit or surplus of provincial governments



April to September of each fiscal year

Public-sector borrowing requirement as a ratio of gross domestic product



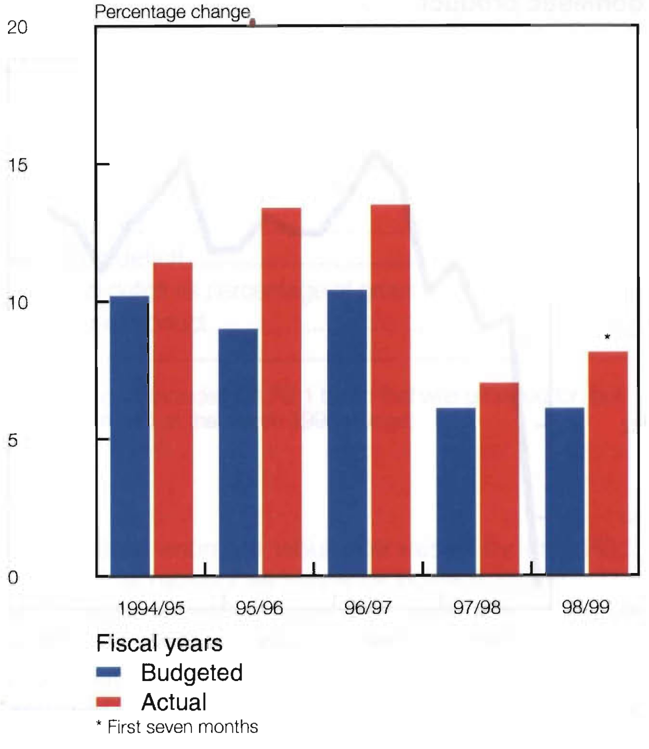
April to September of each fiscal year

Exchequer account

The fiscal accounts for the first six months of fiscal 1998/99 indicate that government will probably slightly overshoot the expenditure estimates that had been envisaged in the Budget of March 1998. However, revenue growth has also been stronger than projected in the Budget, indicating that the size of the deficit before borrowing and debt repayment relative to the gross domestic product could still be lower in fiscal 1998/99 than it was in fiscal 1997/98.

The year-on-year rate of increase in *Exchequer issues* to government departments (adjusted to reflect cash flows) in the first half of fiscal 1998/99 amounted to 8,1 per cent, which was notably higher than the budgetary provision of 6,1 per cent for the year as a whole. Reflecting government's commitment to

Budgeted and actual Exchequer issues to government departments



prudent fiscal policies, the year-on-year growth in Exchequer issues in the first half of the current fiscal year was well below the average year-on-year rate of increase of 12,2 per cent in the corresponding period of the preceding five fiscal years. As a *ratio of gross domestic product*, Exchequer issues to government departments amounted to 32,0 per cent in the first half of fiscal 1998/99. This was only fractionally lower than the 32,1 per cent recorded in the first half of fiscal 1997/98.

In October 1998, Exchequer issues increased by 7,7 per cent compared with October 1997, which brought the year-on-year rate of increase in these issues to 8,1 per cent in the *first seven months* of fiscal 1998/99. Exchequer issues for the first seven months of fiscal 1998/99 therefore equalled 59,1 per cent of the total expenditure of R201,3 billion budgeted for the year as a whole.

The year-on-year rate of increase in *Exchequer receipts* (excluding proceeds from privatisation and transfers from the Strategic Oil Fund) amounted to 8,7 per cent in the first half of fiscal 1998/99, compared with a budgeted increase of 8,9 per cent for the fiscal year as a whole and an average rate of increase of 13,6 per cent for the corresponding period of the preceding five fiscal years.

Inland revenue receipts in the first half of fiscal 1998/99 were 9,6 per cent more than in the first half of fiscal 1997/98. This means that the year-on-year growth in Inland revenue receipts in the first half of fiscal 1998/99 was 2,2 percentage points higher than the projected growth rate of 7,4 per cent for the full fiscal year. Increased efficiency in the collection of value-added tax and an expansion of the corporate tax base as a result of improved company results made noteworthy contributions to the growth in Inland revenue receipts in the first half of fiscal 1998/99. By contrast, revenue from customs and excise duties fell short of the budgeted projections in the first half of fiscal 1998/99, largely because of the implementation of tariff reductions ahead of the time scale agreed to in the Final Act of the Uruguay Round of trade negotiations.

Table 14. Increase in government revenue
Percentage change over same period of previous year

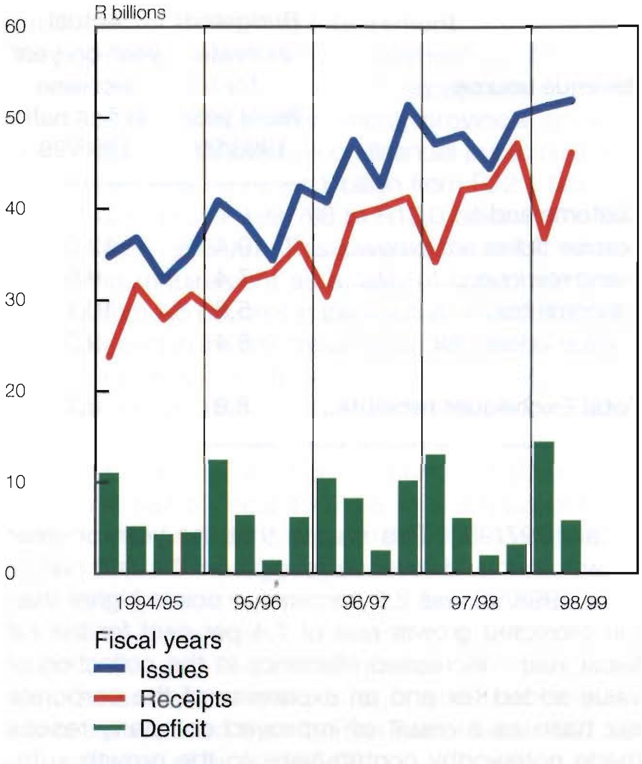
Revenue source	Budgeted increase for fiscal year 1998/99	Actual year-on-year increase in first half 1998/99
Customs and excise duties	19,4	12,0
Inland revenue	7,4	9,6
Income tax	5,6	10,1
Value-added tax	8,4	9,0
Total Exchequer receipts	**8,9**	**8,7**

As a ratio of gross domestic product, Exchequer receipts amounted to 25,7 per cent in the first six months of fiscal 1998/99 – the same as in the first half of fiscal 1997/98.

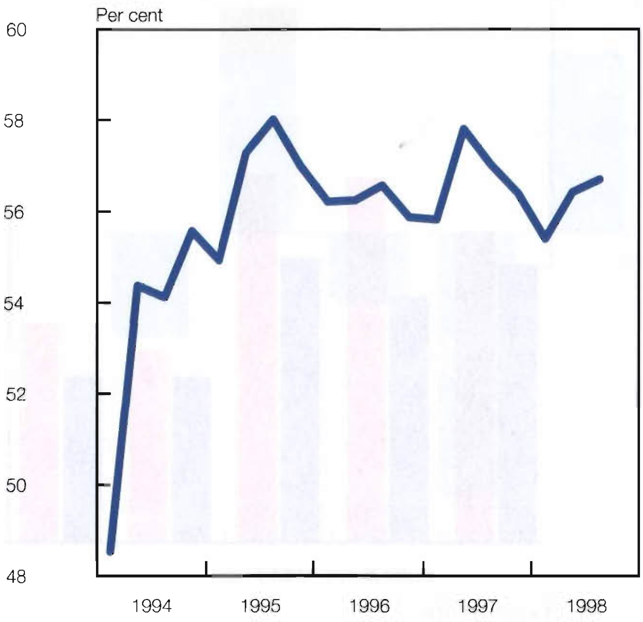
The year-on-year rate of increase in revenue collected by the government in October 1998 amounted to 14,4 per cent. This brought the year-on-year rate of increase in Exchequer receipts to 9,7 per cent in the first seven months of fiscal 1998/99. Over this period, Exchequer receipts amounted to 56,7 per cent of the total revenue of R177,6 billion budgeted for the year as a whole.

The lower-than-budgeted revenue and higher-than-budgeted expenditure in the *first half* of fiscal 1998/99 resulted in a *deficit on the Exchequer Account* before borrowing and debt repayment of R20,1 billion. This was equivalent to 6,3 per cent of gross domestic product compared, with a ratio of 6,4 per cent in the corresponding period of fiscal 1997/98, and a budgeted deficit of 3,5 per cent of gross domestic product for the fiscal year 1998/99 as a whole. For the *first seven months* of fiscal 1998/99 the deficit before borrowing and debt repayment amounted to R18,2 billion or 76,9 per cent of the deficit budgeted for the year as a whole.

Exchequer issues, receipts and deficit



Total government debt as a ratio of gross domestic product



As shown in Table 15, the deficit for the first half of fiscal 1998/99 was financed largely through the issuance of long-term government bonds and Treasury bills. Long-term government bonds were issued at an average interest rate of 15,84 per cent in the first six months of fiscal 1998/99, whereas the average rate at which short-term instruments were sold was 16,65 per cent. In both instances the budget assumptions allowed for an average interest rate of 13,0 per cent for fiscal 1998/99. Altogether, the borrowing activities of government gave rise to an increase in government debt from R336,2 billion or 55,4 per cent of gross domestic product at the end of March 1998 to R358,2 billion or 56,7 per cent of gross domestic product at the end of September 1998.

Table 15. Financing of Exchequer deficit in the first half of fiscal 1998/99

	R billions
Government bonds (including discount)	14,5
Less: Discount on government bonds	3,3
Net receipts from government bonds issued	11,2
Treasury bills	6,3
Foreign loans	-0,7
Redemption of Section 239 debt*	-0,2
Transfer from IMF accounts**	0,7
Extraordinary receipts	1,8
Increase in available cash balances	1,0
Total net financing	**20,1**

* Debt of the former Transkei, Bophuthatswana, Venda and Ciskei and self-governing states

** Transfer effected for the repayment of a loan in terms of the Compensatory and Contingency Financing Facility (CCFF) due to the International Monetary Fund

Adjustments Budget for fiscal 1998/99

The Minister of Finance noted in his Adjustments Budget, tabled in Parliament on 2 November 1998, that the global financial and economic developments of the past year had been a real test of government's commitment to the vision and objectives that were set out in the Reconstruction and Development Programme (RDP). The Minister reaffirmed that government would continue to follow the course outlined in the RDP, while recognising that this was a difficult course with no room for short cuts. In view of the changed economic outlook it was inevitable that the Budget presented in March 1998 would have to be amended to reflect the changed circumstances.

In the Adjustments Budget the Minister sought approval for additional expenditure for the fiscal year 1998/99 amounting to R5,4 billion. However, if savings and roll-overs were taken into account, the original

Table 16. Adjustments Budget estimates for 1998/99

	R billions
Original budgeted expenditure*	201,3
Plus: Additional expenditure	5,4
Total	206,7
Less: Roll-overs, savings and suspensions	2,2
Total adjusted expenditure	204,5
Total revenue	178,6
Adjusted deficit	**25,9**
Adjusted deficit as percentage of gross domestic product	3,9

* This amount includes the R2,1 billion that was provided for, but not approved, in the March 1998 Budget

expenditure estimate would be raised by only R3,2 billion to a revised estimate of R204,5 billion. The adjustment to expenditure was necessitated by the sharp rise in debt service costs, the unforeseen and unavoidable expenditure by government departments and additional transfers to provinces. As a ratio of estimated gross domestic product, estimated government expenditure would amount to 31,1 per cent in fiscal 1998/99 compared with the 31,3 per cent recorded in fiscal 1997/98.

In the Adjustments Budget, provision was also made for an upward revision of the initial estimate of revenue from R177,6 billion or 26,5 per cent of gross domestic product to R178,6 billion or 27,2 per cent of gross domestic product for fiscal 1998/99. The additional revenue came from the surrender of R350 million to the Exchequer following the closing of the Post Office Fund and from donor funding totalling R651 million.

The adjustments to the expenditure and revenue estimates resulted in a deficit before borrowing and debt repayment on the budget of the national government of R25,9 billion in fiscal 1998/99. This revised deficit is R2,2 billion higher than the deficit envisaged by the Minister of Finance in the initial budget proposals. The revised deficit for fiscal 1998/99 is equivalent to 3,9 per cent of the revised estimated gross domestic product compared with the original budgeted deficit of 3,5 per cent of gross domestic product.

The Medium Term Budget Policy Statement

Together with the Adjustments Budget the Minister of Finance also presented the revised Medium Term Budget Policy Statement to Parliament on 2 November 1998. The Minister stated that the forecasts presented in the Statement were based on government's best assessment of domestic and international economic conditions, but cautioned that the projections were subject to uncertainty and that the eventual outturn might deviate from what was projected.

The Minister emphasised that the Growth, Employment and Redistribution strategy (GEAR) was a set of policy choices that had been made to enhance growth and redistribution over the medium term and that these policy choices had not been abandoned owing to the global economic problems. On the contrary, the Minister asserted that government's commitment to reconstruction and development served as an anchor in the recent economic turmoil. Government remains committed to:

- giving priority to spending on education, health, welfare and social infrastructure;
- reducing the government deficit and debt service costs;
- halting the increase in government's wage bill;
- improving the quality and efficiency of service delivery;
- improving the ratio of capital expenditure to current expenditure; and
- maintaining sound fiscal management.

The revised Medium Term Expenditure Framework contained in the Statement indicates several shifts in spending priorities. The relative shares of spending on social services and protection services are projected to rise over the next three years, whereas spending on economic services and administration will be reduced. Social services are delivered mainly at the provincial level. The increase in spending on education, health and welfare is therefore reflected in a growing share of total spending on these services being allocated to the provinces. Spending on economic services, such as trade, industrial and agricultural services, is projected to fall as a share of total non-interest spending.

The revised allocations also incorporate the final results of the *1996 Population Census.* The changed figures for the geographical distribution of the country's population mean that some provinces will receive a smaller share of total provincial allocations than envisaged earlier. The changes in the formula for allocating funds to the provinces will be phased in over the next five years to allow provinces ample time to adjust to changes in their relative funding levels.

Growth in capital expenditure is projected to be lower than the growth in total spending. This is mainly a result of public-private sector partnerships for the provision of infrastructure, which means that significant amounts of infrastructural investment no longer appear as part of capital spending on the budget of the national government. Personnel expenditure is projected to fall slightly as a share of total expenditure over the next three years, mainly as a result of slower growth in spending on personnel in national government departments.

Table 17. Fiscal projections

	1999/ 2000	2000/ 2001	2001/ 2002
	R billions		
National Budget revenue..........	191,3	206,2	220,1
National Budget expenditure ...	216,5	229,6	245,0
Deficit before borrowing...........	25,2	23,4	24,9
Primary surplus	22,8	27,6	29,1
	Percentage of gross domestic product		
National Budget revenue..........	26,9	26,8	26,5
National Budget expenditure ...	30,5	29,9	29,5
Deficit before borrowing...........	3,5	3,0	3,0
Primary surplus	3,2	3,6	3,5

Government's commitment to the containment of growth in spending over the next three fiscal years is indicated in the accompanying table. Government remains committed to the reduction of the budget deficit to the equivalent of 3,0 per cent of gross domestic product, but intends to achieve that goal one year later than previously intended.