ANNUAL ECONOMIC REPORT 1996

INTRODUCTION

The relatively strong recovery in general economic activity from the second quarter of 1993 seemed to have lost much of its vigour from the second half of 1995. Although it is still too early to claim that the recovery has run its course and that the economy has entered, or is about to enter, a downward phase of the business cycle, there is sufficient evidence available to support the view that the recovery has lost some of its earlier momentum. This is confirmed by the downward trend in the coincident composite index of business cycle indicators from June 1995 and the slight downward, though fluctuating, movement in the leading indicator of business activity from the beginning of 1995.

The quarter-to-quarter growth in the real value added by the non-primary sectors of the economy also reached a peak in the second quarter of 1995 and began to subside progressively over the ensuing four quarters. It nevertheless still seems as if aggregate output growth exceeded its trend rate by some 0,5 percentage points in 1995. Growth at a rate persistently higher than the trend rate will usually exert pressure on productive resources and often warrants some pause in the acceleration in economic growth to make new room for sustained non-inflationary increases in overall real output.

Several other indicators also suggest that growth in the economy is slowing down. These include:

- the sharp decrease in the utilisation of production capacity in the manufacturing sector since the third quarter of 1995;

- the tight financial situation of private households and their heavy indebtedness, which allow very little scope for continued growth in real private consumption expenditure;

- the smaller additions to inventories from the second half of 1995;

- the uncertainty and sharp fluctuations in financial markets and the high growth of the money supply and bank credit extension to the private sector, which led to persistent inflationary pressures and prevented any relaxation of conservative macro-economic policies;

- the increases in production losses because of confrontational industrial relations from the beginning of 1996; and

- the weakening of capital inflows from abroad after the middle of February 1996, which could have strengthened the expansion of production in a country in which the domestic savings ratio has declined persistently from the early 1980s to the current very low levels.

The growth in economic activity and production is, however, still supported by sharp increases in agricultural production owing to favourable weather conditions experienced during the past summer. Output growth in the agricultural sector could prop-up general economic activity in the last half of 1996 because the bulk of the summer crop will be harvested during this period and good winter crops are expected. A strong export demand for base minerals and coal and further increases in productivity could help to achieve steady growth in the output of the non-gold-mining industry.

Capital productivity has increased in the current economic upturn, as is clearly reflected by a decline in the capital-output ratio. At the same time, real gross domestic fixed investment increased at an average annualised quarter-to-quarter rate of 8½ per cent. This is a much higher increase than during any other economic recovery since the beginning of the 1980s. Moreover, the strongest growth in real fixed investment took place in the private sector over a broad front of activities in the form of new investment in machinery and equipment, i.e. in capital assets used directly in the production process. A large number of new ventures were also started in manufacturing, mining, commerce, accommodation and financial services, which should enhance the export potential of the economy.

South Africa's successful transition to a new political order, reintegration in the international capital markets and favourable credit ratings improved its overall balance of payments position and made the gradual liberalisation of exchange control possible. After having been forced to maintain a surplus on the current account of the balance of payments from the middle of the 1980s, these changed circumstances allowed the current account to move into a deficit without restricting economic growth. The large demand for capital and intermediate goods could be satisfied in full by supplementing domestic production with imported goods that was financed with an inflow of capital.

In the same period, the conclusion of trade agreements, the opening of new markets and the coming into production of new manufacturing enterprises, enabled the country to increase its exports and made its production less dependent on domestic demand. In contrast to preceding economic upswings where the ratio of merchandise exports to gross domestic product eventually levelled off, it increased unabatedly in the current economic recovery. What made this achievement even more remarkable is that it occurred while the government initiated the phasing-out of export subsidies.

Although the new political order and the re-establishment of international relationships led to a large inflow of capital from other countries, it also made the South African economy more vulnerable to the vagaries of international financial markets. The net inflow of capital to the country from the middle of 1994 consisted largely of portfolio and shorter-term investments, which could easily turn around when the confidence of foreign investors becomes affected. The uncertainty in the South African foreign exchange market and the sharp depreciation of the rand from the middle of February 1996 had just this effect and resulted in large speculative capital outflows in March and April 1996. Only after the rand had depreciated to a substantially lower level and it became apparent that some stability had returned to financial markets, did these foreign investors come back hesitantly to the South African market.

The instability in the foreign exchange market and the depreciation of the rand prompted the Reserve Bank from March 1996 to sell a substantial amount of foreign exchange in the market in order to provide the required exchange for balance of payments purposes and to smooth out the adjustment process. The outflow of funds drained liquidity from the domestic money market, increased the accommodation needed by banks at the discount window to high levels and put upward pressure on money market interest rates. In an effort to restore some order in the financial markets and taking into account the monetary stimulus that could flow from the depreciation of the rand, a more restrictive monetary policy approach was adopted by the authorities.

The persistent pursuance of a conservative monetary policy stance was further necessitated by the high growth in both the money supply and credit extension by monetary institutions to the private sector. Nearly all the underlying motives for holding money were at times high. The transactions motive for holding money remained firm because of the rising demand for consumer and capital goods. The precautionary motive to keep money balances was at times strong due to uncertainties regarding economic and political developments, and a high speculative demand reflecting expected interest rate changes and expectations of major adjustments in share and bond prices contributed to a rise in deposits of the private sector and accordingly also in the money supply. The motive for holding money as a store of value was enhanced by lower levels of inflation and the high positive real rates of return on depository-type investments.

In a statistical or accounting sense, the large increase in the money supply was due to excessive credit extension by monetary institutions to the private sector. Credit was boosted on the demand side by strong consumer and investor confidence, the need for working capital to build up inventories, the generally high domestic demand for goods and services and exceptionally large increases in the turnover in financial markets. A switching from foreign to domestic financing of international trade transactions arising from the instability in the South

African foreign exchange market during the first half of 1996 contributed to the high rate of increase in credit extension. On the supply side, banks actively promoted the use of credit facilities, while a large number of retail outlets introduced in-house credit cards to promote sales.

In the financial markets, the decline in interest rates during the second half of 1995 was turned around by the uncertain conditions that developed early in 1996 in the foreign exchange market. The yield curve not only moved upwards from January 1996, but also became noticeably more inverted. Volatility in bond yields led to sharp increases in the volume of transactions in the secondary bond market, while net new issues in the primary bond market contracted. New capital raised in the primary equity market, however, rose sharply and activity in the secondary equity market was exceptionally brisk during 1995 and the first half of 1996, resulting in a sharp rise in the average price level of all classes of shares. The mortgage market remained vibrant, despite a lacklustre real estate market.

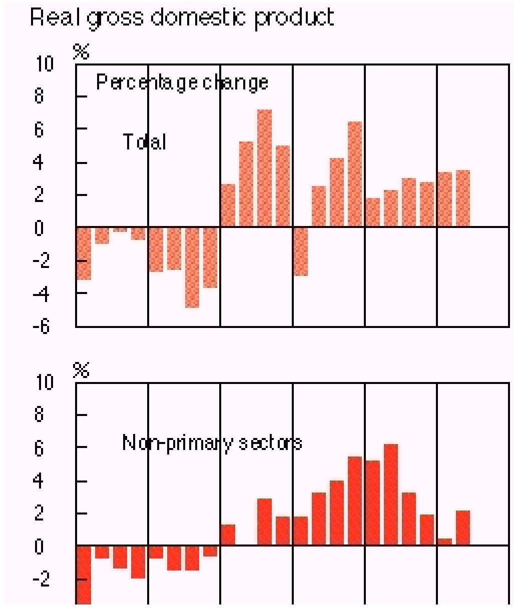
The main objective of fiscal policy in 1995 and the first half of 1996 continued to be the pursuance of fiscal discipline. The government aimed at the reduction of the deficit before borrowing and debt repayment, while reprioritising and, at the same time, restricting government expenditure and keeping the tax burden of the country unchanged. Against the background of this fiscal policy stance, government was able to reduce the public-sector borrowing requirement further in fiscal 1995/96. However, the fiscal deficit for this stage of the business cycle still seems to be too high. The more rapid decline of this deficit as advocated in the Macro-Economic Strategy of the government is therefore a welcome proposal, particularly because it could relieve some of the pressure on monetary policy in combating inflation.

Another major problem that needs to be solved urgently is the low labour-absorption capacity of the economy. In the current economic recovery, employment growth responded slowly to the increase in economic activity and then rose only very moderately. The extent of the decline in employment in preceding years was so large that no growth has been recorded in the availability of jobs over the past thirteen years. In the meantime, the economically active population continued to grow rapidly, with the result that one out of every three economically active persons is at present unemployed. The creation of more flexible labour market conditions to raise the labour-absorption capacity of the economy has therefore become crucial for the attainment of sustainable higher economic growth and the general improvement of living standards.

DOMESTIC ECONOMIC DEVELOPMENTS

Production

Growth in aggregate real gross domestic product in the current economic upswing accelerated from about 1½ per cent in 1993 to 2½ per cent in 1994 and 3½ per cent in 1995. Production growth from quarter to quarter was particularly strong in the second half of 1994 when annualised rates of 4 and 6½ per cent were recorded in the third and fourth quarter. Subsequently, the quarter-to-quarter



.output growth fluctuated between 1½ and 3 per cent in 1995 and strengthened to 3½ per cent in the first and second quarter of 1996. This brought the growth in real gross domestic product in the first half of 1996 to a level that was 3 per cent higher than in the corresponding period of the preceding year.

From the lower turning-point in real gross domestic product in the final quarter of 1992, quarter-to-quarter growth (at an annualised rate) averaged 3½ per cent. Output growth over this period was mainly concentrated in the secondary and tertiary sectors of the economy. Real value added in the primary sectors fell back gradually between the end of 1993 and the end of 1995, primarily because of shrinking output volumes in the mining sector. However, in the first half of 1996 both agriculture and non-gold mining were responsible for the somewhat stronger economic growth, while output in the secondary and tertiary sectors levelled off.

Table 1. Changes in real gross domestic product

Average annualised percentage changes in seasonally adjusted quarterly data

	Phases of the business cycle				
Sectors	Upswing from second quarter of 1983 to second quarter of 1984 (5 quarters)	Downswing from third quarter of 1984 to first quarter of 1986 (7 quarters)	Upswing from second quarter of 1986 to first quarter of 1989 (12 quarters)	Downswing from second quarter of 1989 to second quarter of 1993 (17 quarters)	Upswing from third quarter of 1993 to second quarter of 1996 (12 quarters)
Primary sectors	1	4	½	-1	1
Secondary sectors	7	-4½	3	-2½	3½
Manufacturing	8	-6	4½	-3	3½

Electricity, gas and water	5½	4½	4½	2	4
Construction	3½	-6½	½	-4	1½
Tertiary sectors	8	-1	3	½	3
Commerce	14	-7	3	-1	5
Transport and telecommunication	11	-1½	3½	-	4
Financial services	3½	2	2½	½	3
Gross domestic product	6½	-2	3	-½	3

Real economic growth over the past three calendar years was strongly influenced by wide swings in the real value added by the agricultural sector. An increase of 24 per cent in agricultural output in 1993 was halved in 1994 and followed by an absolute decline of 15 per cent in 1995 due to poor climatic conditions. The unusually high rainfall of the past summer season, which was well dispersed over a large part of the country, has raised the prospects for a strong recovery in agricultural output in 1996. In the first two quarters of 1996 the real value added by the agricultural sector was already 5 per cent higher than in the corresponding period a year earlier. As the bulk of the summer crop is to be harvested in the second half of the year and the outlook for the wheat crop is good, the main thrust to the output growth by the agricultural sector is yet to come.

The output of gold mines has been in a secular decline since the early 1970s. As a ratio of gross domestic product, the value of gold output contracted from approximately 11 per cent in the first half of the 1980s to 4½ per cent in the first half of the 1990s. This long-term decline in gold production was interrupted by a short-lived increase at an average annualised rate of about ½ per cent per year during the recession of 1989-93, but from the third quarter of 1993 the real value added by gold mines has been declining again at an annualised rate of 7½ per cent. The lower quality of ore milled and a decline in the tonnage of gold-carrying ore brought to the surface were the main reasons for this rapid decline. However, from the third quarter of 1995 the quality of ore milled has been rising owing to an improvement in industrial relations, which led to an increase in underground production relative to the use of poor quality surface material.

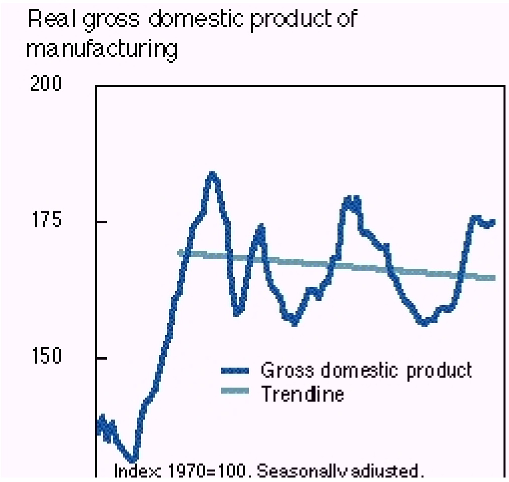
In the non-gold-mining industry real output has been rising at an annualised rate of 4 per cent since the beginning of the current economic recovery. This took production in the non-gold-mining sector in the second quarter of 1996 to 15½ per cent above the lower turning-point in output volumes in the first quarter of 1991. Strong international demand for base minerals and coal, the high domestic demand, easier labour relations and higher productivity were among the main factors responsible for the sound results of non-gold mines in recent years.

Growth in the real output of the manufacturing sector at an annualised rate averaged 3½ per cent during the current cyclical upswing owing to a high international and domestic demand and an expansion in the production capacity of manufacturers, notably in the minerals beneficiation sector. The increase in manufacturing production was particularly strong in the first three quarters of 1995, when average real output exceeded the level in the corresponding period of 1994 by 8½ per cent. The year-on-year growth rate then faltered to 5 per cent in the fourth quarter of 1995 and to only ½ per cent in the first six months of 1996. The output in the industries producing capital goods, such as the manufacturing of machinery and electrical equipment, was mainly responsible for this slower growth. An increase in the number of man-days lost on account of strikes also impacted negatively on manufacturing output in the first half of 1996.

Over the longer term, the real value added by the manufacturing sector has been fluctuating around a downward-sloping growth trend since the early 1980s (see graph). Between 1981 and the first half of 1996 the output in manufacturing declined steadily at an annualised rate of approximately ½ per cent. The reasons for the stagnation in manufacturing production, are inter alia:

- the international isolation of South Africa and the tightening of trade sanctions against the country during the 1980s;

- the disinvestment campaign of the 1980s and the outflow of capital from 1985, which effectively blocked any new foreign direct investment in South Africa and raised the cost of introducing new production technologies;



- the deterioration in the domestic savings ratio, which contributed to the low investment ratio and the expansion of manufacturing production capacity;

- the inward-looking attitude of manufacturing industries, which concentrated on meeting domestic demand rather than facing competition in export markets;

- inefficiencies in domestic production processes, which stemmed from the high levels of protection accorded to South African producers by an elaborate system of import tariffs; and

- the poor skills level of the labour force, together with persistent upward pressure on wages coming from a well-organised labour movement.

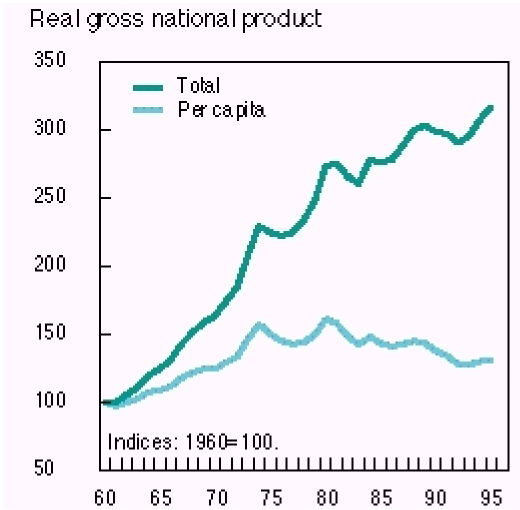
The government indicated in its Macro-Economic Strategy of 14 June 1996 that it was determined to promote manufacturing production by making the industry more export-oriented and cost competitive. Central to this strategy is the need to keep the real effective exchange rate at its current more competitive level. Along with the continued phasing-down of import tariffs by an average of one-third over five years, several so-called industrial support measures will be introduced to enhance competitiveness. Among these is an accelerated depreciation scheme that will be applicable on all new investments in manufacturing. The tax allowance programme will be applicable to qualifying plant and equipment to be acquired and put into production during the period 1 July 1996 to 30 September 1999. This incentive will be bolstered by a tax holiday for approved projects that will start operating in the three-year period from the fourth quarter of 1996 to the third quarter of 1999.

The real value added by the sector supplying electricity, gas and water rose at an annualised rate of 4 per cent from the beginning of the current recovery. Electricity supply was boosted by the extension of the electricity distribution network to areas that were not previously serviced by Eskom. The growth in the output of organisations in this sector was nonetheless low in comparison with average annualised rates that varied between 4½ and 8½ per cent in the previous three economic upswings.

In the construction sector the real value added expanded at an annualised rate of 1½ per cent in the current recovery. The modest increase in the output of the construction industry was mainly brought about by a strengthening in the demand for new buildings as well as additions and alterations to existing buildings. Additional impetus for growth in the construction sector from the development of economic, social and household infrastructure in terms of the Reconstruction and Development Programme has not yet gained momentum.

The real value added by the tertiary sectors increased briskly at an annualised rate of 3 per cent from the start of the current recovery to the fourth quarter of 1995, but then proceeded at a fairly modest pace of ½ per cent in the first quarter of 1996 and again more rapidly at 2½ per cent in the second quarter. Lower increases in the value added by the retail and motor trade were mainly to blame for the weaker growth in the services sector in the first half of 1996. The extraordinarily high level of household debt, coupled with the high debt-servicing costs and steep increases in the prices of durable household goods in the wake of the depreciation of the rand, put downward pressure on the growth in the real value added of these sectors. In contrast, real output growth in wholesale trade remained firm in the first half of 1996 owing to the buoyancy of foreign trade and sharp increases in the volume of agricultural products traded. The sector transport, storage and communication benefited as usual from a recovery in general economic activity and the real value added of this sector expanded at an annualised rate of 4 per cent since the beginning of the economic recovery. The real value added in the sector finance, real estate and business services continued to increase fairly rapidly from the start of the upswing. The growing participation of foreigners in domestic financial markets made a significant contribution to the firm output growth of these services.

The real gross national product of South Africa increased at an annualised rate of 3½ per cent since the beginning of the current economic recovery.



Not only is this rate of expansion much weaker than that of the three preceding economic upswings when annualised growth rates of between 4 and 7½ per cent were recorded, but it hardly exceeded the rate of population growth. As a result, the real gross national product per capita in the second quarter of 1996 was only 6 per cent higher than its low point in the recession of 1989-93.

Aggregate expenditure

Aggregate real gross domestic expenditure increased at an annualised rate of 5½ per cent from the beginning of the economic recovery in the middle of 1993 up to the second quarter of 1996.

This was higher than the annualised rate of increase of nearly 4 per cent in the economic upswing of 1986-89, but considerably lower than the annualised rates of increase of 13 and 8½ per cent in the preceding two upturns. An outstanding feature of the current economic recovery is the strong growth in real gross domestic fixed investment, while consumption expenditure, at constant prices, rose much more moderately than in previous periods of rapid expansion in economic activity.

Table 2. Percentage change in real gross domestic expenditure

	1993	1994	1995	1996 1st half*
Private consumption expenditure	½	3	5	3½
Consumption expenditure by general government	3	4	½	3
Gross domestic fixed investment	-3	8½	10½	6
Change in inventories (R billions)	0,5	4,7	7,7	4,3
Gross domestic expenditure	1½	6½	5½	3½

* Average annualised quarter-to-quarter growth rate.

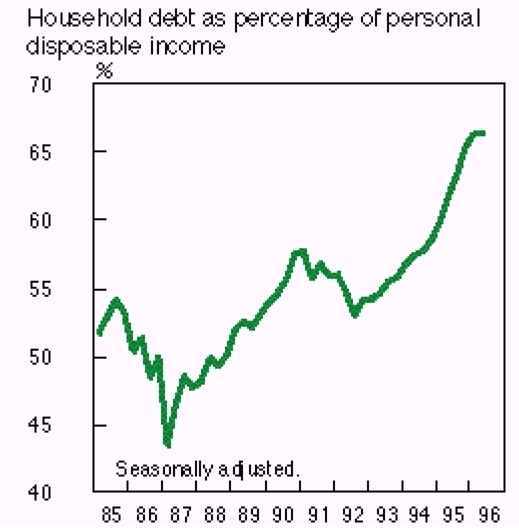
Firm growth of 6½ per cent in real gross domestic expenditure in 1994 and 5½ per cent in 1995 tapered off to a more sedate average annualised quarter-to-quarter rate of 3½ per cent in the first half of 1996. A more cautious attitude towards spending on consumer goods and services by households and considerably smaller investments in inventories contributed to the slowdown in real gross domestic expenditure in the first half of 1996. Growth in real consumption expenditure of general government accelerated in the first half of 1996, whereas real gross domestic fixed capital formation continued to rise firmly, but at a somewhat lower rate.

Private consumption expenditure

Households began to step up aggregate consumption expenditure from 1993. After having turned positive in the first quarter of this year, the annualised rate of increase from quarter to quarter in real private consumption expenditure strengthened progressively to levels varying between 4 and 6½ per cent in 1995. In the first two quarters of 1996 more moderate increases in real spending on non-durable goods and services caused the average annualised rate of increase in real private consumption expenditure to fall back to 3½ per cent. The rise in consumption expenditure was assisted by relatively firm income growth and a reduction in personal saving.

The growth in real personal disposable income accelerated from an annualised rate of 1½ per cent in the second quarter of 1995 to approximately 3½ per cent in the second quarter of 1996. Such an increase in a community with a high marginal propensity to consume will inevitably lead to a strong response in consumer spending. The rise in real personal disposable income was achieved despite further increases in the direct taxation on households, and was mainly brought about by increases in wages, higher dividend payouts by the corporate sector and, more recently, by a rise in the profits of farmers.

The growth of real personal disposable income from 1995 nevertheless generally fell short of the growth in real private consumption expenditure, signalling that households had to resort to debt financing to support their strong propensity to spend.



Accumulated household debt as a ratio of personal disposable income, increased further from a recent low of 53 per cent in the third quarter of 1992 to a new high of 66½ per cent in the first half of 1996. As a result of this increase and the relatively high level of interest rates in South Africa, gross interest payments on household debt currently absorb about 12 per cent of the annual income of households; the average household therefore has to devote almost 1½ months' income for the sole purpose of meeting its annual debt-servicing costs.

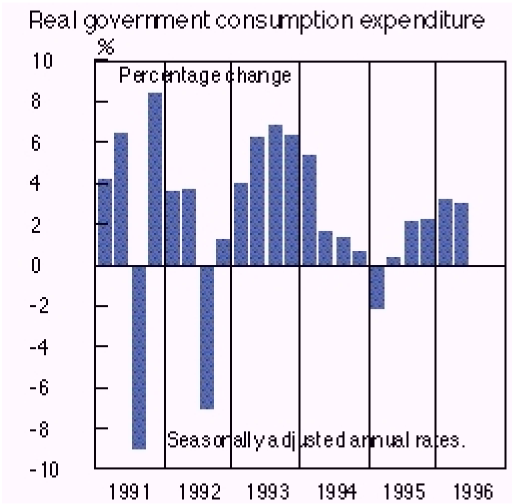
The strong preference of South African households for debt financing can partly be explained by expectations of high income growth and greater employment opportunities by many consumers in the aftermath of the political transition of 1994. This positive sentiment, coupled with the aggressive marketing of credit facilities by financial institutions and sales promotions of retail outlets, encouraged a strong preference for current expenditure. This behaviour of consumers can develop into serious financial discomfort for many households, should the expected growth in future income fail to materialise.

All the major categories of private consumption expenditure increased firmly in the current economic recovery, but more pronounced gains were registered in the spending on durable and semi-durable goods such as furniture and appliances, transport equipment and clothing and footwear. The replacement of ageing household durables, that was delayed during the recession of 1989-93, provided a strong boost for the purchases of more expensive goods. The sales of lower-priced household equipment and appliances benefited from the improved access to housing and electricity in some urban and rural areas.

Consumption expenditure by general government

Increases in real consumption expenditure by general government, which had been subdued in the second half of 1994 and the first half of 1995, subsequently became more prominent. Calculated at an annualised rate, the quarter-to-quarter growth in the real consumption outlays of general government rose from an average of less than ½ per cent in the four quarters until June 1995 to roughly 2 per cent in the second half of the year; it then strengthened further to 3 per cent in both the first and second quarter of 1996.

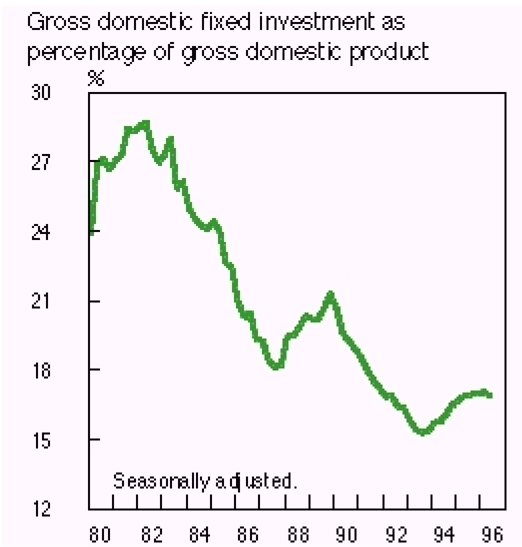
As a ratio of gross domestic product, government consumption expenditure nonetheless receded from 21½ per cent in the second quarter of 1994 to about 20 per cent in the second quarter of 1996. This decline conforms with the government's Macro-Economic Strategy aimed, *inter alia*, at a reduction in government consumption expenditure as a percentage of gross domestic product to 20 per cent in 1996 and 18 per cent in the year 2000.



The recent acceleration in the growth of real consumption expenditure by general government was the combined result of a small rise in the real remuneration of government employees and a more pronounced increase in expenditure on intermediate goods and services. Expenses incurred for the creation of the administrative capacity of the new provincial governments and the new local government structures were primarily responsible for the rapid expansion of government expenditure on goods and services of a non-capital nature.

Gross domestic fixed investment

One of the major structural weaknesses of the South African economy with serious implications for sustainable high economic growth has been the secular decline of aggregate gross domestic fixed investment relative to gross domestic product. From a peak value of nearly 28 per cent in 1982, the ratio of gross domestic fixed investment to gross domestic product contracted to a low of 15½ per cent in 1993. The more positive mood in the country in the current economic recovery, the removal of external constraints on economic growth and the encouragement of investment through tax incentives for certain approved projects inspired a wave of fixed investment activity in the period since 1993, which lifted the fixed-investment ratio to 17 per cent in the first half of 1996.



Measured at a seasonally adjusted annualised rate, real fixed investment outlays increased from quarter to quarter at an average rate of 8½ per cent since the third quarter of 1993. This was a much higher increase than during any other economic recovery since the beginning of the 1980s.

Despite this sharp increase, the net addition to South Africa's fixed capital stock in the 1990s still averaged only 1 per cent per year; this is relatively low compared with rates of 5 per cent, 6 per cent and 3 per cent recorded in the 1960s, 1970s and 1980s, respectively. The rate of increase in real gross domestic product therefore exceeded the rate of increase in total real fixed capital stock during the current economic recovery. As a consequence, the capital-output ratio of South Africa declined by 4½ per cent between 1992 and 1995, following an increase of 8 per cent in the period 1989 to 1992. The improvement in capital productivity was discernible in all the major sectors of the economy, with the exception of the mining industry. More in particular, the capital-output ratios of the electricity and transport sectors continued to decrease sharply because of the utilisation of the excess capacity created in these sectors in the early 1980s.

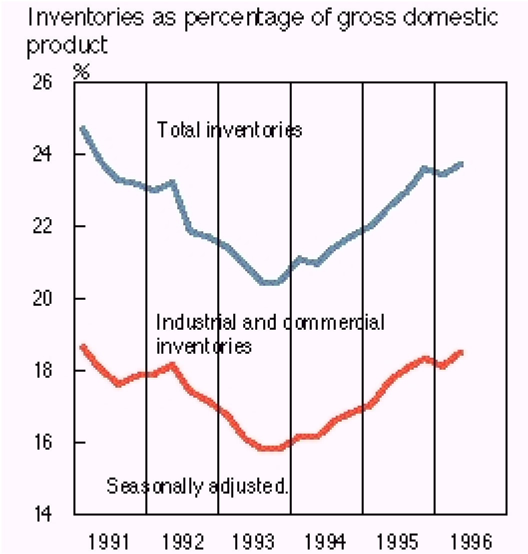
The strongest growth in real fixed investment during the economic recovery took place in the private sector, where the average annualised rate of expansion was calculated at 10½ per cent. Fixed investment by private manufacturing enterprises increased at an even higher average annualised rate of 13½ per cent from the second quarter of 1993 to the second quarter of 1996. New production capacity in the manufacturing sector was created to enhance the export potential of the economy, especially in the area of metals and minerals beneficiation, motor vehicles, basic iron and steel products and chemical products. All the other major sectors of economic activity participated in the expansion of fixed investment. Rising real farm incomes and the ageing of agricultural implements gave rise to sharp increases in the fixed capital expenditure of the agricultural sector. New ventures were started in the mining, commerce, accommodation and financial sectors, while the production capacity of existing enterprises was improved and extended. Investment in new machinery and transport equipment financed by means of leasing contracts and hire-purchase agreements also gave impetus to the growth in real investment in the financial sector.

Real fixed investment expenditure by public corporations rose significantly from the second half of 1994. Transnet was very active among these institutions and stepped up its capital-formation programme. Eskom also increased its capital expenditure on the electrification of high-density residential areas and an extension of the electricity supply network into the southern African sub-region.

In contrast to the increases in the investment of the private sector and public corporations, real capital formation by public authorities remained subdued during the current recovery and even declined, on balance, by 11½ per cent between the second quarter of 1994 and the second quarter of 1996. Apart from temporary increases in 1989 and 1993, real fixed investment spending by public authorities has now been moving downwards since 1983. As a result of this lower capital expenditure by public authorities, infrastructural investment spending as a ratio of gross domestic product fell from 8½ per cent in the 1970s to 5½ per cent in the 1980s and to 2½ per cent in the first half of the 1990s. The implementation of government's initiatives in terms of the Reconstruction and Development Programme should stop the downward drift in the relative importance of real capital formation by public authorities. One of the medium-term objectives of the Macro-Economic Strategy of the government is an expansionary public infrastructural investment programme to provide adequate and efficient services in support of industrial and regional development and to address major backlogs.

Inventory investment

Aggregate inventory investment, at constant prices, increased progressively at a more rapid rate during the early stage of the current upward phase of the business cycle and reached a peak in the second quarter of 1995.



Although net additions to stocks were still made in the next four quarters, these additions were much smaller than those during the earlier period. In the first half of 1996 the seasonally adjusted and annualised accumulation of inventories, at the prices prevailing in 1990, averaged R4,3 billion per quarter, compared with R8,8 billion per quarter in the first half of 1995. Inventory accumulation therefore made a negative contribution to economic growth in the twelve months up to June 1996.

The rise in inventory investment in the early stages of the current recovery was the result of a strong expansion in domestic manufacturing output and a rise in the volume of merchandise imports, which outpaced the demand for intermediate and final goods. Accordingly some involuntary additions to commercial and industrial inventories were experienced and the inventory-to-sales ratio in the industrial and commercial sectors rose from a lower turning-point of 44 days in the fourth quarter of 1993 to almost 50 days in the second quarter of 1996. In addition, non-gold-mining stocks increased markedly because the sustained high level of foreign demand encouraged the holding of larger inventories.

The smaller additions to inventories since the second half of 1995 were particularly evident in industrial and commercial inventories and could have been prompted by:

- the high cost of carrying inventories owing to the high level of inflation-adjusted interest rates;

- the earlier involuntary accumulation of commercial and industrial inventories and the desire to reduce stocks to more suitable levels;

- the strong export demand for South African manufactured goods, which made inroads into inventories; and

- the unexpected increase in the purchases of durable consumer goods and of capital goods in order to avoid paying the higher prices that were expected to follow the depreciation of the rand.

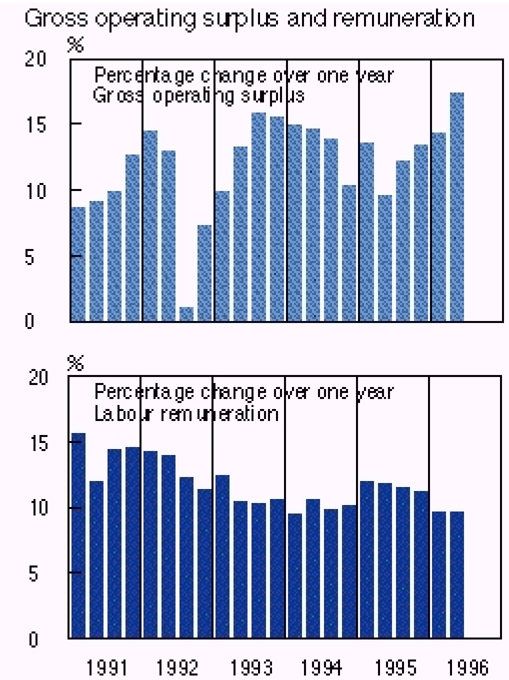
Inventory investment has always been correlated very narrowly with movements in the business cycle: total inventory investment lagged the business cycle on average by one quarter, while movements in industrial and commercial inventories more or less coincided with the business cycle. It is therefore possible that the decline in the extent of the total investment in inventories as well as the investment in industrial and commercial stocks for four consecutive quarters portends slower economic growth. This may indicate that the business cycle has reached a mature phase of the economic upswing or that it has already moved beyond that stage.

Factor income

The year-to-year changes in nominal factor income since 1993 fluctuated within a relatively narrow margin around an average rate of about 12½ per cent. In the past eighteen months, however, the year-on-year rate of increase in total nominal factor income slowed down from 13 per cent in the first half of 1995 to 11½ per cent in both the second half of 1995 and the first half of 1996. This slower increase in factor income was essentially the result of lower growth in the remuneration of employees; the rate of increase in gross operating surpluses of business enterprises accelerated somewhat over this period.

The poor labour-absorption capacity of the economy and the consequent small increase in formal-sector employment, together with the scaling-down of inflation expectations and lower wage settlements, moved the rate of change over four quarters in labour remuneration down from 12 per cent in the first half of 1995 to an average of about 9½ per cent in the first half of 1996. This slower growth in nominal salaries and wages was not concentrated in any particular activity, but was apparent in all the major sectors of the economy.

Whereas the growth in employee remuneration slowed down, the increase over one year in total nominal gross operating surpluses rose more rapidly from 11½ per cent in the first half of 1995 to 16 per cent in the first two quarters of 1996.

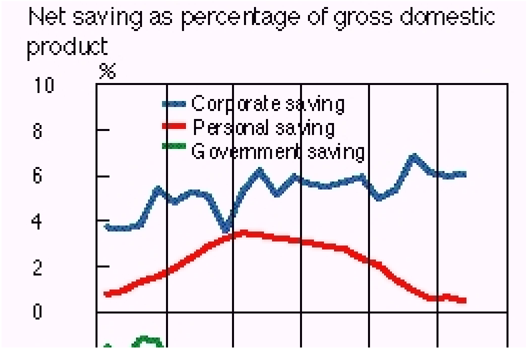


Higher increases in the operating surpluses of the agricultural and mining sectors were mainly responsible for this acceleration. Farm income benefited in the second half of 1995 from exceptionally good weather conditions and the generally upward movement of the prices of field crops, domestically as well as internationally. In the mining sector, the higher growth in the operating surpluses went hand in hand with the higher rand price of gold and more harmonious labour relations. Higher growth in the operating surpluses of the secondary and tertiary sectors was fuelled by the sustained strong growth in domestic demand and by a rise in export proceeds arising from the recent depreciation of the rand.

Domestic saving

The ratio of domestic saving to gross domestic product, which had contracted continuously from

24½ per cent in 1985 to 17 per cent in 1994, decreased further to 16½ per cent in 1995 and the first half of 1996. The further deterioration in the savings ratio was due to a decline in the saving of the private sector relative to gross domestic product, while the dissaving by general government improved somewhat.



The value of domestic saving in the eighteen months until June 1996 also fell far short of the total gross investment in the economy: 16 per cent of total gross domestic capital formation had to be financed through an inflow of foreign capital into South Africa, compared with 3 per cent in 1994.

Net dissaving by general government relative to gross domestic product reached the alarmingly high proportion of 6 per cent in 1993, but subsequently improved to 3½ per cent in the first half of 1996. This lower ratio of dissaving by general government was mainly achieved by a rapid growth in revenue, largely through direct and indirect tax revenues, rather than by cuts in recurrent expenditure. The fact that general government was still a dissaver means that a part of government's current expenditure was still financed through borrowed funds in the first half of 1996, albeit to a lesser extent than before.

The lower dissaving by general government relative to gross domestic product was offset by a decrease in the ratio of net private-sector saving to gross domestic product from 9 per cent in 1993 to 6½ per cent in the first half of 1996. The decline in the saving of the private sector relative to domestic production occurred despite a slight increase in the ratio of corporate saving to gross domestic product. However, household saving as a percentage of gross domestic product decreased sharply in the current economic recovery.

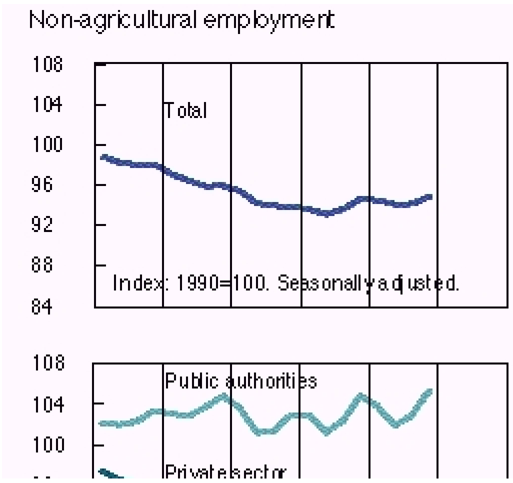
Net saving by the corporate sector re-affirmed itself as the mainstay of the national saving effort and increased as a percentage of gross domestic product from 5½ per cent in 1993 to 6 per cent in the first half of 1996. The steady improvement of gross operating surpluses relative to gross domestic product since the beginning of the economic upswing was mainly responsible for the gradual improvement in the corporate saving ratio. From the beginning of 1996 the improvement in agricultural and gold-mining income also reinforced the net saving of the corporate sector.

Household saving has recently declined to a precariously low level: as a ratio of gross domestic product, household saving was down to ½ per cent in the first half of 1996 from 3½ per cent at the beginning of the economic upturn in 1993. Over this period households have allowed their consumption expenditure to increase at a rate well in excess of the rate at which their personal disposable income has been growing. Personal saving relative to personal disposable income therefore also contracted from just over 5 per cent in 1993 to 1 per cent in the first half of 1996. Paradoxically, this strong preference for current consumption expenditure may end up in lower future consumption as the prospects for continued income growth weaken on account of the paucity of savings.

Employment

The strengthening of real output growth in the economic recovery, which had started in the middle of 1993, was not matched by equally vigorous growth in total employment. In fact, in the first two years of the economic upturn employment continued to decrease; it was only towards the middle of 1994 that it became apparent that the employment cycle had reached a lower turning-point. Although employment growth faltered somewhat in the first half of 1995, this became the first calendar year since 1989 in which an increase was registered in employment in the non-agricultural formal sectors of the economy. This increase was, however, relatively weak and came to only 0,6 per cent. The extent of the decline in employment in preceding years was such that the average level of formal-sector employment in 1995 was broadly equal to that in 1982 and 6,4 per cent below the peak in 1989.

This weak performance of employment was particularly evident in the private sector of the economy. Employment in the non-agricultural private sector declined by 11,7 per cent between 1989 and 1994, or at an average annual rate of 2,5 per cent, before it rose by 0,7 per cent in 1995. The manufacturing, trade and financial sectors were mainly responsible for this reversal in the downward tendency in employment in the private sector. At the end of 1995 the total number of job opportunities in the non-agricultural private sectors of the economy was nonetheless about 440 000 less than at its peak in the fourth quarter of 1988.



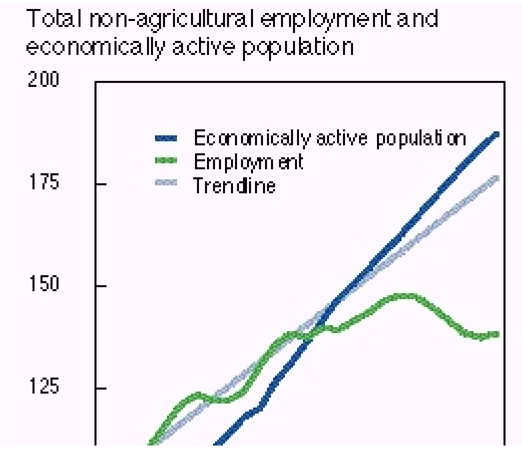
Contrary to these developments, employment by public authorities continued to show a distinct upward trend. Employment by public authorities increased at an average annual rate of 1,5 per cent from 1989 to 1992; it then fell back by 1,2 per cent in 1993, before rising again by 0,5 and 0,6 per cent over the next two years. The recent increases in public-sector employment during the second half of 1995 were mainly concentrated in provincial governments. At the end of 1995 public authorities employed about 130 000 more people than at the end of 1988, thereby offsetting somewhat the decline in private-sector employment.

The growth in overall employment during 1995 was too small to have had any impact on the number of unemployed people in the country. It is estimated that aggregate unemployment could have increased by some 280 000 workers in 1995. The margin between the economically active population and the actual level of employment in the formal non-agricultural sectors, which had begun to move apart since the early 1980s, therefore widened further in 1995.

Between 1970 and 1982 the average annual growth in formal non-agricultural employment exceeded the growth in the economically active population, indicating that the underutilisation of labour resources was being reduced steadily. Employment then stagnated from 1982 to 1995, while growth in the economically active population accelerated to an average of 2,8 per cent per year, leading to a sharp rise in unemployment. If employment growth had been sustained at the average rate recorded between 1970 and 1982, the gap between employment and the size of the labour force could have been reduced by 2,1 million people in 1995.

The 1994 October Household Survey of the Central Statistical Service reported the total number of unemployed at 4,7 million people, which is equal to 32,6 per cent of the economically active population. A tentative extrapolation of unemployment totals indicates that the number of unemployed could have grown to approximately 5 million people at the end of 1995, yielding an unemployment rate of about one out of every three economically active people. A large number of the unemployed was relatively young, while about two thirds had been out of work for more than a year at the time of the survey; this confirms that a major part of the unemployment must be attributed to structural deficiencies in the job-creating capacity of the economy.

The labour-absorption capacity of the South African economy was impeded during most of the 1980s and the early 1990s by slow economic growth and the inadequate creation of production capacity in the domestic economy. This could to a large extent be related to the imposition and tightening of sanctions against the country and the outward movement of capital from 1985 to 1993, which seriously eroded the growth in productive investment.



The removal of these growth-inhibiting factors nevertheless did not strengthen the labour-absorption capacity enough to reduce unemployment, probably because of the inflexibility of existing labour market institutions. In many countries it has been found that steps taken to provide workers with greater job security, often tend to undermine the labour-absorption capacity of the economy. Rather than being burdened by a multitude of regulations in respect of employment conditions, employers refrain from increasing the size of their workforce and prefer to switch to capital-intensive methods of production.

In their report released recently, the Commission to Investigate the Development of a Comprehensive Labour Market Policy recognised the need for reforms in the labour market to promote flexibility that will enhance the labour-absorption capacity of the economy. The Commission held the view, however, that labour market reform on its own would not generate the required growth in employment. Strong labour absorption would also require the design of macro-economic, industrial and trade policies to promote employment creation. The Commission also argued that the objective of stronger employment growth was more likely to be achieved when labour market policies and macro-economic policies were co-ordinated by means of a national accord involving all the major interest groups in the economy. These views are broadly in agreement with the Macro-Economic Strategy of the government announced on

14 June 1996.

In addition, the Commission admitted that wage levels in some sectors might discourage employment growth, but it was also convinced that low wage levels were a prime source of poverty in the country. To strike a balance between the need for faster employment creation and job security, the Commission proposed mechanisms for minimum wage-setting with the aim of extending minimum wage protection to all sectors of the economy but which will be sensitive to differences between regions and sectors. The Commission further recommended a move in the direction of greater flexibility by granting the Minister of Labour more discretion in deciding whether or not to extend bargaining council agreements to non-participating parties. Other measures to bolster flexibility could include reduced minimum wage schedules for young trainees and increased incentives for more shifts and job-sharing.

Labour costs and productivity

The downward rigidity of nominal wage changes was an important reason for the steep decline in employment during the early 1990s. The inflexibility of wage formation developed over a long period of high inflation, and wage settlements adjusted slowly to lower rates of inflation. The increase in the nominal remuneration per worker in the non-agricultural sectors of the economy receded only gradually from a high point of 18,4 per cent in 1989 to 15,2 per cent in 1992, before declining more markedly to 10,5 per cent in 1993. Somewhat more generous wage adjustments in the year of the general election caused the pace of wage growth to accelerate again to 12,0 per cent in 1994; it then slowed down to 9,5 per cent in 1995. Recent quarterly figures, however, point to a more rapid growth in nominal wages per worker in both the private and public sector.

A unique feature of South Africa's labour market during the first half of the 1990s was that the increase in nominal remuneration per worker exceeded the rise in output prices, in spite of the high and growing unemployment in the country. Real remuneration per worker (i.e. nominal remuneration per worker deflated by the price deflator for the non-agricultural gross domestic product) increased in every calendar year since 1987, except in 1993 when it declined fractionally by 0,3 per cent. The average annual rate of increase in the real remuneration per worker was equal to 1,3 per cent between 1989 and 1995. Unlike real wage growth in the public sector, the growth in real remuneration per worker in the private sector increased steadily over this period.

Table 3. Changes in labour costs and productivity in the non-agricultural sectors

Per cent

	Remuneration per worker			Unit labour costs	
	Nominal	Real	Productivity	Nominal	Real
1990	17,3	0,4	0,3	17,3	0,1
1991	16,1	1,5	0,4	15,7	1,2
1992	15,2	1,7	1,2	13,9	0,5
1993	10,5	-0,3	2,8	7,4	-3,1
1994	12,0	3,3	2,8	9,1	0,6
1995	9,5	0,9	3,2	6,1	-2,2

Real wage growth usually implies a shift in the distribution of income in favour of labour and away from operating surpluses if there is no accompanying growth in labour productivity.

Labour productivity growth was, however, also relatively firm during the first half of the 1990s. From 1989 to 1995 the average annual rate of increase in labour productivity in the non-agricultural sectors amounted to 1,7 per cent, which was 0,4 percentage points higher than the growth in the real remuneration per worker. The rate of increase in the real output per worker even reached 3,2 per cent in 1995, which was higher than any other rate recorded in the calendar years since 1984. Labour productivity growth in the manufacturing sector was particularly strong at 6,8 per cent in 1995. Despite this strong growth in productivity, the share of labour in the value of aggregate output still increased from 58,3 per cent in 1989 to 61,5 per cent in 1992, and only then moved back to 60,0 per cent in 1995.

The moderation in the rate of increase in the nominal remuneration per worker and the relatively rapid growth in labour productivity led to a decline in the increase in nominal unit labour costs from 17,3 per cent in 1990 to 6,1 per cent in 1995. This, of course, made a significant contribution towards the reduction of inflation in recent years. Welcome as these developments might have been, South Africa's productivity growth and changes in manufacturing labour costs still compare less than satisfactorily with those of its main trading partner countries. The lower labour productivity growth and higher rate of increase in unit labour costs in manufacturing in South Africa relative to the country's main trading partners imply a persistent weakening of the competitiveness of the South African manufacturing industry.

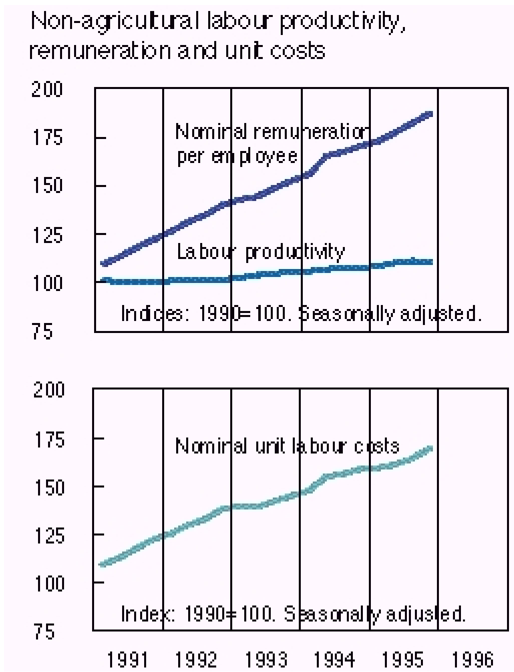


Table 4. International comparison of average growth in nominal unit labour costs and labour productivity in manufacturing, 1970-1994

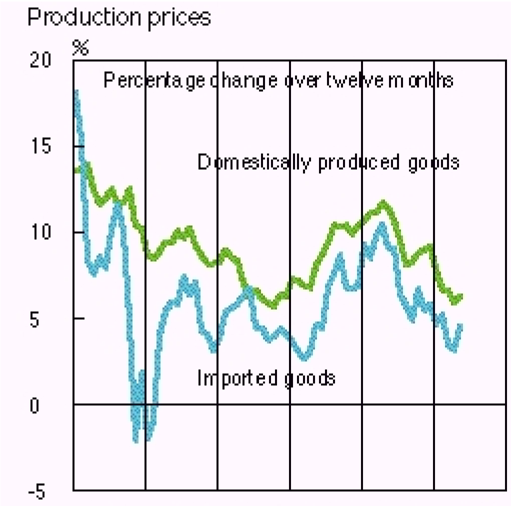
	Unit labour costs	Labour productivity
Canada	5,0	2,4
France	6,1	3,1
Germany	4,0	2,2
Italy	8,9	4,4
South Africa	12,4	1,4

United Kingdom	8,6	3,1
United States	3,8	2,4 [1]

1) For the period 1977-1994.

The South African government is fully aware of the need to ensure and strengthen the competitiveness of domestic producers. In the Macro-Economic Strategy of the government recognition is given to the need to shift economic growth to a higher level by means of a transformation towards a competitive outward-oriented economy. The danger of a wage-price spiral is seen as a threat to the successful implementation of such a strategy. The strategy accordingly calls for the moderation of nominal wage demands to help contain inflationary pressures. A further element of the strategy is the promotion of productivity improvements, which should also serve as a benchmark for wage settlements.

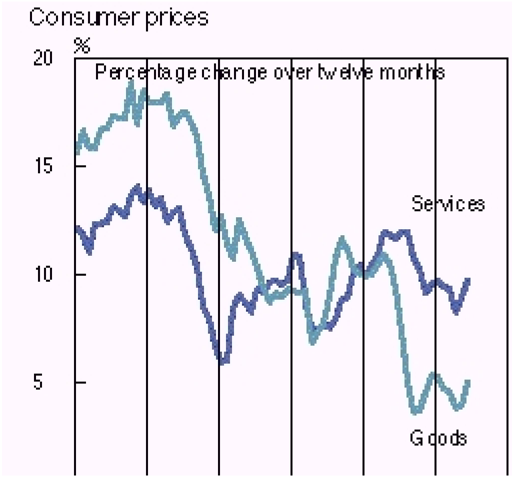
These sentiments are echoed in the report of the Labour Market Commission. The Commission argues that labour market processes must not intensify upward pressures on unit labour costs which would undermine efforts to penetrate the markets of other countries and efforts of import-competing industries to compete effectively in the domestic market.



There is a strong likelihood that a further acceleration in these prices could take place and that this might spill over into higher increases in the production prices of domestically produced goods and ultimately into higher increases in the prices of consumer goods and services. The challenge for the authorities is to prevent the price-raising effects of the depreciation of the rand from turning into successive rounds of rising costs and prices.

After having declined from a peak of 11,7 per cent in April 1995 to 5,9 per cent in April 1996, the rate of increase over periods of twelve months in the prices of domestically produced goods rose again to 6,5 per cent in June 1996. Apart from the increased competition from foreign suppliers, the increase in the prices of domestically produced goods was constrained by relatively moderate rises in nominal unit labour costs and some fortuitous developments in the prices of processed and unprocessed food.

Measured over periods of twelve months, the increase in the overall consumer price index receded from a peak of 11,0 per cent in April 1995 to 5,5 per cent in April 1996, before moving higher again to 6,9 per cent in June. The rate of increase in the prices of consumer goods started to subside even earlier from 11,6 per cent in September 1994 and fell much more abruptly to 3,8 per cent in April; in the ensuing two months it rose again to 5,0 per cent in June. In addition to the price-moderating effects of increased foreign competition and lower wage settlements domestically, slower increases in food prices were an important factor in containing the growth in the prices of consumer goods.



The twelve-month rate of increase in the prices of food and non-alcoholic beverages dropped from 21,4 per cent in September 1994 to 2,7 per cent in June 1996.

The prices of consumer services responded less impressively than the prices of consumer goods to the counter-inflationary forces at work in the domestic economy. The twelve-month rate of increase in the prices of consumer services slowed only modestly from a peak of 11,9 per cent in April 1995 to 8,2 per cent in April 1996, largely because of a continued high growth in the prices of housing services. This rate of increase in the price index of consumer services then accelerated to 9,7 per cent in June 1996, mainly on account of a rise in home mortgage rates.

Underlying inflation (defined as the change over periods of twelve months in the overall consumer price index excluding the prices of food and non-alcoholic beverages, home owners' costs and value-added tax rates) also slowed down over the past year, but to a lesser extent than the overall consumer price inflation. From a recent high point of 9,2 per cent in May 1995, underlying inflation decelerated by 2,6 percentage points to 6,6 per cent in April 1996; the corresponding decline in overall consumer price inflation was 5,3 percentage points. In the next two months the underlying inflation rate also rose more moderately than the overall consumer price index to a twelve-month rate of 7,3 per cent in June 1996.

FOREIGN TRADE AND PAYMENTS

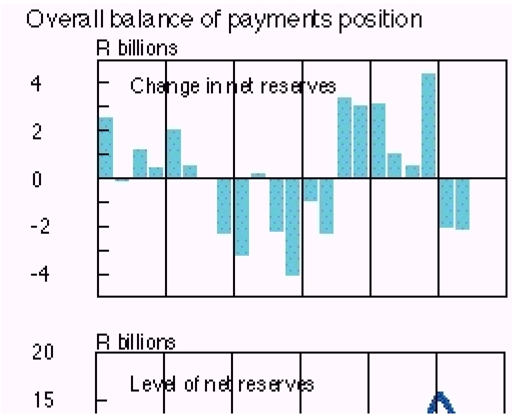
Overall balance of payments position

South Africa's reintegration in the international capital markets, the expansion of its international financial relations and its re-acceptance in various multinational forums after the election of the Government of National Unity (see Annual Economic Report of 1995), augured well for an improvement of the overall balance of payments position. The net gold and other foreign reserves of the country, which had declined by R12,4 billion from the end of 1992 to June 1994, recouped all previous losses and rose by no less than R15,4 billion during the eighteen-month period ended December 1995.

This turnaround in the overall balance of payments position was the result of a large net inflow of capital not related to reserves of R30,8 billion from the middle of 1994 to the end of 1995; in total, capital to the amount of R51,7 billion left the country in the preceding period from the beginning of 1985. At the same time, as could be expected of a relatively open economy in an advanced stage of the upswing in economic activity, the balance of payments on current account deteriorated considerably. Mainly as a result of the continued sharp increase in the value of merchandise imports, a contraction in the proceeds from net gold exports and a higher level of net service and transfer payments to non-residents, which more than offset the rise in the level of merchandise exports, the current account deficit weakened to R12,7 billion in 1995. This was substantially higher than the deficit of R2,2 billion registered in 1994. As a ratio of gross domestic product, the deficit on current account amounted to 2½ per cent in 1995.

From the middle of February 1996, however, South Africa had first-hand experience of the risks involved in relying on foreign capital to supplement domestic saving to attain higher economic growth. Unfounded rumours and uncertainties about the removal of capital controls and the future policy stance of the government, changed the perceptions of international investors and triggered an outflow of portfolio and short-term capital. The total net inflow of capital accordingly contracted to a mere R234 million in the first quarter of 1996, before increasing again to R2,5 billion in the second quarter when the instability in the financial markets began to subside from May 1996. The deficit on the current account remained high at R6,9 billion in the first half of 1996, with the result that the net gold and other foreign reserves declined by R4,2 billion during this period.

Taken at a seasonally adjusted and annualised rate, the deficit on the current account came to R13,4 billion in the first half of 1996, or to just more than 2½ per cent of gross domestic product.



The continued high deficit in the first six months of 1996 was related to a further substantial growth in the value of merchandise imports and a steadfast increase in net service and transfer payments to non-residents. These developments were countered to some extent by a marked higher value of merchandise exports and a somewhat better performance of net gold exports.

Table 5. Balance of payments on current account

Seasonally adjusted and annualised rates

R billions

	1995				1996	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr

Merchandise exports	81,4	79,0	81,2	82,4	88,3	92,3
Net gold exports	20,0	19,3	23,3	18,0	21,2	20,8
Merchandise imports	-94,5	-97,7	-101,4	-100,2	-103,6	-113,7
Net service and transfer payments	-15,6	-15,4	-15,3	-15,2	-16,3	-15,8
Balance on current account	**-8,7**	**-14,8**	**-12,2**	**-15,0**	**-10,4**	**-16,4**

Despite the weaker overall balance of payments position in the first half of 1996, the level of the net gold and other foreign reserves at the end of June 1996 was just slightly lower than its previous peak in August 1992. The underlying strength of the balance of payments created the opportunity to proceed with the gradual liberalisation of exchange control, which had gained momentum with the termination of the dual exchange rate system on 13 March 1995. The first initiative in relaxing exchange control on residents was the announcement on 13 July 1995 that insurance companies, pension funds and unit trusts would be allowed to undertake foreign investments by way of swap arrangements with foreign investors that provided for the exchange of these institutions' existing asset portfolios against foreign assets for up to 5 per cent of their total assets. At the same time, it was announced that the Reserve Bank would in future only provide forward cover to authorised dealers against documentary evidence of foreign financing transactions. This was followed on 23 January 1996 by an extension of the asset swap dispensation, permitting institutional investors to acquire up to 10 per cent of a government Euro-sterling issue of £ 100 million launched on that day.

When it became apparent that the financial markets had become more stable, the authorities announced a further package of exchange control liberalisation measures on 14 June 1996, including:

- more flexibility in allowing direct investment in countries outside the Common Monetary Area;

- an increase in the limit applicable to the procurement of foreign assets by insurance companies, pension funds and unit trusts by way of asset swaps from 5 to 10 per cent of their total assets;

- the authorisation of investments of institutional investors directly abroad up to 3 per cent of the net inflow of funds to these institutions during 1995, but subject to the overall limit of 10 per cent of total assets;

- the doubling of the local borrowing limit of foreign-controlled South African organisations from 50 to 100 per cent of non-residents shareholders' equity;

- the approval of the offsetting of costs of imports against the proceeds of exports of entities that export to and import from abroad, provided that set-off transactions take place within a period of 30 days; and

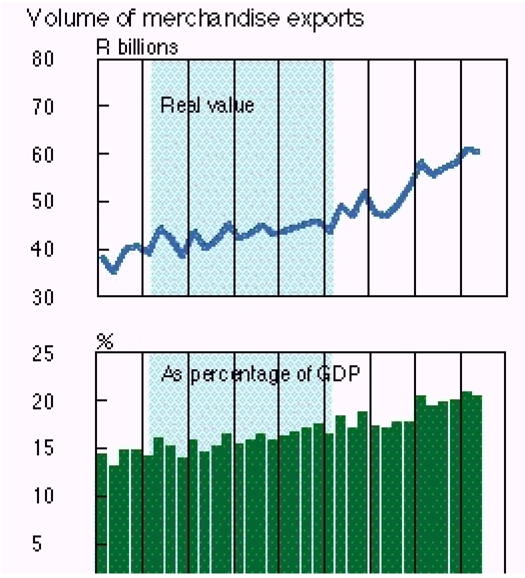
- upward adjustments in exchange control limits and measures designed to effect administrative exchange reform.

Merchandise exports

The value of merchandise exports, which had increased at an average annual rate of 15 per cent in 1993 and 1994, advanced further by 24½ per cent in 1995 and 12½ per cent in the first half of 1996 compared with the corresponding period in the preceding year. This more rapid growth in the value of exports could be attributed to sharp increases in both the volume and prices of exported goods. Despite an increase in the nominal exchange rate of the rand and a downward trend in international commodity prices during 1995, the average export price in that year was still 8 per cent above the average in 1994. This was mainly due to the statistical carry-over to 1995 of the sharp rise in export prices during 1994. In the first half of 1996 the depreciation of the rand caused export prices to rise to 5½ per cent above the level in the corresponding period of the preceding year.

After having increased at an average annual rate of 4½ per cent in 1993 and 1994, the volume of merchandise exports rose by no less than 16 per cent in 1995 and 7 per cent in the first half of 1996 compared with the first half of the preceding year. This growth outstripped the nearly 9 per cent growth in world trade, with a consequent increase in South Africa's share in the international trade of goods. Moreover, the volume of merchandise exports as a ratio of gross domestic product increased unabatedly during the current economic recovery; during previous upswings this ratio eventually either declined or levelled off. The shift from exports to domestic sales, that has been a characteristic of the South African economy in past upturns, therefore occurred to a lesser degree in the current economic upswing, inter alia because of a greater awareness among exporters of the need to maintain hard-earned foreign markets and less capacity constraints in export sectors than in previous periods of recovery.

What made this achievement even more remarkable is the fact that it occurred during a period in which government initiated a process to terminate the General Export Incentive Scheme.



In April 1995 government made the benefits arising from the scheme taxable, reduced the number of export categories eligible for the subsidy and cut the level of the subsidy. This was followed in March 1996 by an announcement that the phasing-out of this export subsidy would be accelerated, and in April and July 1996 by cuts in the subsidies applicable to manufactured and material-intensive products. These reductions in export subsidies will be replaced by the implementation of new and the reinforcement of existing supply-side measures.

Despite these changes, exports continued to grow sharply. The good performance of the physical quantity of exported goods could probably be attributed to:

- the conclusion of various new multilateral and bilateral trade agreements;

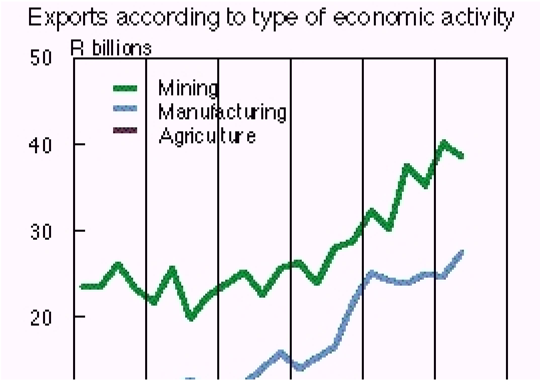
- the opening-up of new markets not previously available to South Africa; and

- the coming into production of certain manufacturing enterprises specifically developed for the export market.

South Africa has achieved considerable success in the 1990s in export promotion and in making its production less dependent on domestic demand. As a ratio of real gross domestic product, the volume of merchandise exports increased sharply and fairly consistently from about 14 per cent in 1988 to nearly 20 per cent in 1995; in the 1980s this ratio averaged 12½ per cent. The assistance received by exporters under the General Export Incentive Scheme was to a large extent responsible for this rise in the relative importance of export goods. Relative stability in the real exchange rate of the rand was perhaps another important factor that contributed to the good performance of exports.

An analysis of exports according to main type of economic activity demonstrates that the higher value of merchandise exports was mainly the result of increases in the exports of the mining and manufacturing sectors. Adverse climatic conditions during 1994 caused the exports of agricultural products to move downwards during 1995. From the beginning of 1996, however, agricultural exports picked up again after the exceptionally favourable circumstances that had been experienced in the summer rainfall area.

The main contribution to the relatively high export growth in 1995 and 1996 was made by the exports of mining products (excluding gold). Owing to the high international demand for South African commodities, the value of non-gold-mining products increased sharply from the middle of 1994. As a ratio of total exports, these exports rose from 39 per cent in the second quarter of 1994 to 42 per cent in the second quarter of 1996.



Significant increases were recorded especially in the exports of coal, ferrochrome and nickel.

The exports of manufactured goods, on the other hand, fluctuated around a more or less horizontal level during 1995. Higher exports of chemical products and machinery and electrical equipment were offset by a decrease in the exports of paper products and transport equipment. Mainly because of the sharp depreciation in the external value of the rand, the value of manufactured goods exported started to rise rapidly again in the first half of 1996.

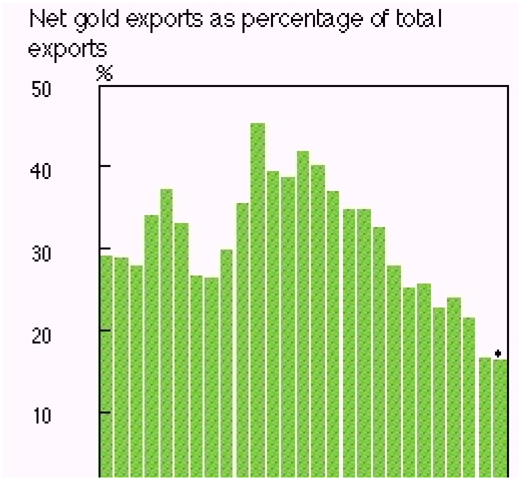
Net gold exports

The volume of net gold exports contracted markedly in 1995. A decline of 11 per cent in the physical quantity of net gold exports in 1994 was followed by a further decrease of almost 14 per cent in 1995. This sizeable decline in the volume of net gold exports was brought about by a drop of almost 10 per cent to 520 tons in the country's gold output, related to a decrease in the quality of gold-bearing ore. In addition, the throughput of ore also decreased because of ongoing poor labour productivity and the closing-down of certain mining operations.

Mainly due to the contraction in South Africa's production, the total world supply of gold decreased in 1995. This decline in gold production was offset by net official sales of gold on the market that were more than twice as large as in the preceding year, as well as by hedging and forward selling transactions by a number of international mining companies. The price of gold on the London market was therefore characterised not only by the smallest year-on-year movement, but also by the greatest stability since the termination of the London Gold Pool in March 1968. In view of the steady performance of the rand against the US dollar, the average monthly rand price of gold per fine ounce rose from a low of R1 340 (US$379) in January 1995 to R1 419 ($387) in December 1995; for calendar 1995 as a whole, the average rand price per fine ounce equalled R1 393, against R1 363 in 1994.

The weakening in the external value of the rand led to a sharp increase in the price of gold to R1 715 per fine ounce in May 1996, before falling again to R1 677 in June. For the first half of 1996 the average price of gold came to R1 596 ($395) per fine ounce. This higher price, together with an increase in the physical quantity of gold exports, was responsible for a rise in the value of net gold exports from a seasonally adjusted and annualised value of R18,0 billion in the fourth quarter of 1995 to R20,8 billion in the second quarter of 1996.

The relative share of gold in South Africa's exports of goods has contracted substantially since the beginning of the 1980s.



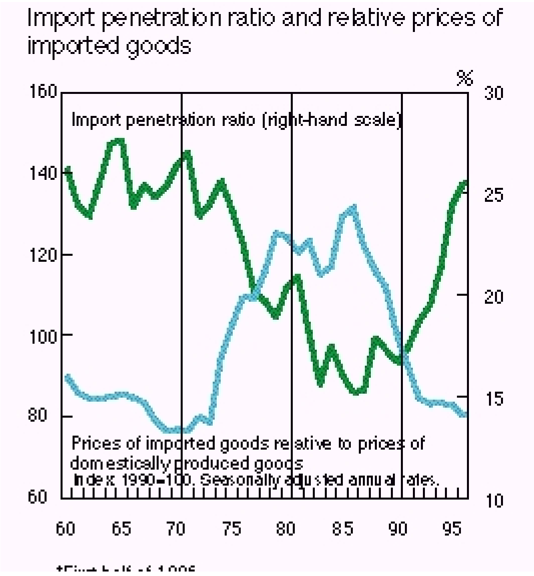
Whereas gold on average accounted for 41 per cent of the country's export of goods in the first five years of the 1980s, this share receded to only 23½ per cent in the first five years of the 1990s and to 16½ per cent in the eighteen months up to June 1996. This partly reflected a reduction in the volume of gold production because of factors such as the mining of lower gold-bearing ore, the closure of some gold mines and more labour unrest. In addition, the volume of South Africa's other exports, as described in some detail above, also increased sharply. The greater diversity in South Africa's exports made the country less dependent on the capricious behaviour of the price of one product in international markets.

Merchandise imports

The exceptionally strong cyclical upswing in the value of merchandise imports, which has been a characteristic of the economic recovery from the middle of 1993, continued throughout 1995 and the first half of 1996. Following increases of 15½ per cent in 1993 and 27½ per cent in 1994, the value of merchandise imports rose by no less than 29 per cent in 1995. In the first half of 1996 the rate of increase in the value of imported goods slowed down somewhat to 13 per cent above the level in the corresponding period of the preceding year. Increases in the imports of capital and intermediate goods were primarily responsible for the rapid rise in imports in the eighteen months up to June 1996. More particularly, sharp increases were recorded in the imports of machinery and electrical equipment and transport goods.

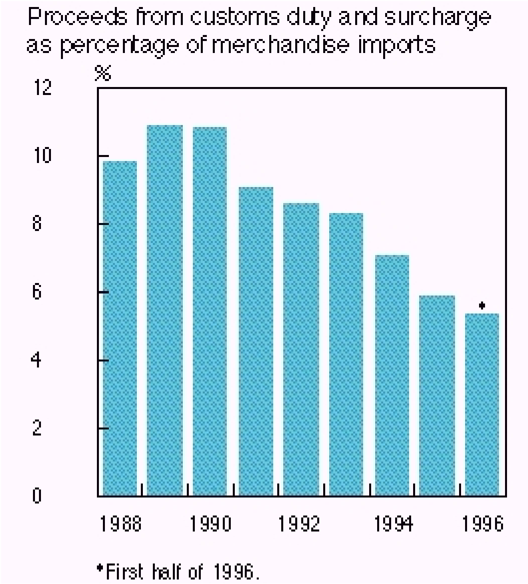
The steep upward movement in the value of imports was closely related to the country's relatively high marginal propensity to import. Increases in real domestic expenditure normally result in rapid increases in the volume of merchandise imports, especially if fixed capital formation and inventories are mainly responsible for the increase. During the current economic upswing the volume of imported goods rose by 2,8 percentage points for every one percentage point increase in real domestic expenditure; this is marginally lower than the average ratio of 3,1 percentage points recorded during the previous upward phase in 1986-89.

As a consequence, South Africa's import penetration ratio (i.e. the ratio of imported goods at constant prices to real gross domestic expenditure) increased steadily from 21½ per cent in 1994 to 24½ per cent in 1995 and 25½ per cent in the first half of 1996. This ratio, however, also increased during the economic downturn of 1989-93. The increase in economic activities is therefore not the only explanation for the upward movement in the import penetration ratio. Two other factors probably contributed to this development. Firstly, as is evident from the graph in which changes in the import penetration ratio are compared with the relative prices of imported goods to domestically produced goods, there is an inverse



relationship between changes in these two aggregates: an increase in relative prices of imported goods is followed with a lag by a decline in the import penetration ratio, while a decline in relative prices of imported goods is followed with a lag by an increase in the import penetration ratio. The sharp decrease in relative prices of imported goods to domestically produced goods since the late 1980s therefore probably contributed to the rise in the import penetration ratio.

Secondly, the trade reform initiated in the country to open up the economy more to international competition, also led to an increase in the import penetration ratio. The competitiveness of imported goods has already been improved from the early 1990s. This is demonstrated by the consistent decline in the ratio of revenue collected from customs duty and the surcharge on certain imports to the value of merchandise imports from nearly 11 per cent in 1989 to below 6 per cent in 1995, without any significant changes in the composition of imports. This ratio, of course, also does not reflect the effect that the abolition of quantitative and other more direct controls could have had on imports. In 1994 South Africa embarked on a comprehensive trade reform under the auspices of the Uruguay Round and World Trade Organisation, which had an effect on the higher import penetration ratio.



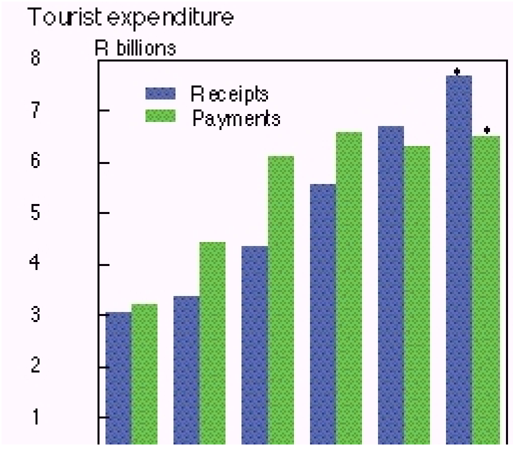
This trade reform provided, inter alia, for a gradual reduction of ad valorem duties by an average of one-third over five years; a simplified set of protective rates; a replacement of all remaining quantitative import restrictions and formula duties with ad valorem duties; and a standardisation of tariff rates in six categories.

A rise in import prices contributed to the higher value of merchandise imports. Having increased by slightly more than 8 per cent in 1994, import prices rose by 7½ per cent in 1995 and a relatively modest 3½ per cent in the first half of 1996 compared with the corresponding period in the preceding year despite the sharp decline in the external value of the rand.

Net service and transfer payments to non-residents

Net service and transfer payments to non-residents, which had increased unabatedly from R10,7 billion in 1991 to R13,6 billion in 1994, rose further to R15,4 billion in 1995 and to a seasonally adjusted and annualised rate of R16,0 billion in the first half of 1996. As a ratio of gross domestic product, net service and transfer payments to non-residents amounted to 3,2 per cent in 1995; significantly lower than the peak of 5,9 per cent recorded in 1986.

Service payments rose more rapidly than service receipts in transactions with non-residents during the eighteen-month period ended June 1996, largely on account of higher freight and insurance payments stemming from the higher value of merchandise imports.



In addition, interest and dividend payments on foreign loan and equity capital increased, reflecting a rise in South Africa's foreign debt and increases in the profits of domestic organisations. Nonetheless, total interest and dividend payments as a ratio of total exports remained virtually unchanged at almost 9 per cent in the eighteen months to June 1996.

One of the interesting developments in the so-called invisibles account of the balance of payments was the switch from a negative to a positive balance in the tourist account with non-residents during the period under review. A substantial rise in the number of tourists visiting South Africa (especially from outside Africa) caused net foreign travel expenditure of R990 million in 1994 to change to net receipts from the tourist industry of R975 million in the eighteen months ended June 1996. Tourism has been targeted by government as one of the strategic sectors to create growth and employment. In a White Paper on tourism released at the end of June 1996 it was indicated that this sector employs about 480 000 people and contributed about 4 per cent to gross domestic product - low by international standards. In order to achieve the full tourist potential of South Africa, the government and the industry will, however, have to resolve a number of troublesome issues, such as crime and violence, inadequate funding, lack of tourist infrastructure, poor education, training and the provision of high quality services.

Capital account

South Africa's successful transition to a new political order, growing international confidence in the future of the country, favourable credit ratings and the inclusion of the country with a high ranking in emerging market indices, led to a further large total net inflow of capital in 1995. After having turned around from a net outflow of R3,7 billion in the first half of 1994 to a net inflow of R9,0 billion in the second half, the capital movements not related to reserves registered large net inflows of R10,5 billion and R11,2 billion in the first and second half of 1995, respectively. For the year 1995 as a whole the total net inflow of capital accordingly came to R21,7 billion. Although the magnitude of the net inflow of capital in each of the two halves of 1995 was more or less the same as in the second half of 1994, it consisted largely of capital that flowed to the private sector. More than 85 per cent of the net inflow of capital in the second half of 1994 was for the account of the public sector, compared with only about 12 per cent in 1995.

The turmoil in the South African foreign exchange market and the sharp depreciation in the external value of the rand, made international investors wary of investment opportunities in South Africa and led to speculative outflows of capital from the middle of February 1996. Only after the rand had depreciated to substantially lower levels and some stability had again become apparent in domestic financial markets, did the outflow change to a moderate inflow of capital. The total net inflow of capital not related to reserves in the first half of 1996 therefore amounted to only R2,7 billion.

Table 6. Net capital movements not related to reserves

R billions

	1995			1996
	1st half	2nd half	Year	1st half
Long-term capital				
Public authorities	1,4	0,2	1,6	1,4
Public corporations	-0,6	3,0	2,4	1,9
Banking sector	0,5	0,8	1,3	-0,6
Non-bank private sector				
Net purchases of shares	2,9	1,9	4,8	4,3
Other	0,1	2,3	2,4	0,3
Total	4,3	8,2	12,5	7,3
Short-term capital				
Public sector	-1,6	-	-1,6	0,1
Banking sector	6,1	2,9	9,0	2,5
Non-bank private sector	1,7	0,1	1,8	-7,2
Total	6,2	3,0	9,2	-4,6
Total net capital movements	**10,5**	**11,2**	**21,7**	**2,7**

A good indicator of the confidence of international investors in South Africa during 1995 was the rapid growth in the Euro-rand market. Beginning in September 1995, a series of rand-denominated bonds were issued in the European market by non-resident entities and this market grew to R6,7 billion by the end of February 1996. In the ensuing months it increased much slower to R7,4 billion at the end of July 1996. This strengthening in sentiment was also evident in the narrowing of the spread between yields on South Africa's global bond issue in December 1994 and the equivalent United States Treasury paper, which fell from 250 basis points in June 1995 to 155 in January 1996, i.e. to below the spread of 193 basis points at the time of issue. This spread then rose to 195 basis points in May, before declining again to 169 basis points at the end of July 1996.

Long-term capital, i.e. capital with an original maturity of longer than one year or with an indefinite period, contributed R12,5 billion on a net basis to the inflow of capital in 1995. More than half of this inflow, however, consisted of non-residents' net purchases of securities on the Johannesburg Stock Exchange and on the Bond Exchange of South Africa, which can be a very volatile type of capital flow. Bearer bond issues of R4,4 billion by both the public and the private sector in 1995 had a hand in the inflow of long-term capital, while long-term syndicated loans raised abroad amounted to R3,6 billion.

In the first half of 1996 international investors were, on balance, again net purchasers of listed securities to the amount of R7,1 billion.

The monthly transactions in these securities were, however, very volatile: a net inflow of R4,5 billion in the first two months of 1996, became negligible in March, changed to a net outflow of R1,9 billion in April and again to a large net inflow of R4,3 billion in May and June 1996. The public sector kept on issuing bonds in the international markets to the amount of R1,1 billion in the first six months of 1996, while its syndicated loans totalled R0,6 billion. These positive flows were supplemented by a net inflow of R0,3 billion registered in the long-term capital movements of the non-bank private sector if listed securities are not taken into account. The result of these capital movements was a still large net inflow of long-term capital of R7,3 billion in the first half of 1996.

The weaker capital account in the first half of 1996 could primarily be attributed to a large net outflow of short-term capital. After having registered an inflow of R9,2 billion in 1995, a net amount of R4,6 billion in short-term capital left the country in the first half of 1996. As in the second half of 1994, the private banking sector was the main contributor to the short-term inflow in 1995. Boosted by a marked fall in short-term interest rates in the major industrial countries in 1995, short-term credit facilities were offered at relatively favourable costs to private banking institutions in South Africa. In total, these institutions borrowed short-term funds to the amount of R9,0 billion during 1995. In the first six months of 1996 a further net inflow of short-term funds to the banks of R2,5 billion was registered, despite large repayments that took place at times with the uncertainty in the domestic foreign exchange market. The large outflow of short-term capital (including errors and unrecorded transactions) in the first half of 1996 was therefore mainly trade-related and reflected leads and lags in foreign payments and receipts.

Foreign debt

The net borrowing of South Africa in other countries led to a rise in South Africa's foreign-currency-denominated debt from a low of US$16,7 billion at the end of 1993 to $22,3 billion at the end of 1995. Over this same period the country's rand-denominated debt also increased from $8,8 billion to $9,7 billion because of net purchases by non-residents of South African bonds. As a result of these changes, the total outstanding foreign debt of South Africa was equal to $32,0 billion at the end of 1995, or 24 per cent of gross domestic product.

Table 7. Foreign debt of South Africa

$ billions

	1991	1992	1993	1994	1995
Renegotiated debt[1])					
Public sector	1,9	1,8	1,3	0,8	1,1
Monetary sector[2])	2,5	2,1	1,6	1,0	0,7
Other	1,6	1,6	1,5	1,6	1,2
Total	6,0	5,5	4,4	3,4	3,0
Other foreign-currency-denominated debt					
Public sector	4,9	4,7	4,7	5,3	6,8
Converted long-term loans	4,8	4,8	4,5	3,9	2,9
Other	2,4	2,3	3,1	6,1	9,6
Total	12,1	11,8	12,3	15,3	19,3

Rand-denominated debt					
Bonds	4,7	6,0	6,1	6,7	7,1
Other[3])	2,8	3,9	2,7	2,5	2,6
Total	7,5	9,9	8,8	9,2	9,7
Total foreign debt	**25,6**	**27,2**	**25,5**	**27,9**	**32,0**

1) Debt renegotiated in terms of the 1994 Debt Arrangements with foreign creditors.

2) Including onlending to other sectors.

3) Including blocked and freely transferable funds, but excluding equity.

South Africa's renegotiated debt (i.e. debt subject to the standstill arrangements) contracted further by $0,4 billion to $3,0 billion at the end of 1995. Valued at exchange rates prevailing on 31 August 1985, these debts have been reduced from $13,6 billion at that time to only $2,7 billion at the end of 1995 by means of debt repayments and conversions into longer-term loans and equity in terms of the various agreements with foreign creditor banks.

As opposed to the decline in the country's renegotiated debt, other foreign-currency-denominated loans increased from $15,3 billion at the end of 1994 to $19,3 billion at the end of 1995. This large increase was due to a government bond issue in the Samurai market, a number of private placements in international capital markets and borrowings by private banks. The South African Reserve Bank repaid all its outstanding foreign loan commitments in November 1995. Further repayments were also made on longer-term loans that arose from the conversion of renegotiated debt.

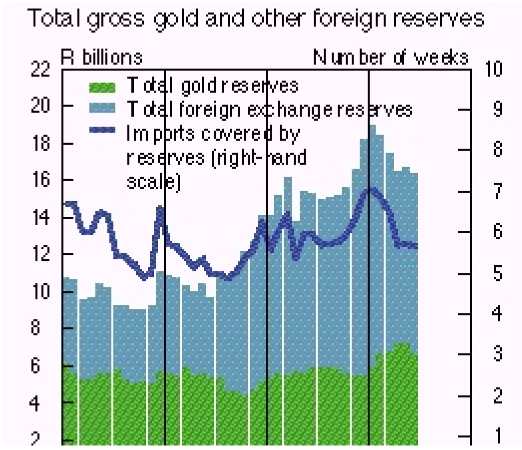
Because a significant part of the private banking sector's borrowings consisted of loans with a maturity of less than one year, the maturity structure of other foreign-currency-denominated debt deteriorated markedly in 1995. The share of other foreign-currency-denominated debt falling due within twelve months rose from 45 per cent at the end of 1994 to 49 per cent at the end of 1995.

Foreign reserves

As denoted in the previous section, the Reserve Bank redeemed all its outstanding short-term foreign loan commitments not related to reserves in 1995. Owing to the improvement in the overall balance of payments position, these liabilities were reduced from R6,8 billion at the end of May 1994 to R5,1 billion at the end of December 1994 and to zero in November 1995. The drop in the net foreign reserves of the Reserve Bank during the first four months of 1996 forced the Bank to again utilise foreign short-term credit facilities to the amount of R920 million in April 1996; this amount was fully repaid in May when the foreign exchange market became calmer. From the end of May 1996 the Reserve Bank's gross foreign reserves therefore have again reflected "earned" and not partly "borrowed" exchange holdings.

Despite the redemption of the Reserve Bank's liabilities related to reserves, the total gross gold and other reserves advanced from R9,7 billion at the end of June 1994 to R18,2 billion at the end of December 1995; in January these reserves increased even further to R19,0 billion. The ensuing volatility in capital movements and foreign exchange transactions caused the country's gross foreign reserves to drop by R2,5 billion to R16,5 billion at the end of April 1996. They then decreased slightly to R16,4 billion at the end of June 1996, or to a level equal to 5½ weeks' imports of goods and services. In July the gold and other foreign reserves of the Reserve Bank receded more markedly with R0,9 billion to a level of R10,4 billion at the end of the month.

Over the twenty months up to the end of June 1996 the Reserve Bank replenished its gold reserves to 4,63 million fine ounces from a low of 3,57 million fine ounces at the end of October 1994.



Although the gold reserves on average accounted for 46 per cent of total foreign reserves in 1995, this ratio increased to 53 per cent in the first half of 1996.

Foreign exchange market

The external value of the rand was relatively stable in 1995 and the beginning of 1996 despite rather volatile exchange rate movements in the currencies of the major industrial countries. After having declined by 7,6 per cent in the first five months of 1995, the nominal effective exchange rate of the rand rose by 4,4 per cent up to the end of December 1995 and by a further 1,1 per cent up to the middle of February 1996. The net effect of these movements in 1995 was a decline of 3,6 per cent in the weighted value of the rand - considerably smaller than the decline of 8,5 per cent in calendar year 1994. The rand depreciated against all the major currencies in 1995, with the exception of the Japanese yen. More in particular, large depreciations were recorded against the German mark and the Netherlands guilder.

Table 8. Changes in the exchange rates of the rand

Per cent

	31 Dec 1994 to 13 Feb 1996	13 Feb 1996 to 29 Feb 1996	29 Feb 1996 to 27 Mar 1996	27 Mar 1996 to 30 April 1996	30 April 1996 to 30 June 1996	30 June 1996 to 31 July 1996	31 Dec 1995 to 31 July 1996
Weighted average	-2,5	-5,4	-2,4	-9,4	1,1	-4,1	-18,1
US dollar	-2,8	-5,2	-2,9	-9,7	1,2	-3,0	-18,3
British pound	-0,9	-5,3	-2,2	-8,9	-1,4	-3,8	-18,9
German mark	-7,6	-5,6	-1,9	-7,1	1,0	-6,6	-16,6

Japanese yen	4,1	-7,2	-1,1	-11,6	6,6	-5,8	-15,3
Netherlands guilder	-7,7	-5,6	-2,0	-7,1	1,2	-6,4	-16,4
Italian lira	-6,2	-6,5	-1,4	-10,1	-0,8	-4,0	-21,8

These relatively stable conditions came to an abrupt end towards the middle of February. Owing largely to unfounded rumours at that time, the exchange rates of the rand decreased sharply against all the major currencies and the nominal effective exchange rate of the rand fell by 5,4 per cent in the second half of February 1996. The external value of the rand then stabilised somewhat in March 1996 and the average weighted value of the rand against a basket of currencies decreased by only 2,4 per cent in this month. Thereafter, more fundamental factors started to affect the overall balance of payments position, causing the rand to tumble against all the major currencies and the nominal effective exchange rate to drop by 9,4 per cent in April 1996. In May, conditions in the foreign exchange market became more orderly and the rand actually regained some of its losses. From the end of April to the end of June the nominal effective exchange rate of the rand rose by 1,1 per cent; it then, however, declined again by 4,1 per cent in July 1996. These changes brought the decline in the nominal effective exchange rate of the rand to 18,1 per cent in the first seven months of 1996.

The turbulence in the market for foreign exchange during the first half of 1996 had important other effects on the market, such as:

- leads and lags in the payment and repatriation of foreign exchange, which did not only put additional downward pressure on the spot exchange rate, but also affected the volume of transactions in the market;

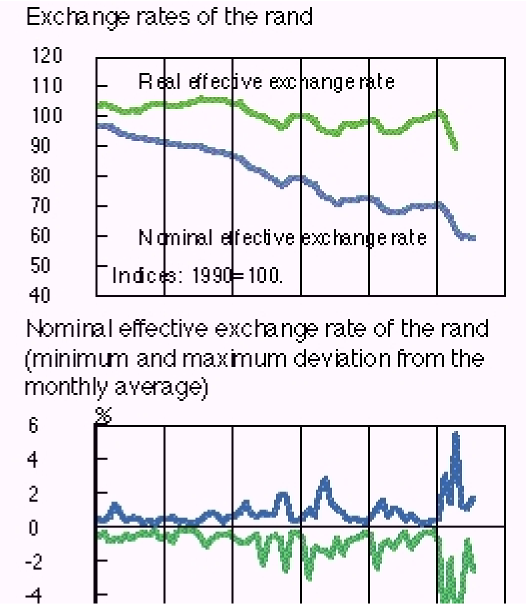
- an increase in the ratio of the net daily turnover in foreign exchange to the value of foreign trade from 17½ in 1995 to 24½ in the first six months of 1996;

- an increase in the value of the net turnover in the foreign exchange market from a daily average of $4,9 billion in 1995 to no less than $8,2 billion in April 1996 and an average of $6,6 billion in the first half of 1996;

- large margins between foreign exchange selling and purchasing rates from the middle of February 1996, which only began to narrow again from May;

- considerable intervention by the Reserve Bank in the market in order to ensure that the downward adjustment of the rand would be as smooth as possible; and

- a rise in the Reserve Bank's net foreign currency open position to no less than $13,7 billion at the end of June 1996, after it had declined from more than $20 billion at the end of October 1995 to $8,1 billion at the end of February 1996.



As a result of the increase in the nominal effective exchange rate of the rand during the period June to December 1995 as well as the rapid narrowing of the inflation differential between South Africa and its main trading partner countries, the real effective exchange rate of the rand rose on average by 0,2 per cent during calendar 1995. The sharp downward adjustment in the nominal effective exchange rate of the rand in the first five months of 1996 brought about a decline of 13,5 per cent in the real effective exchange rate of the rand during this period. The level of the real effective exchange rate of the rand in May 1996 was accordingly 8,5 per cent below its lower turning-point in May 1995.

MONETARY DEVELOPMENTS AND INTEREST RATES

Monetary policy and financial stability

The ultimate objective of monetary policy continued to be the maintenance of financial stability, which is an important requirement for sustainable high economic growth. This not only entails relative stability in the price level, but also embraces well-functioning and efficient financial markets and sound and well-managed financial institutions. In order to achieve this objective, the Bank operates within a monetary policy framework which is anchored by the setting of guidelines for growth in the broad money supply (M3). These guidelines are not meant to indicate a strict and inflexible money-growth rule, but rather serve as an indicator of the monetary policy stance and probable policy responses in given situations.

Policy responses are not merely guided by a divergence of the observed money growth from the indicated guidelines, but also by developments in other economic variables, such as:

- growth in the amount of credit extended by the monetary sector;

- the funding requirements of the government and public sector;

- the level of interest rates;

- the level of and changes in the gold and other foreign reserves; and

- movements in the exchange rate of the rand.

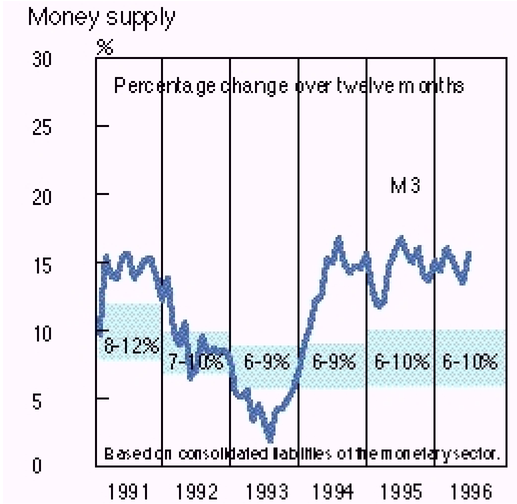
The Reserve Bank's operational variable for managing the rate of monetary expansion is the level of interest rates. The main instrument for influencing the general interest rate level is Bank rate, i.e. the interest rate charged by the Reserve Bank on the financing of shortfalls in the cash reserve holdings of banking institutions. The Reserve Bank, however, also makes use of other policy instruments to influence the interest rate level, including open-market operations, the shifting of government deposits to the government's accounts with the Bank or from those accounts to Tax and Loan Accounts with other banks, changing the composition of the asset holdings of the Corporation for Public Deposits, intervening in the foreign exchange market, and varying the banks' minimum required cash reserve ratios.

In pursuing its mission to protect the value of the rand and creating a stable financial environment to achieve the economic growth potential of the country, the Reserve Bank adopted a more restrictive monetary policy stance as from 26 September 1994 and raised Bank rate from a low of 12 to 13 per cent. All other related interest rates charged by the monetary authority were also increased by one percentage point. This change was based on indications of inflationary pressures that were building up: money supply growth exceeded the upper limits of the guideline range by a substantial margin; claims by banks on the private sector rose sharply; the depreciation of the rand earlier in 1994 began to affect domestic prices; salaries and wages per worker rose more rapidly; imports increased substantially; and certain market interest rates moved up markedly.

In the subsequent months these economic conditions remained basically unchanged and the Reserve Bank accordingly regarded a further increase in nominal interest rates as essential. On 21 February 1995 Bank rate was raised from 13 to 14 per cent for accommodation to banks against the collateral of Treasury bills, government stock, Reserve Bank bills and Land Bank bills with an outstanding maturity of less than 92 days. The rate on overnight loans extended against maturities of this same paper with a duration of 92 days and longer but less than three years, i.e. on the so-called second-tier accommodation, was raised even more sharply from 14 to 15,5 per cent per annum. For a more effective management of overall liquidity, the basic minimum cash reserve requirement of banks was also increased from 1 to 2 per cent of their total liabilities (as adjusted) with effect from 21 March 1995, while the additional interest-bearing reserve requirement of 1 per cent of short-term liabilities was retained. In accordance with this more stringent monetary policy stance, Bank rate was raised further to 15 per cent on 30 June 1995.

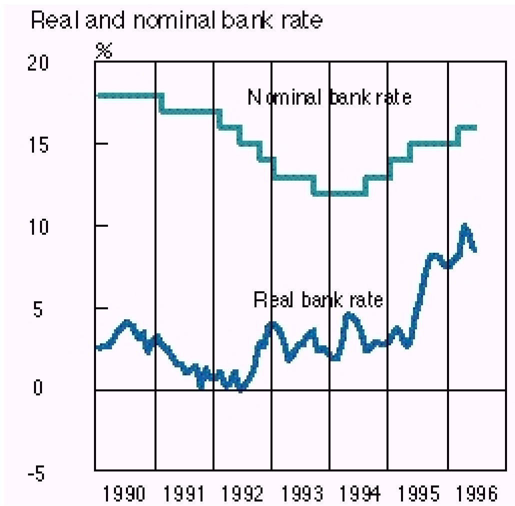
As a result of these changes in nominal Bank rate, the inflation-adjusted Bank rate (i.e. the nominal rate adjusted for current changes in the consumer price index) fluctuated around an average level of about 3 per cent from the start of the economic upswing until the middle of 1995. This relatively restrictive monetary policy stance achieved some success during the second half of 1995 and the rate of inflation subsided to levels last attained at the beginning of the 1970s. High money supply growth, total domestic credit extension and credit extension to the private sector caused the Reserve Bank to retain Bank rate at 15 per cent during the second half of 1995. This meant that real Bank rate increased markedly to 7,6 per cent in December 1995, indicating a considerably tighter monetary policy stance.

After taking into account these financial developments, the high fiscal deficit, a rise in nominal labour costs per unit of production and the turmoil on the South African foreign exchange market from the middle of February 1996, the Governor of the Reserve Bank announced on 24 April 1996 that the Reserve Bank had decided to keep the guidelines for an appropriate rate of growth in the M3 money supply at 6 to 10 per cent from the fourth quarter of 1995 to the fourth quarter of 1996.



This money supply guideline range provides for a higher real economic growth rate in 1996 than in 1995, but also requires a deceleration in the inflation rate. In announcing these guidelines, the Governor of the Reserve Bank reiterated that they should not be interpreted as a forecast for 1996 or as representing targets that must be achieved at all costs. The guidelines merely contribute to greater transparency in monetary policy and provide an indication of the Reserve Bank's monetary policy stance.

The instability in the foreign exchange market and the sharp depreciation of the rand from the middle of February 1996 had serious adverse implications for the domestic financial situation. In its efforts to "lean against the wind", the Reserve Bank sold, on a net basis, a substantial amount of foreign exchange in the market in the three months up to the end of April 1996. This intervention in the foreign exchange market drained liquidity from the domestic money market, increased the amount of accommodation at the discount window to the banks to high levels and put upward pressure on money market interest rates. In an effort to restore stability in the foreign exchange market and taking into account the monetary stimulus that could flow from the depreciation of the rand, the Reserve Bank raised Bank rate further by one percentage to 16 per cent, effective from 29 April 1996.



This brought real Bank rate to the exceptionally high level of 10,0 per cent at the end of April 1996, underlining the urgency to curb the outflow of capital and to restore stability in the foreign exchange market.

In view of the tight money market conditions during May 1996 and perceptions that the market could tighten even further towards the month-end, funding costs rose and the margin between banks' deposit and lending rates narrowed substantially. As a consequence, the banks decided to raise their prime lending rates even further from 19,5 to 20,5 per cent on 20 May 1996. Given the facts that the exchange rate of the rand had stabilised somewhat, the capital outflow had subsided, the level of nominal and real interest rates in South Africa was already high, the growth in the non-agricultural sectors of the economy had slowed down, and indications were that the growth in money supply and bank credit extension could also decelerate, it was decided not to increase Bank rate further. Such a unilateral increase in the banks' prime lending rates is not uncommon and also occurred in December 1984, January 1987 and January 1988, although conceivably for different reasons.

Towards the end of June 1996 most money market interest rates had softened and the banks decided to lower their prime lending rates again by one percentage point from 1 July 1996, i.e. to the level before their unilateral action. In an effort to lend some marginal support to this downward movement, the Reserve Bank reduced the margin between first- and second-tier loans made available at the discount window from 1,50 to 0,75 percentage points above Bank rate from 26 June 1996. Accommodation at the Reserve Bank's discount window therefore became available at a slightly reduced average rate when the money market shortage is high. The Governor of the Bank, however, also indicated that under the prevailing economic conditions a reduction in Bank rate was not warranted. Real Bank rate therefore amounted to 8,5 per cent in June 1996.

As already indicated, financial stability also requires efficient banking and other financial institutions as well as well-functioning financial markets. (The rest of this section concentrates only on developments in the banking sector, while improvements in the soundness of financial institutions and financial markets are discussed later in the chapter dealing with the financial markets.) The restructuring that is taking place in the international banking industry has made banking supervision an increasingly important function of central banks all over the world. Systemic risks have arisen in the banking industry in many countries in the wake of wide-ranging deregulation and financial innovations. The lifting of regulatory control over assets, liabilities and interest rates, the reduction in geographical and functional barriers, and technological advances have led to major structural and organisational changes in the banking industry.

Banks in South Africa have not escaped these international developments. Deregulation, financial innovations and the implementation of advanced technology have been characteristic of South African banking in the 1990s. Since April 1995 the Banks Act has been amended to allow branches of foreign banks to operate in South Africa. This has led to the establishment of five such branches in the country. The number of representative offices of foreign banks in South Africa also increased from 40 at the end of 1994 to 51 at the end of June 1996. These developments have exposed South African banks to increased competition, especially regarding wholesale banking business.

The banks, however, coped well with the increased international competition and recorded a before-tax return on assets of approximately 1,3 per cent in 1995; in the preceding year the same ratio was slightly higher at 1,4 per cent. This profitability measure of South African banks compared well with the major banks in the industrialised countries, which according to the 66th Annual Report of the Bank for International Settlements varied between a low of minus 0,75 cent in Japan and a high of 1,87 per cent in the United States in 1995. Some of the smaller banks in South Africa over the past year nevertheless experienced liquidity and solvency problems. Fortunately this did not present any systemic risks. The Reserve Bank, however, assisted some of these banks, which did not have insoluble solvency problems, with their liquidity problems. For socio-political reasons the government also assisted one bank facing a solvency crisis.

An important milestone was reached in the safeguarding of banking deposits when the required ratio of banks' capital and reserves to risk-weighted assets was lifted from 7 to 8 per cent in January 1995, i.e. to the capital adequacy guidelines of the 1988 Basle Accord. This was the final step in the phasing-in of capital adequacy requirements, which had started off from 4,5 cent of risk-weighted assets in 1991. By mid-1996 the actual level of the total capital and reserves of South African banks was equal to approximately 10 per cent of risk-weighted assets.

Considerable attention was also given to the upgrading of the national payment system, involving inter alia the provision for real-time intraday settlements. The first phase of the project was completed on 15 November 1995, when the banks accepted a strategy for the development of the payment system. In addition, the Reserve Bank supported the drafting of legislation to combat money laundering in South Africa.

Financial stability was also promoted in a broader regional context in the period under review after South Africa had taken on the responsibilities for the Finance and Investment Sector in the Southern African Development Community from 3 May 1995. As part of the work of this Sector a Committee of Governors of Central Banks was established on 13 July 1995 to achieve closer co-operation and interaction between the central banks within the Community. A number of specific duties and tasks were identified and it was decided to concentrate the work of the Governors Committee on:

- the development of an economic and financial data base for the Southern African Development Community;

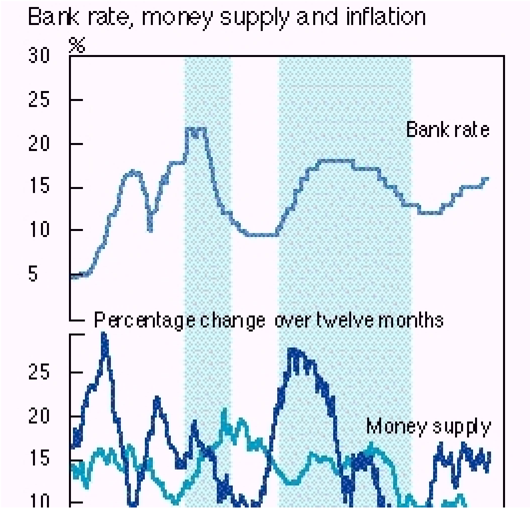
- the compilation of information on organisational structures, policy aims and instruments, international financial relations and legal frameworks of the central banks of the member countries;

- a survey of the current payment, clearing and settlement arrangements in member countries with the objective to eventually apply a uniform system in member countries; and

- an investigation of problems experienced with the flow and repatriation of notes and coin in the region.

Money supply

As could be expected with the restrictive monetary policy stance pursued by the authorities in the current economic upswing, the growth rate in the broadly defined money supply (M3) continued to accelerate at first and only later showed signs of levelling off. As clearly illustrated in the accompanying graph, a lagged relationship between changes in Bank rate and changes in the money supply and the inflation rate is a normal pattern in the South African economy.

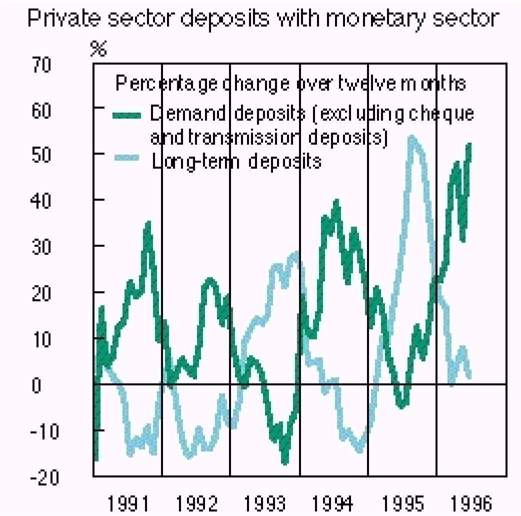


The lag between adjustments in the cost of accommodation and its discernible effect on the growth in money supply usually varies between four and eight quarters. Similarly, a lag exists between changes in money supply and its effect on the rate of inflation. These lags are clearly due to the fact that it takes time for the substitution, income and wealth effects of changes in interest rates to work through to domestic demand, transactions with the rest of the world and relative prices. The different effects of changes in interest rates may not always be equally strong or may at times pull in opposite directions, which could affect the length of the time lags.

In the current upward phase of the business cycle the growth in the M3 money supply reached an upper turning-point relatively quickly in the middle of 1994, probably because of the consistent maintenance of positive real interest rates. After having declined from 16,9 per cent in July 1994 to 11,8 per cent in February 1995, the twelve-month rate of increase in M3 rose again to 16,8 per cent in June 1995 and fluctuated around a level of approximately 15 per cent in the ensuing twelve months. In June 1996 the rate of increase over twelve months in M3 amounted to 15,7 per cent. The quarter-to-quarter rate of increase in the value of the broadly defined money supply (seasonally adjusted and annualised) accelerated recently from 13,7 per cent in the first quarter of 1996 to 21,2 per cent in the second quarter.

This relatively high demand for money in the current economic recovery was probably largely related to the exceptionally sharp increase in domestic expenditure on consumption and capital formation, despite the high levels of real interest rates, i.e. the transactions motive for holding money. The precautionary motive for holding money in response to uncertainties regarding political developments and the liquidity preference reflecting expected interest rate changes and expectations of major adjustments in share and bond prices, at times also supported the strong demand for money balances. In addition, the high growth in the money supply during 1995 and the first half of 1996 was related to an enhanced confidence in money as a store of value in view of the recorded lower levels of inflation and the high positive real rates of return on depository-types of investment. This is confirmed by a decline of 4,6 per cent in the income velocity of M3 from the second quarter of 1994 to the second quarter of 1996.

The twelve-month growth rates in the narrower monetary aggregates were broadly similar to that in M3, but they contracted to much lower levels than M3 in the first half of 1995, moved sharply upwards until March 1996 and fluctuated around these higher levels in the ensuing three months. The greater volatility in the growth of M1 and M2 over twelve months was again related to changes in the liquidity preference of the private sector. As shown in the accompanying graph, there is a definite inverse relationship between call deposits and long-term deposits.



When the twelve-month growth rate of long-term deposits increases, the corresponding growth rate of call deposits normally decreases. Similarly, when the twelve-month rate of increase of long-term deposits slows down, the corresponding rate of increase in call deposits accelerates. These changes in the liquidity preference of the private sector are responsible for more volatility in M1 and M2 (which include call deposits but not long-term deposits) than in M3 (which includes call and long-term deposits).

The increase in the public's liquidity preference was therefore mainly responsible for the relatively high growth in M1 and M2 over the twelve months up to June 1996. Expected changes in interest rates and adjustments in share and bond markets encouraged private-sector entities to shift their funds to overnight, other short- and medium-term deposits. The deposits of insurers and pension funds with banks, in particular, increased by R9,5 billion in the first six months of 1996, indicating these institutions' high liquidity preference. The transactions motive for holding deposits, however, also remained relatively high, as reflected in the twelve-month growth rates in M1A which rose from a low of 6,6 per cent in March 1995 to 17,6 per cent in January 1996 and only then contracted to 14,7 per cent in June 1996.

In a statistical or accounting sense, the increase in M3 in 1995 and the first six months of 1996 was predominantly due to an even larger increase in the claims of monetary institutions on the private sector. All the other "statistical causes" of the change in M3 decreased, on balance, over the twelve months up to June 1996.

Table 9. Main counterparts of M3 in the year ended 30 June 1996

R billions

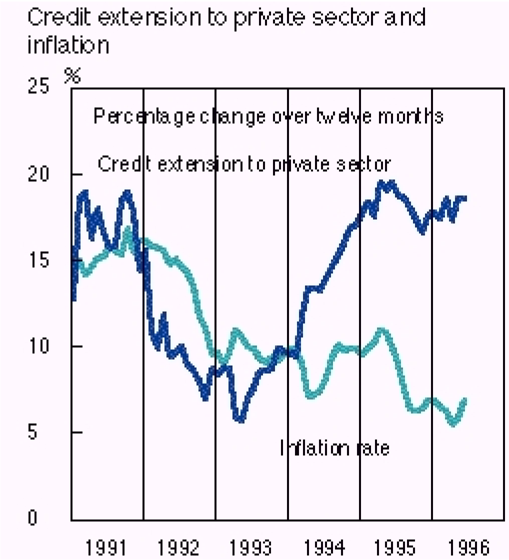
	1995		1996		Year ended June 1996
	3rd qr	4th qr	1st qr	2nd qr	
Net foreign assets	0,3	1,5	1,6	-9,5	-6,1
Net claims on the government sector	-6,7	-3,3	-2,7	8,9	-3,8
Claims on the private sector	13,6	14,9	14,2	10,8	53,5
Net other assets and liabilities	-0,8	-1,4	-5,1	5,0	-2,3

Total change in M3	**6,4**	**11,7**	**8,0**	**15,2**	**41,3**

Credit extension

Despite the high cost of borrowing from the monetary sector, the growth in total domestic credit extension remained relatively high during 1995 and the first half of 1996. The rate of increase over twelve months in total domestic credit extension, however, receded from a peak of 24,2 per cent in May 1994 to 13,2 per cent in December 1995; it then fluctuated around this lower level in the first five months of 1996, before increasing to 16,4 per cent in June 1996. This somewhat lower growth in domestic credit extension was mainly due to a decline in the net claims of the monetary institutions on the government sector, but the rate of increase in credit extended to the private sector remained relatively high throughout the first half of 1996.

One of the main characteristics of the economic recovery from the middle of 1993 is that the growth in credit extension by monetary institutions to the private sector started relatively early and remained vigorous.

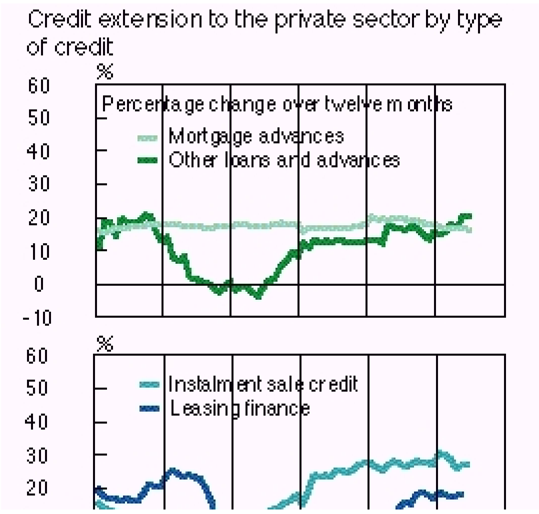


The twelve-month growth rate in monetary institutions' claims on the private sector increased almost continuously from a lower turning-point of 5,7 per cent in May 1993 to 19,5 per cent in June 1995; it then receded to 17,6 per cent in December 1995, and fluctuated around this level to 18,7 per cent in June 1996. The high rates of increase in credit extension to the private sector in the year ended June 1996 coincided with a substantial decline in the inflation rate. The monetary institutions' real credit extension to the private sector therefore continued to increase from 6,5 per cent in December 1994 to 11,6 per cent in March 1996 and 11,0 per cent in June.

The sharp increase in domestic expenditure on consumption and investment that exceeded the growth in income, was only made possible by a substantial rise in credit extension by the banks to the private sector. Credit extension was boosted on the demand side by strong consumer and investor confidence as fears of political instability subsided and the economy improved. The demand for working capital by small and medium-sized enterprises also rose sharply, inter alia to a build up of inventories to provide for the requirements of consumers. A switching from foreign to domestic financing of international trade transactions arising from the instability in the South African foreign exchange market during the first half of 1996 contributed to the steady credit demand. On the supply side banks actively promoted the use of credit facilities, while a large number of retail outlets introduced in-house credit cards to encourage consumption expenditure.

An analysis of monetary institutions' claims on the private sector by type of credit shows that mortgage advances still constituted the largest component and were responsible for no less than 38 per cent of the increase in this aggregate in the twelve months up to June 1996. Banks are endorsing the use of this credit facility on account of the low capital requirements applicable to it and the low credit risk of such loans. In view of the flexibility of some mortgage schemes and the comparatively low interest rates charged on these advances, many bank clients are willing to use them to finance purchases of durable and other consumer goods. With the decline in domestic demand in the first half of 1996, the rate of increase in mortgage advances also slowed down somewhat. After having fluctuated around a level of about 19 per cent in 1995 and amounting to 17,7 per cent in December 1995, the rate of increase over twelve months in mortgage advances contracted to 16,5 per cent in June 1996.

The rate of increase over twelve months in instalment sale credit fluctuated around a considerably higher level of 27 per cent during 1995 and peaked at 30,7 per cent in January 1996 - the highest rate since June 1989; it then decreased somewhat to 26,8 per cent in June 1996.



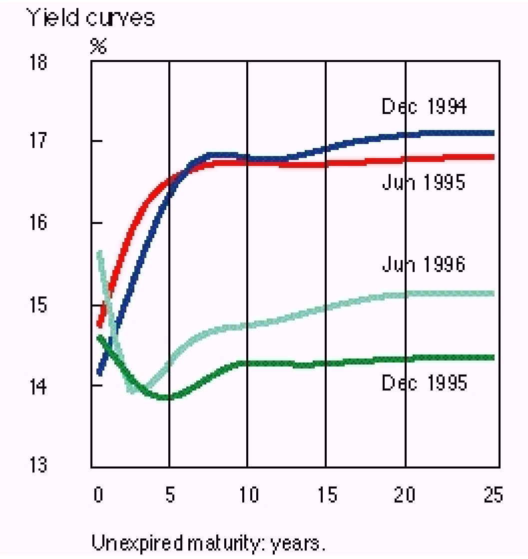
The twelve-month rate of increase in leasing finance rose sharply from 7,2 per cent in December 1994 to 16,6 per cent in December 1995 and further to 17,5 per cent in March 1996; it then declined to 16,8 per cent in June 1996. The high rates of increase in both instalment sale credit and leasing finance could be ascribed largely to the purchases of new and also used motor vehicles. The purchases of other consumer durables and industrial, commercial and office equipment probably contributed to the lively demand for these forms of credit.

The twelve-month rate of increase in other loans and advances (including overdrafts) increased from 12,8 per cent in December 1994 to 15,8 per cent in December 1995 and 18,0 per cent in March 1996, with the increased use of household debt to maintain consumption expenditure and more recently also because of the switch from foreign to domestic financing of transactions arising from the high currency risk of foreign borrowing. The rate of increase over twelve months in other loans and advances then increased even further to 20,3 per cent in June 1996. Although credit extended on credit cards amounted to only R7,9 billion in June 1996 (i.e. about 7 per cent of other loans and advances), this type of credit increased by no less than 37,7 per cent over the twelve months to June 1996, reflecting the increased popularity of this type of payment in a society with a high crime rate.

Interest rates and yields

In accordance with its normal cyclical pattern, market interest rates and yields followed the economic recovery with a lag and only started to rise from February 1994, i.e. in the ninth month after the upturn started. By the end of that year most of these market rates had moved to considerably higher levels, with the result that long-term yields remained fairly stable in the first six months of 1995. Short-term interest rates and yields, however, firmed further in this period, especially in the wake of the two upward adjustments in Bank rate described above. The yield curve accordingly flattened, but remained fairly steep over the first five years of the maturity spectrum.

Despite the still buoyant domestic demand, market interest rates and yields (except at the very short end of the market) declined sharply in the second half of 1995. This somewhat abnormal behaviour of rates reflected an improvement in domestic liquidity caused by capital inflows, a more optimistic view regarding inflation, an expected less stringent monetary policy stance, lower bond yields on world markets and generally positive perceptions regarding the future economic development of the country. Yields on long-term government bonds eased substantially more than on short-term government paper, causing the yield curve to become flatter and even inverted in January 1996. This slope of the yield curve possibly indicated impending slower economic growth.



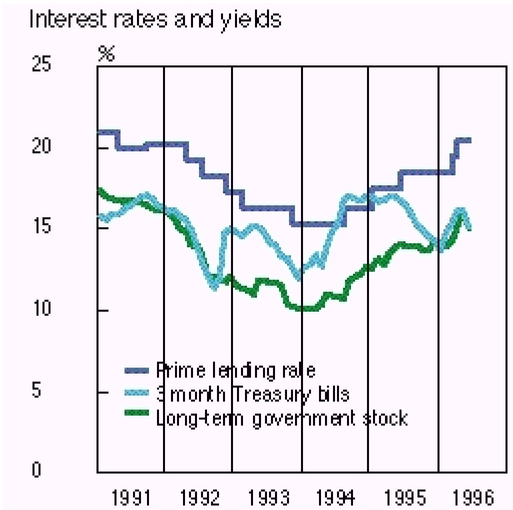
The disturbances in the foreign exchange market, which had started in the middle of February 1996, then spilled over into the bond market and yields moved sharply upwards. Yields on long-term government stock reacted immediately to the depreciation of the rand and rose from 14,72 per cent at the end of February 1996 to 16,01 per cent at the end of April, before softening to 14,71 per cent at the end of June and rising again to 15,74 per cent at the end of July 1996. Shorter-term interest rates and yields reacted slower to the changes in the foreign exchange market and only started to move sharply upwards towards the end of April with the increase in Bank rate. They then rose more than longer-term rates, with the result that the yield curve not only moved upwards from January 1996, but also became noticeably more inverted.

As a consequence of market participants' apprehensions about economic fundamentals, bond yields became excessively volatile. The inordinate volatility of bond yields made the information content of market yields more difficult to analyse and the shape of the yield curve significantly less valuable as a forecaster of real economic activity. Movements in domestic long-term yields, however, still continued to reflect international markets' expectations regarding policy adjustments and uncertainties in the financial markets. They also remained closely linked to those in the United States, despite signs of a decoupling of bond yields in the United States and Europe. This relationship probably reflected the growing importance of the United States' investor in the South African market.

In real terms the monthly average yield on long-term government stock receded from 6,8 per cent in January 1995 to 6,4 per cent in January 1996; it then moved up sharply to 9,7 per cent in April 1996 as nominal yields hardened and the inflation rate subsided. With the subsequent decline in nominal rates and the rise in inflation, the real yield on long-term government stock eased again to 8,3 per cent in June 1996.

Money market interest rates, which had increased steeply in the first six months of 1995, moved sideways during the second half of that year and the first three months of 1996 before rising in a somewhat delayed reaction to the depreciation in the external value of the rand. The rate on bankers' acceptances with a maturity of three months, for instance, moved slightly upwards from 14,20 per cent at the end of June 1995 to 14,60 per cent at the end of December 1995, and then softened again to 14,20 per cent at the end of March 1996. This rate then firmed to 15,20 per cent at the end of April and 16,40 per cent at the end of May, and fell back to 15,20 per cent at the end of June 1996. With the depreciation in the external value of the rand, it rose again to 15,55 per cent at the end of July.

As already indicated, the prime overdraft rate of banks was increased from 18,50 per cent to 19,50 per cent on 29 April 1996 and to 20,50 per cent as from 20 May 1996.



The mortgage bond rate was also increased by one percentage point in each case to 19,25 per cent and 20,25 per cent on the same dates. Following the announcement of a one percentage point decline in the prime rate effective from 1 July 1996, the predominant mortgage rate was reduced to 19,25 per cent. Some of the banks, however, at the same time became more aggressive in the marketing of mortgage advances and offered their customers a new mortgage option that guarantees them a maximum mortgage rate of 17,5 per cent for one to two years.

Other interest rates and yields broadly displayed similar patterns to those described above. The predominant rate on fixed deposits of twelve months, which may be regarded as indicative of deposit rate behaviour in general, declined from 14,50 per cent in June 1995 to 13,50 per cent in February 1996, before being adjusted upwards again to 15,00 per cent in June. The cost of wholesale funds, however, increased by more than that of retail deposits in the first half of 1996: the rate on negotiable certificates of deposit of three months rose from 14,55 per cent at the end of February 1996 to 16,90 per cent at the end of May and decreased to 16,00 per cent at the end of July 1996. The standard interest rate applicable to loans granted by the State Revenue Fund (Exchequer Act, Act No 66 of 1975) was reduced from 17,25 per cent in June 1995 to 13,75 per cent in March 1996, and was then raised again in three steps to 16,50 per cent as from 1 June 1996 before being reduced to 16,00 per cent from 1 July 1996.

In contrast to these movements in the general pattern of interest rates, the maximum permissible rates laid down in terms of the Usuary Act were increased by two percentage points in September 1995 and then remained unchanged up to the end of July 1996. In the ten months to July 1996 the maximum permissible rates in respect of money lending, credit and leasing transactions were 28 per cent for amounts of between R6 001 and R500 000 and 31 per cent for amounts up to R6 000.

FINANCIAL MARKETS

Structural changes in financial markets

The normalisation of South Africa's international financial relations, globalisation, the removal of restrictions on international capital movements and the linking of financial systems and markets have posed new challenges to the financial markets in South Africa. In order to maintain a well-developed and sophisticated financial system and to ensure an investor-friendly environment, it became even more important to enhance transparency and liquidity in the financial markets and to reduce risk. Important structural changes were therefore implemented recently or are being planned for the near future to cope with these new circumstances.

Considerable progress was made to make South Africa a more investor-friendly country during 1995 and the first six months of 1996, including:

- the removal of the financial-rand mechanism from 13 March 1995 that terminated restrictions on the inward and outward movement of capital by non-residents;

- the abolition of non-resident shareholders tax with effect from 1 October 1995;

- the lowering of the Secondary Tax on Companies (the tax payable on cash dividends) from 25 to 12,5 per cent on 14 March 1996;

- the reduction in Marketable Securities Tax and stamp duty from 1,0 to 0,5 per cent from 1 April 1996; and

- the relaxation of access to domestic credit of foreign-controlled South African entities by a doubling of the borrowing limit from 24 June 1996.

As already described in some detail, various other exchange control measures were also relaxed to allow South African institutional investors to diversify their investments geographically. The acceptance of South Africa in the international financial community made it possible for some important multilateral institutions to enter the domestic market. The International Finance Corporation, in particular, became actively involved in developing South Africa's capital markets and initiated a two-pronged investment strategy: assisting in economic growth among disadvantaged groups and supporting private investments to narrow down income inequalities. In 1995 this Corporation approved its first three investments in South Africa to the amount of $35,3 million.

Several other investments were facilitated by the relationship of South Africa with the International Finance Corporation, as well as by the country's membership of the Multilateral Investment Guarantee Agency of the World Bank. The addition of the Johannesburg Stock Exchange to the Morgan Stanley Index on 1 March 1995 and the inclusion in the International Finance Corporation's Emerging Markets Global and Investable Indices on 7 April 1995 also impacted positively on the international acceptability of the South African equity market.

Various other tax changes that will affect institutional investors and therefore the financial markets in South Africa have been introduced or are under consideration. Following the Third Interim Report of the Commission of Inquiry into the Tax Structure of South Africa (Katz Commission), the government accepted the following principles for the taxation of retirement funds:

- consistent treatment of private and public funds;

- tax neutrality between different forms of retirement provision;

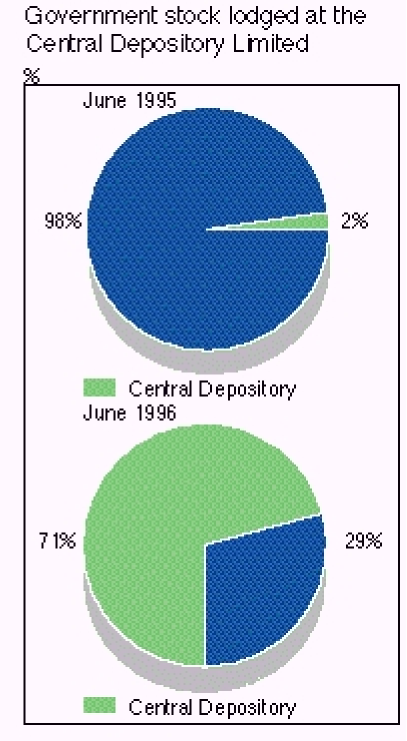
- minimisation of opportunities for arbitrage arising from taxation;

- an incentive in favour of lifetime annuities; and

- taxation of retirement fund income as it arises rather than when it is paid out.

As a first step in the implementation of a new tax dispensation for retirement funds, a tax at a rate of 17 per cent of the monthly gross interest and net rental income received by or accrued to all pension, provident and retirement annuity funds was imposed from 1 March 1996. A value-added tax will also be introduced from 1 October 1996 on all fee-based financial services except premiums payable in respect of life policies issued in terms of the Insurance Act, contributions to pension, provident, retirement annuity and medical aid funds, and compulsory charges built into the selling price of units in unit trust schemes.

Significant operational and regulatory changes were implemented in the domestic bond market to maintain competitiveness and comply with international standards. Trading on the gilts floor of the Johannesburg Stock Exchange came to an end in November 1995. Bond trading after that date shifted to the Bond Market Association, which since its inception on 16 June 1989 had operated an informal screen and telephone trading system with the Universal Exchange Corporation Ltd (Unexcor) as its clearing house. The Rulebook and underlying principles of the official bond market were approved on 27 March 1996 and the Bond Exchange of South Africa was licensed to trade on 15 May 1996. Certain operational and regulatory changes must still be executed, namely the establishment of a surveillance department and a reporting system for trade in bond options, and the implementation of the recommendations of the Group of Thirty on rolling stock settlement.



The Central Depository Limited, which was established in 1993 as a key element of an efficient settlement system, will also enable bond lending. This should add depth to the market as well as the immobilisation and eventual dematerialisation of all listed bonds. As at the end of June 1996, a substantial amount of bonds had already been lodged at the Central Depository, including 71 per cent of domestic marketable government stock debt.

On the Johannesburg Stock Exchange important operational and regulatory changes were also introduced or are envisaged to meet domestic and international demands, mobilise domestic capital more efficiently for reconstruction and development purposes, establish a transparent environment, enhance investor protection and deregulate the exchange. The Stock Exchanges Control Amendment Act of 1995, passed by Parliament on 13 September 1995 and promulgated in October 1995, facilitated the restructuring of the stock exchange. This led to the introduction of the following changes on 8 November 1995:

- corporate membership, with the option of limited liability;

- the opening of membership to non-residents (subsidiaries of foreign banks and securities firms) and domestic financial institutions;

- the establishment of the South African Institute of Stockbrokers;

- the introduction of new capital adequacy requirements based on European Union standards with real-time electronic surveillance; and

- the revision of the Johannesburg Stock Exchange Guarantee Fund rules.

As from 8 March 1996 the phasing-in of the Johannesburg Equities Trading System, with dual capacity trading and fully negotiated brokerage, was started on a sector-by-sector basis to replace the open outcry floor trading system and to enhance security, speed of trading, efficiency and ultimately liquidity. As shares were moved to the new system, they ceased to be traded on the floor and this process culminated with the closure of the trading floor on 7 June 1996.

Other changes implemented in the eighteen months up to June 1996, included:

- new listing requirements to improve investor protection and to contribute to the Reconstruction and Development Programme by improving access to the market for emerging entrepreneurs and companies;

- an extensive revision of the Johannesburg Stock Exchange market indices and the introduction of new indices to address the needs of portfolio managers and derivative traders; and

- the introduction of the concept of host broker as part of capital requirements.

Further envisaged changes to the stock exchange will concentrate on the extension of the automated trading system and the implementation of an electronic scrip registry and rolling settlement.

A number of changes were also made in the formal derivatives market during the period under review. Trade in commodities futures commenced on 31 July 1995 with a beef futures contract. This was broadened to include potato cash-settled contracts from 16 October 1995 and yellow and white maize contracts from 26 February 1996. The financial and industrial futures contract (FNDI) started to trade on 9 October 1995, followed in March 1996 by the introduction of the new set of concentrated indices of the Johannesburg Stock Exchange.

The rules and regulations applying to the formal derivatives market were also adjusted. Capital adequacy requirements came into effect on 1 November 1995 and the rules of Safex were amended to provide for the Automated Trading System, which was implemented and became mandatory as from 31 May 1996. With effect from 1 April 1996 all bond futures contracts expiring after May 1996 have to be physically settled with the purpose of increasing the volume of trade and reducing risks.

Money market

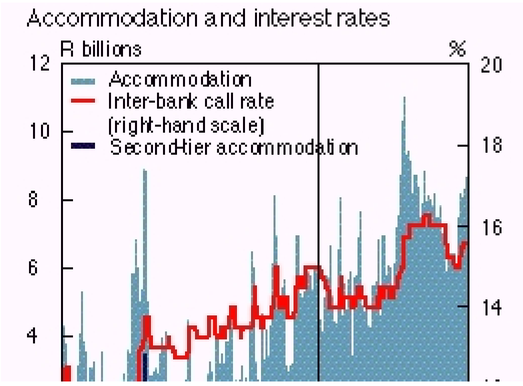
Money market conditions, which had generally been easy in the first seven months of 1995, tightened considerably during the rest of the year and in the first seven months of 1996. This was clearly reflected in the amount of accommodation which the Reserve Bank provided to the banks at month-ends. Although this so-called money market shortage sometimes fluctuated markedly, it increased on balance from R3,2 billion at the end of July 1995 to R5,1 billion at the end of December 1995; it then fluctuated even more and moved sharply upwards to R11,0 billion at the end of April before receding to R5,8 billion at the end of June 1996. In July it rose again to R8,6 billion at the end of the month. In view of these large shortages, banks were at times forced into the second-tier of accommodation with some upward pressure on money market interest rates.

As illustrated in the accompanying graph, money market interest rates generally reacted only marginally to the size of the money market shortage. This is mainly because accommodation at the discount window is provided immediately and automatically to the full extent of the banks' aggregate shortfall. In view of the relative ease in financing this shortfall, money market interest rates are usually affected only by the size of the shortage when second-tier accommodation is provided. Money market interest rates are much more responsive to actual or expected Bank rate changes than to the level of the money market shortage.

The tight conditions in the money market in the last half of 1995 could to a large extent be attributed to an increase in government deposits with the Reserve Bank and an increase in notes and coin in circulation outside the Reserve Bank. The actions of the Reserve Bank during this period were also primarily aimed at mopping up liquidity emanating from the substantial increase in the net foreign assets of the Bank during the first half of 1995 and in the fourth quarter of that year. Conforming to this approach, the Reserve Bank sold assets from its own portfolio to an amount of R2,1 billion in the last six months of 1995. In addition, adjustments were made to the asset portfolio of the Corporation for Public Deposits and government deposits were managed in a way that would counter large fluctuations in the money market shortage.

The sharp increase in the amount of accommodation in the first four months of 1996 were primarily related to a decrease in the net foreign assets of the Reserve Bank. In the first quarter of 1996 this tightening effect was partly countered by a decline in banknotes and coin in circulation outside the Reserve Bank, but in April the banknotes and coin in circulation increased again sharply. A reversal of both these factors contributed to the decline in the money market shortage in May and June 1996. A decline in the net foreign assets of the Bank was then largely responsible for the tighter conditions in July.

The Reserve Bank's operations in the money market during the first six months of 1996 were generally neutral and aimed at maintaining liquidity.



Transfers of government deposits between the Exchequer Account with the Reserve Bank and the government's Tax and Loan Accounts with banks were used to adjust the money market shortage. With the sharp depreciation of the rand from the middle of February 1996, the Bank at first drained liquidity through net sales of government stock. Later in May and June 1996 the government deposits with the Reserve Bank decreased. The Reserve Bank also took up R640 million of the R1 000 million Treasury bills on offer at the tender of 10 May 1996 to inject some liquidity into a very tight market.

Bond market

Activity in the domestic primary bond market continued to decline in 1995 and the beginning of 1996, with a further reduction in the borrowing requirement of the public sector. A large amount of funds was, however, procured internationally in the form of public issues and private placements before the rand began to depreciate in February 1996. Greater volatility in capital market yields and attractive spreads between domestic and foreign long-term interest rates then led to a strong revival in the activity in the secondary bond market.

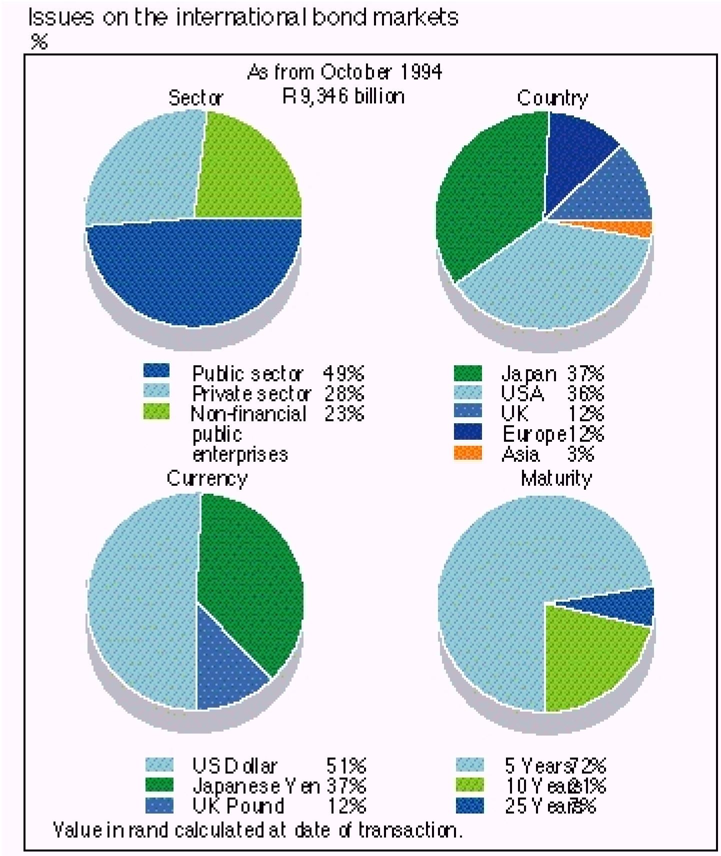
Net new issues of fixed-interest securities in the domestic primary bond market by entities in the public sector decreased from R31,7 billion in 1993 to R26,7 billion in 1994 and R24,6 billion in 1995. In the first quarter of 1996 these issues amounted to R8,5 billion, which was significantly higher than the R3,5 billion recorded in the first quarter of 1995. Nearly two-thirds of the net new issues of public-sector stock in fiscal 1995/96 consisted of securities with maturities ranging from seven to ten years, while the remaining third fell in the ten-year and longer range of the maturity spectrum.

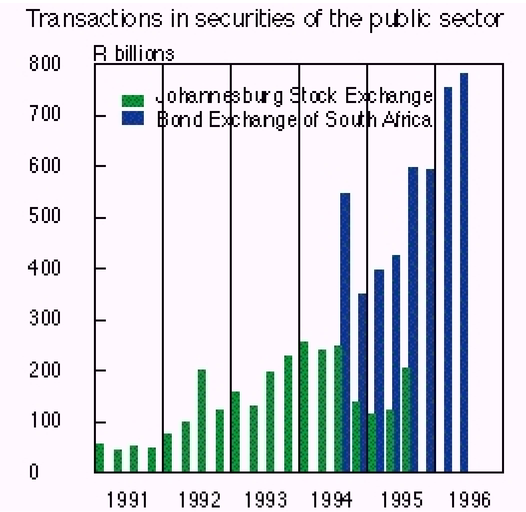
Funds acquired by listed private-sector companies through new rights issues of fixed-interest securities were still relatively small at R0,9 billion in 1995, but at least more than R0,1 billion raised in 1994. The high liquidity of the corporate sector, the relatively high cost of domestic borrowing, the availability of funds from abroad and the acquisition of capital through scrip dividend issues were some of the factors responsible for this relatively low domestic borrowing needs of the private sector. With the firming of long-term interest rates and yields, no such issues were made in the first half of 1996.

The normalisation of South Africa's international economic relations expanded the investor base of the country and allowed the government to tap international bond markets. After having been successful with a global US dollar bond issue of R2,7 billion in December 1994, a stock issue of R1,3 billion was made in the Japanese Samurai bond market in June 1995. This was followed in January 1996 with a Euro-sterling bond issue of R560 million in the United Kingdom. With a maturity of ten years, this issue extended the maturity profile of government's foreign debt portfolio and accessed a large institutional base. Local institutions were also allowed to buy up to 10 per cent of this issue. In 1995 a number of private companies raised capital in foreign markets by means of convertible bonds to the amount of R1,9 billion. No such issues were made in the first half of 1996. Non-financial public enterprises obtained R1,4 billion in 1995 and R0,7 billion in the first half of 1996 in the Japanese bond market.

Activity in the secondary bond market increased markedly from the third quarter of 1995 as yields began to soften, leading especially to a higher level of stock traded in August and November 1995. The value of stock traded on the bond market, as published by the Bond Exchange of South Africa, rose from R819 billion in the first half of 1995 to R1 187 billion in the second half of 1995 and R1 534 billion in the first half of 1996.

The Reserve Bank continued to reduce its role as market-maker in the secondary market for government stock. Gross sales of government stock by the Bank receded from R178 billion in 1993 to R165 billion in 1994 and more sharply to R97 billion in 1995.





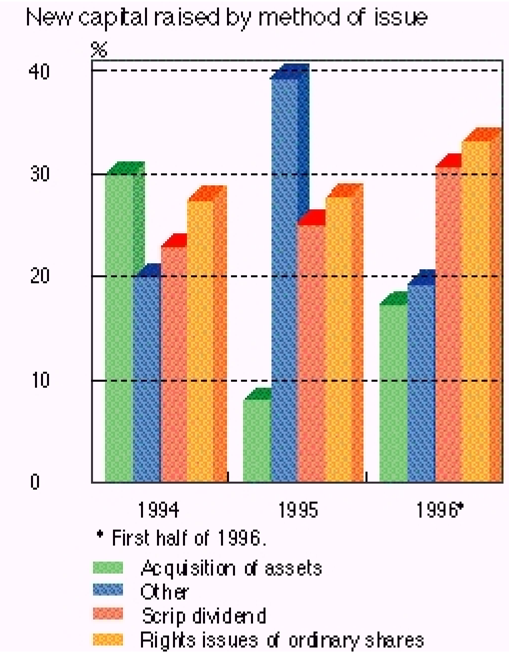
These transactions amounted to R57 billion in the first half of 1996, i.e. somewhat more than the R43 billion in the corresponding period of the preceding year. The Reserve Bank's trading in government stock options also decreased from a monthly average of R7,4 billion in 1994 to R5,2 billion in 1995 and R3,6 billion in the first six months of 1996.

Non-residents were actively involved in the secondary bond market as net purchasers of stock from April 1995 to February 1996 after the termination of the dual exchange rate system and because of the relatively stable value of the rand. In the first two months of 1996 their net purchases came to no less than R2,6 billion. With the ensuing uncertainty about the external value of the rand they became net sellers to the amount of R2,5 billion in March and April 1996. When some stability returned to the financial markets, they purchased more gilts than they sold; the net amount totalled R2,6 billion in May and June 1996. However, with the further weakening in the exchange rate of the rand these net purchases receded to R0,7 billion in July 1996.

Equity market

New capital raised in the primary equity market by listed companies more than doubled from R10,0 billion in 1994 to R21,4 billion in 1995, reflecting the capital formation taking place in the private sector. With the slowdown in economic activity in the non-agricultural sectors of the economy, the funds raised in the equity market also contracted to R9,6 billion in the first half of 1996; these funds were considerably lower than the R12,1 billion registered in the first half of the preceding year. By far the largest part of the funds raised on the equity market in the eighteen months ended June 1996 was obtained for the industrial sector (52 per cent) and the financial sector (27 per cent). The total number of 27 new listings in 1995 and 16 in the first six months of 1996 also reflected the interest in and strength of the share market as a source of finance. Total capital raised by means of Global Depository Receipts (listed or issued instruments kept in safe custody by the market participant offshore and traded abroad) amounted to R2,6 billion in 1995 and only R21 million in the first six months of 1996 owing to the instability in the external value of the rand.

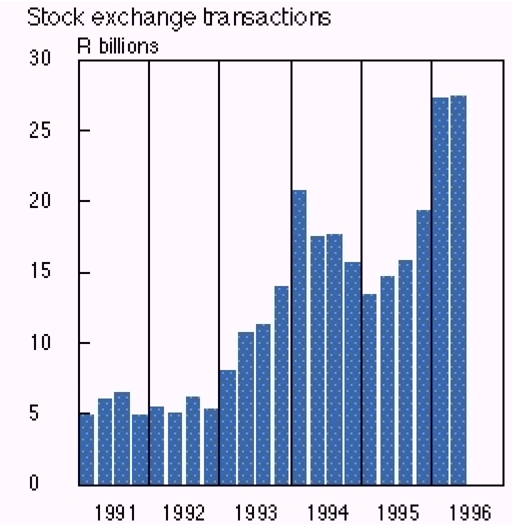
The proportion of funds raised in the primary equity market by means of rights issues of ordinary shares increased over the period under review. New capital acquired through scrip dividend issues (scrip issued to the holder of shares in lieu of a cash dividend) also remained an important method of raising capital on the Johannesburg Stock Exchange as a result of the high rate of Secondary Tax on Companies at the time. The percentage share of these two sources of new capital raised on the stock exchange rose from 50 per cent in 1994 to 53 per cent in 1995 and 64 per cent in the first half of 1996.



Capital procured through the acquisition of assets (shares issued for the acquisition of assets not already listed) declined markedly from 1994 to 1995, before increasing again in the first half of 1996.

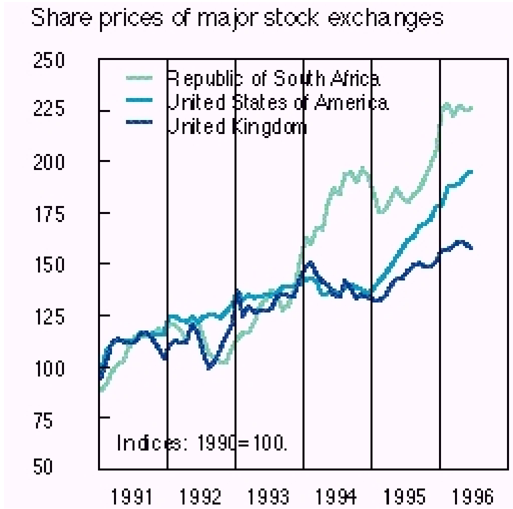
The value of shares traded in the secondary equity market, which had reached a low in the first quarter of 1995, recovered significantly during the course of the year in response to a softening in bond yields and higher share prices on the domestic and other major stock exchanges of the world. Despite this upward movement in turnover, at R63,2 billion the value of these transactions for the full calendar year 1995 was still 11,6 per cent lower than in 1994. Activity in the secondary equity market was exceptionally brisk and volatile in the first half of 1996 and turnover reached an all-time quarterly high of R27,4 billion in the second quarter of 1996. The increase in the value of shares was mainly brought about by a sharp upward movement in the volume traded.

Non-residents became net buyers of equities on the Johannesburg Stock Exchange as from January 1995. The net purchases of equities by non-residents rose markedly in the second quarter of 1995, probably boosted by the eventual successful removal of the financial-rand system and the inclusion of the Johannesburg Stock Exchange in the International Finance Corporation's Emerging Markets Index.



The net inflow of funds from abroad in the form of purchases of listed shares amounted to R4,8 billion in 1995, compared with R0,2 billion in 1994. Net purchases by non-residents in the first quarter of 1996 remained high at R2,4 billion, before receding somewhat to R1,9 billion in the second quarter and R0,7 billion in July 1996 when expected returns on equities had to be scaled down because of potential currency risks.

The performance of share prices on the Johannesburg Stock Exchange compared favourably with that of previous periods of economic recovery. After having increased nearly uninterruptedly by 93,1 per cent from October 1992 to a peak in November 1994, the average price level of all classes of shares receded fairly sharply up to February 1995 in reaction to a decline in share prices on Wall Street, a lower gold price, the ripple effect of the Mexican crisis on emerging markets, the earthquake in Japan and pre-emptive action in anticipation of the then possible abolition of the financial rand. This downward movement was reversed by the announcement of the termination of the dual exchange rate system, attempts in the Budget to encourage foreign investment in South Africa and higher company profits. The average price level of all classes of shares rose steadily by 30,3 per cent from February 1995 to an all-time high in February 1996; it then moved sideways before it declined by 1,4 per cent in July 1996. The gains recorded by domestic equities compared quite favourably with those of the main industrial countries.



These broad movements in the average prices of all classes of shares were mainly due to corresponding movements in the prices of industrial and commercial shares and financial shares. The prices of gold-mining shares, however, declined by 44,0 per cent from September 1994 to December 1995, mainly due to lower gold-mining profits related to labour unrest on certain mines and the mining of lower grade gold-bearing ore. In January 1996 the prices of gold-mining shares reacted vigorously to the higher gold price, which broke through the $400 per fine ounce resistance level for the first time since July 1993. Towards the end of February 1996 the gold price began to level off in dollar terms, but rose sharply in rand terms owing to the depreciation of the rand. As a result, the average price of gold-mining shares in July 1996 was 37 per cent above its level at the end of 1995.

Table 10. Dividend yield, earnings yield, price-earnings ratio and yield gap on all classes of shares on the Johannesburg Stock Exchange

	Dividend yield Per cent	Earnings yield* Per cent	Price-earnings ratio*	Yield gap Percentage points
1994: Dec	2,19	5,27	18,97	14,61
1995: Mar	2,50	5,95	16,80	14,22
• June	2,44	5,94	16,84	14,34
• Sept	2,51	6,31	15,85	12,98
• Dec	2,32	6,04	16,56	12,24
1996: Mar	2,21	6,07	16,48	12,83
• June	2,23	6,11	16,36	13,55

* Excluding gold-mining shares

As shown in Table 10, indicators such as the dividend yield, the earnings yield, the price-earnings ratio and the yield gap (monthly average yield on government stock less the dividend yield on all classes of shares), clearly reflected the high level of share prices.

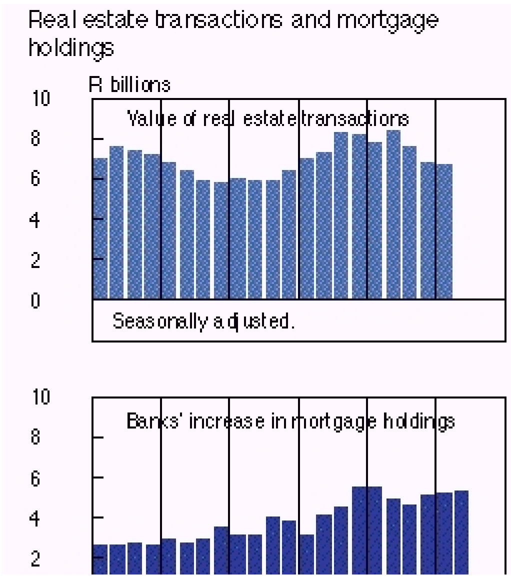
Market for derivatives

The high level of economic activity and the strong share market led to a high turnover on the South African Futures Exchange throughout 1995 and the first half of 1996. At an average of 98,8 per cent of total turnover, equity futures and options contracts continued to dominate trade on the futures exchange, while activity in bond, Krugerrand and bank bill futures contracts was relatively insignificant. In view of the dominance of equity futures, activity in the formal derivative market closely resembled that on the stock exchange. After having increased to a new record level of 1,4 million contracts in the first quarter of 1995, the level of activity subsided to an average of 0,7 million contracts in the last three quarters of the year. This decline could mainly be attributed to relatively stable conditions in the equity, bond and foreign exchange markets and greater wariness about futures transactions in the wake of the Barings incident. Volatility in the underlying financial markets and divergent views about future developments then caused an increase to 1,1 million contracts in the first quarter of 1996 and 0,9 million contracts in the second quarter.

Trade in commodity futures is still very illiquid because the futures exchange only recently introduced these contracts. The first maize commodity futures contract was physically delivered at a silo in May 1996. Activity in commodity futures contracts will probably start to expand as the marketing of agricultural products is transformed from the existing protectionist system to a more market-oriented system.

Mortgage and real estate market

The mortgage market remained relatively vibrant during 1995, despite a lacklustre real estate market. The lively activity in this market was to a large extent due to the active promotion by banks of mortgage lending and the flexibility of some of the mortgage schemes.



The banks' total mortgage loans outstanding increased from R110 billion in December 1994 to R130 billion in December 1995 and R139 billion in May 1996. Mortgage advances paid out increased by 24 per cent in 1995, but much more modestly by 14 per cent in the first five months of 1996 compared with the corresponding period in the preceding year.

The government's mass housing programme, which had been launched in June 1995, had only a small impact on mortgage financing due to delivery problems. Several institutional innovations were, however, set up to promote this scheme, including a Mortgage Indemnity Fund, a National Home Builders Registration Council and a rationalisation of various housing finance intermediaries. The Mortgage Indemnity Fund was established by the Department of

Housing as a special purpose vehicle to indemnify mortgage lenders against the risk of default by certain classes of borrowers following the understanding reached between the Minister of Housing and the Association of Mortgage Lenders. A Builders Warranty Scheme was also introduced to protect banks against defective products, and the credit criteria for subsidies were revised by the Association of Mortgage Lenders and government.

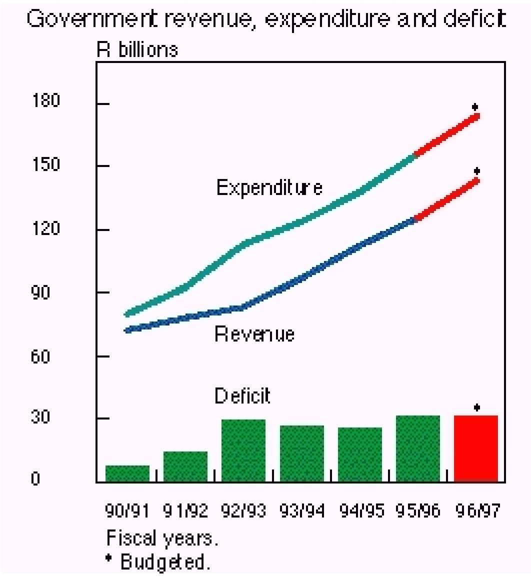
The real estate market remained sluggish in 1995. The cost of mortgage finance, as reflected in the high nominal and real mortgage rates as well as the high level of the home owners' cost component of measured inflation, and expected further rises in interest rates, were probably mainly responsible for these dull conditions. The value of real-estate transactions receded more specifically in the second half of 1995 from a high of R8,3 billion in the second quarter to R6,8 billion in the fourth quarter. In the first five months of 1996 real estate transactions totalled R13,5 billion, which was 0,3 per cent lower than in the corresponding period of the preceding year.

PUBLIC FINANCE

Fiscal policy

As part of a broader overall economic policy to promote economic growth with outward-oriented policies and increased international competitiveness while addressing the problems of poverty, unemployment and low living standards, the government adopted a medium-term fiscal programme in 1994. The main thrust of this policy was to create conditions conducive to sustained high economic growth and improving the lot of the underprivileged population through education, housing, health care, land reform, water supply, electrification and other elements of urban restructuring, as was set out in the Reconstruction and Development Programme of government. It was, at the same time, recognised that government must reduce its demands on domestic saving by cutting the fiscal deficit.

The main objective in the past three years has accordingly been the reprioritisation of government expenditure, while applying fiscal discipline to reduce the deficit before borrowing and debt repayment by ½ percentage point of gross domestic product annually to a ratio of 4,5 per cent in fiscal 1998/99.



Government also aspired to lower government consumption expenditure relative to gross domestic product to keep overall wage and salary increases within tolerable limits and to strengthen general government's contribution to gross domestic fixed investment. Besides the savings in expenditure, the reduction in the budget deficit had to be achieved through a reform of the tax system, while capping the ratio of government revenue to gross domestic product at approximately 25 per cent.

Taking these broad objectives into consideration, the Budget for fiscal 1996/97 provided for a deficit of R30,7 billion, or 5,5 per cent of estimated gross domestic product if extraordinary receipts are regarded as part of financing and are not included in revenue. If scheduled loan redemptions of R16,3 billion are taken into account, the gross borrowing requirement is R47,0 billion, which the government intends to finance mainly by issuing domestic government stock to the amount of R39,6 billion. The rest of the shortfall will be met by proceeds from Treasury bills (R3,0 billion), foreign loans (R2,5 billion) and extraordinary receipts (R1,9 billion). The gross borrowing requirement in fiscal 1996/97 is expected to increase government debt to R311,7 billion, or 55,6 per cent of gross domestic product at the end of March 1997.

Government revenue was projected to rise by 13,6 per cent to R143,0 billion in fiscal 1996/97. This should bring about a marginal increase in the ratio of government revenue to gross domestic product from 25,3 per cent in fiscal 1995/96 to 25,5 per cent in fiscal 1996/97, i.e. to a level slightly above the stated target of government. As part of the restructuring of government revenue, various measures were introduced and tax changes announced, including the following:

- the establishment of the South African Revenue Service, which will be responsible for the collection of taxes in order to increase the efficiency of tax administration;

- modifications to value-added tax, consisting of the removal of exemptions on gambling and fee-based financial services, but maintaining the rate of this tax at 14 per cent;

- the abolition of the levy on financial services;

- amendments to income tax on individuals by increasing the minimum taxable income threshold, reducing the number of tax brackets and raising the threshold on which the maximum marginal rate of 45 per cent becomes applicable from R80 000 to R100 000;

- the reduction of the secondary tax rate on companies' dividend payments from 25 to 12,5 per cent, while retaining the corporate tax rate at 35 per cent;

- the introduction of a 17 per cent tax on the monthly gross interest and net rental income of pension, provident and other retirement funds; and

- increases in excise duties, the fuel levy and the rates of estate duty and donations tax.

Government expenditure was projected to increase by 10,4 per cent to R173,7 billion in fiscal 1996/97. This should bring the ratio of government expenditure to gross domestic product down from 31,4 per cent in fiscal 1995/96 to 31,0 per cent in fiscal 1996/97. Important changes envisaged on the expenditure side of the Budget, include:

- a reform of the budgetary process and the development of a medium-term expenditure framework;

- the restructuring of the public service that will reduce the number of employees in the civil service by 300 000 over three years;

- an improvement in the conditions of service of government employees, with a rise of 13,2 per cent in the wage bill in fiscal 1996/97, reflecting partly the costs associated with voluntary retirement packages;

- cutbacks in non-interest current outlays, mainly affecting subsidy programmes and defence, while expenditure on education, health and policing will be increased;

- a decrease in the funds allocated to housing, but actual outlays are expected to rise by as much as 24 per cent owing to funds carried over from previous allocations and new allocations to the Reconstruction and Development Programme amounting to R7,5 billion; and

- a decline in the ratio of capital expenditure to gross domestic product from 2,6 per cent in fiscal 1995/96 to 2,5 per cent in fiscal 1996/97.

As part of a general framework for a Macro-Economic Strategy for South Africa, the government announced on 14 June 1996 an acceleration in this reform of fiscal policy. The new Macro-Economic Strategy of government envisages:

- a progressive strengthening in economic growth over the following years to reach a level of 6 per cent in the year 2000;

- containing inflationary pressures in the economy below the level of 10 per cent by adopting a tighter fiscal stance, an appropriate monetary policy able to stabilise the real exchange rate over the long term, further tariff reductions and a commitment to moderate wage demands;

- employment growth above the increase in the economically active population by increasing the labour-absorption capacity of the economy;

- a deficit on the current account of the balance of payments varying between 2 and 3 per cent through an expansion of non-traditional exports;

- a gradual rise in the ratio of gross domestic saving to gross domestic product to a level of 21½ per cent in 2000, primarily because of a reduction in government dissaving; and

- an improvement in income distribution through a change in the composition of government spending, the direction of tax and investment incentives and the delivery of social services.

An important element in this strategy is a much quicker improvement in the fiscal deficit. This will involve tighter fiscal policy measures to bring the fiscal deficit target down from 4,5 to 4,0 per cent of gross domestic product in the fiscal year 1997/98 and to reduce it further by 0,5 per cent per year to 3,0 per cent of gross domestic product in fiscal 1999/2000. According to the strategy, this will mainly be achieved through a cut in government expenditure and the creation of a more cost-effective civil service. Careful management of the government wage bill is central to this strategy, including a voluntary severance policy package that will be managed to limit the loss of skilled personnel and costs to the fiscus. This will allow for an increase in expenditure on projects of a capital nature and the upliftment of the poor.

A range of budgetary restructuring initiatives is also indicated in the Macro-Economic Strategy, such as the earlier presentation of budgets to parliament, the switch to an accrual accounting system, a revised basis for reporting assets and liabilities, revision of the accountability of government departments and a transformation of the structure of inter-governmental financial relations. Further steps will be taken to overhaul the tax system, while keeping the ratio of tax to gross domestic product at approximately 25 per cent. The existing arrangements for the financing and management of government debt will also be reviewed.

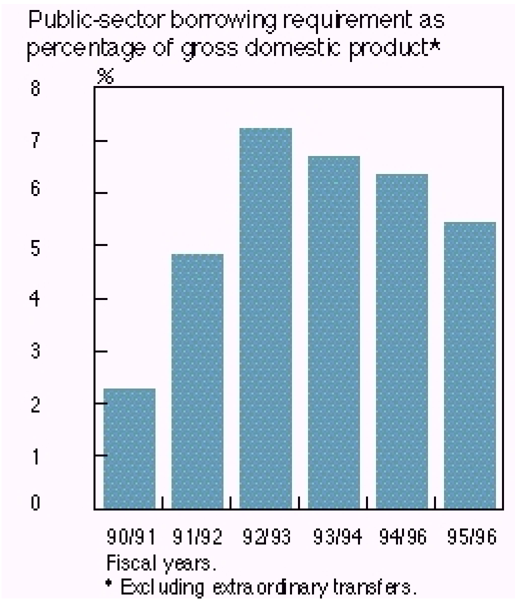
Fiscal policy will be affected by the substantial increase envisaged in investment in social and economic infrastructure in the strategy to improve productivity and achieve higher growth. Land reform, education, health and welfare services, housing, agricultural development, technology enhancement, crime prevention, urban infrastructure, water and sanitation are some of the areas that will receive attention. Although part of this expenditure will have to be financed with government funds, three other sources of finance are potentially available: concessional finance from multilateral institutions and other international sources, development finance channelled through development finance institutions and loans raised on commercial terms.

A further element of this strategy in the realm of fiscal policy is the implementation of asset-restructuring programmes by the public sector. Detailed sectoral consultations, planning and preparation are already taking place in this regard. The restructuring should lead off with the sale of non-strategic assets and the creation of partnerships between the public and private sector in transport and telecommunications. This may involve the total sale of the asset, a partial sale to partners or the sale with government retaining the main interest.

Public-sector borrowing requirement

Against the background of this fiscal policy stance, the total 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 enterprises) amounted to R30,0 billion in fiscal 1995/96, or R1,8 billion above the level in the preceding year. If the extraordinary transfer of R3,1 billion to the Reserve Bank in March 1996 to defray the losses on the Gold and Foreign Exchange Contingency Reserve Account is not taken into account, the total public-sector borrowing requirement in fiscal 1995/96 was actually R1,3 billion less than in fiscal 1994/95.

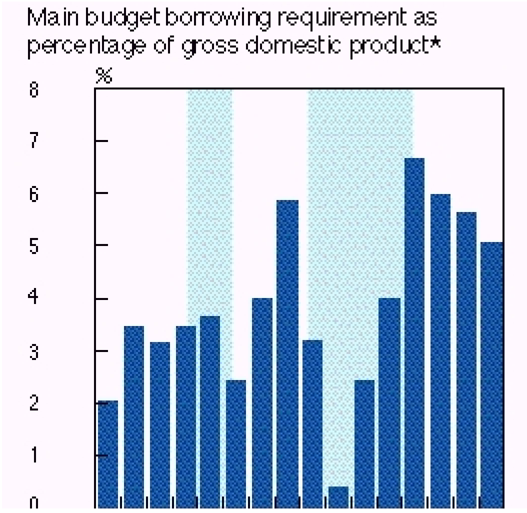
As a ratio of gross domestic product, the public-sector borrowing requirement has been reduced from an all-time high of 10,4 per cent in fiscal 1993/94 to 6,3 per cent in fiscal 1994/95 and 6,0 per cent in fiscal 1995/96. If extraordinary transfers are excluded, the ratio of the borrowing needs of the public sector to gross domestic product contracted from 6,7 per cent in fiscal 1993/94 to 5,4 per cent in fiscal 1995/96.



This was exactly equal to the average ratio of 5,4 per cent that had been recorded in the public-sector borrowing requirement (excluding extraordinary transfers) relative to gross domestic product in the 1980s.

An analysis of the public-sector borrowing requirement by type of institution shows that the larger requirement in fiscal 1995/96 was mainly due to a deterioration in the deficit on the Main Budget and in the internal financing of public corporations. An increase in the investments of public corporations caused the surplus of R0,6 billion on these institutions' income and expenditure accounts in fiscal 1994/95 to turn around to a deficit of R1,4 billion in fiscal 1995/96. Total investment by non-financial public corporations increased from R8,7 billion in fiscal 1994/95 to R10,7 billion in fiscal 1995/96, of which no less than R7 billion was spent on electricity, gas and water. The overall financial position of all the other public-sector entities improved in fiscal 1995/96: the borrowing requirements of the extra-budgetary institutions and provincial governments, in fact, switched around from deficits of R0,8 billion and R2,4 billion in fiscal 1994/95 to surpluses of R0,2 billion and R0,1 billion in fiscal 1995/96, respectively, while the borrowing requirement of local authorities improved slightly from R0,5 billion to R0,4 billion over the same period.

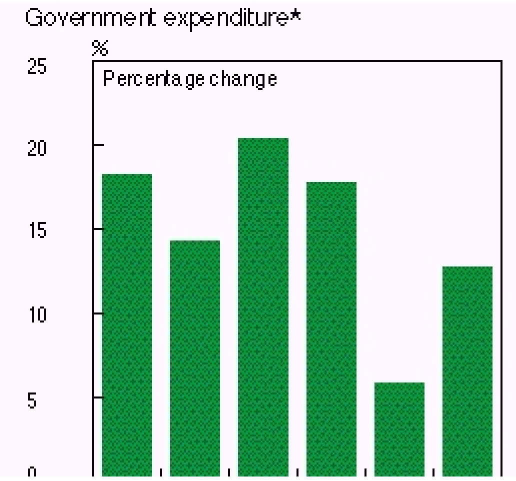
The deficit on the Main Budget increased from R25,0 billion in fiscal 1994/95 to R28,2 billion in fiscal 1995/96, largely as a result of a more rapid expansion in government expenditure (including extraordinary transfers) than in government revenue.



As a ratio of gross domestic product, the deficit on the Main Budget (excluding extraordinary transfers) amounted to 5,1 per cent in fiscal 1995/96; this ratio can be compared with 5,6 per cent in fiscal 1994/95 and 6,6 per cent in fiscal 1992/93, i.e. at the start of the upturn in economic activity. As illustrated in the accompanying graph, this is high for the advanced stage in the upswing of economic activity. In previous periods of economic recovery, the ratio of the deficit on the Main Budget to gross domestic product had receded to much more manageable levels. Considerable fiscal restraint will therefore have to be applied by the government to reduce this ratio further in the next few years.

Government expenditure

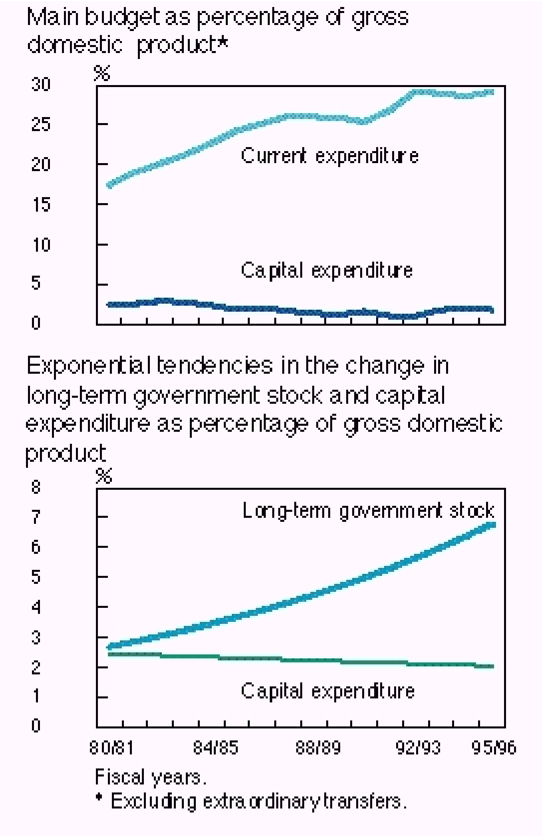
After having restricted the growth in government expenditure to an average annual rate of 10,1 per cent in fiscal 1993/94 and fiscal 1994/95, the total outlays of the government rose by 15,0 per cent in fiscal 1995/96. A large part of this higher rate of increase was due to the capital transfer to the Reserve Bank for losses incurred on the Gold and Foreign Exchange Contingency Reserve Account. If this transfer is not taken into consideration, other government expenditure rose by 12,7 per cent in fiscal 1995/96.



A large capital transfer was, however, also made in fiscal 1993/94; disregarding this transfer, expenditure rose at an average annual rate of only 11,8 per cent in fiscal 1993/94 and 1994/95.

Without downplaying this remarkable achievement in constraining the growth in government expenditure to levels considerably lower than the average of 16,2 per cent in the three-year period to fiscal 1992/93, it was to some extent also due to the fact that government did not succeed in implementing all its planned expenditure. The amount of rolled-over expenditure that was not spent from allocated funds increased steadily to R1,2 billion at the end of fiscal 1993/94, R3,4 billion at the end of fiscal 1994/95 and R6,4 billion at the end of fiscal 1995/96. If all these carry-overs should be spent in fiscal 1996/97, it would increase the growth in government expenditure and perhaps be interpreted as a failure to maintain fiscal discipline.

The increase in government expenditure in fiscal 1995/96 occurred mainly in current expenditure. Capital expenditure (excluding extraordinary transfers) as a ratio of gross domestic product, declined marginally further from 1,9 per cent in fiscal 1994/95 to 1,8 per cent in fiscal 1995/96; this level is somewhat lower than the average ratio of 2,2 per cent in the 1980s and 2,5 per cent in the 1970s.



The restriction in the growth of capital expenditure formed part of a strategy to contain the increase in total expenditure, while allowing current expenditure to grow relatively rapidly. The ratio of current expenditure (excluding extraordinary transfers) to gross domestic product rose nearly unabatedly from 17,4 per cent in fiscal 1980/81 to 28,9 per cent in fiscal 1993/94; it then declined to 28,6 per cent in fiscal 1994/95, before rising again to 29,1 per cent in fiscal 1995/96.

Not only did government increase current expenditure at the cost of capital expenditure, but a progressively larger proportion of the rise in expenditure was financed by means of an increase in government debt. As shown in the accompanying graph, the gap between the increase in long-term government debt (obligations for future generations) as a percentage of gross domestic product and the increase in capital expenditure (gains for future generations) as a percentage of gross domestic product has widened substantially since the early 1980s.

These developments, together with a rapid growth in population and urbanisation, has led to a large increase in the need for infrastructural expenditure in the country. A government study has estimated this need at R170 billion for the next five years. To render municipal services at an affordable level to everyone within an urban local authority, will cost the country R61 billion over the next ten years. These costs are, of course, too high for the government to bear on its own, and other institutions will also have to make a contribution. Some private-sector organisations have already started creating their own development funds.

An economic classification of government's current expenditure clearly shows that the increase in this expenditure relative to gross domestic product could be attributed to rapid increases in transfer payments (due to the new constitutional developments) and the servicing of government debt. In contrast to these developments, there has been a sharp reduction in the ratio of expenditure on goods and services to gross domestic product from a high of 9,6 per cent in fiscal 1992/93 to 7,0 per cent in fiscal 1995/96.

Table 11. Components of government's current expenditure as percentage of gross domestic product

	1980/81	1990/91	1992/93	1993/94	1994/95	1995/96
Goods and services	5,0	8,7	9,6	8,9	9,2	7,0
Interest payments	1,7	4,0	4,7	5,2	5,2	5,9
Subsidies	1,2	1,4	2,0	1,8	1,4	1,3
Transfers	9,5	11,6	13,4	14,9	12,8	14,9
Current expenditure	**17,4**	**25,8**	**29,7**	**30,8**	**28,6**	**29,1**

The high increase in interest payments by government was related to two factors: a sharp increase in government debt combined with the substantially higher cost of borrowed funds. Moreover, the figures in Table 11 do not even include the discount on the issuing of marketable government securities, which has risen sharply in recent years. The continued increases in interest payments have, of course, reduced the amount available for other purposes. Despite this, the funds allocated for social services have increased from 44,1 to 46,1 per cent of total expenditure over the two-year period to fiscal 1995/96, reflecting higher expenditure on infrastructure, housing and welfare. This increase has been achieved at the expense of a reduction in the percentage share of expenditure on defence and economic services. Part of the decline in expenditure on defence was used to increase the expenditure on other protection services relative to total expenditure. The share of economic services to total expenditure was reduced by lower expenditure on transport, agriculture and export promotion.

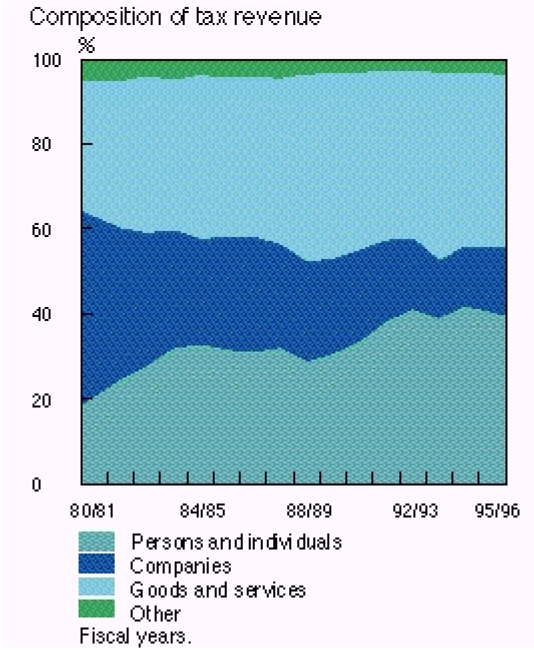
Government revenue

Total government revenue amounted to R127,1 billion in fiscal 1995/96, or to 15,3 per cent more than in the preceding year. This growth rate was slightly below the 15,7 per cent in fiscal 1994/95, and brought the average annual rate of increase in the economic upswing, which had started in June 1993, to 16,4 per cent. Although this high increase in government income was to a large extent caused by the acceleration in economic activity, the ratio of government revenue to gross domestic product rose from 23,1 per cent in fiscal 1992/93 to 25,6 per cent in fiscal 1995/96. The sharp rise in government revenue was therefore also due to increases in tax rates, such as the introduction of a temporary transition levy, an increase in value-added tax in fiscal 1993/94 and higher excise duties.

An analysis of South Africa's government revenue according to type of income reveals that the rise in government revenue over the past three years was mainly due to an increase in taxes. A consistent feature of government revenue in South Africa is that less reliance is placed on the earnings arising from property, fees and administrative charges than in many other countries where non-tax revenue is also an important source of government income. For example, the percentage share of non-tax revenue of total revenue in New Zealand came to 11,3 per cent and in Malaysia to a high 22,0 per cent in the fiscal year 1994/95, compared with only 7,3 per cent in South Africa.

Not only is South Africa heavily dependent on taxation as a means of government income, but it also relies mainly on income tax and taxes on goods and services (excise duties, fuel tax and value-added tax) to finance its expenditure. These taxes were responsible for no less than 93 per cent of total government revenue in fiscal 1995/96. Taxes on property (donations tax and estate duty) had a percentage share of 2,1 per cent of total government income in fiscal 1995/96, while the share of taxes on international trade transactions came to 1,8 per cent. Moreover, the contribution of collections from taxes on international trade transactions has decreased sharply over the past two years due to the gradual abolition of the surcharge on imported goods and the recent lowering of import tariffs.

The government has continued to rely increasingly on income tax on individuals as a source of income.



This tax as a proportion of gross domestic product, has increased from 3,4 per cent in fiscal 1980/81 to 7,9 per cent in fiscal 1990/91 and to 9,8 per cent in fiscal 1995/96. In contrast to this development, the ratio of income tax paid by companies to gross domestic product decreased from 8,6 per cent in fiscal 1980/81 to 5,1 per cent in fiscal 1990/91 and 4,0 per cent in fiscal 1995/96.

Financing of government deficit

Newly issued long-term government stock was the main borrowing instrument used to finance the government's deficit before borrowing and debt repayment in fiscal 1995/96. In view of the prevailing high market interest rates and the markedly lower coupon rates, the cost of such borrowing has increased substantially in the past two years: the discount on government stock as a ratio of the total funds raised through stock issues rose from 6,5 per cent in fiscal 1993/94 to 31,1 per cent in fiscal 1994/95 and 24,5 per cent in fiscal 1995/96. Although this practice of low coupon rates alleviates the interest commitments of government in the short term, it increases the nominal value of the paper needed to finance the deficit, and the eventual higher liability is deferred only until the maturity date of the stock.

Table 12. Financing of the government deficit in fiscal 1995/96

	R millions
Government stock (excluding discount)	29 902
Treasury bills	2 901
Non-marketable securities	-267
Money market instruments	-4 215
Foreign loans	1 745
Increase in available cash balances	-1 878
Total net financing	**28 188**

Most of the government stock issues were taken up by the non-monetary private sector and by non-residents. A sharp increase was, however, also reported in the holdings of government stock by the monetary institutions, which according to their consolidated balance sheets rose from R19,8 billion at the end of fiscal 1994/95 to R26,4 billion at the end of fiscal 1995/96. This increase included the R3,1 billion stripped coupon stock issued to the Reserve Bank in settlement of the losses on the Gold and Foreign Exchange Contingency Reserve Account. As a percentage of total government stock outstanding, the holdings of stock by monetary institutions also increased from 9,4 per cent on 31 March 1995 to 10,6 per cent on 31 March 1996.

In sharp contrast to preceding years, the Public Investment Commissioners, on a net basis, made no contribution to the financing of the government's deficit in fiscal 1995/96. In fact, the Public Investment Commissioners were net sellers of government paper to the amount of R1,1 billion; in fiscal 1994/95 they still took up R14,0 billion of the financial instruments of government. This change in the investment behaviour of the Public Investment Commissioners was due to the shifting of funds of certain members of the associated pension fund away from the Commissioners to private institutions and the Public Investment Commissioners' objective of obtaining a more diversified investment portfolio which, until now, consisted mainly of government stock.

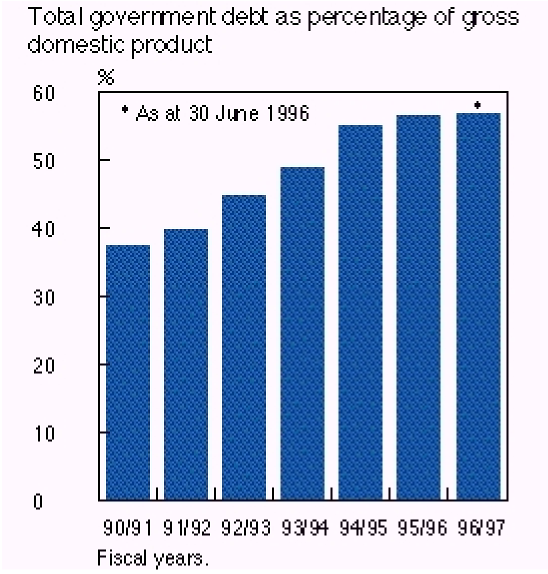
Consistent with government's policy to pave the way to finance more of the economic development needs of South Africa on international capital markets, R1,7 billion of the financing requirement was obtained in this way in fiscal 1995/96. The outstanding amount of Treasury bills also increased by R2,9 billion in the year, partly replacing maturing money market instruments previously used to finance shortfalls of the former TBVC countries and self-governing states.

Government debt

As a result of the large financing requirement of government and the high discounts on the issue of new government stock, total government debt rose sharply further to R289,1 billion at the end of June 1996. As a ratio of gross domestic product, government debt increased from 31,1 per cent at the end of fiscal 1980/81 to the high level of 56,5 per cent at the end of June 1996. Such a sharp increase in government debt is clearly unsustainable. The unsustainability of government finances is also accentuated by economic indicators, such as the high level of the fiscal deficits, the level of real interest rates relative to economic growth, the ratio of interest payments to government expenditure and changes in the net asset value of government. For example, the gap between real long-term yields on government debt and the growth rate in real gross domestic product increased from 2,0 percentage points in fiscal 1990/91 to 5,0 percentage points in fiscal 1995/96.

The government expanded its investor base during fiscal 1995/96 through two foreign bond issues. These new issues of longer-term foreign marketable stock led to an increase in the average maturity of the total foreign marketable stock from 18 months at the end of fiscal 1989/90 to 37 months at the end of June 1996. Contrary to this development, the average maturity of domestic marketable stock receded from 126 months at the end of fiscal 1989/90 to 119 months at the end of June 1996.

Other important changes occurred in the composition of government debt over the past fifteen years from the end of June 1981 to the end of June 1996, such as:



- government stock as a percentage of total government debt increased from 75,0 to 88,1 per cent, while the share of Treasury bills remained unchanged at 5,7 per cent;

- foreign debt as a ratio of total government debt increased from 3,4 to 4,1 per cent, because the government has recently made some use of foreign capital markets for its financing needs;

- the Public Investment Commissioners remained the dominant holders of government stock, but their holdings of total government stock declined from 47,2 to 33,6 per cent.

- the private banks' holdings of government stock, which continued to consist mainly of short-term stock, declined from 17,6 to 6,5 per cent of the total government stock outstanding; and

- the ratio of the non-monetary private sector's holdings of government stock (including holdings of nominees and the Central Depository on behalf of non-residents) to total government stock outstanding increased from 30,5 to 56,3 per cent.

Exchequer account in the first quarter of fiscal 1996/97

Total Exchequer issues to government departments (adjusted to reflect cash flows) amounted to R40,8 billion in the first quarter of fiscal 1996/97, which was only 0,1 per cent higher than in the corresponding period of the preceding year. This increase in Exchequer issues was well below the 10,4 per cent envisaged in the Budget for the fiscal year as a whole. As a proportion of projected government expenditure for fiscal 1996/97, Exchequer issues came to 23,5 per cent; this is considerably lower than the ratio of 26,7 per cent recorded for the corresponding period in the preceding year.

Exchequer receipts increased by 6,4 per cent from the first quarter of fiscal 1995/96 to the first quarter of fiscal 1996/97, or also at a much lower rate than the budgeted rate of 13,6 per cent for the full fiscal year. Income tax receipts and the income on value-added tax increased at a much lower rate than projected in the Budget.

The net result of these increases in government revenue and expenditure was a deficit before borrowing and debt repayment of R10,7 billion in the first quarter of fiscal 1996/97, or 8,0 per cent of gross domestic product. This deficit, together with the discount on new stocks issues to the amount of R2,4 billion, was financed as follows:

	R millions

Government stock (including discount on new stock issues)	6 370
Non-marketable securities	-56
Money market instruments	-2 981
Foreign loans	-2
Treasury bills	5 133
Extraordinary receipts	1 878
Decrease in available cash balances	2 716
Less: discount on government stock	2 405
Total net financing	**10 653**