Annual Economic Report

1992

South African Reserve Bank

A review of economic and financial conditions in the Republic of South Africa presented as background to the chairman's address to stockholders at the seventy-second ordinary general meeting to be held on 25 August 1992.

Contents

Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

Structural weaknesses in the economy, a severe drought in the summer rainfall areas, internal social and labour unrest, problems encountered in the political negotiation process, and relatively weak economic growth in most of the major industrialised countries, prolonged the downward movement in economic activity in South Africa. The recession, which started in March 1989, has therefore now become the longest downward phase of the business cycle in the post-war period, and in this century it was surpassed in length only by the recession of 1904-1908 (which lasted for about four years).

Although the downturn in economic activity was initially relatively mild, its long duration caused it to become very severe. During the downward phase non-agricultural domestic product decreased for six consecutive quarters and approximately 160 000 job opportunities were lost. Total real gross domestic product decreased by ½ per cent in both 1990 and 1991, and a further decline is projected for 1992.

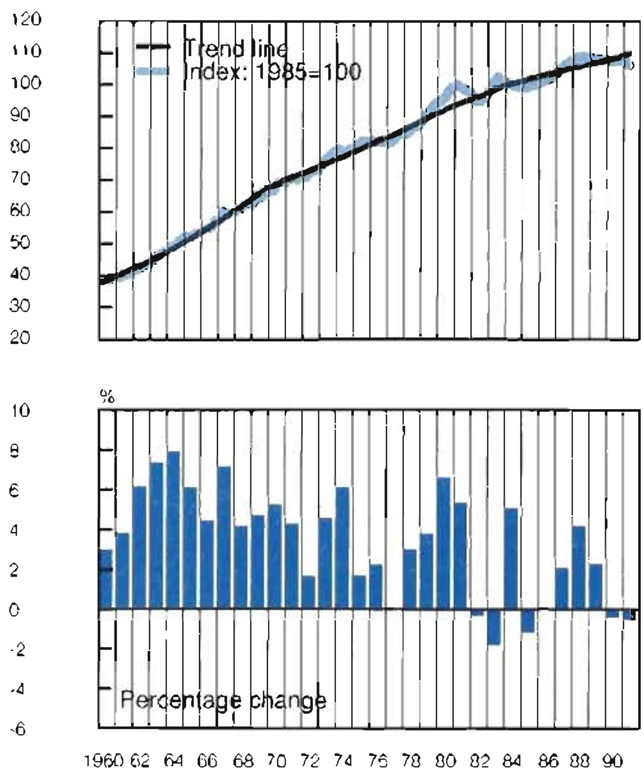
As economic activities continued to decline, the decrease in domestic production became more widespread throughout the economy. Initially only the real output of manufacturing and mining contracted; in the first half of 1992, however, decreases were registered in the value added by most of the major sectors such as agriculture, non-gold-mining, manufacturing, construction and wholesale and retail trade. These declines were countered somewhat by a small rise in gold production and in the real value added of some of the tertiary sectors.

The initial mildness of the economic downswing was supported by a firm demand for consumer goods and services, while real gross domestic investment decreased sharply. From the beginning of 1991 substantial cutbacks in households' real outlays on durable and semi-durable goods contributed to the severity of the cyclical downturn. As real personal disposable income began to decline, even real consumption expenditure on non-durable goods and on services contracted moderately. Uncertainties created by the retrenchment of a large number of employees and the faltering political negotiation process led to a rise in precautionary savings and a lower propensity to consume. The high level and cost of consumer debt together with the erosion of the net wealth of many persons also furthered a moderation of households' consumption expenditure. The resulting decrease in total private consumption expenditure in 1991 and the first half of 1992 was countered somewhat by a continued buoyancy in real government outlays on consumer goods and services.

The rate of decrease in real gross domestic fixed investment accelerated during 1991 and the first half of 1992. The further decrease in fixed investment was prevalent in all three major institutional sectors, i.e. in the investment of public authorities, public corporations and the private sector. Various factors were probably responsible for the poor investment performance, including the excess production capacity related to the low level of domestic economic activity, the low international demand and slowdown in world trade, relatively high nominal interest rates, rationalisation programmes introduced by many enterprises to cut production costs, the completion of the Mossgas project and the drought experienced in a large part of the country. Perhaps even more important than these economic developments, was the effect on domestic investment of uncertainties created by the political negotiation process, strikes, work stoppages and other socio-political problems.

Inventory investment, which had turned negative in the third quarter of 1989, declined throughout the next

Real gross domestic product



two years. The depletion of inventories, however, slowed down markedly during the second half of 1991 and therefore moderated the economic decline. In the first quarter of 1992 an apparent involuntary build-up of inventories was recorded, probably reflecting a lower than expected domestic and export demand. This was followed again by a moderate disinvestment in inventories in the second quarter of 1992.

Despite the low domestic demand for goods and services, import volumes remained on comparatively high levels for this advanced stage of the cyclical downswing. The high import propensity was caused to some extent by the substitution of imported goods for domestically produced goods in response to a decrease in the relative prices of imports. Exceptional circumstances also contributed to the relatively high import propensity, including the replacement of old and purchase of additional aircraft, a rise in the imports of mineral products, the growth in manufactured exports using a higher proportion of imported goods in the production process than traditional exports, and an increase in agricultural imports.

As a result of the decline in world trade, exports rose at a more moderate rate during 1991 and the first half of 1992, while South Africa's terms of trade weakened over the same period. Moreover, in the first half of 1992 the value of net gold exports decreased sharply and net service and transfer payments rose moderately. The surplus on the current account of the balance of payments therefore contracted significantly from R7,4 billion in 1991 to an amount of R5,2 billion (seasonally adjusted and annualised) in the first half of 1992.

The capital account of the balance of payments improved considerably since 1989, and in the first quarter of 1992 a negligible small total net outflow of capital was recorded. This lower net capital outflow was underpinned by a substantial increase in public and private placements on international capital markets. Net short-term capital movements remained volatile, but changes in these flows were more dependent on economic than political considerations. Recent political developments, however, again had a large negative impact on these capital flows and led to a net outflow of total capital of R1,9 billion in the second quarter of 1992.

The financial markets in 1991 and the first half of 1992 were characterised by levels of trading activity that in most instances bore little relation to the pace of activity in the real economy. New record levels were recorded in the turnover of public sector stock and in the value of real estate transactions. Although transactions in shares quoted on the Johannesburg Stock Exchange declined somewhat, share prices rose to new record levels before being affected by political developments in June and July 1992. Trading activity on the South African Futures Exchange was buoyant and the demand for funds in the primary capital market increased sharply. Capital market yields and longer-term interest rates generally tended downwards from the second half of 1991, reflecting slightly more optimistic inflation expectations, increased money market liquidity and a lowering of Bank rate. A softening of short-term interest rates, which had already started in February 1990, also contributed to these changes in long-term rates.

In accordance with monetary policy objectives and to prevent unduly large short-term fluctuations in liquidity, the Reserve Bank intervened quite heavily at times in the money market. Monetary discipline was maintained to create a stable financial environment that would be conducive to sustainable economic growth. The guideline ranges for the growth in money supply were accordingly reduced progressively from 14 to 18 per cent in 1989 to 7 to 10 per cent in 1992, while positive real interest rates were maintained.

Considerable success was achieved by the monetary authorities in the creation of this stable financial environment, namely:

- the twelve-month rate of increase in M3 fell from a peak of 27,5 per cent in August 1988 to 7,5 per cent in June 1992 and the growth in most of the narrower monetary aggregates was also well below the inflation rate;
- the growth in credit extended to the domestic private sector similarly declined to levels lower than the increase in the consumer price index;
- the gross gold and other foreign reserves rose to a level equivalent to just more than two months' imports of goods and services at the end of June 1992 and all the reserve-related foreign debt of the Reserve Bank was repaid;
- the real effective exchange rate of the rand became relatively stable; and
- various changes and amendments were made to legislation in order to improve the financial structure of the country.

Despite the more stable financial environment, the inflation rate as measured by changes in the consumer price index over twelve months remained high and only started to recede somewhat towards the beginning of 1992. This was not unexpected because considerable time lags exist between a decline in the growth of money supply, increases in interest rates and a reduction in the rate of inflation. Other factors that continued to inhibit a decline in the inflation rate included high inflation expectations, high wage increases, a growing budget deficit, import parity pricing practices made possible by the tariff structure in South Africa, increases in indirect taxes and the drought. In view of the recent improvement in the rate of inflation, Bank rate was reduced in two steps from 17 to 15 per cent in the first half of 1992.

Contrary to the success of the restructuring in the financial area, little progress has been made in obtaining a more efficient real production structure in the economy. In fact, most of the acknowledged structural weaknesses in the real economy worsened further in the past three years, partly because of the long and severe downturn in economic activity. In particular, the following problems became even more serious:

- unemployment increased substantially and was accompanied by real wage increases which exceeded low increases in productivity and led to further rises in real unit labour costs;
- capital productivity continued to decline more rapidly than the increase in labour productivity, which further reduced multi-factor productivity;
- the capital-labour ratio continued to rise, indicating a further capital deepening;
- the gross domestic savings ratio continued to contract sharply;
- the terms of trade deteriorated further; and
- government's involvement in the economy was increased.

Although government committed itself to restructuring public finance, it was hampered in the pursuance of this objective by low rates of increase in revenue, the severity of the drought, the need for the social upliftment of a large part of the population, the provision of relief to poverty-stricken people and the objective of obtaining parity in the provision of social benefits to the various population groups. These factors did not make it possible for the fiscus to reduce government expenditure as a ratio of gross domestic product, to decrease the tax burden on individuals and companies, to bring the government's deficit before borrowing and debt repayment down to more sustainable levels, to reduce direct taxes as a proportion of total taxes, or to eliminate dissaving by Central Government. The actual outcome of the government's finances in fiscal 1991/92 was also more expansionary than originally planned. Not only were Exchequer issues to government departments underestimated, but Exchequer revenue was overestimated; this caused the deficit before borrowing and debt repayment to rise to levels substantially higher than budgeted. The government, however, remains committed to structural reforms.

It is absolutely essential that a definite programme be developed for a gradual but concerted removal of structural impediments to economic growth, and that government, business and labour co-operate to implement such a programme in order to improve the production structure of the country. In pursuing this objective, political parties should accept that economic development should not be sacrificed for political gain. Economic retrogression is not an easily reversible process. Damage to the economy brought about by political actions may be difficult to restore once political objectives have been achieved. All and sundry should rather become committed to the promotion of economic growth in South Africa through adjustments which may be painful over the short term, but will be to the benefit of the whole country over the long term.

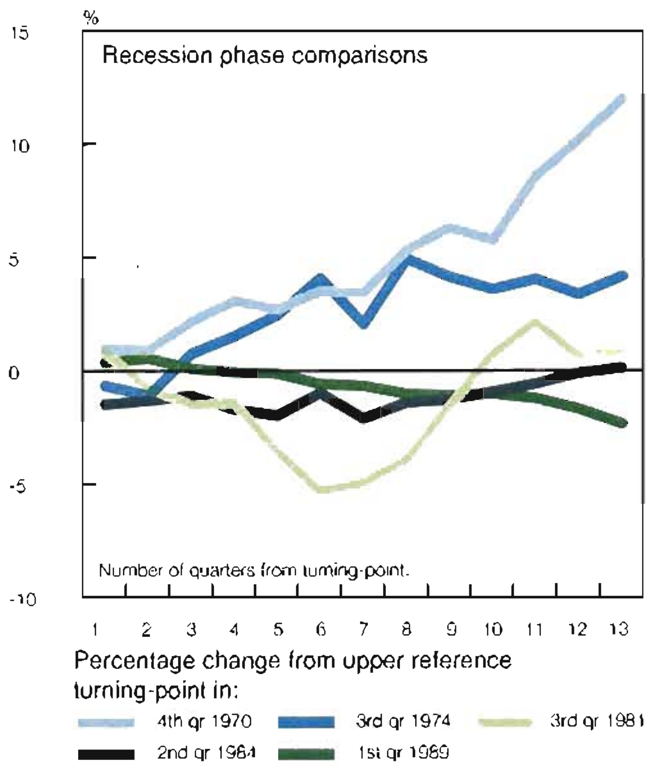
Domestic economic developments

Long and severe economic downturn and downward trend in output

The cyclical downturn in economic activity, which began in March 1989, continued throughout 1991 and the first seven months of 1992. By the end of July 1992 the economy had therefore experienced a downswing of no less than 41 months. This is considerably longer than the average length of 17 months of such cyclical contractions in the post-war period and is now also longer than the recession of 1974-1977 (40 months). In this century the length of the current downturn was only surpassed by the recession of 1904-1908, which lasted for about four years.

Not only is the length of the current downswing exceptionally long, but it has become very severe. As discussed in the *Annual Economic Report* for 1991 and illustrated in the accompanying graph, the slowdown of economic activity during the first few quarters of the recession was relatively mild compared with the recessions of 1981-1983 and 1984-1986. In fact, from the beginning of the downturn until even the second quarter of 1992 the real gross domestic product declined by only 2 per cent. However, as also shown in the graph, the downturn increased in intensity because of its long duration. In all the other downswings depicted in the graph, the economy recovered at a much earlier stage, and thirteen quarters after the start of these downturns economic activity was again on a much higher level than in the current recession. Moreover, in post-war recessions before 1980 output growth slowed down from relatively high to lower but still positive rates; in the current recession, and for that matter during the other recessions since 1980, real output declined. Employment opportunities lost during the current downswing accordingly amounted to almost 160 000, while employment continued to rise in downturns before 1980 and declined only slightly in subsequent recessions.

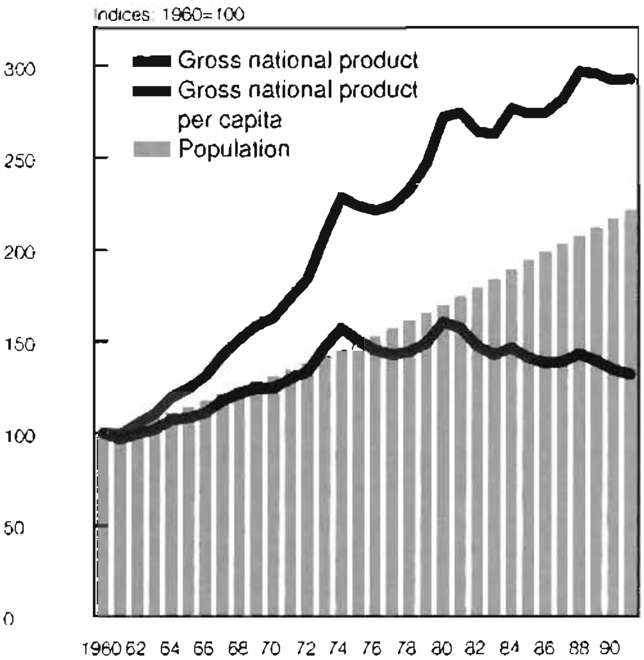
Gross domestic product at factor cost



Economic growth during the current recession was particularly affected by the following factors:

- Structural weaknesses which impeded growth, such as rising real wages, a deterioration in the terms of trade, distortions in relative factor prices, poor labour productivity, the low domestic savings ratio, inefficient use of production factors, a rising burden of taxation and high inflation. These adverse structural developments probably had a more important negative impact on growth than cyclical developments, with the result that the downturn was superimposed on a relatively flat, longer-term growth path.
- Exogenous and non-economic forces. The external liquidity crisis of 1985 and the subsequent standstill on the repayment of certain foreign debt forced South Africa to maintain a surplus on the current account of the balance of payments and to restrict economic growth. Social unrest, violence and political developments severely undermined the wealth-creating capacity of the economy, while threats of nationalisation of private assets reduced the propensity to invest.
- The extent and divergence of changes in the components of real domestic expenditure. During the first two years of the current recession declines in expenditure on capital equipment and inventories were neutralised to some extent by positive growth in real private and general government consumption expenditure. Since the second quarter of 1991 the reduction in real domestic expenditure was also brought about by a pronounced decrease in real private consumption expenditure.

Gross national product and population



- The extent and timing of the international business cycle. Traditionally, the business cycle in South Africa, as in other developing countries, responded with a time lag to cyclical changes in the industrial world. The peak of the business cycle in South Africa in February 1989, however, actually preceded the turning-points of the business cycles in most industrialised countries. Their continued high demand for South African exports therefore initially stabilised the slowdown of activity in South Africa somewhat, and the subsequent downswing in their economies later aggravated the slower domestic growth.
- Monetary policy. In earlier recessions monetary policy was pro-actively applied to stabilise growth in aggregate domestic demand over the short-term. Since 1989 monetary policy has been directed towards protecting the domestic and external value of the rand as a first step towards correcting some of the many structural weaknesses of the economy.

The combined effect of these factors and the cyclical downturn in economic activity was a decrease of ½ per cent in real gross domestic product in both 1990 and 1991 and annualised rates of decrease of 2 and 2½ per cent in the first two quarters of 1992. However, real gross national product recorded an increase of ½ per cent in 1991, following decreases of ½ and 1 per cent in 1989 and 1990, respectively. The small increase in real gross national product in 1991 could be attributed to an improvement in real net factor payments to the rest of the world which more than offset a further weakening in the terms of trade. In the first half of 1992 the terms of trade deteriorated more markedly, with the result that real gross national product declined again at an annualised rate of approximately 4 per cent compared with the last half of 1991.

The growth performance in South Africa's real gross national product amounted to a meagre 1 per cent in the 1980s, compared with 4½ per cent in the 1970s. Rapid population growth of about 2½ per cent per annum caused living standards to deteriorate sharply in the 1980s, and it seems unlikely that a merely normal cyclical recovery will result again in sustained increases in living standards without further ado. This will probably be achieved only with the help of comprehensive structural reforms.

More diffused sectoral output declines

The current downturn in economic activity was initially restricted to certain sectors. In 1989 only the real value added by the secondary and mining sectors contracted, whereas the real output of the tertiary and agricultural sectors remained buoyant. Subsequently growth in the real value added by some tertiary sectors cushioned decreases in the physical production of the primary and secondary sectors.

After having decreased on average by 7½ and 1½ per cent in calendar 1990 and 1991, current estimates suggest that *agricultural production* could recede further by as much as 15 per cent in 1992. The drought in the summer rainfall areas had a negative influence on most of the summer crops. Maize production suffered especially badly and fell back from a peak crop of 11½ million tons in 1989 to an estimated 3 million tons in 1992. In a "normal rainfall" year maize production usually varies between 7 and 8 million tons. The production of grain sorghum, sunflower seed, soya beans and dry beans was also more than halved by the low rainfall. Record deciduous and citrus fruit crops were, however, harvested in the winter rainfall area in the season of 1991/92.

It has been estimated that the growth in real gross domestic product in 1992 may be about 1,8 percentage points lower as a result of the drought and that it will have a large negative effect on the current account of the balance of payments. The drought has already caused a sharp increase in food prices and without any financial assistance it could have led to a loss of an estimated further 69 000 job opportunities and a substantial rise in the already high debt of the farmers. The lower agricultural employment could have caused the movement of an additional 250 000 people to the urban areas with substantial financial implications for public authorities. The drought is not only resulting in increased government expenditure to provide assistance to the farmers, but it also has a negative influence on the income of government as well as on the income of business enterprises associated with the farming industry.

Real *output of the mining sector*, which had declined from the first quarter of 1989 up to the middle of 1991, increased moderately in the next four quarters. The real value added by the mining industry nevertheless shrank at an annualised rate of 1 per cent from the beginning of the downturn until the second quarter of 1992. These movements in total mining output mainly reflected corresponding changes in gold production. During the beginning of the downturn cost-cutting efforts of gold mines resulted in a fall in gold output related to the closure of entire shafts and a contraction in the throughput of ore. From the middle of 1991, however, gold production started to rise moderately in response to the mining of higher-grade ore.

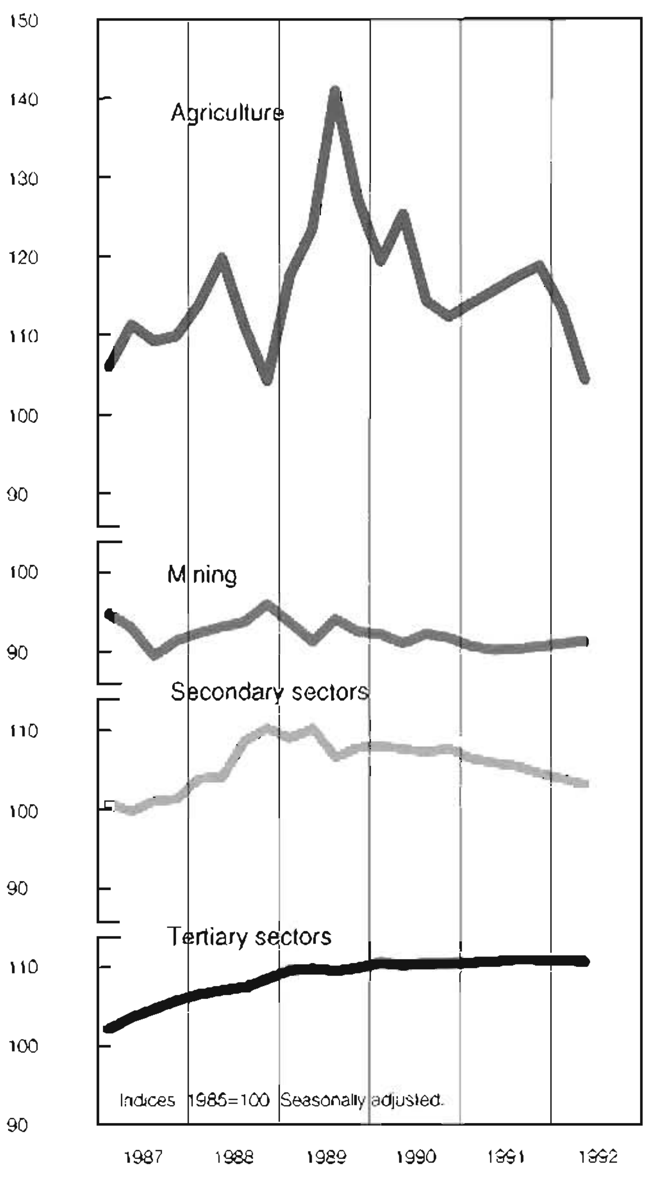
Non-gold-mining production began to decline from the middle of 1990 because of a lower demand by major industrialised countries as well as work stoppages experienced at certain mines. Coal production was also affected by an increase in world supply, while the low levels of oil prices after the Gulf War provided little incentive for users to substitute coal for oil. In the domestic market the closure of three coal-burning power-stations forced the collieries supplying them to either close down or to cut back their operations. Real value added by "other" mining industries also continued to contract markedly in the past three years.

Real output in the *secondary sectors* declined at a relatively moderate annualised rate of 1½ per cent in the current downswing, compared with corresponding declines of 7½ and 4½ per cent recorded in the cyclical downswings of 1981-1983 and 1984-1986, respectively. This decline started in the middle of 1989, and the long period over which it took place seriously affected the secondary industries, especially manufacturing enterprises. Output of the *manufacturing industry* was also hampered by sporadic unrest, industrial action by trade unions and stay-aways. From the second half of 1991 manufacturing enterprises were badly affected by the generally weaker than expected domestic demand, which induced some factories to reduce the length of the work week and in some instances to close down temporarily. The low domestic demand caused some manufacturers to seek foreign outlets for their goods, leading to a sharp increase in manufactured exports. The percentage utilisation of manufacturing production capacity nevertheless receded from nearly 85 per cent at the beginning of the downturn to 81 per cent in the second quarter of 1992.

The real value added in the secondary sector *electricity, gas and water* increased throughout the downswing of 1989-1992, albeit at moderate rates. However, the real output of the *construction industry*, which had moved virtually horizontally in 1990, contracted sharply in 1991 and in the first half of 1992 as the demand for non-residential buildings and construction works fell back sharply.

In contrast to the contraction in the output of the primary and secondary sectors, the real value added by the *tertiary sectors* rose moderately in the current recession, and in the first half of 1992 it was about 1 per cent higher than at the beginning of the downswing. This relatively steady rise reflected

Components of real gross domestic product



continued increases in real value added by financial services and general government, which neutralised decreases recorded by the commercial and transport sector. The real value added by enterprises providing transport, storage and communication services decreased in 1991 before rising again in the first half of 1992. This recent buoyancy was related to a rise in foreign trade volumes handled by domestic carriers because of the lifting of trade sanctions and the importation of maize. The value added by the commercial sector started to decrease from the first quarter of 1991 when decreases in the value added by retail and wholesale trade coincided with lower sales of motor vehicles. Reflecting lower consumption expenditure, the rate of decline in real value added by the commercial sector accelerated noticeably from the fourth quarter of 1991.

Moderate decline in real domestic expenditure

Real gross domestic expenditure began to decrease from about the middle of 1988 – i.e. even before the downturn in economic activity. Although following a fairly erratic pattern, the rate of decrease in this aggregate was at first relatively moderate, but it then began to accelerate towards the end of 1989. On an annual basis the rate of decrease in domestic expenditure rose from ½ per cent in 1989 to 2½ per cent in 1990 and then slowed down again to ½ per cent in 1991. As a result of stockbuilding and a rise in real government consumption expenditure, real gross domestic expenditure increased sharply at an annualised rate of 8 per cent in the first quarter of 1992; it then resumed its downward trend, decreasing at an annualised rate of 6½ per cent in the second quarter of the year.

As already indicated, divergent movements took place in the *main components* of domestic expenditure. During the first two years of the economic downswing it was mainly real gross domestic fixed investment and inventories which decreased sharply. This was countered to some extent by a firm demand for consumer goods and services. From 1991 real private consumption expenditure decreased and the rate of decline in real gross domestic fixed investment accelerated. However, the rate of destocking slowed down and real government consumption expenditure, on balance, rose further.

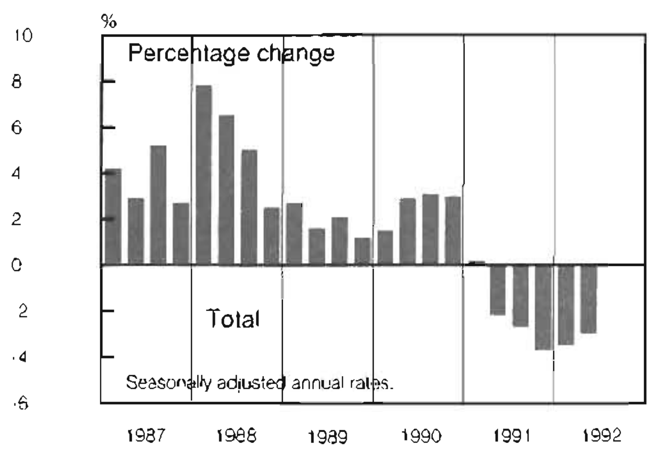
Sharp decline in real private consumption expenditure

Real private consumption expenditure not only contracted during 1991 and the first half of 1992, but the annualised rate of decrease accelerated from 2 per cent in the second quarter of 1991 to 3½ per cent in the first quarter of 1992; in the second quarter of 1992 it decreased at a marginally lower rate of 3 per cent. These high rates of decrease in the expenditure on goods and services by households mainly took the form of substantial cutbacks in real outlays on durable goods, which reflected the more discretionary and less essential nature of spending on these types of consumer items. Real expenditure on semi-durable and non-durable goods and services also decreased during 1991 and the first half of 1992, but at much more moderate rates. In the first half of 1992 the level of real durable goods purchased was 8½ per cent lower than the average annual level of 1990, while semi-durable and non-durable goods and services decreased only moderately over the same period.

The decrease in real private consumption expenditure during the eighteen months up to June 1992 was related to a corresponding decrease in *real disposable income of households*. Real personal disposable income declined by about 3½ per cent from its peak in the first quarter of 1991 to the second quarter of 1992, while real personal disposable income *per capita* contracted by 6 per cent over the same period. The lower real personal disposable income was, in turn, the result of increases in aggregate remuneration of employees that were lower than the rate of inflation, as well as a decline in the real value of household property income reflecting depressed agricultural conditions and a growing number of insolvencies among individuals and non-corporate business enterprises.

Not only the absolute value of real consumer spending, but also households' *average propensity to consume* (nominal private consumption expenditure as a ratio of personal disposable income) receded during

Real private consumption expenditure

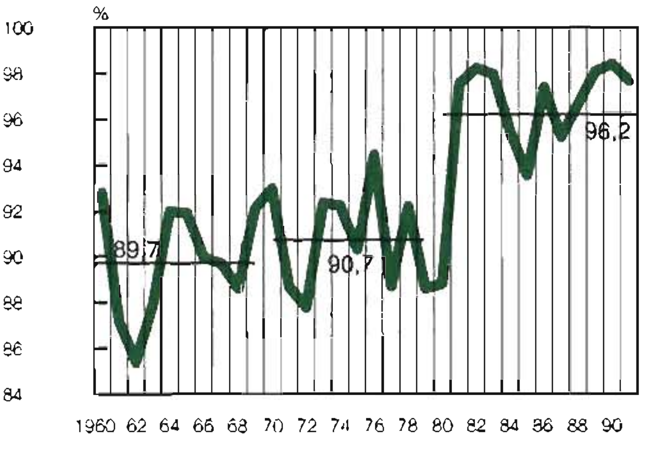


1991 and the first half of 1992. After having increased consistently from 95 per cent in 1987 to 98½ per cent in 1990, the average propensity to consume of households fell to 97½ per cent in 1991 and to 97 per cent in the first half of 1992. This, of course, indicates that lower real personal disposable income was not solely responsible for the decline in real private consumption expenditure. Other factors which probably contributed to this decrease, included:

- uncertainty created by the retrenchment of a large number of employees, leading to a rise in precautionary savings;
- the low level of consumer confidence and uncertainty created by the faltering political negotiation process, which impressed on many households the need to conserve and to retain spending power;
- the high level of consumer debt, which rose from an average of 23 per cent of disposable income in the second half of the 1980s to about 28½ per cent in 1990 and 1991;
- the high costs of debt related to high nominal interest rates, while income began to increase at a slower rate; and
- the erosion of the net wealth of households owing particularly to lower real estate values. The real value of private residential buildings fell by about 4½ per cent from the second quarter of 1990.

Despite the recent contraction in the average propensity to consume, the South African economy has been characterised by a sharp increasing trend in this aggregate (or vice versa, a declining trend in households' savings ratio) especially during the 1980s. In the 1960s the average propensity to consume

Households' propensity to consume



amounted to 89½ per cent; it then rose moderately to 91 per cent in the 1970s and more sharply to 96 per cent in the 1980s. As shown in the accompanying graph, this change (unlike the more recent decrease) cannot be regarded as a temporary or cyclical phenomenon. It represented a structurally higher propensity to consume or a structurally lower propensity to save by households, which probably reflects factors such as:

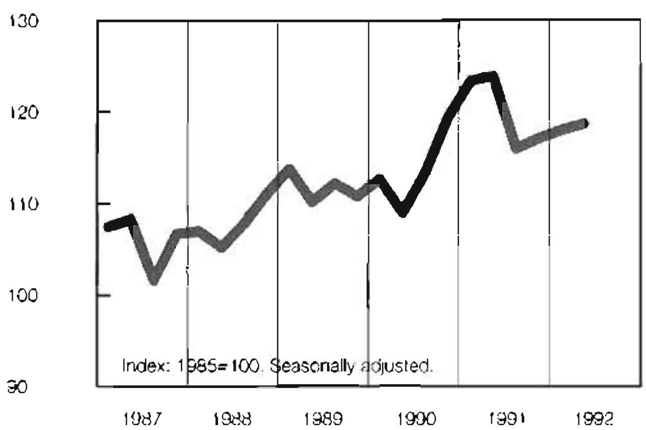
- the persistently high rate of inflation, which, combined with at least rising nominal incomes, encouraged households to purchase durable and semi-durable goods before they become even more expensive;
- the attempt of households to maintain living standards while real income per capita continued to decrease;
- the redistribution of income (that has already taken place) to population groups with a higher propensity to consume and a lower propensity to save;
- political developments, which encouraged certain residents to increase their expenditure on consumer goods and services because they created expectations of higher future incomes; and
- the relatively low level of interest rates that existed during a large part of the 1980s and which encouraged households to purchase goods and services on credit.

Further increase in real consumption expenditure by general government

Real consumption expenditure by the general government continued to rise during the current economic downturn and the rate of increase actually accelerated from 1½ per cent in 1990 to 5½ per cent in 1991; from the middle of 1991, however, the rate of increase in consumption expenditure by general government slowed down somewhat. The further rise in government consumption expenditure was the result of increases in real spending on intermediate goods and services as well as a higher real salary and wage bill. The increase in real labour remuneration of general government was caused largely by expansions of personnel in the security forces and by the governments of the TBVC countries and self-governing national states.

The relative strength of real outlays on consumption expenditure by general government during 1991 and the first half of 1992 was also evident in the increase in the *ratio of government's consumption expenditure to gross domestic product*. This ratio rose to no less than 19 per cent in 1991 and the first half of 1992, compared with an average of 11½ per cent in the 1960s, 13½ per cent in the 1970s and 16½ per cent in the 1980s.

Real government consumption expenditure



Substantial contraction in real gross domestic fixed investment

Real *gross domestic fixed investment*, which started to decline from the beginning of 1990, decreased at a more rapid rate in 1991 and the first half of 1992. The rate of decrease in real fixed investment accelerated from 1½ per cent in 1990 to 8½ per cent in 1991; this was followed by annualised rates of decrease of 6½ per cent in the first quarter of 1992 and 4 per cent in the second quarter. In the current economic downswing *net domestic fixed investment* as a ratio of gross domestic product therefore contracted from a peak of 4½ per cent in 1989 to 2½ per cent in 1991; this ratio averaged 14½ per cent in the 1970s and 8 per cent in the 1980s.

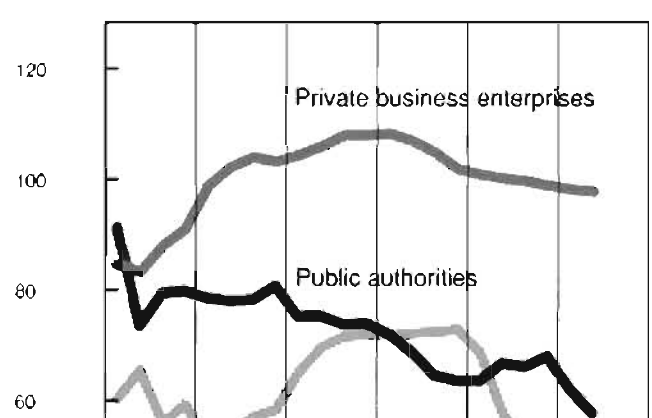
Decreases in fixed investment at constant prices during the past eighteen months were recorded in all three institutional sectors. Real fixed capital formation by the *private sector* contracted by 5½ per cent in 1991 and further at annualised rates of 2½ per cent in the first quarter of 1992 and 2 per cent in the second quarter. These declines were brought about by cut-backs in real fixed capital formation in all the major sectors of the economy, with the notable exception of the trade and accommodation sectors. Improvements in tourist-associated facilities, the development of new shopping centres and the expansion of recreational and entertainment centres in some of the TBVC countries were mainly responsible for the increase in investment of enterprises involved in wholesale and retail trade, catering and accommodation services.

The relatively large outstanding debt of the farming community, high interest rates and the current severe drought in the country, continued to depress gross fixed investment in agriculture. Mining investment was discouraged by factors such as rationalisation programmes in the gold-mining industry, low international demand and commodity prices, and the low level of domestic economic activity. After still performing relatively well in 1990, investment outlays by private manufacturing enterprises decreased by 5 per cent in 1991 and at a further, albeit lower, annualised rate of 3 per cent in the first half of 1992. This lower investment in manufacturing reflected a scaling-down of investment programmes in sub-sectors involved in the production of non-metallic minerals, basic metals and metal products.

The low investment levels in private sector companies could also be ascribed to the existence of unused production capacity. In addition to these more economic factors, investment was also seriously influenced by socio-political developments. Uncertainty regarding the future political dispensation of South Africa and a general lack of confidence led to a wait-and-see attitude which did not favour capital investment. Internal unrest in certain areas, damage to property, and statements that a future government may nationalise private assets, also had an adverse effect on new capital investments.

Expenditure on capital formation by *public corporations* was dominated by the Mossgas project in 1988 and 1989. The capital outlays on this project during 1990 also more than offset a decline in the capital expenditure of Eskom. During 1991 the Mossgas project neared completion. At the same time

Real gross domestic fixed investment



Armscor and its subsidiaries scaled down new investment expenditure because of the cessation of cross-border hostilities in southern Africa, while Eskom's excess production capacity still did not favour additional large capital formation. As a result, gross fixed investment by public corporations declined by no less than 27 per cent in 1991 and at an average annualised rate of 15 per cent in the first half of 1992.

Public authorities also proceeded with further cuts in their real fixed investment expenditure in 1991 and the first half of 1992. In an attempt to consolidate public finances the real fixed capital expenditure of the general government was reduced by 13 per cent in 1991 and further at an annualised rate of 13½ per cent in the first half of 1992. Discretionary public investment projects continued to be easier to cut than public consumption (a large part of which consists of salaries and wages of government employees), with the result that fixed investment of general government reached a level of only about 2 per cent of gross domestic product in the beginning of the 1990s, against an average of 4 per cent in the 1970s. Real fixed investment by business enterprises of general government still increased in 1991, mainly because of the acquisition of new passenger aircraft and related equipment by Transnet. However, in the first half of 1992 the fixed capital formation of these business enterprises also decreased.

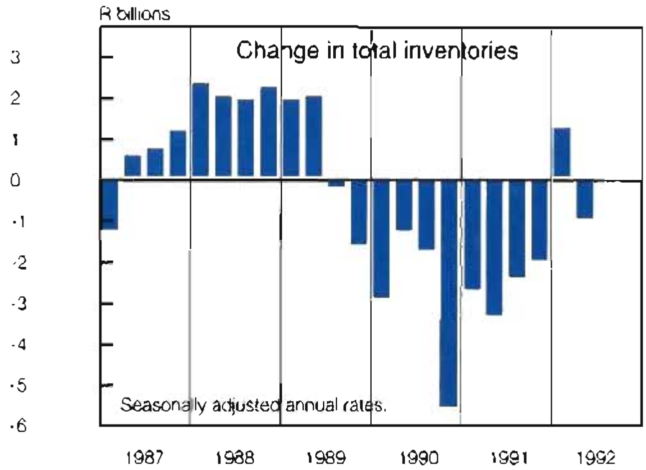
Slowdown in the depletion of inventories

Aggregate real inventory investment turned negative in the third quarter of 1989. The running-down of inventories continued in the ensuing nine quarters, but from the second half of 1991 the depletion of inventories slowed down markedly. In 1991 as a whole inventory disinvestment was slightly lower than in 1990 and therefore served to hold back the decline in output. In the first quarter of 1992 an apparently involuntary build-up of inventories took place in industrial and commercial enterprises. This could possibly be ascribed to a contraction in final domestic and export demand. In the second quarter of 1992 inventories decreased again moderately because of disinvestment by private manufacturing and commercial enterprises.

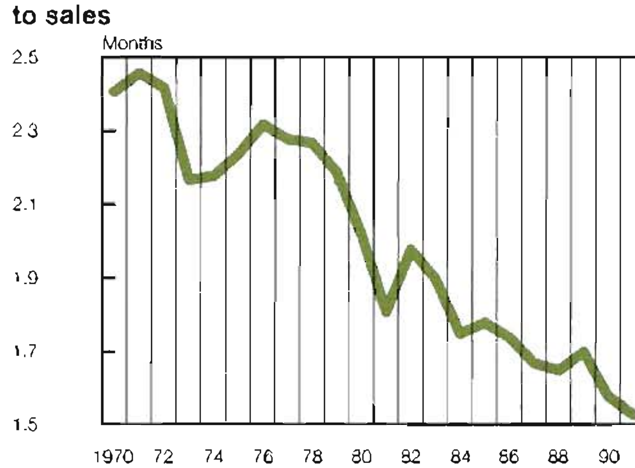
Despite the slowdown in the depletion of industrial and commercial inventories from the middle of 1991, the ratio of these inventories to non-agricultural gross domestic product moved to a low level of 18½ per cent in 1991 and almost 18 per cent in the first half of 1992. This can be compared with 19½ per cent recorded in 1990 and an average ratio of 22½ per cent during the 1980s.

Although the decrease in inventories over the past three years mainly reflected a cyclical downturn in stock levels, it also formed part of a broader structural adjustment. The use of cheaper and more powerful information-processing technologies encouraged more efficient inventory management which allowed firms permanently to reduce their inventory-to-sales ratios. Computers and advanced telecommunications permitted "just-in-time" management of inventories and eliminated the need for large buffer stocks. It is now common practice for suppliers to deliver direct to production lines or points of final sale. In South Africa, as in many industrialised countries, the inventory-to-sales ratio fell significantly; holdings of industrial and commercial inventories had been reduced to the equivalent of 6 weeks' sales in 1990 and 1991, against

Inventories



Ratio of industrial and commercial inventories to sales



a long-term average of about 9 weeks' sales. Even so, the present level of inventories is very low and an increase could contribute to an upturn in economic activity.

Further slowdown in nominal factor income growth

The rate of increase in *aggregate nominal factor income* at market prices slowed down during the current downturn from nearly 18 per cent in 1989 to 13 per cent in 1990 and 12½ per cent in 1991. In the first half of 1992 the quarter-to-quarter annualised growth rate receded further to 8 and 6 per cent in the first and second quarter. In a general sense the slower growth in aggregate nominal value added in 1991 and the first half of 1992 could be ascribed to the deepening of the recession and the slower growth in the volume of exports.

An analysis of the changes in the two principal components of factor income (remuneration of employees and the gross operating surplus) shows that the recent slower growth in aggregate factor income was mainly the result of lower rates of increase in labour compensation. The rate of increase in the *total remuneration of employees* declined from 17 per cent in 1990 to 14½ per cent in 1991 and about 11½ per cent (annualised) in the first two quarters of 1992. This deceleration in the growth of the total wage bill was fairly broadly based, but was particularly evident in the sectors mining; manufacturing; electricity, gas and water; transport, storage and communications; and general government. As discussed in more detail below, increases in the nominal wage per worker declined only moderately; the sharp decrease in the growth of the total wage bill in 1991 and in the first half of 1992 was therefore mainly due to retrenchments, rationalisation programmes and the effect of a sharp increase in the number of liquidations.

The rate of increase in the *gross operating surplus* rose from 9½ per cent in 1990 to 11 per cent in 1991. The effect of the long drawn-out cyclical downturn on corporate profits is, however, more clearly reflected in the quarterly changes at annualised rates in nominal gross operating surplus that varied between 13 and 19 per cent in the first three quarters of 1991 and at lower levels of between 7½ to 8 per cent in the next three quarters.

In view of the fact that the growth in total salaries and wages exceeded the growth in the operating surplus, the share of labour compensation in aggregate nominal factor income rose further from 57½ per cent in 1989 to 60 per cent in both 1991 and the first half of 1992. An increase in the relative share of labour remuneration in total factor income is a typical development in the advanced stages of a downturn in economic activity.

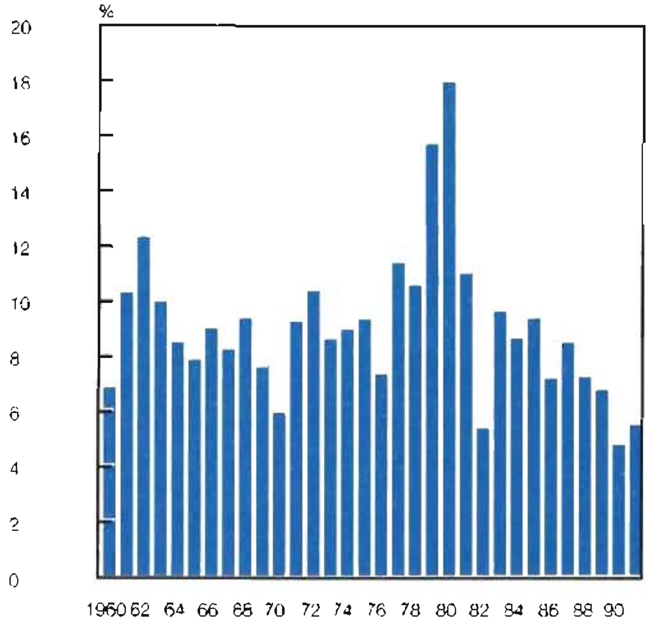
Contraction in domestic saving

The *domestic savings ratio* (i.e. the ratio of gross domestic saving to gross domestic product) was relatively firm in the long run and averages of 23½, 25½ and 24½ per cent were recorded in the 1960s, 1970s and 1980s, respectively. In the years 1985 to 1989 the ratio contracted slightly to an average of 23 per cent before it declined significantly to 21½ and 19 per cent in 1990 and 1991. In the first half of 1992 the domestic savings ratio deteriorated even further to about 18 per cent.

Although the South African savings ratio compares favourably with that of many other countries, the recent declining trend stands in sharp contrast to developments in the newly industrialised countries during the 1980s, where this ratio increased sharply. As a developing country with a high rate of unemployment, South Africa needs a satisfactory rate of economic growth which, in turn, requires an adequate rate of investment and therefore an adequate supply of domestic saving or access to external funds. Since the easy access to foreign saving came to an end in 1984, adequate domestic saving is essential for the financing of domestic investment or to repay foreign debt.

The recent deterioration in the domestic savings ratio was mainly the result of increasingly large dissaving by general government. In the post-war period general government recorded net negative

Net domestic private saving as percentage of gross domestic product



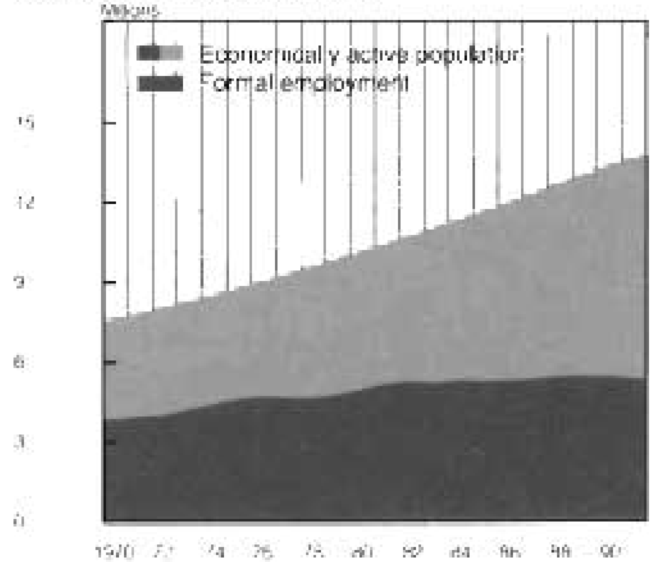
saving for a full calendar year for the first time in 1984. Dissaving then took place in the ensuing years (except for 1989 when general government was a net saver to the amount of R0,9 billion) and reached a peak in calendar 1991 of more than R7 billion. In the first half of 1992 the seasonally adjusted and annualised rate of dissaving by the general government amounted to more than R9 billion. The recent poor performance of general government saving was essentially the result of continued high increases in government consumption expenditure, the cost of servicing the public debt, current transfers to households, and of a deterioration in the growth of general government revenue.

Net saving by the *private sector* (i.e. saving by households and incorporated business enterprises), just like total saving, maintained a relatively stable ratio to gross domestic product: this ratio rose from an average of 9 per cent in the 1960s to 9½ per cent in the 1970s before it declined again to 9 per cent in the 1980s. In 1990 and 1991, private sector net saving to gross domestic product averaged only 5 per cent.

The movement of the *two main sub-components* of total private saving shows, however, divergent tendencies in the long run. Net corporate saving as a ratio to gross domestic product rose from 2½ to 4½ and 7 per cent in the 1960s, 1970s and 1980s, whereas households' net savings ratio for the corresponding periods declined from 6½ to 5½ and 2 per cent. The rising trend in the savings ratio of the corporate sector during the 1980s took place in an environment of high inflation and low to negative after-tax rates of return on depository types of saving for households. The household sector therefore acted rationally by substituting better yielding corporate saving for their traditional types of saving.

In 1990 and 1991 the savings *ratio* of the corporate sector contracted to an average of 4 per cent per year. This could, among other things, be attributed to the deterioration of company profits, the slower growth in the gross operating surplus, and the increase in the average effective corporate tax rate. Households' net saving as a ratio of gross domestic product reached a low of 1½ per cent in 1990 before rising somewhat to 2 per cent in 1991 and 3 per cent in the first half of 1992. As already explained above, this reflected a decline in real private consumption expenditure which exceeded the decline in real personal disposable income.

Economically active population versus formal non-agricultural employment



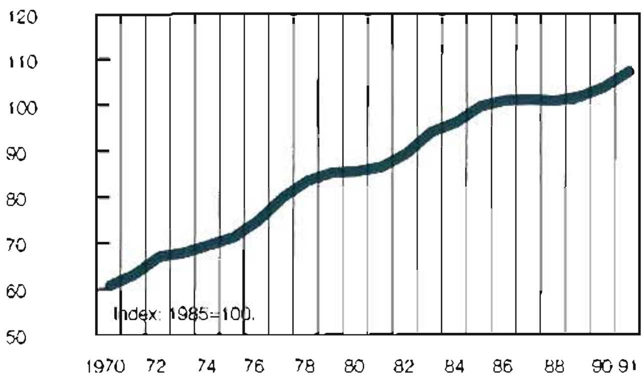
Continued decrease in employment growth, and rising unemployment

It is a well known fact that since the early 1980s the *supply of labour has exceeded the demand for labour* to an increasing extent. The economically active population increased at an average rate of 2,9 per cent per annum in the years 1970 to 1991. In the 1970s the growth in non-agricultural employment more or less kept up with this supply of labour and rose at an average annual rate of 2,8 per cent from 1970 to 1981; in the next ten years, however, the provision of formal employment in the non-agricultural sectors rose at an average of only 0,3 per cent per annum. These developments, of course, imply that the total number of persons who are engaged in informal sector activity or are unemployed increased rapidly in the period 1981 to 1991.

In fact, as shown in the table on the next page, the number of persons underemployed or unemployed in South Africa rose by an estimated 3,1 million persons from 1981 to 1991. Moreover, in this ten-year period there was an actual decrease in employment by private-sector enterprises in the non-agricultural sectors of the economy. Decreases were recorded in particular in employment in major sectors such as mining, manufacturing and construction; employment opportunities rose only in the tertiary private sectors and in general government. In the past two years employment has started to recede in all major sectors and only general government has continued to create additional employment.

The low rate of increase in employment in the formal sectors of the economy can partly be ascribed to the contraction in the growth performance of the economy, but it was also due to a sharp decrease in the *output elasticity of the demand for labour*. This elasticity was halved from an average of 0,8 during the period 1970 to 1981 to only 0,4 in the next ten years. This means that, whereas an increase of 1 per cent in the real non-agricultural gross domestic product from

Capital-labour ratio in non-agricultural sectors



1970 to 1981 would have resulted in an increase of 0,8 per cent in the number of people employed in the formal sectors of the non-agricultural economy, an increase of 1 per cent over the past ten years would have resulted in an increase of only 0.4 per cent in formal-sector employment.

This structural problem in South Africa is confirmed by the observed changes in the *capital-labour ratio*, which has increased rapidly since the early 1970s. The propensity of producers to use increasing amounts of capital rather than labour can be attributed to a number of factors, including:

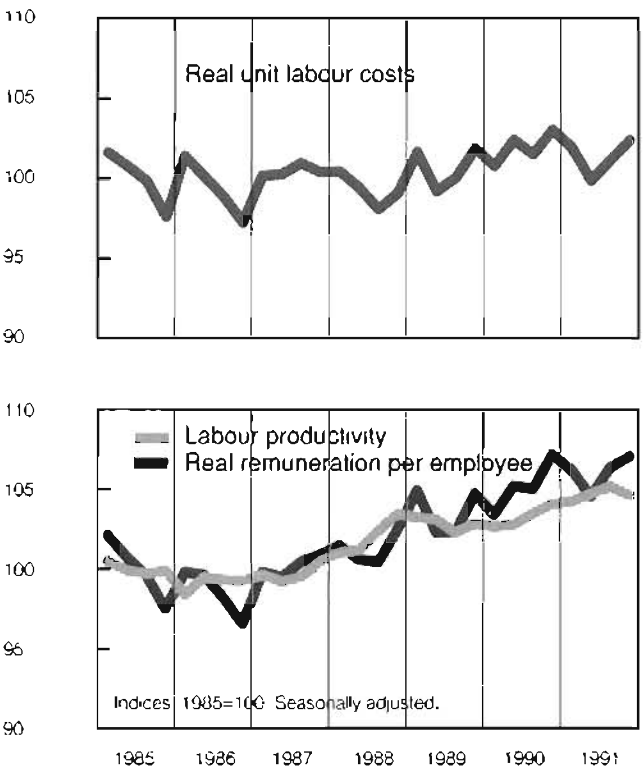
- prolonged periods of low and often negative real interest rates from the beginning of the seventies;
- the over-valuation of the exchange rate at times, especially during the early 1980s;
- tariff policies protecting local industries against foreign competition;
- tax concessions and investment allowances which reduced the cost of employing capital by producers;
- the continued rapid rise in real wages per worker;
- unionisation and the militancy of trade unions, the political element in the trade union movement, protest actions, strikes and unrest; and
- the development of strategic industries with the express purpose of making the South African economy self-sufficient in certain areas.

More recently, total *non-agricultural employment* also reacted quite markedly to the cyclical downswing in economic activity. The year-to-year rate of increase in total employment declined from 1,5 per cent in 1988 to 0,7 per cent in 1989 before it turned negative to the extent of 0,5 and 2,1 per cent in 1990 and 1991, respectively. The contraction in employment again occurred mainly in the private sector: the year-to-year rate of increase in employment in the non-agricultural private sector declined from 1,6 per cent in 1988 to 0,5 per cent in 1989, and then employment in the private sector decreased by 0,7 per cent in 1990 and 3,6 per

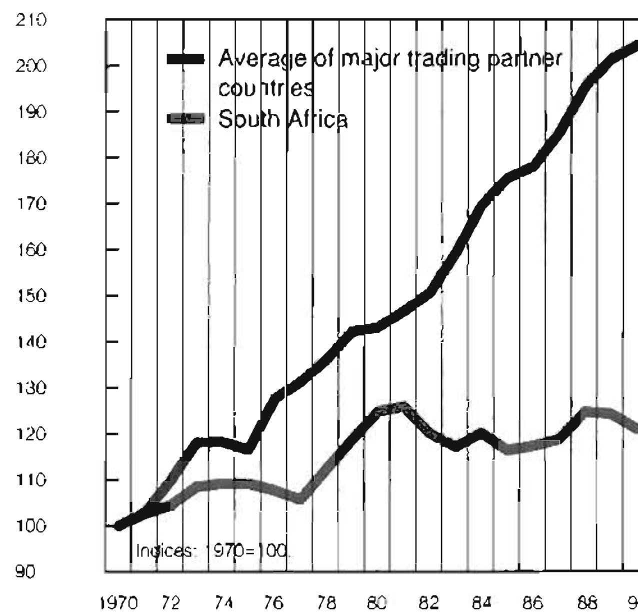
Employment in the formal sectors of the economy

	Number of persons employed 1981 (thousands)	1991 (thousands)	Change in employment from 1981 to 1991 (thousands)
Public authorities			
General government	1 029	1 350	321
Business enterprises	348	260	–88
Total	1 377	1 610	233
Private sector			
Agriculture	1 146	1 186	40
Mining	765	700	–65
Manufacturing	1 510	1 432	–78
Construction	414	389	–25
Trade	713	734	21
Other	373	433	60
Total	4 921	4 874	–47
Total employment	6 298	6 484	186
Increase in economically active population			3 327
Increase in underemployment and unemployment			3 141

Non-agricultural labour productivity, remuneration and unit costs



Labour productivity in manufacturing



cent in 1991. The rate of increase in employment by public authorities initially also slowed down from 1,7 per cent in 1987 to 0,1 per cent in 1990, but then accelerated sharply to 1,6 per cent in 1991.

Labour cost increases exceeded rising but low productivity

Despite the substantial deterioration and recent actual decreases in employment opportunities, *real unit labour costs* in South Africa showed a distinctly increasing trend in the last half of the 1980s. In the 1970s the real labour costs per unit of physical output decreased on balance to a low point in 1980; it then increased sharply up to 1982, subsided somewhat until 1986, before increasing again until 1991. The average rate of increase in real unit labour costs amounted to 1,1 per cent per annum from 1981 to 1991.

Contrary to what could be expected under normal circumstances in the labour market, the increase in unemployment in South Africa was accompanied by rising unit labour costs in the last half of the 1980s. This increasing trend in unit labour costs could mainly be ascribed to the role of labour unions. Not only did their actions affect productivity adversely because of output foregone by strikes and work stoppages, but the unions also continued to demand improved remuneration for their members without due regard to the longer-term effects on economic and social conditions.

More recently, the cyclical downturn in economic activity has begun to have an impact on the rise in unit labour costs: the rate of increase in real unit labour costs declined only moderately, at first, from 1,4 per cent in 1989 to 1,2 per cent in 1990, but real unit labour costs subsequently decreased by 0,6 per cent in 1991.

An increase in *labour productivity* to some extent countered the rise in the real unit labour costs in the last half of the 1980s. Labour productivity rose at an average annual rate of 1,1 per cent from 1986 to 1991. Over this same period *nominal salaries and wages* per worker rose by no less than 16,2 per cent per year, which represented an average annual increase of 1,7 per cent in real terms. In fact, even in the current cyclical downturn with its severe adverse effects on employment, the *real wage per worker* increased by 2,3 per cent in 1989, 1,6 per cent in 1990 and by 1,8 per cent in 1991.

Even though labour productivity in South Africa has increased over the past five years, an *international comparison of labour productivity* specifically in the manufacturing sector shows that the increase in real output per worker since the beginning of the 1970s was significantly lower than such output increases in the country's main trading partner economies. Together with the relatively high rates of increase in the remuneration of workers in South Africa, this implies that the international competitiveness of domestically produced manufactured goods has been eroded considerably since 1970.

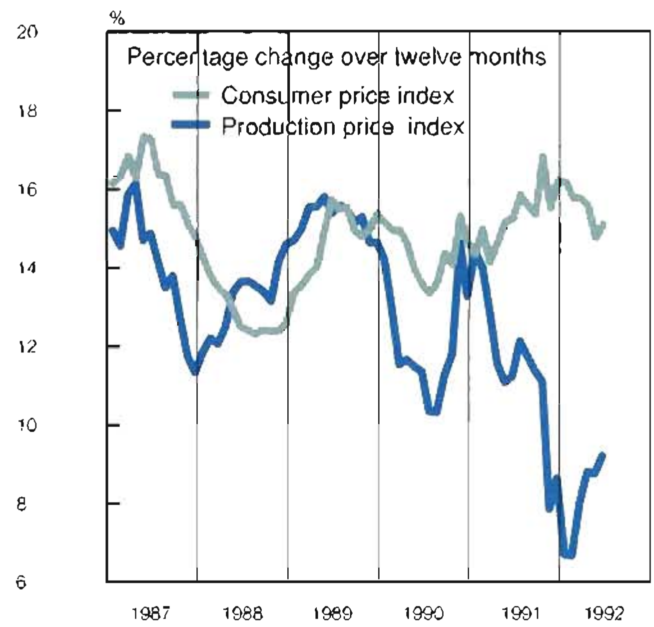
Persistently high rate of inflation, but recent encouraging signs

The South African economy has also been characterised by *a long period of high and even rising inflation.* From 1960 to 1973 consumer prices in South Africa rose at an average rate of only 3,8 per cent per annum; this rate then accelerated significantly to an average annual rate of 13,8 per cent in the years up to 1991. In 1991 the year-to-year rate of increase in the consumer price index amounted to 15,3 per cent, compared with 14,4 per cent in 1990 and 14,7 per cent in 1989. In view of the fact that inflation can only be sustained if it is continuously accommodated by an increasing money supply, the Reserve Bank's monetary policy since 1989 has been aimed mainly at restricting high inflation. Various factors, however, continued to inhibit a decline in the rate of inflation, including:

- expectations of continued high inflation, which result in upward wage adjustments as a defence mechanism against expected declines in real incomes;
- wage increases that are higher than increases in labour productivity;
- inadequate competition in the economy, which facilitates the passing-on of rising input costs by large corporations that are not unduly concerned about potential losses of market share;
- the relative size of budget deficits, which causes fears that financial discipline may be abandoned;
- the sharp increases in domestic fuel prices related to the Gulf War;
- the tariff structure in South Africa, which not only restricts foreign competition but also leads to import parity pricing policies;
- the impact of increases in indirect taxes (including the introduction of value-added tax); and
- the current drought in South Africa, which has contributed significantly to sharp increases in the consumer prices of food.

Despite the effect of these factors, encouraging signs of lower inflation have become discernible in most of the main price indices. In particular, the *year-to-year rate of increase* in the *all-goods production price index* declined quite significantly from a peak of 15,2 per cent in 1989 to 11,4 per cent in 1991. This lower rate of increase in production prices was mainly

Consumer and production prices



brought about by an even stronger decline in the rate of increase in the prices of imported goods from 16,3 per cent in 1989 to only 8,3 per cent in 1991. The rate of increase in the prices of domestically produced goods also declined during this period, albeit more modestly, from 14,8 per cent in 1989 to 12.2 per cent in 1991.

The rates of increase in the *prices of imported goods* over periods of twelve months have generally been lower than the corresponding rates of increase in the all-goods production price index since April 1990. The twelve-month rate of increase in the prices of imported goods declined from its Gulf War high of 19,1 per cent in November 1990 to 4,9 per cent in October 1991. Thereafter these prices actually declined at rates of 2,0, 1,9 and 0,9 per cent in November 1991, January and February 1992, respectively. The twelve-month rate of increase in the prices of imported goods then started to accelerate relatively strongly to 5,9 per cent in June 1992; these higher rates were, however, mainly due to the comparatively low rates of increase which were recorded in the corresponding months of the preceding year.

Mainly as a result of the Gulf War, the rate of increase in the *prices of domestically produced goods* over periods of twelve months rose to a high point of 13,9 per cent in March 1991; it then moved downwards to a low of 8,5 per cent in February 1992 before increasing again to 10,1 per cent in June 1992. This recent reacceleration was largely due to higher rates of increase in the prices of unprocessed and processed food.

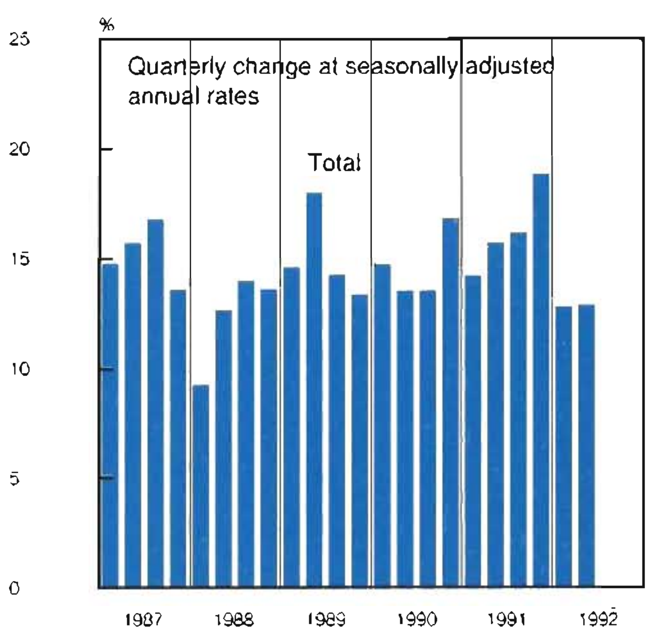
The combined result of the changes in the prices of imported and domestically produced goods was that the rate of increase in the *all-goods production price index* over *periods of twelve months* declined from a peak of 14,6 per cent in November 1990 to 6,7 per cent in January and February 1992 before it rose again to 9,2 per cent in June 1992. The *quarter-to-quarter* rate of increase in the production price index dropped even more significantly from a seasonally adjusted and annualised rate of 20,8 per cent in the fourth quarter of 1990 to 3.2 per cent in the first quarter of 1992, and then rose again to 11,4 per cent in the second quarter of 1992.

In contrast to these changes in the production price index, the rate of increase in the *consumer price index* did not resume its downward movement immediately after the Gulf War. After having declined from 15,7 per cent in June 1989 to 13,3 per cent in July 1990 (i.e. before the crisis in the Middle East could have had an impact on the domestic economy), the rate of increase in the consumer price index over periods of twelve months rose to 16,8 per cent in October 1991 (a fifty-two-month high); only then did it start to move hesitantly downwards to 15,6 per cent in April before declining more sharply to 14,8 per cent in May and to 15,1 per cent in June 1992.

The main contributing factor to this movement in the overall consumer price index has been high and even accelerating increases in the *prices of consumer goods*. For quite some time now the rates of increase in the prices of consumer goods have been significantly higher than the corresponding increases in the prices of consumer services. The high rates of increase in the prices of consumer goods were again related mainly to the substantial increases in the consumer prices of food, which for the past seven months had recorded twelve-month rates of increase of nearly 30 per cent. According to the Preliminary Report on an Investigation into the Price Mechanism in the Food Chain by the Board of Tariffs and Trade, the high increases in food prices could mainly be ascribed to corresponding high increases in input costs and to the imperfect functioning of various agricultural control boards. The extremely high rates of growth in these prices over the past few months have undoubtedly also been affected by the severe drought in the country.

Even more encouraging than the moderate slowdown in the rise in the consumer price index over periods of twelve months has been the recent sharp deceleration in the *quarter-to-quarter rate of increase* in this index. Taken at a seasonally adjusted and annualised rate, the rate of increase in consumer prices rose during 1991 from a low of 14,2 per cent in the first quarter to 18,8 per cent in the fourth quarter (i.e. with the introduction of value-added tax in October). The quarter-to-quarter rate of increase in the consumer price index then slowed down substantially to a seasonally adjusted and annualised rate of 12,8 per cent in both the first and the second quarter of 1992. If food prices are excluded, the quarter-to-quarter rate of increase in other consumer prices slowed down from 18,2 per cent in the fourth quarter of 1990 to 8,4 per cent in the second quarter of 1992.

Consumer price index



Foreign trade and payments

Sustained but smaller current account surplus

The lower growth experienced by South Africa since 1985 was to some extent a reflection of the need to manage the economy in such a manner that surpluses on the current account of the balance of payments would be large enough to meet all the country's foreign loan commitments. Relatively subdued domestic economic growth was necessary to restrain the increase in import volumes. Fortunately exports increased vigorously, making less painful restrictive measures possible than would have been necessary under different circumstances.

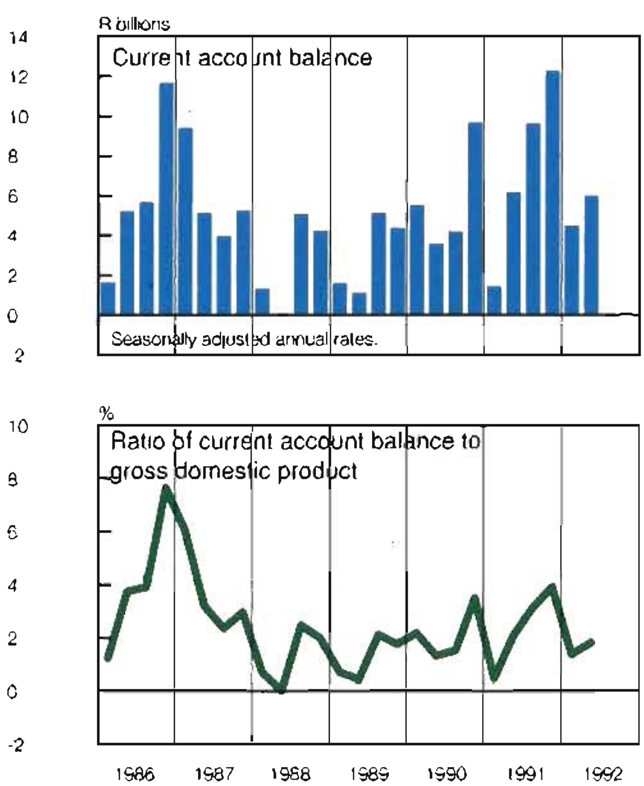
As already discussed in detail in previous *Annual Economic Reports*, this balance of payments adjustment process was undertaken very successfully. Surpluses have therefore now been recorded continuously on the current account of the balance of payments (after adjustment for seasonal factors) for thirty consecutive quarters. From the beginning of 1985 until the second quarter of 1992 the total cumulative surplus on the current account amounted to no less than R39,6 billion, or to the equivalent of 2½ per cent of gross domestic product. This represented a considerable change in the South African economy, which normally experienced deficits on the current account of the balance of payments together with an inflow of capital during the 1960s and 1970s.

In the first half of 1992 further but significantly smaller surpluses were registered on the current account. After having increased to a record annual surplus of R7,4 billion in 1991, the seasonally adjusted and annualised surplus on current account fell to R4,5 billion in the first quarter of 1992 and recovered to R6,0 billion in the second quarter. As a ratio of gross domestic product, the surplus on current account therefore contracted sharply from 2½ per cent in 1991 to 1½ per cent in the first half of 1992. The seasonally *unadjusted* surplus on current account during the first six months of 1992 was, however, still substantially higher than the net outflow of capital.

The deterioration in the current account surplus during the first half of 1992 could be ascribed mainly to:

- substantially higher merchandise imports than would normally have been expected at this stage of the business cycle;
- a marked decline in the value of net gold exports and a generally depressed gold price;
- a slower rate of increase in the value of merchandise exports in a more subdued international market; and
- a moderate rise in net service and transfer payments to non-residents – i.e. a reversal of the declining trend in these payments which had been discernible over the two years 1990 and 1991.

Balance of payments



Higher than expected merchandise imports

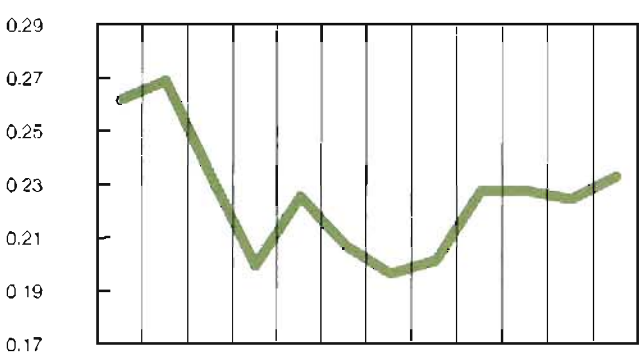
The *value of merchandise imports*, which had decreased by ½ per cent in 1990, rose by 9 per cent in 1991 and by a further 5 per cent from the second half of 1991 to the first half of 1992. These sharp increases in the value of imports over the eighteen-month period until June 1992 were recorded in most of the main categories of imported goods. Particularly the imports of transport equipment, machinery and electrical equipment, chemical products and textiles increased sharply in 1991, whereas imports of mineral products and agricultural goods rose strongly in the first half of 1992.

The sharp rise in the value of imports was largely the result of higher *import volumes*, which advanced by

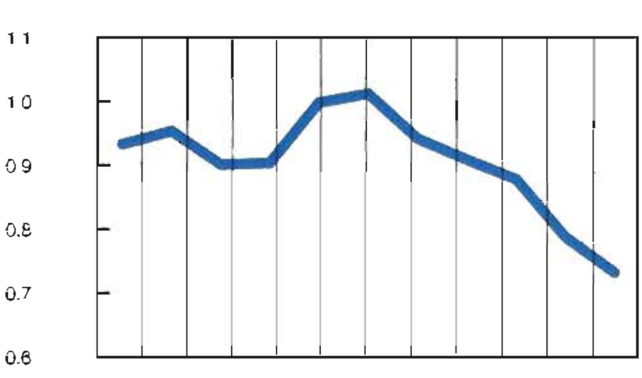
3½ per cent in 1991 and by 4½ per cent from the second half of 1991 to the first half of 1992. In fact, import volumes remained on a relatively high level during the current downturn of economic activity. The *import penetration ratio* (the volume of merchandise imports as a ratio of real gross domestic expenditure) actually showed an increasing trend from 1986 and rose further from 22,5 per cent in 1990 to 23,3 per cent in 1991 and to 23,9 per cent in the first half of 1992. At these levels, this ratio was substantially higher than the lows of 20,0 per cent in 1983 and 19,6 per cent in 1986 – both years in an advanced stage of the downswing of the business cycle.

The increasing trend in the import penetration ratio during the current economic downturn could probably be attributed partly to a substitution of imported goods for domestically produced goods in response to a decline in the relative prices of imported goods. As illustrated in the accompanying graph, there existed an inverse relationship between the import penetration ratio and the prices of imported goods relative to the prices of domestically produced goods. The average price of imported goods has increased at a slower rate than the deflator of gross domestic expenditure, and in 1991 the relative prices of imported goods were no less than 27½ per cent below their peak of 1986.

Import penetration ratio[1]



Relative price of imported goods[2]



1 Real merchandise imports as percentage of real gross domestic expenditure

2 Ratio of prices of imported goods to deflator for gross domestic expenditure.

The comparatively high level of imported goods in the current cyclical downswing was also due to somewhat exceptional developments, such as:

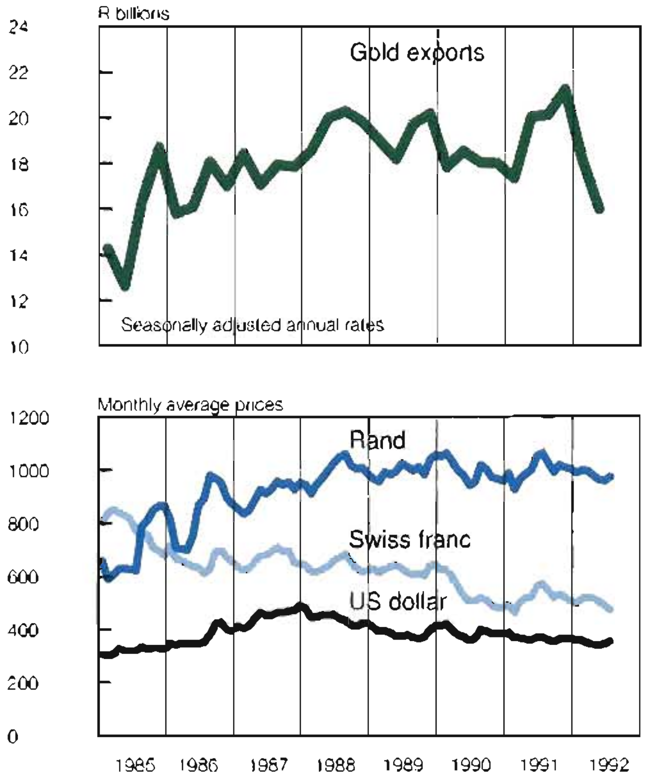
- the replacement of existing aircraft and the purchase of additional aircraft by the South African Airways, which had previously been postponed because of the limited expansion of activities and even termination of certain international flights during the second half of the 1980s, when sanctions were applied against South Africa;
- sharp increases in the imports of mineral products, which were related to the low level of international prices of these products and to the development of chemical industries;
- the change in the composition of exports in favour of manufactured goods, which require a higher proportion of imported intermediate goods than the traditional South African exports; and
- higher agricultural imports during the second quarter of 1992 as a result of the severe drought experienced in certain regions of the country.

Import prices benefited materially from the relative stability of the exchange rate of the rand, low price inflation in major trading partner countries and a decrease in international oil prices during 1991. After having increased at an average annual rate of 15 per cent from 1984 to 1989, the rate of increase in import prices amounted to only 3½ per cent in 1990 and 5½ per cent in 1991; in the first half of 1992 this rate of increase fell even further to only ½ per cent.

Levelling-off in net gold exports and depressed gold price

The *value* of South Africa's net gold exports fluctuated around a more or less horizontal trend from the beginning of 1988 until the end of 1990. At times it deviated quite significantly from this trend value because of changes in the exchange rate of the rand or in the dollar price of gold. During the course of 1991 the value of net gold exports (seasonally adjusted and annualised) rose sharply from R17,3 billion in the first quarter to R21,2 billion in the fourth quarter, mainly because of favourable forward gold sales which boosted the average realised gold price. This rise in the value of net gold exports was therefore, in a sense, somewhat artificial and could not be expected to be maintained indefinitely. In the first half of 1992 the value of the net gold exports decreased substantially to a seasonally adjusted and annualised level of only R16,0 billion in the second quarter of the year.

Gold exports and prices



Despite these fluctuations, the *fixing price of gold* expressed in rand remained fairly stable at a level of around R1 000 per fine ounce from 1988 to 1991, but then dropped to R957 per fine ounce in June 1992 before rising again to R971 in July. In contrast to this relatively stable rand price, the US dollar price of gold per fine ounce weakened sharply from a high of $477 in January 1988 to $341 in June 1992; in July this price recovered to $353. In terms of most other currencies, the price of gold already started to decline in the beginning of 1983. For instance, the price of gold expressed in Swiss francs dropped from a high of SF947 in January 1983 to a low of SF460 in February 1991; it then fluctuated upwards to SF502 in July 1992.

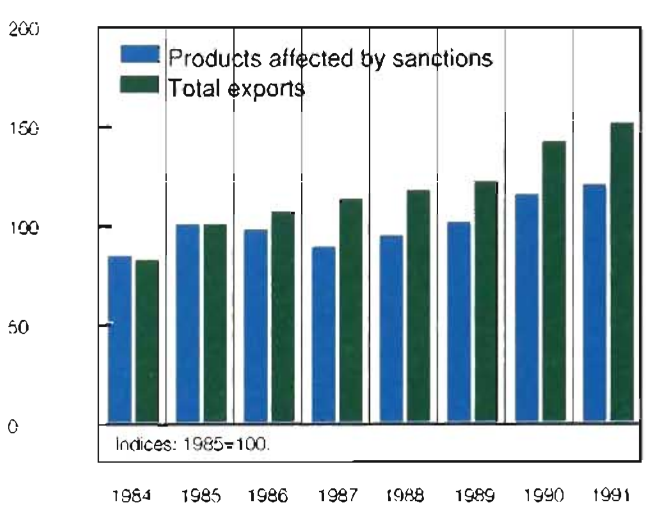
The generally poor performance of the gold price during the second half of the 1980s and the beginning of the 1990s was related to various factors, including a substantial increase in the gold production of the United States of America, Australia and Canada, a sharp increase in the value of forward sales and a more subdued investment demand for gold related to low inflation in industrialised countries and relatively high nominal and real interest rates. In recent years the gold price has also been affected considerably by economic and other developments in the former communist countries of eastern Europe.

The *volume of net gold exports* from South Africa has exhibited a secular decline since the early 1970s. An average annual rate of decrease of 4 per cent was recorded in the 1970s, which then slowed down to 1½ per cent in the 1980s. This substantial contraction in the volume of gold exports was mainly due to a corresponding substantial decrease in the average grade of ore milled from 13,28 grams per ton in 1970 to 5,05 grams per ton in 1990; the decline in the quality of gold ore mined was, however, countered to some extent by a sharp increase in the volume of gold-bearing ore milled. The mining of a slightly higher grade of ore was responsible for an increase of 1½ per cent in the volume of net gold exports in 1991; in the first half of 1992 a contraction of 7 per cent was again reported in the physical volume of gold exported compared with the average level in the last half of 1991.

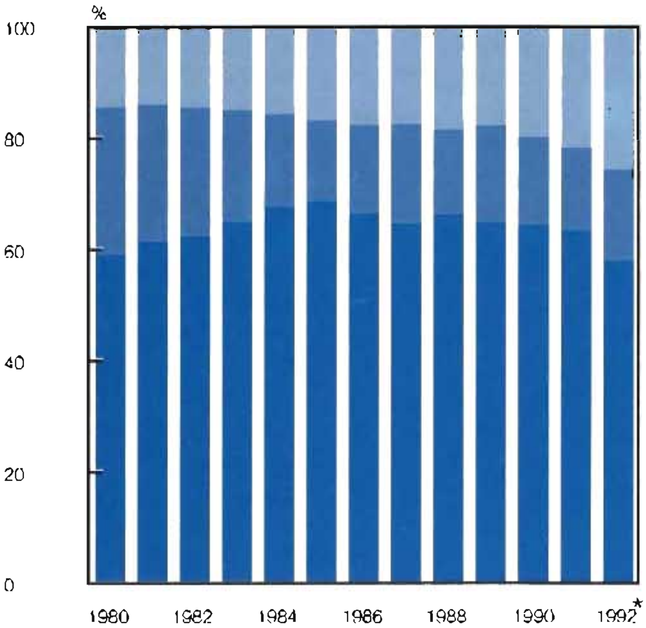
Slower rate of increase in merchandise exports

After having increased at an average annual rate of 22 per cent from R12,8 billion in 1984 to R42,4 billion in 1990, the *value of merchandise exports* rose by 8 per cent in 1991 to R45.9 billion. In the first half of 1992 it was only 1 per cent higher than in the second half of 1991. This deceleration in the growth of exports could be attributed partly to a corresponding slowdown in the increase in *export prices* because of the poor performance of international commodity prices.

Real exports



Categories of total merchandise exports



Commodity prices on international markets, which had begun to move downwards from the middle of 1988, dropped by 9½ per cent in US dollar terms in 1991 before recovering somewhat by 5½ per cent from an average low in December 1991 to June 1992. The rate of increase in the rand prices of South Africa's merchandise exports therefore amounted to 4½ per cent in 1991, followed by a decrease of ½ per cent in the first half of 1992 owing to a more stable exchange rate of the rand.

Even more important than these price developments in explaining the slower rate of increase in the value of merchandise exports during the past eighteen months, was the deceleration in the rate of increase in the *volume of merchandise exports*. Vigorous growth in the physical quantity of merchandise exports at an average rate of 10 per cent per year from 1984 to 1990 made a significant contribution to the surpluses on the current account of the balance of payments, in spite of sanctions and other embargoes imposed on exports from South Africa. As illustrated in the accompanying graph, these measures were mainly responsible for a decrease in export volumes of products affected by the sanctions in 1986 and 1987, but from 1988 onwards new markets were exploited and the export volumes of these products rose again markedly.

This relatively buoyant growth in export volumes was followed by more moderate rates of increase of only 3½ per cent in 1991 and 1½ per cent in the first half of 1992, owing to the weak performances of the economies of most industrial countries and a decline in the growth of world trade. Particularly the exports of mining products were seriously affected by these developments, while the exports of manufactured goods continued to rise and increased their share of total exports further from 13½ per cent in 1987 to 19½ per cent in 1991 and to 22 per cent in the first half of 1992. Agricultural exports still performed well in the first half of 1992, mainly owing to good yields of deciduous and citrus fruit and a rise in the exports of wine. The effect of the severe drought in the summer rainfall areas was, however, already felt in the second quarter of 1992 when the country started importing grain, with the result that the margin between the exports and imports of agricultural products narrowed considerably; the agricultural sector was nevertheless still a net earner of foreign exchange in this quarter.

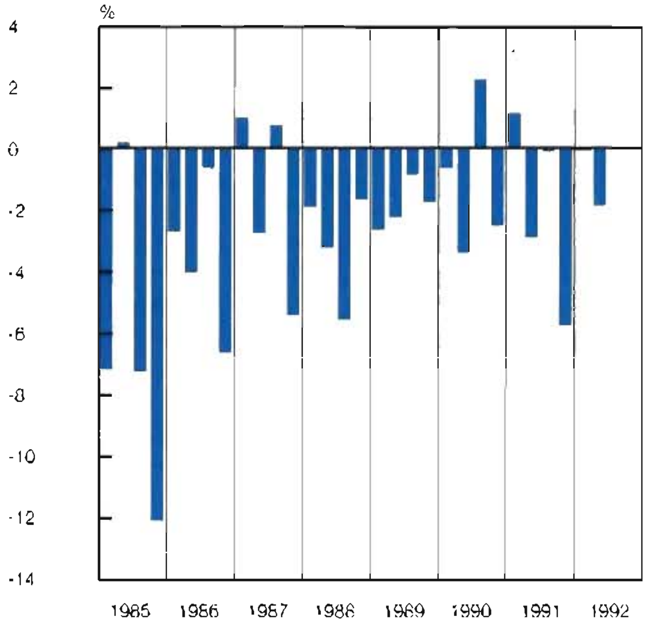
Moderate rise in net service and transfer payments to non-residents

The service and transfer account of the balance of payments, which had improved in 1990 and 1991, deteriorated again somewhat in the first half of 1992. After having declined from R10,9 billion in 1989 to R10,6 billion in 1990 and R9,9 billion in 1991, *net service and transfer payments* to non-residents rose again to R10,5 billion (seasonally adjusted and annualised) in the first half of 1992. As a ratio of gross domestic product, net services and transfers amounted to 3½ per cent in the first half of 1992 – i.e. the same level as in 1991 – compared with a peak of 6 per cent in 1985.

The higher deficit on the services account with the rest of the world in the first half of 1992 was due to the fact that the increase in *service payments* outpaced higher service receipts. Service payments rose sharply in the first six months of 1992, mainly on account of higher freight and merchandise insurance payments stemming from the higher value of imports, higher tourist expenditure because of an increase in South Africans travelling abroad, and payments for transport services rendered by foreign carriers. Higher freight and merchandise insurance payments in the second quarter of 1992 were also partly related to the drought, which led to increased imports of agricultural products.

On the other hand, interest and dividend payments on foreign loan and equity capital receded further in the first half of 1992 as a result of the reduction in South Africa's foreign debt, a sharp decline in equity investments of non-residents and the poor financial results of certain domestic organisations. Total interest and dividend payments to non-residents as a

Capital movements not related to reserves as percentage of gross domestic product



percentage of total export proceeds contracted from a peak of 14½ per cent in 1986 to 9½ per cent in 1991 and 9 per cent in the first half of 1992.

Higher receipts from transport services, foreign tourists travelling in South Africa and income earned on investments in other countries contributed to an increase of 2 per cent in *service receipts* from the rest of the world in the first half of 1992, compared with 7 per cent in 1991. In part, the rise in transport service receipts was related to foreign exchange earned on the transport of maize and other foodstuffs to neighbouring countries which were also plagued by drought conditions. The rise in the expenditure of foreign tourists was mainly due to increases in domestic prices and a sharp increase in the number of foreign tourists (excluding African countries) visiting South Africa, viz. from 290 000 in 1986 to 512 000 in 1991. This increased popularity of South Africa was brought about by the gradual relaxation of sanctions and relatively promising political developments during 1990 and 1991. More recently, the increased social unrest in the country and problems experienced with the constitutional negotiating process have again started to influence activities related to the visits of foreign tourists.

Improvement in the capital account

The capital account of the balance of payments improved considerably from 1989: the *total outflow of capital* not related to reserves contracted from R6,2 billion in 1988 to R4,3 billion in 1989, R2,8 billion in 1990 and R1,4 billion in the first three quarters of 1991. As a percentage of gross domestic product, the outflow of capital fell from 3 per cent in 1988 to only ½ per cent in the first nine months of 1991. In the fourth quarter of 1991 the total outflow of capital not related to reserves increased substantially to R4,7 billion, or 5,8 per cent of gross domestic product. This large outflow of capital was, however, caused by exceptional circumstances. In order to help drain the excess liquidity from the economy, the Reserve Bank, among other things, stopped quoting preferential rates on forward exchange cover transactions, which caused many importers to switch from foreign to domestic sources of trade financing. For 1991 as a whole, the total net outflow of capital amounted to R6,1 billion, or to 2,0 per cent of gross domestic product. In the first quarter of 1992 a negligible small net outflow of capital was recorded. This was again followed by a large net outflow of capital amounting to R1,9 billion in the second quarter, probably related to domestic political developments.

The capital account of the balance of payments during the first half of 1992 was aided substantially by the inflow of proceeds of funds from *foreign debt issues*. After South Africa had been completely cut off from long-term international capital in the period 1985 to 1987, some borrowers succeeded in raising foreign capital by means of private placements from 1988 onwards. In 1990 the funds obtained in this way increased considerably and in the second half of 1991 the South African government launched the first public bond issue since the debt crisis. In January 1992 the government raised ECU250 million by means of a public debt issue, followed by issues of DM200 million for the Development Bank of Southern Africa in February, an issue of DM300 million for Eskom in March, DM50 million for the Industrial Development Corporation in April and DM120 million for Telkom in May. A total of some R2,1 billion was raised in the first half of 1992 by means of these issues, which exceeded the amount of bearer bonds and notes maturing during 1992 as a whole by about R200 million.

The inflow of foreign long-term funds from these debt issues was more than neutralised by the repayment of about US$200 million on debt inside the standstill net in February 1992, and to the outflow of other capital from the private sector. Foreigners also remained net sellers of securities listed on the Johannesburg Stock Exchange. These transactions, of course, do not cause a decrease in foreign exchange holdings because of the financial-rand system; the financial rand created in this way mostly found their way into financial-rand deposits with authorised dealers. The result of these capital movements was that a small net outflow of long-term capital of R324 million was recorded in the first half of 1992, against a net outflow of R2,7 billion in 1991.

Net short-term capital not related to reserves has shown very volatile quarterly movements since the beginning of 1990 – an outflow in one quarter was normally followed by an inflow in the next quarter. These volatile movements in short-term capital suggest that capital transactions with the rest of the world were beginning to return to normal because short-term capital movements were being affected again by economic factors such as changes in the value of foreign trade, expected exchange rate movements, interest rate differentials and the cost of forward exchange cover. These improved conditions were also reflected in new foreign credit lines of £30 million from the British Export Credit Guarantee Department and of US$50 million from the Finnish Export Credit, which were arranged in the first half of 1992. Unfortunately, renewed internal unrest and uncertainty regarding political developments probably again adversely influenced these short-term capital movements towards the end of the second quarter of 1992. This resulted in a net outflow of short-term funds of R1,8 billion in this quarter.

An increase in South Africa's *foreign assets* was also partly responsible for the capital outflows during the past eighteen months. Foreign assets rose by R0,9 billion in 1991 and by a further R1,1 billion in the first half of 1992, owing mainly to higher export credits but also to the acquisition of foreign companies by South African organisations.

Further reduction in foreign debt

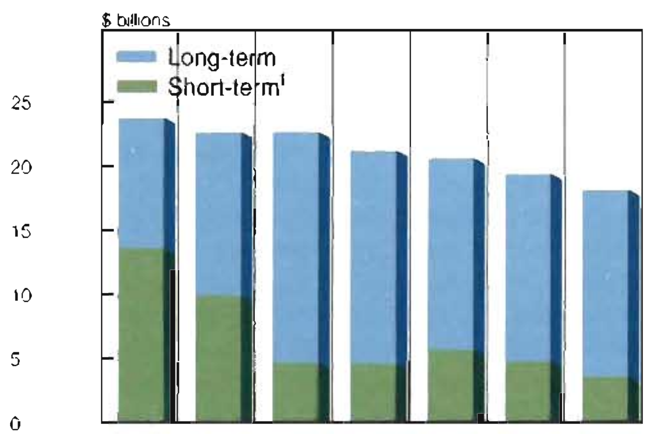
The largest part of the net outflow of capital in 1991 was related to repayments on foreign loan commitments, with the result that South Africa's *total outstanding foreign* debt receded further from US$19,4 billion at the end of 1990 to $18,1 billion at the end of 1991. In rand terms South Africa's foreign debt remained unchanged at R49,7 billion from the end of 1990 to the end of 1991 because of a depreciation of the rand over this period, but this amount was nevertheless significantly lower than the outstanding amount of R65,8 billion on 31 August 1985. If allowance is made for exchange rate changes and the debt is valued at exchange rates of the US dollar against other currencies as at 31 August 1985, the outstanding foreign debt of South Africa totalled $15,6 billion on 31 December 1991 compared with $16,4 billion at the end of 1990 and $23,7 billion at the beginning of the debt standstill arrangements on 31 August 1985. This implies that the outstanding debt, valued at the exchange rates of 31 August 1985, was reduced by $8,1 billion from that day until the end of 1991, or by slightly more than one-third.

The foreign *affected debt* of South Africa also decreased further from $6,6 billion at the end of 1990 to $6,0 billion at the end of 1991. Valued at the exchange rates prevailing on 31 August 1985, the affected debt was reduced by $8,3 billion from $13,6 billion at the end of August 1985 to $5,3 billion at the end of 1991. No less than $3.2 billion has been repaid on affected debt in terms of the interim debt arrangements concluded with foreign creditor banks, and a further $1,2 billion will have been repaid by the end of 1993. The further reduction in affected debt was due to conversions into longer-term loans outside the net and to debt-equity swaps. A total amount of about $5,5 billion has now been converted into debt outside the standstill net or to equity.

South Africa's *non-affected debt* also declined from $12,8 billion at the end of 1990 to $12.2 billion at the end of 1991. Mainly as a result of the large amounts of affected debt converted into non-affected debt and recent issues on the international capital market, the non-affected debt (valued at exchange rates of 31 August 1985) rose slightly from $10,1 billion at the end of August 1985 to $10,3 billion at the end of 1991. The decrease in non-affected debt during 1991 occurred particularly in bearer bonds and notes held by non-residents, foreign loans of the Reserve Bank and short-term trade-related credit. On the other hand, loans provided to the public sector in South Africa and guaranteed by a foreign government and/or agency of such a government rose from $2,8 billion at the end of 1990 to $3,1 billion at the end of 1991.

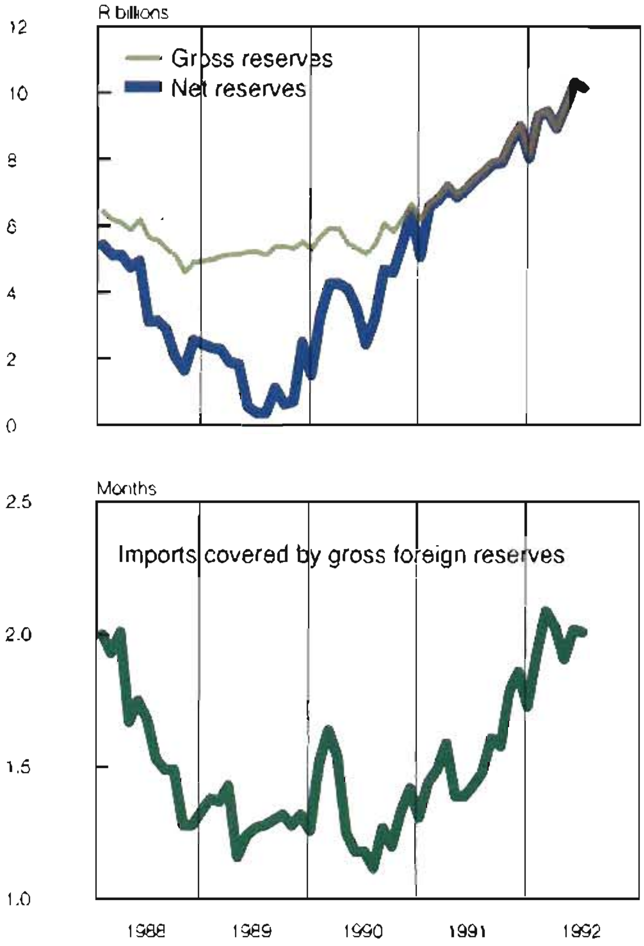
Not only the outstanding amount, but also the *maturity structure* of South Africa's foreign debt continued to improve substantially. At the end of August 1985 debt due within one year constituted no less than 57 per cent of the total outstanding foreign

Total foreign debt



1. Falling due within twelve months

Reserves of the Reserve Bank



debt of the country. Indeed, this inability of South Africa to meet all its immediate repayment obligations because of a liquidity shortage was the main problem in 1985, because there was little doubt at that time that the country would be able to service its debt in the long term. At the end of 1991, debt falling due in the ensuing twelve months amounted to only 20 per cent.

The improvement in South Africa's foreign debt also benefited the country's *credit ratings*. After having declined from number 29 in the world in 1984 to as low as 57 in 1987, South Africa's rating according to a leading investor journal rose gradually to number 45 in March 1992. During the twelve months to March 1992, South Africa was one of the countries which showed the largest improvement in their credit ratings. As a percentage of the exports of goods and services, South Africa's foreign debt decreased from 70 per cent in 1990 to 65 per cent in 1991: the corresponding ratio of developing countries in the Western Hemisphere amounted to 250 per cent. South Africa's foreign debt as a ratio of gross domestic product also declined from 43 per cent at the end of August 1985 to 19 per cent at the end of 1990 and to 17 per cent at the end of 1991.

Strengthening of the gold and other foreign reserves

The combined result of the sustained surpluses on the current account and the improvement in the capital account of the balance of payments was that South Africa's total *net* gold and other foreign reserves rose by R1,4 billion in 1991 and further by R1,5 billion in the first half of 1992. The *gross* gold and other foreign reserves rose from R7,3 billion at the end of 1990 to R11,8 billion at the end of June 1992. At this level the gross foreign reserves represented somewhat more than two months' imports of goods and services, up from a low of slightly more than one month in July 1990. In July 1992 the gross gold and other foreign reserves of the Reserve Bank rose further by R1,1 billion to a level of R11,3 billion at the end of the month and the Bank had no outstanding reserve-related loans.

Over the past 2½ years the Reserve Bank built up its *gold reserves* from 3,1 million fine ounces at the end of 1989 to 6,8 million fine ounces at the end of June 1992. However, reflecting mainly the low price of gold, the gold component of the total foreign reserves rose only moderately from 42 per cent at the end of 1989 to 49 per cent at the end of June 1992. Over this same period the *foreign exchange holdings* of the country increased from R4,0 billion to R6,0 billion.

Greater stability displayed by effective exchange rate of the rand

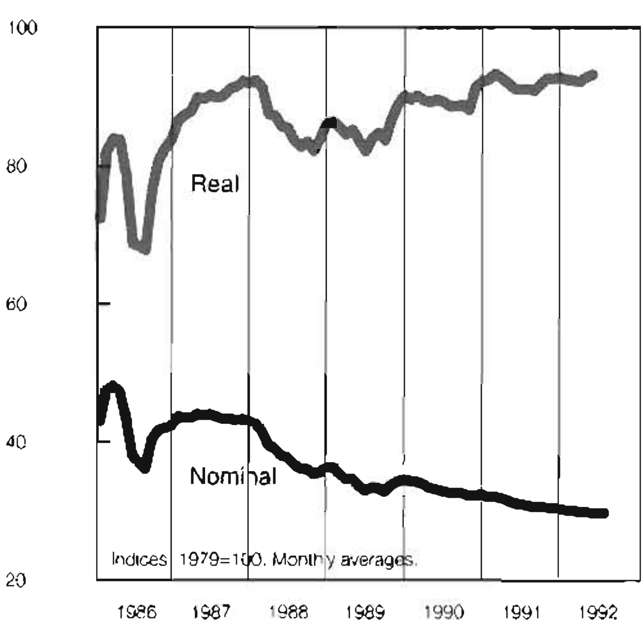
The exchange rates of the world's leading currencies were affected to a large extent by more unstable conditions in international markets over the nineteen months up to the end of July 1992. Events in Europe and the former Soviet Union played an important role in the international exchange markets where currencies were caught between political pressures for change on the one hand and moves to greater integration on the other hand. Movements in interest rate expectations were also important factors determining exchange rate changes.

The *US dollar* reached a low of DM1,45 on 12 February 1991 and then appreciated by 27 per cent to DM1,84 on 5 July 1991 because the resolution of the Gulf crisis as well as political turmoil in the former Soviet Union tended to favour the dollar. Contrasting signals regarding an economic recovery in the United States, a lowering of interest rates by the Federal Reserve Board and an increase in Germany's Lombard rate to its highest post-war levels, forced the dollar to depreciate again to DM1,51 on 7 January 1992. In the first five months of 1992 the dollar moved around this lower level before depreciating further from the beginning of June, mainly against the German mark and British pound. At the end of July 1992 the dollar reached an exchange rate of DM1,48.

The high degree of volatility in the movement of the dollar caused the *rand* to fluctuate between a high of R2,52 per dollar on 12 February 1991 and an all-time low of R2,91 per dollar on 20 August 1991. During the first six months of 1992 the rand was more stable against the dollar, fluctuating by 6,4 per cent between its low and high points; this was markedly smaller than the fluctuation of 13,4 per cent recorded during the previous year. The rand began to appreciate fairly sharply against the dollar from about the end of June to R2,76 per dollar on 31 July. However, from the end of 1990 to the end of July 1992 the rand, on balance, still depreciated by 7,2 per cent against the dollar.

Over the same period the rand also depreciated against all the other main currencies. The rate of depreciation against the major European currencies was, however, much more moderate than against the dollar. As a result of the relative strength of the yen, the rand depreciated by 12,6 per cent against the yen from the end of 1990 until the end of July 1992 - the highest depreciation recorded against any of the major currencies. The net effect of all the individual exchange rate movements of the rand was that the *nominal effective exchange rate* of the rand receded by 6,3 per

Effective exchange rate of the rand



Changes in exchange rates of the rand
%

	31 Dec 1990 to 31 Dec 1991	31 Dec 1991 to 31 July 1992	31 Dec 1990 to 31 July 1992
Weighted average	-6,3	-1,6	-7,9
US dollar	-6,6	-0,7	-7,2
British pound	-4,2	-3,5	-7.5
German mark	-5,4	-3,3	-8.5
Japanese yen	-13,2	0,7	-12,6
Netherlands guilder ...	-5,1	-3,3	-8,2
Italian lira	-4,6	-3,5	-7,9
Financial rand	6,7	-17,9	-12.4

cent during 1991, but the rate of decrease then slowed down considerably to 1,6 per cent in the first seven months of 1992 - the smallest change over a seven-month period since the introduction of managed floating exchange rates in 1979.

Owing to the narrowing of the margin between the increase in South Africa's production prices and in those of its main trading partner countries, the relatively small decline in the nominal effective exchange rate of the rand during the first six months of 1992 was sufficient to maintain a stable *real effective exchange rate* of the rand. In June 1992 the real effective exchange rate of the rand was only 1,0 per cent higher than in December 1991 and 1,6 per cent higher than in December 1990.

In contrast to the relative stability in the commercial exchange rates of the rand, the *financial rand* fluctuated sharply in the nineteen-month period to July 1992. The financial rand at first appreciated in the first eleven months of 1991, recording a record low discount of 7 per cent against the commercial rand on 19 November 1991. This higher value of the financial rand was related to more optimistic perceptions of foreign investors regarding political developments in the country, assisted by the State President's speech at the opening of Parliament and the lifting of sanctions by several governments. The financial rand then started to depreciate again to R3,95 per dollar or to a discount of 27 per cent on 17 March 1992, its lowest level since 5 September 1990. This sharp depreciation was mainly caused by uncertainties regarding the taxability of non-residents' interest income from local sources as well as the outcome of the referendum on 17 March 1992.

Following the mandate given to the State President to proceed with political reform and the announcement by the Reserve Bank on 20 March that it intended to intervene in the financial rand market, the financial rand strengthened again to R3,36 per dollar and a narrower discount of 14,2 per cent on 22 April 1992. Up to the beginning of June the financial rand exchange rate then remained fairly stable. Even the announcement by the Minister of Finance on 3 June 1992 that all interest payments to non-residents would be exempt from South African income taxes, did not have a material effect on the financial rand exchange rate. However, the events at Boipatong on 17 June 1992 and the subsequent suspension of negotiations at Codesa then gave rise to a sharp depreciation of the financial rand to R3,86 per dollar on 31 July 1992, or to a discount of 28,5 per cent.

Financial markets

Monetary policy aimed at financial stability

In order to achieve the mission of the Reserve Bank (the protection of the internal and external value of the rand), the Governor of the Bank in 1989 stipulated the following *priorities of monetary policy*:

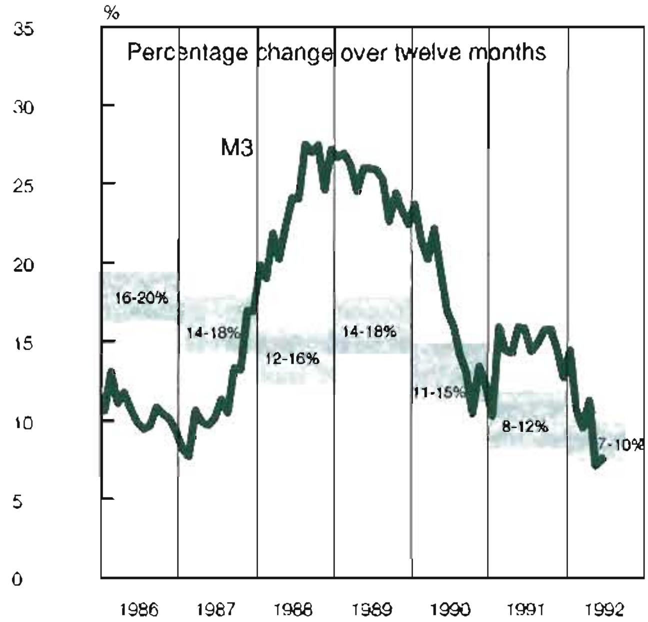
- managing the process of money creation in such a manner that an adequate, but not excessive, amount of new money is supplied to the economy;
- maintaining positive real interest rates;
- keeping the rate of increase in total bank credit extended to the private sector within reasonable limits, preferably under the current rate of inflation;
- raising the gold and other foreign reserves to a level equivalent to at least three months' imports of goods and services;
- maintaining a relatively stable real effective exchange rate of the rand; and
- developing a sound financial infrastructure, consisting of healthy financial institutions together with efficiently functioning markets that can facilitate the implementation of policy and provide the financial services needed by a developing and vigorous economy.

The Reserve Bank believes that the attainment of these objectives will lead to a stable financial environment which should serve to promote sound business decisions regarding new investments, savings, production activities and the efficient employment of production factors. In this manner maximum sustainable economic growth can be obtained over the longer term, if such a consistent monetary policy is accompanied by other structural reforms in the economy.

Against this background the *guideline ranges* for the growth in money supply were progressively reduced from 14 to 18 per cent in 1989, to 11 to 15 per cent in 1990 and further to 8 to 12 per cent in 1991. Bank rate was also raised on seven occasions – from 9½ per cent to its eventual peak of 18 per cent – in 1988 and 1989, and then maintained at this higher level throughout 1990. Bank rate was eventually reduced to 17 per cent from 1 March 1991. In taking this step the authorities responded to improvements in the external and internal financial conditions.

Considerable success was achieved by the authorities in attaining a *more stable financial environment*. As already discussed in this report, the improvement in the overall balance of payments position led to a sharp increase in the gold and other foreign reserves, which made it possible to maintain a fairly stable real effective exchange rate of the rand.

Guidelines for growth in M3



The rate of increase in the M3 money supply over twelve months slowed down from 27 per cent in December 1988 to 22 per cent in December 1989, 12 per cent in December 1990 and 10,6 per cent in February 1992. Similarly, the corresponding rate of increase in total credit extended by the monetary sector to the private sector declined from 28 per cent in December 1988 to 20 per cent in December 1989, 16 per cent in December 1990 and 10,8 per cent in February 1992.

Despite these improvements in financial conditions, consumer price inflation remained stubbornly high and only towards the beginning of 1992 did it become apparent that inflation was starting to recede somewhat. This delay was not unexpected because a considerable time lag exists between a change in the stance of monetary policy and its observable effect on inflation rates. Over a period of several years, however, movements in the general price level tend to correspond with movements in the money supply. In view of this improvement in the inflation rate and the continued slowdown in the growth of domestic monetary aggregates, the authorities reduced Bank rate from 17 to 16 per cent from 23 March 1992 and further to 15 per cent from 30 June 1992.

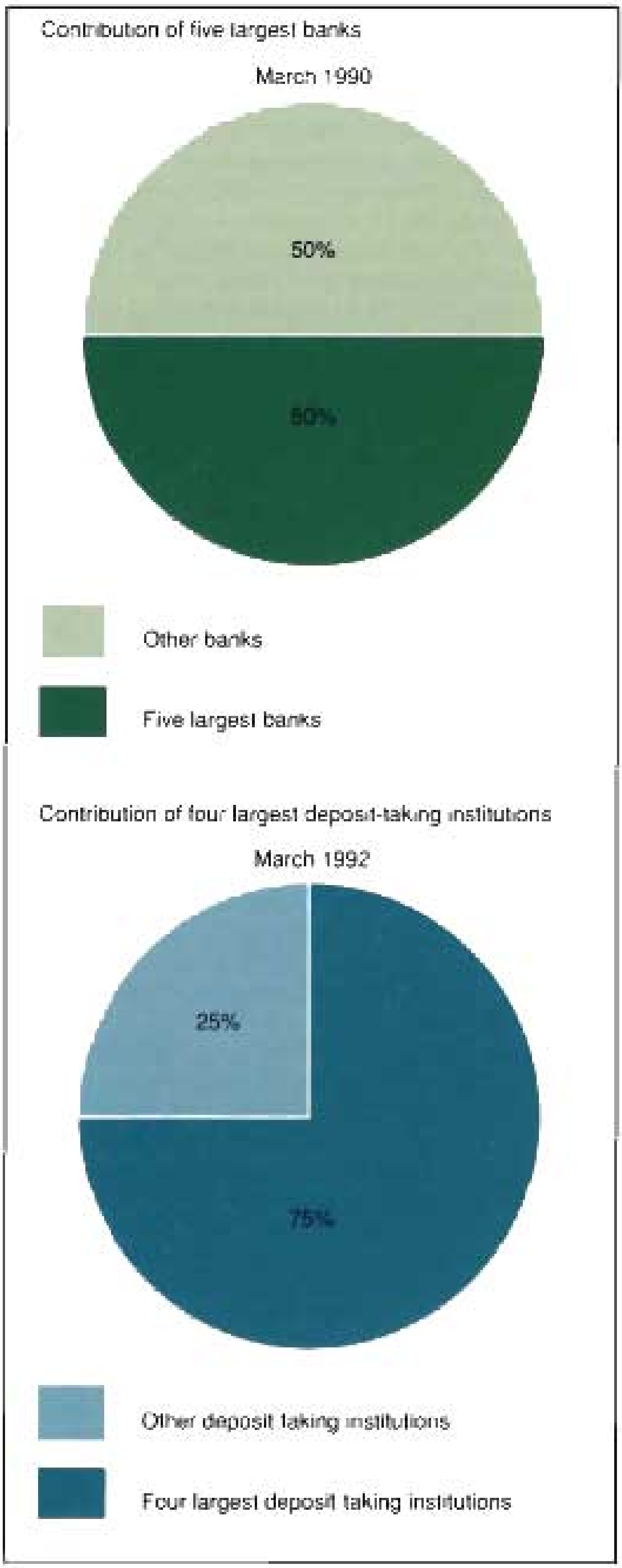
These adjustments were effected to acknowledge the success reached so far in attaining monetary policy objectives, but should not be seen as the abandonment of financial discipline. The monetary authorities have indicated on various occasions that they will not tolerate any excessive monetary expansion. The need for monetary discipline was again confirmed by recent trends in the major components of the government's accounts, salary and wage increases and the demands placed on the state by political developments in the country. Signalling the continuation of a relatively restrictive monetary policy, the Reserve Bank lowered the money supply guidelines further to a growth in M3 money supply of between 7 and 10 per cent from the fourth quarter of 1991 up to the fourth quarter of 1992.

Changes in financial environment

Over the past few years the financial environment has been characterised by three major developments. One of these developments was the implementation of the *Deposit-taking Institutions Act* as from 1 February 1991 with the basic objective of protecting the interests of depositors and maintaining the integrity of the financial intermediation function of deposit-taking institutions. This Act emphasises the promotion of sound risk management by deposit-taking institutions, not by the involvement of the regulatory authorities but rather by the board of directors and management of each institution. From a macro-economic analytical point of view the regulatory changes under this Act caused some off-balance-sheet items to move back on the balance sheets of these institutions, which statistically increased the money supply figures and the credit extension to the private sector to markedly higher levels in February 1991. This obviously distorted the observed growth rates over twelve months of these monetary aggregates from February 1991 to January 1992.

Since early 1990 the financial system has also been characterised by the *amalgamation of banking institutions, building societies and other financial institutions* leading to a higher concentration of activities. The share of the four largest deposit-taking institutions in total credit extension to the private sector amounted to 75 per cent in March 1992; the corresponding contribution of the five largest former banking institutions to total credit extension was 50 per cent in March 1990. In a similar vein, the share of deposits at the four largest deposit-taking institutions to total deposits of the monetary sector was 76 per cent in March 1992, compared with the corresponding share of 59 per cent of the five former banking institutions in March 1990. Although some of the recent amalgamations took place before the implementation of the Deposit-taking Institutions Act on

Concentration of credit extention to the private sector



1 February 1991, the number of registered deposit-taking institutions decreased from 59 at the end of February 1991 to 48 at the end of April 1992.

The third major development in the financial environment during recent years has been the considerable *increase in informal financial arrangements*, such as credit unions and stokvels. Strictly speaking, these institutions should be regarded as deposit-taking institutions, but for practical reasons they have not been made subject to the Deposit-taking Institutions Act. The promotion of credit unions and stokvels was undertaken to mobilise savings among members and to make the pooled savings available in larger amounts as advances to their members. Early in 1992 South Africa had 61 credit unions, with 5 318 members and total assets of R1,4 million. In 1991 there were an estimated 49 910 stokvels in the metropolitan areas of the country with a total membership of about 1,3 million people and estimated contributions of R600 million per year.

Deceleration of growth in broadly defined money supply

The rate of increase in the *broadly defined money supply* (M3), which had peaked at very high levels in the third quarter of 1988, then receded significantly. The twelve-month rate of growth in M3 fell from a peak of 27,5 per cent in August 1988 to 10,2 per cent in January 1991; it then rose again to 15,9 per cent in February, fluctuated around this higher level throughout the rest of 1991 and amounted to 14,4 per cent in January 1992. The higher rates of increase from February 1991 were mainly the result of changes under the Deposit-taking Institutions Act which caused certain off-balance-sheet items to be converted into conventional deposits and advances of these institutions. Because the effect of the regulatory changes was from March 1992 no longer reflected in the twelve-month growth rate of M3, this rate of increase decelerated to 9,5 per cent in that month; this was more or less the level that had prevailed before the new regulations came into effect. The twelve-month rate of growth in M3 subsequently fluctuated around this level and amounted to 7,5 per cent in June 1992.

Growth in the quarterly average value of M3 from the fourth quarter of 1990 to the fourth quarter of 1991 amounted to 14,8 per cent. The growth in M3 therefore exceeded the upper limit of the guideline range for 1991 by a margin of 2,8 percentage points. This overshoot was, however, mainly due to the effect of the regulatory changes; the seasonally adjusted and annualised rate of growth in M3 from February 1991 to December 1991 amounted to only 7,4 per cent, which was even below the lower limit of 8 per cent. In the 1992 guideline year the rate of increase in M3, as measured for guideline purposes, amounted to 7,7 per cent (seasonally adjusted and annualised) from the fourth quarter of 1991 to June 1992. This relatively slow growth in M3 was mainly due to the sustained restrictive monetary policy stance, the deepening of the cyclical downturn in economic activity and disintermediation practices.

In a *statistical or accounting sense* the R13,2 billion increase in M3 during the twelve months to the end of June 1992 was the result of a R16,4 billion increase in the monetary institutions' claims on the domestic private sector and a R1,9 billion increase in net gold and other foreign reserves. On the other hand, net claims on the government sector and "net other assets" declined during this period by R2,0 billion and R3,1 billion, respectively.

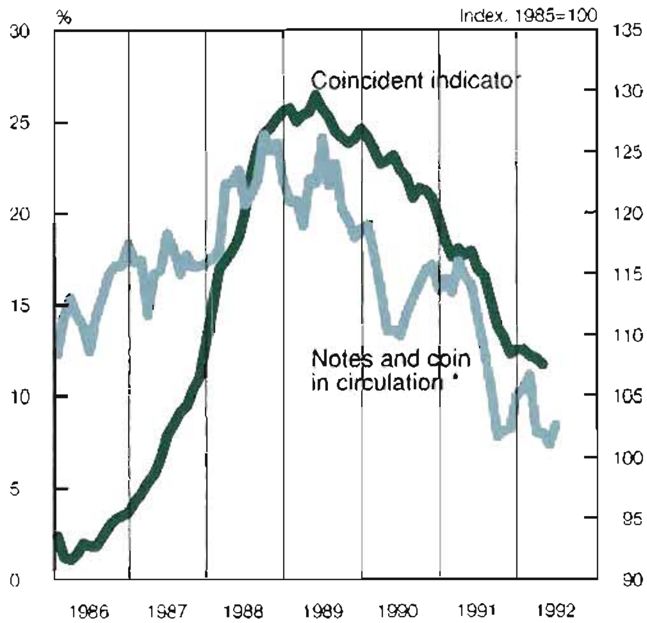
The *income velocity* of M3, which had remained virtually constant from the second to the fourth quarter of 1990, declined in the second quarter of 1991 to a level of 1,67, which was the lowest level in the past twelve years. This decline was mainly brought about by reintermediation practices caused by the regulatory changes. The velocity of circulation then started to increase again to 1,71 in the second quarter of 1992 because of disintermediation as the margin between the lending and deposit rates of deposit-taking institutions widened considerably.

Changes in narrower aggregates affected the composition of M3

The *composition of M3* changed markedly in the twelve months up to the end of June 1992. The relative share of long-term deposits in total deposits decreased from 16,4 per cent at the end of June 1991 to 13,1 per cent at the end of June 1992, while the share of cheque and transmission deposits rose over the same period from 12,2 per cent to 14,2 per cent. The relative share of medium-term deposits in total deposits also decreased from 40,2 per cent at the end of June 1991 to 30,8 per cent at the end of June 1992, while the share of other short-term deposits increased over the corresponding period from 10,8 per cent to 20,7 per cent. The relative shares of the other components of M3, namely banknotes and coin and "other" demand deposits, remained fairly stable during this period.

Despite this increasing relative share of cheque and transmission deposits, the growth rate in *M1A* moved sharply downwards from the second half of 1991. After having increased from a low point of 6,9 per cent in March 1990 to a high point of 29,6 per cent in August 1991, the twelve-month growth rate of M1A fluctuated downwards to 16,4 per cent in February 1992 and to 18,7 per cent in June 1992. The twelve-month growth rates of *M1 and M2 also* accelerated sharply during 1991 to 22,4 per cent and 22,9 per cent in September, but then fell back to 14,2 per cent and

Percentage change in notes and coin in circulation and the coincident indicator



* Percentage change over twelve months in the three-month moving average of notes and coin in circulation outside the monetary sector.

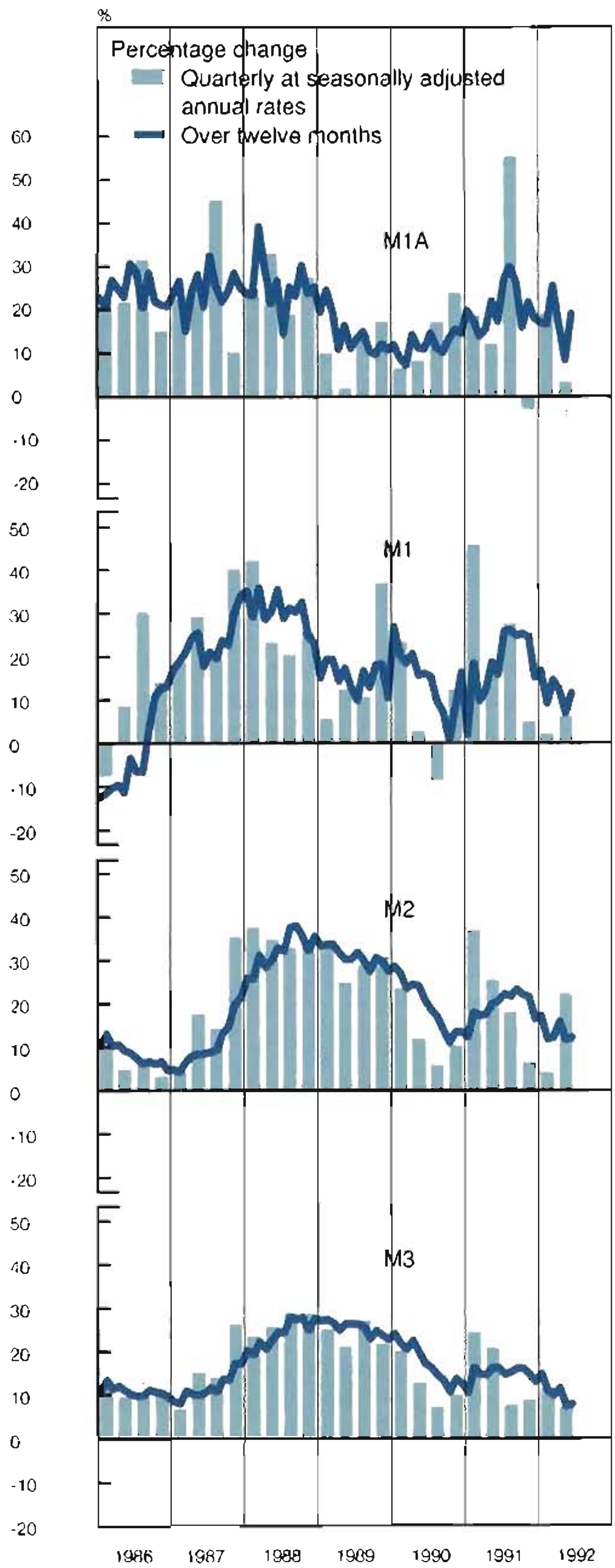
11,8 per cent in March 1992; these growth rates in M1 and M2 amounted to 11,1 per cent and 11,8 per cent in June 1992. On a weighted basis these narrower monetary aggregates were distorted even more by the regulatory changes than M3 and their growth rates have generally continued to exceed those of M3.

The monetary aggregate which was probably affected the least by the regulatory changes was *"banknotes and coin in circulation"* outside the monetary institutions. This monetary aggregate's twelve-month rate of increase declined from a recent high of 19,1 per cent in November 1990 to 3,8 per cent in June 1992. Although subject to obvious shortcomings, this aggregate was probably a better indicator of the slack economic conditions than the other monetary aggregates since the beginning of 1991, when most banking statistics were distorted by the new Deposit-taking Institutions Act.

Low growth in credit extension by monetary institutions

The underlying growth in *total credit extended* by monetary institutions to the domestic private sector remained relatively low during 1991 and the first six months of 1992. Mainly as a result of the regulatory

Monetary aggregates



changes under the Deposit-taking Institutions Act, the rate of increase in credit extended measured over a period of twelve months rose from 12,8 per cent in January 1991 to 18,7 per cent in February; it then fluctuated around this level during most of the year before dropping abruptly to 14,5 per cent in December 1991 and 15,6 per cent in January 1992. However, the underlying growth rate in credit extended over this period, as measured from the end of February 1991 (the month in which the new regulations came into effect) to the end of January 1992, amounted to only 10,9 per cent (seasonally adjusted and annualised). This relatively low underlying growth rate is confirmed by rates of increase (over twelve months) in the ensuing months, which fluctuated around this level and amounted to 9,1 per cent in June 1992.

The seasonally adjusted and annualised rate of increase in the quarterly average of monetary institutions' claims on the domestic private sector receded from 22,1 per cent in the second quarter of 1991 to only 4,4 and 11,2 per cent in the first and second quarter of 1992, respectively. At these levels the rates of increase in credit extension to the private sector by monetary institutions were well below the current rate of increase in the consumer price index.

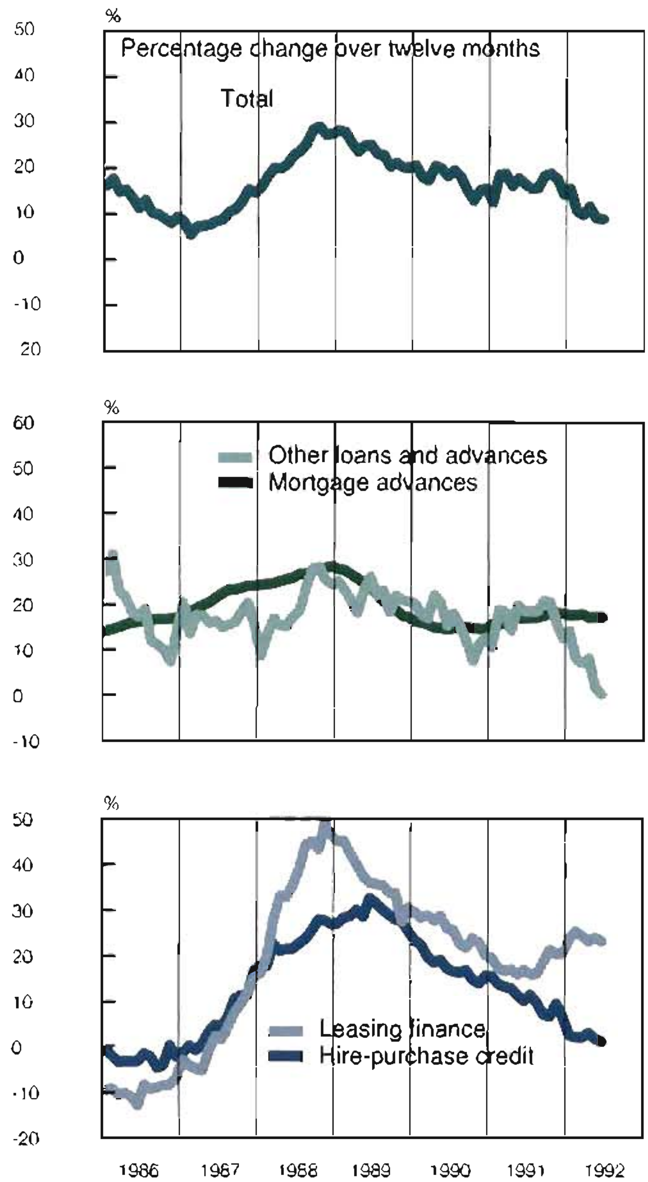
This general easing in credit extension by monetary institutions to the private sector was largely related to a lower demand for credit, reflecting the more depressed economic conditions and the effect of positive real interest rates. Households became less inclined to make use of additional consumer credit to finance the purchase of durable goods, while business enterprises began cutting expenses to maintain profit levels. Some monetary institutions also became more reluctant to provide further credit to certain clients in the process of active credit risk management. Disintermediation, related to the widening of the margins between lending and deposit rates of monetary institutions, also contributed to the slowdown in measured credit extension.

An *analysis* of monetary institutions' claims on the domestic private sector by *type of credit* extended reveals that the lower growth in credit extension occurred mainly in hire-purchase credit and overdrafts. The twelve-month rate of increase in hire-purchase credit decelerated from 15,7 per cent in December 1990 to 6,7 per cent in December 1991 and to only 2,2 per cent in March 1992; it then receded further to 1,3 per cent in June. The rate of increase in "other loans and advances" (mainly overdrafts) similarly receded from 12,8 per cent in December 1990 to 7,0 per cent in March 1992 and to 0,3 per cent in June.

The lower rate of increase in *hire-purchase credit* extended was due to lower rates of increase in nearly all the main categories of this type of credit extended and even induced actual decreases in hire-purchase credit for the purchase of new motor vehicles, agricultural machinery and equipment, and industrial, commercial and office equipment. In the twelve-month period ended June 1992 the utilisation of hire-purchase credit for the purchase of new motor vehicles (22 per cent of total hire-purchase credit) decreased by 2,9 per cent, reflecting the lower demand for such vehicles. Over the same period the utilisation of hire-purchase credit for the purchase of used motor vehicles (29 per cent of total hire-purchases) rose by 9,4 per cent, and for the utilisation by non-incorporated farmers and individuals (55 per cent of total hire-purchases) by 8,5 per cent.

In contrast to these developments, the twelve-month rate of increase in *mortgage advances* rose

Credit extention to the private sector



from 14,7 per cent in December 1990 to 18,0 per cent in December 1991 but declined somewhat to 17,2 per cent in June 1992. These growth rates in mortgage advances were well in excess of the consumer price inflation rate. This could be related to a slower repayment of capital, an increase in the value of real estate transactions, increased use of this kind of credit facility to finance consumer expenditure, and the lower interest rates charged on mortgages. Lower capital requirements against mortgage advances also induced deposit-taking institutions to promote this kind of credit extension.

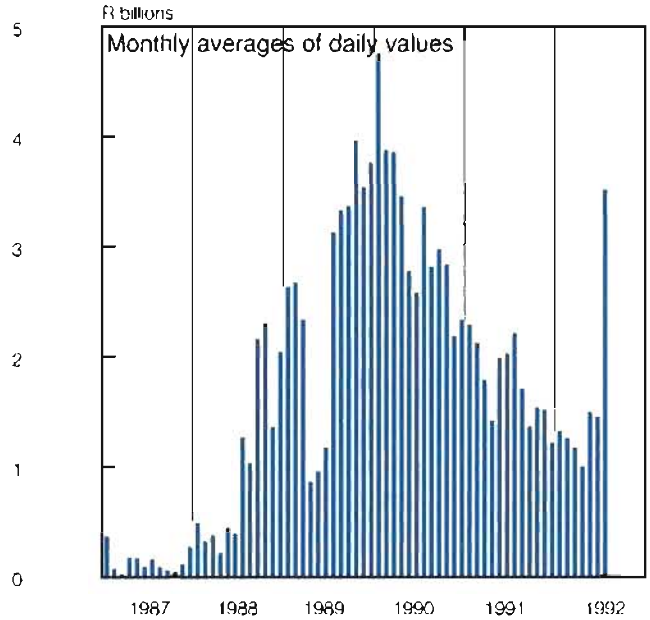
Despite the sluggish demand for durable goods, *leasing finance* remained buoyant during 1991 and the first half of 1992. The twelve-month rate of growth in leasing finance rose from a low point of 16,0 per cent in July 1991 to 20,6 per cent in December 1991 and even further to 24,4 and 23,3 per cent in March and June 1992, respectively. An analysis of the utilisation of leasing finance over the twelve-month period from June 1991 to June 1992 reveals that:

- the use of this type of credit for purchases of new and used motor vehicles and trucks increased by 34,7 per cent (partly as a result of the introduction of new leasing finance schemes), but the amount utilised for this purpose was still only 76 per cent of hire-purchase credit extended for this purpose in June 1992;
- the amount of leasing finance for new motor vehicles was considerably larger than the amount utilised for used motor vehicles and trucks;
- the utilisation of leasing finance for industrial, commercial and office equipment increased by 50,1 per cent;
- as could be expected, very little use was made of leasing finance for the purchase of agricultural machinery and equipment by non-incorporated farmers; and
- the utilisation of leasing finance by individuals and other purchasers (mainly business enterprises) rose by 35,5 and 10,2 per cent, respectively.

Easy money market conditions and Reserve Bank operations to counter the rise in liquidity

Money market conditions, as measured by the market's need for accommodation at the Reserve Bank's discount window, eased markedly from early 1990 throughout 1991 and then became slightly tighter from May 1992. The average daily *level of accommodation* at the Reserve Bank's discount window declined from a peak of R4,8 billion in January 1990 to R2,4 billion in December 1990 and to R1,2 billion in December 1991; it then declined marginally further to R1,0 billion in April 1992 before increasing to R1,5 billion in May and June and to R3,5 billion in July 1992. These relatively easy money market conditions

Accommodation at the discount window

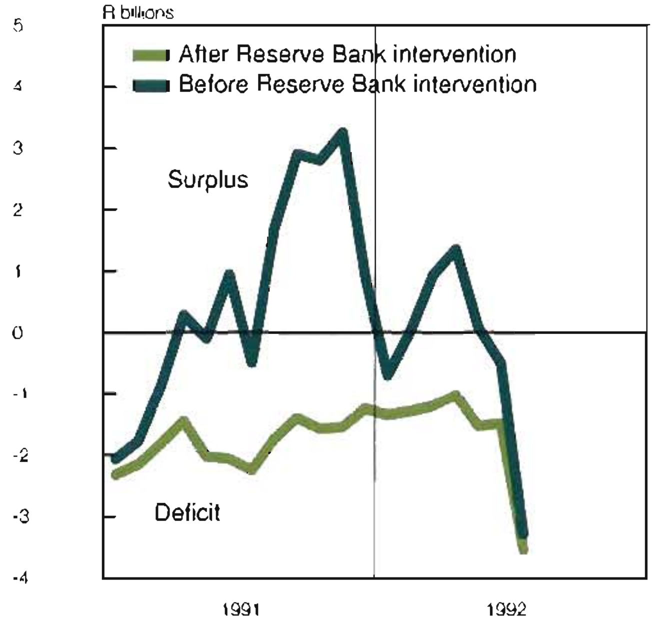


were also reflected in a sharp decline in the month-end value of accommodation at the discount window from a peak of R5,5 billion at the end of January 1990 to R3,4 billion at the end of December 1990 and R1,4 billion at the end of March 1992; month-end accommodation then increased again to R4,0 billion at the end of June and July 1992.

The easier money market conditions were even more clearly reflected in the increase in the money market shortage *before taking Reserve Bank intervention into consideration*. The average daily level of the money market's cash deficits or surpluses before Reserve Bank intervention rose from a deficit of R1,8 billion in December 1990 to a record surplus of R3,3 billion in November 1991; it then tightened somewhat to a surplus of R0,9 billion in December before easing again to a surplus of R1,4 billion in April 1992. Money market conditions subsequently tightened again to deficits before Reserve Bank intervention of R0,5 billion in June and R3,3 billion in July 1992.

The easier conditions in the money market during 1991 and the first half of 1992 are also underlined by the fact that *overnight loan accommodation* to deposit-taking institutions had to be provided only at month-ends during the beginning of 1991 and that even then the amounts involved were insignificant. At the end of March 1991 such assistance amounted to R0,4 billion; thereafter deposit-taking institutions did not make use of this relatively expensive form of accommodation until

Money market deficit



a small amount of R0,2 billion was borrowed early in July 1992.

An increase in the Reserve Bank's holdings of *net gold and other foreign reserves* was to a large extent responsible for the rise in liquidity in the money market. From the end of 1990 to the end of 1991 the net foreign reserves of the Reserve Bank rose by R3,5 billion, followed by a further increase of R2,5 billion in the first six months of 1992. The relative strength of the balance of payments and the associated effect on the money market contributed to the Bank's decision to gradually reduce the preferential margin for forward foreign exchange cover in respect of new foreign finance from June 1991 and to abolish this margin in September 1991.

The easier money market conditions during 1991 and the first half of 1992 were also enhanced by the deficits recorded by the Reserve Bank in the provision of *forward cover* in the second and the third quarter of 1991, and by the phasing-in of the reduction, to an amount of almost R1,0 billion, of the *minimum cash reserve requirements* for deposit-taking institutions. This reduction, which was brought about by the lowering of the cash reserve requirement against the deposit-taking institutions' short-term liabilities from 5 to 4 per cent and by the abolition of the 2 per cent cash reserve requirement against their medium-term liabilities, was phased in over a period of four months from 21 March 1991.

A decrease in *banknotes in circulation* also contributed to the rise in liquidity during the first six months of 1992. After having increased steadily from a monthly average level of R9,2 billion in January 1991 to R9,9 billion in November 1991 and to a peak of R11,9 billion in December, banknotes in circulation decreased again to R10,1 billion in June 1992.

During 1991 and the first seven months of 1992 the increase in *government deposits* with the Reserve Bank had a narrowing effect on money market conditions. The average of the daily balances on the Exchequer, Paymaster-General and Stabilisation Accounts increased from R8,2 billion in December 1990 to R10,0 billion in December 1991; it then rose further to R13,4 billion in June 1992 and to R15,6 billion in July. The balance on the Stabilisation Account was increased from R2,1 billion in January 1991 to R3,7 billion in May 1991; it was then held at this amount until 4 February 1992, when it was raised further to R3,8 billion.

Included in these balances of the government are the proceeds from the net *sales of government stock* and special short-dated Treasury bills by the Reserve Bank. Net sales of government stock by the Reserve Bank increased sharply from R7,7 billion in fiscal 1990/91 to R12,2 billion in fiscal 1991/92. During the first four months of the new fiscal year (April to July 1992) net sales of government stock amounted to R10,3 billion.

In addition to these sales of government stock, which were mainly intended for the funding of government expenditure, the Reserve Bank drained short-term excess liquidity from the money market also by means of *foreign exchange intervention swaps* with major banking institutions and the *issuing of special short-dated Treasury bills*. These measures were normally used over the very short-term to counter excessive fluctuations in the money market. In particular from April 1991 the Bank stepped up these intervention activities to eliminate short-term fluctuations in the liquidity of the local money market, and the combined maximum outstanding amount of these operations amounted to R2.9 billion in that month; this amount was then increased further to R3,4 billion in June and July and rose progressively to R5,4 billion in November 1991. In December 1991 and January 1992 the Bank did not intervene in this way in the money market, but from February the Reserve Bank used foreign exchange intervention swaps and special short-dated Treasury bills to combined maximum amounts of R3,9 billion in both March and April and R3,1 billion in May. In June 1992 the seasonal tightening in the market again made the use of these measures unnecessary.

The amount of *Treasury bills* offered at the weekly tender was raised periodically during 1991 and the first half of 1992. At the beginning of 1991 Treasury bills amounting to R100 million were provided on tender each week. This amount was then increased to R130 million from 5 April 1991, to R150 million from 30 May and to R200 million from 1 November 1991. From 20 March 1992 the Bank also issued Treasury bills of six and nine months at the weekly tender. As from that date, R100 million of each of the three types of Treasury bills were issued, for a total of R300 million per week. The issuing of these additional Treasury bills with different maturities was introduced in order to develop the market for Treasury bills, to create a convenient instrument for purposes of money market intervention and to satisfy the apparent demand for money market instruments with maturities of six and nine months. From 5 June 1992 the Bank issued only Treasury bills of three and six months, to an amount of R150 million each, at the weekly tender, because it also began to issue nine-months special Reserve Bank bills.

The Reserve Bank also announced on 20 March 1992 that it would intervene in the *financial rand market,* partly with a view to counter the excess liquidity in the money market. In the ensuing four months the intervention in the financial rand market had only a marginal effect on money market liquidity.

Despite these Reserve Bank operations in the money market, the market remained fairly liquid and projections indicated that the liquidity could increase even further until at least the end of August 1992. On 5 June 1992 the Reserve Bank therefore issued a statement in which it announced the following *additional measures* to alleviate the shortage of money market paper:

- The issuing of negotiable special Reserve Bank bills with nine months' maturity on a public tender basis. Bills to the amount of R500 million were subsequently issued by the Bank in June, which will only be rediscountable with the Reserve Bank on reaching an outstanding maturity of 91 days or less. In the meantime, they qualify as liquid assets and will be accepted as collateral for overnight loans extended by the Reserve Bank.
- Authorised dealers in foreign exchange were allowed to increase their deposits with foreign banks from a total of $316 million to $632 million.
- From 21 July 1992 each registered deposit-taking institution was required to maintain, in a special deposit account with the Reserve Bank, an additional cash reserve equal to 1 per cent of its short-term liabilities. In total, deposit-taking institutions therefore now have to hold as a compulsory minimum cash reserve an amount equal to 5 per cent of their short-term liabilities to the public. Interest at a rate of 0,5 per cent below the latest weekly 91-day Treasury bill tender rate is paid on the daily balances in the special deposit account, up to a limit of one per cent of each deposit-taking institution's latest applicable figure for outstanding short-term liabilities to the public as reduced.

Owing to the temporary tighter conditions in the money market in July 1992, the Reserve Bank introduced short-term measures to support the market, consisting of repurchase agreements of R1 000 million, transactions in the foreign exchange market of R713 million, and purchases of Land Bank bills and promissory notes by the Corporation for Public Deposits to the amount of R1 269 million. These measures therefore more than neutralised the effect of the increase in deposit-taking institutions' required cash reserves of R947 million, which became effective on 21 July 1992.

The development of the financial markets, as an intermediate goal of monetary policy, was also actively pursued by the Reserve Bank during 1991 and the first half of 1992. In this regard, the Reserve Bank's trading of *government stock options* rose from a monthly average of R0,8 billion in 1990 to a monthly average of R2,0 billion in 1991 and of R4,6 billion in the first six months of 1992. Similarly, total Reserve Bank transactions in government stock (purchases and sales) increased from a monthly average of R1,4 billion in 1990 to a monthly average of R3,9 billion in 1991 and R10,4 billion in the six months to June 1992.

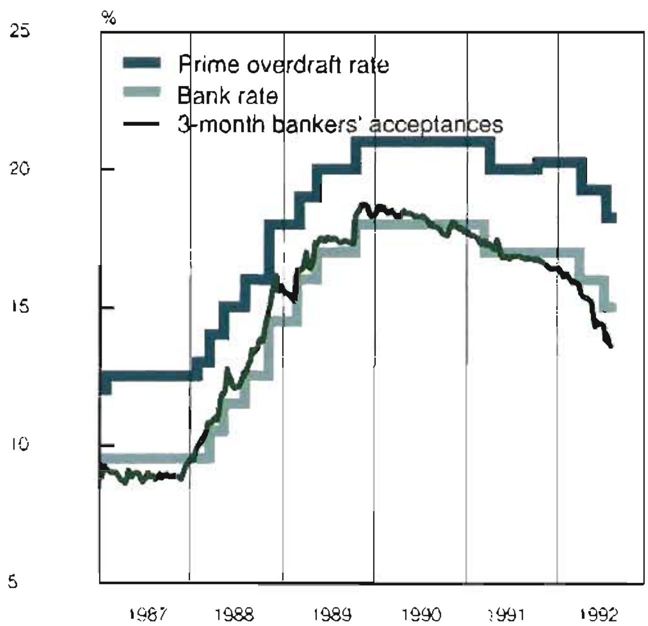
Gradual softening of money market interest rates

The gradual softening of money market interest rates, which had started in February 1990, continued throughout 1991 and gathered momentum in 1992. The downward trend in money market interest rates could be attributed to a general easing in the demand for funds in the private sector because of the cooling-down of the economy (as reflected in the slackening of monetary expansion and credit growth), an increase in money market liquidity and increased expectations of a lower Bank rate.

The downward trend in money market interest rates was clearly reflected in the *rate on three-month bankers' acceptances,* which from February 1990 until the end of 1991 declined by 2,20 percentage points to reach 16,40 per cent at the end of December 1991; in the first eleven weeks of 1992 this rate declined more rapidly by 0,60 percentage points to 15,80 per cent on 21 March 1992. After the Reserve Bank had reduced its rediscount and other lending rates by 1 percentage point (with the exception of the rate for the rediscounting of liquid bankers' acceptances, which was reduced by only 0,50 percentage points) on 23 March 1992, money market interest rates generally continued to soften at an even faster pace towards the end of May. The rate on three-month liquid bankers' acceptances receded by a further 1,30 percentage points to 14,50 per cent at the end of May 1992.

The decline in the rate on three-month bankers' acceptances slackened somewhat towards the end of May and early June because of a temporary increase in

Short-term interest rates



the growth in the money supply, the persistently high rate of inflation as measured by the consumer price index, and the announcement by the Reserve Bank on 5 June 1992 that it would provide additional paper to the money market. This rate receded, however, to 13,80 per cent at the end of June (with the reduction in Bank rate) and further to 13,55 per cent at the end of July 1992. At this last-mentioned level the rate on three-month bankers' acceptances was 2,45 percentage points below the Reserve Bank's rediscount rate for such acceptances, reflecting the market's expectations of further reductions in Bank rate.

Most other money market interest rates recorded a similar declining tendency. The three-month *Treasury bill rate* declined from 18,0 per cent at the beginning of January 1990 to 16,13 per cent at the end of December 1991 and further to 14,07 per cent at the end of June and 13,34 per cent at the end of July 1992. The rate on the newly introduced six-month Treasury bills softened after their introduction on 23 March 1992 from 14,88 per cent to 12,55 per cent at the end of July; the rate on the nine-month Treasury bills similarly declined from 14,33 per cent to 13,10 per cent on 29 May 1992, whereafter the issuing of these bills was terminated. The rates on other longer-term money market instruments, such as six and nine-month negotiable certificates of deposit, also declined fairly sharply.

The *prime lending* rate of deposit-taking institutions followed the changes in Bank rate, except when the tax on financial services was introduced on 1 October 1991. At that stage the deposit-taking institutions increased their prime lending rate by 0,25 percentage points to 20,25 per cent to compensate for the tax. In response to the subsequent reductions of Bank rate, the prime lending rate of these institutions was reduced by 1 percentage point to 19,25 per cent on 1 April 1992 and to 18,25 per cent on 6 July 1992.

The *inflation-adjusted prime lending rate* of deposit-taking institutions decreased from 6,0 per cent in March 1991 to 3,5 per cent in December 1991. In the first half of 1992 this rate fluctuated around this level and amounted to 3,6 per cent in June, reflecting the reduction in the nominal prime lending rate in April and the moderate deceleration in the rate of inflation from December 1991 to June 1992.

Structural changes in capital market

Over the past few years important structural changes have taken place which affected capital market activities or could affect these activities in the future. In particular, various *amendments* were made *to existing legislation*, providing *inter alia* greater freedom in portfolio selection for institutional investors as from 30 September 1991. The maximum limits on investments in preference and ordinary shares, convertible debentures and unit trusts were raised from 55 to 65 per cent for short-term insurers and from 65 to 75 per cent for long-term insurers. New individual asset limits on investments in shares and convertible debentures of companies with a market capitalisation of under and over R2 billion were also introduced. Furthermore, convertible debentures are now treated as shares, while options and futures are not regarded as insurance assets.

Other significant changes to existing legislation included:

- revised limits on assets in which a registered pension fund and a registered friendly society may invest;
- a tax imposed on financial services from 1 October 1991 in lieu of value-added tax;
- participation of non-residents in the derivative markets was allowed from 2 December 1991 and this facility was later extended to transactions financed with financial rand; and
- all interest accruing to non-residents was exempted from tax on 3 June 1992.

Another important development was the *lifting of financial sanctions* by the European Community, which enabled certain institutions to roll over maturing loans or to successfully place large stock issues in European financial centres. Since September 1991, when the first stock issue was floated in Europe, the public sector has raised R2,7 billion on foreign capital markets. Although a number of European companies have also shown renewed interest in South Africa and, in certain instances, have announced significant planned investment in local subsidiaries, most have opted for a wait-and-see approach in the light of the instability on the socio-political front.

Insurers and retirement funds, as the normal main source of long-term finance, continued to contribute substantially to the financing of the public sector and marketable equity funding. These institutions' net acquisition of equities made it possible for the capital market to absorb all new issues of equities plus the additional supply flowing from the net sales of listed equities by non-residents. The financing provided by insurers and retirement funds ultimately represents a significant percentage of the funds needed to finance the actual fixed investment of the relevant issuers of stock and equities.

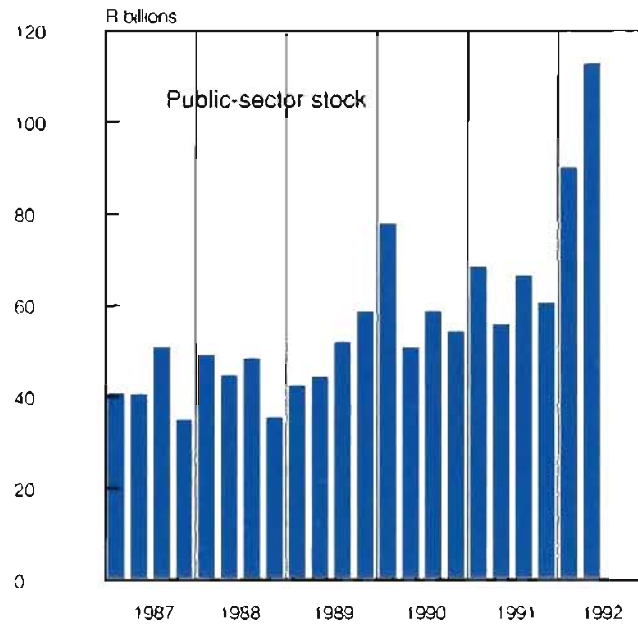
In recent years, however, the capital market has been characterised by a more subdued inflow of funds to insurers and retirement funds (excluding special employer contributions to official pension funds to reduce the actuarial deficits in these funds). This has been discernible in spite of the contractual system of collecting pension fund income and the automatic adjustment of contributions following wage increases and inflation-adjusted increases in insurers' premiums. The percentage increase in the inflow of current income to long-term insurers, for example, declined from 22,0 per cent in 1988 to only 11,0 per cent in 1991. The rising rate of claims paid (including all policy surrenders) is outstripping the growth in gross premium income of insurers, while the spate of personnel retrenchments is also eroding the net current income of retirement funds.

Another important recent capital market development was the first tender offer of *zero-coupon stocks* of the Department of Finance in the middle of June 1992. Two issues of R300 million (nominal value) with maturities of five and seven years were marketed in multiples of R1 million. Zero-coupon bonds bear no explicit interest, but are issued at a considerable discount on their face value. Although the characteristics of the bond (including especially the advantage of having no reinvestment risks) should have appealed to investors, these issues were poorly supported, perhaps mainly due to their low yield. The Public Investment Commissioners therefore took up the entire offer of R130 million. A second and more successful issue of zero-coupon stock with a maturity of ten years and amounting to R144 million, was allotted by Eskom at the end of June 1992.

Increased activity in the secondary capital market

The value of *public-sector stock* traded on the Johannesburg Stock Exchange rose by 4 per cent from R239,4 billion in 1990 to R249,1 billion in 1991. The level of trading activity fluctuated around the average quarterly amount of R62,3 billion throughout 1991 and then rose to R89,5 billion in the first quarter of 1992. This sharp increase in trading activity was mainly caused by the softening of interest rates and expectations of a further decrease in yields on long-term fixed-interest stock. Trading increased even further to a level of R112,3 billion in the second quarter, as a result of the further softening of interest rates and a sustained substitution of gilts for equities.

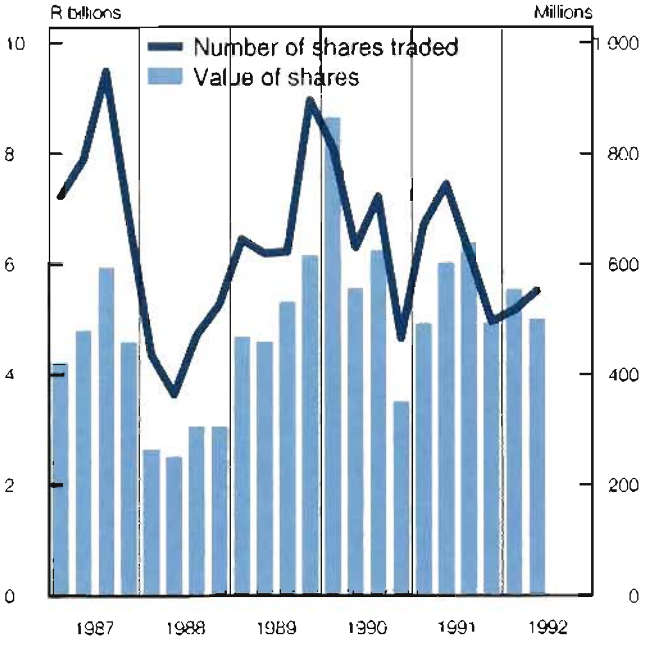
Stock exchange transactions



Non-residents once again had a significant impact on market sentiment throughout 1991 and the first half of 1992. The favourable returns offered on fixed-interest securities purchased with financial rand led to an increase in net purchases of public-sector stock by non-residents to R2,0 billion in 1991 from R1,5 billion in 1990. In the first half of 1992 these net purchases amounted to R1,1 billion.

After having increased moderately by 15,5 per cent to R23,9 billion in 1990, the value of *shares traded* on the Johannesburg Stock Exchange decreased by 7,1 per cent to R22,2 billion in 1991. The value of shares traded improved in the first three quarters of 1991, but then dropped sharply from R6,4 billion in the third quarter to R4,9 billion in the fourth quarter of 1991; it then rose again to R5,5 billion in the first quarter of 1992 before falling back to R5,0 billion in the second quarter. During this period institutional investors (insurers and pension funds) dominated share trading activity. In particular, holdings of blue chip industrial shares were acquired more aggressively.

Stock exchange transactions

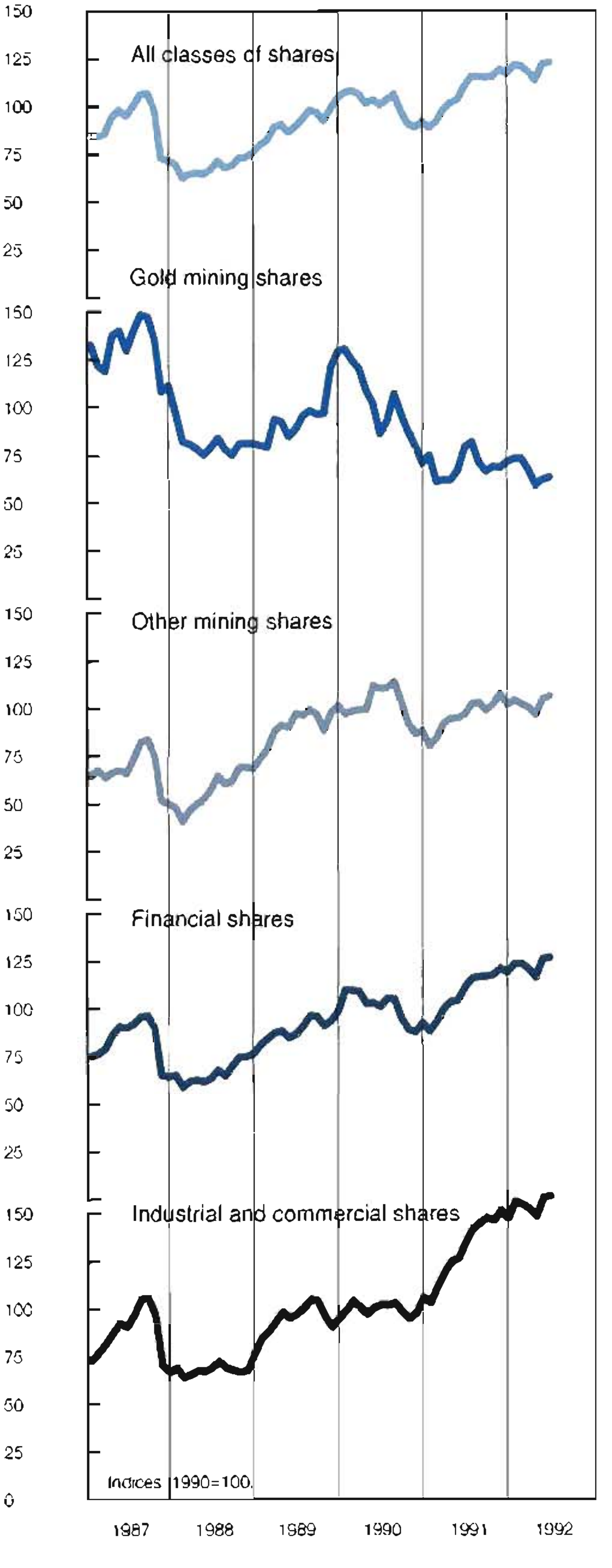


Net sales of shares by non-residents fell slightly to R4,1 billion in 1991 from R4,5 billion in 1990. The markedly stronger financial rand which prevailed throughout 1991 together with the excellent returns offered by the bond market, led to a sharp decrease in both purchases and sales of shares by non-residents during this period. A weaker financial rand in the first half of 1992 resulted in a moderate recovery in share purchases by non-residents, but share sales were maintained at the average monthly level reached in 1991.

The *number of shares traded* decreased by 26 per cent from a peak in the second quarter of 1991 to the second quarter of 1992 largely because of the disappearance of the small investor from the market as well as the fact that institutional investors and non-residents had begun to regard the market as becoming overvalued. The resultant decline in share turnover velocity (measured as the value of share turnover as a percentage of market capitalisation) from 4,7 per cent in 1990 to 3,8 per cent in 1991, further reduced the relative attractiveness of share trading on the Johannesburg Stock Exchange in comparison with that of its counterparts abroad where turnover velocities of 30 per cent and higher abound.

Despite the decline in the volume of shares traded, the average price level of all classes of shares rose by 37,1 per cent from January 1991 to January 1992. During this period the rise in *share prices* was led by industrial and commercial shares, which advanced by

Share prices



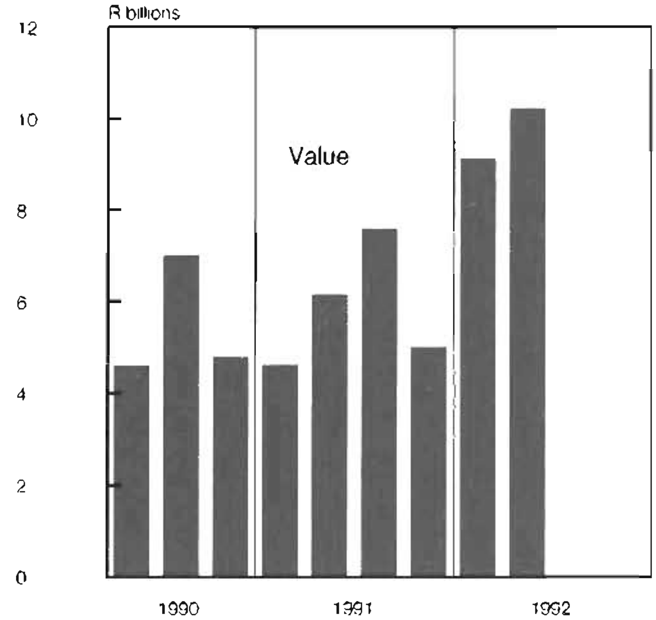
51,6 per cent against increases of 40,4 per cent in financial share prices and 16 per cent in mining share prices. This sharp rise in share prices was not matched by commensurate increases in corporate earnings, but was largely the result of a sustained institutional demand for scrip that remained in short supply. As the lifting of trade, financial, technical and other sanctions over a wide front gathered momentum, expectations of a possible earlier economic recovery became apparent and served to reinforce an already positive market sentiment.

However, from January 1992 to April the average price level of all classes of shares fell back by 6,7 per cent. This easing occurred in the prices of all the main categories of shares and was the result of the increasingly disappointing turnover and earnings performance of a number of large listed companies as well as the weakening in investor sentiment following the disconcerting decline in some of the main stock exchanges of the world. A sharp decline was recorded in the prices of gold-mining shares in particular, as a result of a lower gold price and negative market sentiment concerning the profitability of certain gold mines.

Slightly improved world economic growth prospects, more stable and positive trading conditions on the larger stock exchanges of the world, some positive sentiments after the outcome of the referendum and lower domestic interest rates, again supported the equity market, and share prices on the stock exchange began to recover by the end of April 1992. A 7,5 per cent increase in share prices in May took the monthly average price level of all classes of shares for that month to 0,3 per cent above the peak reached in January 1992. By the middle of June 1992 negative sentiment flowing from expectations of mass action on the political front, greater uncertainty as to whether interest rates would in effect continue to soften in the light of measures taken to reduce liquidity in the money market, and a sudden floundering of some of the major stock markets, reversed this relatively sharp but short-lived recovery in the prices of all classes of shares.

The value of *transactions in futures contracts* increased substantially from R4,7 billion in the fourth quarter of 1990 to R7,6 billion in the third quarter of 1991. Despite falling back again to R5,0 billion in the fourth quarter of 1991, the level of these transactions for the year as a whole amounted to no less than R23,3 billion – 5 per cent more than the value of share turnover on the Johannesburg Stock Exchange during this period. In the first half of 1992 foreign participation and transactions by institutions caused the value of transactions in futures contracts to rise to R9,1 billion and R10,2 billion in the first and second quarter, respectively. Interest in the share-index futures contracts in particular ensured that large volumes were obtained. Contracts in share indices represented 73 per cent of the total value of futures contracts during the eighteen months ended June 1992.

Futures exchange transactions



Activity was at first fairly brisk after the opening of the Johannesburg Stock Exchange's *Traded Options Market* in February, but then weakened progressively in the ensuing two months: the 395 contracts with an underlying value of R3,6 million in February 1992 decreased to 70 contracts with an underlying value of only R0,7 million in May. In the next month no options were traded; this lacklustre performance was probably partly due to investors' inexperience with the new market and its procedures.

Higher demand for funds in the primary capital market

The demand for funds in the primary capital market increased sharply in 1991 and activity remained fairly high in the first six months of 1992. Net new borrowing by the public sector through issues of *fixed-interest securities* increased from R8,1 billion in 1990 to R9,3 billion in 1991. The amount of new issues of public-sector stock peaked at R4,9 billion in the fourth quarter of 1991, fell back to R0,5 billion in the first quarter of 1992 and then rose substantially to R11,3 billion in the second quarter.

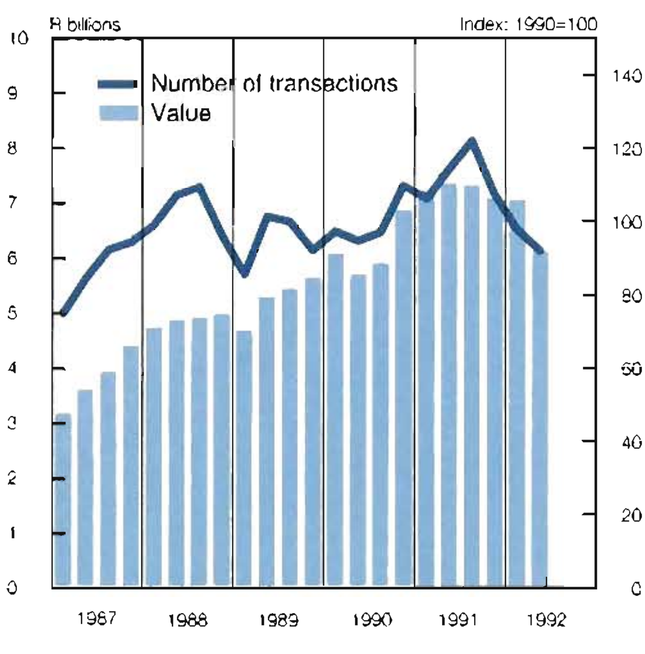
Similarly, the value of new issues of fixed-interest securities (including convertible preference shares and debentures) and ordinary shares of listed private-sector companies rose from R722 million in 1990 to R1,6 billion in 1991 and to R1,8 billion in the first six months of 1992. The value of new issues of ordinary shares by listed private-sector companies increased from R4,5 billion in 1990 to R6,0 billion in 1991. In the first five months of 1992 a further amount of R4,3 billion in new capital was raised in this manner. The high cost of borrowed funds, the high demand for good quality scrip and the concomitant high prices of prime equities, made share capital issues increasingly attractive.

The *mortgage market* in 1991 and the first half of 1992 witnessed the increasingly competitive marketing of mortgage loans by certain deposit-taking institutions. More flexible bond facilities were made available to approved clients and computerised procedures were introduced to speed up the process of loan approval. This allowed access to less expensive finance which is not necessarily earmarked entirely for real estate purposes and therefore reduces the relationship between an increase in financial institutions' holdings of mortgage bonds and an increase in the value of real estate transactions. As already indicated, the mortgage advances of deposit-taking institutions rose significantly over the past eighteen months.

In contrast with these developments, the mortgage loans paid out by participation mortgage bond schemes decreased by 4,4 per cent to R1 billion in 1991; in 1990 these loans had risen by no less than 42 per cent. In the first quarter of 1992 a further amount of R263 million was paid out by participation mortgage bond schemes.

The relative buoyancy displayed by the *fixed-property market* throughout the greater part of the current cyclical downswing continued to prevail during most of 1991 because of further increases in the portfolios of insurers and pension funds. The value of real estate transactions increased by 18 per cent from R24,6 billion in 1990 to a record level of R29,1 billion in 1991. However, in the first and second quarters of 1992 the value of these transactions declined to R7,1 billion and R6,1 billion, respectively, compared with an average quarterly value of R7,3 billion in 1991. The *number* of fixed property transactions increased by 13 per cent in 1991, after having increased by 5 per cent in 1990, but fell back by 17,2 per cent in the first six months of 1992.

Real estate transactions



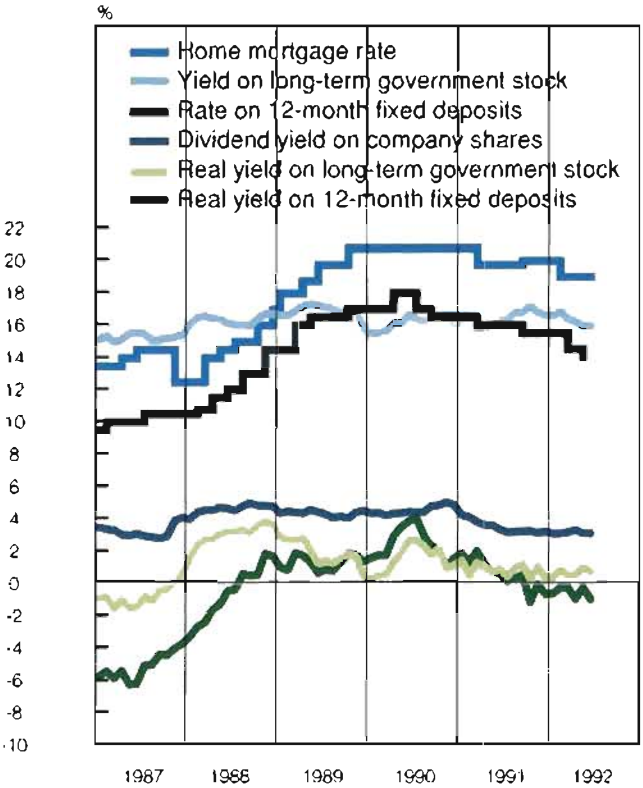
Lower capital market yields and interest rates

The monthly average yield on *long-term government stock* increased gradually from 15,6 per cent in February 1991 to 17,2 per cent in October 1991; eased to 16,6 per cent in January 1992, firmed again to 16,9 per cent in February and softened further in the next four months to 15,9 per cent in June 1992. The upward trend in long-term nominal interest rates during the first three quarters of 1991 was a result of upward pressure exerted by substantial public-sector borrowing in the primary market, the almost uninterrupted decline in the dollar price of gold and the continued high level of consumer price inflation. The decline in the long rates in late 1991 and in the first half of 1992, however, reflected the softening in short rates, more optimistic inflation expectations, increasing money market liquidity and the eventual lowering of Bank rate, which had a greater impact on long rates than the resumed downward drift in the dollar gold price and the rand exchange rate.

The monthly average *real* yield on government stock (i.e. the nominal rate after adjustment for the prevailing year-on-year inflation rate) increased from a low of 0,5 per cent in July 1991 to 1,3 per cent in September, but eased again to 0,4 per cent in December 1991; it then firmed to 0,9 per cent in February, but softened again to a rate of only 0,8 per cent in June 1992.

The deposit-taking institutions' predominant home *mortgage bond rate*, which had remained at 19,75 per cent since April 1991, was increased by 0,25 percentage points to 20,00 per cent in October 1991 in response to the taxation introduced on financial services in lieu of value-added tax. In an attempt to pre-empt a cut in Bank rate, most of the larger deposit-taking institutions announced late in January 1992 that home loan rates would be reduced by 1,0

Capital market interest rates and yields



percentage point to 19,0 per cent with effect from 2 March 1992. The subsequent reduction in Bank rate on 23 March 1992 therefore had no further impact on the mortgage bond rate. In May deposit-taking institutions announced a further reduction in their predominant mortgage bond rate to 18 per cent with effect from 1 July 1992.

The rapid rise in share prices in 1991 and the fact that disappointing financial results led many companies to reduce dividends, caused the *dividend yield* on all classes of shares to decline significantly from 4,3 per cent in January 1991 to 3,1 per cent in January 1992. The dividend yield then firmed to 3,4 per cent in April and fell back to 3,2 per cent in June.

The *earnings yield* on all classes of listed shares (excluding gold-mining shares) declined from 11,3 per cent in January 1991 to 7,6 per cent in January 1992 before recovering to 7,8 per cent in April; it then decreased sharply to 7,3 per cent in June because of lower profits and a levelling-off in share prices.

In reaction to the decrease in the bond rate in March-April 1991, the deposit-taking institutions' *twelve-month deposit rate* was reduced by 0,5 percentage points to 16,0 per cent in April 1991. Deposit-taking institutions thereby attempted to restore more comfortable interest-rate margins in an easier credit-demand situation. This rate was subsequently lowered further to 15,5 per cent in October 1991 in response to the taxation on financial institutions referred to above. The reduction in Bank rate on 23 March 1992 was followed by a lowering of 1 percentage point in the twelve-month deposit rate in April 1992. Since lending rates did not decline to the same extent as deposit rates over the past two years, the margin between the twelve-month deposit rate and the predominant prime overdraft rate of clearing banks widened from 3 percentage points in July 1990 to 5,25 percentage points in June 1992.

The *rates on partially tax-free investments* with deposit-taking institutions, the Post Office Savings Bank and the Treasury remained at 12,0 per cent after having been increased by 0,5 percentage points in March 1991 as partial compensation for the phasing-out of the tax-free status of the interest income earned on these investments.

After having remained unchanged since 27 July 1990, the maximum permissible *finance charges rates* as determined in terms of the Usury Act, were reduced in tandem with reductions in other rates with effect from 29 May 1992 from 29 to 28 per cent in respect of money lending, credit and leasing transactions for amounts of more than R6 000 (but not exceeding R500 000), and from 32 to 31 per cent in respect of transactions for amounts of up to R6 000.

Government finance

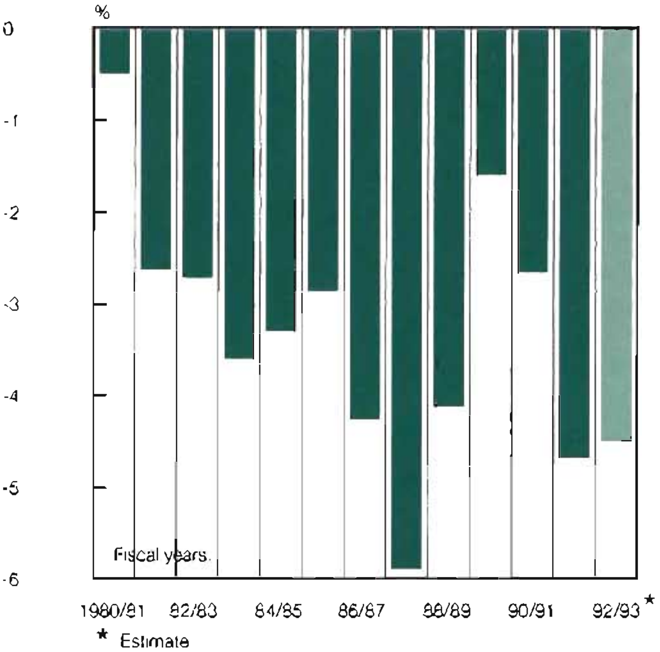
Expansionary short-term fiscal policy stance, but unchanged longer-term objectives

A more *expansionary fiscal policy* stance has been pursued by the authorities over the past two fiscal years. The more lenient fiscal policy adopted during 1990, was strengthened by the eventual outcome of the Budget for 1990/91 which was even more expansionary than originally intended. The finances of the government in fiscal 1991/92 remained fairly stimulatory, and this stimulatory effect of the Budget was further enhanced with off-budget expenditures on socio-economic upliftment, which were financed by means of the Exchequer surplus of 1990/91 and by the spending of a further R1 billion from strategic oil sales. In view of the prolonged downturn in economic activity combined with the severe drought in South Africa, the government provided again for a stimulatory budget for fiscal 1992/93.

Despite these changes over the shorter term in the finances of the fiscus, the *restructuring of the South African economy* remains the longer-term objective of the authorities. By means of supply-side measures the authorities continue to support sustainable higher economic growth rates that should create income and employment opportunities. The authorities also believe that more rapid economic growth will create the means whereby it will be possible to provide more equal opportunities for all the residents of South Africa. As indicated in the *Budget Review* of 1992, the fiscal strategy followed by the authorities therefore concentrates on:

- "The raising of the economic growth potential via tax reduction, changes in tax structure, greater tax effectiveness, more efficient and more purposeful state spending, a relatively lower level of state expenditure and the systematic elimination of government sector dissaving.
- Promotion of more equal opportunities via priority shifts of state expenditure towards socio-economic services and the more effective targeting of assistance on the expenditure side of the Budget in the case of the genuinely needy.
- Promotion of macro-economic stability via the reduction of the fiscal deficit, the avoidance as far as possible of money creation in financing, the redemption of public debt and a larger role for dynamic public debt management in short-term stabilisation policy."

Deficit before borrowing as percentage of gross domestic product



* Estimate

Some progress was made in the achievement of these objectives during the past three years, but certain factors restricted a more rapid restructuring of the Central Government's finances. Firstly, the process of political reform during the past few years aggravated the imbalance between government revenue and expenditure in that it hampered increases in revenue and led to increased pressure for additional expenditure. Secondly, the economy has been in a downward phase of the business cycle for more than three years, resulting in low rates of increase in revenue which limited the ability of the authorities to introduce extensive fiscal policy changes. Finally, the severity of the drought, the alarming and increasing extent of poverty in the country and the objective of attaining parity in the provision of benefits to the various population groups (such as social security payments) also narrowed the manoeuvrability of certain measures that the government could take.

These factors forced the government to depart from certain structural adjustments it had planned. In particular, the authorities were unable to:

- lower state expenditure as a ratio of gross domestic product;
- increase expenditure on social and economic upliftment of the population to preferred levels;

- lower the income tax rate on companies to the planned level;
- reduce the income tax rate applicable to individuals sufficiently to eliminate the effects of fiscal drag;
- reduce direct taxes as a proportion of total taxes, or to increase the share of indirect taxes;
- decrease the government's deficit before borrowing and debt repayment as a percentage of gross domestic product: and
- eliminate dissaving by the Central Government.

The government, however, remains committed to these structural reforms. As part of this process the Tax Advisory Committee and the Tax Research Unit of the Department of Finance are still involved in a large number of investigations to improve the tax system of the country. A task force under leadership of the Central Economic Advisory Services, with representatives of the Departments of Finance and State Expenditure as well as of the South African Reserve Bank, was formed in 1991 to advise the Cabinet on a macro-economic framework for expenditure ceilings, revenue estimates and loan financing.

Sharp rise in public sector borrowing requirement

The more stimulatory fiscal policy stance of the authorities during the past two years is confirmed by a substantial increase in the *public sector borrowing requirement* (i.e. the deficit before borrowing of the Central Government, provincial administrations, local authorities, non-financial government enterprises and public corporations). After having decreased to a low of 1½ per cent of gross domestic product in fiscal 1989/90 mainly as a result of privatisation proceeds, this ratio rose again to 6 per cent in fiscal 1990/91 and 5 per cent in fiscal 1991/92, or to a level comparable with the average ratio of 5½ per cent in the 1980s.

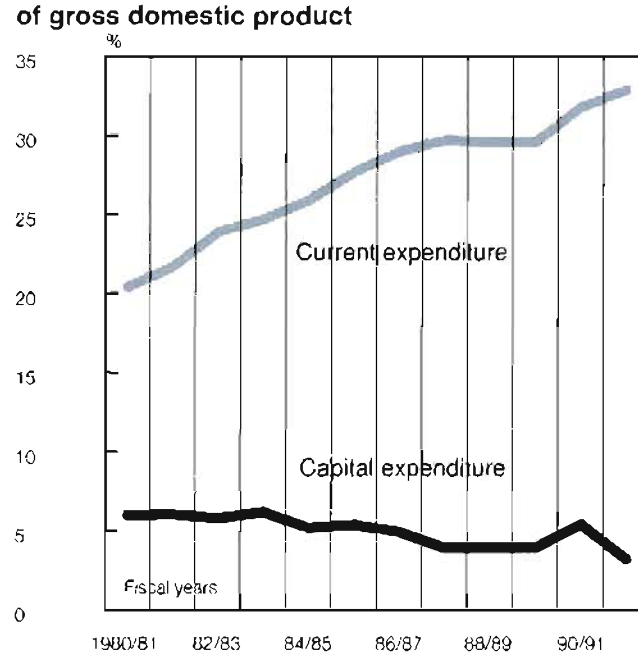
The increase in the public sector borrowing requirement in fiscal 1990/91 was mainly due to the fact that the rate of increase in the expenditure of the general government (Central Government, provincial administrations and local authorities) was considerably higher than the growth in general government revenue. In fiscal 1991/92 the rate of increase in general government expenditure was again marginally lower than in income. The relatively high level of the general government's deficit before borrowing requirement in that year was countered somewhat by a decline in the deficit before borrowing of non-financial public business enterprises and public corporations as a ratio of gross domestic product.

After having increased from slightly more than 15 per cent in fiscal 1989/90 to nearly 23 per cent in fiscal 1990/91, the rate of increase in total *expenditure of the general government* amounted to only 10 per cent in fiscal 1991/92. This substantial deceleration of the growth in total expenditure was partly due to a sharp contraction in the capital expenditure of general government, especially capital transfers to other sectors. However, the rate of increase in general government current expenditure also slowed down from 18½ per cent in fiscal 1990/91 to slightly less than 17½ per cent in fiscal 1991/92, mainly because of a low rate of increase in subsidies and other current transfers. This lower rate of increase in government expenditure during fiscal 1991/92 took place at all levels of government except the expenditure on extra-budgetary accounts (including the TBVC countries and self-governing states).

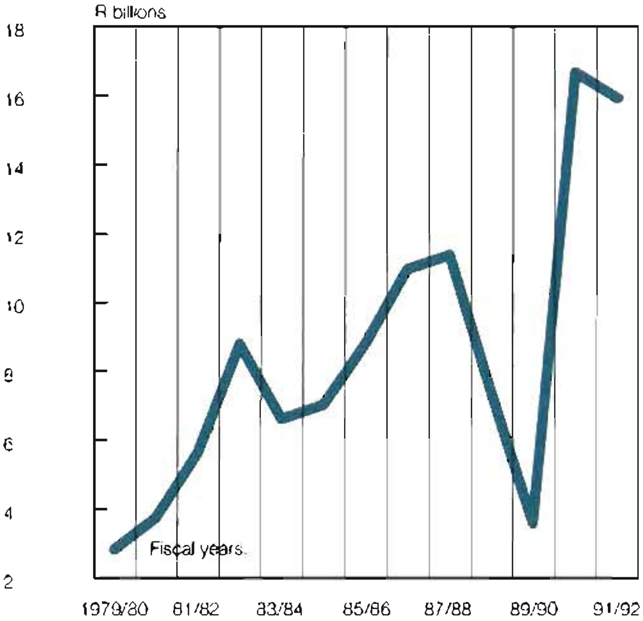
As a ratio of gross domestic product, the current expenditure of general government rose from 20½ per cent in fiscal 1980/81 to 32 per cent and 33 per cent in the past two fiscal years. All the various components of current expenditure contributed to the relatively rapid increase in this ratio. On the other hand, capital expenditure of general government decreased from 6 per cent of gross domestic product in fiscal 1980/81 to 5½ per cent in fiscal 1990/91 and then very sharply to 3½ per cent in fiscal 1991/92.

The rate of increase in *general government revenue* slowed down even more sharply than expenditure, namely from approximately 24 per cent in fiscal 1989/90 to 13 per cent in fiscal 1990/91 and 10½ per cent in fiscal 1991/92. As could be expected, this

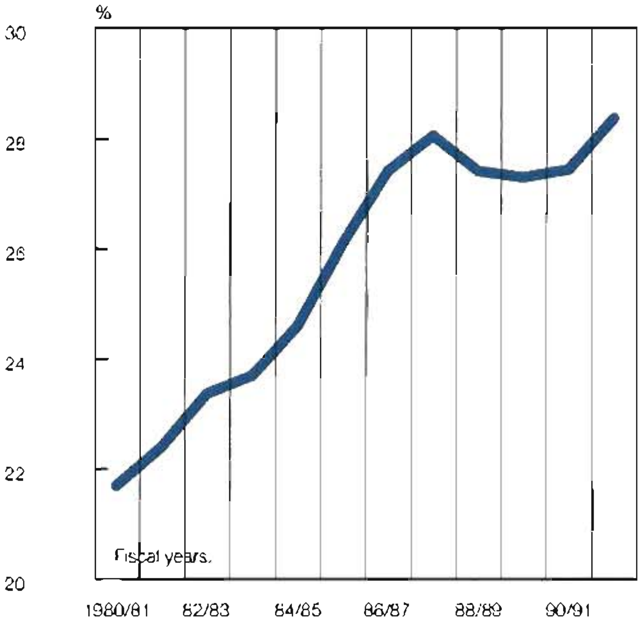
General government expenditure as percentage of gross domestic product



Public sector borrowing requirement



Exchequer issues to government departments as percentage of gross domestic product



lower growth in revenue was related mainly to the relatively low rise in tax collections by the Central Government because of the downswing in economic activity. The growth in the revenue of local authorities also slowed down sharply in fiscal 1991/92; in the previous two years, fairly high rates of increase had been recorded in these revenue collections. Total revenue of general government as a percentage of gross domestic product rose from 27 per cent in fiscal 1980/81 to 33 per cent in fiscal 1990/91 before declining marginally to 32 per cent in fiscal 1991/92.

The increase in the general government's deficit before borrowing since the beginning of the 1980s was countered to some extent by the smaller borrowing requirement of non-financial public business enterprises. In particular, the borrowing requirements of public corporations fell sharply as a result of cutbacks in capital spending and other rationalisation programmes to improve cost-effectiveness. Despite the declining trend in the value of public sector investment, the public sector borrowing requirement rose at an even more rapid rate.

More expansionary outcome of the Budget for fiscal 1991/92

The actual outcome of the government's finances (on a basis comparable to the Budget) for fiscal 1991/92 was more expansionary than originally planned. Not only were Exchequer issues to government departments underestimated, but government revenue was overestimated. As a result, the deficit before borrowing and debt repayment was substantially higher than the amount budgeted.

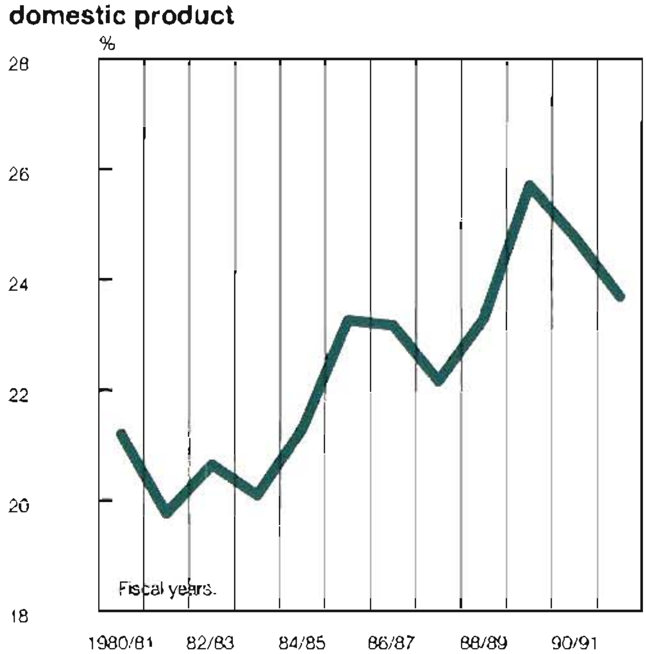
Owing mainly to additional expenditure made available for the alleviation of socio-economic backlogs and for defraying the higher costs of the public debt, *government expenditure* was eventually 1,7 per cent higher than the original Budget estimate for fiscal 1991/92. Exchequer issues to government departments therefore rose to R86,4 billion, which represented an increase of 16,1 per cent in fiscal 1991/92; this rise was, however, still considerably lower than the average annual rate of growth of about 19 per cent in the 1980s. These higher expenditures led to an increase in the ratio of Exchequer issues to gross domestic product from 27,4 per cent in fiscal 1990/91 to 28,3 per cent in fiscal 1991/92, signifying a reversal of the moderate declining trend in this ratio over the previous three years. It also presented a departure from the government's longer-term objective of reducing the ratio of Exchequer issues to gross domestic product.

Moreover, the current expenditure of the government increased again very sharply, whereas capital expenditure decreased further. Capital expenditure as a percentage of total expenditure has declined from 12,0 to 2,9 per cent over the past ten fiscal years. Part of the continued fairly high average rates of increase in current expenditure was made possible by cuts in capital expenditure. Another disconcerting feature of government expenditure during the 1980s has been the sharply rising trend in interest paid on government debt. In 1991/92 interest payments by the Exchequer amounted to R13,7 billion, or 15,9 per cent of total Exchequer issues; in 1981/82 this ratio was considerably lower at 10,5 per cent. This rising trend in public debt costs was mainly due to a rise in debt; continued high rates of inflation and concomitant increases in nominal interest rates; and the easing of prescribed asset requirements applicable to insurance companies and pension funds in 1984 and 1989, which has forced interest rates on government debt issues to become more market-related.

Current transfers by government departments to other levels of general government also increased further to 35,8 per cent of total expenditure in fiscal 1991/92, from 33,6 per cent in fiscal 1990/91. In particular, a substantial increase was recorded in transfers to self-governing states and the TBVC countries. In contrast to these developments, the share of expenditure on goods and services in total government expenditure remained virtually unchanged over the past two years.

Total *government revenue* (on a basis comparable to the Budget) rose to R72,1 billion in fiscal 1991/92, or by only 7,4 per cent; in the Budget provision had been made for an increase of 11,1 per cent. This lower than expected increase in government revenue led to a shortfall of R2,8 billion, or 3,7 per cent of the amount originally budgeted.

Total revenue as percentage of gross domestic product



The shortfall in Exchequer revenue was to a large extent related to the fact that the downturn in economic activity had become more severe and was lasting longer than had been anticipated at the time the Budget was presented in March 1991. This led to lower than budgeted increases in the taxes collected from companies and individuals, as well as in certain indirect taxes. In addition, the government introduced value-added tax at 10 per cent instead of the originally planned 12 per cent and exempted certain selected foodstuffs (such as samp, crushed maize, whole maize, dried beans, soya beans and lentils) from the tax. In an attempt to recover at least a part of the revenue forfeited by these changes to the value-added tax, the government increased the fuel levy on petrol and diesel by 10 cent and 8 cent per litre, respectively, from 24 August 1991 and introduced an additional *ad valorem* duty of 2,5 per cent on certain goods from 30 September 1991.

The ratio of government revenue to gross domestic product declined for the second consecutive year from its record high level of 25,7 per cent in fiscal 1989/90 to 24,7 per cent in fiscal 1990/91 and to 23,7 per cent in fiscal 1991/92; in the 1970s and the 1980s this ratio had averaged 20,0 and 22,2 per cent. Contrary to the longer-term objective of the government to reduce the share of direct taxes in total income, this decline was brought about by a smaller relative contribution of indirect taxes. In particular, income tax on individuals as a percentage of gross domestic product rose virtually consistently from 3,4 per cent in fiscal 1980/81 to 8,5 per cent in fiscal 1990/91 and further to 9,5 per cent in fiscal 1991/92. Largely as a result of lower tax proceeds from gold mines and the lower level of economic activity in South Africa, the income tax on companies as a percentage of gross domestic product contracted from 8,6 per cent to 5,2 and further to 4,4 per cent over the same period.

The higher than expected expenditure and lower than expected revenue brought the *deficit before borrowing and debt repayment* in fiscal 1991/92 to 4,7 per cent of gross domestic product, compared with 2,7 per cent in fiscal 1990/91. The average ratio of the deficit as a percentage of gross domestic product amounted to 3,3 per cent in the 1980s. The stimulatory effect of government finance is also clearly illustrated by the so-called "primary balance", i.e. revenue less expenditure before taking interest payments on government debt into account: the primary balance as a percentage of gross domestic product moved from a surplus of 2,3 per cent in fiscal 1989/90 to a deficit of 0,2 per cent in fiscal 1991/92.

The deficit of R14 307 million for fiscal 1991/92 was financed in the following way:

	R millions
Government stock (including discount on newgovemment stock)	17 838
Treasury bills	-129
Foreign loans	549
Non-marketable securities	-77
Decrease in available cash balances	1 417
Total financing of Exchequer deficit	19 598
Plus: Transfers from the National Supplies Procurement Fund and the Central Energy Fund	809
Less transfers to: Reinsurance Fund for Export Credit and Foreign Investment	450
Govemment Service Pension Fund	1 000
Maize Board	350
Less: Discount on new government stock	4 300
Total net financing	14 307

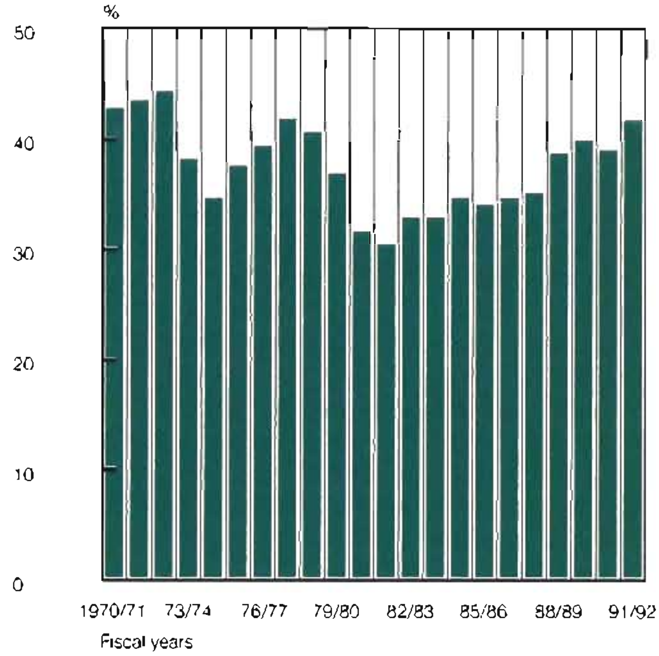
The financing of the deficit of R14 307 million, plus the discount of R4 300 million on new issues on government stock, was provided from the following sources:

	R millions
Public Investment Commissioners	4 551
Non-monetary private sector	15 290
Deposit-taking institutions	-1 142
Corporation for Public Deposits	46
Other	-1 188
Foreign sector	899
Less: Transfers paid	1 800
Plus: Transfers received	809
Total net financing of fiscal deficit and discount	18 607

From this information it is apparent that R15 290 million, or 78 per cent of the total financing requirements of the Exchequer, was obtained from the non-monetary private sector. This high ratio may be compared with a figure of approximately 33 per cent in fiscal 1990/91. In particular, the proportion of the financing requirements financed by the Public Investment Commissioners remained virtually unchanged in fiscal 1991/92, while the government made net repayments on financial paper held by deposit-taking institutions. The Exchequer was also able to secure foreign financing of R899 million to meet part of its financing requirements in fiscal 1991/92.

The financing of the fiscal deficit and the high discount on new issues of *government debt* caused the ratio of the total outstanding government debt to gross domestic product to increase from 38,9 per cent at the end of March 1991 to 41,5 per cent at the end of March 1992. This ratio has therefore again reached levels prevailing in the last half of the 1970s, before the

Total government debt as percentage of gross domestic product



substantial surge in the gold price and accompanying higher government revenue allowed the authorities to curb the growth in outstanding government debt. Although the current debt ratio is not excessively high by international standards, the sharply increasing trend in government debt as a ratio of gross domestic product does cast doubt on the sustainability of current developments in government finance. This is even more disquieting because government debt has been increasing to finance current expenditure and not infrastructural development.

In accordance with the trend of the past few years, the government borrowed mainly in the domestic capital market. The outstanding marketable domestic stock of the government therefore rose from R82,8 billion at the end of fiscal 1990/91 to R100,7 billion at the end of fiscal 1991/92. It is, however, also interesting to note that the amount of outstanding Treasury bills rose from R2,0 billion to R3,3 billion over the same period in an effort to develop this market further in South Africa. As already indicated, the government also borrowed relatively small amounts on foreign capital markets, causing its foreign debt to rise to R2,9 billion at the end of fiscal 1991/92. On the other hand, the non-marketable debt of the Central Government declined from R8,0 billion at the end of March 1991 to R6,5 billion at the end of March 1992.

The lengthening of the maturity structure of the domestic stock debt of the Central Government related to the consolidation of government stock, was reversed in fiscal 1991/92. After having increased from a low of 114 months in fiscal 1988/89 to 129 months in fiscal 1990/91, the average maturity of domestic stock debt declined to 123 months in fiscal 1991/92. The declining tendency in the average maturity of foreign stock debt over the last few fiscal years was also reversed with the new foreign borrowing in 1991/92; it came to 22 months in this year against 20 months in fiscal 1990/91.

Expansionary Budget for 1992/93

In his presentation of the Budget for the fiscal year 1992/93 to Parliament on 18 March 1992, the Minister of Finance stated that the Budget had to seek a balance between meeting expectations that are increasing in intensity and the government's limited financial resources. In the process of political reform fiscal policy had to continue enunciating the theme of the preceding year's Budget: "Equity through growth and stability."

Although the present economic conditions in South Africa forced the authorities to digress somewhat from certain longer-term objectives, the Minister reiterated the Government's commitment to *structural reform*. The main objective of fiscal policy is still to raise the growth and job creation capacity of the economy, which is necessary to relief poverty and improve the quality of life and the pattern of income distribution. To achieve this objective the Government will continue to rely on various so-called supply-side measures. The need for financial discipline aimed at macro-economic stability was also recognised in the Budget.

As in the preceding year, the economic constraints on the Budget allowed little room for manoeuvring, causing the government to determine priorities very carefully. To overcome socio-economic backlogs in the country, large increases were announced in the *expenditure* on *social services*. In an attempt to address certain important imbalances, the Budget provided for increases of 24 per cent in expenditure on education, 22 per cent on health care and 22 per cent on housing. Further allowance was also made in the Budget for social assistance and for the removal of the disparities that still exist in the old-age pensions of the various population groups. In view of the increasing rate of unemployment, job creation was also an important priority in allocating expenditure.

In the case of *protective services*, the Budget projected an increase of only 5,6 per cent on defence expenditure and of about 22 per cent in the vote for the police. As a result of the high incidence of crime and violence in the country, the savings on defence expenditure had to be reallocated to policing, the administration of justice and corrective services.

Increases in expenditure on *economic services* concentrated mainly on the promotion of exports. An amount of R2 029 million was set aside in the Budget for the financing of export incentives, of which R872 million was destined for the redemption of promissory notes issued under the former export incentive scheme.

The Minister also announced that the government would no longer make use of a general contingency reserve for unforeseen expenses, but targeted reserves were provided for in the Budget. These targeted reserves amounted to R1 250 million, consisting of R1 000 million for drought relief and R250 million for retrenchment costs. The drought relief provided for assistance in the form of wage subsidies, subsidies on interest on debt and production credit, and a monthly allowance to farmers compelled to leave the industry because of the drought. Subsequently, on 7 May 1992, the Minister of Agriculture and Agricultural Development announced that an amount of R3 826 million would be granted over the next four years for drought relief. In fiscal 1992/93 this relief will be restricted to the R1 billion set aside in the targeted reserve, while the remaining R2 826 million will be spent over the next three years.

The substantial increase in the outstanding debt of the government and the high level of nominal interest rates gave rise to an increase of 17,1 per cent in expenditure on the servicing of public debt, which represents 16,2 per cent of total expenditure.

Total current expenditure of the Exchequer was accordingly estimated at R94,2 billion. After taking a projected R6,5 billion in capital expenditure into account, total government expenditure was budgeted at R100,7 billion for fiscal 1992/93. This represented an increase of 16,5 per cent, which should increase Exchequer issues to government departments further to an estimated 29 per cent of gross domestic product.

The main features on the *revenue* side of the Budget are:

- The marginal tax rate on individuals and the company tax rate were not reduced in accordance with the five-year plan of the government that was announced in the Budget speech on 14 March 1990.
- Tax relief was provided to individuals most severely affected by bracket creep, for married women and for the elderly. Although these concessions will result in a decline of R1,4 billion in the taxation of individuals, the government is again relying on a large increase in the income tax on individuals; this increase was estimated at 22,3 per cent.
- The *ad valorem* excise duty introduced on 30 September 1991 was converted into an equivalent specific duty and certain specific excise duties were raised.
- The levies on petrol and diesel were increased by 8 cents and 6 cents, respectively, and the farmers' diesel rebate by 2 cents per litre.

- Transfer and stamp duties on bank debits were raised.
- Further progress was made in the phasing-out of the surcharge on non-gold-mining companies, and the formula rate for gold mines was adjusted downwards.

In accordance with these proposals, income tax was expected to rise by 14,0 per cent in fiscal 1992/93. This included an increase of 16,7 per cent in income tax and an increase of 9,9 per cent in value-added tax. Subsequently, the temporary exemption from value-added tax granted on certain selected foodstuffs, which should have ended on 31 March 1992, was extended indefinitely. Customs and excise duty is expected to rise by 28,4 per cent, which should bring total revenue to R84,7 billion. This increase of 15,7 per cent in government revenue should cause the income of the Exchequer to rise to about 24,5 per cent of gross domestic product.

As a result of the more rapid rise in the budgeted expenditure than in revenue, the *deficit before borrowing and debt repayment* was estimated at R15 927 million, or 4,5 per cent of the projected gross domestic product. This deficit was to be financed as follows:

	R millions
Government stock	13 023
Bonds	-66
Foreign loans	351
Total	13 308
Plus: Transfers from National Supplies Procurement Fund and Central Energy Fund	1 600
Change in cash balance	1 019
Total financing	15 927

High deficit in the first quarter of fiscal 1992/93

In the first quarter of fiscal 1992/93 total *Exchequer issues* (after the usual adjustments for changes in the balance on the Paymaster-General Account) were 13,0 per cent higher than in the corresponding quarter of fiscal 1991/92. This could be compared with the budgeted increase of 16,5 per cent for the fiscal year as a whole. As a percentage of total government expenditure for fiscal 1992/93, Exchequer issues in the first quarter amounted to 23,6 per cent, which is slightly lower than the average ratio of 24,8 per cent in the first quarters of the preceding five fiscal years.

Exchequer receipts in the first quarter of fiscal 1992/93 rose by 8,9 per cent from the level of the corresponding quarter in the preceding year; for the fiscal year as a whole revenue was budgeted to rise by 15,7 per cent. As a percentage of total budgeted revenue, Exchequer receipts amounted to 18,8 per cent in the first quarter of fiscal 1992/93, which was significantly lower than the corresponding ratio of 20,5 per cent during the past five years. This lower than expected increase in revenue could be ascribed mainly to the deepening of the current cyclical downturn which particularly affected receipts from value-added tax.

The *deficit before borrowing and debt repayment* in the first quarter of fiscal 1992/93 amounted to R7 814 million, or about 49,1 per cent of the deficit budgeted for the fiscal year as a whole. This deficit, plus the discount of R1 676 million on new government stock issues, was financed from funds obtained from the Public Investment Commissioners (R3 353 million), the non-monetary private sector (R8 181 million), the monetary sector (–R3 039 million) and the foreign sector (R995 million).

New government stock issued for the *financing of the government deficit* amounted to R13 022 million in the first quarter of fiscal 1992/93, of which R879 million was raised on the international capital market and R12 143 million domestically. This large proportional share of the government's total financing requirement of R18 495 million in the first quarter of fiscal 1992/93 formed part of the policy to drain excess liquidity from the money market. The Governor of the Reserve Bank has also stated that during the rest of the current fiscal year, government paper in excess of the budgeted amount may be issued, depending on the needs of the Treasury and money market conditions.