Annual Economic Report

1993

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-third ordinary general meeting to be held on 24 August 1993.

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Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

The recession in the South African economy, which had started in March 1989, deepened considerably in 1992 and then levelled off in the first half of 1993. Although the decrease in real gross domestic product was relatively small over this cyclical downward phase, the recession nevertheless affected the inhabitants of the country seriously because it followed a long period of low average economic growth. In addition, uncertainties arising from the process of constitutional negotiations, intermittent civil unrest and violence, a generally weak international economy and the widespread drought in 1991/92, prolonged the downturn in economic activity and increased its severity. Many people therefore became unemployed and insufficient new job opportunities were created: the number of people unemployed or involved in the informal sector of the economy rose to approximately 46 per cent of the economically active population in 1992 from about 39 per cent in 1988.

Despite the severity of the recession, real gross domestic expenditure decreased only moderately, on account of the relative firmness of consumption expenditure. Real consumption expenditure of general government continued to rise in the economic downswing and as a ratio of gross domestic product it reached an all-time high in 1992. Real private consumption expenditure also increased in the initial stages of the downswing, but began to decline sharply from the beginning of 1991. Owing mainly to pre-emptive buying to avoid higher prices, it recovered somewhat in the first half of 1993. Consumer demand, however, remains fragile. Factors such as the decline in real personal disposable income, expected low salary and wage adjustments, job insecurity and the generally low level of consumer confidence are not supportive of a sustainable increase in consumption expenditure.

The firmness of consumption expenditure was neutralised by sharp decreases in real fixed capital expenditure and in inventory investment. A general lack of confidence, the high percentage of unutilised production capacity, low international growth, the high rate of taxation and rationalisation and cost-cutting programmes led to a decrease of no less than 23½ per cent in real gross domestic fixed investment from the third quarter of 1989 to the second quarter of 1993. As a result of the need to replace ageing machinery and equipment and a strong export demand for manufactured goods, fixed investment in private manufacturing was maintained at a relatively high level.

Notwithstanding the rising unemployment, the real remuneration per employee in the formal non-agricultural sectors increased at an average annual rate of 2 per cent in the downswing. The share of labour rewards in total nominal factor income therefore increased. The redistribution of factor income in favour of labour contributed to a high propensity to consume and a low propensity to save. It also had important negative implications for entrepreneurial motivation, innovation and investment, and therefore for the development potential and international competitiveness of the economy.

At the same time, non-agricultural labour productivity increased at a rate that was considerably higher than its long-term trend growth. This was a sharp divergence from its cyclical behaviour in the previous two recessions when productivity contracted. The stronger growth in labour productivity over the period 1989 to 1992 was achieved not so much through a stronger commitment to work, but more by retrenching workers at a quicker rate than the decrease in output volumes. Even so, the rate of increase in the real remuneration per worker still exceeded the growth in productivity, with the result that real unit labour costs continued to increase.

There are nevertheless very promising indications that the measured inflation rate is abating and that the country could be moving into an era of greater price stability. If it had not been for price increases associated with specific incidents, such as the Gulf War of 1990, the drought, the introduction of value-added tax and the recent increase in the rate at which this tax is levied, consumer price inflation could have receded much more. However, it remains important that the authorities continue to deal decisively with inflationary pressures because of the serious disadvantages of persistently rising prices, even at relatively moderate and stable rates of increase.

Developments on the current account of the balance of payments in the recession of 1989-93 also deviated from the normal cyclical pattern where a deficit on current account is usually transformed into a surplus during an economic downswing, which is maintained well into the subsequent upswing. In the downward movement of economic activity from March 1989, the current account of the balance of payments started off with a fairly large surplus, which increased as the downswing progressed. Notwithstanding the deepening of the recession in 1992, the current account weakened sharply to only a small surplus in the first quarter of 1993. This temporary deviation from its cyclical pattern in the past came to an end in the second quarter of 1993, when a substantial surplus reappeared.

The deterioration in the current account surplus in 1992 and the first quarter of 1993 was caused mainly by a substantial increase in the value, and more specifically in the volume, of merchandise imports. In contrast to most other economic downswings, when lower capital formation has customarily been accompanied by a lower volume of imports, the ratio of the physical quantity of imports to real gross domestic expenditure rose in the current recession. This somewhat unusual behaviour of the import penetration ratio reflected partly the substitution of imported goods for domestically produced goods in response to a decline in relative prices of imported goods; it was also due to somewhat exceptional circumstances, such as higher agricultural imports because of the drought, the purchases of new aircraft, oil imports, and pre-emptive buying in anticipation of a depreciation in the exchange rate of the rand.

The weakening of the current account surplus in an advanced stage of a cyclical downswing could also be attributed to a decline in the terms of trade of the country and an increase in net service and transfer payments to the rest of the world. A sharp increase in the volume of exports, coupled with a higher gold price and a decline in the volume of imports, then led to a dramatic recovery in the surplus on the current account in the second quarter of 1993.

The smaller surpluses on the current account were accompanied by a large outflow of capital from about June 1992, which caused the gross gold and other foreign reserves of the country to contract. At first this capital outflow reflected mainly renewed uncertainty arising from political developments and civil unrest. Later it was exacerbated by the strength of the dollar on international foreign exchange markets, leads and lags in foreign payments and receipts and the ready availability of domestic funds. As a result of the redemption of foreign loans, South Africa's foreign debt position improved significantly further. At the end of June 1993 the level of the gross gold and other foreign reserves was equivalent to the value of only 1½ months' imports of goods and services – an uncomfortably low level of foreign reserves.

The net effect of these changes on the balance of payments was a decline of 4,3 per cent in the nominal effective exchange rate of the rand in 1992 and of a much more significant 9,2 per cent in the first seven months of 1993. In June 1993 the real effective exchange rate was therefore 1,3 per cent lower than at the end of 1989. If movements in the real effective exchange rate are regarded as an accurate reflection of changes in the purchasing power parity of the rand, the international competitiveness of South Africa in the first half of 1993 was restored to levels prevailing at about the beginning of the economic downswing.

As a result of a restrictive monetary policy stance, the decline in real economic activity and the lower rate of inflation in South Africa, the growth in money supply slowed down substantially in the recession of 1989-93. This slower growth in money supply was accompanied by a significant change in the composition of M3: the ratio of long-term deposits to total liabilities of banks included in M3 declined from a year-end high of more than 28 per cent in 1986 to less than 13 per cent at the end of 1992. This change was made possible by new regulatory measures applicable to banking institutions, and was encouraged by banks through the offering of favourable interest rates on medium- and short-term deposits. The percentage share of all other types of deposits in total M3 therefore rose sharply in the economic downswing, with the notable exception of savings and other short-term deposits (excluding demand deposits) and coin and banknotes in circulation.

The demand for bank credit by the private sector in the recession was relatively weak and differed considerably from its behaviour in other downturns. In these earlier downturns, the ratio of bank credit to gross domestic expenditure usually increased with a decline in economic activity and only began to decline towards the end of the economic downswing. In the recession of 1989-93 the expansion in the banks' credit ratio already levelled off in 1990 owing to factors such as the increase in unemployment, a sharp decline in the sales of durable consumer goods, the low level of fixed investment, the comparatively high nominal and real cost of borrowing and uncertainties regarding future political developments.

Money market conditions, which had been relatively easy from early 1990, became fairly tight during 1992 mainly because of the deterioration in the overall balance of payments position and a higher level of government deposits. With the tightening of the market, the monetary authorities' role consisted largely of neutralising short-term fluctuations in the market shortage by adjusting the asset portfolio of the Corporation for Public Deposits, by entering into buy-back agreements and by transferring funds from the Exchequer Account with the Reserve Bank to the banking sector. A lower demand for funds and expectations of a downward adjustment in Bank rate caused the downward trend in money market interest rates (which had started in February 1990) to gain momentum in 1992 and the first half of 1993.

Capital market activities, with the notable exception of transactions in fixed property, remained buoyant during the current prolonged downswing in economic activity. Factors contributing to this development included the more than doubling in the net cash flow to retirement and insurance funds from R23 billion in 1988 to R49 billion in 1992, the declining trend in interest rates, the Reserve Bank's supportive market-making activities in government stock, the large budget deficit of the government and the continued popularity of investments serving as a hedge against inflation. Various structural and regulatory adjustments were also made to improve the functioning of the financial markets.

The downswing in economic activity, a more expansionary fiscal policy stance and certain structural weaknesses in government finance were responsible for a substantial increase in the public-sector borrowing requirement as a ratio of gross domestic product from 2 per cent in fiscal 1989/90 to 9½ per cent in fiscal 1992/93. This larger deficit was nevertheless financed with relative ease and did not have any crowding-out effects on private-sector borrowers because of their low demand for funds. Such a large deficit is, however, unsustainable over the long term and will require a major reform of government finance to ensure a financially stable environment.

The rise in the public-sector borrowing requirement was the combined result of sharply higher government expenditure and a decline in government revenue as a ratio of gross domestic product. However, the ratio of total taxation to gross domestic product amounted to no less than 25½ per cent in 1992; in the 1960s this ratio averaged only 16 per cent. This high level of taxation poses a serious constraint for an improved growth performance of the economy because it could deter investments (including foreign capital inflows) and have an adverse effect on incentives to work and save.

As already indicated, the protracted economic downturn levelled off in the first half of 1993. In fact, after having declined nearly consistently from the fourth quarter of 1989, gross domestic product increased sharply in the first half of 1993. This recovery in domestic output was brought about mainly by a substantial increase in agricultural output. If agriculture is excluded, the real value added by the non-agricultural sectors moved more or less sideways in the first six months of 1993. Unfortunately, this does not necessarily signify an upward movement in the economy. Most of the main economic indicators only show that the downturn in economic activity may be levelling out. The still hesitant and wavering economic recovery in industrial countries, the drop in international commodity prices to a very low level and the socio-political conditions in the country are still important factors restricting an economic recovery in South Africa.

Various positive factors can, however, also be listed, which may favour an improvement in economic conditions in the rest of 1993 and in 1994, viz:

- a gradual recovery in some of the world's major industrial economies;
- the impact of new large investment projects which have already commenced or are planned to start during the remainder of 1993 or in 1994;
- the present very low level of inventories, which could lead to a sharply higher demand for goods and services once the economy starts to recover;
- the need to replace machinery, equipment and consumer durables;
- the primary and secondary effects of the good agricultural crops expected in the second half of 1993; and
- the possible further normalisation of the international economic relations of the country.

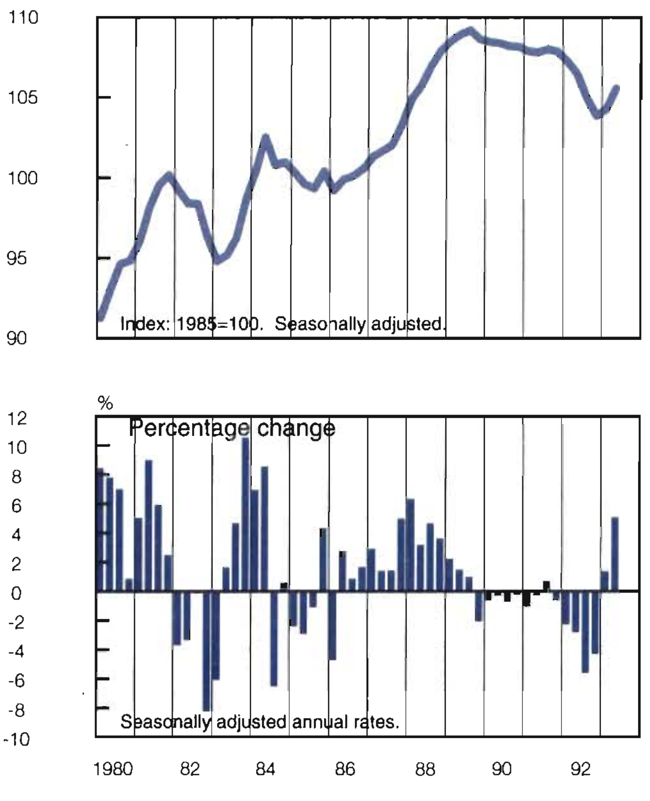
Domestic economic developments

Total production

In the current recession *real gross domestic product* started to decline from the fourth quarter of 1989 and negative growth rates were recorded in each of the subsequent quarters until the end of 1992, with the exception of the third quarter of 1991 when output increased slightly. Moreover, the rate of contraction in total domestic production accelerated from ½ per cent in both 1990 and 1991 to more than 2 per cent in 1992. However, total real value added then started to rise at annualised rates of 1½ per cent in the first quarter of 1993 and 5 per cent in the second quarter. This improvement in real economic growth could be attributed mainly to a rise in agricultural output related to more normal weather conditions.

Although South Africa has now been experiencing a recession for no less than 4¼ years, the contraction in total output was fairly modest: real gross domestic product decreased at a compound rate of just more than ½ per cent per year. If agriculture is excluded, the average annual rate of decline in the real output of the other sectors was even lower at less than ½ per cent. The average annual rate of decline in real gross domestic product in the economic downswings of 1981-83 and 1984-86 came to more than 3 per cent and approximately 2 per cent, respectively. More alarming, however, is the fact that the recent decrease in real output lasted so long and that it started off after a period of relatively low growth throughout the 1980s. Structural weaknesses impeded the growth potential of the country and on top of that a long drawn-out recession intensified the impact of the downturn.

Real gross domestic product



Various factors were responsible for the long duration of the downturn in domestic production, including:

- The turbulent process of political negotiations which undermined confidence.
- Periodic civil unrest, violence, stay-aways and mass actions, which aggravated negative perceptions of unstable conditions, deterred domestic as well as foreign investments and led to a substantial loss in man-days worked.
- A sharp drop in international commodity prices, which started from as early as the middle of 1988 – well before the downturn in economic activity in South Africa – and continued throughout the ensuing period up to the middle of 1993.
- The generally poor performance of the world economy during the past three years.
- Trade and financial sanctions applied against South Africa during the larger part of the recession. Many of these restrictions were eased only when foreign governments became convinced that the negotiation process for constitutional reform had reached a stage of no return.
- One of the most severe and widespread droughts in the country's history.

Economic conditions improved somewhat towards the end of 1992 and in the first half of 1993. Even if the better agricultural conditions are discounted, the combined real value added by the other economic sectors moved more or less sideways in the first half of 1993. This does not signify an upward movement in the economy. The leading and coincident business cycle indicators of the Reserve Bank are, in fact, not yet showing any clear signs of an imminent upturn in economic activity. From the information available for the first half of 1993 it can therefore only be concluded that the downturn in economic activity has levelled off. However, increases were recorded in the output of a number of sectors, including gold-mining, manufacturing, electricity, gas and water, and financial services, but these increases were partially neutralised by further decreases in the value added by non-gold mining, construction, wholesale and retail trade, transport and general government services.

The severe impact of the long duration of economic retrogression was also evident in a decline in *gross national product.* The real gross national product per head of the population (a measure of average material well-being) in the second quarter of 1993 was some 13½ per cent lower than its upper turning-point in the second quarter of 1988. Indeed, the average annualised income of R3 200 per capita (at 1985 prices) in the first half of 1993 was about equal to that already reached as long ago as 1971.

Sectoral output

An analysis of real value added by main economic sector indicates that with the notable exception of agriculture, all other sectors recorded only modest rates of decline in the current recession compared with the other downswings in economic activity during the 1980s. During the larger part of the recession of 1989-93 *agriculture* performed relatively well and actually supported the level of total production. In 1992, however, the severe drought resulted in a decrease of more than 25 per cent in agricultural output. Recent more favourable weather conditions should lead to a sharp rise in agricultural output in 1993. The maize crop, for instance, is estimated at more than 8 million tons for the 1992/93 season; in the previous season not quite 3 million tons of maize were harvested.

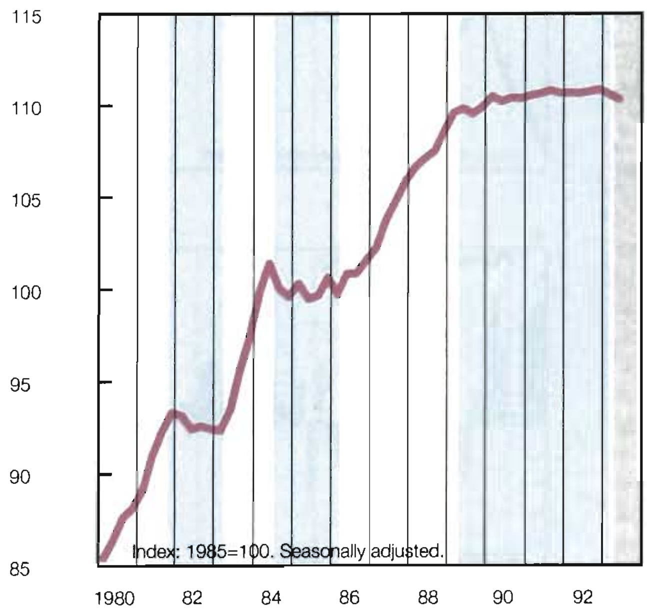
Despite the longer-term downward trend in real output by the *mining industry*, owing largely to the mining of ore with a lower gold content, the physical volume of production of the mining industry reached a lower cyclical turning-point in the third quarter of 1991. As a result of a squeeze on the profitability of gold mines by rising operating costs and a lacklustre gold price, the industry shifted to the mining of higher-grade ore. The real value added by gold mines therefore rose to a level in the second quarter of 1993 that was 6½ per cent higher than the recent low in the third quarter of 1991. The real value added by the rest of the mining industry remained generally depressed because of relatively weak international demand and an over-supply of certain mining products on world markets. The local demand for coal was also adversely affected by Eskom's decision to place some generating capacity of its power stations into reserve storage.

The real value added by the *secondary sectors* declined sharply in 1992, but recovered somewhat in the first half of 1993. The level of output by the secondary sectors in the second quarter of 1993 was nevertheless still 7½ per cent lower than its most recent high in the second quarter of 1989. Low domestic demand was mainly responsible for a decline at an average annual rate of approximately 2 per cent in manufacturing output in the current recession. This rate of decline in the real value added by manufacturing compared favourably with declines at compound average annual rates of as much as 9 per cent and 6 per cent in the economic downswings of 1981-83 and 1984-86, respectively. A slack demand for residential and non-residential buildings and construction works led to a continued decrease in the real value added by the construction sector, while the real value added by the sector supplying electricity, gas and water essentially remained unchanged during 1992 and then increased appreciably at an annualised rate of 3 per cent in the first half of 1993.

Notwithstanding the long duration of the current cyclical downswing, the growth in real value added by the *tertiary sectors* remained positive. This has been the normal cyclical pattern of the real value added by the services sectors (which are responsible for about 50 per cent of real gross domestic product) in the downward phases of the business cycle during the 1980s. The tertiary sectors therefore customarily served as a buffer against a sharp decline in domestic output in periods of low or negative growth and contributed materially to the higher growth during an upswing in economic activity.

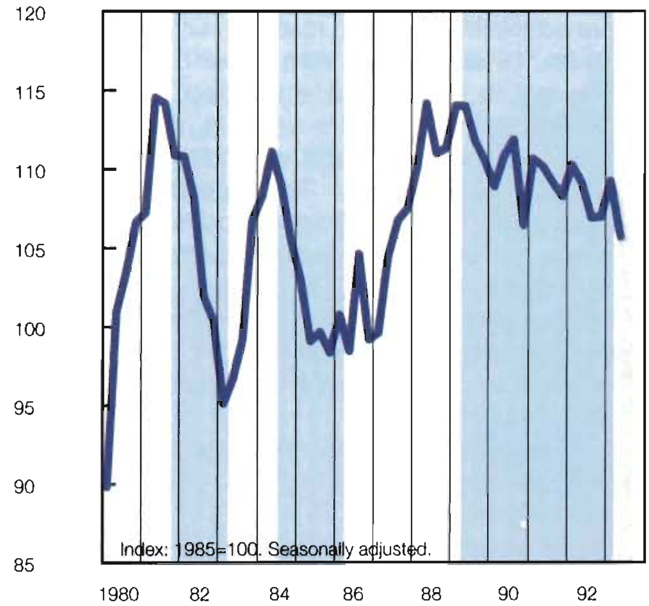
In the current economic downswing the real value added by financial institutions and general government showed a sustained rise, while the real output in the sector transport, storage and communication remained almost unchanged. A decline in the real value added

Real gross domestic product of tertiary sectors



by the sub-sector storage and communication was offset by the buoyancy experienced by the sub-sector harbour and dock traffic; the rise in the value added by the last-mentioned sub-sector reflected the rises in South Africa's international trade and in re-exports of food to neighbouring countries that were affected by the drought in 1992. In contrast to these developments, a fairly sharp decrease was recorded in the real value added by businesses involved in commerce. In particular, pronounced declines occurred in the output of the retail and motor trades; this arose mainly from a decline in real personal disposable income, the negative influence of cost-cutting and retrenchment programmes, and sporadic disruption of trading activities in black residential areas because of boycotts and violence. However, real output in the motor trade rose moderately in the first half of 1993 when new models were introduced and some buying took place ahead of expected price rises.

Real gross domestic expenditure



Domestic expenditure

The recession of 1989-93 was also characterised by a relatively small decrease in real gross domestic expenditure. The average annual rate of contraction in domestic expenditure from the second quarter of 1989 to the second quarter of 1993 amounted to approximately 1½ per cent; in the economic downturns of 1981-83 and 1984-86 average annual rates of decline of 11½ per cent and 5½ per cent were recorded. The relatively modest decrease in real gross domestic expenditure in the current recession was due to a firmness in the consumption expenditure of households and general government, while fixed investment and inventories at constant prices declined sharply.

During the course of the 1989-93 recession real gross domestic expenditure fluctuated considerably. In 1989 and 1990 domestic expenditure declined markedly as a result of a substantial contraction in capital formation. After having increased to a significantly higher level in the first quarter of 1991 because of a slower rate of destocking, real domestic expenditure fluctuated downwards again in the rest of that year and in 1992. In the first half of 1993 real domestic expenditure increased at a seasonally adjusted and annualised rate of 9 per cent in the first quarter and then shrank at a rate of 12 per cent in the second quarter.

Changes in real gross domestic product
Compound annual rates of change in seasonally adjusted quarterly data

	Downswing from:		
	4th quarter 1981 to 1st quarter 1983	3rd quarter 1984 to 1st quarter 1986	2nd quarter 1989 to 2nd quarter 1993
Primary sectors	–4½	4	–2
Agriculture	–16	20	–5½
Mining	½	–1	–
Secondary sectors	–7½	–4½	–1½
Manufacturing	–9	–6	–2
Tertiary sectors	–	–1	–
Total gross domestic product	**–3**	**–2**	**–½**

Private consumption expenditure

In the initial stages of the current cyclical downturn real outlays on consumption expenditure by households remained relatively firm and rose by nearly 3 per cent in 1989 and by about 2 per cent in 1990. These sharp increases in private consumption expenditure originated particularly from a rise in real outlays on consumer durables – notably expenditure on furniture and household appliances. Real expenditure on semi-durable goods and non-durable goods and services also rose, but at more moderate rates than in the case of durable goods.

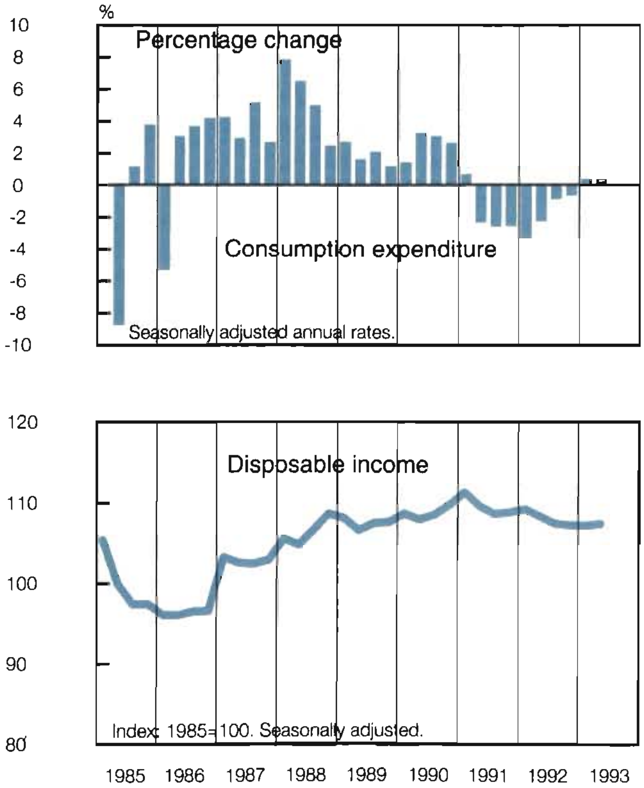
Various factors contributed to the firm demand for consumer goods and services, including:

- an upward movement in labour's share of nominal factor income;
- a sustained increase in real personal disposable income, mainly in the form of large wage adjustments;
- larger proportional increases in the wages of lower-paid workers with a high propensity to consume than higher-paid workers with a high propensity to save;
- relatively high wage settlements in all major sectors of the economy which supported high levels of consumer borrowing;
- the pressures of replacement demand because of the higher average age of consumer durables; and
- the high rate of inflation which encouraged households to purchase goods before they became more expensive.

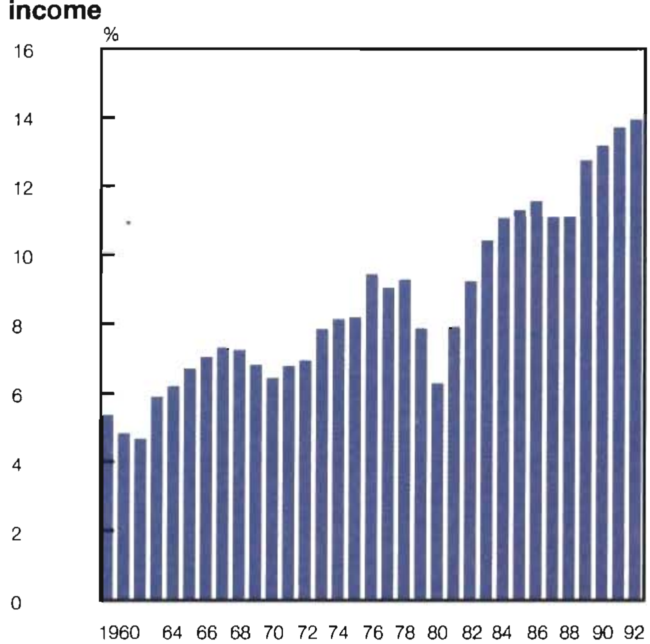
In 1991 and 1992 the financial position of households weakened considerably as retrenchments rose and the rate of decline in real personal disposable income per capita accelerated from 1 per cent in 1990 to 1½ per cent in 1991 and as much as 3½ per cent in 1992. Increases in aggregate remuneration of employees were lower than the rate of inflation, while a decline in the real value added by household property income reflected depressed agricultural conditions and a growing number of insolvencies among individuals and non-corporate business enterprises. At the same time, the tax burden of households continued to rise: the ratio of direct taxes paid by households to their current income rose from nearly 13 per cent in 1989 to 14 per cent in 1992. This ratio averaged 10½ per cent in the 1980s and only 6 per cent in the 1960s.

Consumer indebtedness also rose from a low of 18½ per cent of personal disposable income in the first quarter of 1987 to a high of 28½ per cent in the fourth quarter of 1990. Greater job insecurity, lower rates of increase in nominal income, and uncertainties about the future political dispensation of the country, made consumers less willing to commit future income. The ratio of consumer credit to personal disposable income therefore declined to approximately 24 per cent in the

Real private consumption expenditure and real personal disposable income



Households' direct tax as percentage of current income



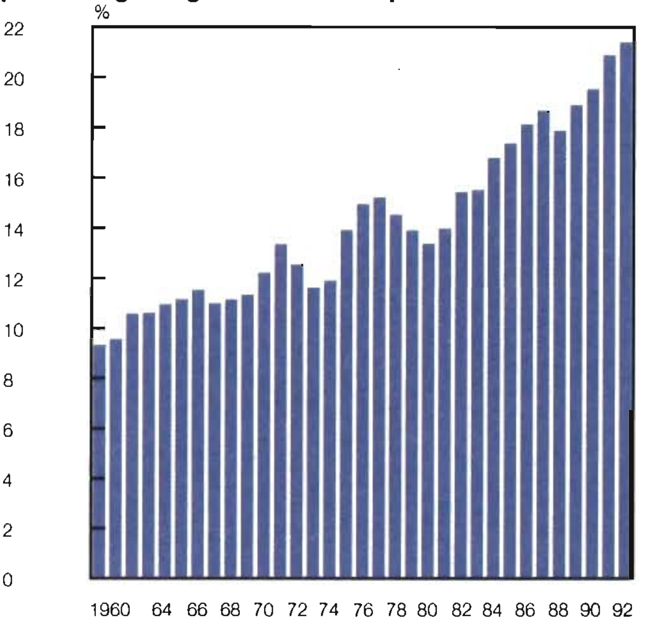
first half of 1993. At the same time the wealth of households was being eroded particularly by declines in real estate values.

It was therefore not surprising that households' real outlays on consumer goods started to fall sharply from the second quarter of 1991 until the end of 1992. The average level of real private consumption expenditure in 1992 was 2½ per cent lower than that in the previous year. This high rate 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 kinds of consumer items. However, real expenditure on non-durable goods also decreased.

In the first half of 1993 real consumer spending by households advanced slightly from the level reached at the end of 1992. Further decreases in real private consumption expenditure were presumably averted in the first quarter of 1993 by pre-emptive buying, aimed at avoiding price increases that were expected to arise from an anticipated increase in the value-added tax rate. Downward adjustments of the mortgage rate also kept households' gross debt-servicing burden on a downward course. The recovery of agricultural income, the need to replace worn-out stocks of durable goods, rising house prices, and the strengthening in share prices on the stock exchange may also have encouraged higher consumer spending.

Consumer demand, however, remains fragile. Factors such as the decline in real personal disposable income, expected relatively low salary and wage increases, job insecurity, the prevailing high unemployment, boycott actions and the generally low level of consumer confidence are not supportive of a sustained recovery in consumption expenditure. These factors have created a desire among many households to reduce their level of indebtedness instead of increasing their current consumption levels.

Government consumption expenditure as percentage of gross domestic product



Consumption expenditure by general government

Real consumption expenditure by general government continued to rise during the current economic downturn and the *rate of increase* actually accelerated at first from 1½ per cent in 1988 to 5 per cent in 1991. However, from the middle of 1991 the rate of increase in general government expenditure on consumer goods and services slowed down considerably to negligibly low levels in the first half of 1993. In the period from the second quarter of 1989 to the second quarter of 1993 the compound annual growth rate in real government consumption expenditure therefore amounted to 1½ per cent; this was much lower than the corresponding rates of increase of 2½ per cent and nearly 3 per cent in the previous two economic downswings.

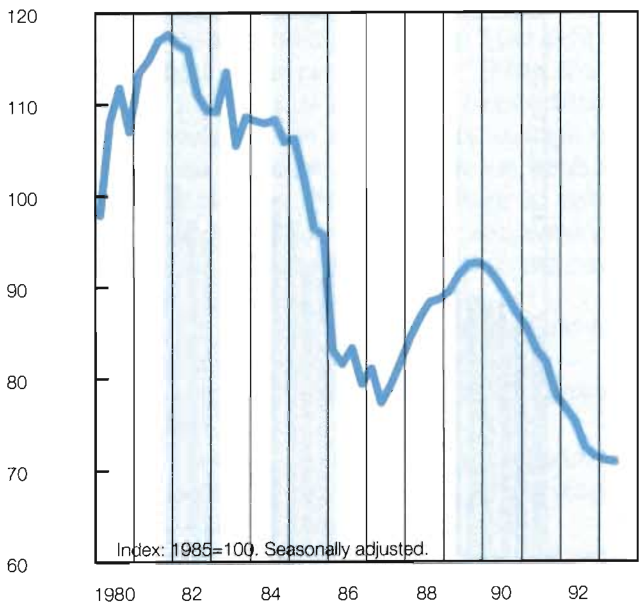
The deceleration in the growth rate of total real consumption expenditure by general government originated from similar slowdowns in the growth of its two major sub-components: remuneration of employees, and expenditure on intermediate goods and services. In particular, the real expenditure on goods and services of a non-capital nature by the general government decreased in 1992 and remained about unchanged in the first half of 1993.

Despite this slower growth in real consumption expenditure by general government, it still exceeded the rate of increase in total real output. As a result, the ratio of government consumption expenditure to gross domestic product rose from a low of 18 per cent in 1988 to an all-time high of 21½ per cent in 1992; in the first two quarters of 1993 it eased somewhat to approximately 21 per cent. This level may be compared with an average of 10½ per cent in the 1960s, 13½ per cent in the 1970s and 16½ per cent in the 1980s.

Gross domestic fixed investment

After having increased fairly sharply from a low level in 1987 to 1989, *real gross domestic fixed investment* contracted at a more rapid rate in the ensuing period. In the first half of 1993 the level of gross domestic fixed investment was therefore 40 per cent lower than its all-time high in the final quarter of 1981 and 23½ per cent lower than its most recent cyclical peak in the fourth

Total real gross fixed investment



quarter of 1989. The contraction in total real gross domestic fixed investment expenditure during the current cyclical downswing was brought about by substantial decreases in the capital expenditure of all institutional sectors (public authorities, public corporations and the private sector).

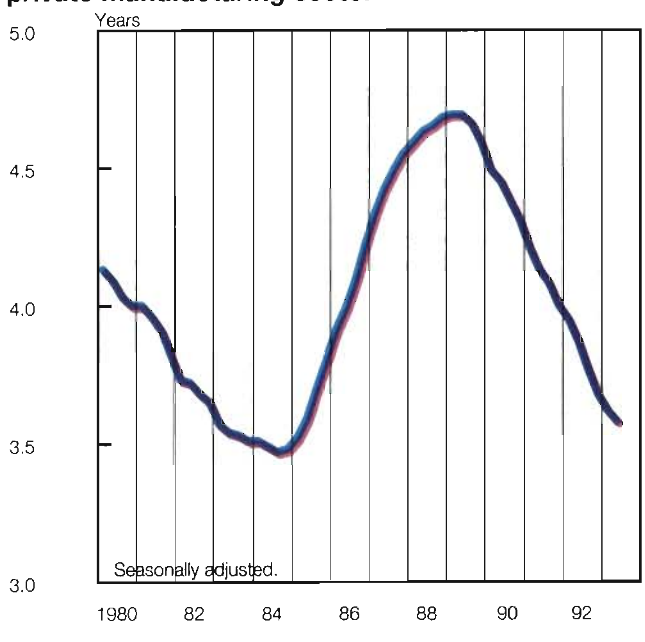
The decline in real fixed investment expenditure by the *private sector*, at a compound average annual rate, came to 3½ per cent in the downswing of 1989-93, compared with ½ per cent and 18 per cent in the previous two downturns. Real fixed capital formation in most economic sub-sectors of the private sector declined at average annual rates varying from 1½ per cent in the case of commerce to 9 per cent in the mining sector. The apparent reluctance of the private sector to invest in new projects could be attributed to a number of factors, including:

- a general lack of confidence because of uncertainty regarding future political developments, unceasing civil unrest and violence in many parts of the country, and the recent poor economic performance;
- the high level of unutilised production capacity in the manufacturing sector;
- relatively low economic growth in the rest of the world;
- the comparatively high level of taxation in South Africa;
- mounting levels of farm debt and a deterioration in the terms of trade in agriculture (increases in output prices did not fully match increases in input costs);
- a rationalisation in the gold-mining industry owing to the weak performance of the gold price during the greater part of the recession.

In contrast to the decreases in real fixed capital expenditure by most of the economic sub-sectors in the private sector during the current cyclical downswing, real outlays on fixed investment in the *private manufacturing sector* rose at an average annual rate of approximately 4½ per cent over the seventeen quarters until the second quarter of 1993. However, this higher level of investment in manufacturing was confined mainly to the earlier part of the cyclical downturn. From the middle of 1990 investment in private manufacturing enterprises drifted downwards. The sharp rise in real gross fixed investment in private manufacturing in the early stages of the downswing could have been caused by the need to replace machinery and equipment, of which the average age had increased from about 3½ years in 1985 to more than 4½ years in 1989. The average age of machinery and equipment receded again to just less than 4 years in 1992, which is almost in line with the longer-term average of about 3½ years. New investments in manufacturing in the current downswing were concentrated in the production of motor vehicles, chemical products, oil, beverages, machinery and electrical equipment.

Real fixed investment expenditure by *public corporations* declined at an average annual rate of no less than 16½ per cent from the second quarter of

Average age of machinery and equipment in the private manufacturing sector



1989 to the second quarter of 1993; this decline took place especially in 1991 and 1992. The substantial contraction in the fixed capital outlays of public corporations was partially a correction of the earlier creation of excess capacity by some of these enterprises. It also formed part of determined cost-cutting plans aimed at improving the cost-effectiveness of these corporations. In the first two quarters of 1993, however, real capital expenditure by public corporations rose slightly at annualised rates of 1 per cent in both quarters, mainly because of expenditure by Eskom for the electrification of low-cost housing areas.

The decline in real fixed capital formation by *public authorities,* at an average annual rate of 5 per cent in the current recession, was to a large extent brought about by a considerable decrease in the fixed investment of general government and a small decrease in fixed investment by government business enterprises. The decline in the investment of general government reflected the increased emphasis by government on current expenditure on social services, in an environment in which current revenue began to rise only moderately. In the first two quarters of 1993, however, general government recorded moderate increases in real fixed investment expenditure. In the case of business enterprises of general government, the decline in fixed investment came about because of rationalisation programmes instituted especially by Telkom and by Transnet.

An analysis of total real gross domestic fixed investment according to *type of capital asset* in the current cyclical downswing shows a decline in the investment in all types of assets. In particular, fixed investment in buildings and construction work decreased very sharply. The investment in machinery and equipment declined more moderately, but the level of these investments in the first half of 1993 was close to its lower turning-point in the second quarter of 1987.

As could be expected, the decline in total real gross fixed investment had an important effect on the net addition to the real *fixed capital stock* of the country: the rate of increase in the net real fixed capital stock slowed down to less than ½ per cent in 1992, compared with an average of 3 per cent during the 1980s. Moreover, in the first half of 1993 South Africa's total production capacity did not expand at all. This deterioration in net capital investment was due to decreases in real fixed capital stock in agriculture, electricity, gas and water, construction and transport, storage and communication, while mining's net capital stock remained about unchanged from 1990. In the manufacturing sector the rate of increase in real net fixed capital stock slowed down from 3½ per cent in 1991 to 2 per cent in 1992 and to an annualised rate of less than 2 per cent in the first half of 1993.

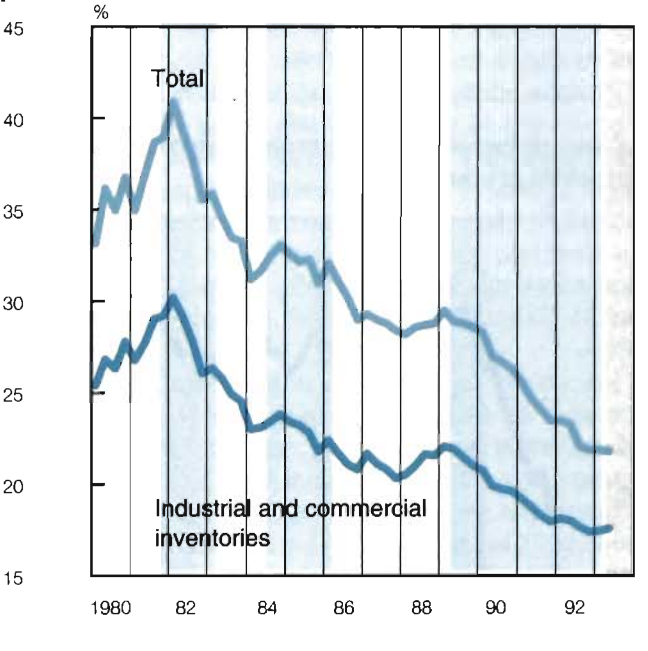
Inventory investment

From the third quarter of 1989 until the end of 1992 there was a virtually uninterrupted drawing-down of inventories. The rate of decline in inventory investment at constant prices, however, varied considerably from quarter to quarter, clearly illustrating the uncertainty among business enterprises about the short-term prospects for the South African economy. In the first quarter of 1993 real investment in inventories increased. This strengthening of inventories coincided with a rise in South Africa's international trade and in manufacturing output. However, in the second quarter of 1993 inventory destocking again took place, largely because of a substantial increase in the volume of merchandise exports and a decline in the volume of imports.

The increase in industrial and commercial inventories in the beginning of 1993 resulted in a levelling-out of the longer-term downward trend in the ratio of industrial and commercial inventories to gross domestic product in the non-agricultural sectors of the economy. After having reached a high of 30 per cent in the first quarter of 1982, this ratio had declined almost uninterruptedly to a level of 17 per cent in the fourth quarter of 1992 and then rose marginally to 17½ per cent in the first half of 1993. In the case of *total inventories* (excluding agricultural and strategic stocks), the corresponding ratio receded from 40½ per cent to 21½ per cent over the same period.

The longer-term downward trend in real inventory levels appears to have been associated with the

Inventories as percentage of gross domestic product



introduction of more efficient inventory management systems made possible by advanced computerised techniques and more reliable delivery systems. In a difficult business environment it became increasingly prudent for commercial and industrial undertakings to apply so-called "just-in-time" inventory systems in an attempt to cut costs and rationalise activities. The positive real interest costs of carrying inventories provided a further incentive for economising on inventory holdings. Over the short term, efficient inventory administration led to an improvement in the cash flow of these undertakings.

Nominal factor income

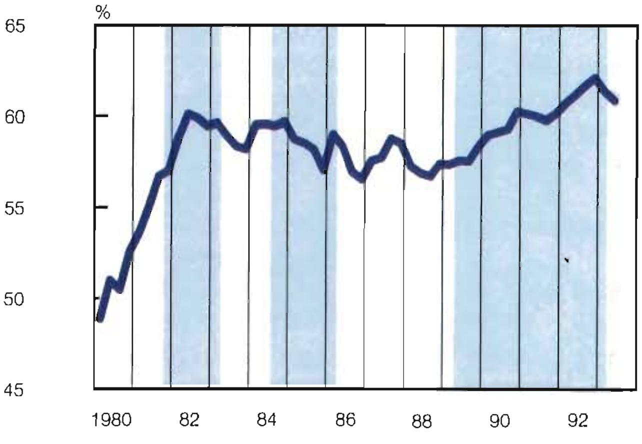
The long duration of the current cyclical downswing in economic activity led to a gradual slowdown in the annual rate of increase in *total nominal factor income* from 18 per cent in 1989 to 10 per cent in 1992; growth in nominal factor income in the first half of 1993 was even lower at 9½ per cent compared with the corresponding period in the preceding year. This pronounced slowdown in the rate of increase in nominal factor income was the combined result of slower growth in gross operating surpluses and in total remuneration of employees.

The rate of increase in the *total gross operating surplus* contracted from nearly 15 per cent in 1989 to 11½ per cent in 1991 and even further to 6½ per cent in 1992. This low growth in total gross operating surplus in 1992 was apparent in the agriculture, mining, construction and transport sectors and reflected the poor weather conditions over a large part of the country, the generally weak performance of the corporate sector and a steady increase in company liquidations throughout 1992. However, the nominal gross operating surplus in the first half of 1993 was about 9 per cent higher than in the first six months of 1992. This acceleration was mainly the result of better agricultural conditions and a rise in the profits of mines related to the rise in the rand price of gold, increased output volumes and the curtailment of running costs. A number of companies involved in manufacturing, commerce and finance also reported better financial results.

The rate of increase in the total *remuneration of employees* also fell from 18 per cent in 1989 to 14 per cent in 1991 and nearly 13 per cent in 1992. In the first half of 1993 the total of nominal salaries and wages was about 10 per cent higher than in the corresponding period of the previous year. This slower growth was discernible throughout the economy and could probably be attributed to the retrenchment of a large number of workers, more realistic wage demands by some trade unions and increased emphasis being placed on the preservation of jobs.

In sharp contrast to the normal cyclical pattern, the *share of labour rewards* to total nominal factor income rose throughout the current cyclical downturn, from 57½ per cent in 1989 to 61½ per cent in 1992; it then declined only moderately to 61 per cent in the first half of 1993. The comparatively high and rising levels of this ratio were recorded despite the decrease in total formal-sector employment relative to the economically active population. As already indicated, the redistribution of factor income in favour of labour contributed to a high propensity to consume. It also has important negative implications for entrepreneurial motivation, innovation and investment, and therefore for the longer-term development potential and international competitiveness of the economy. The recent decline of labour's share in the total value of output may be a tentative sign that the domestic investment environment is improving somewhat.

Labour remuneration as percentage of gross domestic product



Domestic saving

The ratio of *gross domestic saving* to gross domestic product decreased from 22½ per cent in 1989 to 16½ per cent in 1992 and in the first half of 1993; in the 1980s this ratio averaged 24½ per cent. The substantial decline in the domestic savings ratio in the current recession was due to a deterioration in the finances of general government and lower private saving.

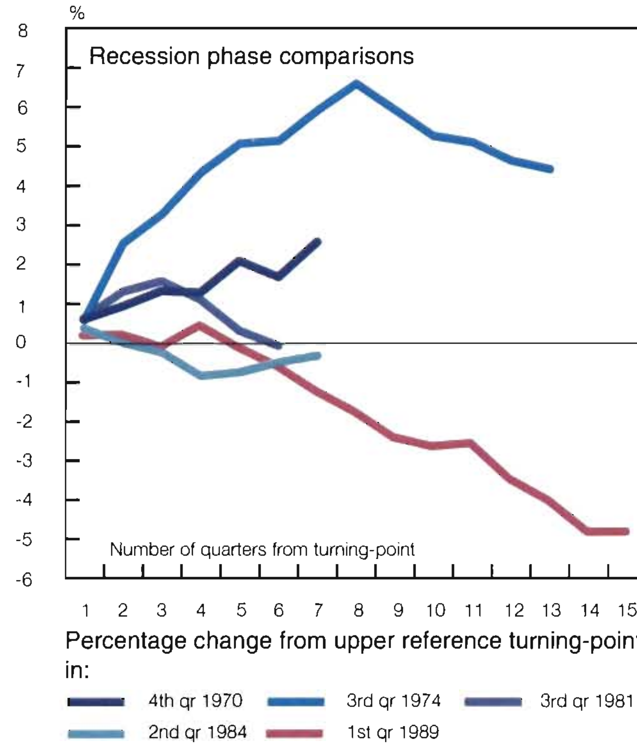
After the *general government* had become a net dissaver in 1984, its dissaving rose from R1,3 billion in 1989 to R8,6 billion in 1991 and to the alarming level of R15,5 billion in 1992. Dissaving by general government in the first half of 1993 is estimated to have reached an annualised rate of R13,8 billion. This poor performance by general-government saving was essentially the result of continued high increases in government consumption expenditure, in the cost of servicing the public debt, and in current transfers to households, combined with a slower growth in general government revenue.

Private saving (i.e. the saving of households and incorporated business enterprises) as a ratio of gross domestic product, decreased from 7 per cent in 1989 to 5½ per cent in 1992 and in the first half of 1993. These ratios can be compared with a relatively stable long-term ratio of 9 per cent of gross domestic product in the period from 1960 to 1988. The substantial decline in the private savings ratio could be attributed to a decrease in corporate saving and a continued low level of household saving.

The ratio of net *corporate saving* to gross domestic product, which had shown a sharply rising trend in the 1980s, decreased from nearly 6 per cent in 1989 to 4 per cent in 1992 and in the first half of 1993. This weaker corporate saving effort was, of course, influenced by lower growth in company earnings. In addition, the investment climate probably discouraged some companies from re-investing large surplus funds.

The continued high propensity to consume led to a decrease in net *personal saving* as a percentage of gross domestic product from 2 per cent in 1988 to ½ per cent in 1990. The subsequent more reticent consumption behaviour of households (described in some detail above) then caused this ratio to rise to 1½ per cent in 1992 and the first half of 1993. One of the most important disincentives to a meaningful improvement in households' saving performance remains the negative real after-tax rates of return on depository types of financial assets in South Africa.

Non-agricultural employment



Employment

One of the main characteristics of the current recessionary phase of the economy has been a substantial decrease in employment. As shown in the accompanying graph, this was not an uncommon feature of economic downswings in the 1980s. In contrast to cyclical downward phases in the 1970s, which were normally accompanied merely by a slower rate of growth in employment in the formal non-agricultural sectors of the economy, a distinct decrease in employment took place in all three the downward phases from the beginning of the 1980s.

However, in the recession of 1989-93 the long duration and the severe downturn in economic activity resulted in a considerably sharper decrease in employment than in the other two recessions that started in the 1980s. Total employment in the formal non-agricultural sectors of the economy, for instance, declined by 4,8 per cent (or by nearly 286 000 employment opportunities) from the beginning of the recession in early 1989 up to the end of 1992 (i.e. the most recent period for which information is available, but still not the end of the recession). In the recession from September 1981 to March 1983 employment in the non-agricultural sectors of the economy decreased by only 0,1 per cent, and in the recession from July 1984 to March 1986 by only 0,3 per cent. When new job-seekers are taken into account, an additional number of about 1,5 million people were unable to find employment in the formal non-agricultural sectors of the economy since the beginning of the current recession. Over the same period employment in the agricultural sector decreased by an estimated 3 per cent, leading to an increase in the ratio of people unemployed or involved in the informal sector to the total economic active population of South Africa from about 39 per cent in 1988 to approximately 46 per cent in 1992.

As in the preceding two recessions, the decline in employment in the recession of 1989-93 was due entirely to a contraction of employment in the private sector: total non-agricultural employment in the private sector declined significantly (by 7,8 per cent) from the first quarter of 1989 to the fourth quarter of 1992, while employment by the public authorities still increased by 2,7 per cent. In contrast with these earlier downswings in the 1980s, the contraction in employment in the current recession was, however, dispersed more

Percentage change in non-agricultural employment

Sector	February 1989 to December 1992
Manufacturing	–4,6
Construction	–13,6
Electricity generation	–18,5
Mining	–18,0
Trade	–2,9
Hotels and laundry services	–10,1
Private road transportation	–16,3
Insurance industry	15,4
Banking institutions	3,7
Private sector	–7,8
Public authorities	2,7
Total non-agricultural sectors	**–4,8**

widely. Banking institutions and the insurance industry were the only sectors that reported increases in employment during this period. In particular, high rates of decline were recorded in employment by businesses that are engaged in construction, electricity generation, mining, the provision of hotel and laundry services, and private road transportation.

The recent deterioration in employment in the formal sectors of the economy was not only a cyclical phenomenon. As described in some detail in the *Annual Economic Report* of 1992, South Africa is facing *problems of structural unemployment.* Before 1982, the rate of growth in total employment in the formal sectors of the economy roughly matched the rate of increase in the economically active population. For example, between 1970 and 1982 employment in the formal non-agricultural sectors increased at an average annual rate of 2,7 per cent, compared with a growth of 2,9 per cent per annum in the economically active population. Subsequently, average annual employment growth slowed to 0,5 per cent during the years 1983 to 1989 and to a *negative* rate of 1,5 per cent from 1989 to 1992.

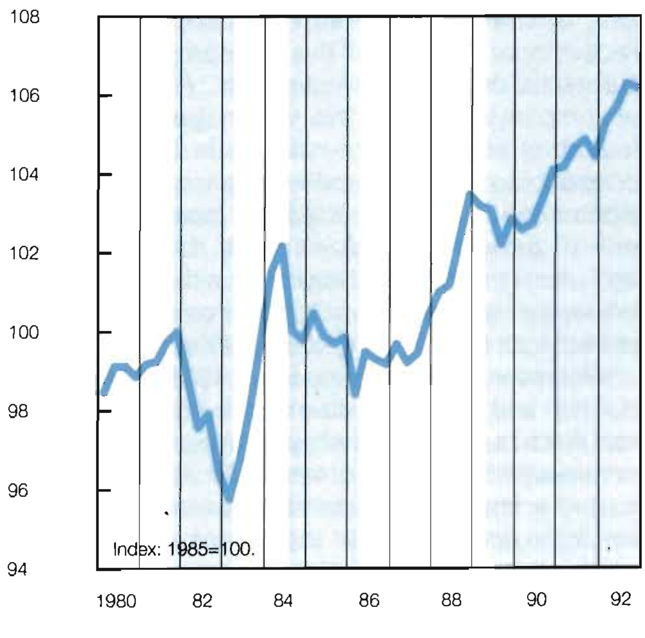
This persistent increase in the rate of under-utilisation of labour resources took place against the backdrop of political changes that began with the introduction of the tri-cameral parliamentary system of government in 1984 and gained momentum from February 1990. The uncertainties associated with this process of political change, the external trade and financial sanctions applied against the country, the rapid unionisation of the labour force, the rising bargaining power of the emerging trade unions, and growing demands for changes in areas that sometimes were only tenuously related to working conditions, combined to undermine investors' confidence and to discourage productive investments in the South African economy. Where investments were still undertaken, they were of a capital-intensive nature and contributed little towards alleviating the serious problems of rising unemployment and underemployment.

Productivity and labour costs

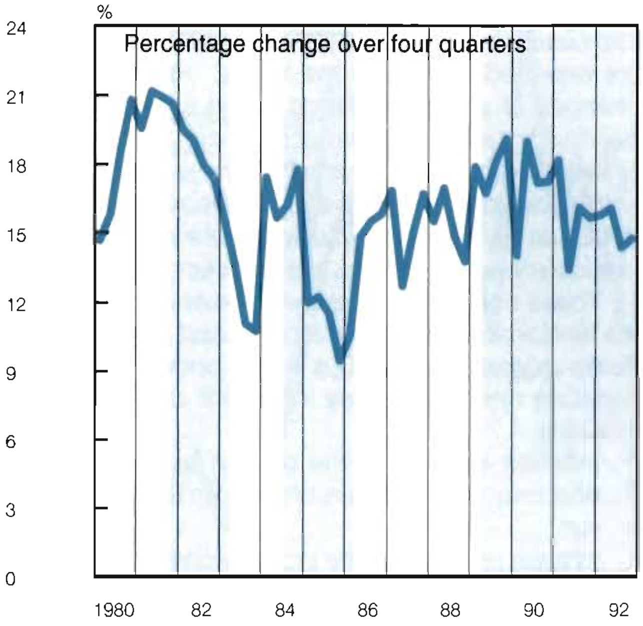
The structural unemployment problem was also related to the fact that *labour productivity* increased at an average annual rate of only 0,6 per cent in the period from 1972 to 1992. This low rate of increase could be attributed largely to the low level of skills of the South African workforce. In 1991 only about 30 per cent of the economically active non-white population had reached a level of education higher than Standard 6, and could therefore be considered as skilled or potentially skilled workers. The President's Council, in an analysis of productivity issues, found that management could also partly be blamed for low productivity because of a lack of productivity awareness, fairly uncompetitive conditions in the domestic economy and insufficient investment in research and development. Moreover, in the 1980s production was frequently disrupted by strikes, mass demonstrations and politically motivated stay-aways.

During the recession of 1989-93 the growth in labour productivity was nevertheless considerably higher than its longer-term trend: labour productivity in

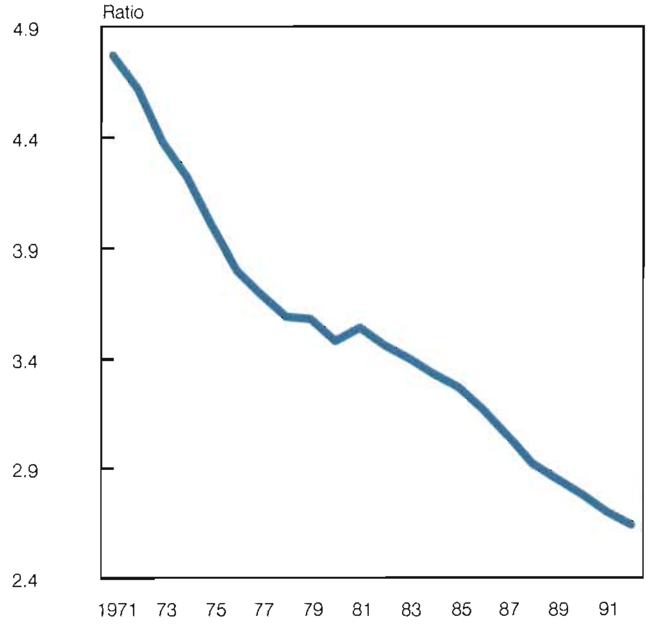
Production per worker in non-agricultural sectors



Nominal remuneration per employee in non-agricultural sectors



Ratio of white to non-white remuneration per worker



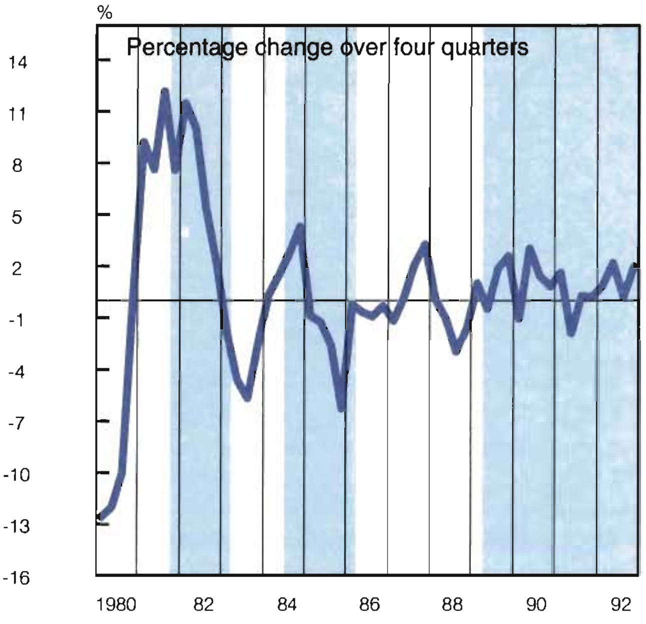
the non-agricultural sectors of the economy rose at an average annual rate of 0,9 per cent from 1988 to 1992. Contrary to its cyclical pattern in the previous two recessions (when productivity declined sharply), non-agricultural labour productivity in the current recession showed a pronounced upward trend. In 1991 and 1992 the real output per worker in the formal non-agricultural sectors even increased at an average annual rate of 1,3 per cent. This relatively higher growth in productivity was not so much achieved by a stronger commitment to the work effort, but rather by the laying-off of workers at a rate faster than the contraction in output volumes. In this manner, real output levels in the non-agricultural sectors of the economy in 1992 were back at the level that prevailed in 1988, but 200 000 fewer workers were required to produce this output.

Despite the substantial increase in unemployment and the still relatively low productivity growth, the *real remuneration per worker* rose at an average rate of 2,0 per cent per annum from 1988 to 1992, and by as much as 2,7 per cent in the calendar year 1992. This was mainly due to the fact that the average nominal remuneration per worker (i.e. salaries and wages including overtime pay; employer contributions to pension funds, medical aid schemes and other such funds; and fringe benefits, vacation bonuses, and tool and other similar allowances) in the non-agricultural sector rose by 16,5 per cent per year from 1988 to 1992, or at a rate well above the rate of inflation. In 1992 the rise in nominal salaries and wages per worker employed in the formal non-agricultural sectors of the economy decelerated somewhat to 15,2 per cent from 15,8 per cent in 1991 and a peak of 18,0 per cent in 1989.

The excessive growth in the average remuneration per worker relative to average productivity growth is widely attributed to the so-called "living-wage" campaign of the organised labour movement and the practice, followed by many trade unions, of linking the remuneration of unskilled workers to that of skilled workers in order to close the wage gap between white and black workers. In 1971 the average monthly nominal remuneration of a white worker was 4,8 times that of a non-white worker. This ratio then declined to 3,6 in 1979 and partly because of the efforts of the organised labour movement, further to 2,6 in 1992.

Owing to the fact that the rise in the real remuneration per worker exceeded the growth in productivity, *real unit labour costs* continued to increase in the recession of 1989-93. From the first quarter of 1989 to the fourth quarter of 1992 real unit labour costs increased by 3,3 per cent. This development was also contrary to the cyclical pattern in the 1980s when real unit labour costs normally showed a distinct downward movement in a downturn in economic activity. The continued rise in real unit labour costs in the current recession points to excessive salary and wage increases which, of course, had a negative impact on business profitability, savings, capital formation and the international competitiveness of local producers. The larger

Real unit labour costs in non-agricultural sectors



proportional retrenchments of lower-paid workers than higher-paid workers also contributed to an increase in unit labour costs in the current recession.

Inflation

The South African economy has experienced a long period of relatively high and gradually rising inflation. From being a country with a remarkable history of relative price stability during the 1960s, South Africa was transformed, in the aftermath of the breakdown of the international monetary system of fixed exchange rates and of the oil price shock of 1973, into a country where price inflation became generally expected to be around 15 per cent per year. Over the past four years, however, very promising indications have become discernible that the measured inflation rates are retreating and that the country could again be moving into an era of greater price stability. In fact, had it not been for price increases associated with specific incidents such as the Gulf War of 1990, the severe drought of 1991/92, the introduction of value-added tax and the recent increase in the rate at which this tax is levied, consumer price inflation would probably have been down to a level durably below the 10 per cent mark.

The period of high inflation in South Africa has brought forth important lessons that cannot be ignored. In particular, it has taught the lesson that it is important in an early stage to deal swiftly and effectively with price rises rather than to allow inflation to develop a momentum of its own which may then be difficult to bring to an end. As inflation becomes entrenched, inflationary expectations are increasingly formulated retrospectively (i.e. inflation rates of the past are expected to recur in the future). Price and wage changes of an earlier period are in this way simply carried forward. Attempts to curb inflationary pressures under such circumstances by means of orthodox monetary and fiscal measures make demands on the economy, which are not always for political and social reasons easily acceptable.

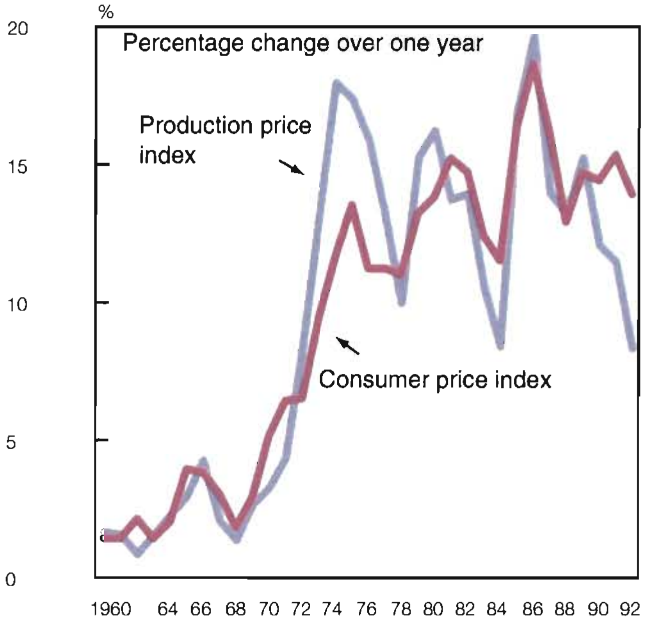
These costs must, however, be weighed against the inefficiencies and distortions caused by persistently rising prices. Continuing rising prices (even at a constant rate) have many important disadvantages, including:

- Inflation depresses the growth potential of the economy and increases unemployment in the long-run.
- Inflation undermines the proper working of the price mechanism and therefore leads to a distorted economic structure.
- Inflation leads to an unequal and unfair redistribution of wealth and income. Rich people are better able to protect themselves against inflation than poor people.
- Inflation leads to an inefficient allocation of resources; scarce capital is often employed to protect asset-holders against an erosion of wealth, rather than in a productive way.
- Inflation discourages saving and favours consumption.
- Inflation impairs the international competitiveness of a country.

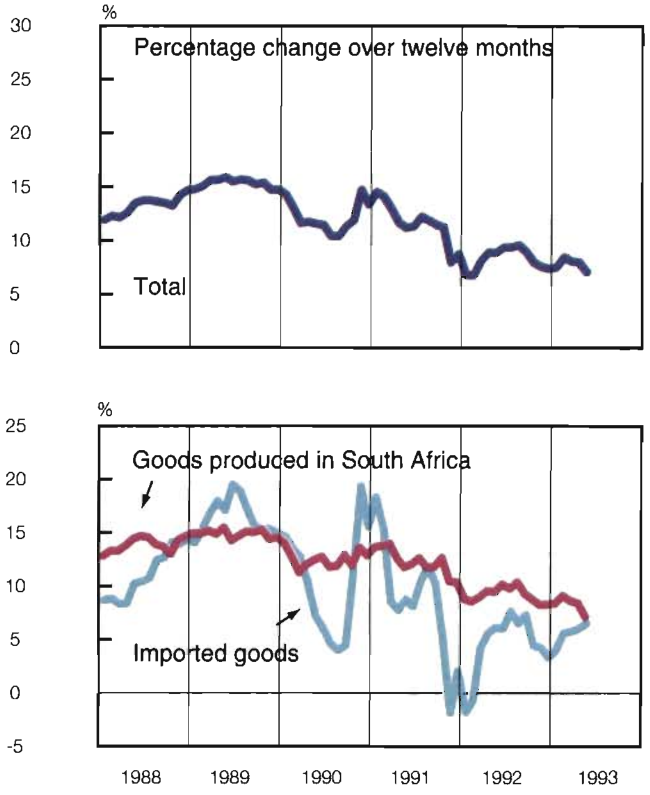
Equally important is that the delay of determined and consistent action against inflation inevitably leads to the loss of policy credibility. Attempts to exploit short-run trade-offs between inflation and employment growth undermine the confidence in policy-makers. The ability of the authorities to shape future events and expectations by means of policy announcements and action is then seriously diminished. The South African experience of the past four years illustrates very clearly that the restoration of policy credibility can be a drawn-out process. Only when trustworthiness has been restored, do expectations become more forward-looking. Macro-economic policies can then be deployed much more effectively to achieve stated objectives.

In response to the consistent pursuit of more restrictive monetary policies and the moderation of inflationary expectations, the rate of increase in the all-goods production price index declined from a high of 15,2 per cent in 1989 to 8,3 per cent in 1992 – its first single-digit level in eight years. In contrast to this development, the rate of increase in the overall

Consumer and production prices



Production prices



consumer price index accelerated slightly from 14,7 per cent in 1989 and 14,4 per cent in 1990 to 15,3 per cent in 1991. This higher consumer price inflation could be ascribed to a large extent to the influence of exogenous factors such as the outbreak of the Gulf War towards the end of 1990, the introduction of a value-added tax towards the end of 1991, the implementation of a new weighting structure for the calculation of the consumer price index, and high rates of increase in the prices of food as a result of abnormal weather conditions during 1991. It was therefore not surprising that the rate of increase in the consumer price index declined to 13,9 per cent in 1992 and to 10,0 per cent in the first six months of 1993 compared with the corresponding period in 1992.

The sharper decline in production price inflation than in consumer price inflation was to a large extent related to the relatively large weight of imported goods in the overall production price index. The rate of increase in the *prices of imported goods* over periods of twelve months declined from a high point of 19,1 per cent in November 1990 to negative levels towards the end of 1991 and the beginning of 1992; it then moved slightly upwards to 7,5 per cent in July of that year before declining to 3,1 per cent in December 1992. A sharp depreciation of the rand subsequently caused this rate of increase to accelerate again to 6,3 per cent in May 1993.

The rate of increase in the *prices of domestically produced goods* over periods of twelve months also declined, on balance, from a post-Gulf War high of 13,9 per cent in March 1991 to a single-digit level of 8,7 per cent in January 1992. This rate of increase in the prices of domestically produced goods then generally remained at single-digit levels and slowed down further to 7,1 per cent in May 1993.

Mirroring the changes in its two main components, the rate of increase over periods of twelve months in the *all-goods production price index* declined from a recent peak of 14,6 per cent in November 1990 to 7,9 per cent in November 1991. (This was the lowest rate of increase since August 1984). It then declined even further to rates of increase of 6,7 per cent in both January and February 1992. Thereafter the twelve-month rate of increase in total production prices accelerated moderately to 9,5 per cent in August 1992 before it declined to 7,0 per cent in May 1993.

In contrast to the movements in the production price index, the rate of increase in the *overall consumer price index* did not immediately resume a downward trend after the Gulf War, but accelerated from a low of 13,3 per cent in July 1990 to 16,8 per cent in October 1991. The main reasons for this divergent movement were identified as being the implementation of a new weighting structure for the calculation of the consumer price index, the introduction of value-added tax in October 1991, and the effect of the drought on the consumer prices of food. Only after the impact of these factors had begun to diminish did this rate of increase in the prices of consumer goods and services decline somewhat hesitantly to 14,3 per cent in August 1992, before falling more sharply to 9,6 per cent in December and to 9,0 per cent in February 1993. This recent more rapid decline in consumer price inflation could be attributed to the consistent financial discipline that was imposed by the monetary authorities, the improvement in agricultural conditions which stopped the upward spiralling of food prices, and the reductions in the mortgage lending rates of banking institutions. Sharp increases in educational fees in March 1993, a four percentage-point increase in the rate of value-added tax, an increase in the price of petrol and increases in other indirect taxes in April 1993, caused the twelve-month rate of increase in the overall consumer price index to accelerate to 11,0 per cent in April. It subsequently declined moderately again to 10,0 per cent in June 1993.

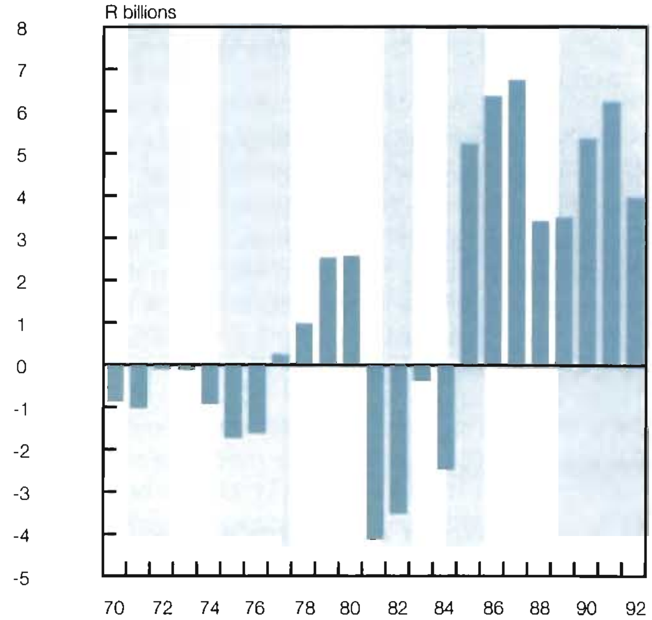
Foreign trade and payments

Balance on current account

Developments on the current account of the balance of payments diverged considerably from the normal cyclical pattern during the recession from March 1989. In the 1970s and the first half of the 1980s the current account was generally characterised by a large deficit at the beginning of an economic downswing. In fact, at that stage of the business cycle a high volume of imports and concomitant declines in the foreign exchange holdings were, in many cases, mainly responsible for the downturn in economic activity, because they forced the authorities to apply restrictive policy measures. The volume of imports contracted as the growth in domestic expenditure levelled off, leading to an improvement in the current account deficit. In addition, the volume and prices of merchandise exports would usually begin to pick up in the course of an economic downturn, because the business cycle in South Africa would customarily lag an upturn in economic activity in the main industrial countries. The deficit on current account would then be transformed into a surplus, which would normally be maintained until well into the subsequent economic upswing.

In contrast to this cyclical pattern, in the recession of 1989-93 the current account started off from a fairly large surplus at the end of the economic upswing, owing largely to a restrictive policy stance that had been necessitated by the financial sanctions applied against South Africa. As could be expected in the downturn of activity, the surplus on current account increased sharply at first from R3,5 billion in 1989 to R6,2 billion in 1991. Despite the deepening of the recession, the current account surplus then deteriorated substantially during 1992 to R3,9 billion for

Current account balance



the full calendar year and even further to a seasonally adjusted and annualised value of only R0,7 billion in the first quarter of 1993. However, in the second quarter of 1993 this temporary deviation from the normal cyclical pattern was reversed and the surplus on current account (seasonally adjusted and annualised) recovered remarkably to no less than R10,1 billion.

Various factors were responsible for the weakening of the current account surplus in 1992 and the first

Balance of payments on current account
Seasonally adjusted annual rates
R billions

	1991	1992					1993	
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Merchandise exports	44,7	47,5	49,6	49,5	49,4	49,0	47,2	56,2
Net gold exports	19,6	18,1	16,7	20,4	18,2	18,4	21,1	22,2
Merchandise imports	–47,4	–49,5	–49,2	–55,4	–53,4	–51,9	–56,4	–56,1
Net service and transfer payments	–10,7	–10,9	–11,6	–11,5	–12,2	–11,6	–11,2	–12,2
Balance on current account	**6,2**	**5,2**	**5,5**	**3,0**	**2,0**	**3,9**	**0,7**	**10,1**

quarter of 1993 when it could have been expected to increase further, including:

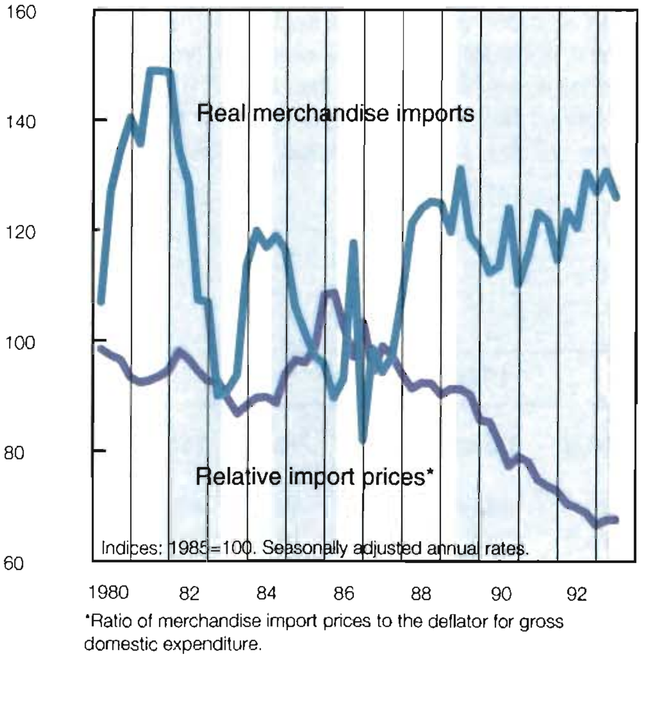
- a sharp rise in the volume of merchandise imports;
- a continued more rapid rise in the prices of imported goods than in the prices of exported goods, i.e. a weakening of the terms of trade;
- a sharp decrease in the value of net gold exports; and
- a reversal from a decrease to an increase in net service and transfer payments to the rest of the world.

The dramatic recovery in the current account surplus in the second quarter of 1993 was primarily brought about by a substantial increase in the volume of merchandise exports, an improvement in the terms of trade related mainly to a sharp rise in the gold price and a marked decline in the volume of merchandise imports. Net service and transfer payments to the rest of the world, however,rose.

Merchandise imports

The atypical behaviour of the current account balance was partly related to the continued high level of the *volume of merchandise imports* in the recession of 1989-93. In contrast to the previous economic downswings, when a decline in economic activity was usually accompanied by a decrease in the volume of imports, the physical quantity of imports in the current recession remained at a relatively high level. The volume of merchandise imports actually rose by nearly 5½ per cent from the first quarter of 1989 to the second quarter of 1993; it decreased by almost 40 per cent and 25 per cent in the economic downswings of 1981-83 and 1984-86. As a ratio of real gross domestic expenditure, merchandise imports (at constant prices) also rose from 22 per cent in 1990 to 24 per cent in 1992 and further to 25 per cent in the first half of 1993. As explained in some detail in the *Annual Economic Report* of 1992, this somewhat unusual rise in the import penetration ratio probably partly reflected the substitution of imported goods for domestically produced goods in response to a decline in the relative prices of imported goods.

Merchandise imports



*Ratio of merchandise import prices to the deflator for gross domestic expenditure.

In addition to these developments, the increase in the volume of imports during 1992 and the first quarter of 1993 was also due to several more or less isolated and random developments, such as the replacement of obsolete and the purchase of additional aircraft by the South African Airways, sharp increases in the imports of mineral products (particularly in the third quarter of 1992 and the first quarter of 1993), higher agricultural imports because of the drought, and pre-emptive buying by South African businesses during the last part of 1992 and the beginning of 1993 in anticipation of a depreciation of the exchange rate of the rand. In the second quarter of 1993 the volume of imports decreased by 3½ per cent, owing largely to a decline in the imports of agricultural products and a decrease in the imports of mineral products.

Import prices were affected favourably in the economic downturn of 1989-93 by the continued relatively low inflation rates in South Africa's main trading partner countries, a relatively small rise in international oil prices, and only a moderate depreciation in the nominal effective exchange rate of the rand. In the period from 1989 to 1992 import prices increased at an average annual rate of only 4½ per cent. As could be expected, the rise in import prices then started to accelerate to 6 per cent with the sharper depreciation of the rand in the first half of 1993.

The combined effect of these volume and price changes was that, after having increased at an average annual rate of 6½ per cent from 1988 to 1991, the *value of merchandise imports* expanded by 9½ per cent to R51,9 billion in 1992. In the first quarter of 1993 the value of merchandise imports (seasonally adjusted and annualised) advanced sharply further to R56,4 billion, before decreasing marginally to R56,1 billion in the second quarter. Increases in value were prominent over the past eighteen months in the import categories of chemical products, machinery and electrical equipment, transport equipment and agricultural products. Better weather conditions and the completion of the maize import programme, however, gave rise to a significant decline in the value of agricultural imports during the first half of 1993.

Merchandise exports

The *value of merchandise exports* increased from R32,1 billion in 1988 to R49,0 billion in 1992, or at an average rate of 11 per cent per year. This may be compared with an average annual rate of increase of 26 per cent in the period from 1983 to 1988. This considerably slower growth in export values in the current recession was due to slower rates of increase in both the volume and the prices of exported goods. On a quarterly basis, the value of merchandise exports levelled off during 1992 and decreased from a seasonally adjusted and annualised value of R49,4 billion in the fourth quarter of 1992 to R47,2 billion in the first quarter of 1993. Merchandise exports then recovered substantially to a seasonally adjusted and annualised value of R56,2 billion in the second quarter of 1993.

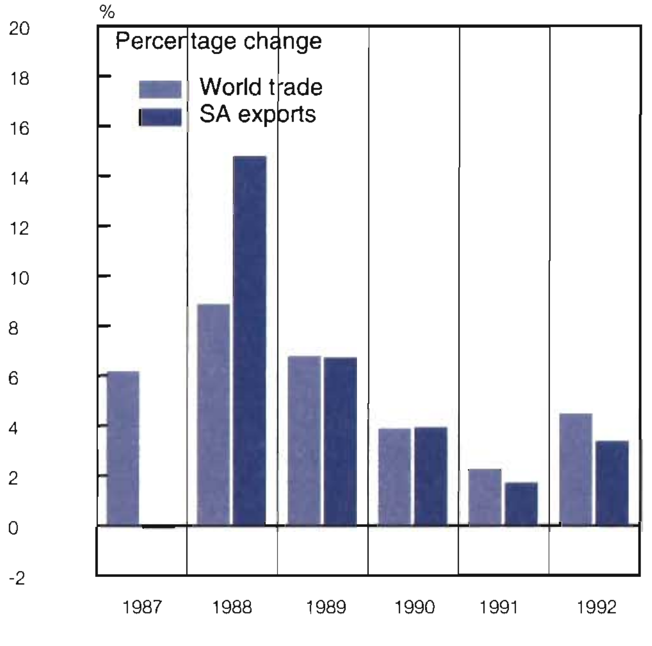
After having increased at an average annual rate of 7 per cent in the period 1983 to 1988, the growth in the *volume of merchandise exports* slowed down to slightly less than 4 per cent per year from 1988 to 1992. In the first quarter of 1993 the volume of exports decreased sharply, but then picked up even more substantially in the second quarter of the year. Although a more moderate growth in the volume of exports was reported in the recession of 1989-93, South Africa's exports did relatively well in comparison with the growth in world trade. As shown in the accompanying graph, the growth in the volume of South Africa's exports, except for 1992 when the drought caused a decline in agricultural production, kept abreast of the rate of increase in the volume of world trade.

This relatively good performance of the physical quantity of goods exported could probably be attributed to:

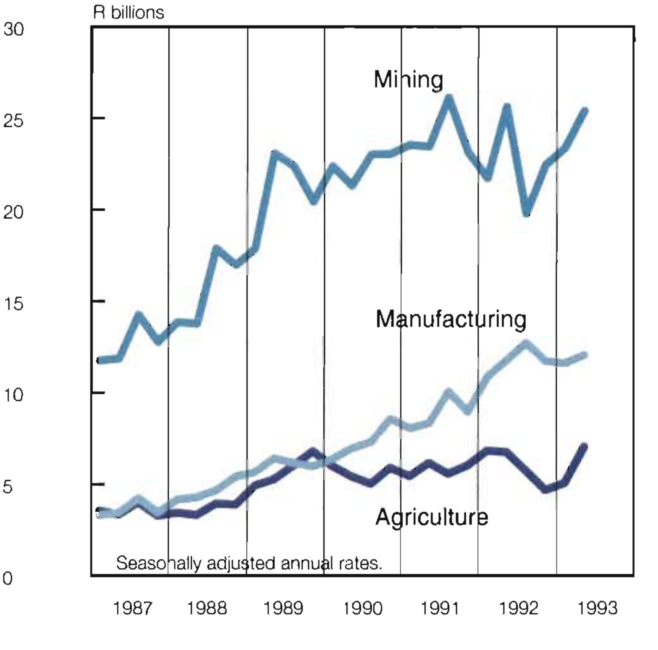
- the low level of domestic demand and high level of excess production capacity which encouraged domestic producers to find other outlets for their products;
- the gradual lifting of some of the remaining sanctions and trade embargoes against South Africa and the consequent opening-up of foreign markets;
- a decline in the nominal effective exchange rate of the rand, which more or less kept pace with the inflation differential between South Africa and its main trading partner countries; and
- the assistance that exporters received under the general export incentive scheme.

The rate of increase in the *prices of exported goods* also slowed down substantially from an average annualised level of 17½ per cent from 1983 to 1988 to an average of 7 per cent per year from 1988 to 1992. In the first half of 1993 export prices continued to rise at a fairly moderate rate. This increase in export prices occurred despite a decline of slightly more than 38 per cent in international commodity prices from June 1988 to June 1993. The export prices of goods not dependent on international commodity prices therefore

Volume of trade



Categories of merchandise exports



rose; a further depreciation in the exchange rate of the rand (especially against the US dollar in which the major part of export prices are denominated) also contributed to this increase.

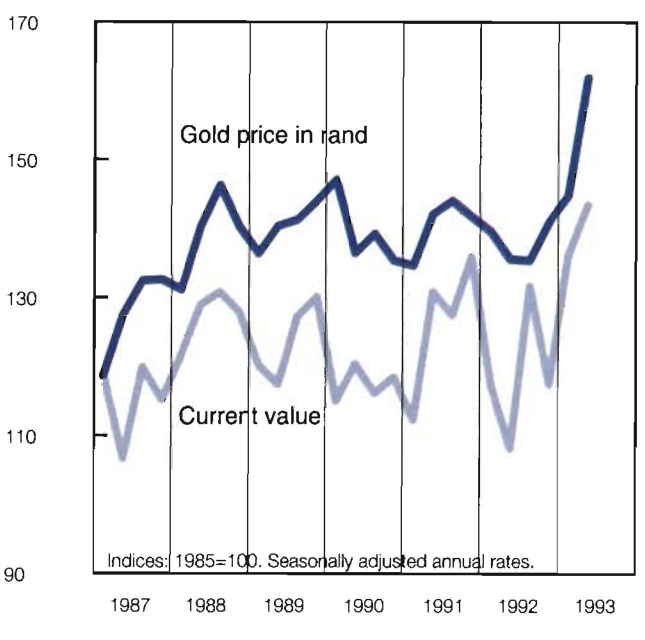
An analysis of exports according to main *economic sectors* shows that the rise in the value of merchandise exports during the current economic downturn occurred over a wide range of goods. In particular, manufactured exports continued to increase very rapidly over the period 1988 to 1992 and, more specifically, the exports of chemical products, textiles, paper and paper products, transport equipment and machinery, and electrical equipment, rose strongly. As a ratio of total merchandise exports, manufacturing exports rose from 16 per cent in 1988 to nearly 24 per cent in 1992. The exports of mining and agricultural products also increased sharply at first in the current economic downturn, but then levelled off as the lower international demand and the drought took effect.

Net gold exports

In the period from 1988 to 1992 the *value* of South Africa's net gold exports fluctuated around a more or less horizontal trend, averaging R19 billion per year. This steady performance of gold exports could be ascribed mainly to the relatively stable rand price of gold during this period, which amounted to close to R1 000 per fine ounce. The *volume* of net gold exports, on the other hand, showed a marginal downward movement from 1988 to 1992. In 1992 net gold earnings declined by 6½ per cent to R18,4 billion, owing to a decline in the volume of net gold exports and in the average rand price of 3½ per cent and 3 per cent, respectively.

After having reached a low of R18,2 billion in the fourth quarter of 1992, the value of net gold exports (seasonally adjusted and annualised) advanced to R21,1 billion in the first quarter of 1993 and further to R22,2 billion in the second quarter. Although the volume of net gold exports increased fairly sharply in the first quarter of 1993 and then remained at this higher level in the next quarter, this considerable improvement in gold exports in the first half of 1993 was mainly due to a sharp rise in the *gold price*. A strong demand from the Far East for gold, a sustained high demand for jewellery, and a sharp rise in the investment demand for gold, caused the average monthly gold price to strengthen considerably from $330 per fine ounce in March 1993 to $372 and $392 per fine ounce in June and July 1993, respectively. Owing to the depreciation of the exchange rate of the rand against the US dollar, the average monthly rand price of gold per fine ounce rose from a low of R949 in August 1992 to R1 049 in March 1993, and then even more sharply to R1 313 in July.

Net gold exports

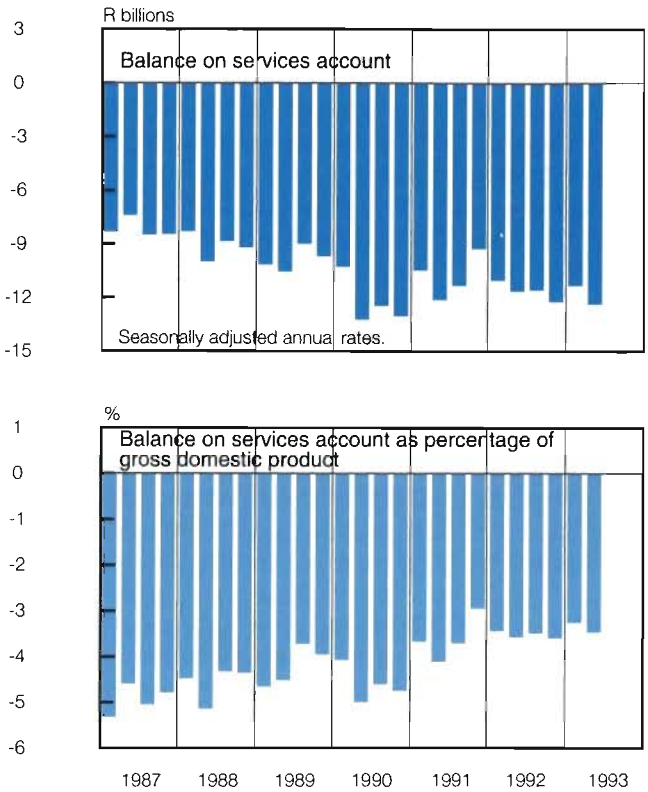


Net service and transfer payments to non-residents

Net service and transfer payments to non-residents, which had declined considerably in 1991, rose somewhat again in 1992 and the first half of 1993. After having declined from a high level of R12,2 billion in 1990 to R10,7 billion in 1991, net service and transfer payments to non-residents rose again to R11,6 billion in 1992 and to R11,7 billion (seasonally adjusted and annualised) in the first half of 1993. On a quarterly basis the seasonally adjusted and annualised value of net service and transfer payments increased at first from R10,9 billion in the first quarter of 1992 to a high of R12,2 billion in the fourth quarter of 1992, before declining to R11,2 billion and R12,2 billion in the first two quarters of 1993. As a ratio of gross domestic product, net service and transfer payments amounted to 3½ per cent in the eighteen months ended June 1993, compared with a peak of 5½ per cent in 1985.

The higher deficit on the services account with the rest of the world in 1992 and the first half of 1993 was due to the fact that *service payments* increased more rapidly than service receipts. In particular, freight and merchandise insurance payments rose substantially because of the higher value of imports, while an increase in the number of South Africans travelling abroad was responsible for a sharp rise in tourist expenditure. The rise in the number of people travelling abroad was partly explained by declines in passenger fares, which arose from competition

Services account



between the larger number of foreign airlines that are now operating in South Africa. In addition, an increased number of foreign destinations are now open to South African travellers.

On the other hand, interest payments on foreign loans receded further in 1992 and the first half of 1993, as a result of a sharp reduction in South Africa's foreign debt and generally lower interest rate levels in most of the main industrial countries. Dividend payments on foreign investments, moreover, moved sideways since 1990, because of a sharp decline in equity investments of non-residents and the poor financial results of some domestic organisations. Total interest and dividend payments to non-residents, as a percentage of total export proceeds, accordingly contracted from a peak of 15½ per cent in 1986 to 10½ per cent in 1992, and to 9½ per cent in the first half of 1993.

Service receipts from foreigners continued to advance rapidly in the recession of 1989-93 to a seasonally adjusted and annualised value of R13,3 billion in the first half of 1993. Higher spending by foreign tourists travelling in South Africa, and increased receipts from freight and merchandise insurance, were mainly responsible for the increase in service receipts in 1992. Dividend receipts on investments in other countries also rose fairly sharply in 1992. In the second quarter of 1993 service receipts were adversely affected by the escalation of violence in the country, which dissuaded many foreigners from visiting South Africa.

Capital account

The capital account of the balance of payments improved considerably at first in the recession of 1989-93: the *total net outflow of capital* not related to reserves receded from R6,9 billion in 1988 to R2,4 billion in 1990 and to a negligible amount in the first three quarters of 1991. However, in the fourth quarter of 1991 a net outflow of capital not related to reserves of R4,8 billion was recorded, bringing the year's total outflow to approximately the same amount. This large outflow of capital was caused by special circumstances: in order to help drain excess liquidity from the economy, the Reserve Bank stopped quoting preferential rates on forward exchange cover transactions, which caused many importers to switch

Net capital movements not related to reserves
R billions

	1991	1992			1993
	Year	1st half	2nd half	Year	1st half
Bearer bonds and notes	–0,3	1,7	–0,8	0,9	–0,7
Converted loans from affected debt	–0,4	–	–0,1	–0,1	–0,4
Loans guaranteed by foreign governments	0,8	–0,2	–0,6	–0,8	–0,7
Other long-term capital	–1,8	–1,8	0,3	–1,5	1,6
Total long-term capital	–1,7	–0,3	–1,2	–1,5	–0,2
Short-term capital	–3,1	–1,4	–3,3	–4,7	–5,2
Net capital outflow	**–4,8**	**–1,7**	**–4,5**	**–6,2**	**–5,4**

from foreign to domestic sources of trade financing. In the first quarter of 1992 the net capital outflow decreased to only R11 million. Towards the end of the second quarter of 1992 renewed political uncertainty and civil unrest led to the resumption of substantial capital outflows, which brought the total net outflow of capital in the first half of 1992 to R1,7 billion. The net outflow of capital then increased substantially to R4,5 billion in the second half of 1992 and to no less than R5,4 billion in the first half of 1993.

Long-term capital reflected a net outflow of R1,5 billion in 1992; slightly less than the outflow of R1,7 billion in 1991. This smaller *net* outflow of long-term capital was the result of bearer bond issues in foreign capital markets in the first five months of 1992 in view of the progress made at that stage in initiating the constitutional reform process in the country. A total amount of R2,1 billion was raised by means of these issues in the first half of 1992, while R0,4 billion was repaid on maturing bearer bonds and notes. New project financing in the form of loans guaranteed by foreign governments was slightly less than the repayments on these loans falling due in the first half of 1992. In addition, a large net outflow of other long-term capital was also recorded over the same period.

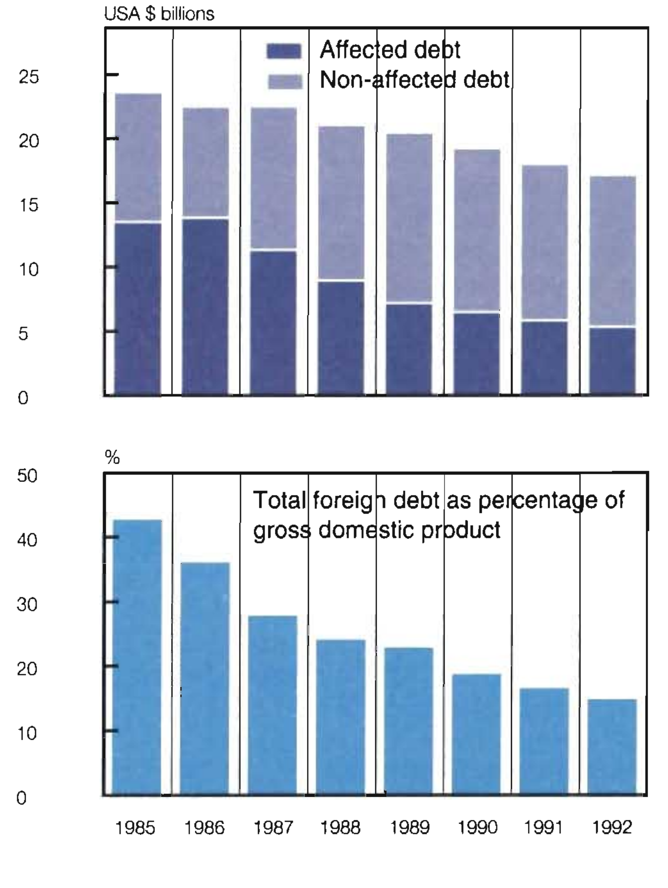
The temporary breakdown in the political negotiation process in May 1992 and the subsequent escalation in violence and internal unrest had an unfavourable effect on further public and private placements in the international capital markets. These factors, together with the fact that funds were readily available in the domestic capital market, led to large net repayments on long-term debt outstanding to non-residents in the second half of 1992 and the first half of 1993. At the same time, a small amount of debt that had been converted into so-called long-term loans with a maturity of 9½ years in terms of the Second Interim Debt Arrangements with foreign creditor banks, fell due for repayment. These longer-term outflows were countered to some extent by a reported net inflow of other long-term capital. This inflow, however, mainly represented net purchases of securities quoted on the Johannesburg Stock Exchange and was funded through the financial rand system, that is by the appropriation of existing financial rand balances in South Africa. It therefore did not represent an increase in foreign reserves.

The deterioration in the capital account from about June 1992 was mainly caused by a substantial net outflow of *short-term capital*, which increased from R1,4 billion in the first half of 1992 to R3,3 billion in the second half and R5,2 billion in the first half of 1993. At first this outflow mainly reflected the renewed political uncertainty and social unrest. From the fourth quarter of 1992, however, the strength of the US dollar in international markets led to an outflow of capital via forward cover transactions in third currencies. The weakening of the exchange rate of the rand against the dollar (the currency in which by far the greater part of South Africa's foreign trade transactions are concluded) also led to adverse leads and lags in foreign payments and receipts and therefore to an outflow of short-term funds. The ready availability of domestic funds facilitated this outflow, while further repayments to the amount of R1,3 billion were made on so-called affected foreign debt in terms of the Third Interim Debt Arrangements with foreign creditor banks in the eighteen months ended June 1993.

Foreign debt

South Africa's *total outstanding foreign debt* was reduced further by US$0,8 billion in 1992 to $17,3 billion at the end of that year. Since the declaration of a partial debt standstill in September 1985, the country has succeeded in bringing down its foreign debt (when expressed in US dollar) at an average annual rate of 4½ per cent. Valued at the exchange rates of the US dollar against other currencies as at 31 August 1985, the total foreign debt has been reduced from $23,7 billion at the beginning of the standstill

Total foreign debt



arrangements to $15,8 billion at the end of 1992, implying that, on a net basis, one-third of the debt outstanding on 31 August 1985 has been redeemed. In terms of rand, South Africa's foreign debt was reduced from R65,8 billion to R52,8 billion over this period.

Debt not payable in terms of the interim debt arrangements with foreign creditor banks declined from $6,0 billion at the end of 1991 to $5,5 billion at the end of 1992 and it is expected that this debt will decrease further to about $5 billion at the end of the Third Interim Debt Arrangements on 31 December 1993. Valued at the exchange rates of 31 August 1985, this so-called affected debt amounted to $5,1 billion; at the beginning of the debt standstill $13,6 billion was affected by the arrangements. In accordance with the three interim debt arrangements with foreign creditor banks, South Africa has repaid $2,7 billion under the proclamation, and $0,8 billion on debt converted into medium- and long-term loans outside the proclamation, up to the end of 1992. A further $0,8 billion is repayable in 1993.

A large part of the reduction in affected debt from the beginning of the standstill arrangements was due to *conversions* of this debt into longer-term loans falling outside the standstill net. At the end of 1992 the outstanding long-term loans converted in this manner amounted to $4,8 billion. In addition to these conversions, the interim debt arrangements with foreign creditor banks also allowed for the conversion of debt into equities; at the end of 1992 these debt-equity swaps amounted to $0,8 billion.

Despite these conversions of debt inside the standstill net into long-term loans outside the net, South Africa's *non-affected debt* increased only moderately from $10,1 billion at the end of August 1985 to $11,8 billion at the end of 1992. Valued at August 1985 exchange rates, the non-affected debt amounted to only $10,7 billion at the end of 1992.

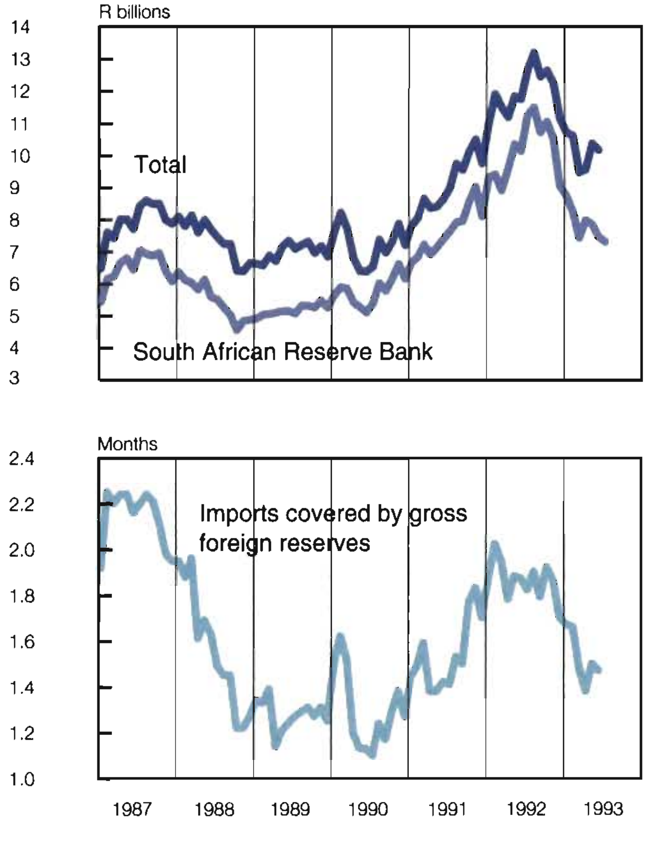
In view of the large repayments on the foreign debt of the country, South Africa's *foreign debt position* has improved dramatically since the mid-1980s and is currently one of the strong points favouring a more sustainable and higher economic growth in the future. As a ratio of gross domestic product, the foreign debt of the country decreased from 43 per cent at the end of August 1985 to only 15 per cent at the end of 1992. The ratio of foreign debt to total export earnings also receded, namely from 126 per cent to only 61 per cent over the same period. Moreover, the maturity structure of the foreign debt has been improved considerably: at the end of August 1985, short-term debt (i.e. debt maturing within twelve months) comprised 57 per cent of the total outstanding foreign debt of the country; at the end of 1992, such debt amounted to about 22 per cent of the total outstanding foreign debt.

Foreign reserves

As a net result of the transactions on the current and capital account of the balance of payments, South Africa's total *net gold and other foreign reserves* declined by R2,3 billion in 1992 and by a further R3,3 billion in the first quarter of 1993. This sharp worsening of the overall balance of payments position forced the monetary sector (the Reserve Bank and private banks) to increase its reserve-related liabilities by R4,4 billion over the fifteen months ended March 1993. Owing to the large surplus on the current account, the net gold and other foreign reserves then increased by R1,2 billion and the reserve-related liabilities of the monetary sector were reduced again by R1,6 billion in the second quarter of 1993. The Reserve Bank, however, continued to be a net borrower in the second quarter, and its outstanding reserve-related liabilities amounted to R1,6 billion at the end of June 1993.

After taking valuation adjustments and liabilities related to reserves into account, the *gross gold and other foreign reserves* of the country also declined from a high of R13,2 billion at the end of August 1992 to R10,2 billion at the end of June 1993, or by R3,0 billion. The level of the total gross gold and other

Gross gold and other foreign reserves



foreign reserves was equivalent to the value of about 1½ months' imports of goods and services in June 1993, compared with almost 2 months at the end of August 1992. From the end of August 1992 the gross gold and other foreign reserves of the Reserve Bank also declined substantially by no less than R4,2 billion to a level of R7,4 billion at the end of July 1993. The Reserve Bank's gold reserves contracted from 6,6 million fine ounces at the end of December 1992 (virtually the same level as at the previous year-end) to 4,8 million fine ounces at the end of July 1993.

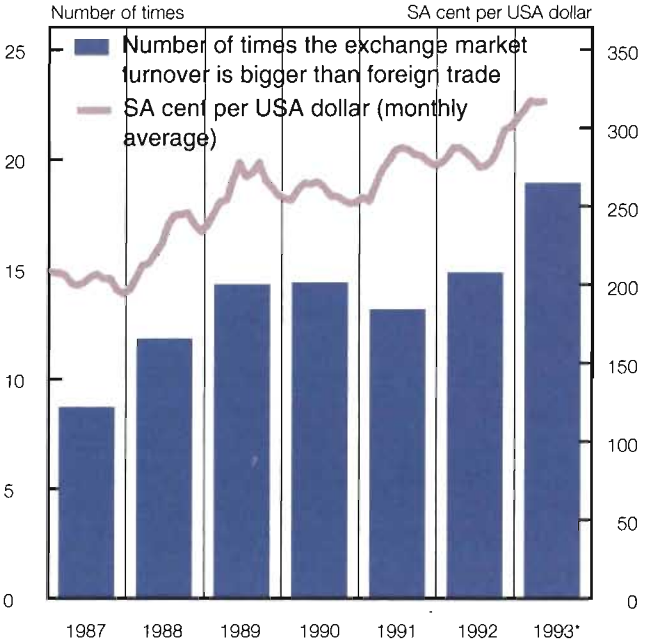
Foreign exchange market

The domestic market in foreign exchange was heavily influenced during 1992 and the first half of 1993 by the behaviour of the US dollar on international foreign exchange markets. After having appreciated in the first quarter of 1992, mainly on account of more positive signs of an imminent economic recovery in the United States, the dollar lost ground again because of renewed concern about the performance of the United States' economy, the widening of interest rate differentials between Germany and the United States, and an appreciation of the UK pound after the general election in that country in April 1992. This caused the dollar to depreciate to a historical low of DM1,39 on 2 September 1992; this was about 15½ per cent lower than its level against the mark at the end of the first quarter of 1992.

The downward trend of the dollar was subsequently reversed owing to the events in the European Monetary System on 16 September 1992. Uncertainties caused by the withdrawal of the UK pound and Italian lira from the European Exchange Rate Mechanism and a widening of the interest rate differentials between the USA and Europe put downward pressure on the European currencies. From 16 September 1992 to 25 February 1993 the dollar therefore appreciated substantially against almost all European currencies and then fluctuated around this higher level in the ensuing five months. Contrary to these developments, the dollar continued to depreciate against the yen throughout this period as a result of the United States' large trade imbalance with Japan.

This instability in the international market in foreign exchange, together with a fairly sharp growth in underlying balance of payments transactions, resulted in a sharp increase in the activity on the South African foreign exchange market in the eighteen months until June 1993. The downward movement in the value of the net daily turnover on the market in foreign exchange (gross figures adjusted for double-counting arising from local interbank business) therefore came to an end: the average net daily turnover rose from a low of \$2,9 billion in 1991 to \$3,5 billion in 1992 and \$4,0 billion in the first six months of 1993. As could be expected, this increase in the activity on the domestic foreign exchange market took place especially from the second half of 1992, because of the more unstable conditions at that time. In view of the strong downward potential of the rand, the share of the turnover of forward covering to the total net transactions rose from 33 per cent in 1991 to 37 per cent in the first six months of 1993, while there was, of course, a corresponding decline in the share of spot transactions.

Turnover on the South African foreign exchange market



* First half of 1993.

Another interesting development in the domestic market in foreign exchange was the recent substantial rise in the ratio of the value of net turnover in foreign exchange to the value of South Africa's exports and imports of goods and services. The turnover fluctuated between a level of 14 to 15 times the value of South Africa's exports and imports in the period 1989 to 1992, before rising to 19 times the value of foreign trade in the first six months of 1993. This suggests that transactions arising from international capital flows, hedging, arbitrage and position-taking have increased significantly recently, especially if compared with the position in 1987 when the value of net turnover in foreign exchange was about nine times the value of South Africa's exports and imports of goods and services. However, in the first six months of 1993 the value of this ratio in South Africa was still considerably lower than the ratio that applies in global exchange trading; based on information compiled by the Bank

Changes in exchange rates of the rand
%

	31 Dec 1991 to 16 Sep 1992	16 Sep 1992 to 31 Dec 1992	31 Dec 1991 to 31 Dec 1992	31 Dec 1992 to 31 July 1993
Weighted average	-2,4	-2,0	-4,3	-9,2
US dollar	-2,3	-8,0	-10,2	-9,7
British pound	-2,0	13,2	10,9	-7,6
German mark	-4,1	-0,3	-4,4	-2,8
Japanese yen	-3,2	-7,8	-10,8	-23,4
Netherlands guilder	-4,1	-0,6	-4,7	-2,7
Italian lira	2,2	12,7	15,2	-1,2
Financial rand	-17,7	-20,7	-34,7	8,8

for International Settlements, the value of the world's total foreign exchange trading in 1992 was approximately 50 times larger than the value of all the world's exports and imports of goods and services during that year.

The greater instability in the international foreign exchange market and the weaker overall balance of payments position in South Africa, caused the exchange rate of the rand to depreciate against all major currencies in 1992, with the notable exception of the UK pound and the Italian lira which were very weak during the last part of the year. In the first seven months of 1993 the rand depreciated even more rapidly against all the currencies of its main trading partner countries. In particular the rand depreciated by no less than 23,4 per cent against the Japanese yen and by 9,7 per cent against the US dollar from the end of 1992 to 31 July 1993.

The net effect of these movements in the exchange rates of the rand was a decline of 4,3 per cent in the *nominal effective exchange rate* of the rand in 1992 and a much more significant decline of 9,2 per cent in the first seven months of 1993. In June 1993 the *real effective exchange rate* of the rand was therefore 4,7 per cent lower than at the end of December 1992 and 4,2 per cent below its level at the end of 1991.

The *financial rand* market was considerably more unstable than that of the commercial rand because it was not only affected by international and domestic economic developments, but also by socio-political changes in South Africa. After having strengthened by 6,7 per cent in 1991, the financial rand exchange rate fell by 16,5 per cent to R3,80 per dollar during the first two months of 1992 because of uncertainties arising from the taxability of non-residents' income and the possible outcome of the Referendum on 17 March 1992. The mandate given to the State President to proceed with political reform, the statement that interest earnings of non-residents are not taxable in South Africa and an announcement by the Reserve Bank that it may intervene in the financial rand market in order to affect domestic liquidity, then caused the financial rand to strengthen again to R3,36 per dollar on 22 April 1992. In the rest of 1992 the suspension of the proceedings of the Conference for a Democratic South Africa (Codesa), large investments by South African companies in other countries through the financial-rand system, certain politically inspired incidents of violence and more negative perceptions by foreigners of domestic developments, contributed to a sharp depreciation of the financial rand. At the end of 1992 the financial rand exchange rate against the dollar came to R4,86 per dollar, which represented a depreciation of nearly 35 per cent from its level at the end of the preceding year.

An announcement by the Minister of Finance on 27 November 1992 on stricter exchange control measures to curtail the acquisition of foreign assets via the financial rand, together with increased foreign interest in South African gold-mining shares, pushed the financial rand exchange rate to a high of R4,44 per dollar on 12 February 1993. This appreciation was again followed by a sharp decline in the value of the financial rand after Mr Chris Hani was assassinated on 10 April 1993. However, the exchange rate of the financial rand recovered fairly quickly because of the recent strong demand for South African gold-mining shares. The stronger gold price and more positive developments in the constitutional negotiating process were instrumental in maintaining a more stable value of the financial rand, which fluctuated between R4,47 and R4,74 per dollar from the end of April 1993 to the end of July. At the end of July 1993 the exchange rate of the financial rand was 8,8 per cent above its level at the end of 1992, while the financial rand discount had narrowed to 24,2 per cent from 37,2 per cent over the same period.

Financial markets

Monetary policy

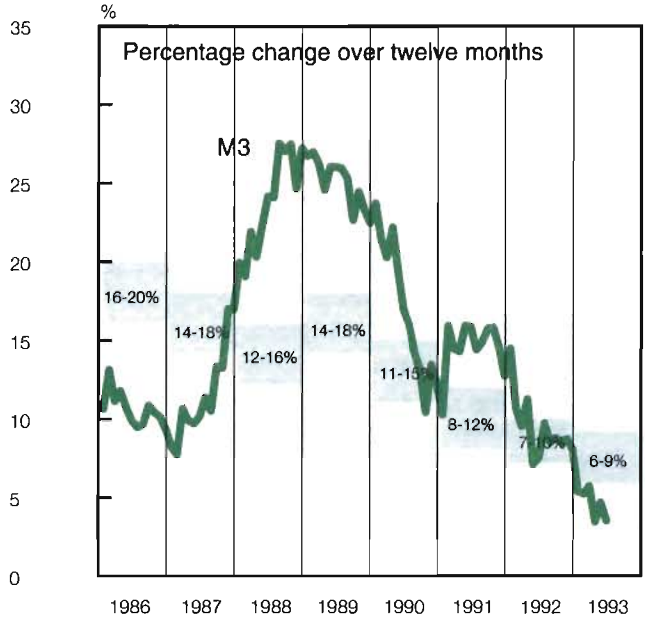
The monetary authorities continued to aim at attaining overall *financial stability* over the past year. The authorities believe that monetary policy forms part of broader macro-economic policy of which the prime objective is to improve the standard of living of all the inhabitants of the country, i.e. to achieve maximum sustainable long-term economic growth where all the people can share in the increased prosperity. The contribution of monetary policy in accomplishing this objective is to create and maintain a stable financial environment by pursuing persistent and transparent monetary policies that facilitate decision-making and encourage enterprise. Monetary policy should therefore not be pursued primarily in an anti-cyclical manner, but a medium to longer-term approach should rather be followed.

The Governor of the Reserve Bank has accordingly stated that the achievement of financial stability will require:

- a rate of growth in money supply that will accommodate real growth in the economy plus a justifiable increase in liquidity preference;
- a rate of expansion in domestic credit extension by banks that is consistent with the objectives for the growth in money supply;
- a market-determined level of interest rates that in the medium and longer term will continuously be above the level of inflation;
- a relatively stable exchange rate of the rand, reflecting underlying changes in the purchasing power of the rand;
- well-functioning money, capital and foreign exchange markets that react with reasonably short time lags to changes in underlying demand and supply conditions; and
- sound and efficient banking institutions to provide in the financial needs of the community.

In accordance with these principles and after due consideration of economic conditions in South Africa, the Reserve Bank reduced its *money supply guidelines* for 1993 further as a signal to the market regarding its monetary policy. The money supply guidelines have therefore now been lowered progressively from 14-18 per cent in 1989 to 7-10 per cent in 1992 and 6-9 per cent in 1993. Although these guidelines are not intended to establish a rigid "monetary rule", they serve as an important indicator of the monetary policy stance. The further reduction in these guidelines in 1993 accordingly demonstrated the Reserve Bank's determination to bring inflation down further, while allowing adequate scope for an increase in real economic activity.

Guidelines for growth in M3



At the same time, the downward movement in the inflation rate and other economic conditions allowed the Reserve Bank to reduce *Bank rate* on three occasions during 1992 and once early in 1993. Bank rate, which had been reduced from its most recent peak of 18 per cent to 17 per cent in March 1991, was lowered to 16 per cent on 23 March 1992, 15 per cent on 30 June 1992, 14 per cent on 18 November 1992 and 13 per cent on 9 February 1993. Reflecting the cautiousness of the monetary authorities in lowering Bank rate, the inflation-adjusted Bank rate was at first allowed to increase from 0,7 per cent in December 1991 to 4,0 per cent in December 1992, before it declined to 2,7 per cent in June 1993.

Although considerable success has been achieved in bringing the rates of inflation down to lower levels, these rates are still substantially higher than the inflation rates of South Africa's main trading partner countries. However, the relatively strict monetary policy stance of the past few years has succeeded in depressing the growth in money supply to levels more or less comparable to those in these countries.

Money supply and consumer prices*
Percentage change over twelve months

Country	M1	M3	Consumer price index
Australia	23,1	9,1	1,2
Canada	14,6	7,2	1,6
France	–2,0	3,1	1,9
Germany	10,1	8,6	4,3
Italy	2,6	6,1	4,2
Japan	2,9	1,4	0,9
United Kingdom	5,0	3,3	1,2
United States of America	12,1	0,1	3,0
South Africa	11,6	3,5	10,0

* Latest information available

Changes in the regulatory framework

Important legislative and regulatory changes were also made in the first half of 1993 in order to improve the functioning of the financial markets. In particular, the Reserve Bank introduced a simplified *system of accommodating cash shortages* in the money market with effect from 1 May 1993. Under the old system the Bank provided accommodation to banks at a wide range of accommodation rates through the rediscounting of Treasury bills, Reserve Bank bills, Land Bank bills and liquid bankers' acceptances, as well as through the extension of overnight loans against the security of several types of eligible assets. This system was complicated, placed a heavy administrative burden on the Bank and represented an open-ended facility for accommodation at the more favourable rates, because bankers' acceptances could readily be created and easily tailored to achieve liquid-asset status.

In view of these shortcomings, the old system was replaced by a new system in which accommodation is provided through overnight loans at basically two different accommodation rates against two categories of financial assets. In the first category, accommodation is provided at Bank rate against the collateral of government stock, Treasury bills, Reserve Bank bills and Land Bank bills with an outstanding maturity of less than 92 days. A second category of these securities with a maturity of 92 days and longer, but shorter than three years, qualifies as collateral for overnight loans at a rate of one percentage point above Bank rate. Accommodation against collateral of other forms of security, such as bank-endorsed bills and long-term government stock, will be made available only in exceptional circumstances and at a discretionary or negotiated rate and for a limited period.

The new system terminates the open-endedness of accommodation provided through the old system to a considerable degree. In view of the exclusion of bankers' acceptances as collateral for normal overnight loans and the resultant smaller amount of paper available for accommodation at reasonable rates, the Reserve Bank assisted banks in adjusting to the new system by undertaking repurchase agreements in May 1993. The change from a system of rediscounting to a system of overnight loans for accommodating money market shortages also reduced the effective minimum cost of accommodation by 0,5 per cent per annum on 1 May 1993, although the official Bank rate remained unchanged.

Considerable progress was also made during the first half of 1993 with the implementation of a *system of Tax and Loan Accounts* in a further attempt to improve the functioning of the money market. Such a system will involve the transfer of part of government deposits currently held with the Reserve Bank to so-called "tax and loan accounts" with private banks; Exchequer transactions (receipts and payments) will in future be channelled through these accounts. This system will enable the Government to earn interest on deposits with banks while reducing fluctuations in money market liquidity brought about by the flow of funds between the private sector and the government sector, changing the latter's cash balances with the Reserve Bank. The government has already accepted this system in principle and a working group has been established to investigate its implementation.

As an interim measure, the Reserve Bank on 14 June 1993 started to transfer funds from the government deposits with the Reserve Bank (Exchequer and Paymaster-General Accounts) to the banking sector, in order to ease a seasonal tightening in money market conditions. The funds are divided between the banks on the basis of the relative values of their capital and reserves. Although this is an effective way of influencing money market conditions, it has the disadvantage that the administration of these flows of Government funds remains the responsibility of the Reserve Bank.

In addition, *other important changes* were also made to the Deposit-taking Institutions Act, No 94 of 1990, and to the Reserve Bank Act, No 90 of 1989 in the first half of 1993, including:

- The *renaming* of deposit-taking institutions as banks.
- The *transfer of the provisions relating to the banks' minimum reserve balance* with the Reserve Bank from the Banks Act to the South African Reserve Bank Act because these provisions are regarded as constituting an instrument of monetary policy.
- A change in the calculation of the *minimum cash reserve requirement* from a fixed proportion of the value of short-term liabilities (as reduced) to a fixed proportion of the value of total liabilities (as

adjusted) of the banks as from the reporting date relating to March 1993 (i.e. fifteen working days after the end of the month). In order to assist the banks in complying with this change, it was decided that the change in the calculation of the minimum reserve requirement (excluding the supplementary reserve requirement of one per cent of short-term liabilities, on which interest is earned) would be phased in over fifteen months. The basic requirement was also reduced from 4 per cent of short-term liabilities as in the reporting month of February 1993 to 3 per cent of short-term liabilities as in the reporting month of March 1993. From the reporting month of April 1993 the requirement in respect of short-term liabilities would be reduced monthly by one tenth of one per cent to reach 1,5 per cent of such liabilities in the reporting month of June 1994; simultaneously, a minimum reserve requirement based on the difference between total liabilities and short-term liabilities would be phased in over the same period at a monthly rate of one tenth of one per cent from nil per cent in the reporting month of March 1993 to 1,5 per cent in the reporting month of June 1994.

- A change in the calculation of the *liquid-asset requirement* from 20 per cent of the banks' short-term liabilities (as reduced by adjustments in respect of cash management schemes and set-offs, certain short-term loans received, and one half of remittances in transit), to 5 per cent of the banks' total liabilities (as reduced only by capital and reserves and by the adjustments in respect of cash management schemes and set-offs), effective from the fifteenth business day in April 1993. In this case, no phasing-in period was provided for.
- The exclusion of bankers' acceptances, self-liquidating bills, promissory notes and negotiable loan levy certificates from the *definition of liquid assets*.

These changes had an expansionary effect on money market liquidity because they reduced the required reserve balances of the banks with the Reserve Bank on 26 April 1993 (i.e. the fifteenth business day in April). Although the lower cash reserve requirement reduced banks' required reserve balances with the Reserve Bank by about R1,0 billion, the money market was affected to a lesser extent because the vault cash holdings of some banks (which are included in the banks' cash reserves for meeting the cash reserve requirement) exceeded their minimum cash reserve holdings. This reduction, of course, also contributed to a significant decline in the so-called monetary base (MO) in April 1993.

In recognition of a need for a mild relaxation of monetary policy, the Reserve Bank announced on 4 August 1993 a further reduction in the minimum cash reserve requirement of ½ percentage point to a phased-in level of 1 per cent (previously 1½ per cent). The minimum cash reserve for the reporting month of August 1993 will accordingly be calculated as 1,5 per cent of short-term liabilities (which will be reduced by 0,1 per cent per month to 1,0 per cent in January 1994) plus 0,5 per cent of other liabilities (which will be increased by 0,1 per cent per month to 1,0 per cent in January 1994). As an interim measure until a more satisfactory solution can be found, banks will also be allowed to reduce their liabilities for purposes of calculating cash reserve requirements not only with capital and reserves, but also with interbank and repurchase agreements that are mainly used for the financing of securities trading. This concession was made because of inequities arising from security dealing between banks and other dealers. These changes will reduce the cash reserve requirement by a further R1,2 billion, but the effect on the money market is expected to be smaller because of the relative large holdings of vault cash by banks which should not show a proportionate decline.

Finally, draft legislation regarding *mutual banks* was made available for comment in the second quarter of 1993. These comments were incorporated in the Mutual Banks Bill, that was published on 9 June 1993 and which may still be enacted in 1993. The Mutual Banks Bill provides for the creation of banks that are capitalised on the basis of mutual participation rather than equity shareholding, while requiring that these mutual banks meet prudential requirements and maintain standards of management expertise that are almost identical to those of conventional equity banks. This bill therefore allows for the registration of "informal" banking institutions and of the existing two permanent mutual building societies as mutual banks. The Mutual Banks Bill states that the services offered by mutual banks should correspond to those offered by existing equity banks, effectively making it possible for mutual banks to offer a full range of banking products. The minimum capital, reserve and liquid-asset requirements generally conform with those applicable to equity banks. It is envisaged that the mutual banks will encourage active participation and involvement by client-members in the welfare of these institutions.

Money supply

As a result of the restrictive monetary policy stance, the decline in real economic activity and the lower rate of inflation in South Africa, the growth in money supply slowed down significantly in the recession of 1989-93. The twelve-month rate of increase in the *broadly defined money supply* (M3), for instance, fell from a peak of 27,5 per cent in August 1988 to 10,2 per cent in January 1991. Owing to the conversion of certain off-balance-sheet items into conventional deposits and advances, it then rose to 15,9 per cent in February

1991, fluctuated around this higher level throughout the rest of 1991 and amounted to 14,2 per cent in January 1992. The rate of increase over twelve months in M3 subsequently contracted again to 10,4 per cent in February 1992 and receded more gradually to 8,0 per cent in December 1992. Some disintermediation, induced *inter alia* by relatively wide margins between banks' deposit and lending rates, the consolidation of clients' deposits and borrowing under flexible mortgage facilities, and the selling of bankers' acceptances to investors in the non-bank sector after it had become known that the liquid-asset status of such paper would be terminated, then contributed to a further decline in this rate to 3,4 per cent in April 1993 before it rose moderately to 3,5 per cent in June.

The slower growth of M3 during 1992 brought it well within the money supply guidelines of 7-10 per cent for that year. The growth in the quarterly average value of M3 from the fourth quarter of 1991 to the fourth quarter of 1992 amounted to 8,8 per cent. From the beginning of 1993 the growth rate in M3 moved below the lower boundary of the new guideline of 6-9 per cent, and M3 showed virtually no growth from the fourth quarter of 1992 to the second quarter of 1993.

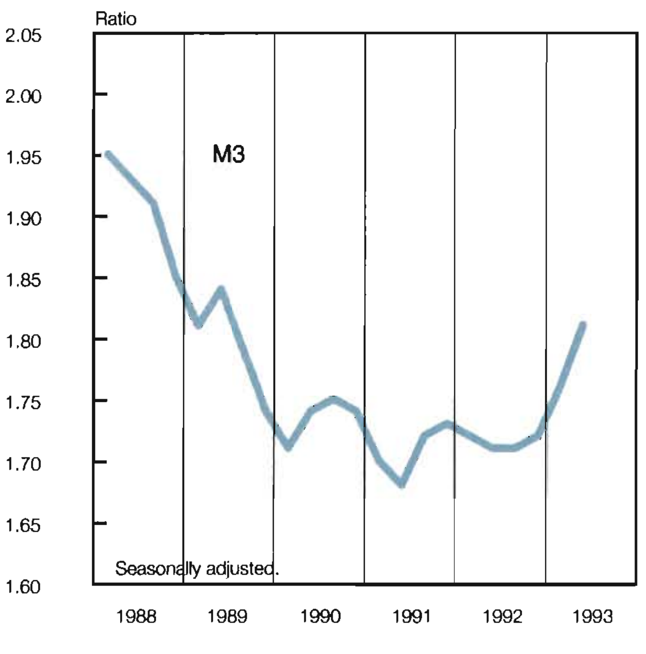
In a *statistical or accounting sense*, the slower growth in M3 during 1992 and the first half of 1993 was due mainly to a decrease in the net gold and other foreign reserves, while the monetary institutions' claims on the private sector grew at a considerably lower rate. In the first half of 1993 a significant rise in government deposits contributed to a lower rate of increase in M3.

The lower growth in money supply during 1992 was accompanied by a relatively stable *income velocity of M3*. Contrary to what may be expected in a period in which the gap between banks' deposit and lending rates widened considerably, the velocity of circulation declined, on balance, by 0,6 per cent in 1992. This could partly have been related to depressed agricultural conditions, which may have reduced measured income by a larger amount than permanent (or "perceived normal") income. Only from the beginning of 1993 did the widening of interest rate margins, which is normally conducive to disintermediation practices, lead to an increase in the velocity of circulation of M3. Although the margin between banks' deposit and lending rates narrowed somewhat, the income velocity of circulation of M3 rose by 5,2 per cent from the fourth quarter of 1992 to the second quarter of 1993.

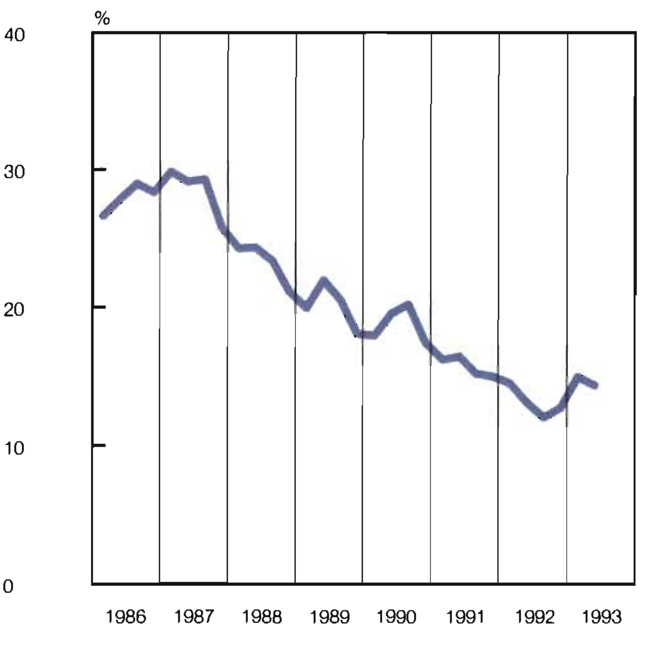
Composition of money supply

Not only did money supply growth slow down, but the composition of M3 also changed significantly. In particular, the ratio of *long-term deposits* to total deposits of banks included in M3 declined consistently from a year-end high of 28,2 per cent in 1986 to only 12,7 per cent at the end of 1992. This shift in banks' deposits was closely related to changes made to the

Income velocity of money



Long-term deposits as percentage of M3



stipulation in the old Building Societies Act that all deposits at building societies, other than on savings and transmission accounts, had to be made for a period of at least one year. From 1986 this restriction on building societies was progressively relaxed and finally abolished with the implementation of the former Deposit-taking Institutions Act in February 1991. The former building societies accordingly encouraged the transformation of the maturity structure of their deposits to make them more competitive with banking institutions. The consequent declining share of long-term deposits in total M3 was reversed only in the first half of 1993, when more favourable interest rates were offered on deposits of twelve months and an expected decline in interest rates induced investors to move to longer-term fixed deposits.

The percentage share of all *other types of deposits* of total M3 therefore rose sharply in the recession of 1989-93, with the notable exception of savings and "other short-term deposits" and coin and banknotes in circulation. Cash and liquid-asset requirements on deposits of less than 32 days were probably mainly responsible for the decline in the relative share of short-term deposits. Relatively favourable interest rates on medium-term deposits led to an increase in the ratio of these deposits to total M3 until December 1991 and they remained on this higher level in the next eighteen months. As could be expected in a society that makes increasing use of credit cards and other electronic means of transferring funds, the percentage share of coins and banknotes in circulation in M3 continued to decrease marginally in the current recession.

As shown in the accompanying table, the ratio of cheque and transmission deposits to total M3 increased only moderately from the end of 1989 to the end of 1991, but then rose to considerably higher levels in 1992 and the first half of 1993. The rise in the relative share of these types of deposits was quite surprising in an environment of relatively high nominal interest rates and a decline in real economic activity. This development was probably related to the active promotion of these types of deposits, modifications to the former Deposit-taking Institutions Act which led to the conversion of short-term repurchase agreements from contingent liabilities to deposits shown on the balance sheets of banks, and the lower opportunity cost of holding such deposits with a decline in the rates on other deposits.

In view of these changes in the composition of deposits, widely divergent movements were recorded in the growth rates of the *narrower monetary aggregates*. The twelve-month rate of increase in M2, which excludes only the long-term deposits of monetary institutions, broadly corresponded to the twelve-month growth rates in M3 and declined from 16,1 per cent at the end of 1991 to 2,1 per cent in April 1993 and to 2,0 per cent in June. The rate of increase over twelve months in M1 (coin and banknotes in circulation and all demand deposits) at first also slowed down from 14,8 per cent at the end of 1991 to 6,6 per cent in May 1992, but then rose sharply to 23,2 per cent in September 1992 before declining again to 11,6 per cent in June 1993. In contrast to these developments, the twelve-month growth rate in M1A (coin and banknotes in circulation and cheque and transmission deposits) fluctuated considerably and remained, on balance, relatively high because of fluctuations in coin and banknotes in circulation and cash management schemes which affected cheque and transmission deposits.

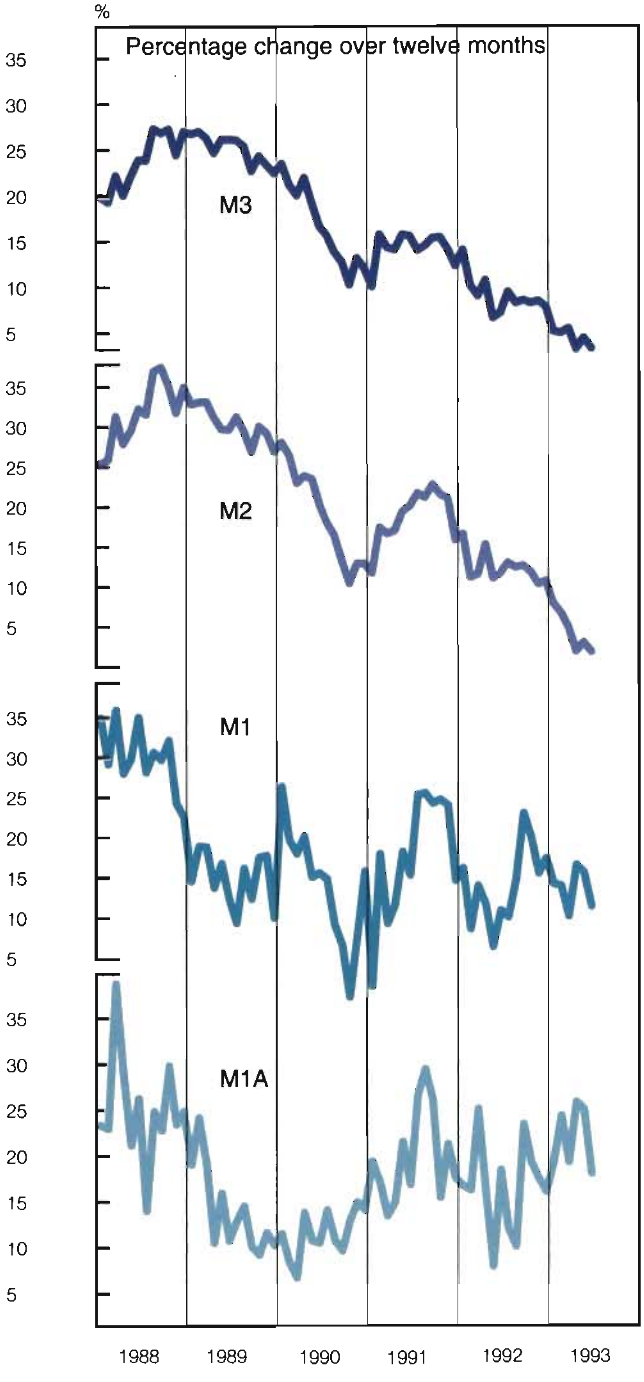
Extension of bank credit

The demand for *bank credit* by the *private sector* in the cyclical downturn of 1989-93 was relatively weak and its behaviour differed considerably from its normal cyclical pattern. In previous cyclical downturns the

Percentage composition of M3

	End of				
	Dec 1989	Dec 1990	Dec 1991	Dec 1992	June 1993
Coin and banknotes in circulation	5,0	5,0	4,8	4,8	5,1
Cheque and transmission deposits	12,6	12,9	13,9	15,3	16,3
Other demand deposits	14,1	14,8	14,6	16,1	15,0
Saving deposits	12,6	11,8	11,0	10,9	10,8
Other short-term deposits	12,7	11,1	11,4	10,8	9,2
Medium-term deposits	25,0	27,0	29,4	29,4	29,3
Long-term deposits	18,0	17,4	14,9	12,7	14,3
M3	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

Monetary aggregates



ratio of bank credit to gross domestic expenditure usually increased sharply until near the end of the downswing and then declined just as sharply until a fairly advanced stage of the upturn in economic activity was reached. In the downturn which started in 1989, the ratio of bank credit extended to the private sector to total gross domestic expenditure also rose fairly steeply at first, but then levelled off significantly in 1990 and probably would already have declined in 1991 if the implementation of the Deposit-taking Institutions Act in February had not led to the reintermediation of certain types of credit. From the beginning of 1992 the rate of growth in bank credit extended to the private sector was lower than the growth in domestic expenditure, and the banks' credit ratio therefore showed a distinct declining tendency.

This abnormal behaviour in the demand for bank credit by the private sector in the current cyclical downturn could probably be ascribed to a number of factors, including:

- the length and severity of the economic downswing;
- the increase in unemployment and less job security;
- a decrease in private consumption expenditure especially the sharp decline in expenditure on durable consumer goods which are normally purchased on credit;
- the decline in and low level of fixed investment;
- the relatively high nominal and real cost of borrowing;
- uncertainties regarding future political developments, which make consumers more hesitant to over-extend their future cash-flow positions; and
- the recent lower rate of increase in salary and wage adjustments.

The rate of increase over twelve months in credit extension to the domestic private sector declined from

Credit extension to the private sector as percentage of gross domestic expenditure

29,2 per cent in October 1988 to 12,8 per cent in January 1991 and fluctuated between 14 and 19 per cent during the rest of 1991 before declining to a low of 7,0 per cent in November 1992; it rose again moderately to 8,8 per cent in March 1993 and then declined again to 7,0 per cent in June. An analysis by *type of credit* of the monetary institutions' claims on the private sector shows that the slow growth in this type of credit during 1992 and the first half of 1993 was due mainly to relatively lower rates of increase in instalment sales, leasing finance and so-called "other loans and advances". However, pre-emptive purchases in anticipation of an increase in the value-added tax rate and a rise in the purchases of new motor vehicles because of the introduction of a number of new models and the fear that the prices of some cars may rise in view of the depreciation of the rand, caused an upward movement in the growth in instalment sales in the first half of 1993.

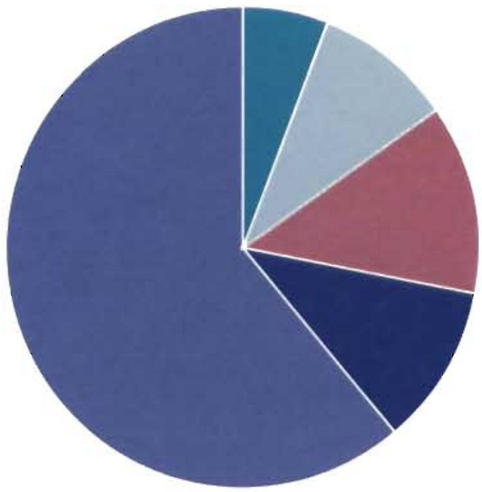
The demand for mortgage advances with monetary institutions remained buoyant during 1992 and the first half of 1993, despite a significant decrease in the nominal value of transactions in real estate. The growth rate over twelve months in mortgage advances declined somewhat from 18,0 per cent in December 1991 to 17,3 per cent in December 1992 before rising again to 17,5 per cent in June 1993. This type of credit remained attractive to borrowers because of the flexibility of some of the mortgage schemes (allowing funds to be utilised for a number of purposes), and the comparatively low mortgage rate, which improves the borrower's cash flow position. The banks also actively promoted this type of credit on account of the lower capital requirements applicable to such advances. The ratio of monetary institutions' mortgage lending to total credit extended by them to the private sector therefore increased from 36,4 per cent in December 1991 to 42,0 per cent in June 1993.

Credit extension to *individuals* as a ratio of total credit extension to the domestic private sector therefore also increased from 50,8 per cent in December 1991 to 52,3 per cent in June 1993. As could be expected, the rise in this ratio was mainly related to a corresponding rise in the relative share of individuals' mortgage advances to their total bank credit. In June 1993 mortgage lending accounted for nearly two-thirds of total credit extended to individuals by monetary institutions. Credit in the form of instalment sales and leasing finance to individuals from banks and the percentage share of "other loans and advances" (excluding overdrafts) to total bank credit of individuals decreased in relative importance. In contrast to these developments, the relative shares of individuals' outstanding debit balances on credit cards and overdrafts at banking institutions increased somewhat.

The composition of bank credit extended to *companies and close corporations* (amounting to

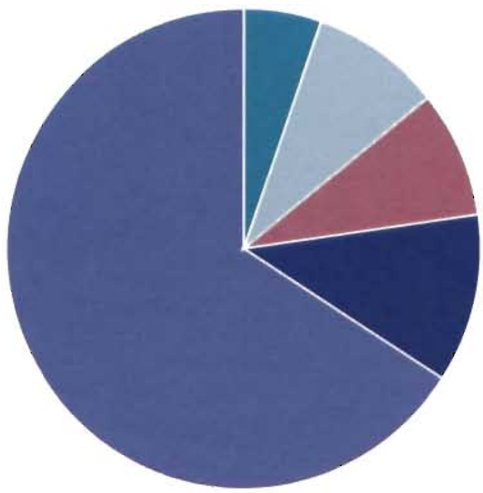
Credit extension to individuals

December 1991



*Including credit card credits

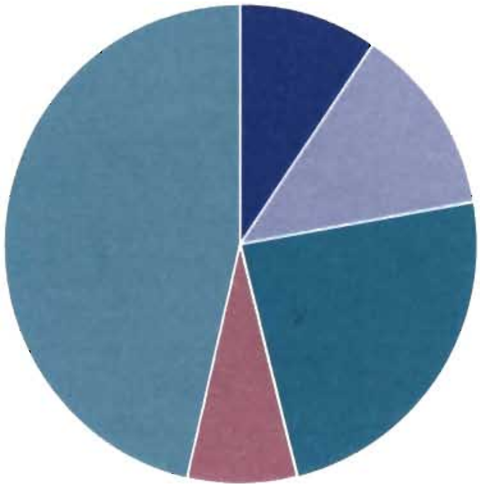
June 1993



*Including credit card credits

Credit extension to companies

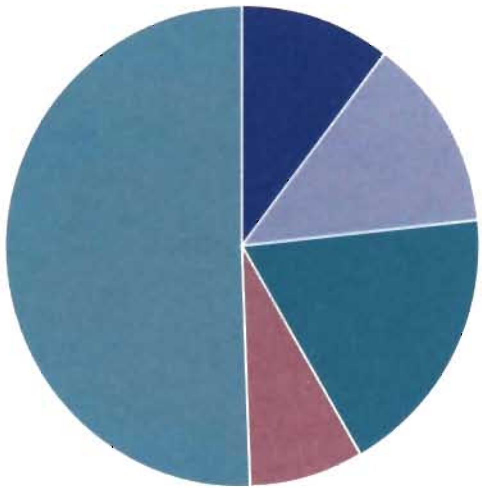
December 1991



Leasing	9,5 %
Instalment sales	12,8 %
Other loans and advances	46,4 %
Other*	24,0 %
Mortgages	7,4 %

*Including investments, bills and credit card credits

June 1993



Leasing	10,4 %
Instalment sales	13,2 %
Other loans and advances	50,3 %
Other*	18,1 %
Mortgages	8,0 %

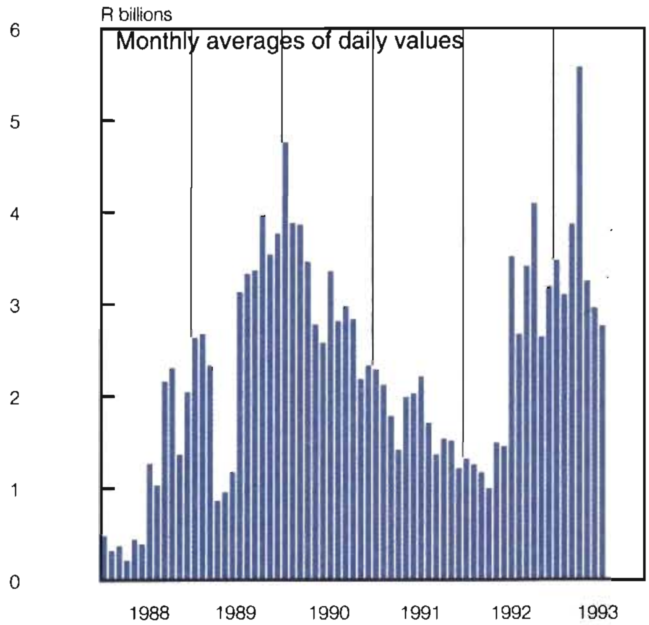
*Including investments, bills and credit card credits

about 37,3 per cent of total credit extended in December 1991) also changed quite significantly in 1992 and the first half of 1993. In particular, the relative share of "other loans and advances", instalment sales, leasing finance, mortgages and investments increased, while decreases were recorded in the relative share of overdrafts and bills held by the banks.

Money market conditions and Reserve Bank operations in the money market

Money market conditions, which had been relatively easy from early 1990 until April 1992, became fairly tight in the next six months, eased moderately in November and December 1992 and then tightened again in the first seven months of 1993. This was clearly reflected in the *average daily accommodation* at the discount window, which declined slightly from an already low R1,2 billion in December 1991 to R1,0 billion in April 1992; it then rose to R4,1 billion in October, decreased to R3,2 billion in December 1992 and increased again to R5,6 billion in April 1993. Although the average daily level of accommodation receded to R3,3 billion and R3,0 billion in the subsequent two months, this did not reflect an easing of money market conditions; the money market shortage simply adapted to a lower but still restrictive level under the new system of accommodation provided by the Reserve Bank. In July the average daily accommodation declined slightly further to R2,8 billion.

Accommodation at the discount window



The tighter money market conditions during 1992 were brought about mainly by a deterioration in the overall balance of payments position, a higher average level of government deposits with the Reserve Bank in the first ten months of 1992, an increase in notes in circulation and the imposition of an additional cash reserve requirement of 1 per cent against the short-term liabilities of banking institutions. The temporarily easier conditions in the last two months of 1992 were due mainly to a decrease in government deposits with the Reserve Bank. Government deposits subsequently increased again in the first six months of 1993 and this factor, together with a further decrease in the net gold and other foreign reserves, kept the money market relatively tight.

The *actions of the Reserve Bank* in the money market during 1992 were at first aimed at neutralising excess liquidity by means of foreign exchange intervention swaps, the issuing of special short-dated Treasury bills and Reserve Bank bills, and the imposition of the supplementary cash reserve requirement on the banks. During the second half of 1992 and the first seven months of 1993 the operations of the monetary authorities consisted mainly of neutralising short-term fluctuations by adjusting the asset portfolio of the Corporation for Public Deposits. In view of the implementation of the new system of accommodation from the beginning of May 1993, the Reserve Bank deliberately brought the money market shortage more in line with the availability of paper that can be used as collateral for such lending to the banks. This was achieved by the reduction of the minimum cash reserve requirement that banks have to comply with, by means of buy-back arrangements, and by the transference of funds from the Exchequer and Paymaster-General Accounts to the banks. On 31 July 1993 the government funds placed with banks amounted to R6,0 billion.

In performing the *function of funding government debt*, the Reserve Bank also influenced the money market by selling Treasury bills and government stock. The total amount of Treasury bills offered at the weekly tender was increased from R200 million at the end of December 1991 to R300 million from 20 March 1992; this weekly tender amount was then lowered to R250 million on 25 September 1992, but increased again to R350 million on 12 February 1993 and to R400 million on 30 April 1993.

The Reserve Bank's transactions in government stock increased substantially in 1992 and the first half of 1993 in a deliberate attempt to further develop the market for this stock. *Gross sales of government stock* by the Reserve Bank amounted to R112 billion in 1992 and to R86 billion in the first six months of 1993, compared with R29 billion in 1991 and R37 billion in the first half of 1992. Owing to the role of the Reserve Bank as a "market-maker" in government stock, the increased liquidity in this market caused the yield on long-term government stock to recede to below the corresponding yield on Eskom stock, while it also enhanced transparency, market depth and liquidity. However, in establishing an active secondary market in government bonds, the Reserve Bank became involved in small-value ("retail") transactions, which should rather have been handled by other market participants. Accordingly, the Bank announced that from 1 July 1993 it would only be prepared to enter into larger-value ("wholesale") transactions and would introduce an informal market-making system by appointing market participants to handle retail trade on its behalf; this led to a moderate decrease in gross sales of government stock by the Reserve Bank from R15,2 billion in June 1993 to R14,2 billion in July.

Net sales of government stock by the Reserve Bank rose from R11,6 billion in 1991 to R14,6 billion in 1992, reflecting the larger deficit before borrowing of the Central Government. The net sales of government stock amounted to R9,0 billion in the first six months of 1993, against R11,2 billion in the corresponding period in 1992.

Money market interest rates

The downward trend in money market interest rates, which had started in February 1990, gathered momentum during the first nine months of 1992. Money market interest rates eased slightly further in the last part of 1992 and eased more rapidly again in the first two months of 1993; they hardened somewhat in March and April 1993 related to pressures exercised by a decline in the country's net foreign reserves, but eased marginally in May to July. The general downward trend in money market interest rates could be attributed mainly to the lower demand for funds and expectations of a downward adjustment in Bank rate.

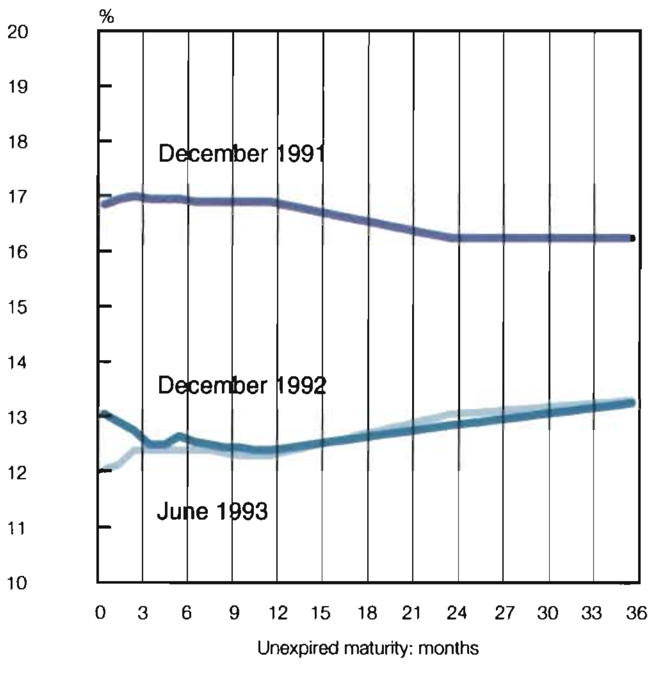
This downward movement in money market interest rates was clearly reflected in the rate on *three-month liquid bankers' acceptances,* which declined sharply from 16,40 per cent at the end of December 1991 to 12,55 per cent at the end of September 1992 and slightly further to 12,40 per cent at the end of December 1992. This rate then contracted to 12,15 per cent at the end of January 1993 and more sharply to 11,60 per cent at the end of February reflecting the reduction of Bank rate by one percentage point on 9 February 1993. The liquid bankers' acceptance rate fell into disuse in March 1993 with the announcement that the liquid-asset status of bankers' acceptances would be terminated from 1 May 1993.

Although on a slightly higher level, the general pattern of money market interest rates was also reflected by the rate on *three-month non-liquid bankers' acceptances.* This rate also declined, from 16,65 per cent at the end of December 1991 to 12,65 per cent at the end of 1992 and to 11,80 per cent at the end of February 1993; it then increased to 12,30 per cent at the end of April before receding to 11,80 per cent at the end of July 1993.

Most other money market interest rates recorded declining movements similar to the rate on three-month bankers' acceptances. The *inter-bank call rate*, for instance, declined from 16,00 per cent at the end of December 1991 to 12,25 per cent at the end of December 1992 and to 10,50 per cent at the end of March 1993; however, it increased again to 11,50 per cent in July 1993. In contrast with these developments, the *three-month Treasury bill tender rate* also declined from 16,13 per cent at the end of 1991 to 11,32 per cent at the end of February 1993, but decreased even further to 11,02 per cent at the end of April 1993; this further decline was probably related to the increased status of this money market instrument in the system of accommodation at the Reserve Bank. This rate then rose again to 11,67 per cent at the end of July 1993.

Changes in the *yield curves for negotiable certificates of deposit* also clearly reflected the downward movement in money market interest rates during 1992 and the first half of 1993. As shown in the accompanying graph, the somewhat downward-sloping yield curve for negotiable certificates of deposit in December 1991 was transformed to an upward-sloping curve in December 1992 at a significantly lower interest rate level. The corresponding yield curve for June 1993 remained more or less on the same interest rate level, but turned into a more upward-sloping curve for unexpired maturities of twelve months and longer than at the end of 1992; this indicated the market's perception that money market interest rates may rise again towards the middle of 1994.

Yield curves for negotiable certificates of deposit



As already mentioned, the progress towards financial stability in 1992 and the first half of 1993 made it possible for the Reserve Bank to lower Bank rate on three occasions in 1992 and again in February 1993 by one percentage point in each case. The *prime lending rate* of banks followed these reductions and was also reduced by one percentage point on three occasions during 1992, to 19,25 per cent on 1 April, 18,25 per cent on 6 July and 17,25 per cent on 23 November. The reduction in Bank rate on 9 February 1993 led to a further lowering by one percentage point of the prime lending rate to 16,25 per cent, with effective dates ranging from 15 February to 2 March 1993 at the various banks.

The inflation-adjusted or *real prime lending rate* fluctuated around 3,5 per cent during the first eight months of 1992 and increased to 5,8 per cent in October and 7,0 per cent in December, because of the decline in the rate of inflation; it then receded again to 6,0 per cent in March 1993 owing to the decrease in the nominal prime lending rate and an increase in the inflation rate. In June 1993 the real prime lending rate still amounted to a comparatively high 5,7 per cent. It should, however, be taken into account that South Africa is still in the process of moving towards financial stability, and that the country's net gold and foreign reserves are still at a low and vulnerable level. This justifies higher real interest rates than in countries where these adjustments have already been made.

Structural developments in the capital market

Further structural changes were introduced or have been proposed in 1992 and the first half of 1993 to enhance the functioning of the capital market, to ensure more equitable competition for funds between different types of institutions, and to improve transparency and liquidity in the markets. Some of the more important developments included the following:

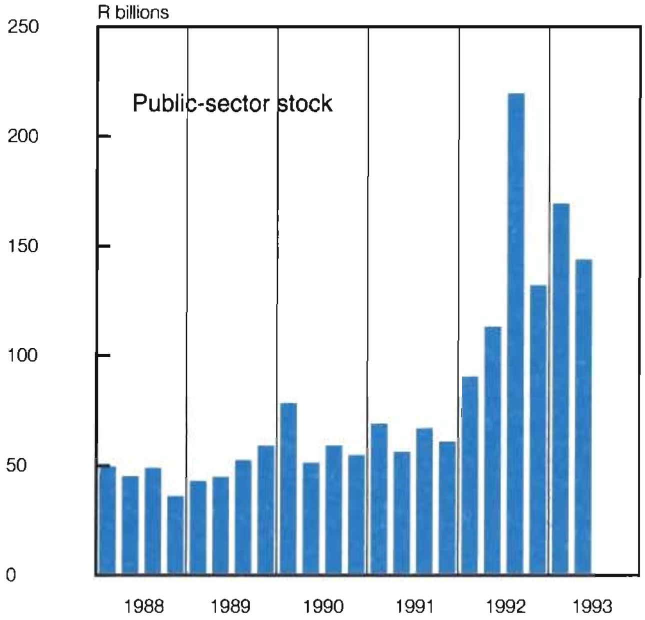
- The *Jacobs Committee* of investigation into the promotion of equal competition for funds in domestic financial markets submitted its recommendations in September 1992. Although some of this committee's proposals have been made subject to further investigation, certain recommendations have already been accepted by government. In particular, the government indicated that the "four funds approach" would be implemented as the appropriate tax system for long-term insurers in South Africa. The government also agreed with the recommendation that competitive neutrality be pursued (not only between life assurers and other financial institutions, but also between various types of policy holders) by not imposing requirements that distort the flow of savings through the financial markets.

- The *Mouton Committee* of investigation into a retirement provision system for South Africa submitted its report in November 1992. Steps were subsequently taken by the Financial Services Board to develop consensus in the financial community on the most important proposals of this committee, such as those regarding contributions to pension funds, supervision, minimum disclosure and the appointment of an ombudsman.
- The *Melamet Committee* completed its investigation into the feasibility of a "holistic" approach to financial supervision of financial institutions, financial services and banks; and enabling legislation for the regulation of the activities of persons who are not currently regulated or under sufficient financial supervision but who act as intermediaries or advisors in respect of financial services to the public. On 29 June 1993 the government announced that it had decided that it was not yet time to integrate the offices of the Registrar of Banks, the Financial Services Board and the Registrar of Companies, but regulatory responsibility for all these activities was extended to the Finance Minister and it was decided to set up a co-ordinating statutory Policy Board for Financial Services and Regulation.
- Most of the members of the *Bond Market Association* were exempted from the provisions of the Financial Markets Control Act because of the delays in establishing a formalised gilt market under the auspices of the Association. The Financial Services Board announced in June 1993 that there would be a phased implementation of the Bond Market Exchange, allowing for the manual reporting of transactions in the bond market, the introduction of a central depository, the creation of full electronic clearing and settlement, and the setting-up of a guarantee fund to safeguard the interests of investors. In the meantime, the Johannesburg Stock Exchange will continue to operate the formal gilt trading floor and clearing house, probably until April 1994. In July the Financial Services Board stated that the bond market would be formalised from 17 July 1993 and that all bond transactions would from that date have to be made through a member of the Bond Market Association.
- A consortium of seven banks applied to the Financial Services Board, in terms of the provisions of the Safe Deposit of Securities Act of 1992, for the registration of a *Central Depository* in Johannesburg, and the first such central depository was licensed in June 1993.
- Deregulation and further technological innovations allowed the banking sector to become increasingly involved in securities business and enabled the corporate sector to use the capital market to a greater extent, with banks assisting not only as financial intermediaries but also as agents.
- The *Community Growth Fund* was established as the first private-sector "socially responsible" investment fund, based on a partnership between organised labour and the financial sector. It will mobilise the funds of over 30 per cent of the trade union movement, for investment in listed shares on the Johannesburg Stock Exchange.
- The permission for non-residents and emigrants to participate in Transnet's "Elfi"-issues was withdrawn, but the Reserve Bank agreed to their participation in the Johannesburg Stock Exchange's Traded Options Market.
- Eskom placed the first issue of its so-called Electrification Participation Notes (essentially project bills) to finance socio-economic electrification projects in co-operation with the Investment Development Unit of the Life Offices Association and members of the Institute for Retirement Funds in May 1993. The issue was well subscribed, despite the lower-than-going-market rate offered, and R580 million was allocated. Eskom also announced that further such issues would be placed during the next three years to cover the estimated cost of electrifying one million homes.
- Two large holding companies announced steps to *unbundle* their holdings, and other companies are expected to follow suit, after the Income Tax Act was amended to accommodate the process of selling-off associated and subsidiary companies.
- The Unit Trust Advisory Committee recommended that equity unit trusts should be allowed to use derivatives subject to certain provisions.
- The People's Benefit Scheme was launched at the end of June 1993 which, based on the stokvel concept, will provide loans to the informal sector of up to 150 per cent of their investments in a unit trust or a fixed deposit in the scheme.

Secondary capital market

The level of activity in the secondary capital market not only remained high during the current economic downswing, but achieved new record levels as the recession deepened. The value of *public-sector stock traded* on the Johannesburg Stock Exchange in the current economic downswing reached levels that were out of step with an almost uninterrupted decline in general economic activity. After having increased significantly in 1990 and more moderately in 1991, the value of public-sector stock traded on the Stock Exchange rose by 121 per cent, to R551 billion, in

Stock exchange transactions



1992. The rise in the level of trading activity from R60 billion in the fourth quarter of 1991 to R218 billion in the third quarter of 1992 was influenced considerably by the continued softening of interest rates and a sharp decline in share prices. With the firming of the yield on long-term government stock, trading activity then receded to R131 billion in the fourth quarter before bullish expectations of a lowering of Bank rate pushed it even higher to R168 billion in the first quarter of 1993. The value of transactions in public-sector stock decreased slightly again to R143 billion in the second quarter of 1993, owing to a smaller number of trading days during this quarter and a firming of yields.

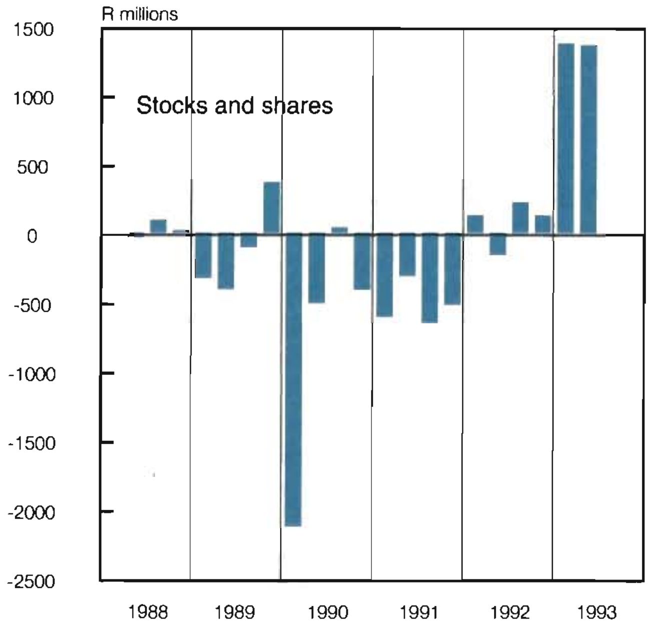
The attractive gilt market placed downward pressure on the turnover in shares. After having decreased by 7 per cent to R22,2 billion in 1991, the total *value of shares traded* on the Johannesburg Stock Exchange in 1992 amounted to R22,1 billion – a further ½ per cent lower than the turnover in 1991. However, the value of shares traded then rose sharply from an average quarterly amount of R5,5 billion in these two years to R8,0 billion and R10,8 billion in the first two quarters of 1993. The decline in short-term interest rates, increased net purchases of shares by non-residents and the higher rand price of gold provided considerable support to the share market in the first six months of 1993.

Non-residents were net sellers of shares and net purchasers of public-sector stock for most of the period since the commencement of the recession. However, from July 1992 non-residents began moving out of stock and into shares as the yield on long-term government stock continued to weaken and share prices were being perceived as having reached attractively low levels. In the twelve months to June 1993, non-residents were therefore net purchasers of stock to the amount of R267 million and net purchasers of shares to the amount of R2,8 billion.

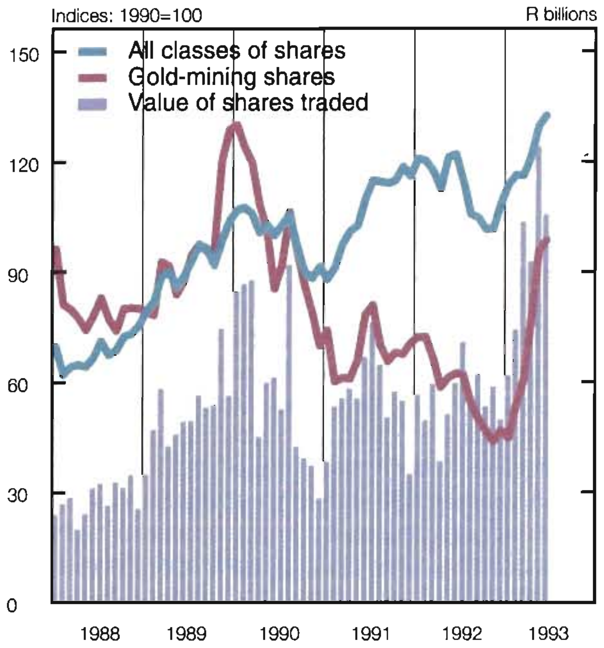
Share prices have to a large extent been supported throughout the economic downswing by the decline in the number of shares traded until the beginning of 1993. The unwillingness of institutional investors to part with blue chip investments, and amendments to legislation which provided for greater freedom in portfolio selection by these investors, served to support and even place upward pressure on share prices. Apart from mining share prices, which were significantly lower, the average monthly price levels of all other classes of shares were generally sharply higher than their levels at the beginning of the recession in 1989.

After having reached a record monthly average peak in June 1992, the average price level of all classes of shares fell by 16,5 per cent in the following five months. Uncertainty on the local equity market arising from disappointing corporate financial results, sharp corrections in the prices of certain shares quoted on international markets, and the deepening recession, were exacerbated by mass action and domestic internal unrest, declining business confidence and increasing turbulence on international equity and currency markets. These factors led to a sharp

Johannesburg Stock Exchange: Net purchases by non-residents



Share prices and value of shares traded



weakening in the prices of especially mining shares, but also in the prices of industrial, commercial and financial shares. The prices of banking and insurance shares, on the other hand, declined only slightly during this period.

In keeping with developments on many of the main stock exchanges in the world, share prices on the Johannesburg Stock Exchange began recovering towards the end of 1992. In particular, the rise in the share prices of gold-mining companies gathered considerable momentum from February 1993, leading to price rises in other classes of shares. These developments moved the average monthly price level of all classes of shares to a new all-time high in June 1993, which was 8,6 per cent higher than in June 1992.

Since starting business on 30 April 1990, the South African Futures Exchange has grown substantially. Although small by international standards in both absolute and relative terms, the value of *futures contracts* traded on this exchange has, since March 1992, consistently exceeded the value of shares traded on the Johannesburg Stock Exchange by a wide margin. Transaction levels were kept high by the recent rise in share prices and uncertainty about the gold price. Divergent expectations resulting from the unexpected instability on international share and foreign exchange markets in the second half of 1992 and the lively local share market during the first half of 1993, also served to stimulate activity on the derivative market to new record levels. Open interest in futures contracts traded on the South African Futures Exchange therefore increased by 64 per cent in the year to June 1993.

Notwithstanding the introduction of scrip-settled options, the acceptance of non-cash collateral and the provision of a mechanism to accommodate non-resident participation, activity on the Johannesburg Stock Exchange *Traded Options Market* weakened during the second half of 1992 and picked up only slightly in January and February 1993 before falling away completely in the next four months. In order to address this problem and at the same time stimulate interest in the Traded Options Market, the Johannesburg Stock Exchange introduced a training programme to educate potential option users.

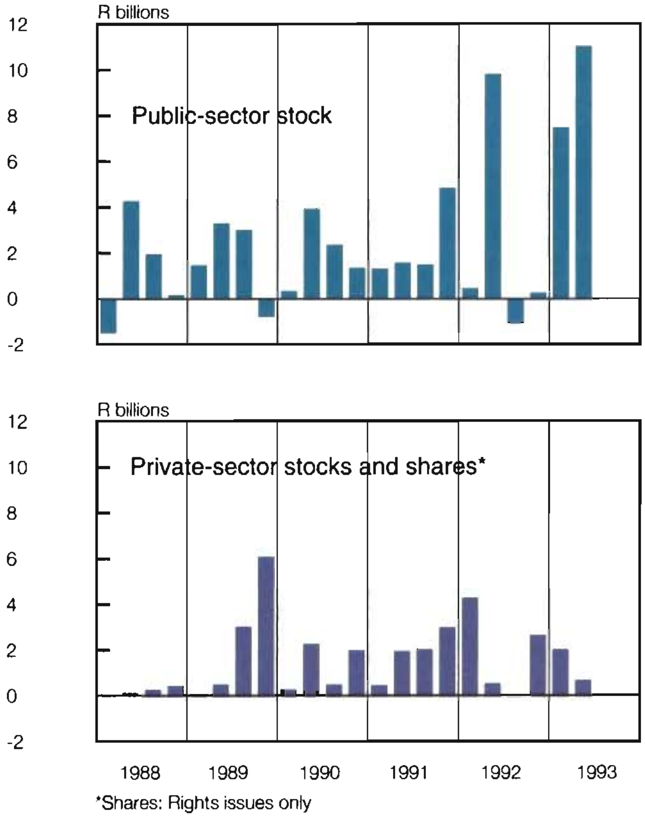
Primary capital market

The demand for funds in the primary capital market by both the public and the private sector in 1992 slightly exceeded that in 1991, despite the continued decline in economic activity, low levels of private-sector real fixed capital formation and an unfavourable environment for share issues. In the first half of 1993 the demand for funds by the public sector increased sharply further, but the funds required by the private sector levelled off.

Net new borrowing by the *public sector* from the private sector through issues of *fixed-interest securities* remained high during the current recession and increased from R7,1 billion in 1989 to R9,3 billion in 1991, and marginally further to R9,5 billion in 1992. By far the major proportion of the budgeted public-sector borrowing requirement had been met in the second quarter of 1992 (i.e. the first quarter of the fiscal year). However, the amount of new issues of public-sector stock increased sharply in the first calendar quarter of 1993 (in contrast to the normal seasonal pattern during the course of a fiscal year), when it became apparent that the actual Budget deficit of the government would be considerably higher than the projected deficit. The value of these issues in the first six months of 1993 amounted to R18,5 billion, compared with R10,3 billion in the corresponding period of 1992.

From the beginning of the economic downswing the value of new issues of fixed-interest securities (including convertible preference shares, debentures and corporate bonds) and ordinary shares taken up by listed companies in the private sector, declined in each ensuing year from R9,8 billion in 1989 to R7,6 billion in 1991, before levelling off in 1992. This sharp drop was a reflection of the significant deterioration in domestic fixed investment and of a substantial decline in the number of listed companies from 778 in December 1989 to 683 in December 1992. During 1992 alone, 30 companies had their listings terminated as a result

Net issues



of poor financial positions.

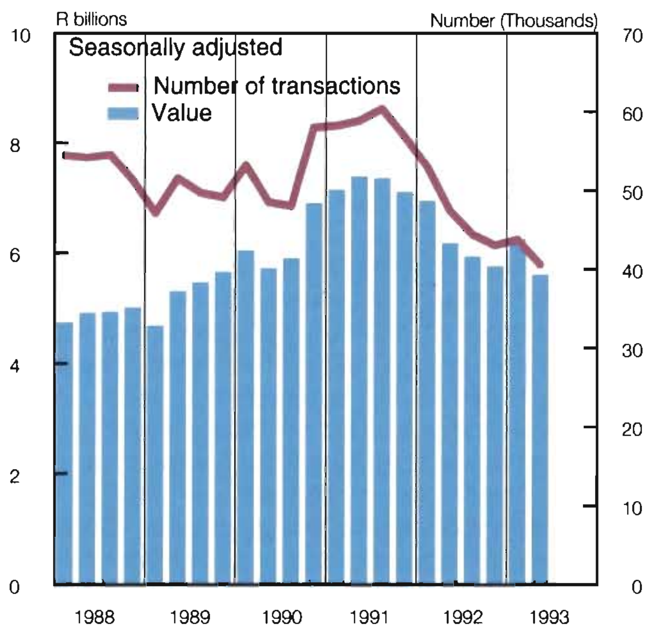
The extent to which corporate enterprises had recourse to the capital market during 1992 was greatly influenced by the conditions that prevailed in the share market during the year. The protracted recession, an easing of lending rates and the decline in share prices in the second half of 1992, affected *share capital issues* adversely from March 1992 onwards. The value of rights issues of ordinary shares decreased to only R11 million in the third quarter of 1992, but increased sharply to R1,7 billion in the fourth quarter after the significant recovery in share prices during that quarter. For the year as a whole rights issues of ordinary shares by listed companies contracted by 21 per cent from R6,0 billion in 1991 to R4,7 billion in 1992. The strong demand for good quality scrip in the first six months of 1993 made share capital issues increasingly attractive again and R2,3 billion was raised in this manner, compared with R1,7 billion in the last half of 1992.

The value of funds acquired by listed companies through new issues of *fixed-interest securities* amounted to R0,4 billion in the second quarter of 1992. No such issues were made during the period July to November 1992, but in December a single issue of corporate bonds amounting to R1 billion was made. In the first six months of 1993 the issues of fixed interest securities by listed companies was R0,5 billion.

In the *mortgage market* the level of activity was kept buoyant by a concerted drive by banks to promote more flexible bond facilities that allow access to relatively inexpensive finance which is not necessarily earmarked entirely for real estate purposes. The total holdings of mortgage loans of these institutions therefore increased from R66,5 billion in December 1991 to R78,5 billion in December 1992. Banks continued to encourage this type of borrowing in the first half of 1993 by providing special concessions to clients in respect of the costs associated with bond cancellation, bond registration and the valuation of fixed property. The average monthly amount of mortgage advances paid out therefore amounted to R2,9 billion in the first five months of 1993 – the same level as in the last half of 1992. The mortgage loans paid out by participation mortgage bond schemes also remained unchanged in 1992 at R1 billion. In the first quarter of 1993 a further amount of R269 million was paid out by these schemes.

Notwithstanding notable further increases in the property portfolios of insurers and pension funds, the *fixed-property market* during 1992 clearly began reflecting the increased severity of the current recession. The annual number of real estate transactions declined for the first time since the commencement of the economic downswing and fell back sharply to 4,8 per cent below the level that had

Real estate transactions



been achieved in 1989. The value of real estate transactions at current prices declined by no less than 14,4 per cent from R29,1 billion in 1991 to R24,9 billion in 1992; the *number* of transactions in fixed property contracted by 19,8 per cent in 1992, while the average value of property transactions rose by only 6,6 per cent. After having declined throughout 1992 – from R7,0 billion in the first quarter to R5,8 billion in the fourth quarter – the seasonally adjusted value of real estate transactions rose quite sharply to R6,3 billion in the first quarter of 1993 (mainly as a result of pre-emptive buying in anticipation of amendments to existing tax legislation) before falling back again to R5,6 billion in the second quarter. The number of property transactions in the first six months of 1993 was still 16,0 per cent lower than in the first six months of 1992, while the average price of such transactions rose by only 7,8 per cent over the same period. The declining level of transactions in fixed property could be ascribed to declining real personal disposable income, increasing uncertainty about political developments in South Africa, and the stagnant commercial and industrial property market, which is characterised by increasing vacancies and lower returns on funds invested.

Capital market yields and interest rates

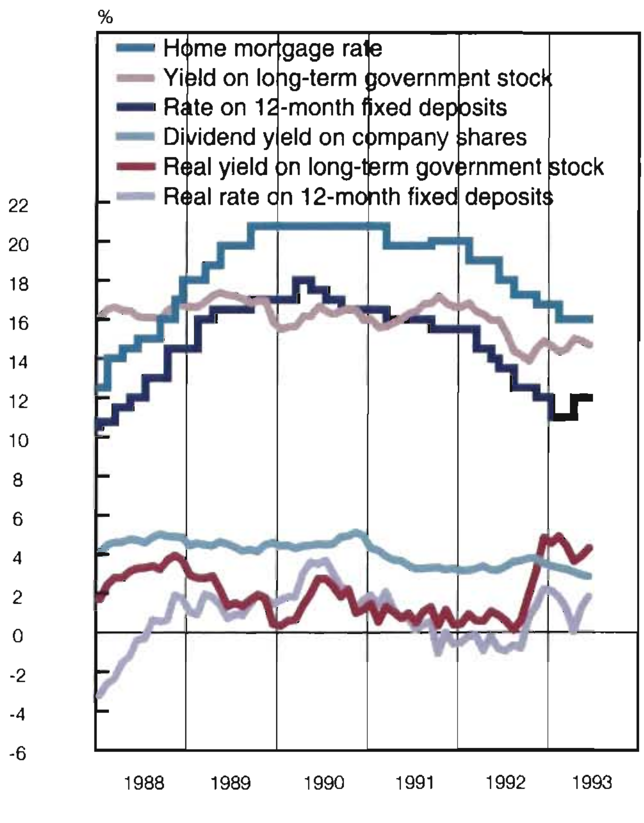
After having declined during the first ten months of 1992, *long-term interest rates* fluctuated at higher levels in the ensuing eight months to June 1993. Fluctuations in the rates on the capital market were mainly a reflection of continued pre- and post-Budget uncertainty regarding the eventual borrowing requirement of the Central Government, alternating inflation expectations, and intermittently unfavourable political developments. Dividend yields, on the other hand, firmed from July 1992 to October and then declined in the following eight months to June 1993.

The average yield on *long-term government stock* declined quite rapidly from 16,9 per cent in February 1992 to 13,9 per cent in October and then fluctuated between 14,4 and 15 per cent in the ensuing eight months up to June 1993. This volatility was the result of a number of factors exerting opposing pressures on long-term nominal interest rates in successive months. Among the factors exerting upward pressure in certain months, were the substantial increase in the borrowing requirement of the Central Government, doubts about the outcome of the Central Government's Budget proposals, the conversion of bank credit of the self-governing states into marketable stock debt, increased disposals of domestic loan stock by non-residents, certain unfavourable political developments, and the depreciation of the exchange rate of the rand. Conversely, the decline in long rates in certain months was a reflection of a more favourable outlook for the inflation rate, the lowering of Bank rate, a softening in short rates, increasing money market liquidity in the last two months of 1992, and the surge in the dollar price of gold.

Real rates on long-term government stock (i.e. nominal rates adjusted for the prevailing year-on-year inflation rate) rose sharply in the fourth quarter of 1992 as a result of the significant drop in the inflation rate and the hardening of nominal rates in November and December 1992. Having softened to a rate of only 0,1 per cent in August 1992, the monthly average real yield on government stock increased to 4,8 per cent in December 1992 (thereby surpassing the most recent peak in this rate of approximately 3,9 per cent that had been reached in November 1988), but eased again to 4,5 per cent in January 1993; it then firmed to 4,9 per cent in February, but declined to a rate of 4,3 per cent in June 1993 because of the higher measured inflation rate.

Mirroring the decline in share prices from July to October 1992 and their recovery from December 1992 to June 1993, the average *dividend yield* on all classes of shares increased from 3,2 per cent in June 1992 to a high of 3,8 per cent in October 1992 and then gradually slipped back to 2,8 per cent in June 1993.

Capital market interest rates and yields



The declining rate on long-term government stock and the increasing dividend yield caused the "inverse yield gap" (i.e. the difference between the yield on long-term government stock and the average dividend yield on all classes of shares) to narrow from 12,8 per cent in June 1992 to 10,1 per cent in October. The inverse yield gap subsequently widened to 11,9 per cent in June 1993.

The average *earnings yield* on all classes of shares (excluding gold-mining shares) increased from 7,3 per cent in June 1992 to a high point of 8,4 per cent in October 1992, but then gradually fell back to 6,7 per cent in June 1993.

The banks' *predominant mortgage bond rate* was reduced in four steps during 1992 from 20 per cent at the beginning of the year to 16,75 per cent on 1 December 1992. After the lowering of Bank rate on 9 February 1993, the mortgage bond rate was reduced further to 16,0 per cent from 1 March 1993. The predominant rate on *twelve-month deposits* with banks, which is regarded as indicative of deposit rates in general, was also lowered in accordance with the decreases in the predominant home mortgage lending rate in 1992. The twelve-month deposit rate was reduced from 15,5 per cent in March to 12,0 per cent in December and then further to 11,0 per cent in February 1993. Without there having been an accompanying increase in the mortgage bond rate, some banks increased the twelve-month deposit rate again to 12,0 per cent in April, while others followed suit towards the middle of May. The margin between the prime rate and the rate on twelve-month deposits consequently fell back to 4,25 per cent in May 1993. The twelve-month deposit rate provided depositors with a positive pre-tax real yield of 1,8 per cent in June 1993.

The maximum permissible *finance charges rates*, as laid down in terms of the Usury Act, were reduced in tandem with reductions in other long rates with effect from 4 December 1992 from 28 to 27 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 31 to 30 per cent in respect of transactions for amounts of up to R6 000. On 31 December 1992 the Minister of Finance announced that money-lending transactions (other than bank overdrafts and credit cards) for amounts of less than R6 000 would be exempted from the provisions of the Usury Act. This step was taken in an attempt to secure a greater willingness on the part of financial institutions to extend credit to the informal sector. The maximum permissible finance charges rates were reduced further on 22 January 1993 to 26 and 29 per cent and again with effect from 12 March 1993 to 25 and 28 per cent, respectively.

The *official rate of interest* as defined by the Income Tax Act (Act No. 58 of 1962) for fringe benefit tax purposes, was reduced by 2 percentage points to 15 per cent with effect from 1 January 1993. However, the *standard interest rate* applicable to loans by the State out of the State Revenue Fund (Exchequer Act, Act No. 66 of 1975) was increased by 0,5 percentage points to 15,5 per cent with effect from 1 January 1993, before being reduced to 14,75 per cent with effect from 1 February 1993; it was then increased further to 15,0 per cent with effect from 1 March 1993 and to 15,5 per cent with effect from 1 May 1993. On 1 July 1993 it was lowered again to 15,0 per cent.

Public finance

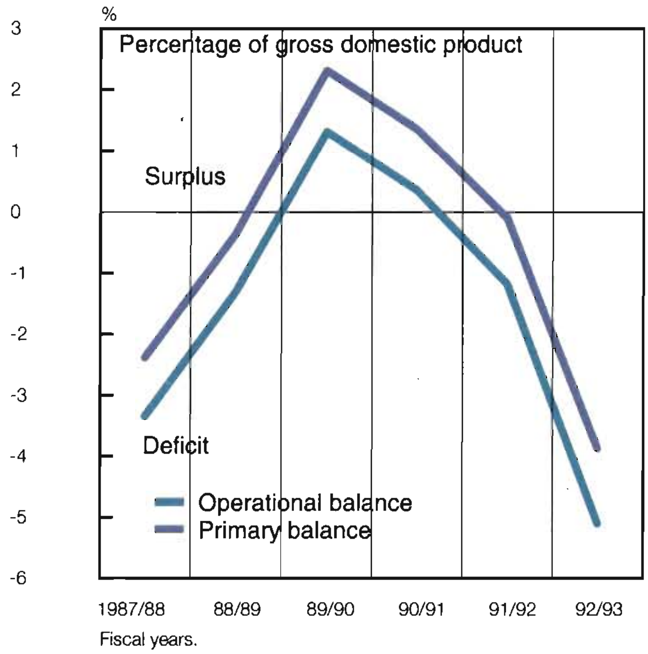
Fiscal policy

The authorities made a significant turnaround in their fiscal policy stance during the recession of 1989-93. At first the limits placed on the growth potential of the South African economy by the large outflow of capital from the country necessitated the maintenance of restrictive fiscal policy measures in fiscal 1989/90. Despite a deepening of the recession, the government persisted with tight measures in 1990/91, but the eventual outcome of the budget was more expansionary than originally intended. In the light of the relatively depressed economic conditions, the dire need for social upliftment of a large part of the population, and the improvement in the overall balance of payments position, a more *expansionary fiscal policy stance* was adopted from fiscal 1991/92.

The subsequent increased emphasis on the stimulation of the domestic economy is clearly illustrated in the accompanying graph by both the so-called "primary" and the "operational" balances of the Central Government* The primary balance as a percentage of gross domestic product changed from a surplus of 2½ per cent in fiscal 1989/90 to a deficit of 4 per cent in fiscal 1992/93. Similarly, the operational balance as a ratio of gross domestic product also turned around substantially, from a surplus of 1½ per cent to a deficit of 5 per cent over the same period. In fiscal 1992/93 both these ratios were considerably lower than in 1987/88 when a stimulatory fiscal policy was also pursued by the authorities.

The deepening of the recession left the Minister of Finance with little scope to manoeuvre in his Budget for fiscal 1993/94. Although the large deficit on the government accounts was unsustainable over the long term, the low level of economic activity necessitated the maintenance of an expansionary fiscal policy stance. The economic conditions made the promotion of employment through the creation of a favourable investment climate and encouragement of greater labour intensity in production, a high priority in determining economic policy. The available resources, in turn, were decisive in determining the priority given to certain expenditure, notably affordable socio-economic and infrastructural development. At the same time it was necessary to

Primary and operational balances



downscale government consumption expenditure to at least reduce the government's budget deficit somewhat.

However, the Minister also gave prominence to the fact that these short-term fiscal policy decisions were being taken not only in the light of immediate exigencies, but also with regard to *longer-term objectives,* such as:

- the restructuring of the economy and the creation of more equal opportunities;
- socio-economic development that will not jeopardise fiscal discipline;
- the necessity of broadening the tax base;
- equal and just treatment of all taxpayers;
- greater emphasis on indirect tax and less on direct tax;
- the simplification of the tax system;
- a reduction of the government's share in the rendering of services that can be provided more effectively by the private sector;
- the implementation of certain structural adjustments to promote income generation and a better distribution of the benefits of economic growth;
- an increasing shift in government spending to social services;
- greater efficiency and stability in government

* The "primary" balance is defined as government revenue *less* government expenditure, excluding interest payments on government debt. The "operational" balance is defined as government revenue *less* government expenditure that includes only the real component of interest payments on government debt.

spending; and

progress with commercialisation, privatisation and deregulation to ensure greater participation in the market economy.

Although various factors – including the prolonged cyclical downswing, the political transition and the uncertainty regarding a new constitutional dispensation – complicated the policies in pursuit of these long-term objectives, the authorities' commitment to *structural reform* was reconfirmed with the publication of the so-called "Normative Economic Model". In this Model a process of structural adjustment is envisaged in order to raise the growth potential of the economy in a financially stable environment. This higher growth is regarded as essential to create job opportunities, to relieve poverty and to improve the quality of life and the pattern of income distribution in the country.

The public-sector borrowing requirement

The stimulatory fiscal policy stance in the current recession was also 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 and non-financial public enterprises). After having decreased to a low of R4,8 billion in fiscal 1989/90 (mainly as a result of privatisation proceeds), the public-sector borrowing requirement rose to R17,0 billion in fiscal 1991/92 and to no less than R32,2 billion in fiscal 1992/93. As a ratio of gross domestic product, the public-sector borrowing requirement amounted to approximately 9½ per cent in fiscal 1992/93, compared with 2 per cent in fiscal 1989/90 and an average of 5½ per cent in the previous five fiscal years. This substantial rise in the borrowing requirements of the public sector was nevertheless financed with relative ease and did not have any crowding-out effects on private-sector borrowers owing to the low demand for funds related to the low level of real economic activity.

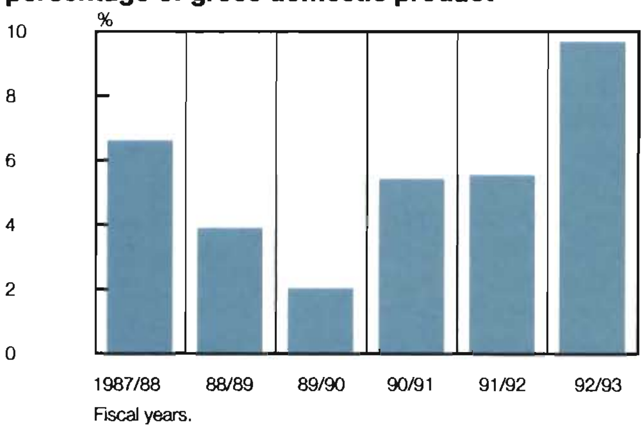
The public-sector borrowing requirement deteriorated despite a considerable improvement in the deficit before borrowing of *non-financial public enterprises* arising from cutbacks in capital spending by these enterprises and other rationalisation programmes to improve their cost-effectiveness. However, the borrowing requirement of *general government* (i.e. the consolidated accounts of the Central Government, provincial administrations and local authorities) rose from R2,1 billion in fiscal 1989/90 to R31,7 billion in fiscal 1992/93. In particular, the borrowing requirement of general government nearly doubled during 1992/93, increasing by 97 per cent.

As shown in the accompanying table, the *borrowing requirement of general government* as a ratio of gross domestic product rose from less than 1 per cent in fiscal 1989/90 to about 9½ per cent in fiscal 1992/93. This increase was the overall result of

General government accounts
Ratios to gross domestic product

	1989/90	1990/91	1991/92	1992/93
Revenue				
Tax revenue	27,9	27,4	26,8	26,1
Non-tax revenue	4,5	4,5	4,7	4,7
Total current revenue	32,4	31,9	31,5	30,8
Capital revenue	0,1	0,1	0,1	0,2
Total revenue	32,5	32,0	31,6	31,0
Expenditure				
Goods and services	21,0	21,8	23,2	23,4
Interest	4,8	4,8	5,1	5,7
Subsidies and current transfers	3,8	4,5	4,6	5,7
Total current expenditure	29,6	31,1	32,9	34,8
Capital expenditure	4,5	4,7	3,2	5,4
Total expenditure	34,1	35,8	36,2	40,2
Net lending to other public entities	–0,7	0,7	0,7	0,3
Borrowing requirement	0,9	4,5	5,2	9,5
Saving	0,6	–1,9	–2,8	–5,1

Public-sector borrowing requirement as percentage of gross domestic product

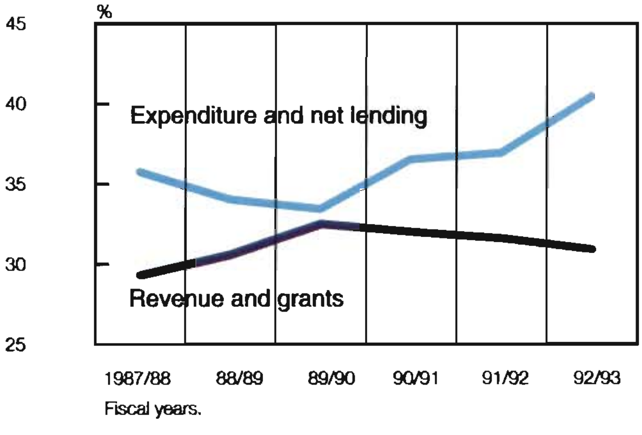


a sizeable upward movement in general government expenditure relative to gross domestic product, while general government revenue as a percentage of gross domestic product decreased moderately.

The ratio of total *general government expenditure and net lending* to gross domestic product increased from 34 per cent in fiscal 1989/90 to 40 per cent in fiscal 1992/93, reflecting the increased demands on general government emanating from the prolonged recession, the political transition, socio-economic backlogs and the severe drought. More particularly, the rise in general government expenditure was related to an increase in interest payments, subsidies to exporters and farmers, transfers, and high salary and wage increases of the employees of general government.

As a ratio of gross domestic product, the total *revenue and grants of general government* contracted from 32½ per cent in fiscal 1989/90 to not quite 31 per cent in fiscal 1992/93. Despite this downward trend, the level of this ratio is still high compared with the average ratio of 29½ per cent in the 1980s, owing mainly to the effects of fiscal drag on personal income tax payments. The decline in the general government revenue ratio in 1992/93 was caused by a lower rate of increase in taxes on net income and profits and on goods and services, and was probably related primarily to the severe downturn in economic activity and the low rate at which value-added tax was introduced.

Revenue and grants and expenditure and net lending of general government as percentage of gross domestic product



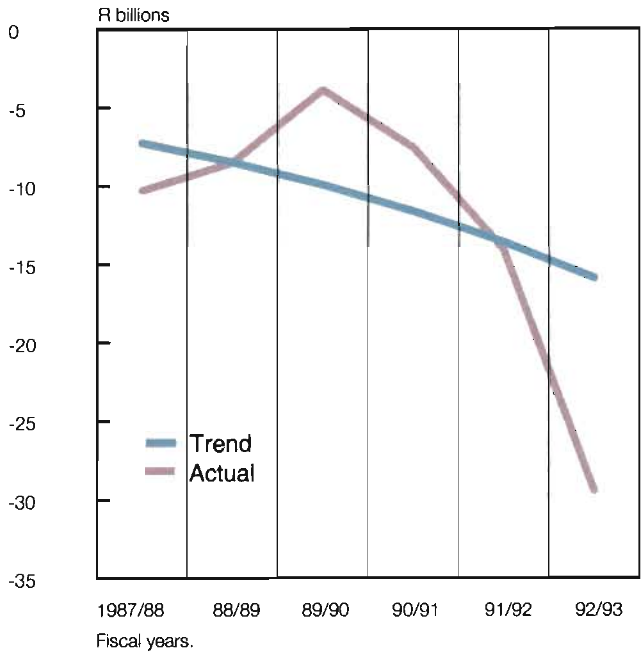
The increasing trend in the borrowing requirement of general government was the net result of significantly different movements in the finances of the several levels of general government. In particular, the borrowing requirement on the Main Budget deteriorated substantially during the current recession from a low of R1,5 billion in fiscal 1989/90 to R31,3 billion in fiscal 1992/93. The borrowing requirement of local authorities, the TBVC countries and most self-governing states also rose fairly sharply over this period, but, of course, at a notably lower level than that of the Central Government. In contrast to these developments, provincial administrations experienced a surplus that rose slightly from R241 million in fiscal 1989/90 to R328 million in fiscal 1992/93. The revenue of extra-budgetary institutions also exceeded their expenditure in 1992/93, probably because of the commercialisation of some of these entities.

Exchequer finances in fiscal 1992/93

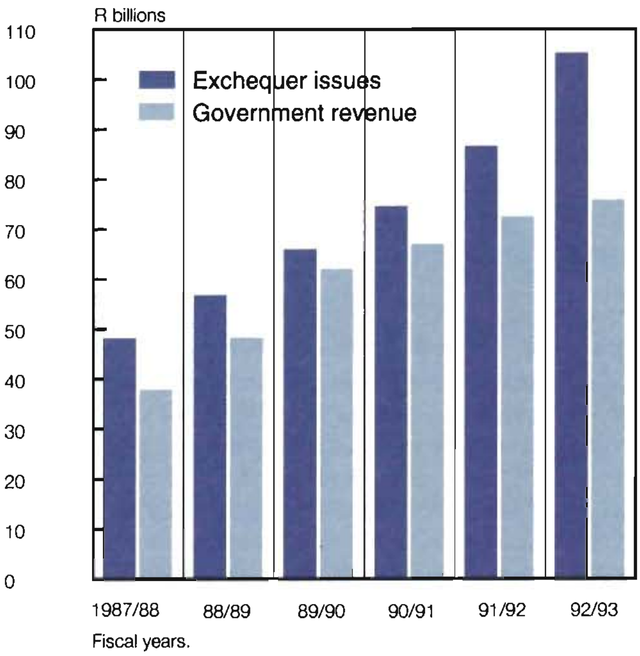
The larger borrowing requirement on the *Main Budget* was due to cyclical as well as structural developments in government finance. As illustrated in the graph, there is a distinct declining trend in the balance before borrowing and debt repayment of the government, which clearly reflected certain adverse structural developments in government expenditure and revenue. In addition to these structural phenomena, the current prolonged and severe recession, combined with the drought experienced in South Africa during 1992, also had a significant effect on the government's finances in fiscal 1992/93. The deficit before borrowing and debt repayment of the government therefore moved markedly below its trend line in this year.

As a result of these developments, *Exchequer issues* to government departments increased by 21½ per cent to R105,1 billion in fiscal 1992/93. This represented an increase of about 11 per cent in *real* government expenditure if this expenditure is deflated by the consumer price index. Because the increase in government expenditure was considerably higher than the increase in domestic production, the ratio of

Deficit before borrowing and debt repayment



Exchequer issues and government revenue

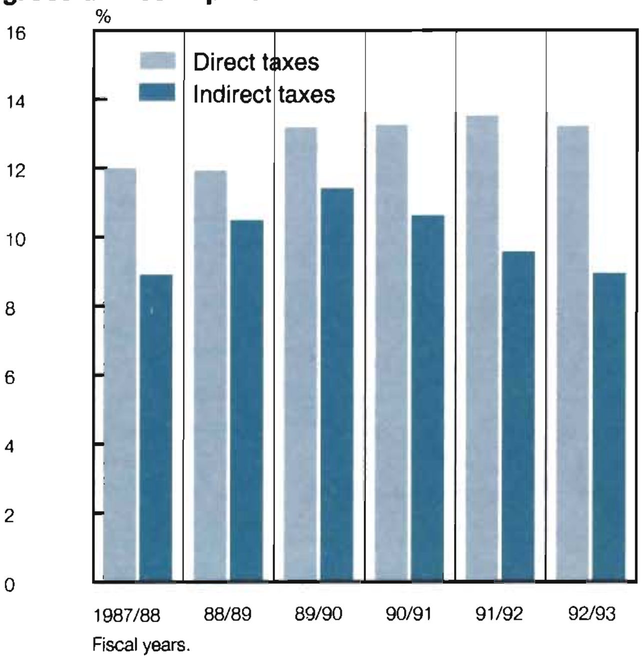


government expenditure to gross domestic product rose from 28 per cent in fiscal 1991/92 to 31½ per cent in fiscal 1992/93. However, the sharp increase in government expenditure was to a large extent due to the drought relief provided to the farming community. When drought-related expenditure of R3,4 billion is not taken into account, the rate of increase in Exchequer issues to government departments at current values amounted to about 17½ per cent in fiscal 1992/93. This was still higher than the rate of increase of 16 per cent in the preceding year and an average annual rate of increase of 16½ per cent in the past five fiscal years.

The drought-related expenditure was also responsible for a substantial increase in the relative share of expenditure on economic services in total expenditure during fiscal 1992/93. When these expenditures are left out of consideration, a *functional classification* of government expenditure indicates that there was a further shift in government expenditure away from protection services to social services in that year. The share of total expenditure allocated to social services has risen from 41 per cent in fiscal 1990/91 to no less than 45 per cent in fiscal 1992/93. Over the same period the share of protection services in total expenditure (especially expenditure on defence) contracted from nearly 22 per cent to just more than 16½ per cent, while the share of economic services remained at about 14 per cent.

Total *government revenue* (on a basis comparable with the Budget) amounted to R75,7 billion in fiscal 1992/93, or to only 4½ per cent more than the revenue collected in fiscal 1991/92. Government revenue as a ratio of gross domestic product therefore continued to decline from a peak of 26 per cent in fiscal 1989/90 to 23 per cent in fiscal 1992/93. Moreover, the declining trend

Total indirect and direct taxes as percentage of gross domestic product

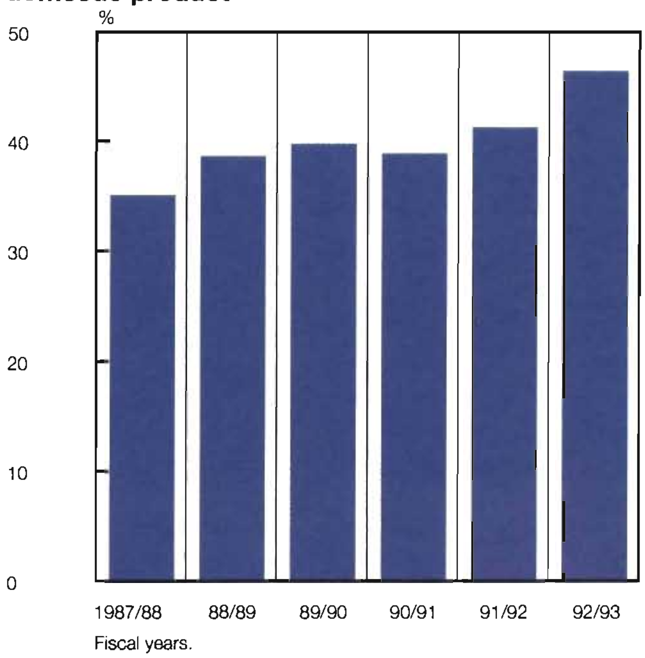


in this ratio was accompanied by a sharp decrease in the proportion of government income collected through indirect taxes. Indirect tax as a proportion of gross domestic product contracted accordingly from just less than 11½ per cent in fiscal 1989/90 to 8½ per cent in fiscal 1992/93. Contrary to these developments, direct taxation continued to fluctuate around a level of about 13 per cent of gross domestic product in the current recession.

Various factors contributed to this poor performance of revenue in fiscal 1992/93, including the long and severe downswing in economic activity, a lower value-added tax rate than originally planned, the exemption of certain foodstuffs from value-added tax, the drought in the country and the downturn in the economies of most of South Africa's major trading partners. In particular, the income from value-added tax decreased by slightly more than 7½ per cent in 1992/93, compared with an average rate of increase of approximately 16 per cent in the preceding five years in the combined proceeds of general sales tax and value-added tax.

Despite the effects of fiscal drag, the income tax receipts from individuals rose at a relatively low rate of only 7½ per cent; in the preceding five years the increase in this tax had averaged nearly 23½ per cent per year. The significantly lower rate of increase in the proceeds from this source was probably the combined result of lower rates of increase in salaries and wages, the decline in job opportunities in the formal sectors of the economy, and the effect of the recession and of the drought on the income of unincorporated enterprises.

Total government debt as percentage of gross domestic product



After having declined in fiscal 1991/92, the receipts from income tax on companies performed better in fiscal 1992/93 and rose by almost 5½ per cent; this rate of increase was, however, also well below the average growth rate of approximately 10 per cent in these tax proceeds in the preceding five years. The income from customs and excise, on the other hand, increased at a fairly rapid rate in fiscal 1992/93.

The high rate of increase in government expenditure and the moderate increase in income in fiscal 1992/93 led to a *deficit before borrowing and debt repayment* of R29,4 billion, or nearly 9 per cent of gross domestic product. This ratio was nearly double the original Budget estimate of 4½ per cent. The deficit was financed in the following way:

	R million
Government stock (including discount on new issues)	32 266
Non-marketable securities	-12
Foreign loans	-342
Treasury bills	40
Change in available cash balances	6 183
Total	38 135
Plus: Transfer from National Supplies Procurement Fund and the Central Energy Fund	1 036
Return on privatisation	108
Less: Transfer to the Gold and Foreign Exchange Contingency Reserve Account	3 777
Transfer to the Government Service Pension Fund	2 000
Discount on new government stock	4 081
Total net financing	**29 421**

No less than R17,6 billion of the gross financing requirement of the Exchequer (i.e. total net financing *plus* the discount on new issues of government stock), or 52½ per cent, was obtained from the non-monetary private sector. The Public Investment Commissioners also provided nearly R14,0 billion (about 42 per cent) of the financing requirement of the government in fiscal 1992/93, compared with R4,6 billion (24½ per cent) in the preceding year. In addition to these two main sources of finance, the monetary institutions contributed R1,1 billion to gross financing, while the Exchequer was able to secure foreign financing of R0,8 billion. The relatively small positive contribution of the monetary institutions to the gross financing needs of the Treasury mainly consisted of an increase in this sector's holdings of Treasury bills deliberately encouraged because of the increasing importance accorded to these instruments in the accommodation process provided by the central bank to other banks.

The monetary sector's ownership of *short-term domestic marketable stock* also rose from R4,8 billion at the end of March 1992 to R5,5 billion at the end of March 1993. The value of these stocks held by insurers expanded even more markedly from R2,4 billion to R5,5 billion over the same period, while the Public Investment Commissioners reduced their holdings of short-term marketable stock from R2,2 billion to R0,7 billion. However, the *long-term marketable government stock* holdings of the Public Investment Commissioners increased substantially from R39,5 billion at the end of March 1992 to R54,5 billion at the end of March 1993. Major increases of R3,2 billion and R6,8 billion were also recorded in the long-term government stock held by insurers and through nominees.

The large budget deficit before borrowing led to an increase of slightly more than 22 per cent in *government debt* in fiscal 1992/93, to R154,7 billion at the end of March 1993. As a ratio of gross domestic product, government debt increased from approximately 41 per cent at the end of fiscal 1991/92 to 46½ per cent at the end of fiscal 1992/93. In the 1980s this ratio averaged 34 per cent. This sharp rise in government debt, the government's commitment to incorporate the debt of the TBVC countries if needed, and the sharp upward trend in interest payments, indicate that the current state of government finance is unsustainable and imply that a better balance between tax revenue and expenditure is required to promote overall financial stability.

The Budget for fiscal 1993/94

As already indicated, the economic constraints on the Budget allowed little scope for manoeuvring and forced the government to determine priorities very carefully. In preparing his Budget, the Minister was guided by two main principles, namely the need for discipline and the need for growth. In accordance with these objectives, the growth in *government expenditure* was restricted to somewhat less than 9 per cent. If expenditure in fiscal 1993/94 remains limited to the budgeted amount of R114,2 billion, Exchequer issues to government departments as a percentage of gross domestic product should decline from 31½ per cent in fiscal 1992/93 to not quite 30½ per cent in fiscal 1993/94.

In order to achieve this low rate of increase in total government expenditure, the *consumption expenditure* of the government in 1993/94 was budgeted to rise by only 8½ per cent, implying only moderate increases in the remuneration of government employees and virtually no growth in the expenditure on other goods and services. After taking a decrease of 7½ per cent in the current transfers of the central government and an increase of 26½ per cent in interest payments on government debt into account, the growth in current government expenditure was budgeted to rise by only 6½ per cent.

In contrast with this moderate rise in current government expenditure, the Budget provided for an increase of 27½ per cent in total nominal *capital expenditure,* excluding capital transfers and loans to other general government institutions and funds. The greater part of this projected capital expenditure will be spent on education, health care and police, with 43½ per cent of capital spending going to social services.

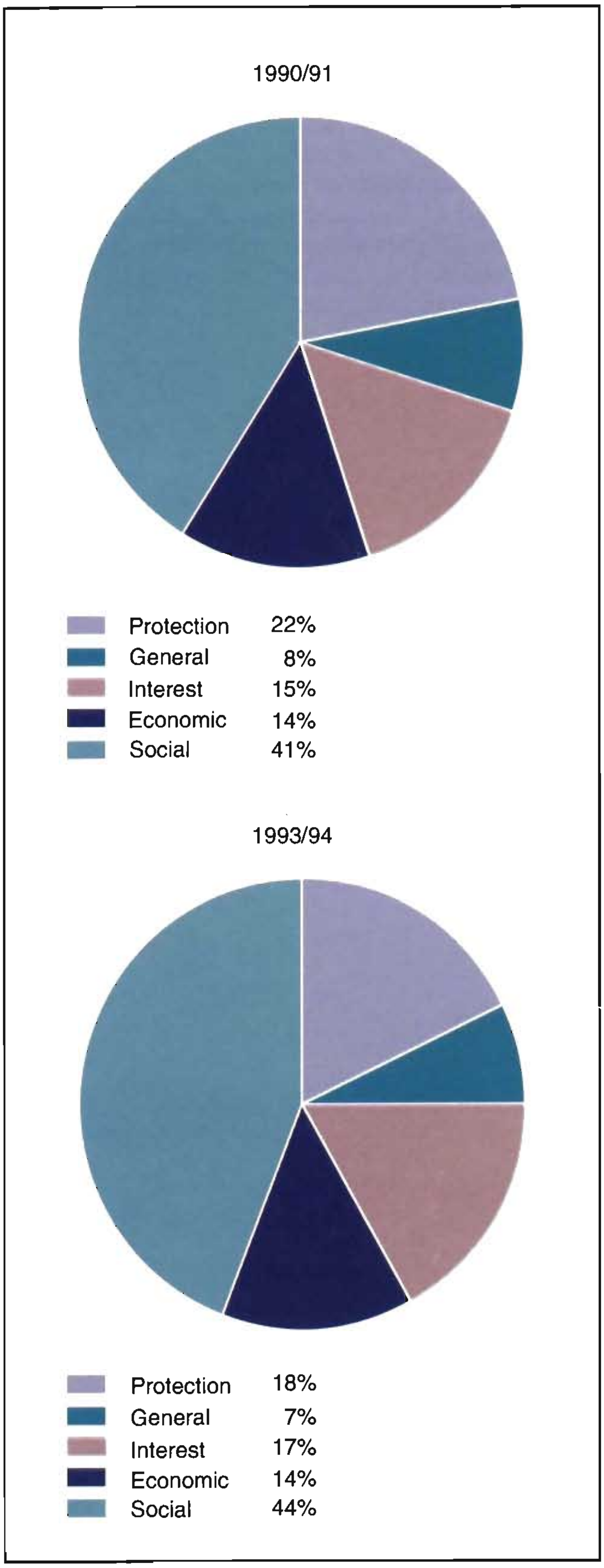
A *functional classification* of government expenditure also indicates that the Budget provided for:

- an increase of only 3 per cent in expenditure on general services;
- a further substantial contraction in the proportionate expenditure on protection services (especially expenditure on defence), with a fairly high rate of increase in expenditure on police and correctional services;
- a continued sharp increase in the expenditure on education and more moderate rates of increase in the spending on other social services, such as social allowances, housing and health care; and
- a decrease in expenditure on economic services, because the payments for drought assistance have fallen away. If these payments are excluded, other economic services were budgeted to increase by 13½ per cent in fiscal 1993/94, with fairly large amounts set aside for export promotion, tourism and the development of small businesses.

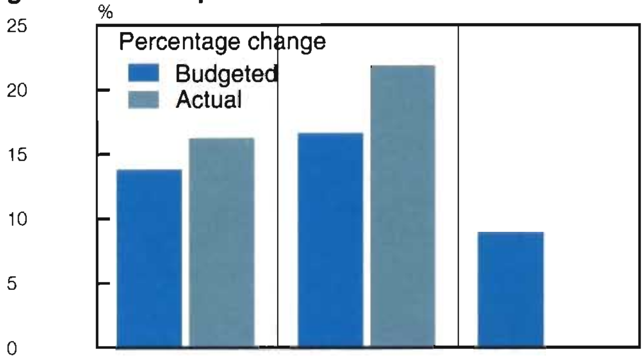
Total ordinary revenue was budgeted to rise by nearly 17½ per cent to R88,2 billion in fiscal 1993/94. This should result in an increase in total *government revenue* as a ratio of gross domestic product from slightly more than 22½ per cent to approximately 23½ per cent in 1993/94 – a sharp reversal of the declining trend of the past three years. Since fiscal 1989/90 the growth in government revenue has averaged only 7 per cent per year. In order to bring about this acceleration in the rate of increase in government revenue, the government is relying particularly on an increase of 43 per cent in the income from value-added tax, because of an increase from 10 to 14 per cent in the rate at which value-added tax is levied as from 7 April 1993 and after taking into consideration the extension of the zero rate applicable to certain goods to cover a wider range of foodstuffs. The government is also relying on an increase of 12 per cent in the receipts from the fuel levy based on growth in the volume of fuel sold and on an increase of 6 cents per litre in the levy on petrol and diesel.

In addition to these measures, the excise duties on certain goods were raised, which should lead to an increase of about 11 per cent in total excise duties. The projected increase in government revenue is also heavily dependent on an increase of 15½ per cent in budgeted income tax receipts from individuals in fiscal

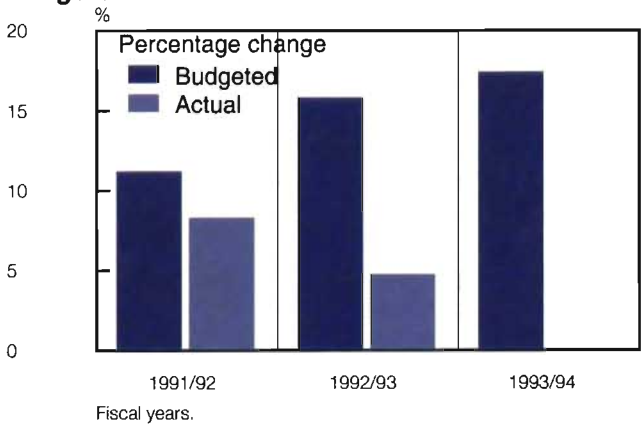
Functional classification of government expenditure as percentage of total government expenditure



Budgeted and actual exchequer issues to government departments



Budgeted and actual revenue



1993/94, owing mainly to the effects of fiscal drag on more moderate salary and wage increases. This rate of increase is considerably higher than the growth of nearly 7½ per cent in fiscal 1992/93.

The other more important changes introduced to the tax system in the Budget included:

- a lowering of the company tax rate from 48 to 40 per cent of taxable income, combined with the introduction of an additional tax of 15 per cent on the distributed profits of companies;
- an increase in the rates at which transfer duty is paid, together with higher exemption limits on the payments of these duties; and
- the abolition of stamp duty on "ordinary" agreements and contracts.

The net result of the projected expenditure and income of the government is an estimated *deficit before borrowing and debt repayment* for the fiscal year 1993/94 of R25,9 billion, or about 7 per cent of the expected gross domestic product. (These estimates differ slightly from those presented by the Minister, because privatisation proceeds have been excluded from ordinary government revenue and are included in the financing of the deficit.) After taking loan redemptions of R6,8 billion into account, the total financing requirement of the government could amount to R32,7 billion. The deficit, excluding loan redemptions, is planned to be financed as follows:

	R million
Government stock (excluding discount on new issues)	24 897
Bonds	50
Foreign loans	-110
Treasury bills	500
Total	25 337
Plus:	
Transfer from National Supplies Procurement Fund and the Central Energy Fund	685
Changes in cash balances (increase-, decrease+)	-78
Total financing	**25 944**

Exchequer account in the first quarter of fiscal 1993/94

Total *Exchequer issues* (after the usual adjustment for changes in the balance on the Paymaster-General Account) in the first quarter of fiscal 1993/94 were 12½ per cent higher than in the corresponding quarter of the preceding fiscal year. This increase in Exchequer issues exceeded the growth rate of nearly 9 per cent that had been envisaged in the Budget for the full fiscal year. As a proportion of total projected government expenditure for fiscal 1993/94, Exchequer issues in the first quarter of 1993/94 amounted to 23½ per cent; this is slightly lower than the average ratio of approximately 24 per cent in the first quarter of the preceding five fiscal years.

Exchequer receipts in the first quarter of fiscal 1993/94 rose by only 13 per cent from the level of the corresponding quarter in the preceding year, i.e. at a notably lower rate than in the Budget estimates for the year as a whole. These lower-than-budgeted receipts could be attributed to some extent to the fact that the "overrun" of receipts from March to April 1993 was much smaller than usual, because of increased efficiency in tax collection. However, as a percentage of total budgeted revenue, Exchequer receipts amounted to 20½ per cent in the first quarter of fiscal 1993/94, which was significantly higher than the corresponding ratio of just more than 17 per cent during the past five years.

In view of these lower-than-budgeted receipts and higher-than-budgeted expenditures, the *Exchequer deficit before borrowing and debt repayment* amounted to R8,7 billion, or to approximately 10 per cent of the gross domestic product. The deficit in the first quarter amounted to about 33½ per cent of the total budgeted deficit for the fiscal year as a whole, compared with an average ratio of 67 per cent in the past five years. The deficit before borrowing and debt repayment, including the discount of R1,8 billion on new government stock issues, was financed as follows:

	R million
Government stock (including discount on new issues)	17 721
Bonds	-18
Foreign loans	-108
Treasury bills	-2 047
Changes in cash balances (increase-, decrease+)	-4 994
Less: Discount on new government stock issues	-1 810
Total financing	**8 744**

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