Annual Economic Report

1994

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-fourth ordinary general meeting to be held on 23 August 1994.

Enquiries relating to this publication should be addressed to:
The Head
Economics Department
S.A. Reserve Bank
PO Box 427
Pretoria 0001
South Africa

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Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

The long recession that the South African economy had experienced from March 1989 came to an end around the middle of 1993, and the economy recovered in the second half of that year. The strengthening of economic activity was reflected in a higher growth rate in gross domestic product and was confirmed by the behaviour of composite economic indicators, such as the leading and coincident business cycle indices. The recovery of economic activity was fostered by favourable weather conditions, which led to a sharp increase in agricultural output, and higher growth in some industrial countries which boosted South Africa's volume of exports. Other factors beneficial to the higher growth included the removal of trade and financial sanctions against the country and the progress made in combating inflation and restoring financial stability.

In the first half of 1994 the upturn in economic activity wavered somewhat as the growth in agricultural output levelled off temporarily and output was affected by exceptional circumstances linked to the processes of political change. Uncertainty about the future political dispensation of the country had an adverse impact on most economic sectors. Labour unrest and work stoppages in the pre-election period and a reduction in work-days arising from the large number of public holidays, brought about lower growth and even declines in the real value added, particularly in manufacturing, gold mining, and the retail and motor trade.

An array of structural weaknesses also continue to impose constraints on the longer-term growth potential of the economy. The more important among these are: the shortage of skilled manpower; the high costs of labour in comparison to skills and training; high non-wage labour costs in the form of labour unrest, work stoppages, strikes and stay-aways; the persistence of uncomfortably high inflation expectations, despite the success achieved in creating more stable financial conditions; the large and increasing involvement of government in the economy; the high tax burden on individuals; the unsustainable size of the government deficit before borrowing; the low level of domestic saving, and high dissaving by government; uncompetitive conditions leading to inefficiencies; and an anti-export bias in the foreign trade policy structure.

In the short term little scope also existed for any policy change in 1993 and the first half of 1994 to stimulate the economy by encouraging domestic demand. Although the long recession has brought about an increase in average unutilised production capacity, many of the major manufacturing sub-sectors are moving quickly towards or are already close to full production capacity. The prolonged period of low investment has also caused an increase in the average age of the South African capital stock. The recent economic recovery consequently had an immediate effect on both real fixed investment and import volumes. In fact, investment in machinery and equipment began to increase even before the revival in economic activity.

The resumption of economic growth also influenced real private consumption expenditure. As a result of the redistribution of income to households with a high propensity to consume, the real outlays on essential goods and services reacted without delay to a rise in personal disposable income. The demand for durable goods also picked up later, causing an increase in consumer credit and a lower growth in households' saving. From the second half of 1993 government consumption expenditure started to increase rapidly; dissaving by the government accordingly remained high. Even though corporate saving was high, the domestic savings ratio receded sharply further in 1993 and the first half of 1994.

The growing demand for investment and consumer goods caused businesses to build up their inventories, which also contributed to the sharp increase in the value and volume of imports. At the same time higher payments on freight and merchandise insurance, tourist expenditure and interest payments on foreign loans resulted in a significant increase in net service and transfer payments to non-residents. In 1993 these increases were offset by corresponding sharp increases in merchandise exports and net gold exports, with the result that a large surplus was maintained on the current account of the balance of payments. However, in the first half of 1994 the growth in merchandise exports slowed down and the surplus on the current account deteriorated. Especially the exports of manufactured goods declined, despite a fairly strong international demand; these exports were probably affected adversely by the exceptional domestic circumstances at that time.

The weaker current account coincided with a continued large capital outflow. Owing largely to political uncertainty, the ongoing internal labour unrest, the high cost of foreign borrowing, debt falling due to non-residents and pressure on the exchange rate of the rand, a massive net outflow of capital was recorded in 1993. This was followed by a smaller but still formidable net outflow of capital in the first half of 1994. The overall balance of payments position therefore became a serious constraint in stimulating economic growth. In order to avoid policy measures that were too restrictive, the authorities had to resort to reserve-related borrowing. The nominal and real effective exchange rate of the rand nevertheless also receded sharply in 1993 and the first half of 1994.

Developments in the monetary sphere also precluded an easing of monetary policy. From the second half of 1993 the growth in money supply began to accelerate and in the first half of 1994 the growth rate of M3 rose above the upper limit of the guideline range for this year. The narrower monetary aggregates increased at an even more rapid pace than the broader aggregates, clearly indicating depositors' rising preference for demand deposits. Although the increase in money supply was partly due to the revival in the domestic economy, it was also related to a considerable rise in the cash flow of business enterprises. Higher company profits, a reduction in government deposits with banks, and a sharp increase in the monetary sector's holdings of government stock, contributed to the large cash flow of the business community. At the same time, the private sector's liquidity preference rose because of uncertain conditions and an expected fall in share and bond prices.

The growth rate in credit extension to the private sector began to advance more rapidly from the middle of 1993 and became positive in real terms in the first half of 1994. Compared with other periods of economic recovery, a normal pattern was discernible in bank credit extension; it did, however, react fairly quickly to the upturn, probably because regulatory changes discouraged disintermediation practices. Mortgage advances, instalment sales credit and leasing finance all had a hand in the increase in bank credit, while the monetary sector's investments and bills discounted actually decreased.

The downward movement in the market interest rates over a period of more than two years was also reversed in the first half of 1994. From February 1994 the yield curve shifted to a higher level without any changes being announced in Bank rate. The continued drain of foreign reserves, tight money market conditions, fears that government finance may get out of hand and crowd out the private sector, net sales of domestic loan stock by non-residents and higher inflation expectations, resulted in higher yields as well as in a steeper slope of the yield curve.

The tight money market conditions in 1993 and the first half of 1994 were mainly due to a substantial decline in the net foreign assets of the Reserve Bank. At times this factor was supplemented by increases in notes and coin in circulation and a decrease in the financing of the Land and Agricultural Bank by the Reserve Bank. The Bank's actions in the money market in 1993 were aimed primarily at preventing conditions from becoming too tight. With the sharp deterioration in the foreign reserve holdings towards the end of the year, the Reserve Bank began to pursue a policy of allowing the market to reflect underlying supply and demand conditions in order to make it difficult for private banks to substitute domestic liabilities for foreign credit facilities; the Bank's policy accordingly discouraged a further outflow of capital from the country.

Only the government was an active borrower in the primary bond market. The private sector's demand for new funds in both the bond and the share market remained low because of the low level of real domestic fixed investment and the cash flow position of business enterprises. Activities in the secondary share and bond markets, as well as in the market for derivatives, remained very buoyant. Non-residents were also very actively involved in the capital market during the period under review and a large part of the volatility in the market was caused by their transactions. Share prices on the Johannesburg Stock Exchange also reached new record levels.

Finally, developments in government finance impeded the pursuit of more lenient policy measures. The public-sector borrowing requirement reached an exceptionally high level in fiscal 1993/94. To some extent this was due to special transfers which did not affect the domestic capital markets. Although no difficulties were experienced in financing the shortfall on the Exchequer Account, the larger size of the borrowing requirement could have a crowding-out effect on private investment in an environment of more vigorous economic growth. The high borrowing requirement of the government naturally also led to a significant increase in government debt and in the cost of servicing this debt.

Considerable emphasis was placed in the Budget for fiscal 1994/95 on the Reconstruction and Development Programme of the government. In view of the large number of unemployed persons and the widespread poverty in South Africa, it is essential that the sustained upliftment of underdeveloped communities and areas remains high on the list of priorities of the government. The acute unemployment problem in South Africa can be alleviated under conditions of accelerated, labour-absorbing, economic growth. Sustainable, high, employment-creating economic growth that will be to the benefit of all South Africans will, however, be possible only in a stable financial environment. A more equitable distribution of wealth and income is difficult, if not almost impossible, to accomplish under conditions of high inflation.

Fortunately, the inflation rate has recently been brought down to single-digit levels last prevailing in the early 1970s; however, relative to South Africa's main trading partners, the current inflation rate is still too high. Measured over four quarters, the growth rate in real unit labour costs actually turned negative from the first quarter of 1993, because labour productivity growth exceeded the lower rates of increase in the real remuneration per worker. The observed increases in labour productivity were partly due to the retrenchment of workers in the formal sector of the economy as part of the rationalisation programmes of the business community. The underlying growth in the productivity of South African workers, however, remains poor. Increases in unit labour costs therefore do not bode well for inflation and could lend support to higher inflation expectations.

Recent aggressive wage demands, combined with the depreciation of the exchange rate of the rand, may frustrate the authorities in their efforts to curb the general rise in prices further. Industrial action, organised labour protest and unrest raise the perceived effective real costs of labour. These actions thereby not only lead to higher price inflation but also reduce the demand for labour and neutralise at least partly the labour unions' efforts to raise the real wages of their members. Such actions accordingly encourage the development of a more capital-intensive production structure, affect business confidence adversely, and hold back private-sector investment. Disorderly labour conditions are therefore detrimental to the objective of high employment-creating economic growth. By restraining output growth, such labour actions also limit the ability of the authorities to achieve the socio-economic upliftment of the population.

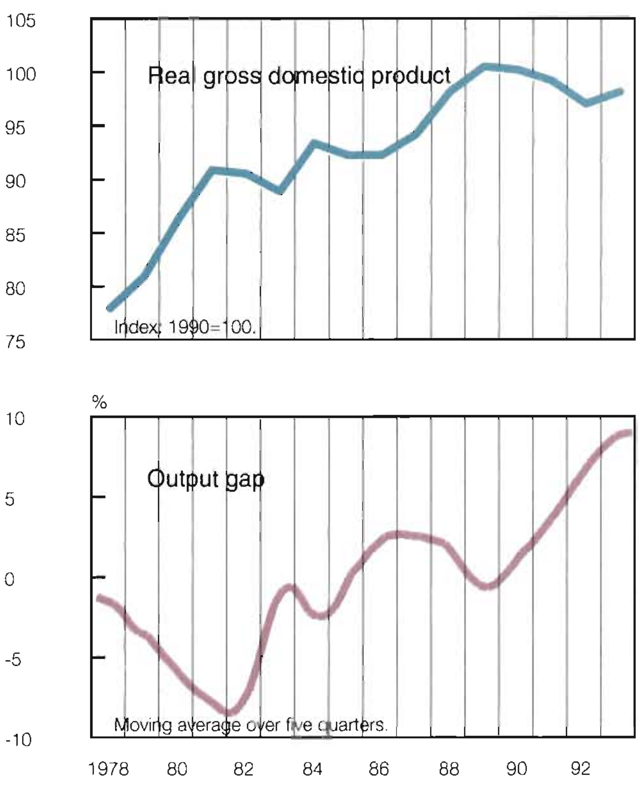
Domestic economic developments

Output and capacity utilisation

The *aggregate real gross domestic product*, which had contracted almost uninterruptedly from the third quarter of 1989, reached a lower turning-point in the fourth quarter of 1992. After having turned positive in the first quarter of 1993, the growth in real domestic output accelerated to an annualised rate of 7 per cent in the third quarter and to 5 per cent in the fourth quarter. In the first quarter of 1994 a sharp drop in the real value added by agriculture from an exceptionally high level in the preceding quarter caused domestic output to recede at an annualised rate of 3½ per cent. This was followed by an increase at an annualised rate of 2 per cent in the second quarter.

The *real gross national product* also rose throughout 1993. Even though some growth momentum was lost in the first half of 1994, real gross national product advanced at an average annualised rate of more than 4 per cent in the six-quarter period up to the second quarter of 1994. If population growth is taken into account, the real gross national product per capita increased at an annualised rate of about 2 per cent from the end of 1992 up to the second quarter of 1994. This increase in real gross national product was the net result of higher domestic output levels and the strengthening of South Africa's terms of trade, which more than offset an increase in real net factor payments to non-residents.

Real gross domestic product and the output gap



Despite the improvement in economic activity, the level of real gross domestic product in the second quarter of 1994 was still well below the upper turning-point in the third quarter of 1989. This poor performance of domestic output naturally resulted in an increase in the unutilised *production capacity of the economy*: the so-called output gap (i.e. the gap between the potential and the actual real gross domestic product) widened considerably from the beginning of the 1990s to a level of approximately 8 to 10 per cent below potential production. This is an approximation of the average utilisation of production capacity and does not signify that all or the majority of economic sectors are producing below production capacity.

A sectoral analysis of the production capacity in manufacturing actually reveals that more than 50 per cent of the major sub-sectors of manufacturing are close to full production capacity or are moving quickly in that direction. The fact that a large number of manufacturers are near or at full production capacity implies that the scope for increasing real growth through a fuller utilisation of existing resources before running into higher import needs or increased price pressures may be smaller than is suggested by the average output gap for the economy as a whole. This is confirmed to some extent by the import penetration ratio of the economy, which is high for this stage of the business cycle, and by the sharp increases in import volumes that have accompanied the recent rise in economic activity.

The low levels of investment spending since the early 1980s have also led to an increase in the average age of the capital stock. This ageing of equipment implies that the excess production capacity of the economy is overstated and carries an obvious risk of increasing technological obsolescence, which has serious implications for South Africa's international competitiveness. It also means that imports are likely to react quickly to an upturn or even to an expected revival in economic activity. The recent changes in investment expenditure and in imports seem to bear this out. As described in some detail below, the imports of machinery and transport equipment began to rise before the end of the 1989-93 recession because investment in machinery and transport equipment began to increase already at that time. Consequently, there is a danger that further increases in domestic demand at this juncture could lead to a comparatively rapid deterioration in the overall balance of payments position which could, in turn, deter domestic growth and fuel price inflation even though the average level of excess production capacity may appear to be high.

Sectoral output

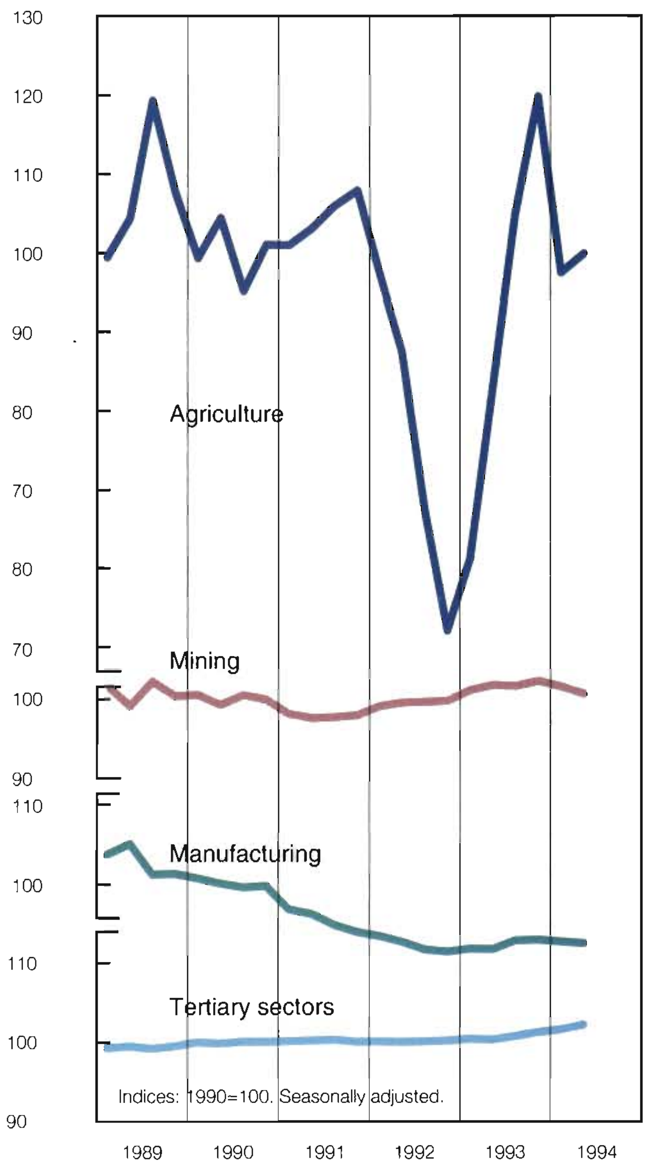
The recovery in domestic output during 1993 and the first six months of 1994 was to a large extent the result of a substantial increase in *agricultural output*. The real value added by the agricultural sector increased by 21½ per cent in 1993, compared with a drought-induced decline of 27½ per cent in 1992. The increase in 1993 could be attributed mainly to a rise in the production of field crops, particularly of maize and wheat. In 1992 only 3 million tons of maize and 1,3 million tons of wheat were harvested; in 1993 these figures rose to 9,1 million tons of maize and 1,9 million tons of wheat. Agricultural production declined somewhat in the first half of 1994 from its exceptionally high level in the last half of 1993. However, maize production in 1994 is estimated at 12,1 million tons in 1994, which will be 33 per cent more than in the previous year.

Since the first quarter of 1993 continuous quarter-to-quarter increases have been recorded in the real output of the *non-agricultural sectors*, but the growth in these sectors' value added slowed down from an average annualised rate of 2 per cent in the last half of 1993 to 1 per cent in the first half of 1994. This slow-down was caused mainly by labour-related difficulties of production.

The real output in the *mining sector*, which had increased at rates of 1½ per cent in 1992 and of 2 per cent in 1993, contracted at an average annualised rate of 3 per cent in the first half of 1994., A decrease in gold-mining production on account of a drop in the throughput of ore and a small decline in the gold content of ore milled, was mainly responsible for this turnaround in total mining production. The coal mines benefited from a stronger demand by Eskom and the Sasols, as well as from the international economic recovery. Platinum output also increased to meet a new peak in autocatalyst demand and a continued strong demand for jewelry. The output of base metals and minerals was generally also favourably affected by purchases by the fast-growing Asian economies.

Growth in the real output of the *manufacturing sector*, which accounts for 23½ per cent of total gross domestic product, showed signs of recovery in the second half of 1993. This recovery, however, faltered somewhat in the first half of 1994, because of the uncertainties of the pre-election period, labour unrest, work stoppages, and a decrease in production days on account of the large number of public holidays.

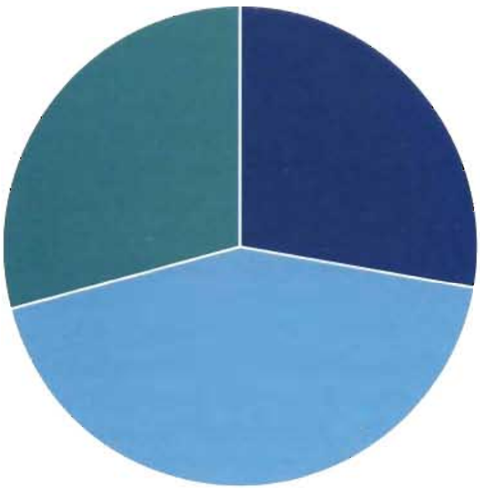
Components of real gross domestic product



After having increased throughout the recession of 1989-93, the real value added by the sector supplying *electricity, gas and water* rose sharply, by nearly 4 per cent, in 1993. This stronger output growth came about because of the on-going electrification of lower-income residential areas, the revival of general economic activity, and an increase in exports of electricity to neighbouring countries. The other secondary sector, viz. the *construction industry*, began to recover towards the end of 1993. The value added in this sector increased at an average annualised rate of 1½ per cent in the first half of 1994, reflecting some improvement in the demand for residential buildings and construction works.

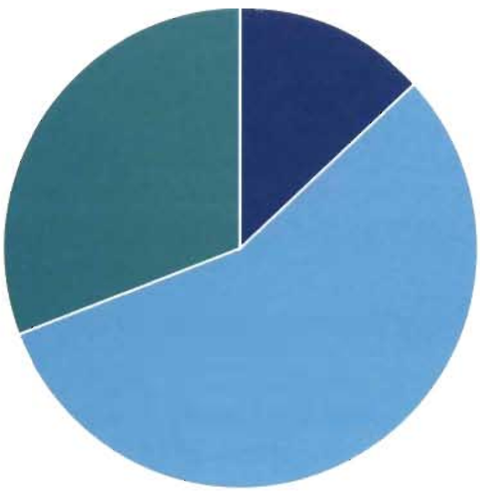
Composition of gross domestic product

1980



Primary	27.9%
Secondary	28.9%
Tertiary	43.2%

1993



Primary	13.3%
Secondary	30.7%
Tertiary	56.0%

The growth in the real value added by the *services sector*, which had become negative in 1992, increased moderately from the second half of 1993, notwithstanding the lacklustre performance of the motor trade. A rise in the volume of foreign trade, the shipment of substantially higher agricultural output volumes, and the strengthening of domestic demand, led to a sharp increase in the real value added by transport, storage and communication undertakings. Continued buoyancy in financial markets also brought about increases in the real value added by financial, insurance and business services throughout 1993 and the first half of 1994.

The more or less continuous increase in the real value added by the services sectors cushioned periodic declines in the aggregate output of the goods-producing sectors and also led to a sharp increase in the relative importance of the tertiary sectors in the domestic economy. Accordingly, the tertiary sector's contribution to gross domestic product rose sharply from 43 per cent in 1980 to as much as 56 per cent in 1993. This more rapid growth in the real value added by the tertiary sector took place at the cost of the primary sector's contribution to aggregate gross domestic product, which receded from 28 per cent to only 13 per cent over the same period, while the share of the secondary sectors rose from 29 per cent to 31 per cent. These shifts in the relative contributions to aggregate output of the various sectors understate the volatility of output in the primary sectors and accentuate the more gradual changes in output that are typical of the secondary and services sectors. The demand for services in particular is less sensitive to changes in income than the demand for output originating in the goods-producing industries.

The increase in the relative importance of the services sector is not unique to South Africa and is generally regarded as a common characteristic of economic development. World trade in manufacturing and services has also grown much faster than trade in commodities, owing to the fact that the share of income spent on basic needs shrinks as the wealth of countries increases. Combined with the introduction of synthetic substitutes, this has suppressed the demand for certain basic metals and has caused the relative prices of commodities to decline in the long term. These broad tendencies in the global economy make economic restructuring and increased productivity and competitiveness all the more urgent for South Africa.

Domestic expenditure

The distinct downward trend in real gross domestic expenditure in the recession of 1989-93 levelled out in the second half of 1992 and the first half of 1993; this aggregate then increased sharply in the second half of 1993 and at a more moderate pace in the first half of 1994. A strong recovery in domestic expenditure

Table 1. Real gross domestic expenditure
Percentage change at annualised rates

	1992	1993			1994
	Year	1st half	2nd half	Year	1st half
Consumption expenditure					
Households	-1½	½	2	½	2
Government	1½	2½	4	1½	6½
Investment					
Fixed	-6	-2½	1	-3	5
Changes in inventories (R millions)	-1 920	515	1 933	1 224	2 454
Domestic expenditure	**-1½**	**1**	**6**	**1**	**4½**

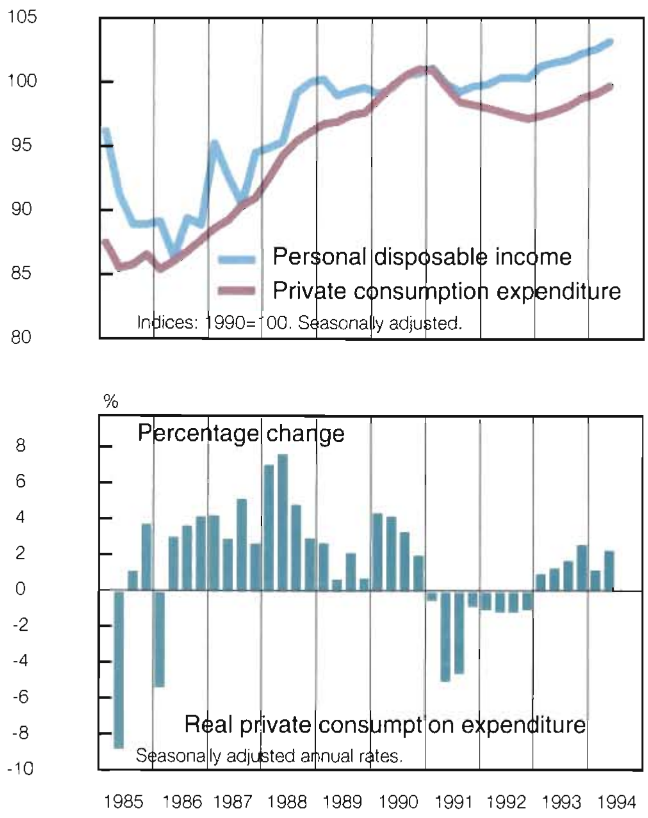
could be observed in all the components of final domestic demand, while inventories valued at constant prices increased from the middle of 1993.

Private consumption expenditure

Real outlays on *aggregate private consumption expenditure* have been rising steadily since reaching a low point in the fourth quarter of 1992. The annualised rate of increase averaged 1½ per cent in the six quarters up to the second quarter of 1994. This recovery in real private consumption expenditure was made possible by an acceleration in the rate of increase in real personal disposable income related largely to improved agricultural conditions. The fall in interest rates since 1991 eased the interest burden of indebted households and enabled them to spend more on consumer goods and services: gross interest payments by households relative to personal disposable income dwindled from a recent high of slightly more than 12 per cent in 1990 to 9½ per cent in 1993.

Although a large part of the increased real outlays on consumer goods and services was financed by an increase in income and although a greater proportion of current income were being spent, the household sector also made use of additional consumer credit to increase consumption expenditure. Borrowing by households, however, increased at a slower rate than income; the ratio of household credit to personal disposable income therefore receded from an average of 25½ per cent during the period 1990 to 1992 to 22½ per cent in 1993. This relatively slower growth in consumer indebtedness was probably due to the fact that consumers became more reluctant to use future income to finance current expenditure in view of the already high level of their debt burden. This is clearly reflected in the levelling-off in households' debt-to-asset ratio, i.e. the ratio of total consumer debt to the value of private dwellings and households' assets of durable goods. After having increased from an average of 45 per cent during the period 1969 to 1984 to 70 per cent in 1990, this ratio remained more or less on this level in the ensuing three years.

Real private consumption expenditure and personal disposable income



At first the revival in consumption expenditure was mainly reflected in a sharper rise in expenditure on non-durable goods and services, but real outlays on durable and semi-durable goods also started to rise very rapidly later. In the first half of 1994 the growth in the last-mentioned two categories again reached a high annualised level of 3 per cent, while the rate of increase in expenditure on non-durable goods and services contracted to 1½ per cent from about 2 per cent in the second half of 1993. Strong increases in the purchases of furniture, appliances and transport equipment by households have become discernible since the second half of 1993.

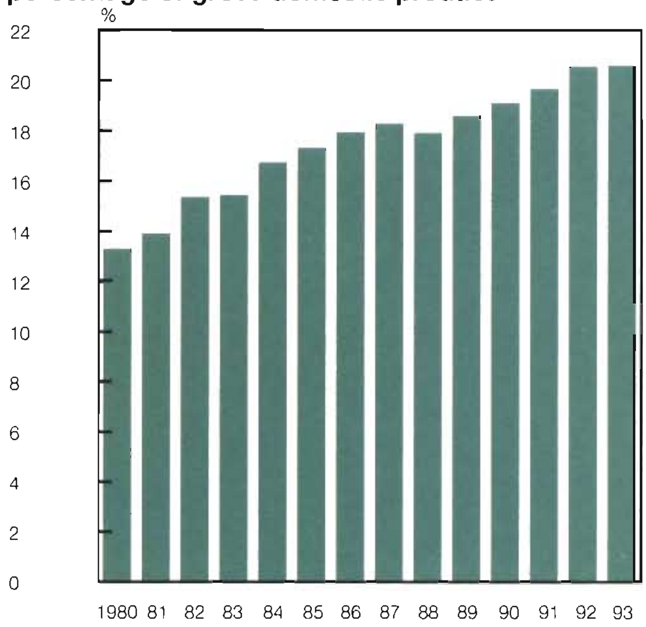
The proportionate expenditure by households on non-durable goods and services is nevertheless still much higher than at the beginning of the 1990s. The ratio of this expenditure to total private consumption expenditure has increased steadily from about 70½ per cent in the early 1980s to 73½ per cent in 1990 and 75 per cent in the first half of 1994, while a corresponding decrease was registered in the relative expenditure on durable and semi-durable goods. Several factors were probably responsible for this development, including:

- the redistribution of income in favour of households with a low income, who spend a larger proportion of income on essential goods and services;
- the relatively high level of consumer credit combined with high interest rate levels, which made consumers reluctant to incur further debt for the purchases of durable goods;
- the recent long recession and consequent cuts in spending on non-essential durable goods;
- the negative effect of high unemployment and lack of job security on the willingness of consumers to increase debt for the purchases of luxury goods;
- the slow growth in income as a result of low overall growth in the economy; and
- the sharp increase in the tax burden of households. Since the early 1980s the ratio of direct taxation to the current income of households more than doubled from 6½ per cent to 13½ per cent in 1993.

Consumption expenditure by general government

After having increased at an average annual rate of 4 per cent in the 1980s, the growth in *total real consumption expenditure by general government* slowed down considerably in the 1990s to an average annual rate of 2 per cent in 1990 and 1991 and to 1½ per cent in 1992 and 1993. Rationalisation programmes followed by the government were therefore successful in containing the consistent sharp increase in government expenditure. However, during the course of 1993 the rate of increase in government consumption expenditure again began to accelerate: the annualised growth rate rose from 2½ per cent in the first half of 1993 to 4 per cent in the second half and to no less than 6½ per cent in the first half of 1994.

Government consumption expenditure as percentage of gross domestic product



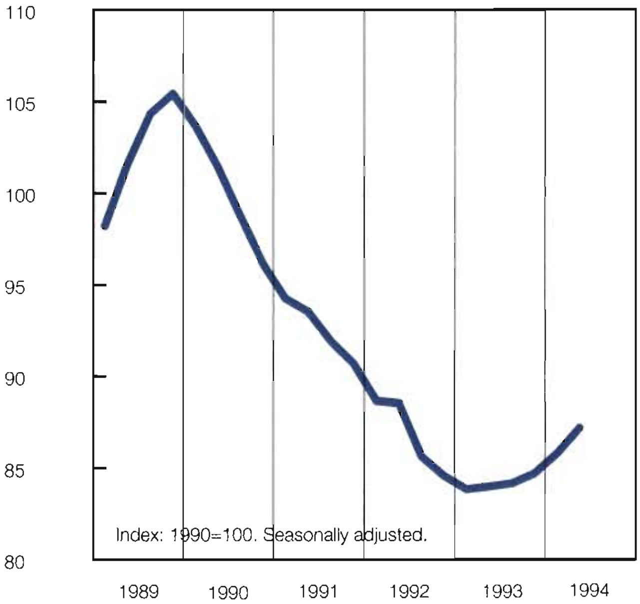
The sharp rise in consumption expenditure by general government was primarily the result of higher *outlays on intermediate goods and services.* This expenditure rose at an annualised rate of approximately 6 per cent in the six quarters up to the second quarter of 1994. On the other hand, total real outlays on the *remuneration of civil servants* rose much more moderately at an average annualised rate of less than 1 per cent over the same period.

The growth in real government consumption expenditure continued to exceed the growth in total real output. As a result, *government consumption expenditure as a ratio of gross domestic product* continued to rise very rapidly from a low of 13½ per cent in 1980 to 20½ per cent in 1993. In the first half of 1994 this ratio rose further to 21½ per cent. The rise in government expenditure relative to gross domestic product, if allowed to continue unchecked, could pose a serious threat to high sustainable economic growth in South Africa. Private-sector fixed investment, in particular, is in danger of being crowded out by the ever-increasing claim on resources being made by government bodies.

Domestic fixed investment

Aggregate real gross domestic fixed investment, which had decreased sharply by 18½ per cent from a recent peak in the fourth quarter of 1989 to the first quarter of

Total real gross domestic fixed investment



1993, subsequently recovered somewhat. This recovery in fixed investment was very hesitant at first and an increase at an annualised rate of only 1 per cent was registered in real fixed investment in the second half of 1993. However, from the beginning of 1994 the growth in fixed investment accelerated sharply to annualised rates of 5½ per cent in the first quarter and 7 per cent in the second quarter.

Capital expenditure on a few major projects was still mainly responsible for the revival in fixed investment in 1993. For instance, although total real fixed investment increased at an annualised rate of about 4 per cent from the second quarter of 1993 to the second quarter of 1994, an increase of only 2 per cent was recorded if the investments on Columbus, Alusaf and other large projects are not taken into consideration. It is estimated that the major capital projects have added approximately 2 per cent to aggregate real gross domestic fixed investment since the beginning of 1993.

The recovery in fixed investment in 1993 was, therefore, also apparent only in the capital outlays of the *private sector*; fixed capital formation of the public sector decreased. Owing mainly to real fixed investment in manufacturing, the aggregate real fixed investment of the private sector rose at an annualised rate of more than 4 per cent from the beginning of 1993. Fixed investment in the agricultural sector rose because of the improvement in weather conditions and expected further increases in output. In the mining and financial sectors the rate of decline in real fixed capital formation slowed down during 1993, and in the first half of 1994 the growth in real fixed capital formation in the mining sector became positive.

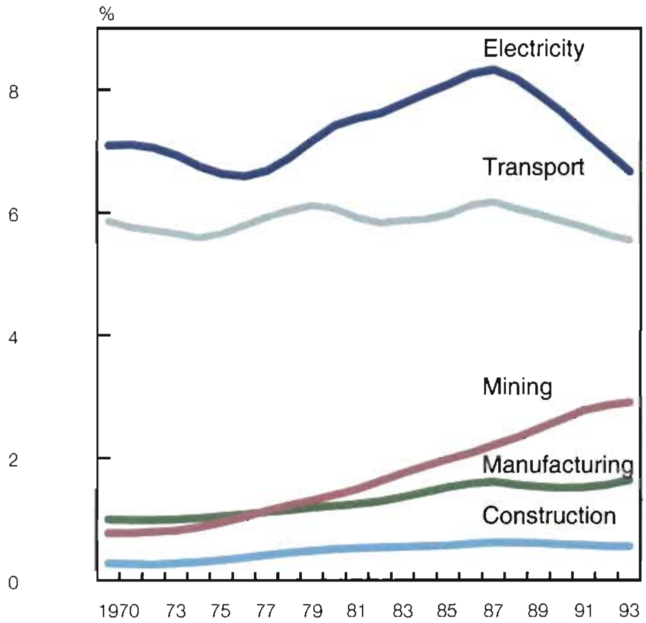
The real fixed capital formation of the *public sector* continued to decline in 1993, but in the first half of 1994 the downward trend in the investment of this sector that had been evident since the end of 1989 seemed to have turned around. Real fixed investment by the *public corporations* rose sharply in the first half of 1994. This increase was probably related to the continued expansion of electricity services to a larger part of the population in South Africa, as well as to an increase in transport and telecommunication facilities.

In accordance with the downward trend in investment expenditure by *general government*, the fixed capital formation by the public authorities decreased further in 1993 and the first half of 1994. From 1960 to 1976 real fixed investment by general government increased at an average annual rate of 7½ per cent, while it decreased at an average annual rate of 2½ per cent between 1976 and 1993. This decline was caused mainly by deliberate attempts to curtail public spending, which invariably left a strong mark on capital expenditure. The recent decrease at an annualised rate of approximately 5 per cent in the fixed capital outlays by general government over the eighteen-month period up to the second quarter of 1994 was therefore essentially caused by a decline in fixed investment by the central government and provincial administrations; the real fixed investment of the local authorities rose sharply.

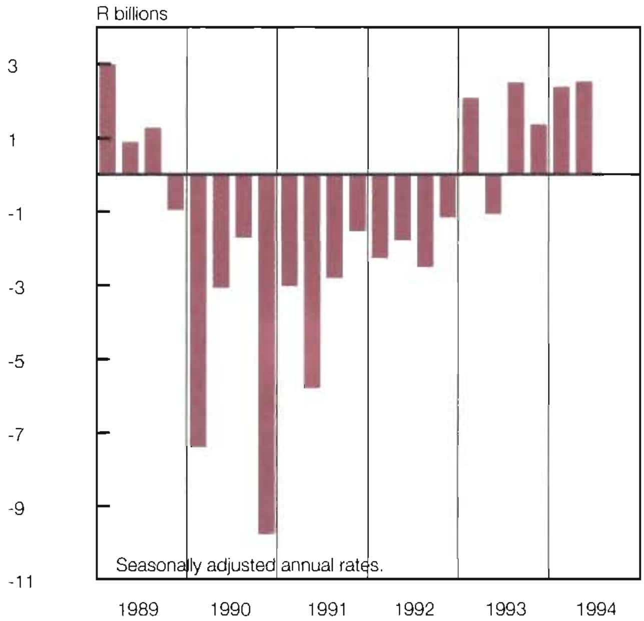
As a *percentage of gross domestic product*, gross fixed capital formation reached a lower turning-point of 15 per cent in the third quarter of 1993 and then rose marginally to 15½ per cent in the second quarter of 1994. This level was nevertheless still well below its peak value of 21½ per cent in the fourth quarter of 1989. Not only was the decline in gross fixed investment arrested, but the slow-down in the growth in the production capacity of the economy was also turned around. The rate of increase in the net real fixed capital stock nevertheless fell back from an average annual rate of 3 per cent during the 1980s to about ½ per cent per year in 1992 and 1993.

Another recent positive development is that the *capital-output ratio* of South Africa declined by 1 per cent in 1993, following an increase of 8 per cent in the period 1989 to 1992. This improvement in the capital-output ratio was probably largely due to a cyclical improvement in domestic output. As illustrated in the accompanying graph, the capital-output ratios of the electricity and transport sectors have already improved over a considerable period of time, reflecting an increasing utilisation of production capacity. However, the capital-output ratios of the other major sectors have generally continued to deteriorate. In particular, capital productivity in the mining sector contracted

Average capital-output ratio per sector



Change in real inventories



sharply, owing to the combined effect of an increase in capital intensity and the mining of a lower grade of gold-bearing ore. The capital-output ratio of manufacturing enterprises has also been rising fairly steadily since the beginning of the 1990s. Investment in strategic industries and other comparatively capital-intensive undertakings was probably responsible for this development.

From the graph it is also apparent that the capital productivity of the various production sectors differed markedly: the average amount of capital invested to produce one unit of output is between four and seven times higher in electricity, gas and water, transport, storage and communication and the financial services sectors (including housing) than in the mining, manufacturing and construction sectors. Shifts in the investment pattern favouring investment in low-yielding assets could therefore reduce the growth and employment-creating potential of the economy.

Inventory investment

In addition to an increase in fixed investment, the upturn in economic activity was accompanied by a reversal of the downward trend in *inventory investment.* The depletion of inventories already slowed down from the second half of 1991, but actual increases in inventory investment were only registered from the third quarter of 1993. The inventory build-up in the second half of 1993 and the first half of 1994 could be ascribed to stock accumulation in the mining industry and the sector electricity, gas and water supply, and to increases in commercial and agricultural stocks-in-trade. The real value of inventories in the wholesale trade rose significantly in 1993, while declines in inventories at constant prices still continued in the retail and motor trade. Stocks in the motor trade were affected by an increase in the demand for motor vehicles and by interruptions of the production process that were caused by labour problems at some of the major assembling plants. Preliminary estimates suggest, however, that real investment in inventories by the commercial sector edged higher in the first two quarters of 1994. Moreover, agricultural stocks-in-trade rose in the second quarter of 1994 on account of the increase in maize production.

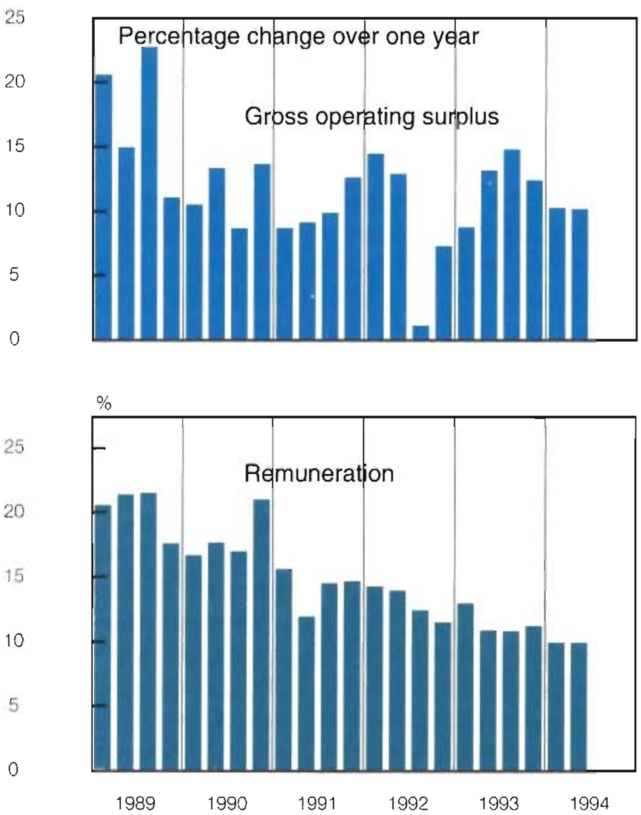
Despite the moderate build-up of inventories, the *stock-to-output ratio* remained at a low level. The ratio of total inventories to gross domestic product receded further to an average of 21 per cent in the eighteen-month period up to June 1994, compared with a high of 42 per cent in 1976. The corresponding ratio for industrial and commercial inventories also decreased from 28 per cent in 1982 to 16½ per cent in 1993, and then remained at this level in the first six months of 1994.

The lower level of inventories since the second half of the 1980s partly reflected the higher holding costs of stocks relative to those in the preceding period. Enterprises were able to adjust to these cost increases by lowering inventory-to-sales ratios with the aid of improved technology, which made more accurate stock control possible. The longer-term average inventories-to-sales ratio of industrial and commercial organisations were therefore reduced from about 9 weeks' sales to approximately 6 weeks' sales from the beginning of the 1990s.

Factor income

The rate of increase in *aggregate nominal factor income* accelerated slightly as the recovery in the domestic economy got under way and then slowed down again somewhat in the first half of 1994. In 1993 total nominal factor income increased by 12 per cent, compared with 10½ per cent in 1992. In the first half of 1994 the year-on-year rate of increase in nominal factor income receded again to 11½ per cent. Gross operating surpluses were mainly responsible for this growth pattern of nominal factor income, whereas the growth in aggregate labour remuneration continued to slow down.

Gross operating surplus and labour remuneration



The rise in *gross operating surpluses* accelerated at first from 8½ per cent in 1992 to 12½ per cent in 1993. Increased agricultural output and higher profitability of the gold-mining industry on account of the stronger rand price of gold, were the main factors driving the more rapid growth in operating surpluses. The growth in operating surpluses subsequently lost some momentum and the year-on-year rate of increase in this aggregate came to only 10½ per cent in the first half of 1994. This more subdued growth in nominal operating surpluses reflected mainly the exceptional circumstances which existed before and immediately after the April elections. A slowdown in export growth in the first half of 1994 could also have affected the rate of increase in operating surpluses.

The rate of increase in aggregate *remuneration of employees* declined from 13 per cent in 1992 to 11½ per cent in 1993, and further to 10 per cent in the first half of 1994 over the first half of 1993. This slower growth in total salaries and wages was evident in all sectors of the economy, but the rate of increase in the remuneration of employees of general government slowed down very sharply from 16 per cent in 1992 to 11 per cent in 1993 and 9½ per cent in the first half of 1994 against the corresponding period in the preceding year. The further slowdown in aggregate wage growth in the first half of 1994 was assisted by the postponement of many wage negotiations until after the election.

In view of the fact that the growth in total salaries and wages exceeded the growth in the gross operating surplus over the past number of years, the share of total labour remuneration rose from 57½ per cent in 1988 to 61½ per cent in 1993. In the six quarters up to the middle of 1994, the somewhat stronger performance of gross operating surpluses caused this ratio to contract slightly to 61 per cent in the first half of 1994. This shift may signal some improvement in the rewards accorded to capital, which could foster stronger investment growth in the near future.

Domestic saving

The *domestic saving ratio* (i.e. the ratio of domestic saving to gross domestic product) was relatively sound during the 1980s at 24½ per cent. In the last half of the 1980s and the early years of the 1990s it receded sharply to 17 per cent in 1993 and to as little as 16½ per cent in the first half of 1994. At this rate the country's domestically generated investible resources are inadequate for the investment requirements of a sustainable high growth rate. Estimates indicate that a long-term growth rate of 2½ per cent (roughly the current rate of population expansion) will require a domestic savings ratio of at least 22 per cent. To increase the growth rate to an average of 3½ per cent per year in the long run, the ratio of gross domestic savings to gross domestic product would have to be raised to 24 per cent. Some of this shortfall in savings could, of course, be met by an inflow of foreign capital. It seems unwise, however, to rely too much on foreign savings for enduring high economic growth.

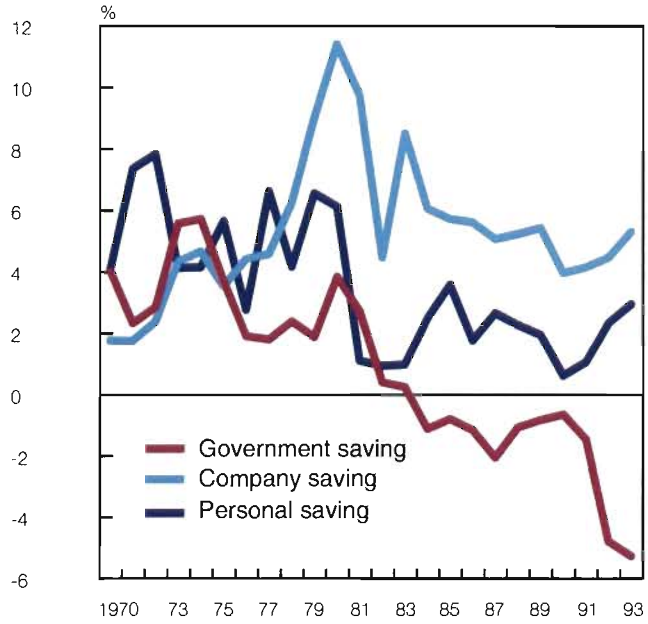
The single most important reason for South Africa's poor savings record in recent times has been the fact that the government has become an increasingly large dissaver. The net *dissaving of general government* as a percentage of gross domestic product increased from ½ per cent in 1990 to 5½ per cent in 1993 and about 5 per cent in the first half of 1994. Overseas experience has shown that the surest way for a country to improve its savings performance is for the government to become more frugal and to bring its current spending more in line with current income.

The ratio of net *personal saving* to gross domestic product reached an average level of 3 per cent in the eighteen months until June 1994, which was significantly below its average level of 5½ per cent in the 1970s. A number of reasons could probably be put forward to explain the low savings ratio of private households, including:

- inadequate or even negative after-tax real rates of return on depository types of investments which failed to induce households to postpone current consumption;
- the high level of indebtedness and high cost of borrowing, which encouraged households to use savings rather than consumer credit in purchasing goods and services;
- the gradual redistribution of income during the 1980s away from the higher-income households with a high propensity to save in favour of lower-income households with a low propensity to save;
- the rise in the tax burden of individuals, which lowered disposable income; and
- the perception of increasing wealth of households related to the sharp rise in asset prices during the 1980s, which caused spending to rise relative to disposable income.

Net *saving by the corporate sector* averaged 5 per cent of gross domestic product in the eighteen months ended June 1994, i.e. it remained at about the level of the second half of the 1980s. A continued large portion of profits is therefore being retained by companies. The withholding of corporate profits causes the net worth of companies to strengthen, equity prices to rise and the net asset values of households to increase. This kind of behaviour will be encouraged in an environment in which personal tax rates are high, low or negative real after-tax rates of return are being earned on deposits or other fixed-interest bearing financial instruments, differential tax rates apply to companies and households, and capital gains have been exempted from taxation. This kind of environment seems to have been typical in almost all respects of the South African situation since the early 1980s. Moreover, corporate saving has recently been encouraged even further by the introduction of the so-called Secondary Tax on Companies in March 1993, which taxes the distributed profits of companies.

Components of domestic saving as percentage of gross domestic product

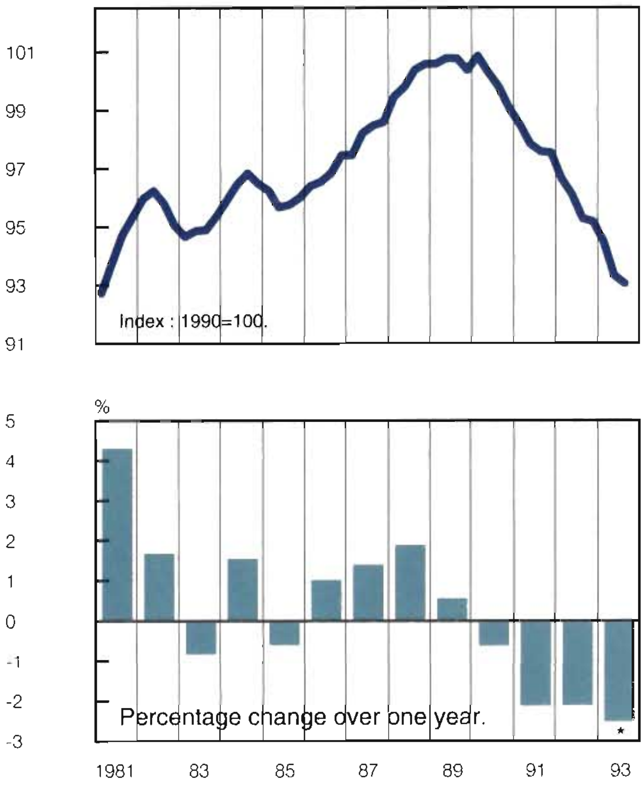


Employment

Despite the revival in economic activity, *total formal-sector employment* continued to decline in 1993. In fact, the rate of decrease in employment accelerated from 0,6 per cent in 1990 and 2,1 per cent in both 1991 and 1992 to 2,5 per cent in the first three quarters of 1993 compared with the corresponding period in the preceding year. Employment contracted by 7,8 per cent, or by nearly 430 000 workers, from a peak reached in the second quarter of 1989 to the third quarter of 1993. This brought the level of total formal employment in the non-agricultural sectors of the economy down to a level that was last reached in the first quarter of 1981. This, in turn, means that the entire employment growth over the period of eight years from 1981 to 1989 was wiped out over the ensuing 4½ years.

After having accelerated from 0,9 per cent in 1990 to 3,6 per cent in 1991, the decrease in employment in the *private sector* moderated somewhat to 3,1 per cent in 1992 and to 2,6 per cent in the first three quarters of 1993 compared with the first three quarters

Total non-agricultural employment



* First three quarters

of 1992. Total formal employment in the private sector in the third quarter of 1993 was therefore 10,1 per cent below its level in the first quarter of 1989. With the notable exception of the financial institutions, all economic sectors contributed to this decline in employment in the private sector. In particular, reductions in the workforce of enterprises in the manufacturing and the mining sector were collectively responsible for nearly 80 per cent of the overall decline in private-sector employment over this period.

In contrast to these developments in the private sector, employment by the *public authorities* continued to increase during the recession. The rate of increase in employment by the public authorities slowed down sharply, however, from 1,6 per cent in 1991 to only 0,1 per cent in 1992. Owing to cut-backs on recurrent expenditure and the implementation of cost-rationalisation programmes, employment by the public authorities then decreased by as much as 2,4 per cent in 1993.

In view of this decline in employment, the total number of registered *unemployed workers* increased by 16,2 per cent in 1992 and by 8,8 per cent in 1993. In December 1993 the seasonally adjusted total number of registered unemployed workers amounted to 287 000 persons. Unfortunately, these official statistics understate the severity of South Africa's unemployment problem because only a small proportion of jobless people take the trouble to register as being unemployed. According to the most recent Household Survey of the Central Statistical Service, the number of workers that were without remunerative work totalled approximately 3,6 million in October 1993. This is equal to 29 per cent of the economically active population. The comparable rate for 1991, as calculated from the Population Census, came to 18½ per cent.

Although the cyclical slowdown in aggregate income and expenditure undoubtedly made an important contribution to the rise in unemployment, certain structural changes also occurred which affected employment growth and which will not disappear when business conditions improve. In addition to low economic growth and a limited expansion of the production capacity of the economy, the labour-absorbing capacity of the economy was impeded by:

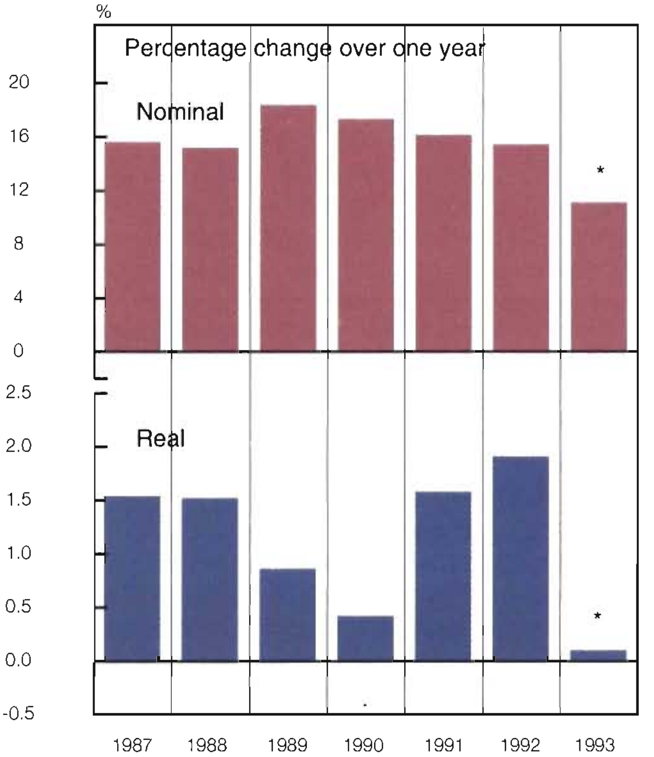
- a sharp increase in the proportion of the workforce with a low level of education and training in a world where technological progress has been biased against unskilled labour;
- an increase in the capital intensity of the production structure, *inter alia* owing to tax concessions and investment allowances, tariff policies, prolonged periods of low and often negative real interest rates and high wage costs;
- an inward-looking economic strategy that fostered the establishment of high-cost industries;
- a rigid wage structure, causing real wages to keep on rising despite a large surplus of labour; and
- a rise in non-wage labour costs related to unionisation, the militancy of trade unions, protest actions, strikes and stay-aways.

Throughout the 1980s and early 1990s the growth in the potential labour force therefore outpaced the growth in formal-sector employment in South Africa. Rising long-term unemployment is, however, not limited to South Africa only. There is a growing concern world-wide about the apparent inability of the market economies to provide sufficient job opportunities on a sustainable basis to those who are willing and able to work. Internationally it has been found that the most important causes of structural unemployment have their origin in policies that were expressly designed by government, labour unions and business to protect people from hardship, not least during cyclical, and therefore temporary, drops in the demand for labour. These labour market and social policy measures introduced rigidities in market economies which prevented them from adapting to change. Some of the more important factors that caused rigidities in labour markets include:

- high minimum wages;
- over-generous unemployment benefits;
- restrictions on the retrenchments of workers;
- social security contributions by employers;
- centralised wage bargaining which does not take differences between regions and industries into account; and
- labour unions that do not allow the real remuneration of workers to change in accordance with changing economic conditions.

There is also general agreement that there are no "quick fixes" to the problem of structural unemployment – it cannot be solved by either the protection of domestic markets against foreign competition or by demand-driven policies aimed at stimulating the domestic economy. A high increase in employment can only be achieved by restoring the capacity of the economy to adapt to change, i.e. by removing rigidities hindering the ability of people and business to adapt to changing economic conditions. According to OECD studies the ability of an economy to create jobs and to adapt to change is dependent on a supportive macro-economic environment, which should include elements such as sound public finance so that the public sector does not impede investment, low inflation so that private companies and workers are not misled by distorted price signals, and the management of aggregate demand in such a way that growth is neither too rapid nor too slow.

Average monthly remuneration per employee in non-agricultural sectors



* First three quarters.

Labour costs and productivity

The inflexibility in the South African labour market is obvious from the long period that it took the rate of increase in nominal wages and, more importantly, that of real wages, to contract as the demand for labour declined and monetary policy tightened. The rigidity of nominal wage behaviour can be observed from the increase in the average *nominal wage per worker* in the non-agricultural sectors, which contracted only slightly from a high point of 18,3 per cent in 1989 to 15,4 per cent in 1992. Only in the first three quarters of 1993 did this rate slow down to 11,1 per cent compared with the corresponding period of the preceding year, when the large number of unemployed persons began to force labour unions to concentrate on issues such as job security rather than wage increases.

To an important extent the slow reaction of nominal wages per worker to the recessionary conditions was due to the fact that many enterprises followed rationalisation programmes in which a large number of the lower-paid workers were laid off, keeping the average wage per worker high. However, this is only a part of the explanation for the slowness of salaries and wages to respond meaningfully to slack labour demand. Aggressive wage bargaining by trade unions, and continued high inflation expectations, led many businesses to accede to high wage demands simply to avoid unruly behaviour of workers and work disruptions. It also took a considerable period of time to convince wage negotiators that inflation was about to be reduced substantially.

Although unemployment rose unabatedly, positive growth rates also continued to be registered in *real wages*. The rate of increase in the real wage per worker (as deflated by the price deflator for the non-agricultural gross domestic product) actually accelerated from an average of 0,9 per cent per year during the preceding upswing phase to 1,2 per cent per year from the start of the recession in 1989 up to the fourth quarter of 1992. Even after unemployment had risen substantially, a positive (albeit small) increase of 0,1 per cent was recorded in the real remuneration per worker in the first three quarters of 1993 compared with the first three quarters of 1992.

As shown in Table 2, the rise in real wages per worker took place in the salaries and wages of employees of both public authorities and the private sector. The real remuneration per worker employed by public authorities rose particularly sharply in the period from 1989 to 1992, before decreasing in 1993. Growth in the real remuneration per worker in the

Table 2. The rate of increase in real remuneration per worker
Per cent

	Public authorities	Private sector	Total
1989	3,9	-0,5	0,9
1990	0,6	0,3	0,4
1991	2,6	0,9	1,6
1992	1,4	2,0	1,9
1993*	-1,3	0,2	0,1

* The rates for the private sector and the total refer to the first three quarters of 1993 compared with the corresponding period of the preceding year.

private sector was also fairly high and even accelerated in 1992; it continued to be positive in 1993.

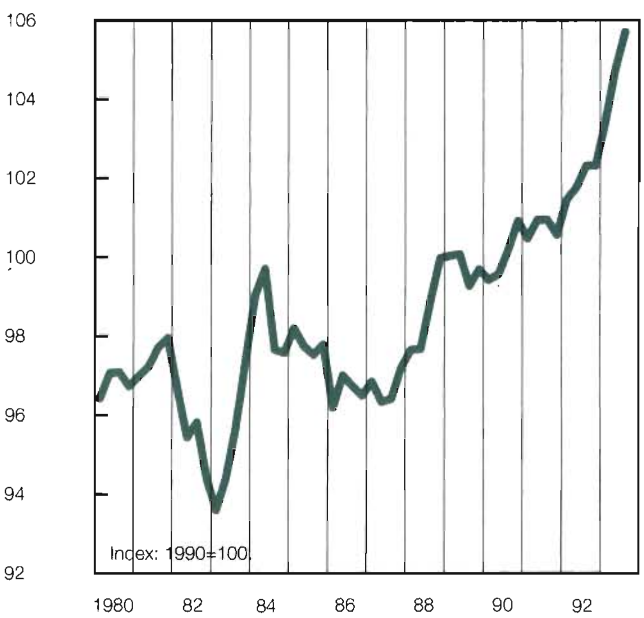
Owing to the fact that the rate of retrenchment of workers in the formal sector of the economy exceeded the decline in real gross domestic product, *labour productivity* continued to increase during the recession. The rate of increase in labour productivity in the non-agricultural sectors of the economy actually accelerated from 0,3 per cent in 1990 to 1,2 per cent in 1992, and to 2,8 per cent in the first three quarters of 1993 compared with the corresponding period of 1992.

The underlying productivity of the South African workers nevertheless remained low. Since the beginning of the 1980s productivity has grown at an average annual rate of only 0,5 per cent. In order to increase the growth potential of South Africa, it is important that productivity be raised. In this regard serious attention needs to be given to:

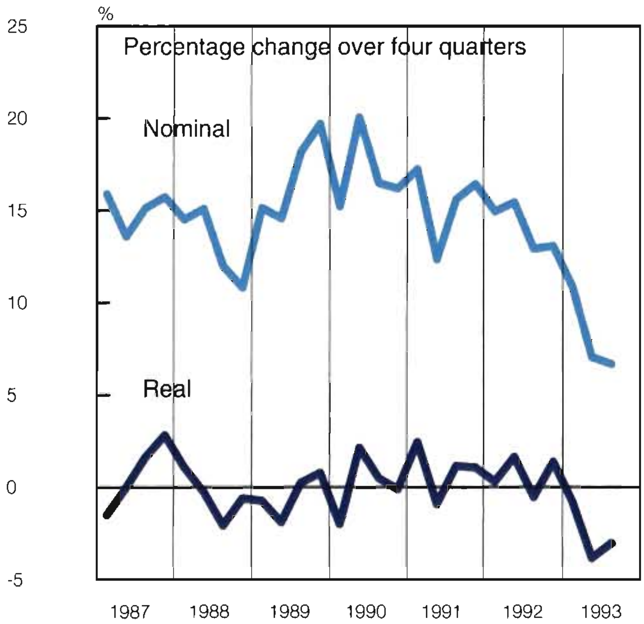
- the provision of high-quality education to a large part of the population and the encouragement of training by the private sector;
- the improvement of services such as health, transportation and electrification;
- the training of managers, particularly middle management;
- the introduction of more advanced technology, which had been impeded in the 1980s by sanctions, disinvestment and internal unrest;
- the promotion of effective competition, deregulation, privatisation and commercialisation; and
- the maintenance of sound fiscal and monetary policy measures aimed at creating a stable financial environment.

The recent sharp improvement in labour productivity and the lower rates of increase in remuneration per worker caused the rate of increase in *nominal unit labour costs* to adjust sharply downwards. At first the year-on-year rate of increase in labour costs per unit of physical output declined only moderately from 19,7 per cent in the fourth quarter of 1989 and 20,0 per cent in the second quarter of 1990 to 15,4 per cent in the second quarter of 1992. However, this

Production per worker in non-agricultural sectors



Unit labour costs in non-agricultural sectors



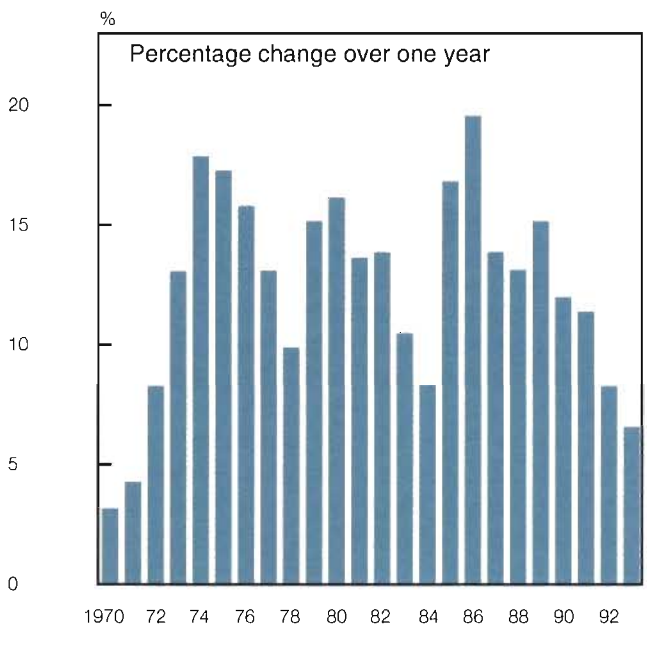
rate then dropped to only 6,6 per cent in the third quarter of 1993. In the first three quarters of 1993 average nominal unit labour costs were 8,1 per cent above the average in the corresponding period in the preceding year, compared with rates of increase of 14,0 per cent in 1992 and 16,9 per cent in 1989.

As a result of the lower rate of increase in nominal unit labour costs, *real unit labour costs* measured over four quarters declined from the first quarter of 1993. In the first three quarters of 1993 real labour costs per unit of physical output was no less than 2,5 per cent lower than in the first three quarters of 1992. This may be compared with an average annual rate of increase of 0,8 per cent in real unit labour costs in the period from 1990 to 1992.

Inflation

The objective of the monetary authority to bring about financial stability and to lower the rate of inflation by way of a conservative monetary policy was initially hampered by factors such as relatively high increases in unit labour costs, abnormally dry weather conditions, increases in and changes to indirect taxation, the Gulf War and, more importantly, sustained inflation expectations. The persistently tight monetary policy was ultimately rewarded when the rates of increase in the main price indices slowed down markedly. The lower rates of increase in prices were also brought about by the impact of the 1989-93 recession on the domestic economy, the return to more normal rainfall patterns, lower international oil prices, and a high degree of price stability in South Africa's main trading partners.

Production price index



The increase in the all-goods *production price index* declined continuously from its most recent high of 15,2 per cent in 1989 to only 6,6 per cent in 1993 – the lowest rate of increase in this price index since 1971 when a rate of 4,3 per cent was recorded. This lower rate of increase in the all-goods production price index was brought about by significantly lower rates of increase in the prices of domestically produced as well as imported goods.

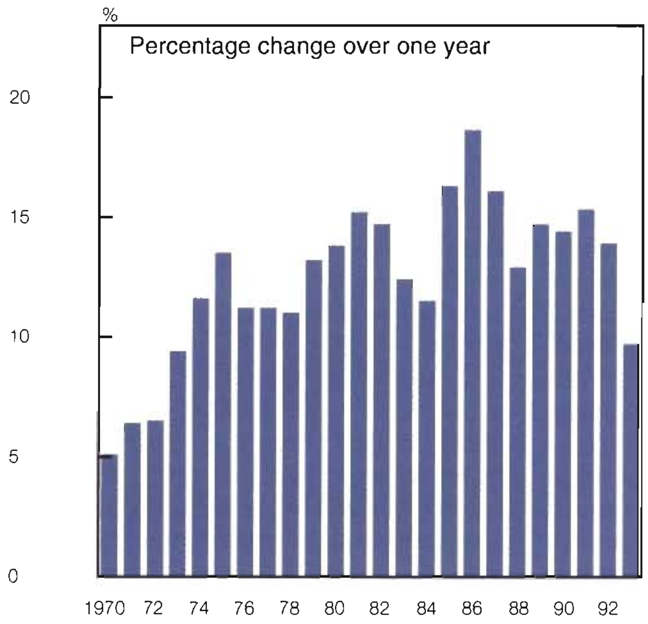
The rate of increase over periods of twelve months in the *prices of imported goods* declined sharply from a post-Gulf War high of 19,1 per cent in November 1990 to negative rates in early 1992; it then fluctuated upwards to 6,8 per cent in June 1993. Largely because of continued relative price stability and greater convergence of price increases of South Africa's main trading partners, the twelve-month rate of increase in import prices moved downwards again to 3,1 per cent in April 1994, before accelerating somewhat to 4,7 per cent in May. The year-to-year rate of increase in the prices of imported goods therefore declined from 16,3 per cent in 1989 to only 4,2 per cent in 1992 and 5,0 per cent in 1993.

The rate of increase in the *prices of domestically produced goods* declined from 14,9 per cent in 1989 to 7,0 per cent in 1993. The change in the prices of domestically produced goods, measured over a period of twelve months, recorded a peak of 15,4 per cent in May 1989 and declined, on balance, to 5,7 per cent in October 1993. This rate of increase then accelerated to 8,1 per cent in May 1994. The recent changes in the prices of domestically produced goods were to a large extent affected by sharp increases in meat prices.

The overall effect of these movements on the prices of imported and domestically produced goods, was to bring the rate of increase over periods of twelve months in the all-goods production price index down from a high point of 15,8 per cent in May 1989 to 5,4 per cent in October 1993, its lowest level in more than twenty-two years; it then moved to higher levels and amounted to 7,5 per cent in May 1994.

Consumer prices took longer than production prices to react to the conservative monetary policy because of the effect of the drought on food prices, the implementation of a new weighting structure for the calculation of the overall index and the introduction of value-added tax in October 1991. The rate of increase over periods of twelve months in the overall consumer price index therefore remained high at first and reached a peak of 16,8 per cent in October 1991 before declining to 9,6 per cent in December 1992. On balance, it increased again to 11,0 per cent in April 1993 and then decreased to 9,9 per cent in January

Consumer price index



and February 1994. It reached a rate of 7,1 per cent in April 1994 and 7,5 per cent in June, when the effects of increases in value-added tax, other indirect taxes and the petrol price in the preceding year dropped out of the price increases measured over periods of twelve months.

As a result of these price changes, the year-to-year rate of increase in the overall consumer price index declined from a high point of 15,3 per cent in 1991 to 9,7 per cent in 1993 – the lowest annual rate of increase since 1973. This slowdown in consumer price inflation was the result of sharply lower rates of increase in the prices of both consumer goods and services. The year-to-year rate of increase in the prices of consumer goods declined from 17,0 per cent in 1991 to 10,4 per cent in 1993, while the corresponding rate of increase in the prices of consumer services receded from 12,6 per cent in 1991 to 8,6 per cent in 1993.

Foreign trade and payments

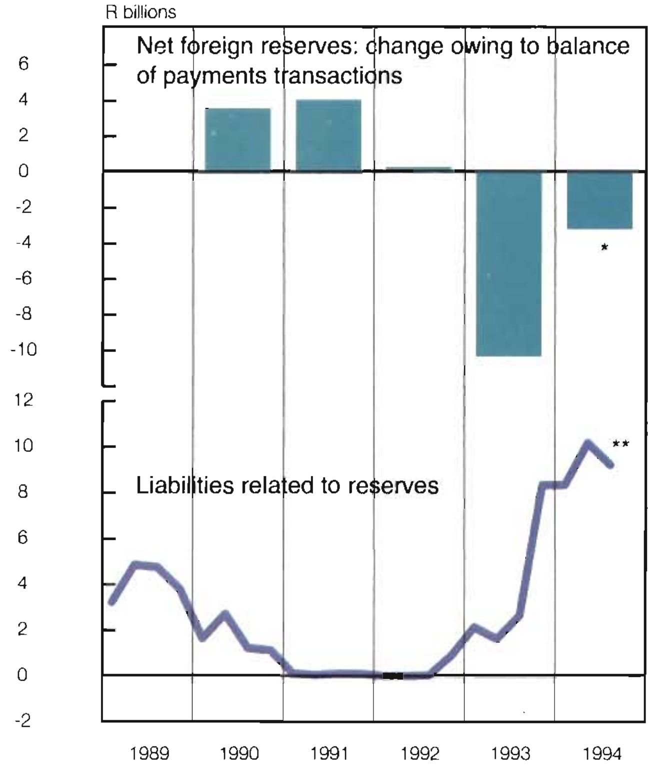
Overall balance of payments position

South Africa's overall balance of payments position again became a serious constraint in the application of economic policy towards the end of 1992. After having recorded a cumulative overall balance of payments surplus of R7,9 billion in the four-year period up to 1992, all the gains during this period to the foreign reserves were wiped out completely in 1993 when the net gold and other foreign reserves decreased by R10,3 billion. In determining economic policy measures, the authorities therefore had to maintain a careful balance between financial stability and nurturing the still vulnerable revival of economic activity under conditions of political uncertainty. In order to avoid applying too restrictive policy measures, the authorities resorted to reserve-related borrowing to the amount of R7,4 billion in 1993.

The substantial deterioration in the overall balance of payments position was the result of a large outflow of capital not related to reserves, which more than fully neutralised a sizable surplus on the current account. Maturing fixed loan commitments and uncertainty at that stage about political developments led to a surge in the outflow of capital in the second half of 1993, which brought the net outflow of capital to R16,3 billion for the year as a whole. Fortunately, conditions on the current account remained favourable: the current account surplus of R5,9 billion in 1993 was significantly larger than the average surplus of R4,7 billion during the period 1989 to 1992. As a percentage of gross domestic product, the surplus on the current account rose from 1,2 per cent in 1992 to 1,5 per cent in 1993. The larger surplus on the current account of the balance of payments in 1993 could be attributed to a continued strong performance in merchandise exports and an increase in net gold exports. On the other hand, merchandise imports and net service and transfer payments to the rest of the world rose sharply further.

In the first half of 1994 the current account balance suddenly decreased to a small unadjusted surplus of R0,5 billion. This was partly due to seasonal factors: the current account balance (seasonally adjusted and at an annualised rate) came to a smaller but still relatively large surplus of R2,5 billion. The contraction in the current account surplus was also caused by exceptional circumstances, which adversely affected domestic production and led to a decrease in the volume of merchandise exports. Rising real fixed investment and an accumulation of inventories were responsible for an increase in the volume of imports, while net service and transfer payments to the rest of the world remained at a high level.

Foreign reserves



* First half of 1994.

** July 1994.

At the same time a somewhat lower but still large net outflow of capital of R3,7 billion was recorded on the balance of payments. As a result of the smaller current account surplus and the further outflow of capital, the net gold and other foreign reserves of the country fell by R3,2 billion in the first half of 1994. In order to ensure an orderly depreciation of the rand and to support the foreign reserves, the authorities were again net borrowers of reserve-related liabilities to the amount of R1,8 billion.

However, in the course of the first half of 1994 the overall balance of payments began improving. In January 1994 a large increase of R1,6 billion was registered in the net gold and other foreign reserves, owing to the return flow of short-term funds that had been taken off the books of certain foreign lenders at their financial year-ends. This was followed by a decrease of R4,5 billion in the ensuing three months because of rising uncertainty in the pre-election period and a contraction in export proceeds. When it became apparent that the new government had assumed power without large disruptions, the decrease in the net gold and other foreign reserves of the country slowed down to only R0,3 billion in May and June 1994. In July, however, the net foreign reserves of the Reserve Bank increased by no less than R1,5 billion.

Merchandise exports

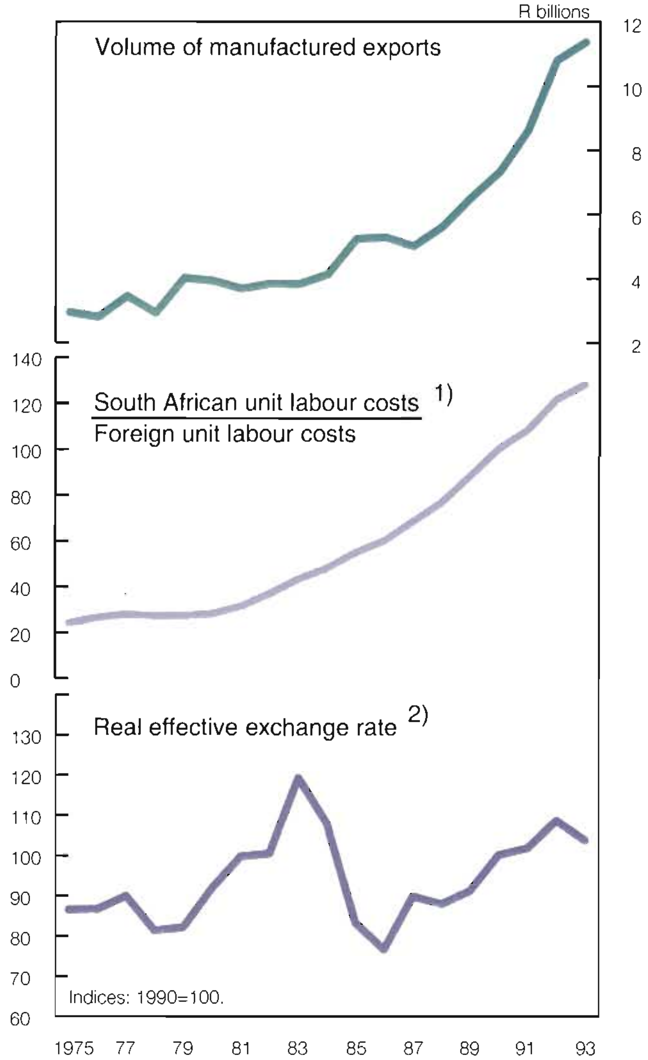
The *value* of South Africa's merchandise exports advanced from R49,0 billion in 1992 to R56,1 billion in 1993, or by 14½ per cent. This further sharp rise in merchandise exports was partly due to an increase of 8 per cent in *export prices* related to the weakening of the exchange rate of the rand against almost all the currencies of South Africa's main trading partner countries. Although the decline in international commodity prices levelled off in 1993, these prices only started to increase from November 1993 and the average price index for international commodities in 1993 as a whole was only moderately higher than in the preceding year.

A substantial increase of 6 per cent in the *volume* of merchandise exports made a major contribution to the rise in exports as well as to the revival of economic activity in 1993. The volume of exports has continued to perform excellently over recent years and registered an average growth rate of about 6 per cent per year from 1987 to 1993; this was well in excess of the 5 per cent increase per annum in world trade over the same period. As a ratio of gross domestic product, the volume of merchandise exports rose consistently from a low of 13 per cent in 1987 to 17½ per cent in 1993.

An analysis of *exports by main type of economic activity* shows that this good export performance took place over a wide range of goods. A substantial increase in the exports of mining products (excluding gold) was mainly responsible for the increase in exports in the late 1980s. With the decline in the international demand for commodities, the growth in the exports of mining products levelled off in the early 1990s and only began to recover again towards the end of 1993. The value of agricultural exports also showed an increasing trend over the period 1988 to 1993, but fluctuated considerably depending on the impact of local weather conditions on agricultural output. The main contribution to the relatively high export growth was made by the exports of manufactured products. As a percentage of total exports, the exports of manufactured goods increased from 14 per cent in 1987 to 24 per cent in 1993. Significant increases were recorded more specifically in the exports of chemical products, textiles, paper and paper products, machinery and electrical equipment, and vehicles and transport equipment.

The volume of manufactured exports rose at an average annual rate of approximately 12½ per cent from 1987 to 1993. This rise in *manufactured exports*

Exports of manufactured goods, unit labour costs and the real effective exchange rate of the rand



1) Six major trading partner countries.
2) Based on unit labour costs.

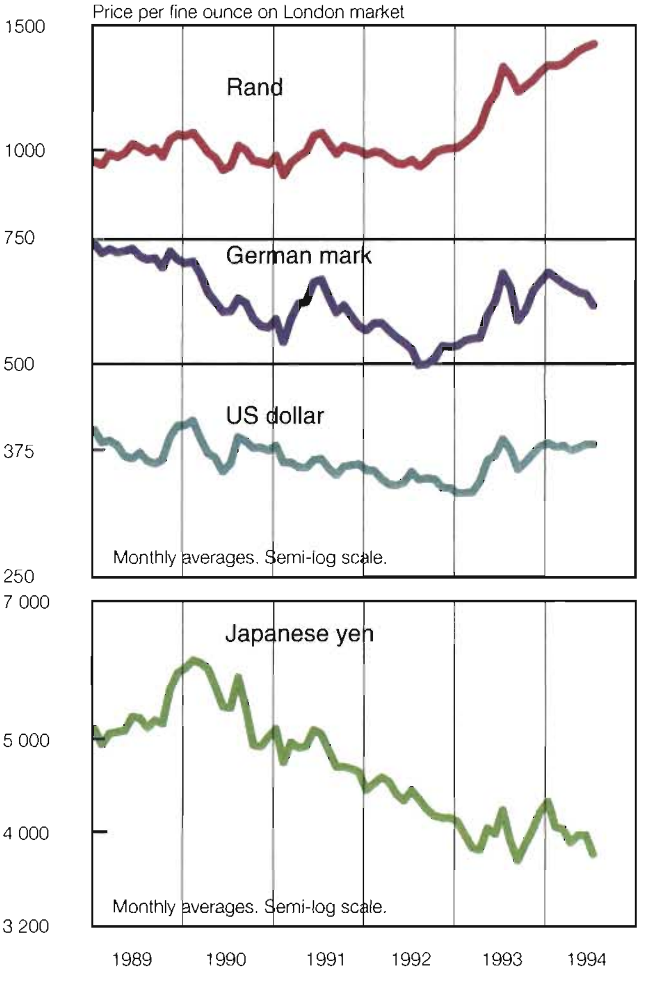
was achieved despite the fact that South Africa's nominal labour costs per unit of production continued to increase steadily relative to those of its main trading partner countries (see graph). Continued increases in labour costs in excess of productivity increases had a strong adverse effect on the international competitiveness of South African manufacturers. This loss of competitiveness was partly compensated for by a depreciation in the exchange rate of the rand. A continued adjustment in the value of the rand is not, however, a sound solution for enduring growth in manufacturing exports because it distorts the production structure of the country. The recent decline in nominal unit labour costs relative to those costs in trading partner countries is a welcome development in view of the fact that it addresses the underlying cause of the loss of international competitiveness.

In addition to the decline in the real effective exchange rate of the rand, the high growth in the exports of manufactured goods over the period 1987 to 1993 could also be attributed to factors such as:

- excess production capacity, which encouraged domestic producers to find other outlets for their products;
- the opening-up of new markets where economic growth was much more vigorous than in South Africa's traditional trading partners; and
- the assistance that exporters received under the general export incentive scheme and the local-content programme applicable to the production of motor vehicles.

The growth in the value of merchandise exports slowed down in the first half of 1994, despite a fairly strong international economic recovery, the recent increase in the relative competitiveness of South African manufacturers and an increase in export prices. Even more surprisingly, this slower growth in exports was recorded notwithstanding a substantial increase in the exports of mining and agricultural products. However, the exports of manufactured goods declined, particularly the exports of chemical products, machinery and electrical equipment, paper and paper products, textiles and transport equipment. These decreases were probably due to exceptional circumstances related to political uncertainty, labour unrest, strikes, work stoppages and special holidays leading to loss of production.

Gold price



Net gold exports

The *value* of South Africa's net gold exports, which had contracted at an annual average rate of approximately 2 per cent from 1988 to 1992, rose by 21 per cent from R18,4 billion in 1992 to R22,2 billion in 1993. The strong growth in the value of net gold exports continued in the first half of 1994, when a seasonally adjusted and annualised value of R22,9 billion was registered. A rise in the price of gold was mainly responsible for this substantial increase in the value of net gold exports.

Having remained fairly stable at a level of around R1 000 per fine ounce from 1988 to 1991 and for most of 1992, the fixing *price of gold* per fine ounce increased steadily from R1 008 in December 1992 to R1 294 in December 1993 and to an all-time high of R1 414 in July 1994. For calendar 1993 as a whole, the average rand price amounted to R1 177 per fine ounce, 20 per cent higher than the average price of R980 per fine ounce in 1992. Expressed in the currencies of large gold consumers, the change in the average price of gold in 1993 deviated quite considerably: in US dollars the gold price advanced by 4½ per cent, whereas the average price of gold in terms of yen actually declined by 8½ per cent.

Apart from the depreciation of the rand, the higher gold price was mainly related to a revival of investor interest in gold. Falling international interest rates during 1993 generally reduced the opportunity costs of holding gold and made it more attractive to investors. Other contributing factors to the higher gold price included fears of an acceleration in inflation with more stimulatory policies in many countries, the volatility in currency and financial markets, a relatively weak US dollar, and a revival in international commodity prices. On the supply side, mining output increased slightly and a large amount of gold was disposed of by official holders, preventing a more robust price rise.

The *volume* of the net gold exports in South Africa rose by about 4 per cent in 1993, owing mainly to a higher average quality of gold-bearing ore milled by the mines. In the first half of 1994 the volume of net gold exports decreased by 12 per cent in comparison with the last half of 1993 because of a contraction in the domestic production of gold.

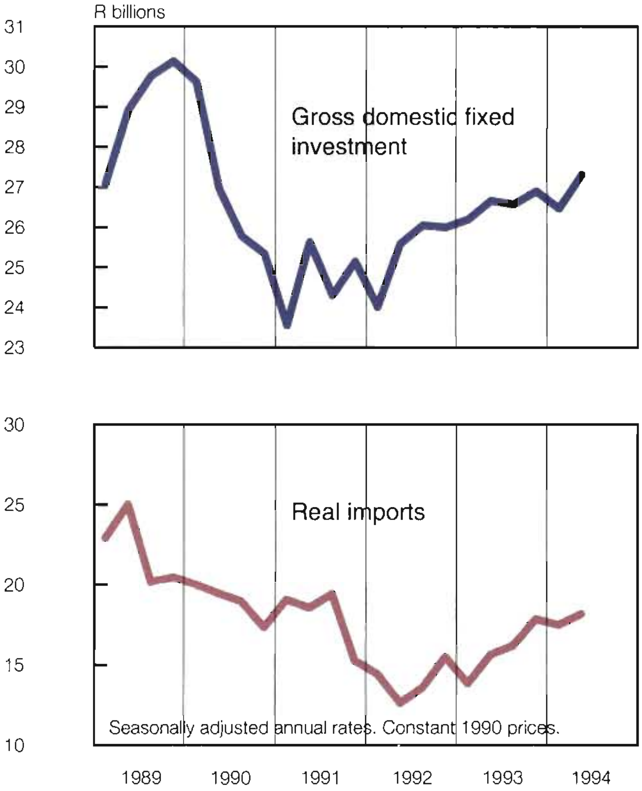
Merchandise imports

The *value* of merchandise imports, which had increased by about 9½ per cent in both 1991 and 1992, advanced much more rapidly by 13½ per cent in 1993 and by 11 per cent in the first half of 1994. Although most of the main categories of imported goods rose at a high rate, the imports of particularly manufactured goods, such as chemical products, textiles, machinery and electrical equipment, transport equipment and professional equipment, rose very strongly. In contrast to these developments, the imports of vegetable products declined sharply, in keeping with the better weather conditions in South Africa and the consequent increase in domestic production.

The relatively low inflation rates in South Africa's main trading partner countries and only a small rise in international oil prices were unable to prevent a rapid increase in the average level of *import prices*. The sharp depreciation of the rand led to an acceleration in the rate of increase in the prices of imported goods from only 4 per cent in 1992 to 9 per cent in 1993; from the second half of 1993 to the first half of 1994 import prices rose by 2½ per cent. However, export prices (including gold) increased at an even faster rate, with the result that South Africa's terms of trade rose by 1 per cent in 1993 and by a further 3,8 per cent in the first half of 1994.

The sharp rise in the prices of imported goods did not have a large impact on the *volume of imports*. Having remained at a relatively high level throughout the 1989-93 recession, the volume of imports advanced strongly from the second half of 1993; an increase of 4 per cent in the second half of 1993 was followed by a further rise of 8½ per cent in the first half of 1994. This strong performance of merchandise imports was probably related to the high marginal import propensity of the South African economy. South African imports consist largely of intermediate and capital goods that are not produced domestically, or are not produced domestically in quantities adequate to meet domestic demand. A strong domestic demand for goods usually gives rise to an immediate increase in the demand for imported goods, which may be reinforced by a rise in domestic investment and an accumulation of inventories. An increase in real fixed investment, in particular, affects import growth because of the relative importance of machinery and electrical equipment and transport equipment in South Africa's imports; in 1993 these categories were responsible for 44 per cent of the value of merchandise imports.

Machinery and transport equipment

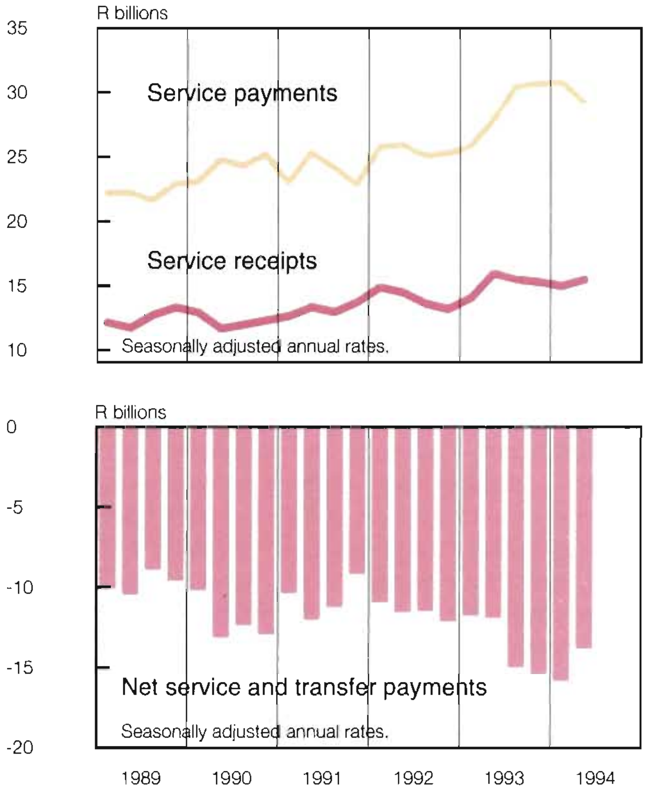


In the accompanying graph, the close correlation that exists between domestic fixed investment in machinery and transport equipment and the volume of the imports of these capital goods is clearly illustrated. From the graph it is apparent that the increase in the real investment in machinery and transport equipment from the beginning of 1992 brought about a corresponding sharp rise in the volume of these goods imported. Even before the start of the current economic recovery in South Africa, the replacement of outdated and obsolete equipment was therefore an important factor in explaining the high level and later acceleration in the growth of the volume of imports.

Net service and transfer payments to non-residents

Net service and transfer payments to non-residents, which had decreased from a peak of R12,2 billion in 1990 to R10,7 billion in 1991, subsequently rose again to R11,5 billion in 1992 and to R13,5 billion in 1993. On a quarterly basis, the seasonally adjusted and annualised value of net service and transfer payments to the rest of the world rose very rapidly during 1993

Services account



from R11,7 billion in the first quarter to R15,5 billion in the fourth quarter; it then rose even further to R15,9 billion in the first quarter of 1994 before declining sharply to R13,9 billion in the second quarter. As a ratio of gross domestic product, net service and transfer payments to non-residents amounted to 3½ per cent in the first six months of 1994, compared with a peak of 5½ per cent in 1985.

The substantial deterioration in the service and transfer account of the balance of payments was due to the fact that the increase in service payments outpaced an only moderate rise in service receipts. As in other developing countries, the services account is still dominated mainly by changes in investment income, freight and merchandise insurance and tourism. A notable increase occurred in interest payments on foreign debt in the eighteen months to June 1994, owing to a rise in domestic bonds owned by non-residents and to reserve-related borrowing by the monetary authority. The rise in merchandise imports coupled with the lower exchange rate of the rand caused payments on freight and merchandise insurance to rise sharply, while a larger number of South Africans travelling abroad led to an increase in tourist expenditure. These higher payments were offset only partly by an increase in tourist receipts in view of the large number of foreigners who visited South Africa.

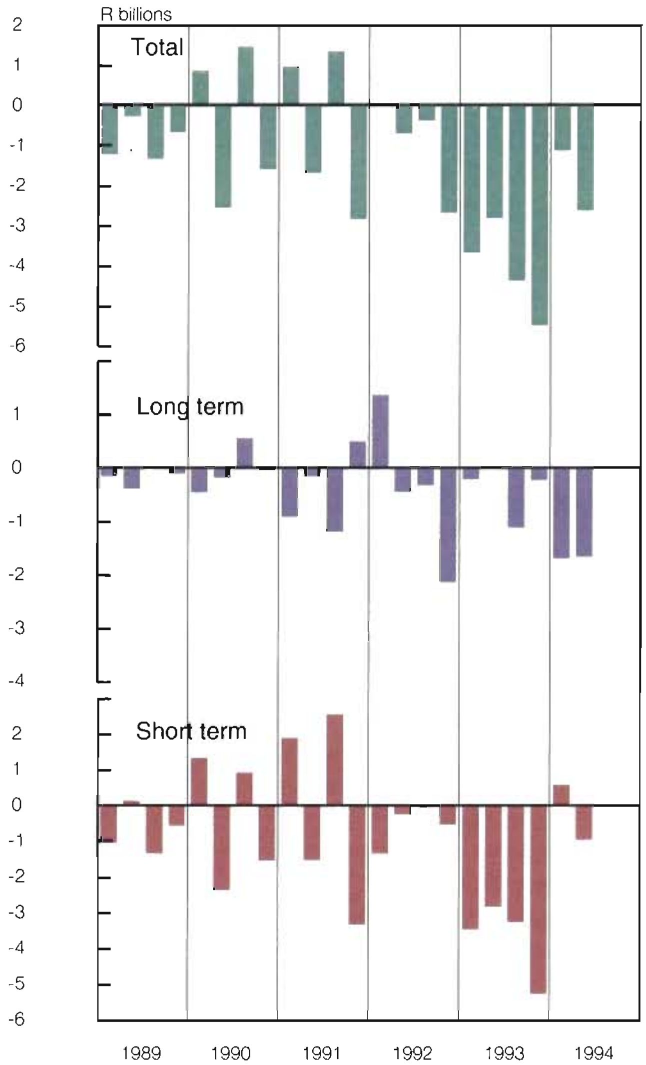
Capital movements

As already pointed out, South Africa experienced a massive *total net outflow of capital* not related to reserves of R16,3 billion in 1993; this may be compared with an average annual net outflow of R4,1 billion from 1985 to 1992. However, in the first quarter of 1994, i.e. in a period of transition to a new political dispensation in which violence and uncertainty were still rife, the capital account of the balance of payments improved dramatically. Following large net outflows of R4,3 billion and R5,5 billion in the last two quarters of 1993, the net outflow of capital not related to reserves declined to R1,1 billion in the first quarter of 1994. Uncertainty surrounding the participation of certain

Table 3. Net capital movements not related to reserves
R billions

	1992	1993			1994
	Year	1st half	2nd half	Total	1st half
Bearer bonds and notes	0,9	-0,7	-0,9	-1,6	-0,3
Converted loans from affected debt	-0,1	-0,4	-1,0	-1,4	-1,3
Loans guaranteed by foreign governments	-0,8	-0,7	-0,5	-1,2	-1,0
Other long-term capital	-1,5	1,6	1,1	2,7	-0,7
Total long-term capital	-1,5	-0,2	-1,3	-1,5	-3,3
Short-term capital	-2,2	-6,3	-8,5	-14,8	-0,4
Net capital movements	**-3,7**	**-6,5**	**-9,8**	**-16,3**	**-3,7**

Net capital movements not related to reserves



political parties in the election and the spirit in which the results would be accepted, then led to a renewed large outflow of capital in April 1994; this tendency was quickly reversed in May and June, when it became apparent that the transition was being achieved in a peaceful manner. The net outflow of capital nevertheless still amounted to R2,6 billion in the second quarter of 1994.

More than 90 per cent of the net capital outflow in 1993 was in the form of *short-term capital*, i.e. capital with an original maturity of one year or less. Owing largely to political and social uncertainty, the ongoing internal unrest, pressure on the exchange rate of the rand and a relatively weak US dollar, the net outflow of short-term capital totalled R14,8 billion in 1993, well in excess of the net outflow of short-term capital of R2,2 billion in 1992. In the first half of 1994 this outflow of short-term capital amounted to only R0,4 billion. This remarkable improvement was to some extent due to a turnaround in the short-term foreign liabilities of private banks, which had decreased by R2,8 billion in 1993 but then rose by R3,6 billion in the first half of 1994. Apart from the fact that tighter domestic money market conditions encouraged banks to utilise foreign credit facilities, this switch reflected a return-flow of funds that had left the country in December 1993 because of the financial year-ends of foreign lenders. The outflow of other short-term capital, however, also decreased considerably, from R8,5 billion in the last half of 1993 to R4,0 billion in the first half of 1994.

In 1993 the outflow of *long-term capital* came to R1,5 billion and consisted mainly of repayments on foreign loans by public authorities and public corporations. Owing to the relatively high cost of foreign borrowing vis-à-vis domestic borrowing, these institutions were reluctant to roll over debt falling due to non-residents. Large amounts of bearer bonds and notes and loans guaranteed by foreign governments were redeemed, while no public and private placements on international capital markets have been undertaken since May 1992. These institutions and the private sector also made net repayments on debt converted to medium- and long-term loans outside the standstill net and the final three instalments to foreign creditors in terms of the Third Interim Debt Arrangements that fell due in 1993.

Long-term capital movements to the private sector, which had shown a net outflow of R4,7 billion in 1992, changed to a net inflow of R2,2 billion in 1993. This net inflow of capital, however, included net purchases of R4,2 billion by non-residents of securities listed on the Johannesburg Stock Exchange which, of course, do not represent a net gain of foreign reserves to the country because these transactions have to be concluded through the financial-rand mechanism. A net outflow of other long-term capital of R2,0 billion from the non-bank private sector was therefore still registered in 1993.

A further net outflow of long-term capital in the first half of 1994 was estimated at R3,3 billion. This outflow of capital was affected by the upfront payment of R1,6 billion in terms of the 1993 Debt Arrangements with foreign creditor banks, repayments of R1,3 billion on debt converted to long-term loans outside the standstill net, and redemptions of loans guaranteed by foreign governments to an amount of R1,0 billion.

Foreign debt

Further reductions were recorded in South Africa's foreign debt in 1993. The so-called *affected debt* of South Africa (i.e. the debt to which the standstill arrangements apply) decreased from US$5,5 billion at the end of 1992 to $4,4 billion at the end of the Third

Table 4. Foreign debt of South Africa
$ billions

	1989	1990	1991	1992	1993
Affected debt					
Public sector	2,6	2,0	1,9	1,8	1,3
Monetary sector	3,5	3,1	2,5	2,1	1,6
Other	1,2	1,5	1,6	1,6	1,5
Total	7,3	6,6	6,0	5,5	4,4
Non-affected debt					
Public sector	5,3	4,8	4,9	4,7	4,7
Converted long-term loans	4,4	4,8	4,8	4,8	4,5
Other	3,6	3,2	2,4	2,3	3,1
Total	13,3	12,8	12,1	11,8	12,3
Rand-denominated debt[1]					
Bonds	4,0	5,0	4,7	6,0	6,4
Financial-rand deposits	0,3	0,8	1,6	2,6	1,3
Other[2]	0,9	1,0	1,2	1,3	1,4
Total	5,2	6,8	7,5	9,9	9,1
Total foreign debt	**25,8**	**26,2**	**25,6**	**27,2**	**25,8**

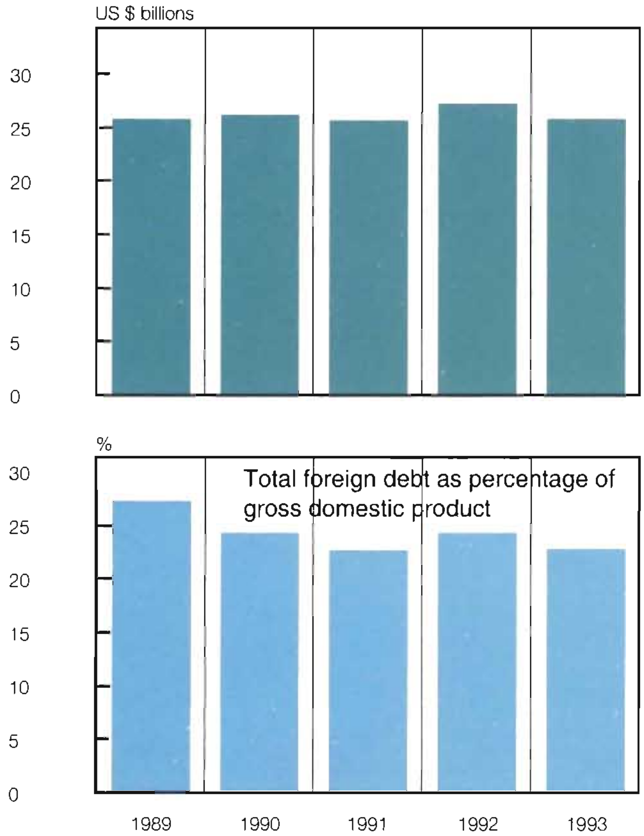
1. Converted into dollars at the exchange rates of the commercial rand.
2. Including blocked and freely transferable funds, but excluding equity.

Interim Debt Arrangements with foreign creditor banks on 31 December 1993. Valued at the exchange rates prevailing on 31 August 1985, the affected debt has been reduced by $9,7 billion from $13,6 billion at the beginning of the standstill at the end of August 1985 to only $3,9 billion at the end of 1993. No less than $3,1 billion has been repaid on affected debt in terms of the interim debt arrangements concluded with foreign creditor banks. The further reduction in affected debt was due to conversions into longer-term loans outside the net and to debt equity swaps. In accordance with the 1993 Debt Arrangements with foreign creditor banks concluded in September 1993, the affected debt will be redeemed in full by August 2001.

In contrast to these developments, the *non-affected foreign debt* (i.e. debt not affected by the standstill arrangements but repayable at the exchange rates of the commercial rand) rose slightly from $11,8 billion at the end of 1992 to $12,3 billion at the end of 1993. This increase was largely the result of a $850 million loan raised from the International Monetary Fund in terms of the Fund's Compensatory and Contingency Financing Facility in December 1993, and of drawings on short-term credit facilities by the Reserve Bank. The non-affected debt in the form of converted long-term loans payable by the private sector decreased sharply in 1993. Because of short-term borrowing by the public sector, the maturity structure of the non-affected debt deteriorated considerably. At the end of 1993 approximately 35 per cent of the non-affected debt was repayable in the next twelve months, while the share of short-term debt was 30 per cent of total non-affected debt at the end of 1992.

The country's so-called *rand-denominated debt* (i.e. debt subject to financial and blocked rand exchange control regulations and converted into dollars at the commercial rand rates of exchange) decreased moderately from $9,9 billion at the end of 1992 to $9,1 billion at the end of 1993. This represented a reversal of the sharp upward movement in this type of foreign debt from 1989 to 1992. This decline was, however, entirely due to changes in the exchange rate of the rand; in rand terms the rand-denominated foreign debt increased slightly from R30,3 billion at the end of 1992 to R30,9 billion at the end of 1993. The slower rate of increase in this type of debt in 1993 was due to the fact that non-residents were large net purchasers of share capital; part of their financial-rand deposits with banks was therefore used for purchasing ordinary shares which are not included in foreign debt.

Total foreign debt 1)



1) Including rand-denominated debt.

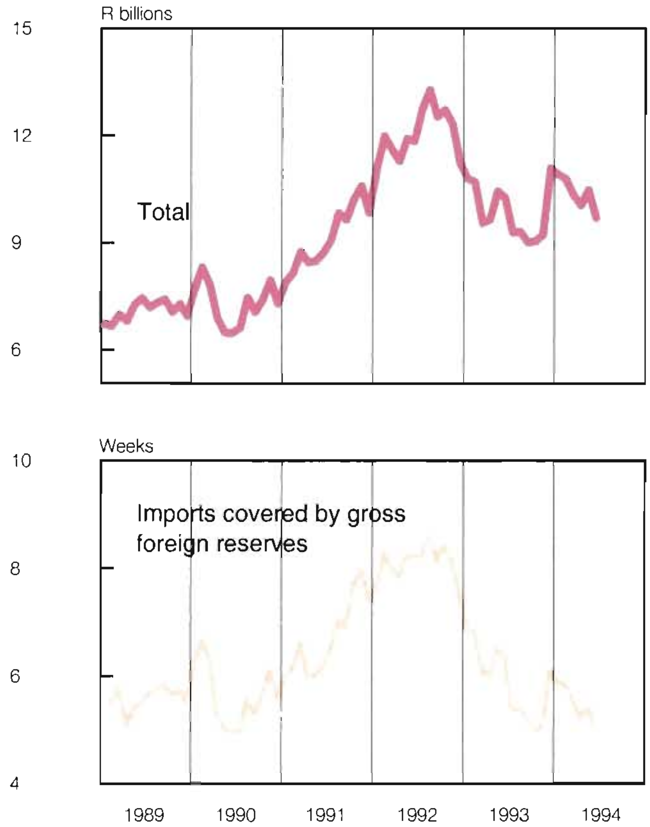
If rand-denominated foreign debt is taken into account when calculating South Africa's *total foreign debt* (in the past this was not always included in total foreign debt because it did not affect the standstill arrangements with foreign creditors and did not represent a direct claim on the foreign reserves of the country because of the financial rand restrictions), South Africa's total outstanding foreign debt amounted to \$25,8 billion at the end of 1993. This may be compared with \$27,2 billion at the end of 1992 and \$25,8 billion at the end of 1989. In terms of rand, South Africa's total foreign debt increased from R83,1 billion at the end of 1992 to R87,6 billion at the end of 1993. Measured in this way, the foreign debt of South Africa was equal to nearly 23 per cent of gross domestic product at the end of 1993; the corresponding ratio at the end of 1989 came to 27 per cent. As a further indication of the creditworthiness of the South African economy, the ratio of interest payments on total foreign debt to total export earnings amounted to only about 7 per cent in 1993.

Foreign reserves

Owing to the fact that the overall deficit on the balance of payments was financed largely by means of reserve-related borrowing in 1993, the *total gross gold and other foreign reserves* of South Africa declined only marginally from R11,2 billion at the end of 1992 to R11,1 billion at the end of 1993. The further deterioration in the overall balance of payments position during the first half of 1994, however, led to a sharp decrease of R1,4 billion in the total gross gold and other foreign reserves to a level of R9,7 billion at the end of June 1994. These reserves were equivalent to the value of about 5 weeks' imports of goods and services.

Reflecting the improvement in the net foreign reserves of the Reserve Bank, the gross gold and other foreign reserve holdings of the *Reserve Bank* rose moderately in July 1994 by R0,5 billion to R7,6 billion at the end of the month. The Reserve Bank's gold reserves on that date amounted to 4,1 million fine ounces, i.e. to less than two-thirds of the gold holdings of 6,6 million fine ounces at the end of 1992.

Gross gold and other foreign reserves



Foreign exchange market

The *international foreign exchange markets* in 1993 and the beginning of 1994 were characterised by relative overall stability of the US dollar. The nominal effective exchange rate of the dollar fluctuated within a fairly narrow range throughout 1993 until April 1994. From May a distinct declining trend in the weighted average value of the dollar became discernible. Despite this overall stability, the value of the dollar against individual currencies showed widely divergent movements: it fell substantially against the Japanese yen but appreciated against the European currencies and the Canadian dollar. From May 1994 the dollar began to decline against most currencies and large intervention by the Federal Reserve System and other central banks could not prevent the dollar from reaching a new post-World War II low of ¥97,26 per dollar on 12 July 1994.

These movements in the dollar again had a profound effect on the *South African market in foreign exchange* because more than 80 per cent of all foreign transactions in South Africa are conducted in this currency. In addition, uncertain domestic conditions also contributed to wide fluctuations in the turnover in the domestic market. The average net daily turnover in the market in foreign exchange (gross figures adjusted to avoid double counting arising from local interbank transactions) rose at first from US$4,0 billion in January 1993 to $4,4 billion in July 1993, but then declined to $3,5 billion in December 1993; it subsequently increased sharply again to $4,5 billion in June 1994.

Another interesting development in the domestic market in foreign exchange since the beginning of 1994 has been the substantial increase in spot market activity relative to that of forward covering. This development could probably be attributed to uncertain conditions which brought about prepayments on imports of goods and services to avoid the impact of an expected depreciation of the rand. Moreover, the ratio of the value of the net turnover in foreign exchange to the value of South Africa's exports and imports of goods and services also rose from between 14 and 15 in the period 1989 to 1992 to 19½ at the beginning of 1993 and to approximately 19 in the first six months of 1994. This suggests that transactions arising from capital flows, hedging, arbitrage and position-taking increased in relative importance to those of underlying foreign trade transactions.

South Africa's weak overall balance of payments position caused the exchange rate of the rand to depreciate against all major currencies in 1993, with the notable exception of the Italian lira. The *nominal effective exchange rate* of the rand decreased very rapidly in the first half of 1993, but was fairly stable in the second half of the year. From the end of December 1992 to the end of December 1993 the weighted average value of the rand contracted by 8,7 per cent.

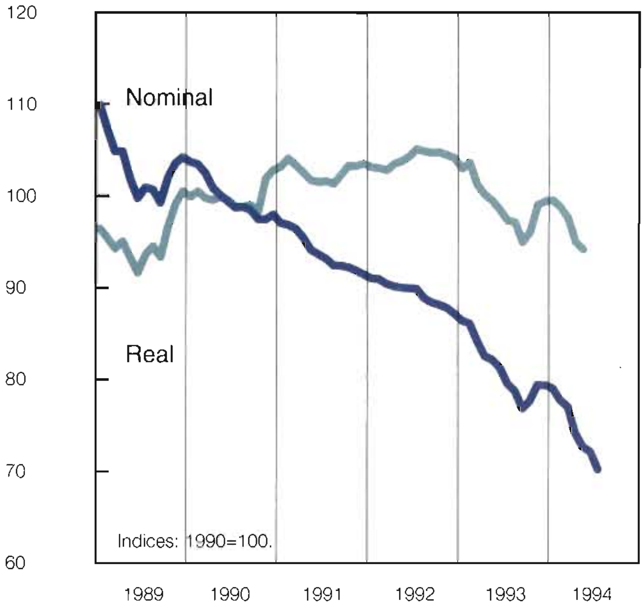
In the first seven months of 1994 the nominal effective exchange rate of the rand again decreased substantially by 11,0 per cent. Sharp fluctuations were also registered in the exchange rate of the rand against individual currencies: the exchange rate of the rand fluctuated in this period between a high of R3,40 per dollar on 10 January 1994 and a low of R3,70 per dollar on 26 July 1994. The further decline in the weighted average value of the rand in the first seven months of 1994 brought the cumulative decline from the end of December 1992 to the end of July 1994 to 18,7 per cent. In view of the strong performance of the Japanese yen over this period, the rand depreciated by no less than 33,3 per cent against this currency. The rand also depreciated against all the other currencies of the major industrial countries, but appreciated against all currencies in Southern Africa with the exception of the Botswana pula.

The decrease in the nominal effective exchange rate of the rand was more than sufficient to offset the inflation differential (measured as the difference between changes in production prices) between South Africa and its main trading partners. After having increased by only 0,7 and 0,6 per cent in 1991 and 1992, the *real effective exchange rate of the rand* declined sharply by 4,5 per cent in 1993 and by a

Table 5. Changes in exchange rates of the rand
Per cent

	31 Dec 1992 to 30 June 1993	30 June 1993 to 31 Dec 1993	31 Dec 1992 to 31 Dec 1993	31 Dec 1993 to 31 July 1994	31 Dec 1992 to 31 July 1994
US dollar	-8,1	-2,2	-10,1	-7,4	-16,8
British pound	-7,7	-	-7,7	-10,5	-17,4
German mark	-3,8	0,4	-3,4	-15,2	-18,0
Japanese yen	-21,5	2,7	-19,4	-17,3	-33,3
Netherlands guilder	-4,0	0,2	-3,8	-14,9	-18,1
Italian lira	-4,3	8,8	4,2	-13,7	-10,1
Nominal effective	-8,6	-0,2	-8,7	-11,0	-18,7

Effective exchange rates of the rand



further 6,0 per cent in the first half of 1994. At the end of June 1994, the real effective exchange rate of the rand was therefore 9,2 per cent below its level at the end of 1990.

In the *financial rand market*, the exchange rate appreciated at first by 15 per cent in the first ten months of 1993 because of the continuing strong demand for South African securities, progress made in the political negotiation process and the lifting of many sanctions against South Africa. On 15 October 1993 the financial rand reached a high of R4,10 per dollar. The financial-rand discount also narrowed substantially from 37,2 per cent at the end of December 1992 to 16,4 per cent on 8 October 1993.

Concern over violence-related incidents, political uncertainty and profit-taking brought about a depreciation of the financial rand to an all-time low of R5,58 per dollar on 11 April 1994, while the financial-rand discount reached a level of 35,7 per cent. As it became apparent that the new political dispensation was acceptable to most South Africans, the financial rand began to appreciate again. This appreciation was strengthened by expectations that the financial-rand mechanism would be abolished shortly and that the depreciation in the exchange rate of the commercial rand would probably be smaller than the financial-rand discount at that stage. The exchange rate of the financial rand accordingly reached R4,61 per dollar on 31 July 1994 and the financial-rand discount narrowed sharply to 20,4 per cent.

Monetary developments and interest rates

Monetary policy

Since about 1989 the main objective of monetary policy has been to secure a stable financial environment within which optimum economic growth and development can be sustained in the long run. In order to accomplish this objective, a fairly restrictive monetary policy stance was adopted and Bank rate was increased to 18 per cent towards the end of 1989. As a result of the success achieved in creating greater financial stability, the monetary authority began gradually to reduce Bank rate from the beginning of 1991. In 1993 Bank rate was lowered further on two occasions: from 14 to 13 per cent from 9 February and to 12 per cent from 28 October. In recognition of the need for a mild easing of monetary policy, the Reserve Bank also lowered the minimum cash reserve requirements in April and August 1993.

The real Bank rate (i.e. Bank rate adjusted for the rate of consumer price inflation in the immediately preceding twelve-month period) also declined from 4,5 per cent in December 1992 to 2,3 per cent in December 1993. Real interest rate levels, however, remained positive throughout this period. In accordance with the objective of financial stability, the money supply guidelines were also lowered from 7-10 per cent in 1992 to 6-9 per cent in 1993. In 1989 the guideline growth range had still been set at 14-18 per cent.

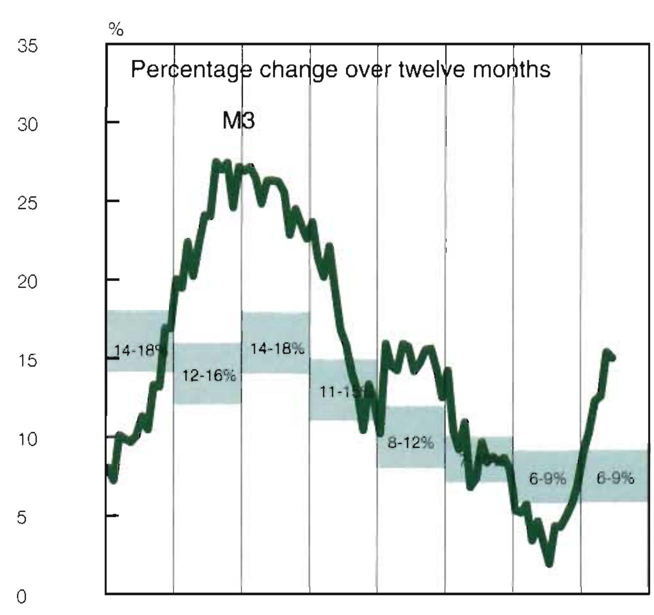
Recent economic developments have precluded any further reductions in Bank rate – the key operational variable of the Reserve Bank. Restrictive measures have had to be maintained in the light of various constraints and developments that have stood in the way of a possible further easing of monetary policy. Such developments have included:

- persistently high and increasing inflation expectations, in conjunction with an inflation rate that remained higher than the corresponding rates in South Africa's main trading partner countries;
- the deterioration of the balance of payments situation in the course of 1993 and the beginning of 1994, which led to a sharp contraction in the gross foreign reserves of the country to low levels, despite extensive foreign borrowing by the authorities to support these reserves;
- downward pressure on the exchange rate of the rand arising from the weaker overall balance on foreign transactions;
- the still high, albeit somewhat lower, deficit on the Budget of the government as a ratio of gross domestic product, and the rising level of public debt; and
- the marked increase in the growth of the money supply and bank credit extension since the second half of 1993.

The Bank therefore maintained an unchanged Bank rate in the first half of 1994 and allowed the real Bank rate, (i.e. Bank rate as adjusted with current increases in the consumer price index) to rise sharply to 4,2 per cent in June 1994. The "underlying" real Bank rate is probably lower, however, if the nominal rate is adjusted for the *expected* inflation rate. The Reserve Bank also decided to keep the money supply guidelines for 1994 at the levels of the previous year. This meant a guideline range of 6-9 per cent for growth in M3 from the fourth quarter of 1993 to the fourth quarter of 1994. In maintaining these guidelines, the Governor of the Reserve Bank stated that monetary policy should serve the requirements of monetary stability together with a recovery in the domestic economy, because these growth rates in money supply should:

- neither restrict the real growth in the economy, which only came under way in 1993, nor stimulate it artificially;
- not facilitate further outflows of capital in an already vulnerable balance of payments situation;

Guidelines for growth in M3



- continue to apply downward pressure on inflation; and
- allow sufficient scope for total monetary expenditure to increase, taking into account prospective changes in the income velocity of money.

The Governor reconfirmed that the Reserve Bank does not regard its money supply guidelines as a rigid overriding money rule which precludes any discretion by the authorities. In making policy decisions, developments in other financial variables, such as interest rates, changes in domestic credit extension by monetary institutions, the level of and the current trend in the foreign reserves, and exchange rate movements, are also carefully monitored.

Money supply

The growth in the money supply, which had reached a peak in the third quarter of 1988, at first continued to decline in the first half of 1993, but at a much more subdued pace. In the second half of the year money supply growth began to accelerate, and M3 rose even more rapidly in the first half of 1994. The twelve-month rate of increase in the *broadly defined money supply (M3)* decreased from 8,0 per cent in December 1992 to only 1,9 per cent in July 1993; it then rose steadily to 7,0 per cent in December 1993 and reached 15,0 per cent in June 1994.

In the first half of 1994 the monthly seasonally adjusted values of M3, which had fallen below the guideline range during most of the 1993 guideline year, rose above the upper limit of the new guideline range for 1994. In fact, the growth in M3 (seasonally adjusted and at an annualised rate) from the base of the current guideline amounted to 14,4 per cent in June 1994, while the seasonally adjusted value of M3 was R6,8 billion higher than the corresponding value of the upper limit of the guideline range.

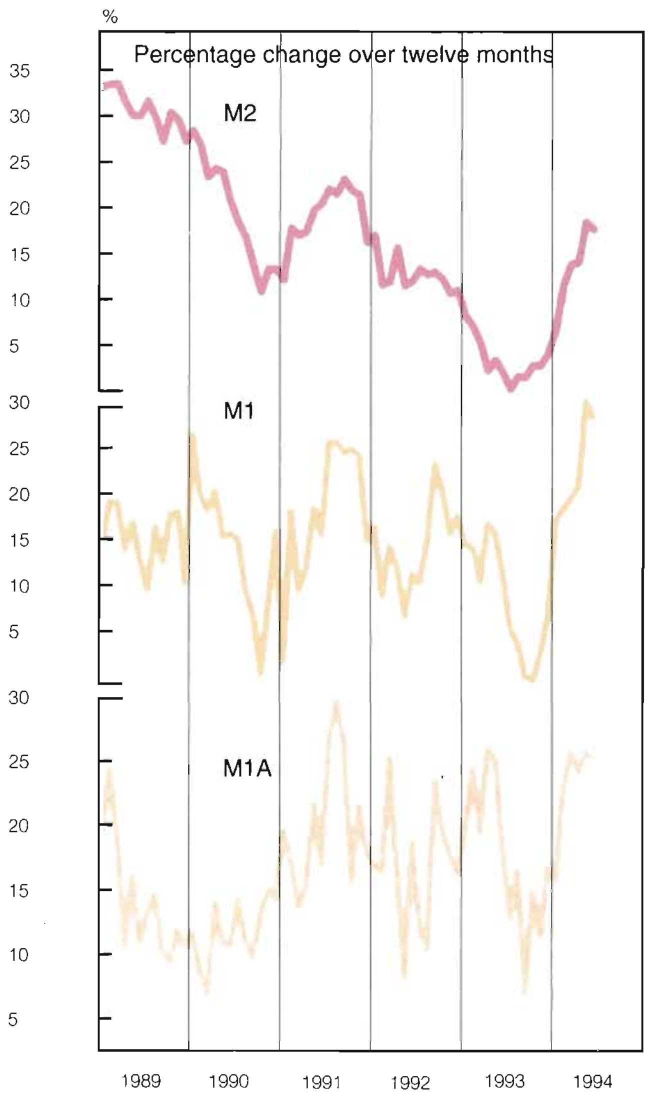
As shown in Table 6, changes in the twelve-month growth rates in the *narrower monetary aggregates*

Table 6. Twelve-month growth rate in monetary aggregates

Per cent

	M1A	M1	M2	M3
Dec 1992......	16,2	17,5	10,8	8,0
Mar 1993......	19,4	10,4	5,1	5,7
June 1993......	18,1	11,0	1,8	3,3
Sep 1993......	6,9	0,0	1,3	4,3
Dec 1993......	16,6	6,7	3,9	7,0
Mar 1994......	25,7	19,4	13,6	12,3
June 1994......	25,1	28,2	17,5	15,0

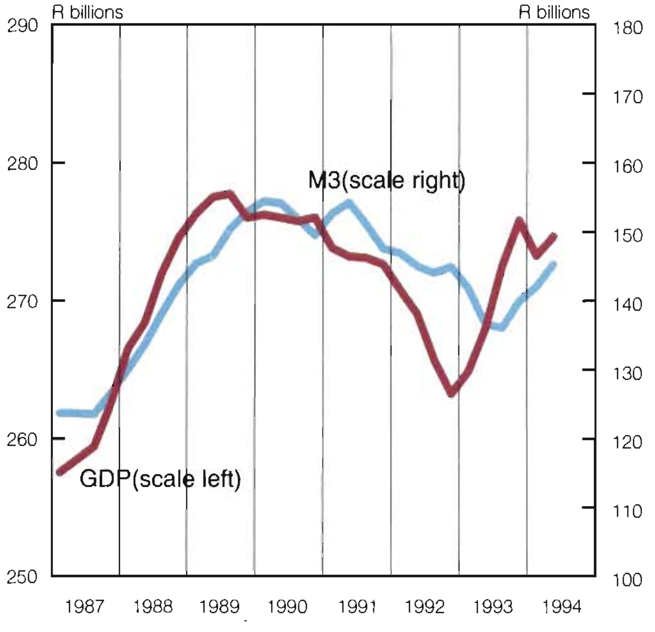
Monetary aggregates



coincided fairly closely with changes in the growth rates of M3. In fact, the changes in the rate of increase in M2 displayed exactly the same time pattern as M3, but displayed wider oscillations than the growth rate in the broader aggregate. The growth in the narrower aggregates, M1A and M1, fluctuated considerably during the first half of 1993, but then fell back sharply to September. Subsequently, the twelve-month growth rates in both these aggregates rose to very high levels in the first six months of 1994, clearly indicating depositors' preference for demand deposits.

The recent increase in money supply was partly due to the revival in the domestic economy. A close correlation normally exists between growth in the real gross domestic product and in the real money supply (deflated by the consumer price index). As illustrated in

Real M3 and real gross domestic product



the accompanying graph, the changes in these two aggregates were closely correlated in the late 1980s and only began to diverge in the early 1990s, when changes to legislation (which led to the reintermediation of off-balance-sheet transactions of banks) caused the money supply to rise sharply in a recessionary period. At the beginning of 1993 the revival in the domestic economy at first did not affect the growth in the money supply, probably because the recovery was largely confined to the agricultural sector with its relatively large debt burden. A reduction in the banks' advances to agriculture reinforced the downward movement in the rate of increase in the money supply. As the real growth in the economy became more widespread, the rate of increase in the money supply also began to accelerate in the second half of 1993. However, from the beginning of 1994 the real economic growth in the country levelled off, while the rate of increase in the money supply rose even further; real economic activity was therefore not solely responsible for the acceleration in the rate of increase in the money supply.

The rapid growth in the money supply was probably also related to a considerable improvement in the cash flow position of business enterprises. A strengthening in the profits of companies, a running-down of government deposits with the banks and a sharp increase in government stock held by banks, led to a large flow of cash to the private business community. The private sector's liquidity preference rose at the same time, *inter alia* on account of political uncertainties, expected interest rate changes and expectations of major adjustments in the share as well as the bond market. Bank deposits of companies, close corporations and unincorporated businesses in the private sector (excluding insurers and pension funds) accordingly accounted for slightly more than 40 per cent of the increase of R29.4 billion in M3 during the twelve months to June 1994, while private individuals (by far the largest holders of bank deposits) contributed 25 per cent. The uncertain political and investment climate not only showed up in an increase in total deposit holdings, but also in a clear preference for shorter-term deposits with monetary institutions.

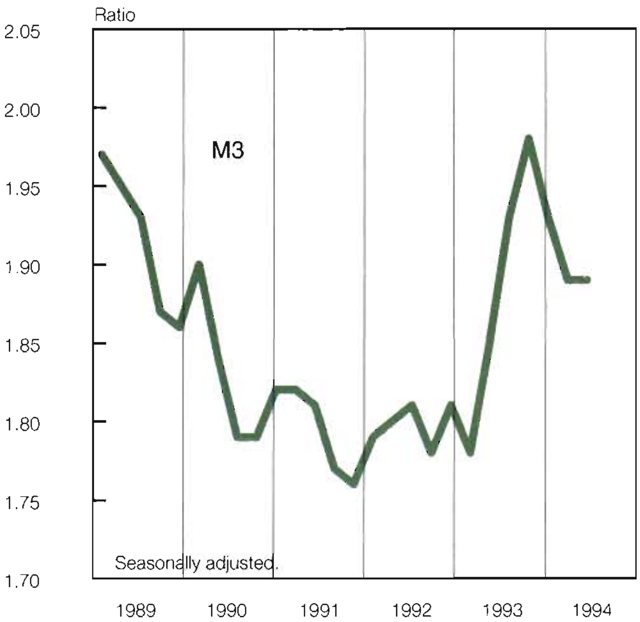
The higher liquidity preference of the private sector has also been reflected in the recent decline in the income velocity of M3. After having increased from 1,78 in the fourth quarter of 1992 to 1,98 in the third quarter of 1993, the income velocity of M3 turned around and declined to 1,89 in the second quarter of 1994. This decline in the income velocity of money took place in a period during which the margin between the banks' deposit and lending rates remained fairly wide. Such a disparity between these rates usually favours disintermediation and an increase in the income velocity of money.

The *main counterparts* (in a statistical or accounting sense) of the increase in M3 in the twelve months until the end of June 1994 were as follows:

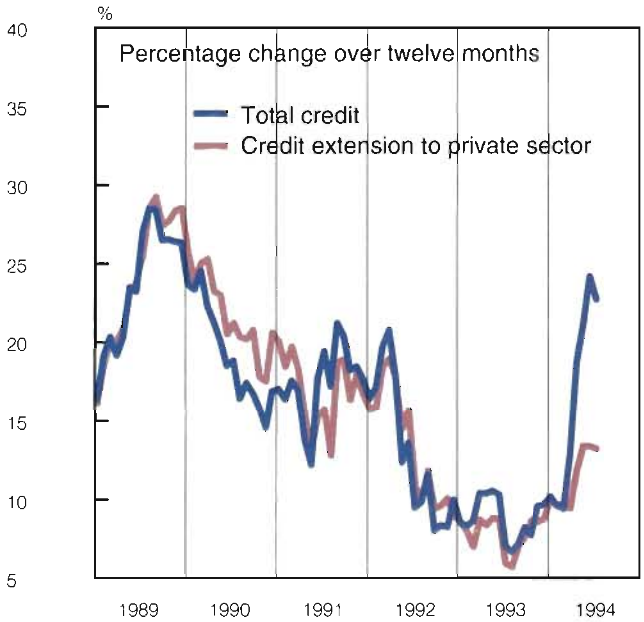
		R billions
Net foreign assets		-10,8
Government sector: net claims		20,6
Gross claims	18,4	
Government deposits	-2,2	
Claims on the private sector		28,2
Net other assets and liabilities		-8,6
Total change in M3		**29,4**

These statistical counterparts were, however, distorted somewhat by the partial redemption by the government of the outstanding balance on the Gold and Foreign Exchange Contingency Reserve Account by issuing special government stock to the Reserve Bank; this caused a shift in the statistical counterparts from changes in "net other assets and liabilities" to changes in net claims on the government sector, without affecting the change in M3. The change in the monetary sector's claims on the government sector (gross and net) was therefore "overstated" by this government stock issue of R7,5 billion to the Reserve Bank; the measured change in "net other assets and liabilities" was "understated" by the same amount. Even after disregarding this amount, the gross claims of the monetary institutions on the government still rose by R10,9 billion, because banks invested large amounts in government stock on account of the eligibility of these stocks at the discount window, zero

Income velocity of money



Credit extended by monetary institutions



capital requirements on them, a low demand for credit by the private sector and gains expected from holding this paper in a downward phase of the interest rate cycle. The decline in government deposits was mainly related to the funding practice of the government: a large proportion of the borrowing requirement of the government was financed by means of stock issues to the non-bank private sector before or shortly after the beginning of fiscal 1993/94; the proceeds of these issues were placed on deposit with monetary institutions, to be used when needed.

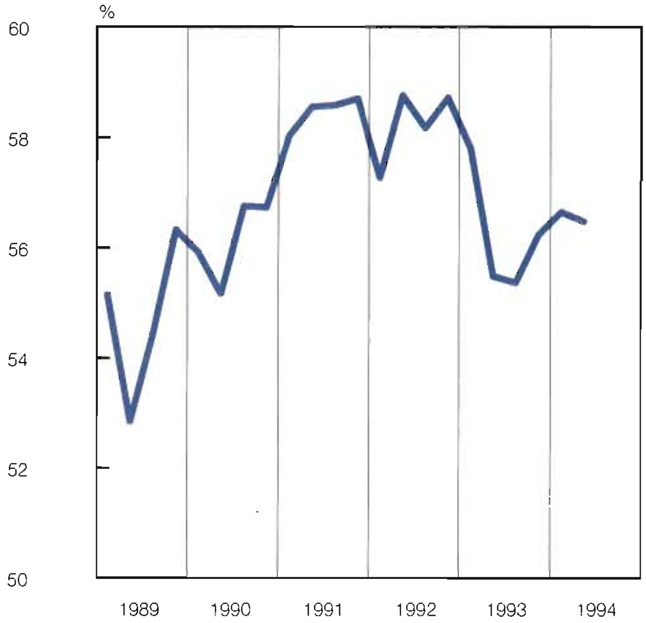
Credit extension

The increase in the net claims of the monetary sector on the government sector was partly responsible for a reversal of the growth of *total domestic credit extension* of monetary institutions. After having declined from the fourth quarter of 1988 until May 1993 as a result of the recessionary conditions, lower inflation, political uncertainties and the relatively high cost of borrowing, a sharply upward trend became discernible in the rate of increase in total domestic credit extension. The twelve-month growth rate in this aggregate picked up fairly hesitantly at first from a trough of 6,7 per cent in May 1993 to 9,6 per cent in December 1993; it then strengthened considerably to 18,7 per cent in March 1994 and 22,7 per cent in June.

This marked acceleration in total credit extension in the first half of 1994 was affected by the special government stock issue to the Reserve Bank. If this stock (which did not represent new credit extension) is not taken into consideration, the twelve-month growth rate in total credit extension still amounted to 19,2 per cent in June 1994. Although this sharp rise in total credit was to a large extent due to an increase in net claims of the monetary institutions on the government, the growth in *bank credit to the private sector* also recovered. The rate of increase over twelve months in the credit extension to the private sector, which had contracted from 8,7 per cent in December 1992 to 5,7 per cent in May 1993, rose to 9,7 per cent in December 1993 and to 13,2 per cent in June 1994.

In *real* terms, i.e. adjusted for inflation as measured by changes in the consumer price index, the growth rate in credit extended to the private sector remained negative during most of 1993 and in the first two months of 1994; it became positive only in March 1994 and amounted to 5,4 per cent in June 1994. Compared with other periods of economic recovery, credit extension to the private sector is following more or less the normal pattern, although it did react fairly quickly to the upturn in activity. As a ratio of gross domestic product, credit extended to the private sector was, at 56,5 per cent in the second quarter of 1994, at an exceptionally high level for the beginning of an economic recovery. This was mainly due to the fact that this ratio had remained fairly stable during the

Credit extension to private sector as percentage of gross domestic product



recession, which could be ascribed to the severe drought that was experienced in 1991/92. The unusual stable relationship between credit extension to the private sector and gross domestic product may also have been the result of regulatory changes that discouraged disintermediation practices.

An analysis of monetary institutions' claims on the private sector by *type of credit* shows that the R28,2 billion increase in credit extension to the private sector during the twelve-month period ended June 1994 could be attributed mainly to increases of R15,0 billion and R8,9 billion in mortgage advances and in so-called "other loans and advances" (including overdrafts), respectively. These two types of credit extension therefore accounted for about 85 per cent of the increase in credit extension to the private sector during this twelve-month period. Instalment sale credit and leasing finance also contributed to this increase. The monetary sector's investments and bills discounted, on the other hand, actually decreased even in absolute terms.

Mortgage advances continued to increase at a fairly high rate throughout 1993 and the first half of 1994. The twelve-month rate of increase in mortgage advances actually picked-up slightly from an already high level of 17,3 per cent in December 1992 to 17,7 per cent in December 1993 before falling back to 16,8 per cent in June 1994. Active promotion of this credit facility by the banks, on account of the low capital requirements applicable to it, was mainly responsible for this continued strong growth in mortgage advances. In view of the flexibility of some of the mortgage schemes and the comparatively low interest rates that are charged on these advances, mortgage accounts have been used increasingly by many bank clients to finance purchases of durables and other consumer goods. This had an important effect on total credit extension, because about 43 per cent of the monetary institutions' claims on the private sector now consists of mortgage advances.

The twelve-month growth rate in *"other loans and advances"* remained negative during the first half of 1993 and rose to only 8,4 per cent in December 1993; however, it then increased sharply to 12,3 per cent in June 1994. This rise in "other loans and advances" reflected to some extent the upturn in real consumption expenditure, but was probably also due to distress borrowing by some smaller- and medium-sized enterprises after a long period of negative growth. "Other loans and advances" to companies and close corporations accordingly rose by nearly 27 per cent during the twelve months ended June 1994. In view of the relatively high cost of overdrafts, the share of this type of lending in total credit extension to the private sector fell from 16,4 per cent in June 1993 to 14,0 per cent in June 1994.

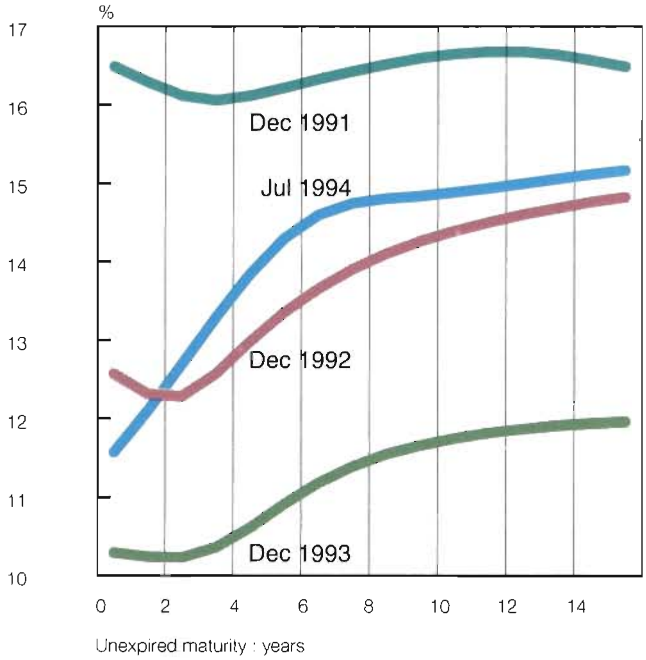
Credit in the form of *instalment sale* financing increased significantly from the beginning of 1993: the twelve-month growth rate in this type of credit rose from 1,5 per cent in December 1992 to 11,4 per cent in June 1993 and to 23,5 per cent in June 1994. The high rates of increase of such credit over the past twelve months could mainly be ascribed to rising sales of motor vehicles, "special rate" vehicle finance schemes that were introduced by banks, and a substantial increase in the use of this type of credit for purchases of second-hand passenger cars.

The twelve-month growth rate in *leasing finance* declined in the first half of 1993 from 9,6 per cent in December 1992 to only 2,2 per cent in June 1993; it then rose moderately to 6,8 per cent in December 1993 and 8,4 per cent in June 1994. The higher growth in leasing finance was mainly the result of increased use of this type of finance for the acquisition of new passenger cars and of industrial, commercial and office equipment, in which case certain tax benefits apply. Leasing finance to companies increased accordingly at a somewhat higher rate than leasing finance to individuals.

Interest rates

As clearly evident from the accompanying graph, which shows the *yield curve* in South Africa, the downward adjustment in the interest rate structure in 1992 and 1993 was reversed in the first half of 1994. From February 1994 the South African yield curve shifted to

Yield curves



a higher level without any changes having been announced in Bank rate. These firmer interest rates were a reflection of the relative tightness of money market conditions and of increasing uncertainty in the pre- and immediate post-election period. The continued drain on foreign reserves, fears that future government expenditure might outstrip the resources of the economy, higher inflation expectations and the realisation that earlier optimism about capital flows after the election had been unrealistically high, served not only to lift the yield curve, but also to steepen it slightly.

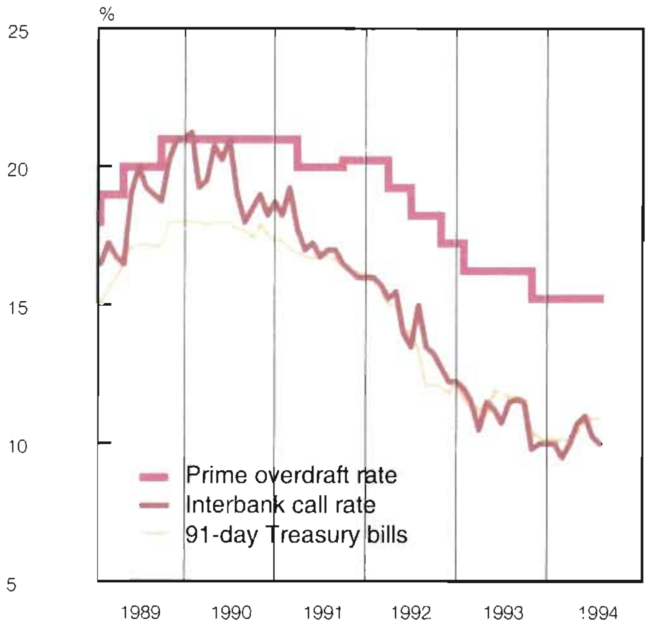
The shape of the yield curve has also changed significantly since the end of 1991. At that stage South Africa had an inversely sloped (i.e. downward-sloping) but fairly flat yield curve. The decline in short-term interest rates in 1992 was more pronounced than that in long-term rates, because of expected further reductions in Bank rate and somewhat pessimistic inflation expectations. These developments caused the yield curve to assume a more normal appearance (i.e. an upward-sloping shape), at the end of 1992, but interest rates on paper with a maturity of less than one year were slightly higher than the rates on paper with a maturity of one to two years. In 1993 longer-term rates decreased more than shorter-term rates, with the result that the traditional normal upward-sloping yield curve was discernible at the end of 1993.

From February 1994 interest rates moved upwards over the whole maturity spectrum. However, yields on medium- and long-term stock increased by more than those on short-term stock. This caused a steepening in the upward-sloping yield curve, probably reflecting stronger expectations of an acceleration in inflation. At the end of July 1994 the yield curve was particularly steep for paper with a maturity of one to six years and was relatively flat over the rest of the maturity spectrum. This yield curve probably also indicated stronger expectations of further future upward adjustments in short-term interest rates.

The initial downward and subsequent upward movement in short-term interest rates was clearly reflected in the rate on *interbank call money*. This rate decreased from 16,00 per cent at the end of December 1991 to 12,25 per cent at the end of December 1992 and to 10,00 per cent at the end of December 1993; it then declined further to 9,50 per cent at the end of February 1994 before rising to 11,00 per cent at the end of May 1994. The inter-bank call rate came down again to 10,00 per cent in July 1994.

Most of the other money market interest rates recorded a similar pattern. The rate on *three-month bankers' acceptances* declined from 16,65 per cent at the end of 1991 to 10,15 per cent at the end of 1993; it then remained at more or less that level in the ensuing three months. In April 1994 this rate started to increase fairly sharply, reaching 11,05 per cent at the end of May. This rate eased somewhat to 10,90 per cent at the end of July 1994. The tender rate on *three-month Treasury bills* also declined from 16,13 per cent at the end of December 1991 to 10,17 per cent at the

Short-term interest rates



end of December 1993, remained at that level during the first quarter of 1994 and increased to 11,00 per cent at the end of May. This rate also eased somewhat to 10,89 per cent at the end of July 1994.

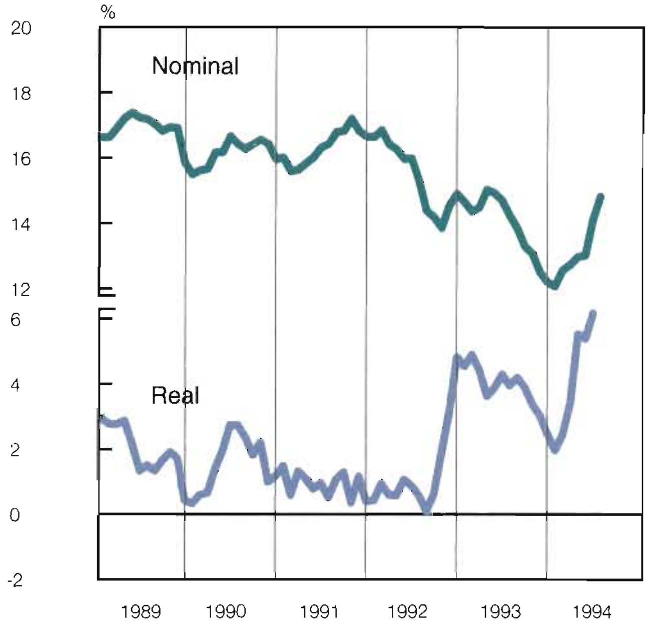
As in the past, the *prime lending rates of banks* followed changes in Bank rate closely. It was therefore also reduced by two percentage points in 1993, namely from 17,25 per cent to 16,25 per cent, with effective dates ranging from 15 February to 2 March 1993, and further to 15,25 per cent from 1 November 1993. Both Bank rate and the banks' prime lending rate remained unchanged during the first seven months of 1994. The inflation-adjusted or *real* prime lending rate of banks declined, on balance, from 7,0 per cent in December 1992 to 5,2 per cent in December 1993. This rate declined further in the first two months of 1994, but increased to 7,2 per cent in June, because of a decline in the recorded inflation rate.

The predominant *rate on twelve-month fixed deposits* with banks, which is regarded as indicative of deposit rate behaviour in general, was lowered from 12 to 11 per cent in November 1993, and again to 10,5 per cent in February 1994. As a result of the fact that the prime overdraft rate of clearing banks was lowered by one percentage point in November 1993, the margin between the twelve-month deposit rate and the predominant prime overdraft rate of banks remained at first at 4,25 percentage points before increasing to 4,75 percentage points in February 1994. The twelve-month deposit rate provided depositors with a positive real pre-tax yield of 2,8 per cent in June 1994.

The downward movement of the monthly average *yield on long-term government stock*, from its level of 17,2 per cent in October 1991, was interrupted briefly when this rate increased from 13,9 per cent in October 1992 to 15,0 per cent in April 1993; the yield then declined quite sharply again in the subsequent months to 12,1 per cent in January 1994. This downward movement was mainly a reflection of the continued success achieved in reducing inflation, a decline in overseas interest rates, and foreign net purchases of domestic loan stock. Owing to factors such as the uncertainties that surrounded the political developments, net sales of domestic loan stock by non-residents, a firming in long-term interest rates in certain major economies and the capital market's concern about the government's financing needs, the yield on long-term government stock rose to a monthly average of 14,8 per cent in July 1994.

The *real* rates on long-term government stock, which had eased only slightly from 4,8 per cent in December 1992 to 3,9 per cent in September 1993, dropped to 2,0 per cent in January 1994, because the inflation rate firmed and long-term rates continued to fall. The subsequent decline in the inflation rate and the firming of long-term rates led to an increase in the monthly average real yield of government stock to 6,2 per cent in June 1994.

Yield on long-term government stock



The maximum permissible *finance charges rates*, as laid down in terms of the Usury Act, were reduced by 3,0 percentage points in 1993. With effect from 24 December 1993 these rates amounted to 23 per cent in respect of money lending, credit and leasing transactions for amounts of more than R6 000 (but not exceeding R500 000), and 26 per cent in respect of transactions for amounts up to R6 000.

Financial markets

Money market

Money market conditions, which had become tight in the second half of 1992, were even tighter during 1993 and the first half of 1994. This was clearly reflected in the amount of accommodation at month-ends, which increased from R3,8 billion at the end of December 1992 to R5,8 billion at the end of December 1993; this amount then fell back somewhat to R3,9 billion at the end of February 1994, but rose substantially again to R7,1 billion at the end of April. Although the amount of accommodation then declined from this exceptionally high level to R6,5 billion at the end of June 1994, money market conditions remained relatively tight throughout this period.

The tightening in money market conditions in 1993 was mainly due to a substantial decline of R5,2 billion in the net foreign assets (including gold) of the Reserve Bank, a decrease in the financing of the Land and Agricultural Bank by the Reserve Bank and the Corporation for Public Deposits, and a relatively small increase in the notes and coin in circulation. A further decrease in the net foreign assets of the Reserve Bank in the first six months of 1994 contributed to the continuation of the tight conditions. Fluctuations in these assets, and a temporary marked increase of R2,0 billion in notes and coin in circulation in March and April 1994, brought about fluctuations in the money market shortage in the first six months of 1994. These developments were offset to some extent by a decline in government deposits with the Reserve Bank.

The *Reserve Bank's actions* in the money market during 1993 were aimed primarily at preventing conditions from becoming too tight by injecting additional liquidity into the domestic money market. In accordance with this objective, in May and August 1993 the Bank lowered the minimum cash reserve requirements that banks have to comply with and transferred a large part of the Treasury cash balances held on deposit with the Reserve Bank to the private banking institutions. In addition, the monetary authority also neutralised short-term fluctuations in money market liquidity by adjusting the asset portfolio of the Corporation for Public Deposits.

With the sharp deterioration in the net foreign reserve holdings of the country in the first half of 1994, the Reserve Bank changed its policy stance and generally allowed the money market shortage to reflect underlying demand and supply conditions. By adopting this approach, the Bank made it difficult for the private banks to substitute domestic liabilities for foreign credit facilities and thereby discouraged the capital outflow from the country. Certain adjustments were, however, made to the asset portfolio of the Corporation for Public Deposits by selling some of the Corporation's assets in the money and capital markets. During the first six months of 1994 these transactions had a net tightening effect of about R2,0 billion on money market conditions. This was partly countered by an increase in the Reserve Bank's own portfolio of financial assets for open market operations to the amount of R0,4 billion. The Bank's total holdings of government stock as recorded on its balance sheet, however, showed a much more substantial rise, owing to the already mentioned special government stock acquired from the government.

As described in some detail in the Reserve Bank's *Annual Economic Report* for 1993, the monetary authority made certain *structural changes* to improve the functioning of the money market in 1993, including:

- the replacement of the former system of accommodation of cash shortages in the money market through rediscounting by a simplified system of overnight loans against the collateral of certain specified financial assets;
- the implementation of arrangements for the introduction of a system of Tax and Loan Accounts; and
- changes in the calculation of the banks' statutorily required minimum cash reserve and liquid asset holdings, which were to be based eventually on the banks' total liabilities (as reduced) instead of on their short-term liabilities as in the case of the earlier requirements. However, the additional cash reserve requirement (of one per cent) is still based on the banks' short-term liabilities only.

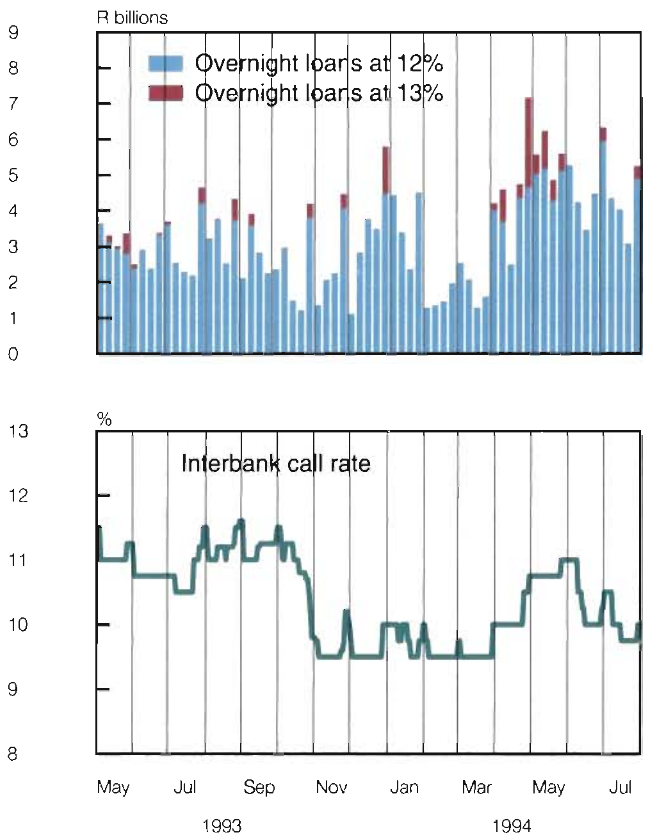
These changes had important implications for money market developments in 1993 and the first half of 1994. Firstly, the change from a system of rediscounting to a system of overnight loans for accommodating money market shortages reduced the effective minimum cost of accommodation by 0,5 per cent per annum from 1 May 1993, although Bank rate was left unchanged. However, short-term market interest rates did not respond to this effective reduction in Bank rate.

Secondly, these changes caused a structural adjustment in the composition of the money market instruments held by banks. The demand for bankers' acceptances decreased sharply because they could no longer be used as collateral for borrowing by banks at the discount window, they lost their liquid asset status, and higher interest rates became payable on them. The value of bankers' acceptances, bills and promissory notes held by banks therefore declined from R7,6 billion on 31 March 1993 (shortly before the changes became applicable) to R4,9 billion on 30 June 1994. At the same time, banks increased their holdings of Treasury bills and Land Bank bills. The banks' holdings of short-term government stock were also strengthened considerably from R9,6 billion in April 1993 to R12,1 billion in June 1994. These increased holdings of short-term government stock were, however, probably not only related to the new system of accommodating cash shortages: government securities were also an attractive investment vehicle, because of the relatively low supply of private-sector paper.

Finally, the limited amount of paper available for accommodation at the discount window at Bank rate and the tight money market conditions at times pushed the banks into "tier two" (Bank rate plus one percentage point) overnight loans, effectively increasing the marginal cost of accommodation. Under the old system of accommodating money market shortages, the size of the shortage had little effect on money market interest rates because banks could obtain additional bankers' acceptances to avoid penalty rates. As illustrated in the accompanying graph, however, the size of the money market shortage in the new system did force the banks to borrow at the higher rate at the discount window.

The monetary authority also implemented a *system of Tax and Loan Accounts* from June 1993 so that money market conditions would not be affected by large transactions of the fiscus. Until the end of 1993 the Reserve Bank mostly transferred government deposits from the Bank to private banks, with corresponding easing effects on the money market. These transactions formed part of the Bank's objective, at that stage, to alleviate tight money market conditions slightly. From the beginning of 1994 and especially since the start of the new fiscal year in April, the Reserve Bank became able to manipulate government deposits between the Exchequer Account and Tax and Loan Accounts on a daily basis, to influence money market conditions in the desired direction.

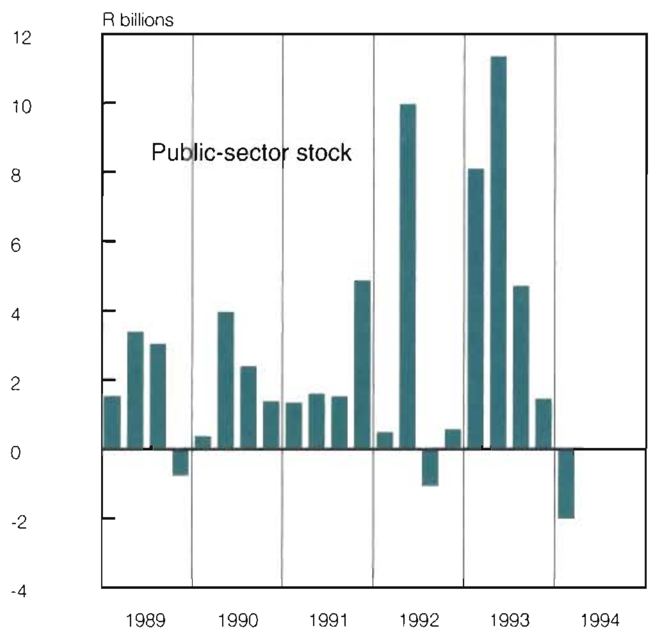
Accommodation and interest rates



Bond market

The demand for funds by the public sector in the *primary bond market* was high in 1993, but declined sharply in the first half of 1994. Net new borrowing by the *public sector* through issues of fixed-interest securities increased sharply from R9,9 billion in 1992 to R25,6 billion in 1993. Nearly 90 per cent of these net issues of marketable securities consisted of gilts, reflecting the large deficit before borrowing on the government's accounts. The largest proportion of the net new borrowing by the government was concluded in the first half of 1993, with the result that net new issues of the public sector declined from R19,4 billion in the first half of the year to R6,2 billion in the second half.

Net issues



In the first five months of 1994 the net new issues of the public sector decreased further to only R2,6 billion. This relatively low level of net borrowing by the public sector was partly due to net repurchases of government stock in the first quarter of 1994. It also reflected a change in the cash flow management of the government. Normally a substantial proportion of the borrowing requirement of the government was satisfied before or at the beginning of the fiscal year. In the current fiscal year, the raising of finance will be timed to coincide more closely with the government's needs.

The value of funds acquired by *listed private companies* through new issues of fixed-interest securities (including convertible preference shares, debentures and corporate bonds) decreased sharply from R2,9 billion in 1992 to R0,8 billion in 1993 and R0,1 billion in the first half of 1994. The demand for these funds remained low in view of the low level of real domestic fixed investment and the relatively high liquidity of the corporate sector. The ratio of interest-bearing debt to equity for all listed companies on the Johannesburg Stock Exchange amounted to only 67 per cent in 1993. New issues of fixed-interest securities nearly fell away completely in the first half of 1994 as a result of the attractiveness of share issues and a firming of long-term rates.

The primary bond market was also characterised in the period under review by the introduction of *new instruments*, such as electrification participation notes and collateralised housing investment paper. Transnet raised about R500 million in a private placing of its equity-linked fixed interest financial instrument (ELFI V), launched in two tranches with redemption values linked to movements in the all-share index. Special investment funds for stokvels and socially responsible projects were introduced to raise additional funds for the social upliftment of the population.

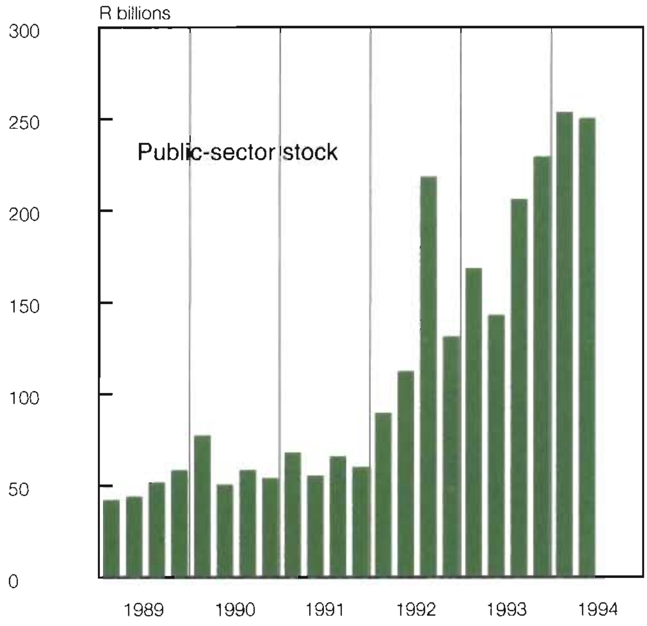
In the *secondary bond market* considerable progress was made in integrating all transactions by establishing a so-called *Bond Market Exchange*. This exchange is expected to receive its licence to trade towards the end of 1994. Once this is achieved, all clearing will be done through Unexcor and there will be only one formal licensed bond market. Further progress was also made in providing for a central securities depository. At the end of June 1994 stock to the value of R0,9 billion had been deposited at the Central Depository Ltd, which was established in the preceding year.

The *Reserve Bank's transactions* in government stock increased substantially in 1993 in accordance with its objective of establishing an active secondary market in these stocks. The gross sales of government stock by the Reserve Bank increased from R112 billion in 1992 to R178 billion in 1993, despite the Bank's withdrawal from small-sized or "retail" transactions in the market. In the first six months of 1994 such sales by the Bank totalled R78 billion, compared with R86 billion in the corresponding period of 1993. As another indication of the Reserve Bank's actions to develop an active secondary market in government stock, the Bank's trading in government stock options increased from a monthly average of R5,2 billion in 1992 to R5,3 billion in 1993 and to R8,0 billion in the first half of 1994.

The success achieved in developing a more active bond market is clearly illustrated by the value of *public-sector stock* traded on the Johannesburg Stock Exchange, which is estimated to represent about half of the total trading in such stock in the secondary market. After having more than doubled in 1992, the value of public-sector stock traded on the stock exchange increased by 35 per cent to R746 billion in 1993. In the first quarter of 1994 it reached a record quarterly level of R254 billion before falling back to R250 billion in the second quarter. This moderately lower turnover in the second quarter of 1994 was probably related to the smaller number of trading days in this quarter, and to a firming of the yield on long-term government stock.

Non-residents also continued to be active participants in the secondary bond market in 1993 and the first half of 1994. In 1993 non-residents were net purchasers of public-sector stock as long-term rates softened: their net purchases amounted to R1,5 billion, compared with R0,8 billion in 1992. In the first quarter of 1994 they became net sellers of public-sector stock with the sudden firming of long-term rates in February and March. Sales subsided somewhat in

Stock exchange transactions



April, and net purchases of public-sector stock by non-residents were again recorded in the ensuing two months. In the first six months of 1994 non-residents were nevertheless still net sellers of public-sector stock to the amount of R0,2 billion.

Equity market

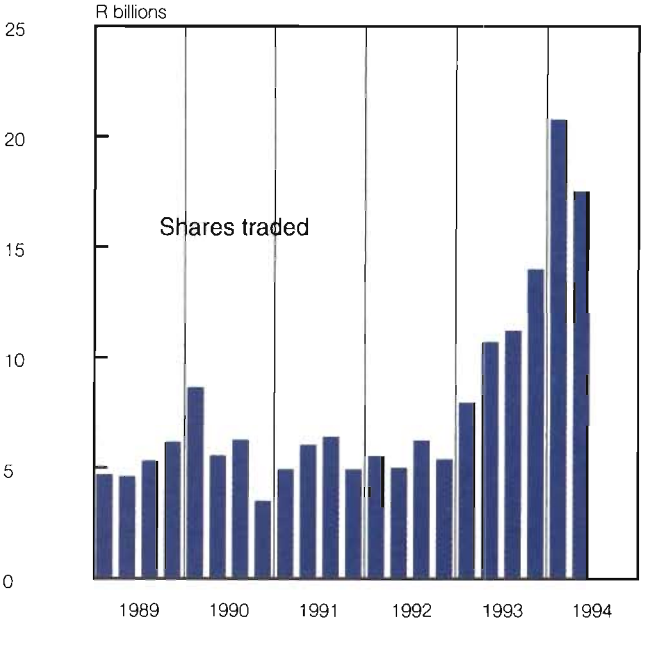
In the *primary equity market* factors such as high and rising share prices, a shortage of scrip and the firming of long-term interest rates favoured share capital issues in the first half of 1994. The demand for new funds nevertheless remained low. The value of rights issues of ordinary shares of listed companies on the stock exchange therefore rose only moderately from R4,7 billion in 1992 to R5,3 billion in 1993. In the first six months of 1994 an amount of R1,6 billion was raised in this manner, compared with R2,9 billion in the last half of 1993.

In the *secondary equity market*, the value of shares traded on the Johannesburg Stock Exchange nearly doubled from R22,1 billion in 1992 to R43,8 billion in 1993. The average quarterly value of shares traded then rose even further from R10,9 billion in 1993 to R19,1 billion in the first half of 1994. The high level of activity in this market was also reflected in the increase in share-turnover velocity (share turnover as a percentage of market capitalisation), which rose from 4,4 per cent in 1992 to 5,9 per cent in 1993 and 8,3 per cent in the first half of 1994.

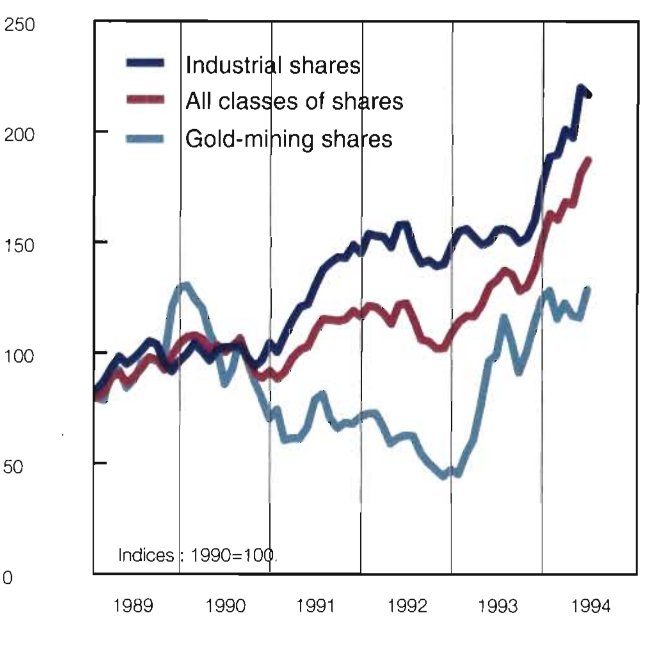
This high turnover was brought about by increases in both the prices and volume of shares traded. After having declined consistently from a peak of 2,8 billion in 1989 to 2,2 billion in 1992, the number of shares traded on the Johannesburg Stock Exchange rose to 3,6 billion in 1993. In the first six months of 1994 it amounted to 2,4 billion. Increased optimism associated with the greatly improved profitability of companies, large-scale buying by non-residents and an increased demand for shares by institutional investors made an important contribution to the high turnover. Compared with the stock exchanges of most industrialised countries, the liquidity on the Johannesburg Stock Exchange is nevertheless still low.

The lifting of sanctions against South Africa, a sharp recovery in share prices, the weak financial rand and the higher gold price led to substantial net purchases of shares by *non-residents* on the stock exchange. After having been net sellers of shares to the value of R0,5 billion in 1992, non-residents became net purchasers of shares to the value of R2,8 billion in 1993. Non-residents' net purchases of shares increased from R0,9 billion in the last quarter of 1993 to R2,1 billion in the first quarter of 1994. Downward corrections on some of the larger stock exchanges in the world, and uncertainty about political developments, then caused non-residents to again become net sellers of shares on the Johannesburg Stock Exchange to the value of R1,2 billion in the second quarter of 1994.

Stock exchange transactions



Share prices



In keeping with many of the world's leading stock exchanges, share prices on the Johannesburg Stock Exchange began recovering towards the end of 1992. After faltering slightly in the third quarter of 1993, share prices rose again to register an increase in the average price of all classes of shares of almost 39 per cent in 1993. In particular, the prices of gold-mining shares rose sharply, but the prices of all other categories of shares improved during the year. The rise in share prices caused the market capitalisation of the stock exchange to increase from R501 billion at the end of 1992 to R738 billion at the end of 1993.

In contrast to the sharp declines in share prices on most of the world's leading stock exchanges from the beginning of 1994, the average price index of all classes of shares on the Johannesburg Stock Exchange continued to rise. Only the prices of gold-mining shares showed a declining trend in the first half of 1994. However, the average price of all classes of shares reached an all-time high in June 1994: the average price level of these shares then was 83 per cent above its lower turning-point in October 1992.

Mirroring the increase in share prices, the average *dividend yield* on all classes of shares decreased sharply from 3,51 per cent in December 1992 to 2,36 per cent in January 1994. Improvements in the financial results of companies then caused this yield to rise to 2,45 per cent in February before the rising share prices brought it down again to 2,14 per cent in June 1994.

The fact that the rate on long-term government stock declined more rapidly than the dividend yield, caused the *yield gap* between government stock and shares (the difference between the yield on long-term government stock and the average dividend yield on all classes of shares) to narrow from 12,0 percentage points in May 1993 to 9,7 percentage points in December. However, as a result of the firming of long-term interest rates and the decline in the dividend yield in the first half of 1994, the yield gap widened again to 11,9 percentage points in June 1994.

The average *earnings yield* on all classes of shares (excluding gold-mining shares) decreased from 7,7 per cent in December 1992 to 5,5 per cent in January 1994; it then increased to 5,7 per cent in February and declined again to 5,1 per cent in June. The *price-earnings ratio* of all classes of shares (excluding gold-mining) increased from 12,9 in December 1992 to 19,7 in June 1994, thereby surpassing its all-time high of 18,6 in September 1987. However, when the discount on the financial rand is taken into consideration, the price-earnings ratio for non-residents amounted to only 15,3 in June 1994.

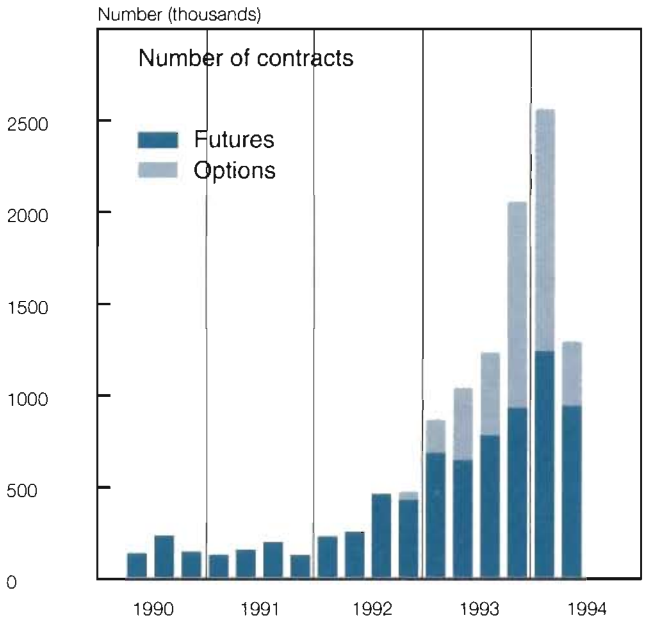
As in the case of the bond market, important *structural changes* are under consideration regarding the functioning of the Johannesburg Stock Exchange. The recommendations of a committee of stock exchange members and other interested parties were accepted by the Johannesburg Stock Exchange to bring about gradual changes in the activities of the stock exchange, including:

- the introduction of negotiated commissions for the portion of a transaction in excess of R3 million;
- the establishment of limited liability corporate membership of the stock exchange;
- the removal of the qualification that membership of the exchange be restricted to South African citizens;
- the revision of the capital requirements for stock brokers;
- the education of the emerging investor on the role and benefits of the stock exchange;
- improved access to a listing on the stock exchange;
- the reduction of the cost of brokerage for small transactors; and
- the development of an electronic share registry.

Market for derivatives

Activity on the South African Futures Exchange, which was licensed as a financial exchange in August 1990, increased substantially in the next four years. After having more than doubled from 0,6 million contracts in 1991 to 1,4 million contracts in 1992, turnover in equity futures contracts increased even more substantially to 3,0 million contracts in 1993. Transaction levels were boosted by the lively local share market, uncertainty

Futures exchange transactions



regarding political developments and a high level of non-resident participation. These factors were also responsible for an all-time high turnover of 1,2 million equity futures contracts in the first quarter of 1994, before falling back to 0,9 million contracts in the second quarter.

Equity futures contracts continued to dominate the formal derivative market. Contracts based on underlying instruments other than equities, such as interest rate contracts, continued to reach only relatively low volumes. Commodity contracts are not yet being traded. In 1993 practically all trading was effected in share index contracts. The ratio of the value of futures transactions to total transactions amounted to 55 per cent for the all-share index, 31 per cent for the all-gold index and 14 per cent for the industrial index. The interest rate futures contract hardly featured in trading.

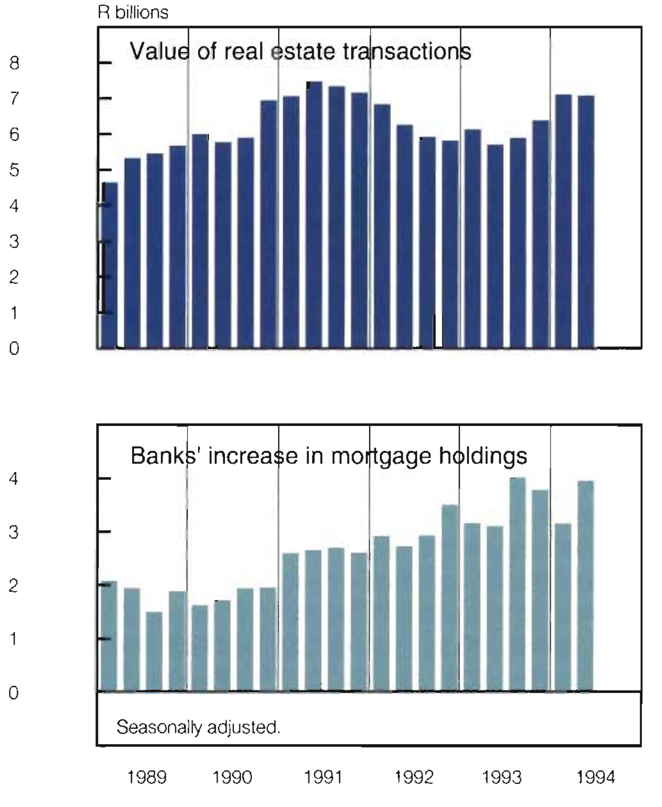
The trading in the number of *options on equity futures contracts*, which had started in October 1992, initially advanced very hesitantly to 0,2 million contracts in the first quarter of 1993; it then gained momentum and reached 1,1 million contracts in the fourth quarter of 1993. In the first half of 1994 the trade in the number of options on equity futures reached 1,7 million, which was more than twice the volume of 0,6 million contracts in the first half of 1993. Contrary to this high level of activity on the South African Futures Exchange, activity on the Johannesburg Stock Exchange Traded Options Market has fallen away completely since February 1993.

The significant growth in *open positions* in futures and options contracts on the South African Futures Exchange indicated that the formal futures market was increasingly serving the hedging needs of the financial community. At the end of June 1994 the open interest in equity futures contracts and in options on equity futures contracts was 63 716 and 284 627 contracts, respectively. Based on the mark-to-market prices of equity futures and options at close of business on 30 June 1994, the total open interest was worth R4,6 billion.

Mortgage and real estate market

The level of activity in the *mortgage market* was kept buoyant during most of 1993 by the *banks'* continued drive to promote flexible bond facilities. The total holdings of mortgage loans of banks (which are responsible for nearly 86 per cent of the formal market) increased steadily from R78,5 billion in December 1992 to R92,9 billion in December 1993. In the fourth quarter of 1993, however, the rise in mortgage lending extended by these institutions tapered off marginally. The relatively stagnant housing market, and the decision of certain banks to stop carrying mortgage registration costs and valuation fees, caused the average monthly amount of loans paid out by banks to decrease marginally from R3,6 billion in the third quarter of 1993 to R3,5 billion in the fourth quarter. Steps taken by banks to end mortgage "loading" (where the stated purchase price of a home exceeds the actual price paid) reduced the average monthly amount of mortgage advances paid out further to R3,3 billion in the first five months of 1994.

Real estate and mortgage holdings



The total amount of mortgage loans paid out by *participation mortgage bond schemes* in 1993 remained at the level of the preceding year, namely at about R1 billion. However, the quarterly amount of mortgage advances paid out by participation mortgage bond schemes decreased by 27 per cent from R269 million in the first quarter of 1993 to R195 million in the first quarter of 1994. Although property brokers began reporting significant increases in the commercial and industrial letting market from the second half of 1993, the long recession in the real economy had led to an oversupply of most kinds of commercial property in several areas. This resulted in far fewer small to medium-sized property developers erecting new buildings and to a reduced demand for finance obtained from participation mortgage bonds.

Mortgage loans of *other financial institutions* generally decreased or remained unchanged in 1993. The total holdings of mortgage loans of long-term insurers contracted sharply from R1,1 billion in December 1992 to R0,8 billion in December 1993. Private self-administered pension and provident funds' holdings of mortgage loans amounted to R253 million in December 1993, i.e. slightly higher than the R246 million in December 1992.

Although the property portfolios of insurers and pension funds grew significantly, the *real estate market* continued to reflect recessionary conditions in 1993. For the year as a whole the value of fixed-property transactions declined by 3,2 per cent from R24,9 billion in 1992 to R24,1 billion in 1993; the number of transactions in fixed property contracted by 10,3 per cent in 1993, while the average value of property transactions rose by 8,2 per cent.

In keeping with an improvement in the economy, the decline in mortgage rates and increased affordability, the value of real estate transactions showed a significant turn-around in the second half of 1993. After having declined from R6,1 billion in the first quarter of 1993 to R5,7 billion in the second quarter, the value of real estate transactions increased to R6,4 billion in the fourth quarter. This trend continued in the first half of 1994. Despite a large measure of uncertainty in the property market before and after the elections, the value of transactions in the first six months of 1994 was 19,9 per cent higher than in the corresponding period of the preceding year. This increase was due to a rise in the number and average price of such transactions over the same period.

The banks' *predominant mortgage bond rate* was reduced by 0,75 percentage points to 16,0 per cent from 1 March 1993, and by a further 0,75 percentage points to 15,25 per cent in November 1993. Since that date no further changes have been made to this rate, which is in line with an unchanged Bank rate.

Public finance

Fiscal policy

In the first Budget of the Government of National Unity on 22 June 1994, the Minister of Finance singled out three important considerations of fiscal strategy, namely:

- "laying the base for public finance to be one of the principal instruments for the reconstruction and development of our country;
- contributing, through fiscal discipline, to macro-economic stabilisation as a crucial element in economic growth; and
- embodying institutional change in the process of transition from the old to the new constitutional order".

The *reconstruction and development programme* of the government is aimed mainly at improving the standards of living of all South Africans by meeting basic needs, promoting human development and building a strong and growing economy. Unfortunately more details on the government's policies and priorities on reconstruction and development will only become available with the release of a planned *White Paper*. In the interim, however, the government has already taken certain steps on the following aspects of reconstruction and development:

- early agreement on key principles of macro-economic management, including guidelines on reducing the government budget deficit, government dissaving and inflation through restraint in general government consumption expenditure;
- improved co-ordination between the Departments of Finance and State Expenditure;
- establishment of a Treasury Committee, which is to assist Cabinet in setting budgetary priorities, evaluating expenditure requests and ensuring prudent fiscal management;
- development of a strategy for the orderly transfer of financial management power and functions to the new provincial governments; and
- design of an action plan to meet the objectives of the reconstruction and development programme without compromising fiscal discipline.

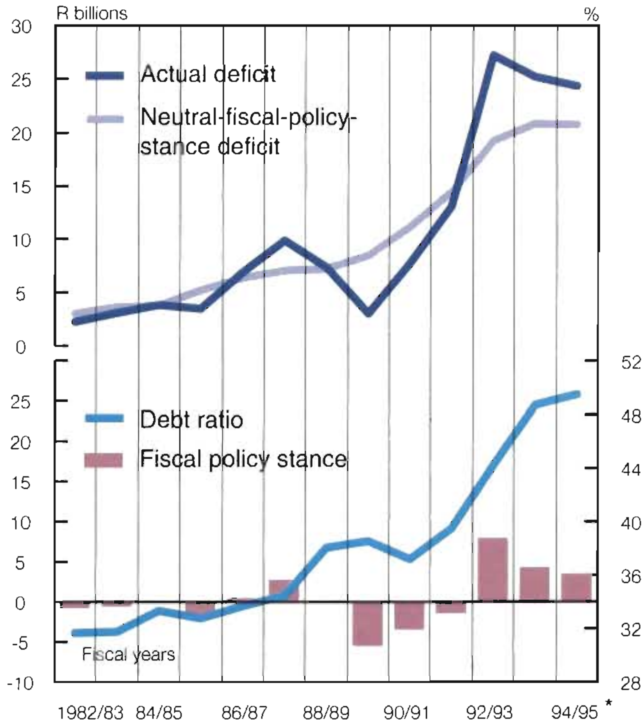
The government has also announced that a Reconstruction and Development Programme Fund is to be established. This Fund will not have borrowing powers, but will be funded from amounts appropriated by Parliament, receipts from grants, and proceeds from the sale of state assets. In the Budget for fiscal 1994/95 an initial allocation of R2,5 billion was made for this purpose, and it was envisaged that these annual allocations would be increased progressively to reach a cumulative total of R40 billion over five years within the overall budgetary constraints.

Allocation of funds from this Fund would be made by the Minister Without Portfolio and the Cabinet, with the assistance of the Central Economic Advisory Service. In the allocation of these funds, special measures would be taken to ensure that the objectives of the Reconstruction and Development Programme, the communities involved and the government will be addressed.

Considerable emphasis was also placed in the Budget on maintaining *fiscal discipline*. In accordance with this objective, the funds allocated to the Reconstruction and Development Programme Fund were found by decreasing other departmental expenditures, i.e. without increasing the planned level of total expenditure. The Minister also made it clear that sound financial management would be applied to fund the process of reconstruction and development by providing, *inter alia*, for:

- the rearrangement of priorities and redirection of funds in the Budget;

Fiscal policy stance



* Budgeted

- efficiency gains through the rationalisation of services and the effective utilisation of public resources; and
- the broadening of the tax base through economic growth.

To evaluate the extent of the fiscal discipline applied in the Budget, the actual budgeted deficit may be compared with the so-called neutral-fiscal-policy-stance balance, i.e. the balance which does not take any changes in fiscal policy into account[1]. The difference between these two balances serves as an approximate but conservative measurement of the fiscal policy stance in a specific year. In the accompanying graph these balances for South Africa are shown from the early 1980s. From this information it is apparent that the fiscal policy stance increased aggregate demand in fiscal 1992/93. Although the government adopted a more restrictive approach in fiscal 1993/94 and in the Budget for fiscal 1994/95, the fiscal policy stance in both these years can still be described as favouring an increase in aggregate demand.

The unsustainability of this fiscal policy stance in the longer term is clearly illustrated by the sharp upward trend in the government debt ratio (government debt as a percentage of gross domestic product) since fiscal 1991/92. The graph also shows that the fiscal policy stance in the 1980s and early 1990s led to an increase in the government debt ratio, while this ratio only levelled off when policy measures restricting aggregate demand were pursued. This points to a major weakness in the South African economy, which is aggravated by the fiscal policy stance expanding aggregate demand in the 1990s. The substantial increase in the budget deficits demonstrates that the level of South Africa's potential gross domestic product is too low to accommodate the present level of government expenditure. Either the real growth potential of the economy will have to be improved to maintain the current level of government expenditure and to alleviate the tax burden, or government finances will have to be restructured more meaningfully.

With regard to the *institutional changes* required for the transition from the old to the new constitutional order, the Minister of Finance announced that the Financial and Fiscal Commission will play an important role in rendering advice and making recommendations to the legislative authorities on the financial and fiscal requirements of the national, provincial and local authorities. The transition from former financing mechanisms to a new model will, however, be a phased process. Until this process is finalised, the expenditure control measures of the Department of State Expenditure will remain in place and the former provinces, TBVC countries and self-governing territories will continue their revenue collections and remain responsible for expenditure control and financial administration under overall co-ordination by the Departments of Finance and State Expenditure.

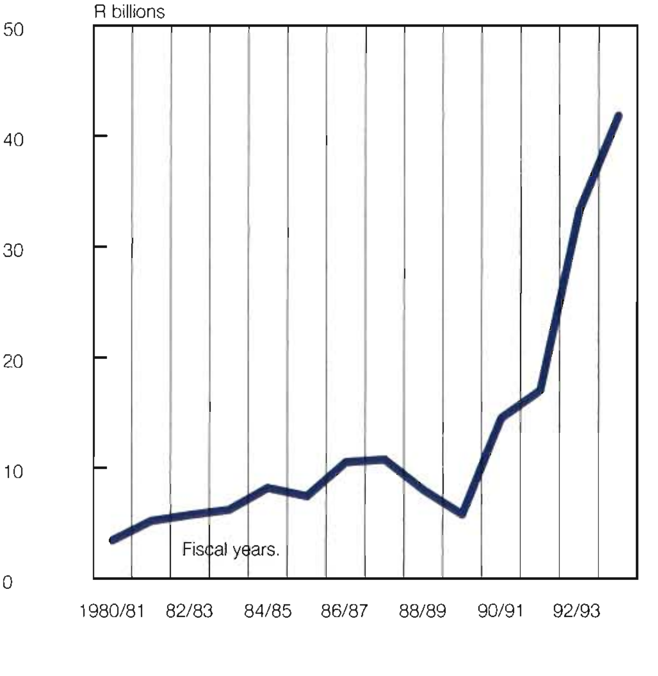
The Minister also appointed a Commission of Inquiry into Taxation in South African to investigate the tax system and to assess what improvements are required.

Public-sector borrowing requirement

The *public-sector borrowing requirement* (i.e. the deficit before borrowing and debt repayment of the consolidated central government, provincial administrations, local authorities and non-financial public enterprises) amounted to R41,9 billion for fiscal 1993/94, or to 26 per cent above the already high level of R33,3 billion of the preceding year. As a ratio of gross domestic product, the public-sector borrowing requirement came to 10,6 per cent; in fiscal 1989/90 it still amounted to 2,3 per cent.

The exceptionally high borrowing requirement of the public sector in fiscal 1993/94 was largely due to

Public-sector borrowing requirement



1. The neutral-fiscal-policy-stance balance is calculated as the difference between neutral government revenue (revenue calculated on the basis of the tax rates applicable in the base year and calculated as a constant ratio of *actual* gross domestic product) and neutral government expenditure (expenditure calculated on the basis of expenditure in the base year projected as a constant ratio of the *potential* gross domestic product).

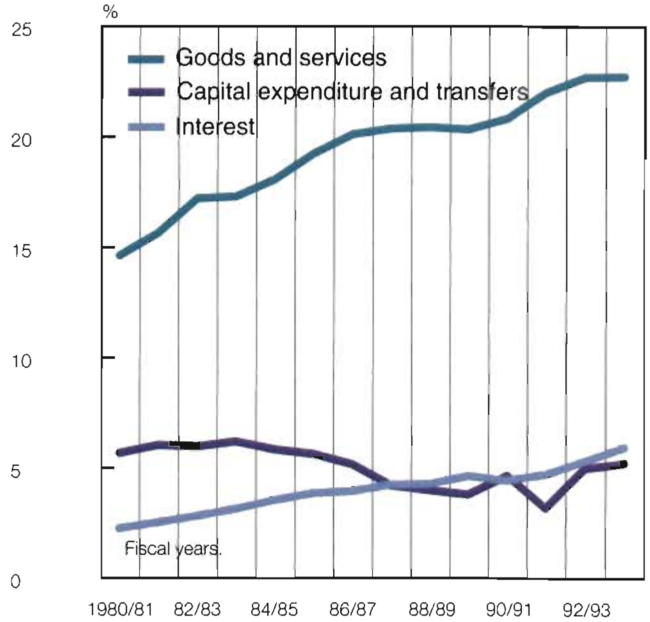
special transfers, which did not affect the domestic capital market. As noted earlier, special government stock to the amount of R7,5 billion was issued to the Reserve Bank as partial redemption of the deficit on the Gold and Foreign Exchange Contingency Reserve Account; a transfer of stock amounting to R7,3 billion was also made to the government employees' pension funds and closed pension funds. If these transactions are excluded, the public-sector borrowing requirement totalled R27,1 billion, or 6,8 per cent of gross domestic product. No difficulties were experienced in financing this shortfall in the domestic capital market. However, with a strong revival in investment demand, such a borrowing requirement could have a crowding-out effect on private investment.

The deterioration in the public-sector borrowing requirement since the beginning of the 1990s was mainly due to a sharp increase in the deficit on the income and expenditure accounts of general government from only R2,2 billion in fiscal 1989/90 to R42,6 billion in fiscal 1993/94. Non-financial public corporations registered a small surplus of R0,7 billion on their income and expenditure accounts in fiscal 1993/94.

Total revenue and grants of *general government* increased at an average annual rate of 11,1 per cent from fiscal 1989/90 to fiscal 1993/94. Owing mainly to an increase in tax revenue related to the introduction of value-added tax and an increase in this tax rate from 10 to 14 per cent in April 1993, revenue and grants as a ratio of gross domestic product rose from 29,6 per cent in fiscal 1992/93 to 30,4 per cent in fiscal 1993/94. However, government expenditure increased much more rapidly at an average annual rate of 18,2 per cent over the period from fiscal 1989/90 to fiscal 1993/94. As a ratio of gross domestic product, government expenditure increased from 33,2 per cent to 40,9 per cent over this period.

As shown in Table 7, this rise in government expenditure was the result of an increase in current expenditure; the capital expenditure of general

General government expenditure as percentage of gross domestic product



government continued to decline in relative importance. In an attempt to curtail the increase in general government expenditure, cut-backs were made to the purchases of capital goods and public works programmes. This is, of course, a process which can only be undertaken for a limited period of time before it starts to have an impact on the efficiency of the civil service and the growth potential of a country.

From Table 7 it is also apparent that higher interest payments and expenditure on subsidies and transfers were mainly responsible for the sharp rise in the relative importance of current expenditure. Interest payments as a ratio of gross domestic product rose sharply

Table 7. Economic classification of general government expenditure
Percentage of gross domestic product

	1989/90	1990/91	1991/92	1992/93	1993/94
Goods and services	20,3	20,8	22,1	22,7	22,8
Interest payments	4,7	4,4	4,7	5,3	6,0
Subsidies and transfers	4,4	4,4	4,5	5,7	7,0
Current expenditure	29,4	29,7	31,2	33,7	35,7
Capital expenditure	3,2	2,8	2,6	2,4	2,4
Capital transfers	0,6	1,9	0,6	2,6	2,8
Total expenditure	**33,2**	**34,3**	**34,4**	**38,8**	**40,9**

owing to a steady increase in the general government borrowing requirement (which averaged 6,6 per cent per year in the period from fiscal 1989/90 to fiscal 1993/94) and the relatively high cost of borrowed funds. The increase in the relative share of subsidies and current transfers mainly took place in the last two fiscal years and was related to the drought conditions experienced in the country and to compensation payments for actuarial shortfalls and retrenchment packages on government pension funds.

As a result of an average annual rate of increase of 17,2 per cent in the total remuneration of employees of the general government, expenditure on goods and services as a ratio of gross domestic product rose steadily from 20,3 per cent in fiscal 1989/90 to 22,8 per cent in fiscal 1993/94. Considerable more restraint was, however, applied to the expenditure on other goods and services over the same period, and this expenditure actually contracted in real terms.

The deterioration in general government finance was the net result of divergent tendencies in the finances of the different *levels of general government*. Throughout the four-year period up to fiscal 1993/94 the provincial administrations maintained a surplus on their income and expenditure accounts, while all other levels of general government recorded deficits. The deficits of the social security funds and local authorities varied considerably from year to year, but generally remained at a fairly low level. At first the borrowing needs of extra-budgetary entities (including the TBVC countries and self-governing states) were well contained. However, in fiscal 1993/94 the borrowing requirement of these entities rose to R2,9 billion from only R0,1 billion in the preceding year. The worsening in the financial position of the extra-budgetary entities was mainly brought about by a considerable reduction in net transfer receipts from the Main Budget.

The increase in the deficit on the Main Budget was mainly responsible for the sharp upward movement in the public-sector borrowing requirement over the past four years. In particular, in the fiscal years 1992/93 and 1993/94 the deficit on the Main Budget reached alarming proportions, mainly because of special transfers related to the drought, the government's contributions to its pension funds, and the shortfall on foreign exchange transactions for the account of the government. Even after allowing for these transfers, the deficits on the Main Budget were still exceptionally large, because of a combination of adverse structural and cyclical circumstances.

Budget outcome for fiscal 1993/94

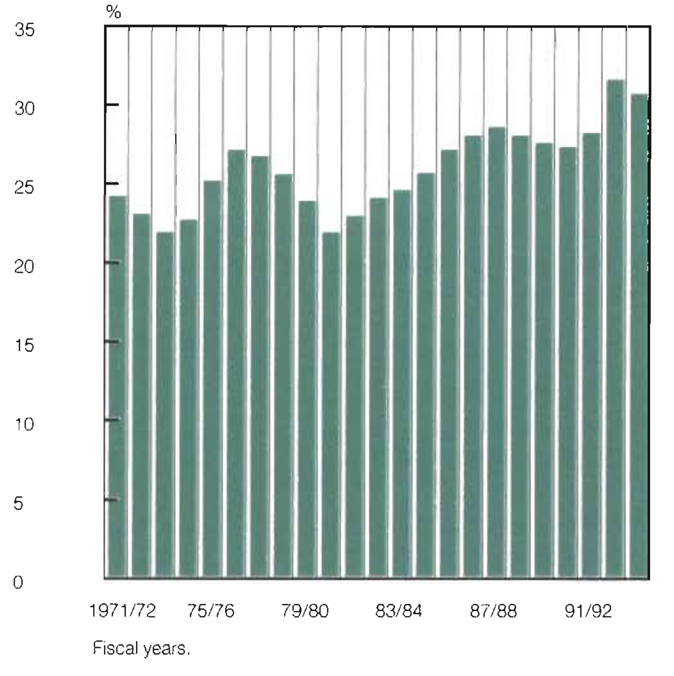
The actual outcome of the *General Affairs Budget* (i.e. the Budget as presented in its old form by the Minister of Finance on 17 March 1993) for the fiscal year 1993/94 was a small underestimation of expenditure and a slight overestimation of revenue. This therefore meant a deficit before borrowing and debt repayment that was somewhat higher than had originally been budgeted.

Exchequer issues to General Affairs departments totalled R114,8 billion in fiscal 1993/94, which was only R0,7 billion higher than the original Budget estimate. Government expenditure increased at a rate of 9,3 per cent in fiscal 1993/94, i.e. at a considerably lower rate than the increase of 21,6 per cent in fiscal 1992/93. However, this low rate of increase in government expenditure could be attributed partly to the inclusion of drought-related aid payments of R3,4 billion in the figures of the preceding year, which were not repeated in fiscal 1993/94 owing to the subsequent favourable weather conditions. If these aid payments are not taken into account, the rate of increase in government expenditure amounted to 12,9 per cent in fiscal 1993/94. This rate of increase was still much lower than the average rate of increase of 17,0 per cent in the preceding five fiscal years.

After having increased consistently from 26,8 per cent in fiscal 1990/91 to 30,1 per cent in fiscal 1992/93, Exchequer issues as a ratio of gross domestic product contracted to 29,1 per cent in fiscal 1993/94. This development was in accordance with the government's long-term objective of reducing the relative share of the government in the economy.

A *functional classification of government expenditure* shows that the percentage share of

Exchequer issues to government departments as percentage of gross domestic product



government expenditure on social services continued to rise in fiscal 1993/94. The share of total expenditure allocated to social services has risen sharply from 41,3 per cent in fiscal 1990/91 to 44,1 per cent in fiscal 1993/94. Over the same period the share of protection services in total expenditure (especially expenditure on defence) contracted from 21,8 per cent to 17,6 per cent, while the share of economic services remained more or less unchanged at a level of 14 per cent. As already indicated, a large part of government expenditure had to be assigned to the servicing of the public debt.

The total *revenue* of General Affairs departments amounted to R88,0 billion for fiscal 1993/94; this was R0,2 billion less than the original budget estimates. Government revenue rose by 16,1 per cent in fiscal 1993/94; this growth rate was considerably higher than the average annual growth rate of 9,7 per cent in these receipts in the preceding three years. The ratio of government revenue to gross domestic product, which had receded sharply from 24,9 per cent in fiscal 1989/90 to 21,7 per cent in fiscal 1992/93, accordingly rose again to 22,3 per cent in fiscal 1993/94.

The considerable improvement in the revenue collected by the government in fiscal 1993/94 was related mainly to increases in the value-added tax rate and in excise tax rates on certain goods. Indirect tax, as a percentage of total income, increased considerably from 40,3 per cent in fiscal 1992/93 to 45,3 per cent in fiscal 1993/94, whereas the share of direct tax declined accordingly. As a result of the 40 per cent increase in the value-added tax rate from 10 per cent to 14 per cent in April 1993, the proceeds from this tax rose by 44,5 per cent in fiscal 1993/94. Revenue from customs and excise duties and income tax on individuals also rose fairly sharply, while the receipts from income tax on companies showed an actual decline because of relatively low profits in the year of assessment and a reduction in the tax rates applicable to companies.

The slightly higher-than-expected expenditure and lower-than-expected income for fiscal 1993/94 led to a *deficit before borrowing and debt repayment* of R26,8 billion, compared with a budgeted deficit of R25,9 billion. As a ratio of gross domestic product, the deficit before borrowing amounted to 6,8 per cent. After taking net transfers of R13,4 billion and the discount on new issues of government stock of R2,7 billion into account, the total borrowing requirement of the Exchequer came to R43,0 billion in fiscal 1993/94. The funds for the financing of this borrowing requirement were mostly obtained from the Public Investment Commissioners and the non-monetary private sector. However, the net claims of the monetary institutions on the government also rose by R15,3 billion, owing to the issue of government stock to the Reserve Bank in order to finance the shortfall on gold and foreign

Direct and indirect taxes as percentage of total tax collected

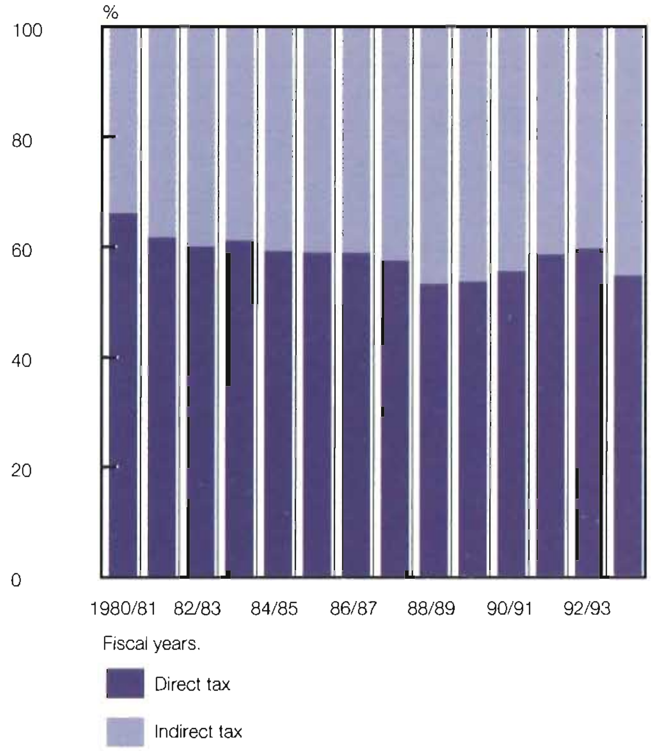


Table 8. Financing of government deficit by type of lender, fiscal 1993/94

Type of lender	R millions
Public Investment Commissioners	14 528
Non-monetary private sector	13 164
Monetary institutions	15 625
S.A. Reserve Bank and Corporation for Public Deposits	11 053
Other monetary institutions	4 572
Foreign sector	-319
Total gross financing	42 998
Plus: Transfers from the National Supplies Procurement Fund and the Central Energy Fund	1 406
Less: Transfers to the Gold and Foreign Exchange Contingency Reserve Account	7 500
Transfers to the government employees' pension funds and closed pension funds	7 340
Less: Discount on new issues of government stock	2 722
Total net financing	**26 842**

Table 9. Redemption schedule of central government stock*

Redemptions in year ended 31 March	R billions	Percentage of total
1994/95	6,3	3,6
1995/96	9,2	5,3
1996/97	16,7	9,5
1997/98	12,7	7,2
1998/99	2,4	1,4
1999/2000	9,0	5,1
2000/01	15,9	9,1
After 2000/01	103,0	58,8
Total	**175,2**	**100,0**

* Domestic marketable stock and floating rate stock.

exchange transactions, a decrease in government deposits with the monetary sector and purchases of government stock by private banks.

As a result of the large deficit on the government's accounts and the transfers made to the government's pension funds, the total outstanding *government debt* rose by 24,2 per cent in fiscal 1993/94 to R192,1 billion at the end of March 1994. As a ratio of gross domestic product, government debt accordingly increased considerably from a lower turning-point of 37,2 per cent at the end of fiscal 1990/91 to 48,7 per cent at the end of fiscal 1993/94. This is, of course, an unsustainable trend which cannot be maintained for too long. The relative level of South Africa's government debt is, however, still comparatively low by international standards.

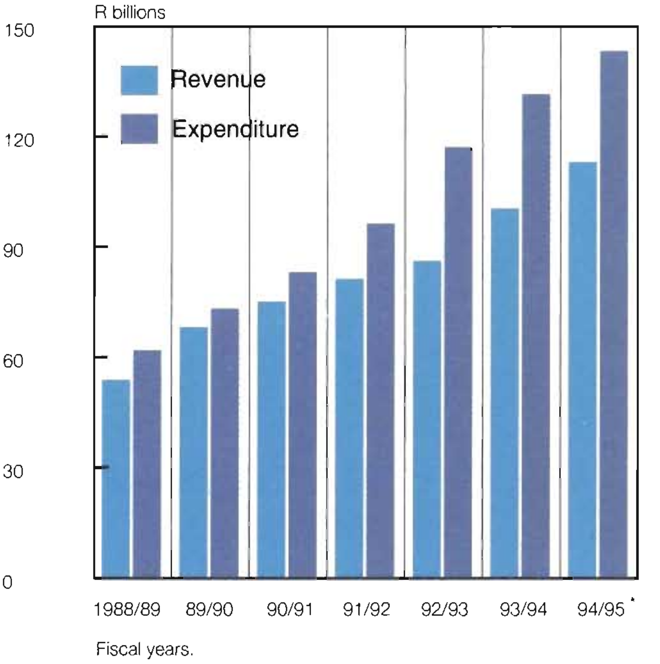
Besides the growth in the size of the debt, the *maturity structure* of the debt also represents a problem that will have to be addressed by the government in the near future. Scheduled redemptions are already very large in the fiscal years 1996/97, 1997/98 and 2000/01, which could have serious implications for the domestic capital market, particularly if large deficits are also going to be recorded on the Exchequer Account in these years and if the demand for funds of the private sector is going to be high. The authorities are aware of this problem and have stated that they are exploring the feasibility of consolidating debt issues and shifting the redemption structure of the total debt so as to avoid imposing excessive pressure on the market in any single year.

The Budget for fiscal 1994/95

As a result of the implementation of the new Constitution, the accounts of the former TBVC countries and self-governing territories have been incorporated in the central government's accounts for fiscal 1994/95. In recognition of this change, the former State Revenue Account has been replaced by a National Revenue Account. Those parts of inland revenue and of customs and excise duties, which in the past had been collected for the accounts of the TBVC countries and self-governing territories and which had been treated as direct deductions from revenue on the State Revenue Account, are now included in government revenue on this National Revenue Account. Direct allocations from the fuel levy and from the ordinary levy to these territories, which formerly were also excluded from government revenue, are now shown as income accruing to the National Revenue Account. An amount equivalent to these amounts is now reported in the Budget as government expenditure.

The Budget data for fiscal 1994/95 have therefore been presented in a new format and are not comparable to the figures published in previous Budget Reviews or in the *Quarterly Bulletin* of the South African Reserve Bank. Both the revenue and the expenditure on the National Revenue Account are at a higher level than those on the earlier State Revenue Account. For analytical purposes, a consolidation of the new National Revenue Account and the revenue accounts of the former provincial administrations, self-governing territories and the TBVC states has been made in a so-called Consolidated Revenue Account.

Consolidated national government



Fiscal years.

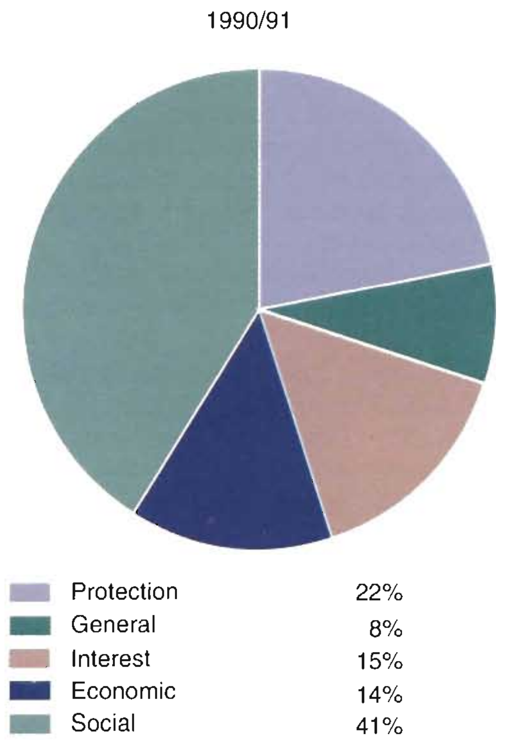
* Budgeted

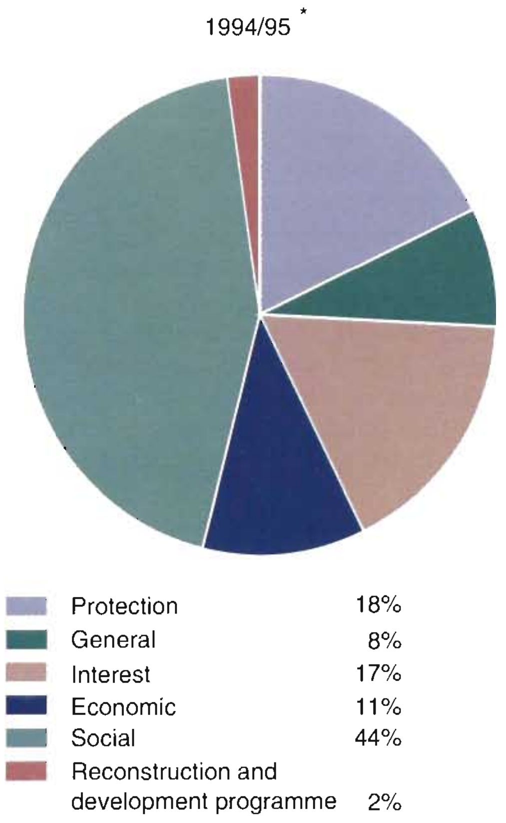
In accordance with its objective of fiscal discipline, the government budgeted for an increase of only 10,2 per cent in the national *government expenditure*, from an estimated R122,6 billion in fiscal 1993/94 to R135,1 billion in fiscal 1994/95. When the expenditure of the former regional administrations and own affairs departments is included, the consolidated national government expenditure is estimated to increase from R131,4 billion in fiscal 1993/94 to R143,2 billion in fiscal 1994/95, or by 9,0 per cent. As a ratio of gross domestic product, consolidated national government expenditure should contract from 33,3 per cent in fiscal 1993/94 to 32,4 per cent in fiscal 1994/95. That would be a remarkable achievement, because this expenditure also includes the non-recurrent transition costs of R3,8 billion. If these costs are not taken into account, the ratio of the remaining government expenditure to gross domestic product should be 31,5 per cent in fiscal 1994/95 – 2 percentage points lower than in the preceding year.

The increase in the consolidated national expenditure includes an increase of 14,7 per cent in the remuneration of employees related to provisions made for the filling of vacant posts, costs associated with initiatives aimed at a more representative civil service, the carry-through effects of upward adjustments in employment and in total remuneration in the TBVC and self-governing states, and salaries of forces that have now been incorporated into the South African Defence Force. An increase of 10,9 per cent is also envisaged in the interest costs of the government debt. The government was able to restrict the growth in budgeted expenditure by budgeting for actual *decreases* in expenditure on goods and services other than remuneration of employees, capital transfers and capital expenditure. In the economic classification it was not possible to allocate the amount of R2,5 billion for reconstruction and development; all the above growth rates could be affected by allocations of money from the Reconstruction and Development Fund.

In a functional classification of the consolidated national government expenditure it was also not possible to classify expenditure on reconstruction and development at this stage. Even without taking this expenditure into account, the government estimates that social services will receive 45 per cent of total allocated expenditure; the relative shares of nearly all the sub-categories of social services will increase sharply. After having declined consistently in the preceding five years, the proportionate expenditure on protection services is budgeted to rise in fiscal 1994/95, owing to an enlargement of the defence force. The relative expenditure on economic services is budgeted to contract further, particularly due to a decline in the funds provided for export trade promotion.

Functional classification of government expenditure as percentage of total government expenditure





* Budgeted

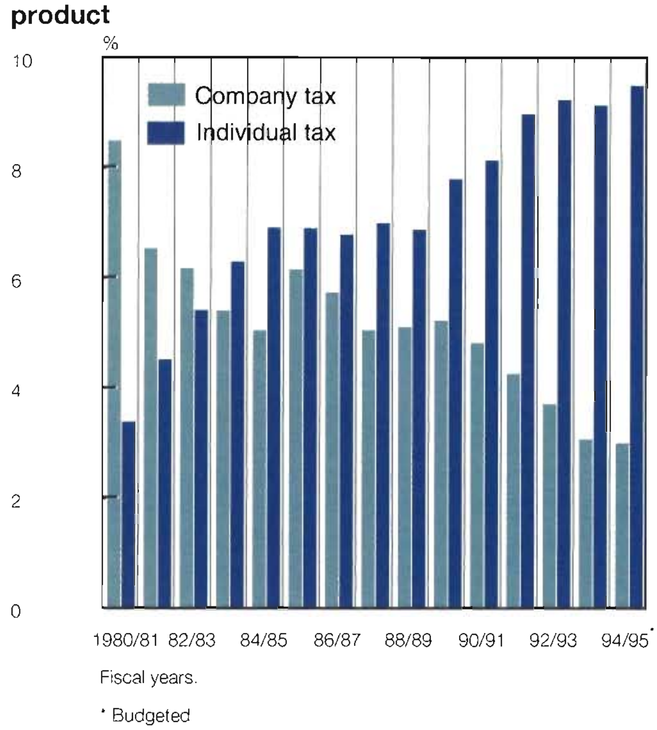
Total *national government revenue* was budgeted to rise by 12,9 per cent to R105,8 billion in fiscal 1994/95. This rate of increase would be marginally higher than the expected increase in nominal gross domestic product in fiscal 1994/95; the ratio of national government revenue to gross domestic product should therefore rise from 23,8 per cent in fiscal 1993/94 to 23,9 per cent in fiscal 1994/95. If the revenue collections of the former regional authorities are included, the estimated revenue collections of the consolidated national government should increase by 12,5 per cent from R100,4 billion in fiscal 1993/94 to R113,0 billion in fiscal 1994/95, or to 25,5 per cent of gross domestic product.

These revenue projections take into account the following revenue proposals made by the Minister of Finance:

- A once-off levy of 5 per cent on the taxable income of individuals above R50 000, to cover the costs of transition. With regard to married women the levy will only be imposed on taxable income exceeding R175 000. This levy will be imposed over two fiscal years, at a rate of 3,33 per cent of taxable income in fiscal 1994/95 and at a rate of 1,67 per cent on taxable income in fiscal 1995/96.
- A transition levy of 5 per cent on companies' taxable income exceeding R50 000 before any assessed losses brought forward from previous years are off-set against current profits. The levy will apply to the taxable income assessment of the year up to 31 March 1995.
- A reduction in the company tax rate to 35 per cent of taxable income and an increase in the Secondary Tax on Companies to 25 per cent on dividends declared on or after 22 June 1994.
- An increase in excise duties which is more or less in line with the rate of inflation. A more substantial increase in the excise duties on tobacco products was imposed to bring it more in line with those in most other countries.
- The abolition from 23 June 1994 of the import surcharge, which was introduced in 1988 to protect the balance of payments, on all capital and intermediate goods. The surcharge on so-called luxury and white goods, however, remains in force.
- The withdrawal of the income tax exemption in respect of the General Export Incentive Scheme from 1 March 1995.

These tax proposals, and the impact of bracket creep, will give rise to a further increase in the already high tax burden on individuals. The ratio of income tax payments by individuals to gross domestic product has increased steadily from 6,9 per cent in fiscal 1988/89 to a high of 9,2 per cent in fiscal 1992/93. After having declined marginally to 9,1 per cent in fiscal 1993/94, this ratio is budgeted to rise again to 9,5 per cent in fiscal 1994/95. In contrast to these

Income tax as percentage of gross domestic product



developments, income tax on companies as a percentage of gross domestic product decreased from 5,2 per cent in fiscal 1989/90 to 3,1 per cent in fiscal 1993/94, and is budgeted to decline further to 3,0 per cent in fiscal 1994/95.

The net result of the budgeted revenue and expenditure of the national government is an estimated *deficit* before borrowing and debt repayment of R29,3 billion, or 6,6 per cent of expected gross domestic product. After taking loan redemptions of R6,9 billion into account, the total financing requirement of the National Revenue Account should amount to R36,2 billion. The government plans to finance this borrowing requirement in the following manner:

	R millions
Government stock	34 483
Treasury bills	500
Foreign loans	1 800
Non-marketable securities	30
Increase in available cash balances	-645
Total financing	**36 168**

The consolidated national government deficit was estimated to amount to R30,2 billion in fiscal 1994/95, or to 6,8 per cent of gross domestic product. The provinces have not yet indicated how their additional expenditure will be financed.

Exchequer account in the first quarter of fiscal 1994/95

Owing to the late presentation of the Budget, *Exchequer issues* in the first quarter of fiscal 1994/95 were regulated by provisions made in the Exchequer Act. The Exchequer Act lays down a limit of 45 per cent of the previous year's Budget on the amounts that could be spent in the first four months of fiscal 1994/95. In fact, Exchequer issues in the first three months of fiscal 1994/95 were only 29,8 per cent of the previous year's budgeted expenditure. The rate of increase in Exchequer issues in the first quarter of fiscal 1994/95 was 21,5 per cent higher than the corresponding quarter of the preceding fiscal year. As already indicated, the Budget provided for an increase of 10,2 per cent for the full fiscal year.

Exchequer receipts increased sharply at a year-on-year rate of 20,1 per cent in the first quarter of fiscal 1994/95. This increase compared favourably with the budgeted estimate of 12,9 per cent, even though the proposed tax increases had not yet been imposed. This high percentage increase was recorded because it was measured from a relatively low base in the preceding year; in the first quarter of fiscal 1993/94, the proceeds from value-added tax had been very low due to pre-emptive consumer buying during the preceding months to avoid an expected increase in the tax rate.

The Exchequer *deficit before borrowing and debt repayment* came to R10,9 billion, equalling approximately 10,4 per cent of gross domestic product. As a percentage of the budgeted deficit of R29,3 billion projected for the year as a whole, the deficit for the first quarter of fiscal 1994/95 amounted to 37,2 per cent. This relatively high proportion compares well with the average ratio of 47,7 per cent in the past 5 years.

If the discount on new issues of government stock of R3,0 billion is taken into consideration, the borrowing requirement of the government totalled R13,9 billion. The deficit before borrowing and debt repayment, including this discount, were financed as follows:

	R millions
Government stock (including discount on new issues)	13 126
Bonds	-90
Foreign loans	-147
Treasury bills	2 961
Other money market instruments	38
Change in cash balance (increase -, decrease +)	-2 002
Less discount on new government stock issues	2 995
Total financing	**10 891**