Annual Economic Report

1995

South African Reserve Bank

This review of economic and financial conditions in the Republic of South Africa is presented as background to the chairman's address to stockholders at the seventy-fifth ordinary general meeting to be held on 22 August 1995. The review also forms part of the Reserve Bank's report to Parliament in terms of Section 31 of the South African Reserve Bank Act No. 90 of 1989.

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Hierdie verslag is ook in Afrikaans beskikbaar.

Introduction

In May 1993 the South African economy emerged from the longest recession since the Second World War when a lower turning-point in the business cycle was reached. The economic upturn in the ensuing period was fairly strong, but the growth in real gross domestic product fluctuated considerably. Total production increased rapidly at the beginning of the economic recovery. Economic growth then faltered somewhat in the first half of 1994, largely because of uncertainties about the outcome of the political transition. In the second half of 1994 the growth in domestic product regained much of its lost momentum and strengthened at a brisk and accelerating rate when it became apparent that the new political dispensation had been established in a peaceful manner. Adverse weather conditions, the mining of lower-grade gold-bearing ore and frequent disruptions of production on gold mines then led to a slackening in economic growth in the first half of 1995.

Despite these ebbs and flows in economic growth, real gross domestic product increased at an average annualised rate of 3 per cent in the eight quarters up to June 1995. This was a considerable improvement on the negative growth in the recession of 1989-93. Moreover, for the first time in many years real gross domestic product per capita increased in the current economic upswing. Employment, displaying its usual cyclical lag, also began to react to the recovery in 1994, but the creation of new job opportunities was too weak to arrest the rise in unemployment. A cyclical strengthening of economic growth will in any case not have a lasting effect on unemployment because it is more a structural problem.

The upturn in economic activity was broadly based, but was particularly evident in the secondary and tertiary sectors. Increased production was boosted by a robust domestic demand for goods and services as well as a sturdy increase in the volume of merchandise exports. Real outlays on fixed investment and the accumulation of inventories were to a large extent responsible for the comparatively high increase in real gross domestic expenditure. The long and severe recession which preceded the current economic upswing, caused these two aggregates to increase at rates well above those registered in the other upward phases of the business cycle since the late 1970s. Capital expenditure on a few major projects contributed to the revival of fixed investment, but investment outlays became more widespread as the economic recovery gained momentum.

Real private consumption expenditure rose at an appreciably slower average rate in the eight quarters ended June 1995 than in any of the preceding three economic upswings. This was probably due to the slow response of households to the improved economic conditions. In sharp contrast to previous periods of economic recovery when real private consumption expenditure per capita advanced immediately with the changed circumstances, per capita consumption only started to increase with a lag of four quarters in the current economic upswing. The slow reaction in the outlays of households on consumption was in all likelihood related to the weak growth in personal disposable income and the unwillingness of households to commit future income during a period of political transition.

When these uncertainties began receding after the new government came into power, a stronger demand for consumer goods and services became evident, supported by an increased recourse to consumer credit. Household debt as a ratio of personal disposable income accordingly rose sharply to 60 per cent in the first half of 1995; in the 1970s this ratio averaged only about 42 per cent. Like the increase in government debt, the sharp rise in household indebtedness is clearly an unsustainable development.

A larger proportion of households' current income was also used to finance consumption expenditure in the economic recovery, with the result that personal saving weakened relative to aggregate production as well as personal income. This was aggravated by a sharp rise in the direct taxes paid by households as a proportion of current income. Fortunately, the shift in funds from the private sector to the government was accompanied by a considerable restraint in the expansion of real government consumption expenditure. The consequent lower dissaving by government and the steady ratio of net saving by the corporate sector to gross domestic product brought about a small improvement in total gross domestic saving relative to total production.

The economic recovery was also bolstered by a sharp increase in both the prices and volume of merchandise exports. At the same time, South Africa's high marginal propensity to import and the sharp increase in gross domestic expenditure gave rise to substantially higher levels of merchandise imports. In addition to the increase in imports, a decline in the volume of net gold exports played an important part in transforming the current-account surplus in the first half of 1994 into a large and increasing deficit in the ensuing twelve months.

This switch in the current-account surplus occurred against the background of the normalisation of international financial and trade relations of South Africa. As a consequence, the large net outward movement of capital from the country turned around and a net capital inflow of R18,6 billion was recorded from the middle of 1994 up to June 1995. The inflow of capital not only led to an improvement in the overall balance of payments, but also enabled the authorities to nurture the upturn in economic activity somewhat.

Part of this inflow of capital consisted of bond issues by the government in international capital markets and several private placements by business undertakings in foreign markets. However, the largest share of capital was obtained to finance trade and for liquidity purposes. Since the abolition of the financial rand in March 1995, non-residents have also become large net purchasers of equities and other securities. These types of capital flows are generally more volatile than direct equity investments, and have resulted in sharp fluctuations in South Africa's overall balance of payments position, which impede the management of the foreign reserves and overall liquidity in the economy.

The growth in the expenditure on consumption, investment and inventory accumulation also led to an acceleration in the rate of increase in money supply to levels generally exceeding the upper limits of the guideline range. The increase in the demand for money during the first twelve months of the recovery was not only related to the transactions motive for money, but also reflected the precautionary motive to keep money because of uncertainties pertaining to the political transition. Other factors which later contributed to the comparatively high growth in money supply were a rise in the liquidity preference of the private sector because of uncertainties about interest rate changes and major price adjustments, and reintermediation owing to the decline in the banks' margins between deposit and lending rates.

Credit extension to the private sector grew at substantially higher twelve-month rates than the broad money supply during the greater part of 1994 and the first six months of 1995. Banks therefore utilised other sources than private-sector deposits to fund credit to the private sector, namely short-term foreign liabilities and capital and reserves.

In view of the high growth in money supply and bank credit extension and the apparent building-up of inflationary pressures, the authorities began to pursue a more conservative monetary policy stance. Initially, the higher rates of increase in the prices of domestically produced goods were largely the result of higher prices charged for unprocessed and processed food because of adverse weather conditions. This made the authorities reluctant to introduce more restrictive monetary policy measures. Late in 1994 other forces, such as the strong rise in nominal unit labour costs and the increasing pressure of domestic demand on the production capacity of the economy, took over as the main propellants of the acceleration in prices. These factors were supported in the first half of 1995 by the weakness of the exchange rate of the rand and higher international oil prices, which caused the so-called underlying rate of inflation to accelerate and intensified the need for an increase in Bank rate and the implementation of other disciplinary monetary measures.

The raising of Bank rate and the associated increases in money market and other short-term interest rates, while long-term rates remained more or less unchanged, caused the yield curve to flatten from the second half of 1994. Over the first five years of the maturity spectrum the yield curve nevertheless remained fairly steep. In the first half of 1995 the Reserve Bank also introduced other measures to mop up excess liquidity in the money market. A large part of the operations of the Reserve Bank were, however, concentrated on countering temporary fluctuations in the money market shortage arising from capital movements between South Africa and the rest of the world.

Activity in the primary and secondary bond markets receded sharply in 1994 and the first half of 1995, mainly on account of the smaller eventual borrowing requirement of the government, funds raised abroad, uncertainties regarding movements in long-term yields and the relatively liquid position of the private sector. Despite the firming of interest rates and high and increasing share prices, the demand for funds in the primary equity market also remained low over this period, but the number of shares issued as scrip dividends increased substantially because of the Secondary Tax on Companies. Turnover in the secondary equity market was negatively affected during the course of 1994 and the first half of 1995 by increases in interest rates and yields, a lacklustre performance of share markets world-wide and a significant decline in the participation of domestic investors in transactions on the Johannesburg Stock Exchange. In contrast to these developments, the markets for derivatives, mortgages and real estate remained buoyant.

The primary objective of fiscal policy in the economic recovery was the achievement of fiscal sustainability in the medium term, including the reprioritisation of government expenditure in order to increase allocations for social services, capital expenditure and the Reconstruction and Development Programme. The government accordingly applied considerable fiscal restraint to contain the growth in government expenditure, despite large special transfers and additional expenses incurred with the constitutional transformation of South Africa. Government revenue rose sharply over the same period because of tax rate increases and the growth in income, profits, domestic expenditure and imports. The government deficit before borrowing and debt repayment relative to gross domestic product nevertheless decreased only moderately in fiscal 1993/94 and 1994/95, which probably indicates the existence of structural deficiencies in government finance. This seems to be confirmed by the further sharp increase in government debt and the already high tax burden of households involved in the formal sectors of the economy.

Domestic economic developments

Production

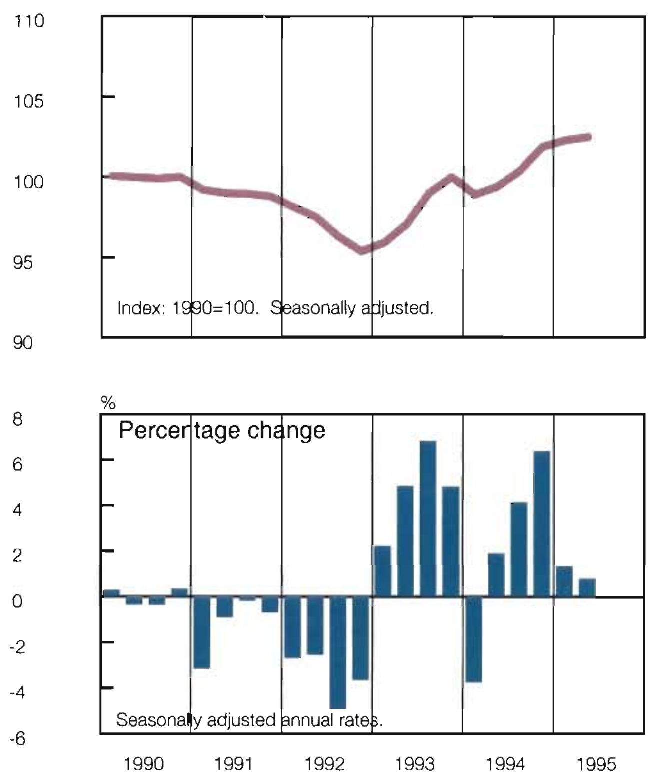
The economic upturn from May 1993 has been characterised by erratic movements in the growth of *aggregate domestic production.* Largely as a result of the transition to a new political dispensation and the uncertainties surrounding such a process, the rapid growth at the beginning of the recovery was followed by a decline in production in the first half of 1994: real gross domestic product increased at a seasonally adjusted and annualised rate of nearly 6 per cent in the second half of 1993 and then contracted at an annualised rate of approximately 1 per cent in the first half of 1994. When it became apparent that the political transition had taken place peacefully, economic growth picked up to an annualised rate of 5½ per cent in the second half of 1994. Adverse weather conditions and a lower production of gold in the ensuing period then caused the growth in real gross domestic product to slacken to an annualised rate of 1 per cent in the first half of 1995.

Notwithstanding these fluctuations in the real growth rate, real gross domestic product increased at an average annualised rate of 3 per cent in the first eight quarters of the current cyclical upswing. This growth was more or less in line with the average rate of increase in real production in the economic recovery of 1986-89, but much lower than in the economic upswings of the early 1980s and the late 1970s. The improvement in economic activity from May 1993 was relatively broadly based, but particularly strong in the secondary and tertiary sectors.

At first *agricultural production* made a major contribution to the rising level of economic activity. In 1994 real agricultural output rose by nearly 9 per cent, mainly as a result of the second-largest maize crop (12,1 million tons) ever harvested in South Africa. However, a severe drought then caused a reduction of almost 1 million hectares, or 24½ per cent, in the area planted to maize in the 1994/95 agricultural season from the preceding year. The estimated maize production for 1995 is only 4,4 million tons and a significant contraction in total agricultural production is projected.

The long-term downward trend in gold-mining production became more pronounced in the first half of 1995 and more than offset increases in real value added by the rest of the *mining sector.* The output of gold mines was adversely affected by a reduction in the quality and quantity of ore milled. The latter could be attributed mainly to disruptions in the labour market and an increase in the number of special and public holidays. In contrast, the mining of coal and some

Real gross domestic product



base metals benefited from a strong revival in international demand and increased productivity. The rise in production by non-gold mines was, however, unable to prevent a decrease in the total real output of the mining sector, which averaged 4 per cent at an annualised rate in the first eight quarters of the current economic upswing.

The major source of economic growth in the current upturn was a revival of the *secondary sectors' activity*, after a long but moderate decline had been recorded during the recession of 1989-93. The upward trend in the real value added by the secondary sectors was primarily due to sharp increases in output volumes throughout the manufacturing industry. Various factors were responsible for the strong performance of the manufacturing sector, including:

- a robust international demand on account of the economic recovery in most industrialised countries;
- the normalisation of South Africa's international trade relations;

Table 1. Average annualised rate of increase in real gross domestic product in current economic recovery

Per cent

	1993	1994		1995	From 2nd qr 1993 to 2nd qr 1995
	2nd half	1st half	2nd half	1st half	
Primary sectors	29	-16½	6½	-18	-2
Secondary sectors	3	1	7	5½	4
Manufacturing	2½	1	9	6	4½
Electricity, gas and water	6½	2½	2	4½	3½
Construction	0	3	1	2	1½
Tertiary sectors	2	2½	3½	3½	2½
Commerce	2½	1½	5½	4	3½
Transportation and communication	8	2	2	5½	4½
Financial services	½	4	4½	4½	3½
Total	**6**	**-1**	**5½**	**1**	**3**

- substantial increases in domestic consumption and investment expenditure;
- the commissioning of the new Columbus stainless steel plant, which strengthened the basic iron and steel production since the middle of 1994; and
- the decline in the number of man-days lost in the manufacturing industry in the first half of 1995.

Despite the rise in manufacturing production, the real value added by manufacturers in the first half of 1995 was still 5 per cent below the peak of the second quarter of 1989.

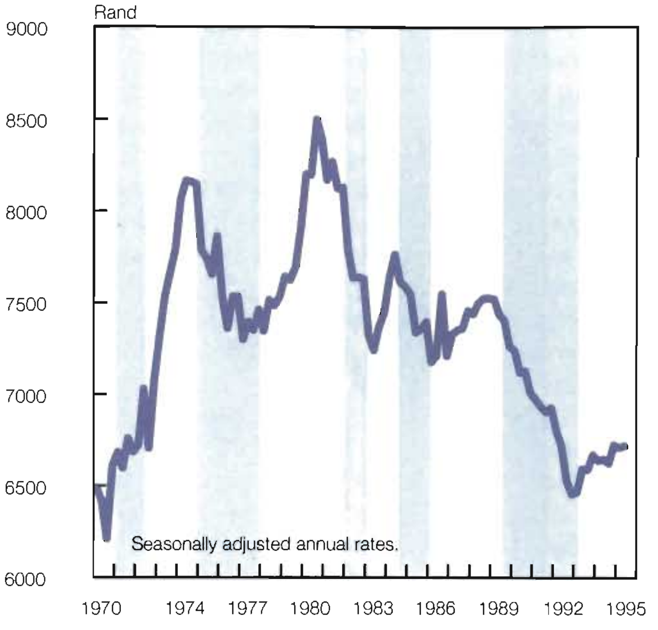
The ongoing expansion programme of electricity services in many underdeveloped regions throughout the country and the general revival of economic activity brought about a steady growth in the real value added by the sector supplying electricity, gas and water. There was also an encouraging growth in the real product of the construction sector during 1994 and the first half of 1995. After having moved downwards almost without interruption from the second quarter of 1990, a lower turning-point was reached in the real value added by the construction sector in the third quarter of 1993. The revival in construction activity was related to a recovery in the demand for new residential and non-residential buildings, while the decrease in civil construction work from the middle of 1990 bottomed out from the middle of 1993.

The real value added by the *tertiary sectors*, which had risen at a modest annualised growth rate of ½ per cent in the economic downswing from 1989 to 1993, increased much more rapidly at an average rate of 2½ per cent per year in the current economic recovery. This increase was mainly due to strong growth in the commercial, financial, transport and communication services.

Reflecting the generally more optimistic consumer sentiment, the wholesale and retail trade increased sharply over the eighteen months up to the end of June 1995. Positive developments in the motor trade were related to a buoyant investment demand for transport equipment owing to expansions in the car rental sector, an increase in export business in the case of automotive components and the replacement demand of households. As in the preceding recession, the real value added by financial services continued to increase steadily, while increased export demand as well as higher outlays on both domestically produced and imported goods led to a substantial increase in the real value added by the transport sector throughout the current upswing. In addition, communication services were boosted by the successful establishment of the cellular telephone network during this period.

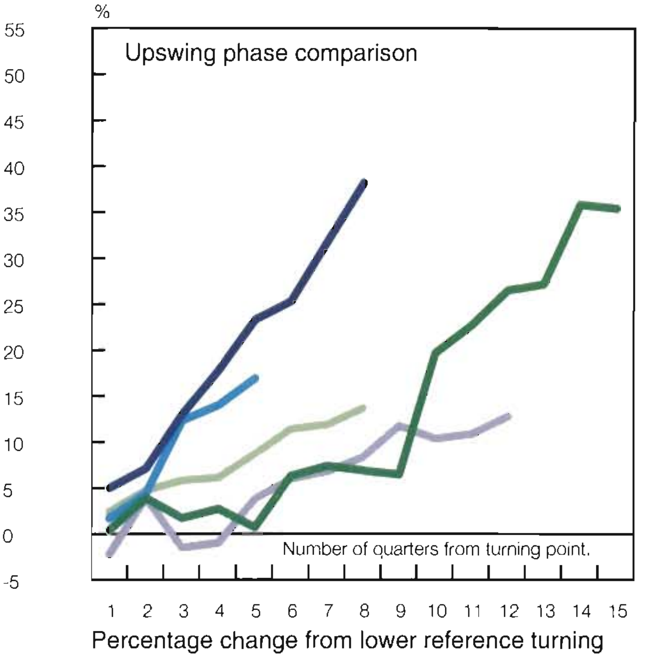
After having fallen back by 6½ per cent from a high in the first quarter of 1989 to a low in the fourth quarter of 1992, the real *gross national product* rose in the second quarter of 1995 to a level that was approximately 9½ per cent higher than at the end of 1992. This increase incorporated lower net factor payments to the rest of the world and a rise in the terms of trade, particularly in 1994. Because the rate of increase in gross national product exceeded the population growth rate in the current economic recovery, the real gross national product *per capita* increased at an average annual rate of 1 per cent. Although this was a significant short-term advancement in the real income of South Africans, the deterioration in living standards in the long term

Real gross national product per capita



Dark area: Downward phase of the business cycle.

Real gross domestic expenditure



Percentage change from lower reference turning point in:

- 3rd quarter 1972
- 4th quarter 1977
- 1st quarter 1983
- 1st quarter 1986
- 2nd quarter 1993

remains a cause of concern. The average real income *per capita* of R6 700 (at 1990 prices) in the first half of 1995 was more or less equal to levels already reached in the early 1970s.

Aggregate domestic expenditure

Aggregate real gross domestic expenditure rose uninterruptedly during the current cyclical upward phase of the business cycle to a level in the second quarter of 1995 that was virtually 13½ per cent higher than at the lower turning-point of the business cycle in the second quarter of 1993. The average annualised increase in real domestic expenditure came to 6½ per cent over this period. As illustrated in the accompanying graph, this was not exceptionally high in comparison with some other upward phases of the business cycle. Where more rapid increases in real expenditure were recorded, however, the upturn lasted for only a comparatively short period. On the other hand, where real gross domestic expenditure increased at a slower pace, the economic upswings lasted considerably longer.

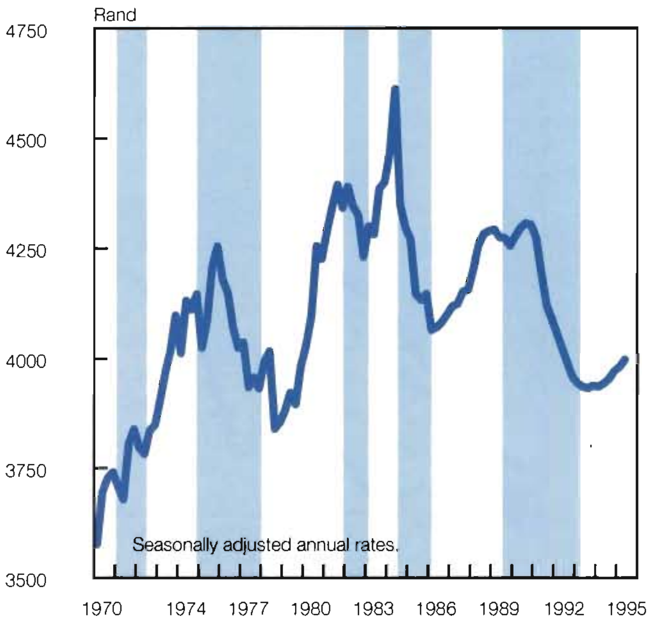
A strong rise in real outlays on fixed investment and the accumulation of inventories were to a large extent responsible for the comparatively high increase in total real gross domestic expenditure. The rates of increase in both these aggregates were well above increases registered in the upward phases of the business cycle during the 1970s and 1980s. Contrary to these developments, the increases in real private consumption expenditure and real government consumption expenditure were relatively modest in comparison with other economic upturns since the late 1970s.

The quarter-to-quarter changes in real gross domestic expenditure, however, contracted substantially in the first half of 1995, to an average annualised rate of 4½ per cent from approximately 10 per cent in the second half of 1994. This could be attributed to a slowdown in the rise of gross capital formation and private consumption at constant prices, while real consumption expenditure by general government remained virtually unchanged.

Private consumption expenditure

Real outlays on *aggregate private consumption* rose at an average annualised rate of nearly 3 per cent over the eight quarters ended June 1995, which was appreciably lower than the average increases per annum of between 4 and 9 per cent in the preceding three upswings. In sharp contrast to its normal behaviour, real private consumption expenditure *per capita* responded very slowly to the economic recovery and, measured from quarter to quarter, the rate of increase in *per capita* consumption only started to increase from the second quarter of 1994. In previous

Real private consumption expenditure per capita



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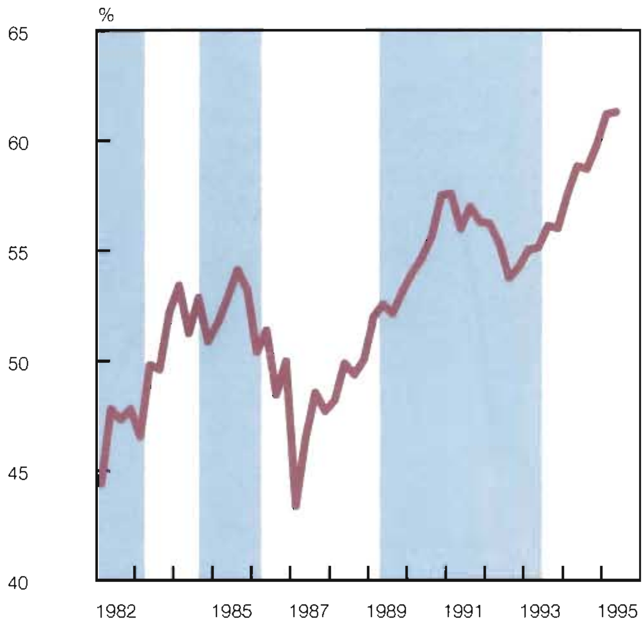
Household debt as percentage of personal disposable income



Dark area: Downward phase of the business cycle.

periods of economic recovery real private consumption expenditure *per capita* reacted more quickly and rose much more rapidly.

Real outlays on consumption by households remained relatively subdued in the first four quarters of the current cyclical upswing. This relative weakness in the growth of consumption was probably related, among others, to:

- the feeble growth of personal disposable income against the background of slow employment growth and further sharp increases in taxation as a proportion of the current income of households;
- uncertainty and an unwillingness to commit future income in the final stages of the political transition process; and
- the violence, mass actions and stay-aways during this period, which did not help to strengthen consumer confidence.

The growth in real private consumption expenditure gained momentum in the second half of 1994 and the first two quarters of 1995 and varied between annualised rates of 3 and 3½ per cent. This stronger demand for consumer goods and services was evident in all its major sub-categories, but spending on furniture and household appliances, personal transport equipment, and clothing and footwear increased more impressively than some of the other spending categories. Real outlays on durable and semi-durable goods benefited from Eskom's electrification programme. Moreover, the sales of new motor cars rose substantially from the fourth quarter of 1994, reflecting the elimination of the backlog of orders that had arisen during the serious strike in the industry in the preceding quarter, as well as replacement demand on account of the increased average age of motor vehicles owned by households. Consumer confidence also improved markedly with the reduced violence in Black residential areas. Real private consumption expenditure in the first six months of 1995 was also buoyed by a moderate rise in aggregate personal disposable income and an increased recourse to consumer credit.

Consumer credit continued to grow at a disconcerting high rate throughout the current economic recovery, when it became more readily available to a wider spectrum of consumers through, *inter alia*, the proliferation of private-label credit cards introduced by a number of retail outlets. The rise in consumers' propensity to borrow could also be attributed to sharp increases in asset prices. As a result, the ratio of household debt to personal disposable income rose from a recent low of 55 per cent in the first half of 1993 to more than 60 per cent in the first half of 1995. This high ratio may be compared with an average of only 42 per cent in the 1970s. A sharp upward trend is discernible in the proportion of household debt to personal disposable income from the beginning of the 1980s, when income growth deteriorated and consumers were reluctant to lower their standards of living.

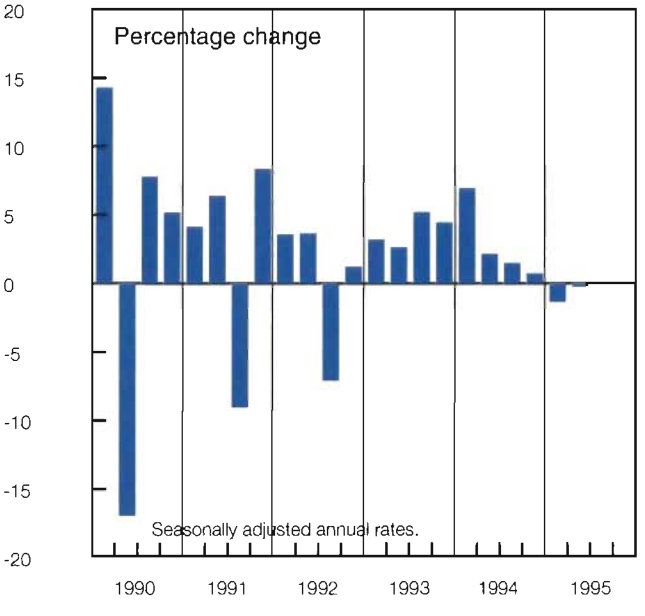
Government consumption expenditure

The rise in real consumption expenditure by general government slowed down to an annualised rate of 2½ per cent in the current cyclical upswing, compared with rates varying between 3½ and 10 per cent in the previous three upswings. The slower rise in general government's real outlays on consumption goods and services stemmed from a markedly lower growth in the real remuneration of employees; the rate of increase in this aggregate amounted to an annualised ½ per cent over the past eight quarters compared with between 3½ and 6½ per cent in the preceding economic upturns. On the other hand, real outlays by general government on goods and services of a non-capital nature continued to increase rapidly.

In calendar 1994 real outlays by general government on consumption expenditure still increased by 4 per cent. More recently, however, real government consumption expenditure actually declined in the first quarter of 1995 before it edged slightly higher in the second quarter. This brought the consumption expenditure by general government at constant prices for the first half of 1995 to a level that was approximately ½ per cent above the corresponding period of the preceding year.

The strong rise in consumption expenditure by general government in 1994 raised the ratio of this aggregate to gross domestic product to an all-time record of 21 per cent. This ratio remained unchanged in the first half of 1995.

Real consumption expenditure by general government



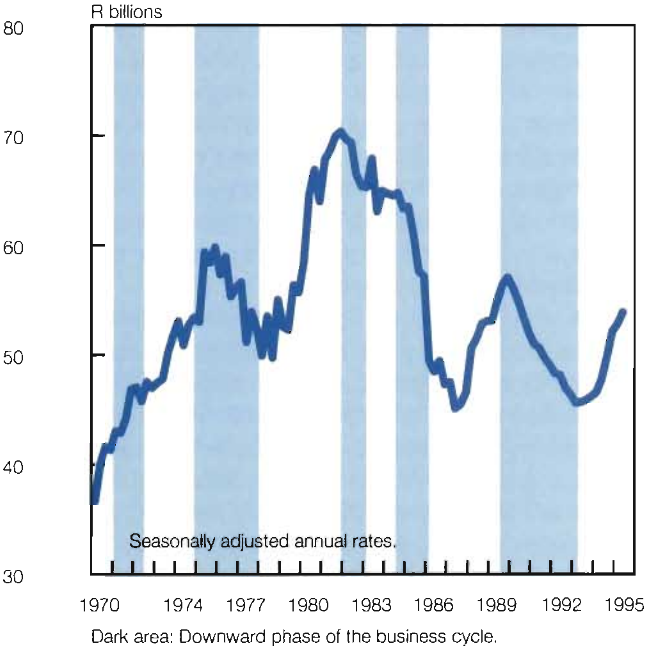
Domestic fixed investment

As indicated before, one of the main features of the economic upswing which started in May 1993 has been the strong growth in *total real gross domestic fixed investment*. This recovery in fixed investment was very hesitant at first, but gained considerable momentum during 1994 and then slowed down somewhat at a relatively high level in the first half of 1995. Taken at an average annualised rate, real fixed investment increased by 8½ per cent in the current upward phase of the business cycle. This rate was higher than in any of the three preceding economic upswings.

Capital expenditure on a few major projects was mainly responsible for the revival of fixed investment in 1993, but the increase in investment became more widespread as the economic recovery gained momentum. Investment in machinery and equipment and transport equipment, in particular, increased at a rapid rate in the economic recovery, while more moderate increases were recorded in real investment in construction works and buildings. A large part of the higher investment was therefore related to the replacement of ageing equipment, which had probably been deferred because of the long recession and the uncertainty about the outcome of the political transition. Various other factors also contributed to the rapid rise in real fixed investment, such as:

- the creation of a more investor-friendly environment and the fading-away of the need to maintain a

Real gross domestic fixed investment



Dark area: Downward phase of the business cycle.

surplus on the current account of the balance of payments to meet the scheduled amortisation of foreign debt;

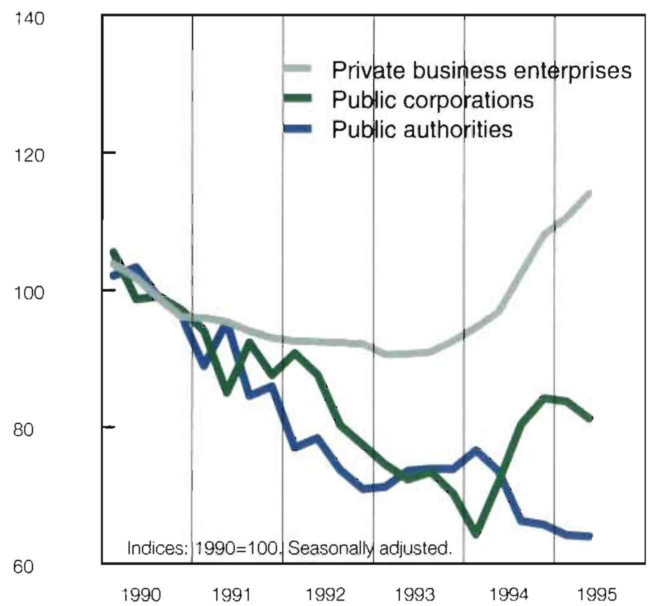
- factor price distortions which in many cases continued to favour the production factor capital at the expense of labour;
- a decline in the user cost of capital in 1993 and 1994;
- a sharp rise in the utilisation of production capacity in the manufacturing sector from 77½ per cent at the beginning of the economic upswing to 83 per cent in the first quarter of 1995; and
- a noticeable rise in the profitability of the corporate sector from the beginning of 1992.

As a *proportion of gross domestic product*, gross fixed capital formation rose from the lower turning-point of 15 per cent in the second half of 1993 to 16½ per cent in the first half of 1995. This level of fixed investment is nevertheless still well below the level of more than 25 per cent which most research has shown is needed for a sustainable high rate of economic growth that will be able to absorb the increase in the economically active population and reduce unemployment. However, the growth in fixed investment in the recovery has succeeded in turning around the decline in the net additions to the production capacity of the economy relative to production. Net fixed investment, which had decreased to a low point of close to 1 per cent of gross domestic product in the first quarter of 1993, subsequently rose to approximately 3 per cent of gross domestic product in the first half of 1995.

A classification of real gross fixed investment by *type of institution* shows that the private sector and public corporations were the main contributors to the higher level of investment activity. The increase at an average annualised rate of 12 per cent in real fixed investment expenditure by the private sector in the present economic upswing was higher than in any of the three previous upturns. Real fixed investment by public corporations also increased very rapidly since the beginning of 1994, following a period when some public corporations deliberately reduced investment outlays in order to correct for the earlier creation of considerable excess capacity.

In sharp contrast to these developments, real capital formation by the public authorities continued to recede in the current economic recovery. This was the combined result of a contraction in the investment outlays by government business enterprises and by general government. However, since the start of the recovery the decline in fixed investment by public authorities has slowed down considerably: real fixed investment by these institutions decreased by 3½ per cent in 1994 and at an annualised rate of 5 per cent in the first half of 1995, compared with rates of decline varying between 11½ and 15½ per cent from 1990 to

Real gross domestic fixed investment



1992. The further decrease in the fixed investment by public authorities brought this investment to a level in the first half of 1995 that was 18 per cent lower than its peak value in the second quarter of 1992. The reduction of fixed investment by public authorities, if not reversed, could impose a constraint on economic growth in the future because of the inadequacy of infrastructural facilities that could develop.

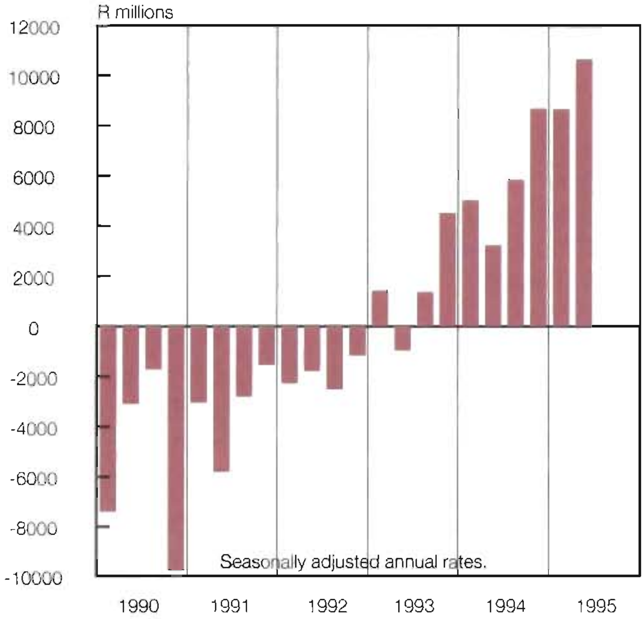
Table 2, which provides an analysis of real gross domestic fixed investment by *economic sector*, clearly shows that, with the notable exception of community, social and personal services (mainly the capital outlays of general government), nearly all sectors made positive contributions to the growth in fixed investment in the current recovery. The exceptionally rapid growth in fixed investment by the agricultural sector must be seen against the background of rising real incomes in this sector in 1993 and 1994 and a long period in which the fixed capital stock of farmers contracted. Expenditure by Eskom on the electrification of high-density residential areas was mainly responsible for the substantial growth in the fixed investment by the sector providing electricity, gas and water. New ventures were started in the mining sector and existing capacity was expanded, while the higher capital expenditure in manufacturing largely reflected the expansion of capacity in the beneficiation of minerals and the manufacturing of motor vehicles, chemical products, paper and paper products, and oil refining.

Table 2. Average annualised changes in real gross domestic fixed investment by economic sector

Per cent

Sector	Upward phases of the business cycle: 1st qr 1978 to 3rd qr 1981	2nd qr 1983 to 2nd qr 1984	2nd qr 1986 to 1st qr 1989	2nd qr 1993 to 2nd qr 1995
Agriculture	12½	-18½	-½	17½
Mining	19½	7½	8½	10½
Manufacturing	15	-22	16	10
Electricity, gas and water	2½	17	-9½	14½
Construction	4½	-1	-1	3½
Commerce	1	3½	-2½	11½
Transportation and communication	4	-13½	-12½	-1
Financial services	10	21½	5	12½
Community, social and personal services	-2½	-1½	2½	-4½
Total	**8**	**-1**	**2½**	**8½**

Change in real inventories



Inventory investment

The strength of the *inventory cycle* in the current economic recovery exceeded the inventory accumulation during the upward phases of the business cycle in the 1970s and 1980s. Moreover, the rise in inventories followed the general business cycle with a much shorter time delay in the current recovery than in previous economic upturns. However, this early response of the inventory cycle was partly a matter of unplanned additions to mining inventories on account of the weak international demand for some important minerals and metals produced in South Africa, and of substantial increases in agricultural stocks-in-trade resulting from the large agricultural crop in 1993. More recently the inventory accumulation may also have been based on businesses' reassessment of the appropriate level of stocks relative to sales in the light of the more favourable political circumstances and the increased participation of South African enterprises in international trade.

The strong inventory build-up in the second half of 1994 and the first half of 1995 stemmed mainly from stock accumulation in the manufacturing and commercial sectors. This was occasioned by a positive mood among businessmen and a willingness to position themselves for an expected continued strong domestic demand, an increase in exports, the imports of goods for large-scale investment projects and pre-emptive buying of imported goods based on exchange rate expectations.

In view of the large inventory accumulation during the economic recovery, *the level of industrial and commercial inventories* relative to the gross domestic product in the non-agricultural sectors of the economy rose to an average of 18½ per cent in the first two quarters of 1995, compared with a record low of 16 per cent in the fourth quarter of 1993. The build-up of inventories also made a major contribution to the growth in gross domestic product: the increase in real investment in inventories over the eight quarters ended June 1995 contributed more than half of the aggregate increase in gross domestic product during this period.

Nominal factor income

Table 3 shows that the rate of increase in *nominal factor income* rose sharply in the current upward phase of the business cycle from 10 per cent in 1992 to 13 per cent in 1994, before declining somewhat to 12 per cent in the first half of 1995 compared with the same period in the preceding year. In a general sense, the higher growth in aggregate nominal income, at factor cost, could be ascribed to the buoyancy of secondary and tertiary activities and a sharp rise in merchandise exports.

Table 3. Rate of increase in nominal factor income by type of income

Per cent

	1992	1993	1994	1st half of 1995*
Nominal factor income.................	10	12½	13	12
Remuneration of employees	13	10½	10	11½
Gross operating surplus	8½	13½	12	12
Primary sectors ..	-6½	21½	14½	-9
Secondary sectors	6½	8½	11½	18
Tertiary sectors....	18½	14	11½	17

* Over the same period of the preceding year.

The higher level of economic activity, labour rationalisation in many enterprises and a generally greater cost consciousness in the private sector caused the rate of increase in the *gross operating surplus* to move to considerably higher levels in the current economic recovery. At first the year-on-year rate of increase in the gross operating surplus accelerated mainly because of good weather conditions which resulted in large agricultural crops. From the beginning of 1994 slower growth in the profits of mines in conjunction with poor weather conditions caused the growth in the operating surplus of the primary sectors to contract sharply. This deterioration in the profitability of the primary sectors was offset to some extent by a rapid rate of increase in the gross operating surpluses of the secondary and tertiary sectors. In particular, the profits of enterprises involved in manufacturing, commerce, transportation, telecommunication and finance rose sharply.

The rate of increase in the *total remuneration of employees* receded from 13 per cent in 1992 to 10 per cent in 1994, owing mainly to smaller wage settlements between employers and employees and a sharp decline in employment. However, the year-on-year rate of increase in total labour remuneration then rose again to 11½ per cent in the first half of 1995, or to well above the average rate of inflation in that period. This higher increase in total salaries and wages was evident in all the major sectors of the economy and reflected a moderate increase in the aggregate level of employment and an acceleration in the growth of the average remuneration per employee.

Domestic saving

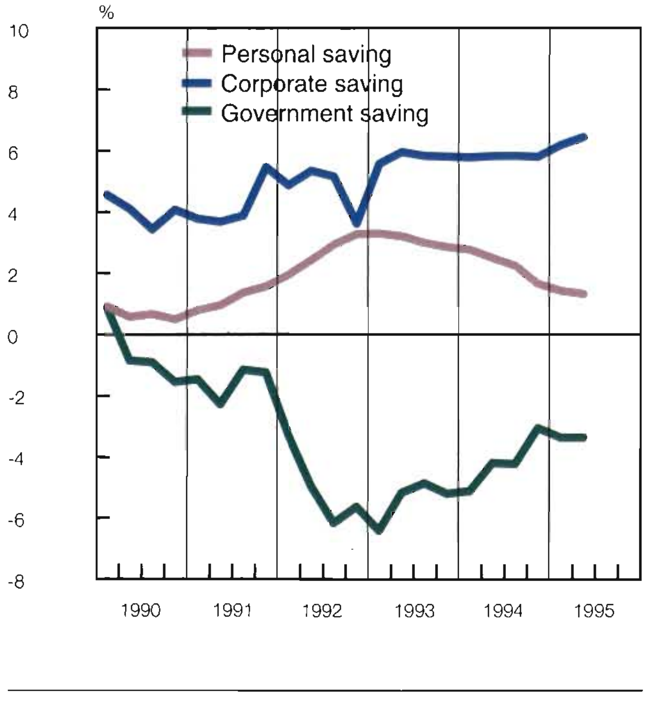
The ratio of *aggregate gross domestic saving* to gross domestic product, which had contracted continuously from 24½ per cent in 1985 to an annual low of 17 per cent in 1992, rose slightly to 17½ per cent in both 1993 and 1994 and to almost 18 per cent in the first half of 1995. The slight improvement in the saving performance was due to lower dissaving by general government, while the saving ratio of the private sector declined.

The *net dissaving by general government* receded steadily from 6½ per cent of gross domestic product at the beginning of 1993 to 3½ per cent in the first half of 1995. Current income of general government over this period was strengthened by a sharp increase in direct and indirect tax revenue, which implies a shift in saving from the private sector to the government. The recent slower growth in the rate of increase in real consumption expenditure by general government also made a sizeable contribution to the curtailment of net dissaving by general government.

The ratio of *net saving by the private sector* to gross domestic product fell back from 9 per cent in the second quarter of 1993 to 7½ per cent in the first two quarters of 1995. This decline occurred despite a relatively firm saving ratio of the corporate sector. The saving ratio of households, however, continued to move downwards.

Sharp increases in the gross operating surpluses of business enterprises in the secondary and tertiary sectors were mainly responsible for the relative stability of *corporate saving* since the beginning of the economic upturn in May 1993. These increases made

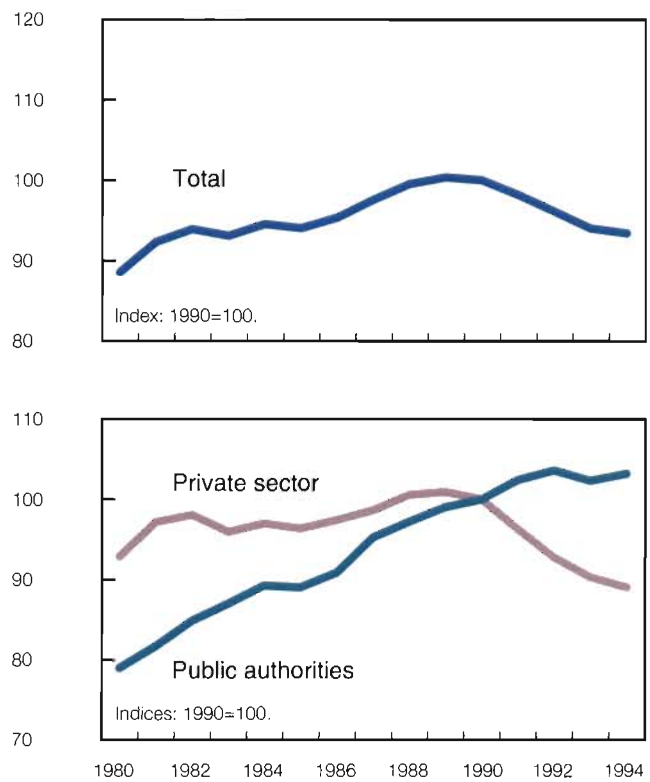
Components of domestic saving as percentage of gross domestic product



up for the less impressive performance of the primary sectors and the relatively slow growth in income received in the form of interest, dividends and rent and royalties. In the aggregate, the rates of return on reproducible assets of the corporate sector nonetheless increased continuously from 6 per cent in the second quarter of 1990 to 8½ per cent in the first half of 1995.

Household saving weakened relative to aggregate production as well as personal income: household saving as a ratio of gross domestic product declined from 3 per cent in the second quarter of 1993 to 1½ per cent in the second quarter of 1995 and receded from 5 to 2 per cent as a proportion of personal disposable income over the same period. The deterioration in the household sector's saving performance in 1994 and 1995 was the combined result of higher consumption expenditure and a continued rise in taxation. Households' average propensity to consume (i.e. private consumption expenditure as a proportion of personal disposable income) rose from 95 per cent in the first quarter of 1993 to about 98 per cent in the second quarter of 1995. Direct taxes paid by households as a share of current income rose to 14½ per cent in the first half of 1995. This was 1 percentage point higher than the ratio of 13½ per cent in 1993 and markedly higher than the ratio of 11½ per cent in 1985.

Employment in non-agricultural sectors



Employment

Employment growth, as was the case during most economic recoveries since the 1970s, was slow to respond to the general upturn in economic activity during 1993 and 1994. The lower turning-point of the business cycle in the second quarter of 1993 was followed by further decreases in total formal non-agricultural employment; only in the second quarter of 1994 did employment begin to advance at a seasonally adjusted and annualised rate of 0,6 per cent. This rate of increase subsequently strengthened to 2,5 per cent in the third quarter of 1994 before falling back to 0,9 per cent in the fourth quarter (latest information made available by the Central Statistical Service). In spite of this relatively strong rise, the average level of employment still contracted by 0,6 per cent for the full calendar year 1994.

The slow reaction of employment growth in the early phase of the recovery was probably due to factors such as a continued rationalisation of labour and the reluctance of firms to hire new workers until the economic upturn was firmly established. Especially employment in the private sector responded slowly to the strengthening of overall economic activity. In the fourth quarter of 1994, i.e. six quarters into the current recovery, the number of people employed by the private sector was about 41 000 less than at the end of the recession of 1989-93. Contrary to this development, employment in the public sector continued to show a sharp upward trend.

An analysis of employment figures by *economic sector* shows that the creation of employment opportunities remained very subdued in the non-gold-mining and retail trade sectors. Notwithstanding the recent growth in construction activities and the continued strong rise in electricity generation, the employment figures in the fourth quarter of 1994 in both these sectors as well as in gold mining were still below the levels reached at the beginning of the recession in the second quarter of 1989. Some net employment gains were, however, made in the private manufacturing sector and in service industries such as banking, insurance and accommodation.

The further decrease in job opportunities in private-sector organisations in the current economic recovery on top of the estimated job losses of 420 000 in the recession of 1989-93, brought the aggregate level of total formal-sector employment more or less back to where it was in the second quarter of 1982. During this period the potential labour force kept on growing rapidly. In addition to the net growth in the domestic economically active population, a number of jobseekers crossed into the country from neighbouring states and from further afield. In consequence, *unemployment* rose substantially.

According to the *Household Survey* conducted by the Central Statistical Service, nearly one-third of the economically active population was unemployed in October 1994. Of these unemployed, approximately half are under the age of 30 years, three-fifths have never held a job before, two-thirds have been seeking work for a period of longer than one year, the bulk are unskilled and nearly half do not engage in job-seeking activities (i.e. are so-called discouraged workers). Moreover, the fact that the number of unemployed has risen steadily for 15 years to its current high level indicates that this is not a cyclical but rather a structural problem. Hence, a typical cyclical strengthening of economic growth which could taper off in the future is unlikely to make any significant inroads on the number of unemployed.

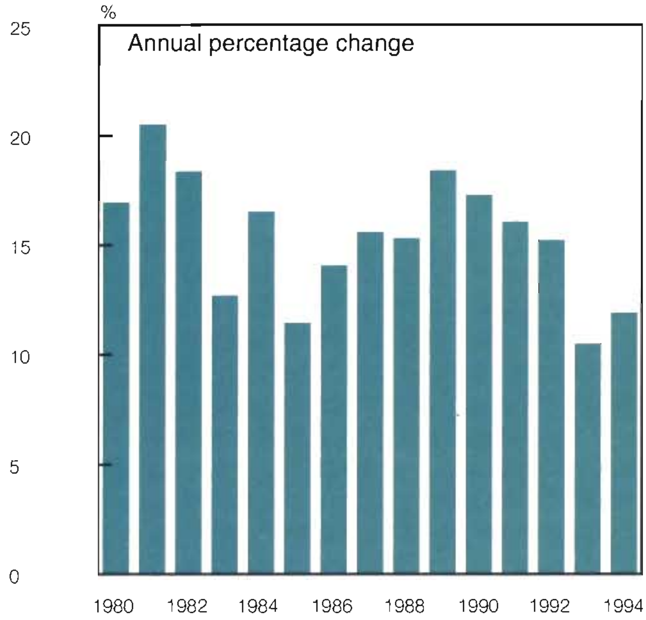
As discussed in some detail in the *Annual Economic Report* of 1994, various factors contributed to the poor *labour-absorption capacity* of the economy, including the low level of education and training of workers, the increase in the capital intensity of production and the inward-looking economic strategy pursued before the early 1990s. The reluctance of private-sector employers to add to their staff complements also appears to be closely related to the high and rising wage costs. To this should be added the high non-wage costs of labour resulting particularly from protest actions, strikes and stay-aways. Much faster growth than during the 1980s and the first half of the 1990s sustained for a lengthy period of time, a reduction in labour unrest, and a more flexible labour market, therefore are preconditions for solving the country's problem of high unemployment.

Labour costs and productivity

Despite the steep rise in the number of unemployed people, the rate of increase in the *nominal remuneration per worker* slowed down only very gradually from 18,4 per cent in 1989 to 15,2 per cent in 1992 before being cut more meaningfully to 10,5 per cent in 1993. In 1994 the rate of increase in the average wages and salaries per worker moved back to a level of 11,9 per cent.

Nominal wage growth in both the private and public sector slowed down over this period. In the private sector the increase in the average remuneration per worker came down from 17,0 per cent in 1990 to 10,2 per cent in 1994. The rise in public-sector remuneration per worker peaked at 21,6 per cent in 1989 and then fell to 9,2 per cent in 1993. Special remuneration arrangements at the time of the general election of the Government of National Unity in April

Nominal remuneration per worker



1994, in particular the payment of special bonuses as well as allowances to temporary workers, raised the rate of increase in labour remuneration per worker to 14,6 per cent in 1994.

The workers' resistance to wage increases more in keeping with labour market conditions, could be attributed to several factors, including:

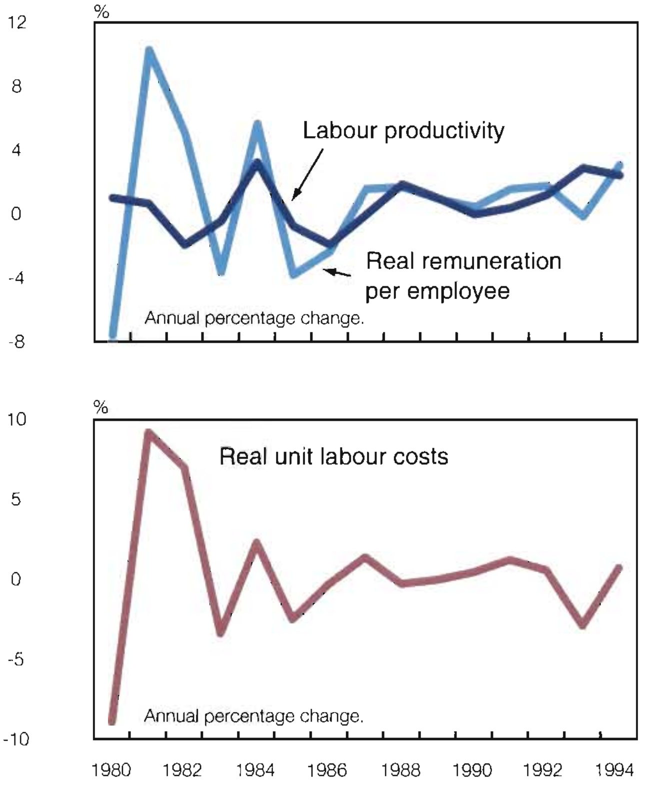
- the strength of trade unions and their success in wage negotiations, underpinned in many cases by industrial action;
- the high degree of concentration in the domestic economy, which allows employers to grant higher wages and then to add the additional costs to output prices without fear of losing market share;
- the system of excessive tariff protection (now being changed), which shields domestic producers from foreign low-cost competitors;
- the view that wages for certain categories of workers are so low that they cannot drop any further and that the number of job grades should be reduced in order to narrow the wage differential between unskilled and skilled workers;
- the practice of wage negotiations at industry level, which causes wage increases to be applied uniformly and to settle at levels that can be afforded by the more profitable enterprises;
- persistent high inflation expectations; and
- the expectations among workers of a rapid improvement in living standards on account of the political transition.

In view of these factors, the rate of increase in nominal remuneration per worker still outpaced the increase in aggregate output prices from 1989 to 1992. Moreover, the rate of increase in *real wages and salaries per worker* (i.e. nominal remuneration per worker deflated by the price deflator for the non-agricultural gross domestic product) accelerated from 0,4 per cent in 1990 to 1,5 per cent in 1991 and 1,7 per cent in 1992. An absolute decrease of only 0,2 per cent in real remuneration per worker in 1993 was then followed by a very rapid rate of increase of 3,0 per cent in 1994.

During the first half of the 1990s the rate of increase in the *real output per worker* in the non-agricultural sectors of the economy rose from 0,4 per cent in 1991 to 2,8 per cent in 1993 and 2,4 per cent in 1994. With nominal wage growth continually exceeding productivity growth, *nominal unit labour costs* (i.e. the ratio of nominal remuneration per worker to real output per worker) kept on rising over the same period. The decline in the rate of growth of nominal remuneration per worker and the rise in the rate of productivity growth nevertheless caused the growth of nominal unit labour costs to slow down from 17,3 per cent in 1990 to 7,4 per cent in 1993. This slowdown, of course, contributed significantly to the decline in price inflation. The rate of increase in nominal unit labour costs then bounced back to 9,4 per cent in 1994.

In contrast to previous periods of economic recovery, when *real unit labour costs* (i.e. the mirror image of employers' share in the overall value of output) at first contracted, these costs started to rise immediately from the start of the upturn in economic activity in the third quarter of 1993. This development is not only harmful for employment growth, but may also have an adverse impact on rates of return on invested capital. The decline in the inducement to invest will inevitably undermine the long-term growth potential of the national economy and employment growth.

Non-agricultural labour productivity, remuneration and unit labour costs



Inflation

The high and accelerating inflation that South Africa had experienced for more than two decades subsided significantly in the early part of the 1990s. For instance, the rate of increase over periods of twelve months in the all-goods production price index receded, on balance, from a peak of 15,8 per cent in May 1989 to only 5,4 per cent in October 1993 – the lowest rate of increase since January 1972. Similarly, the rate of increase over periods of twelve months in the overall consumer price index declined from a high point of 16,8 per cent in October 1991 to 7,1 per cent

Consumer and production price indices

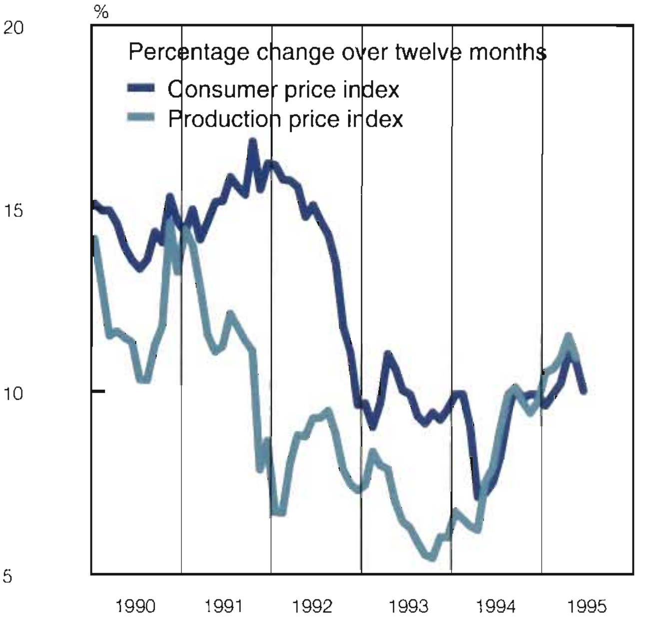


Table 4. Twelve-month rates of increase in production and consumer price indices

Per cent

	1994		1995			
	April	December	March	April	May	June
Production prices						
Domestically produced goods...	6,8	10,4	11,1	11,7	11,4	...
Imported goods	3,1	6,9	9,8	10,5	9,1	...
All goods..................................	6,2	9,7	10,9	11,5	10,9	...
Consumer prices						
Goods......................................	6,8	10,0	10,4	10,9	10,5	9,3
Services	7,5	10,4	10,8	11,9	11,8	11,6
Overall......................................	7,1	9,9	10,2	11,0	10,8	10,0

in April 1994 – the lowest rate of increase since November 1972. This significant slowdown of inflation could to a large extent be ascribed to the consistent application of a more conservative monetary policy since the late 1980s and the impact of the drawn-out recession of 1989-93 on inflation expectations and wage settlements. These factors were supported by the relative price stability in South Africa's main trading partner countries and a somewhat more stable exchange rate of the rand.

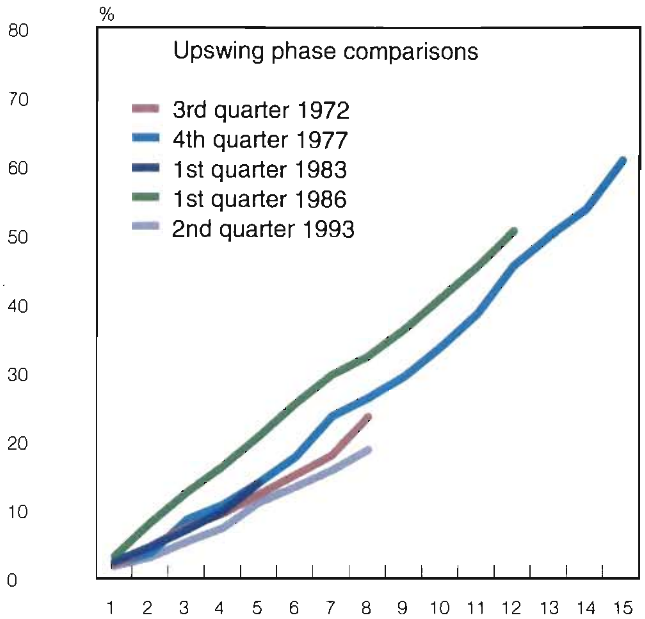
However, towards the end of 1993 the twelve-month rate of increase in the all-goods *production price index* began to edge up slightly to 6,2 per cent in April 1994, before it accelerated much more significantly to 11,5 per cent in April 1995 and 10,9 per cent in May 1995. More rapid rates of increase occurred in the prices of both domestically produced and imported goods. Initially, the higher rates of increase in the prices of domestically produced goods were largely the result of higher prices charged for unprocessed and processed food because of adverse weather conditions. Since November 1994 other forces, such as the strong rise in nominal unit labour costs, have taken over as the main propellant of the acceleration of the rise in prices of domestically produced goods. The acceleration in the rate of increase in the prices of imported goods, in turn, reflected mainly the relative weakness of the exchange ratė of the rand and rising prices of crude oil.

The rate of increase over periods of twelve months in the overall *consumer price index* also began to accelerate from May 1994 to 10,1 per cent in September 1994 and 11,0 per cent in April 1995; it then dropped sharply to 10,0 per cent in June 1995. At first this rise in consumer price inflation was also affected by special factors, such as increases in the prices of food due to adverse weather conditions, the raising of mortgage rates and a depreciation in the external value of the rand. More recently, however, the higher rate of inflation seems to have been pushed upward by more fundamental factors. This is substantiated by changes in the so-called *underlying rate of inflation* (i.e. the overall consumer price index excluding food and non-alcoholic beverages, the costs of home ownership and value-added tax). Measured over a period of twelve months, the underlying inflation rate increased only moderately from 7,2 per cent in June 1994 to 7,9 per cent in December 1994, before declining to 7,3 per cent in February 1995. However, it then rose rapidly to 9,2 per cent in May and 9,0 per cent in June 1995.

This disturbing rise in underlying inflation probably reflected to a large extent the upturn in economic activity coupled with sharply higher import prices. The strong demand-pull on inflation is evident from the rapid increase in credit extension and the broadly defined money supply. The steep upward movement in domestic expenditure led to higher rates of capacity utilisation in manufacturing, while the rise in nominal unit labour costs undoubtedly also influenced pricing policies of business organisations.

Such an acceleration of *inflation during periods of recovery* has been characteristic of the South African economy. During each of the upward phases of the business cycle since the 1970s the rates of increase in both the consumer and production price indices have tended to accelerate. However, as illustrated in the accompanying graph, the increases in the consumer price index during the first seven quarters of the current economic upswing have been smaller than in any of the upward phases since the early 1970s. The consistent conservative monetary policy measures were therefore successful in containing the acceleration of inflation somewhat, because of lower

Overall consumer price index



inflation expectations and more moderate wage settlements.

Certain important *structural factors*, on the other hand, continued to inhibit a decline in the rate of inflation, such as:

- expectations of further general increases in prices, which influence wage negotiations aimed at maintaining or increasing real remuneration;
- an inflexible labour market which does not reflect underlying supply and demand conditions;
- the largely oligopolistic industrial structure, where a few large enterprises operate behind a protective tariff wall which allows them to pass on increased input costs; and
- the still relatively large budget deficits, despite more fiscal restraint by the authorities, which instill fears of a possible abandonment of fiscal discipline.

Foreign trade and payments

Policies on foreign trade and payments

South Africa's successful transformation to a new political dispensation during 1994 paved the way for the normalisation and expansion of the country's *international financial relations*. The first step in this process was taken when a final debt rescheduling arrangement was negotiated with creditors who had been affected by the declaration of a partial debt standstill in 1985. The second step was the re-establishment of South Africa as a borrower in the international capital markets. After having acquired credit ratings by three commissioned international rating agencies, a global bond issue of $750 million was made by the government in December 1994 followed by an issue in the Samurai market of ¥30 billion in May 1995.

A further step in the government's pursuit of full financial liberalisation and integration of the South African economy in the world economy was the abolition of the financial rand system. This decision was taken after a long period of careful planning and preparation of the economy for this event. From 13 March 1995 South Africa therefore has a unitary exchange rate again that applies to both current and capital transactions between residents and non-residents. As described in more detail below, this change had only a marginal effect on the exchange rate of the rand in the subsequent period. In announcing this policy change, the Minister of Finance also indicated that total foreign investment in South Africa would be monitored closely with the specific view to gradually relaxing the exchange controls applicable to residents. The first initiative in achieving this objective was the announcement on 13 July 1995 that insurance companies, pension funds and unit trusts would henceforth be allowed to undertake foreign investments by way of swap arrangements that provide for the exchange, with foreign investors, of part of these institutions' existing asset portfolio against foreign assets. At the same time it was announced that the Reserve Bank would in future only provide forward cover to authorised dealers against documentary evidence of foreign financing transactions.

Coinciding with these measures to normalise international financial relations, the *Final Act of the Uruguay Round of Multilateral Trade Negotiations* (the Marrakesh Agreement) was signed on 15 April 1994. The key elements of this Agreement are:
- the liberalisation of international trade by lowering import tariffs and eliminating non-tariff measures;
- the strengthening of international trade rules, i.e. new agreements on subsidies and anti-dumping measures; and
- new agreements on topics not previously covered by the General Agreement on Tariffs and Trade, such as trade in services, trade related aspects of intellectual property rights and trade related investment measures.

In accordance with this agreement, a *new tariff policy* came into force in South Africa on 1 January 1995, providing for a gradual reduction of *ad valorem* duties by an average of one-third over five years, or somewhat longer periods for agricultural products and certain highly protected industrial sectors. The new system is characterised further by:
- a simplified, more uniform set of protective rates;
- the replacement of all remaining quantitative import restrictions and formula duties with *ad valorem* duties;
- an increase from 55 to 98 per cent in the tariff lines that are bound in terms of the General Agreement on Tariffs and Trade;
- a standardisation of tariff rates in six categories as opposed to the more than 80 *ad valorem* rates that existed under the previous system; and
- an initial reduction in the number of tariff lines (approximately ten thousand at present) of about 15 per cent and eventually of at least another 30 per cent.

A *revised General Export Incentive Scheme* was implemented with effect from 1 April 1995, as part of the phasing-out of this scheme by 31 December 1997 because of South Africa's commitments to the World Trade Organisation. The main changes made to the scheme are:
- receipts of organisations under the General Export Incentive Scheme are taxable;
- beneficiated primary products no longer qualify for benefits;
- the maximum net benefits of the remaining two categories (material-intensive products and manufactured products) were reduced significantly;
- no incentive will be payable if exchange rate changes move to the advantage of exporters so that their net benefits calculated under the scheme move to below 2 per cent of the adjusted export sales value;
- the cut-off point for qualifying for the full incentive was reduced from 75 to 60 per cent of the local-content value; and
- certain products previously regarded as material intensive products were reclassified as beneficiated primary products.

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

	1994				1995	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Merchandise exports	60,6	64,0	67,9	73,0	81,8	79,4
Net gold exports	22,6	23,2	24,8	20,1	20,0	19,3
Merchandise imports	-65,6	-71,3	-82,3	-85,1	-94,4	-97,7
Net service and transfer payments	-16,1	-13,3	-15,8	-15,0	-15,2	-13,5
Balance on current account	**1,5**	**2,6**	**-5,4**	**-7,0**	**-7,8**	**-12,5**

Considerable progress was also made in the period under review in the field of *foreign trade relations*. Trade transactions were concluded with a number of countries that previously applied sanctions or embargoes against the country. In August 1994 South Africa became the eleventh member of the Southern African Development Community. In addition, South Africa was granted the benefits offered by the Generalised System of Preferences of the European Union and a number of other countries such as the United States, Canada, Japan and Norway.

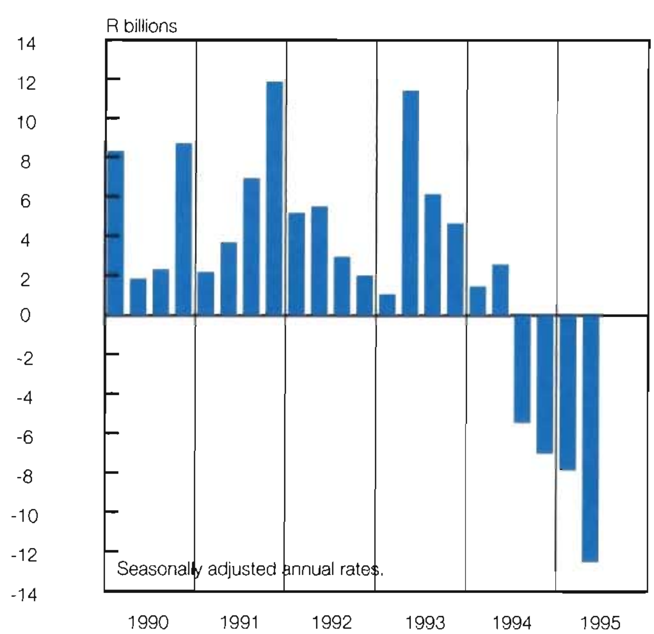
The normalisation of international financial and trade relations was the main thrust behind dramatic changes in the structure of the country's transactions with the rest of the world. For a period of nine and a half years the balance of payments was characterised by substantial net outflows of capital not related to reserves; in total, capital to the amount of R51,7 billion left the country from 1985 up to the second quarter of 1994. Economic growth was consequently constrained because surpluses had to be maintained on the current account of the balance of payments to compensate for these outflows. In 1994 international capital movements turned in South Africa's favour, allowing the current account to move into a deficit and leading to an improvement in the overall balance of payments position. The healthier overall balance of payments position, in turn, enabled the authorities to nurture the upturn in economic activity somewhat.

Another consequence of the normalisation of South Africa's international financial relations and the liberalisation of capital transactions has been increased volatility in financial flows. Becoming part of the international financial community again has made South Africa vulnerable to large capital flows between developed countries and emerging markets, which can turn around in a relatively short period of time. This volatility in capital movements has serious implications for macro-economic policies and encumbers the management of the foreign reserves and overall liquidity in the economy.

Balance on current account

As could be expected of a relatively open economy at this stage of the business cycle, the balance of payments on current account deteriorated considerably. The seasonally adjusted and annualised balance on the current account switched from a surplus of R2,0 billion in the first half of 1994 to a deficit of R6,2 billion in the second half; for calendar 1994 a deficit of R2,1 billion was recorded. In the first half of 1995 the current account deficit widened substantially to a seasonally adjusted and annualised value of R10,2 billion. As a ratio of gross domestic product, the

Balance on current account

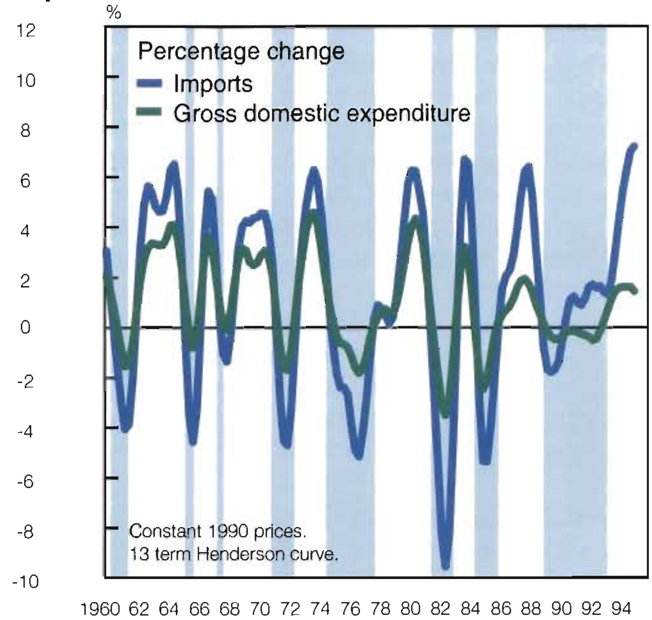


current account deficit was equal to 2,2 per cent in the first half of 1995.

The weakening of the balance on the current account was registered notwithstanding a rise in the prices of exported goods that was persistently, although only marginally, faster than the rise in the prices of imported goods, signifying an improvement in the terms of trade. The appearance of a deficit on the current account of the balance of payments over the past twelve months could predominantly be attributed to:

- a strong rise in gross domestic expenditure, especially outlays on fixed investment and inventory accumulation, which gave rise to substantially higher levels of merchandise imports;
- a sharp slowdown in the value of net gold exports, attributable to a decrease in gold production;
- an increase in the value of merchandise exports, which could offset only partly the developments in imports and net gold exports; and
- net service and transfer payments to the rest of the world which remained on a relatively high level.

Merchandise imports and gross domestic expenditure



Dark area: Downward phase of the business cycle.

Merchandise imports

A strong cyclical expansion in merchandise imports was largely responsible for the large deficits on the current account of the balance of payments. The *value of merchandise imports* rose by no less than 27 per cent in 1994, followed by a further 15 per cent in the first half of 1995 compared with the last half of 1994. This significant rise in the value of merchandise imports was primarily caused by increases in *import volumes.* The physical quantity of imports rose by no less than 45 per cent from the start of the economic upswing in the second quarter of 1993 to the second quarter of 1995.

As illustrated in the accompanying graph, this steep upward movement in the volume of imports was closely related to the country's relatively high *marginal propensity to import*. An increase in domestic expenditure, particularly when due to a rise in real fixed investment and the building-up of inventories, usually brings about a much more rapid increase in the volume of merchandise imports. During the current economic upswing, the volume of imported goods rose by 3,4 percentage points for every one percentage point increase in real gross domestic expenditure. Although this ratio is higher than the average ratio of 2,5 experienced during economic upswings in the 1970s, it is still lower than the average ratio of 3,7 during the upward phases of the 1980s.

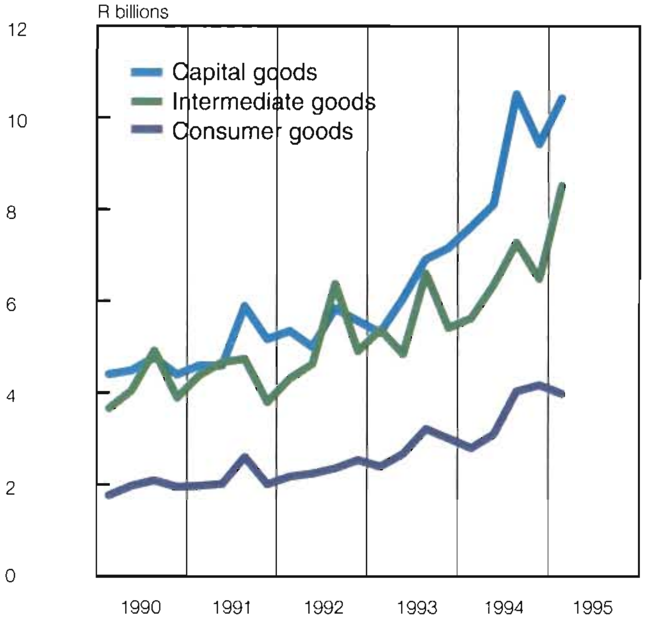
As explained in some detail in previous *Annual Economic Reports*, the physical quantity of merchandise imports in the current business cycle started to increase well before the economic upturn and the *import penetration ratio* (i.e. the ratio of imported goods at constant prices to total real gross domestic expenditure) remained on a relatively high level and even increased during the recent recession. This atypical behaviour of merchandise imports in the recession of 1989-93 partly reflected the substitution of imported goods for domestically produced goods in response to a decline in the relative prices of imported goods to domestically produced goods. This increase was also due to several isolated and random developments, such as higher agricultural imports because of the drought in 1992 and the replacement of obsolete, and the purchase of new, aircraft by the South African Airways.

The further rise in the import penetration ratio from 19 per cent in the second quarter of 1993 to as much as 24½ per cent in the second quarter of 1995 did not coincide with a further decline in the prices of imported goods relative to domestically produced goods. This indicator of the price competitiveness of domestically produced goods levelled off from the beginning of 1993 but was, of course, on a much lower level than at its upper turning-point in the middle of the 1980s. The more recent large increases in the import penetration ratio therefore seem to have been related primarily to the upturn in economic activity and a concomitant rise in real domestic expenditure. However, pre-emptive buying of imported goods in anticipation of a possible depreciation of the exchange rate of the rand in the first half of 1994 (a period characterised by political uncertainty in view of constitutional changes) and in the first half of 1995 (a period in which the dual exchange rate system was terminated), could also have contributed to the higher import volumes.

The correlation between the acceleration in economic activity and the rise in the volume of imports is substantiated by a classification of *imported goods according to stage of consumption.* This classification shows that a substantial increase in the imports of capital goods was mainly responsible for the more rapid rise in the growth of imports. As expenditure on large capital projects and other investment programmes gained momentum, the imports of capital goods increased sharply. More moderate, but nevertheless significant, increases were also registered in the imports of intermediate and consumer goods in 1994 and the first half of 1995.

The increase in the value of merchandise imports was also partly due to a rise in *import prices*. The average level of import prices rose by 8 per cent in 1994 and in the first half of 1995 it was 9½ per cent higher than in the corresponding period of the preceding year. This relatively sharp increase in import prices was mainly caused by the depreciation of the rand and, in the first half of 1995, also by rising international oil prices. Over this period the prices of imported goods continued to be affected favourably by the relatively low inflation rates in South Africa's main trading partner countries.

Imports according to stage of consumption

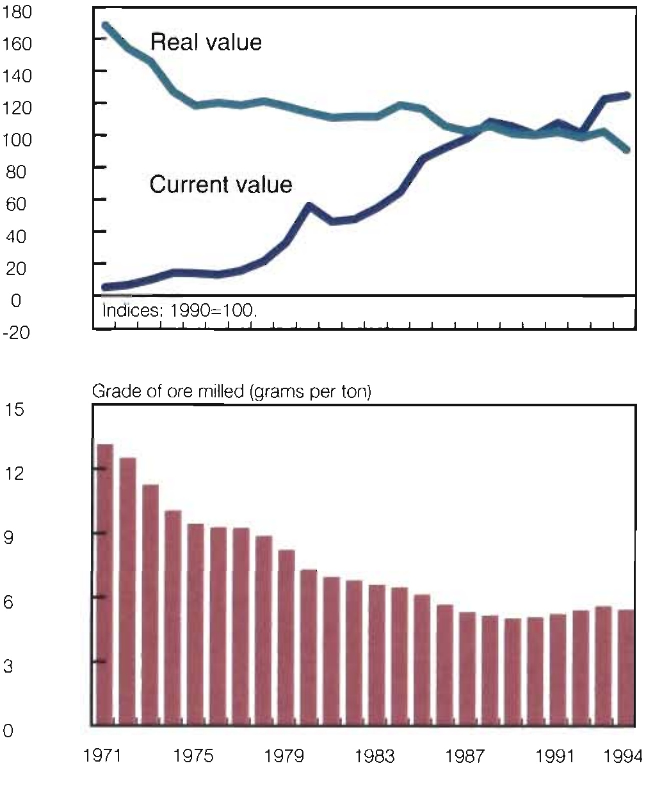


Net gold exports

In addition to the increase in imports, a decrease of 26½ per cent in the *volume of net gold exports* from the lower turning-point of the business cycle in the second quarter of 1993 up to the second quarter of 1995 played an important part in transforming the current account surplus into a relatively large deficit. The volume of net gold exports has showed a secular contraction since the early 1970s. An average annual rate of decrease of 4½ per cent was recorded in the 1970s, which slowed down to 1½ per cent in the 1980s before accelerating again to 3 per cent in the first half of the 1990s. This substantial contraction in the volume of net gold exports was primarily due to a corresponding reduction in the quality of ore milled; the average grade of ore milled declined from 10,5 grams per ton in the 1970s to 6,1 grams per ton in the 1980s and to 5,3 grams per ton in the period from 1990 to 1994.

The sharp drop in the volume of net gold exports in 1994 and the first half of 1995, however, could not only be attributed to a lowering in the quality of ore milled to preserve the life of the gold mines. A much more important cause of this decline was a sharp contraction

Net gold exports



in the throughput of ore because of the closure of some mines; poor labour productivity, reflecting labour disputes and an additional number of special and new holidays; technical difficulties owing to seismic incidents; and a serious mining accident in the first half of 1995.

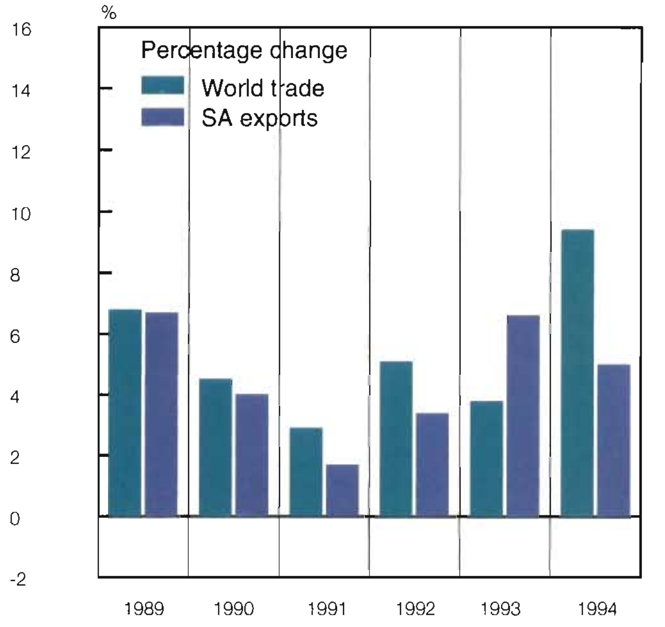
Fortunately, the average *price of gold* per fine ounce rose from US$360 (R1 177) in 1993 to $384 (R1 363) in 1994, with the result that the *value of net gold exports* advanced by 2 per cent to R22,7 billion. Despite a further small increase in the average rand price of gold to R1 382 per fine ounce (in dollar terms the price of gold remained unchanged), net gold exports contracted to a seasonally adjusted and annualised value of R19,7 billion in the first half of 1995.

Merchandise exports

After having increased by 15½ per cent in 1993, the *value of merchandise exports* rose by 17½ per cent in 1994 and by 29½ per cent in the first half of 1995 compared with the corresponding period in the preceding year. This higher growth could be ascribed partly to an increase in *export prices.* The average level of export prices rose by 12 per cent in 1994 and by 9,3 per cent from the first half of 1994 to the first half of 1995. This increase was to a large extent due to the depreciation in the external value of the rand and did not correspond to the substantial rise in international commodity prices. In fact, if South African export prices are expressed in dollar terms and compared with *The Economist's* "all items commodity price index", the rate of increase in South African export prices more or less averaged only one-quarter of the rate of increase in international commodity prices over the eighteen months ended June 1995. The increased international demand for commodities in the current economic upswing was directed towards commodities that are not important exports of South Africa, such as rubber, coffee, soya beans, copper and cotton. The lower rate of increase in South African export prices was also related to the fact that some of the country's goods are exported at fixed-contract prices which react with a lag to international price changes.

It is therefore also not surprising that the rate of increase in the *physical quantity* of South African merchandise exports increased at a much slower rate than the volume of international trade since the beginning of 1994. The volume of merchandise exports nevertheless expanded by 5 per cent in calendar 1994, and by 18½ per cent in the first half of 1995 compared with the corresponding period in the preceding year. The ratio of real merchandise exports to real gross domestic product also rose from a trough of 17 per cent in the third quarter of 1993 to 19½ per cent in the second quarter of 1995.

Volume of trade



An analysis of exports by *main economic sectors* demonstrates that the rise in merchandise exports since the beginning of 1994 occurred in all the main sectors. The exports of both mining and agriculture, which had levelled off in the early 1990s due to lower international demand and the effect of a serious drought in 1992, recovered strongly from the middle of 1993. Adverse weather conditions, however, again hampered the expansion in the exports of agricultural products from the middle of 1994.

The main contribution to the steady growth in exports was made by manufactured products. Having fluctuated around a sideways trend on account of strikes and the additional number of special holidays in the first half of 1994, the exports of manufactured products subsequently resumed its upward movement. More specifically, significant increases were recorded in the exports of chemical products, machinery, transport equipment and paper products. As a proportion of total merchandise exports, manufacturing exports rose from 23½ per cent in 1993 to 25½ per cent in 1994 and 32 per cent in the first six months of 1995.

The sharp growth in the volume of manufactured goods exported was achieved despite the fact that South Africa's nominal labour costs per unit of manufacturing production continued to increase relative to those in its main trading partner countries. During economic upswings, many exporters of manufactured goods normally shift to the more lucrative and protected domestic market. The current sound performance of the exports of manufactured goods benefited from:

- a sharp depreciation in the external value of the rand in real as well as nominal terms;
- rising levels of real economic activity in the main industrial countries and the growth of world trade;
- the opening-up of new markets with vigorous economic growth;
- the assistance received by exporters under the general export incentive scheme;
- the conclusion of various new multilateral and bilateral trade agreements; and
- the coming into production of certain manufacturing enterprises that were developed specifically for the export market.

Net service and transfer payments to non-residents

The deficit on the *service and transfer account* of the balance of payments, which had grown uninterruptedly at a relatively high average annual rate of 10½ per cent from 1991 to 1993, advanced sharply by 15½ per cent to R15,1 billion in 1994; in the first half of 1995, however, this deficit declined to a seasonally adjusted and annualised level of R14,4 billion.

The higher level of net service and transfer payments in the eighteen months ended June 1995 was the net result of a rise in *service payments*, which was offset only partly by an increase in service and transfer receipts. With the exception of tourist expenditure, which had declined from an abnormally high level in 1993, all the other main components of service payments increased in 1994 and the first half of 1995. Substantial increases were recorded particularly in the payments for freight and merchandise insurance on account of the higher value of imports. Interest payments on foreign loans also rose sharply because of the increase in South Africa's foreign debt and generally higher interest rates in most industrialised countries.

Service receipts from foreigners continued to advance, mainly as a result of significantly higher spending by foreign tourists travelling in South Africa. Various factors led to a dramatic increase in the number of foreign visitors to South Africa, such as the active marketing of the tourist potential of South Africa, the political transition of the country and the recent hosting of the Rugby World Cup Tournament. Despite this improvement, the tourist account in the balance of payments still showed a net deficit.

Capital account

As mentioned before, the *capital account* of South Africa's balance of payments improved substantially during the course of 1994 and in the first half of 1995. Having recorded large outflows from 1985 up to the middle of 1994, the capital account switched from a record net outflow of capital of R15,0 billion in 1993 to a net inflow of R5,2 billion in 1994. In the first half of 1995 a further net inflow of capital totalling R9,8 billion was registered.

Various factors contributed to the large net inflow of capital over the twelve months ended June 1995, including:

- the normalisation of international financial relations, the regaining of access to international capital markets and certain tax and other changes to create a more investor-friendly environment;
- the ready availability of foreign trade financing at relatively favourable costs which, together with the sharp rise in the value of imports, encouraged private-sector entities to increase trade-related short-term liabilities;

Table 6. Net capital movements not related to reserves
R billions

	1994				1995	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Long-term capital						
Public authorities	-1,1	-0,1	0,5	3,7	-0,2	1,1
Public corporations	-1,4	-0,2	0,3	0,7	-0,2	0,2
Private sector	0,8	-1,3	-0,4	-0,1	1,0	2,4
Total long-term capital	-1,7	-1,6	0,4	4,3	0,6	3,7
Short-term capital	0,6	-0,9	5,1	-1,0	4,8	0,7
Total capital not related to reserves	**-1,1**	**-2,5**	**5,5**	**3,3**	**5,4**	**4,4**

- the willingness of the banking sector to borrow short-term funds abroad to fund their domestic activities in view of the fairly restrictive domestic liquidity conditions;
- a marked improvement in non-resident investor confidence, boosted by the inclusion of the Johannesburg Stock Exchange in the International Finance Corporation's Emerging Market Index; and
- the relatively large number of foreign companies which returned to or made new investments in South Africa. The investment in direct equity capital by non-residents, however, remained relatively low.

The net inflow of capital in 1994 and the first half of 1995 mainly took the form of *short-term capital.* A net outflow of short-term capital not related to reserves of R14,7 billion in 1993 changed to a net inflow of R3,8 billion in 1994 and to R5,5 billion in the first six months of 1995. This inward movement of short-term capital consisted mainly of trade finance and one-year revolving credit facilities. The interest costs of these loans was at first set at approximately 75 points above the London Interbank Offer Rate in 1994; this margin subsequently declined to between 50 and 60 points in the first half of 1995.

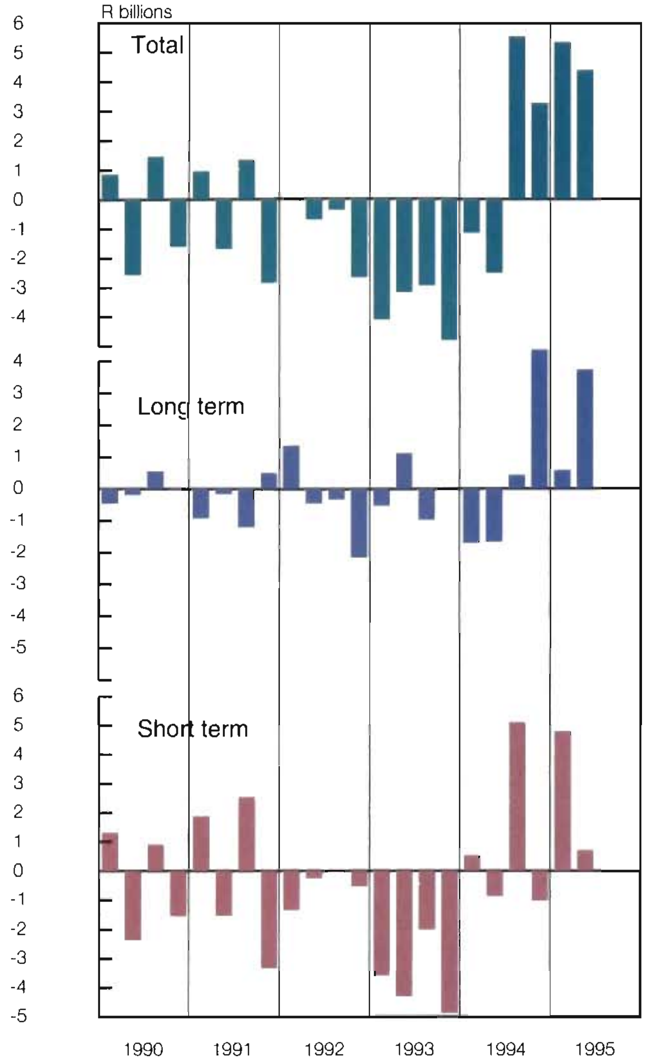
The funding of banks' own activities also led to a net inflow of R4,1 billion in the first six months of 1995. Apart from these short-term inflows, the government sold three-month Treasury bills to non-residents to the value of R1,7 billion in the fourth quarter of 1994 and R160 million in the first quarter of 1995; the full outstanding amount arising from these transactions was, however, repaid in the second quarter of 1995.

Owing mainly to the changed financial relations and the relatively favourable credit ratings that South Africa received from Moodys (Baa3), Standard and Poor (BB) and Nippon Investors Services (BBB), the country experienced an inflow of *long-term capital* from the second half of 1994: the long-term capital movements changed from a net outflow of capital of R3,3 billion in the first half of 1994 to a net inflow of R4,7 billion in the second half and R4,3 billion in the first half of 1995. Bearing in mind the fixed capital repayment obligations of R8,7 billion which fell due in the twelve months ended June 1995, this was a remarkable turnabout.

In December 1994 the government successfully launched a global bond issue in the international capital market to the amount of R2,7 billion; this issue was followed by the first-ever Samurai bond issue of R1,3 billion in May 1995. In addition to this capital acquired by government, private-sector companies made several private placements from October 1994. Starting from the fourth quarter of 1994, the private sector raised capital on foreign markets to the amount of R630 million, followed by R828 million in the first quarter of 1995 and R734 million in the second quarter of 1995.

Non-residents were also net purchasers of securities in South Africa to the value of R2,2 billion in 1994 and R0,6 billion in the first quarter of 1995. These purchases were still made through the financial-rand mechanism and accordingly did not affect the foreign reserves of the country. After the abolition of the dual exchange rate system in March 1995, these net purchases of securities by non-residents on the Johannesburg Stock Exchange picked up sharply to a total of no less than R2,3 billion in the second quarter of 1995, with a concomitant increase in foreign exchange holdings.

Net capital movements not related to reserves



Foreign debt

As a result of the net inflow of loan capital during 1994, South Africa's *total outstanding foreign debt* increased from US$25,5 billion at the end of 1993 to $27,9 billion

Table 7. Foreign debt of South Africa
$ billions

	1990	1991	1992	1993	1994
Renegotiated debt[1]					
Public sector	2,0	1,9	1,8	1,3	0,8
Monetary sector[2]	3,1	2,5	2,1	1,6	1,0
Other	1,5	1,6	1,6	1,5	1,6
Total	6,6	6,0	5,5	4,4	3,4
Other foreign-currency-denominated debt					
Public sector	4,8	4,9	4,7	4,7	5,3
Converted long-term loans	4,8	4,8	4,8	4,5	3,9
Other	3,2	2,4	2,3	3,1	6,1
Total	12,8	12,1	11,8	12,3	15,3
Rand-denominated debt					
Bonds	5,0	4,7	6,0	6,1	6,7
Other[3]	1,8	2,8	3,9	2,7	2,5
Total	6,8	7,5	9,9	8,8	9,2
Total foreign debt	**26,2**	**25,6**	**27,2**	**25,5**	**27,9**

1. Debt renegotiated in terms of the 1994 Debt Arrangements with foreign creditors.
2. Including onlending to other sectors.
3. Including blocked and freely transferable funds, but excluding equity.

at the end of 1994. (These figures have been revised to include the rand-denominated debt of South Africa to non-residents after the termination of the financial-rand mechanism.) Foreign-currency-denominated debt rose from $16,7 billion to $18,7 billion, whereas rand-denominated debt increased from $8,8 billion to $9,2 billion over the same period. As a ratio of gross domestic product, South Africa's total foreign debt was equivalent to the low level of 22,9 per cent at the end of 1994.

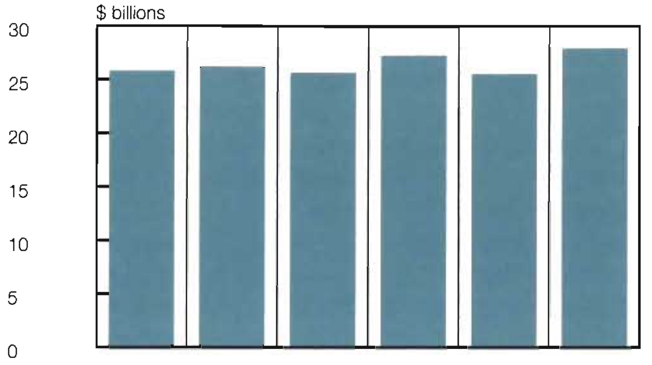
South Africa's *renegotiated debt* (i.e. debt subject to the standstill arrangements with foreign creditors) decreased further from $4,4 billion at the end of 1993 to $3,4 billion at the end of 1994. Valued at the exchange rates prevailing on 31 August 1985, this debt was reduced by $10,5 billion from the end of August 1985 to the end of December 1994. Apart from actual repayments made in terms of the various debt arrangements concluded with South Africa's foreign creditor banks, the reduction in renegotiated debt was also due to conversions into longer-term loans outside the net and to debt for equity swaps.

The option to convert renegotiated debt into longer-term loans expired at the end of 1994. Conversions into longer-term loans in terms of the debt arrangements with foreign creditors banks amounted to $3,9 billion at the end of 1994. In addition, the option to convert renegotiated debt into equity was suspended on 13 March 1995 because of the abolition of the dual exchange rate system. On that date the cumulative applications to make use of this facility had come to $2,2 billion. Such conversions will remain suspended until an acceptable alternative arrangement is formulated.

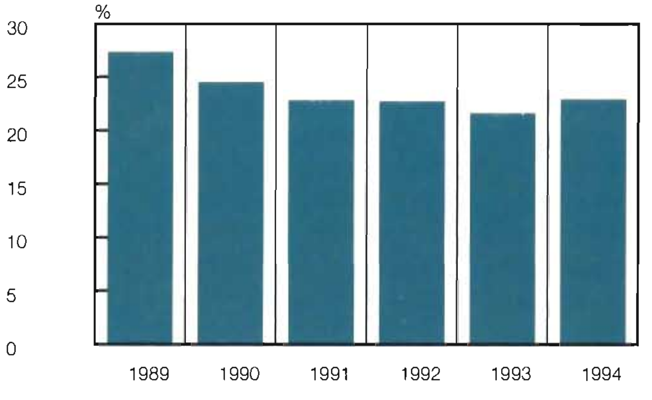
As opposed to the decline in the country's renegotiated debt, *other foreign-currency-denominated loans* rose from $12,3 billion at the end of 1993 to $15,3 billion at the end of 1994. This significant increase resulted mainly from government stock issues and private placements on the international capital markets, as well as short-term borrowings by the banking and private sector. Owing to the fact that the larger part of this borrowing consisted of short-term funds, the share of debt repayable within the next twelve months increased from 35 per cent of other foreign-currency-denominated debt at the end of 1993 to 45 per cent at the end of 1994.

The increase of $0,4 billion in the *rand-denominated debt* in 1994 mainly reflected the increase in net purchases of South African bonds by non-residents, either directly on the Johannesburg Stock Exchange or indirectly in over-the-counter transactions.

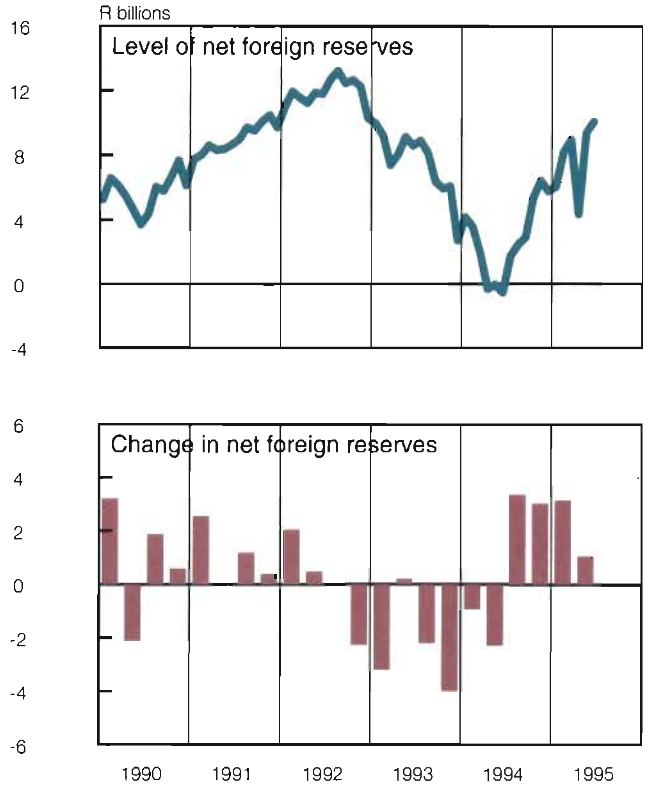
Total foreign debt



Total foreign debt as percentage of gross domestic product



Overall balance of payments position



Foreign reserves

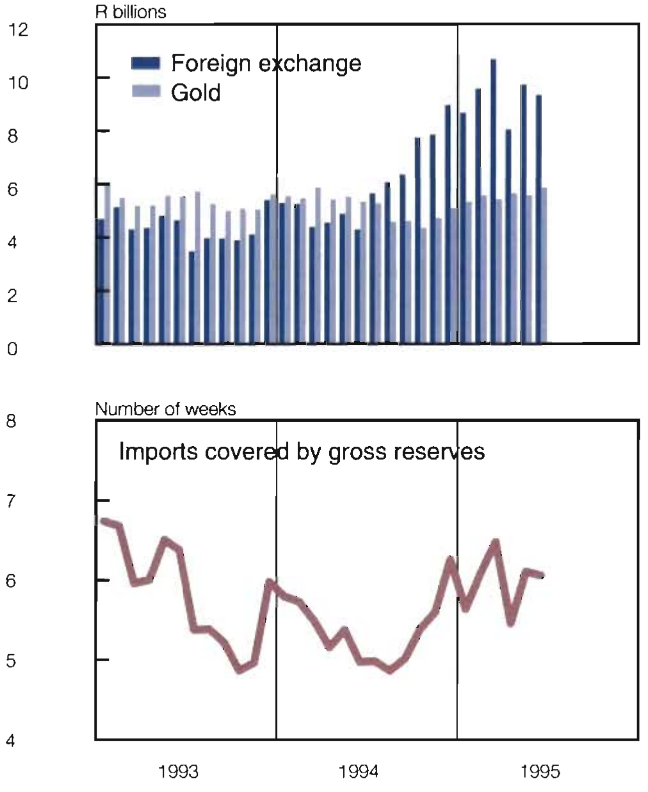
As a result of the turnaround in the capital account of the balance of payments, South Africa's overall balance of payments position started to improve from the middle of 1994. After having dropped by R3,2 billion in the first half of 1994, South Africa's *net gold and other foreign reserves* rose by R6,4 billion in the second half of 1994 and by R4,2 billion in the first half of 1995. In the twelve months ended June 1995 the total net gold and other foreign reserves had thus advanced by R10,6 billion.

The significant improvement in the overall balance of payments position allowed the Reserve Bank to reduce its outstanding *foreign loan commitments*. The reserve-related liabilities of the Reserve Bank reached an upper turning-point of R8,5 billion in April 1994; it then contracted to R1,6 billion at the end of June 1995. This change, of course, increased the available but unused credit facilities significantly. Moreover, in preparation of the lifting of exchange controls on non-residents, the Reserve Bank also negotiated substantial additional credit facilities with a somewhat longer maturity, which places the country in a better position at present to withstand volatile capital movements.

Despite the considerable reduction in the country's reserve-related liabilities, South Africa's total *gross gold and other foreign reserves* rose from R9,7 billion at the end of June 1994 to R16,1 billion at the end of March 1995. The subsequent fluctuations in the capital flows caused the gross foreign reserves to drop by R2,4 billion in April 1995, before increasing again by R1,5 billion in the ensuing two months. At the end of June 1995 the gross gold and other foreign reserves amounted to R15,2 billion, which was equivalent to the value of six weeks' imports of goods and services.

With the improvement in the overall balance of payments position, the authorities followed a policy of building up their foreign exchange holdings rather than the *gold reserves* of the country. The gold reserves accordingly shrank from 4,76 million fine ounces at the end of December 1993 to 4,63 million fine ounces at the end of June 1995. As a proportion of the total foreign reserves, the gold component dropped from 51 to about 39 per cent over this period. Owing to the fact that more than 80 per cent of the country's foreign trade is conducted in US dollars, the higher level of

Total gross gold and other foreign reserves



foreign exchange holdings was primarily held in assets denominated in dollars.

Exchange rates

As in the past, international events dictated to a certain extent the performance of the local currency. This was reflected in a significant depreciation of the external value of the rand in terms of the Japanese yen and most of the European currencies. In contrast to these developments, the rand remained relatively stable *vis-à-vis* the internationally weak dollar. The dollar value of the rand nonetheless declined, on balance, by about 6 per cent during the nineteen months to the end of July 1995.

Developments in the domestic foreign exchange market, however, also contributed materially to changes in the exchange rate of the rand. The relatively weak overall balance of payments position in the first half of 1994, and the consequent large demand for dollars, caused the rand, on a *weighted-average basis*, to decline sharply by approximately 12 per cent from the end of December 1993 to 13 July 1994. When the switch from a net outward to a net inward flow of capital began to increase the supply of foreign exchange in the second half of 1994, the nominal effective exchange rate of the rand rose by 4 per cent in the ensuing period until the end of 1994. Large-scale speculation about the abolition of the dual exchange rate of the rand then resulted in a decline of nearly 6 per cent in the weighted average exchange rate of the rand until 10 March 1995, (i.e. the day on which the termination of the financial rand was announced). Fluctuating capital movements in the subsequent months led to some instability in exchange rates. However, the nominal effective exchange rate of the rand increased, on balance, by only 0,2 per cent from 10 March 1995 to 31 July 1995. This brought the total decline in the nominal effective exchange rate of the rand to about 13½ per cent over the nineteen month period until the end of July 1995.

The average *real effective exchange rate* of the rand (i.e. the nominal exchange rate adjusted for the difference between changes in the production price indices of South Africa and its main trading partner countries) in 1994 was 3 per cent lower than in 1993. Owing to a sharp decline in the nominal effective exchange rate of the rand, the real effective exchange rate decreased further in the first five months of 1995; in May the level of the real exchange rate of the rand

Table 8. Changes in the exchange rates of the rand
Per cent

	31 Dec '93 to 13 Jul '94	13 Jul '94 to 31 Dec '94	31 Dec '93 to 31 Dec '94	31 Dec '94 to 10 Mar '95	10 Mar '95 to 31 Jul '95	31 Dec '93 to 31 Jul '95
Weighted average	-12,1	4,0	-8,5	-5,8	0,2	-13,6
US dollar	-7,0	3,1	-4,1	-2,4	0,2	-6,2
British pound	-12,3	3,6	-9,2	-5,3	0,6	-13,4
German mark	-17,8	4,3	-14,3	-11,7	-1,3	-25,3
Japanese yen	-18,9	5,5	-14,5	-10,7	-3,1	-26,0
Netherlands guilder	-17,6	4,2	-14,2	-11,6	-1,4	-25,2
Italian lira	-17,5	10,5	-8,8	-0,1	-4,4	-12,9

was 3,1 per cent below its level at the end of 1994. From its peak value in July 1992 up to May 1995 the real effective exchange rate of the rand has therefore declined by nearly 10 per cent.

As has so often been the case in the past, the now abolished *financial rand* had to bear the brunt of the volatility in the foreign exchange market in 1994 and the first few months of 1995. In the months prior to the country's major constitutional change, concerns about the election process and fears of an exacerbation of violence played havoc with the financial markets. As a consequence, the financial rand traded at a low of R5,58 per dollar on 11 April 1994, while the financial-rand discount widened to 35,7 per cent on the same day. This was the turning-point for the financial rand. Non-residents' perceptions changed markedly with the peaceful political transition. Although in the subsequent months the financial rand fluctuated sharply at times because of rumours of the termination of the dual exchange rate system, the investment unit appreciated by more than 30 per cent from 11 April 1994 to a high of R3,77 per dollar on 10 March 1995. On this last day of trading in the financial rand, the discount against the commercial rand accordingly came to only 3,6 per cent, allowing the dual exchange rate system to be abolished with minimal disturbance of the foreign exchange and other financial markets.

Monetary developments, interest rates and financial markets

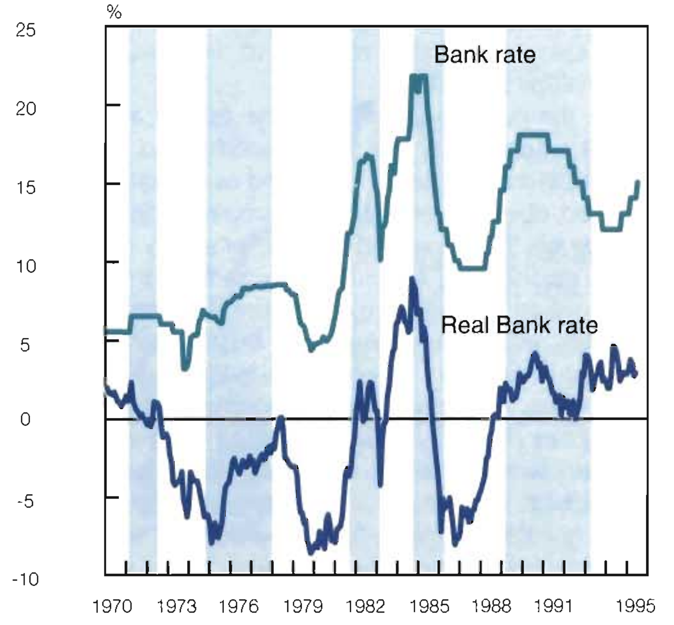
Monetary policy

In accordance with the Interim Constitution, the South African Reserve Bank Act and generally accepted international practice, the Reserve Bank continued in 1994 and the first half of 1995 to operate within a monetary policy framework with price stability as *ultimate objective*. The adoption of the objective to achieve price stability does not mean that the monetary authority believes that the problems of low economic growth, unemployment and wealth creation are unimportant. The need for high and sustained economic growth is fully recognised and supported by the South African Reserve Bank. However, the Bank is convinced that the best contribution it can make towards achieving sustainable economic growth and development is to create a stable financial environment.

In pursuing its mission to protect the value of the rand, the monetary authority also realises that monetary policy forms part of broader economic policy: price stability must be achieved in the most efficient and least disruptive manner possible, taking other economic policy measures into consideration. Mindful of the long and variable lags which characterise the transmission of monetary policy measures to production and expenditure decisions, a gradualist approach is followed in the monetary policy stance in order not to disrupt real economic activities unduly. This medium-term orientation is also one of the reasons why the Reserve Bank does not necessarily react to an overshooting or undershooting of the money supply guideline range in the short term.

Although the Reserve Bank has adopted effective control over the growth in money supply as an *intermediate objective* and sets an acceptable range of increase in the broadly defined money supply (M3) early in each calendar year, these guidelines are not applied in a rigid fashion that precludes any discretion on the part of the monetary authority. In formulating monetary policy, due consideration is given to developments in other macro-economic aggregates, such as changes in interest rates, domestic credit growth, the level of and movements in the foreign reserves, exchange rate changes and the efficiency and stability of financial institutions and markets. The predetermined money supply guidelines nevertheless provides the Reserve Bank's view of the most appropriate rate of monetary expansion in M3 in the guideline year. Deviations of money supply growth from the guideline range are accordingly seen as the most important, but not the only, indicator for a reassessment of the monetary policy stance.

Bank rate and real Bank rate



Dark area: Downward phase of the business cycle.

The key *operational variable* of monetary policy is the general level of short-term interest rates as anchored to Bank rate, i.e. the lowest rate at which funds are advanced by the Reserve Bank to banks experiencing a cash shortfall. Because changes in interest rates impact on expectations, economic activity and investors' preferences, Bank rate changes are an important measure to influence the bank credit extended and the money supply. The Reserve Bank does not set a predetermined target for the general level of interest rates, but believes that interest rates should, as a minimum, be positive in real terms – nominal interest rates should stay above the level of the expected inflation rate for the Bank to achieve its mission.

As already indicated above, considerable success was achieved in the first four months of 1994 in bringing about greater price stability, and the rate of inflation came down to levels last registered about twenty years ago. A fairly lenient but nonetheless restrictive monetary policy stance was therefore pursued by the Reserve Bank in the first eight months of 1994. Evidence of an acceleration in price increases then began to appear: money supply growth exceeded the guideline range by a substantial margin;

claims by banks on the private sector rose sharply; the depreciation of the rand earlier in the year began to affect domestic prices; the remuneration of labour and gross domestic expenditure began to rise; imports increased substantially; and certain market interest rates moved up markedly. As a result, the Reserve Bank decided to tighten its policy stance and raised Bank rate from a low of 12 to 13 per cent on 26 September 1994. All other related interest rates of the monetary authority were also increased by 1 percentage point.

In the subsequent months the rate of increase in credit extended by the banks accelerated, while the growth in money supply measured over twelve months slowed down somewhat but remained on relatively high levels that exceeded the money supply guidelines. The economic recovery gained considerable momentum, domestic expenditure and imports rose sharply, inflationary pressures built up and market interest rates rose. In light of the underlying economic conditions, the Reserve Bank regarded it as essential to tighten monetary policy further in order to prevent inflation from escalating. The following changes were accordingly announced on 20 February 1995:

- A guideline range for the growth of 6 to 10 per cent from the fourth quarter of 1994 to the fourth quarter of 1995 in M3 money supply, compared with the range of 6 to 9 per cent in 1994. The higher upper limit took account of an expected relatively high growth of 2½ to 3 per cent in real gross domestic product in 1995, whereas the accepted range of 6 to 10 per cent also reflected the Reserve Bank's resolve to reduce inflation.
- An increase in Bank rate from 13 to 14 per cent for accommodation to banks against the collateral of Treasury bills, government stock, Reserve Bank bills and Land Bank bills with an outstanding maturity of less than 92 days. The rate on overnight loans extended against collateral of the same financial assets with outstanding maturities of 92 days and longer but less than 3 years, was also raised from 14 to 15,5 per cent per annum.
- An increase in the basic minimum cash reserve requirement of banks from 1 to 2 per cent of their total liabilities (as adjusted) from 21 March 1995, while the additional interest-bearing reserve requirement of 1 per cent of short-term liabilities was retained. This measure was undertaken for a more effective management of overall liquidity in the economy.
- A quantitative guideline of 10 per cent per annum in respect of the growth of bank credit extension to the private sector in order to give effect to the monetary policy objectives of the authorities. These credit guidelines are not mandatory and merely provide a yardstick to banks of the increase in bank credit that will be reconcilable with the monetary policy objectives.

Despite a continued rapid growth in money supply and in credit extended by banks, high wage demands by labour unions and widely expected increases in the rate of inflation, a further tightening of monetary policy in the ensuing months seemed unwise at first because of other economic developments. The rate of increase in domestic production, consumption and investment slowed down considerably, unemployment continued to rise, net foreign reserves, on balance, rose rapidly, domestic liquidity increased, the rise in domestic interest rates levelled off, the exchange rate of the rand remained relatively stable after the abolition of the dual exchange rate system and activity on the domestic capital markets contracted. The Reserve Bank therefore did not change Bank rate until near the end of June 1995 and allowed real Bank rate (i.e. Bank rate as adjusted for current increases in the consumer price index) to decline from 3,7 per cent in late February 1995 to 2,9 per cent in May.

In time, however, it became apparent that underlying inflationary pressures in the economy were building up – stimulated *inter alia* by wage increases, the depreciation of the exchange rate of the rand, a further acceleration in the rate of increase in bank credit extension and growing expectations of a continuously rising inflation rate. If left unchecked, rising inflation could have a negative effect on real economic growth and frustrate the objectives of the Government's Reconstruction and Development Programme. The Reserve Bank therefore announced a further increase of one percentage point in Bank rate and related lending rates with effect from 30 June 1995.

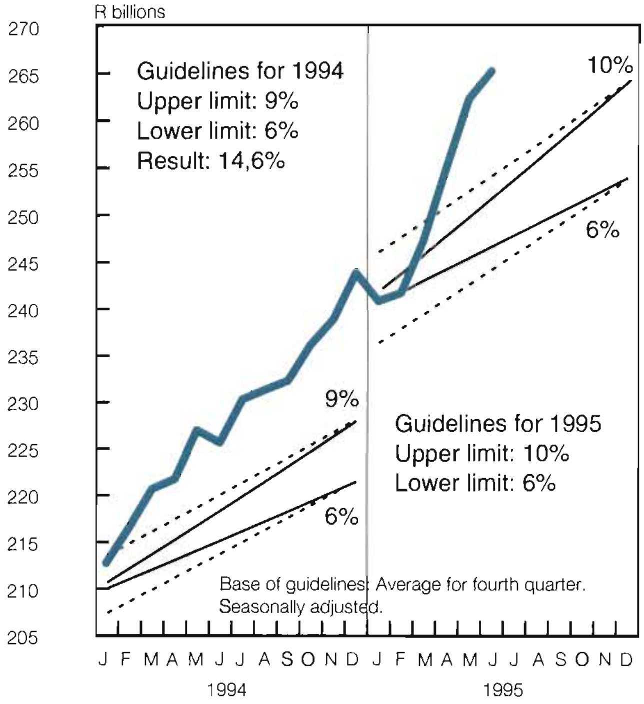
From September 1994 a much more restrictive monetary policy stance has therefore been pursued by the Reserve Bank. In comparison with other upward phases of the business cycle (with the notable exception of the so-called mini-boom from April 1983 to June 1984), the monetary measures applied by the Reserve Bank in the current economic recovery were considerably more restrictive. This is clearly illustrated by the relatively high real Bank rate that was maintained by the monetary authority: the inflation-adjusted Bank rate fluctuated around an average level of about 3 per cent since the start of the economic upswing in May 1993, while it had generally been negative in previous upturns of economic activity.

Although Bank rate has been maintained at generally high levels which may have had a somewhat negative influence on economic growth in the short run, it has become much more stable since the mission to protect the value of the rand was adopted. Whereas the standard deviation of Bank rate (calculated from monthly values) amounted to 4½ percentage points in the 1980s, this measure of dispersion fell to 2¼ percentage points in the 1990s up to June 1995. Extremely high or low values of Bank rate have therefore been avoided. The greater stability in interest rates has probably aided the planning of enterprises and consumers and promoted economic growth.

Financial stability, however, also requires efficient financial institutions and well-functioning financial markets – not only for monetary policy operations, but also to ensure the smooth flow of funds in the economy. The Reserve Bank remained actively involved in 1994 and the first half of 1995 in developing the financial markets in South Africa and in safeguarding deposits. An important milestone in this regard was reached in January 1995 when the required ratio of banks' capital and reserves to risk-weighted assets was lifted from 7 to 8 per cent, i.e. to the capital adequacy guidelines of the 1988 Basle Accord. This was the final step in the phasing-in of capital adequacy requirements, which had started off from 4,5 per cent of risk-weighted assets in 1991. By mid-1995 the actual level of the total capital and reserves of the South African banking sector was some 10 per cent of risk-weighted assets.

Greater competition and international participation in the South African financial system was brought about by allowing foreign banks to open branches in South Africa in May 1995. Considerable attention was also given to the upgrading of the payments system, involving *inter alia* the development of facilities that would allow intraday and real-time settlement of payments for large transactions between participating banks.

Guidelines for growth in M3



Money supply

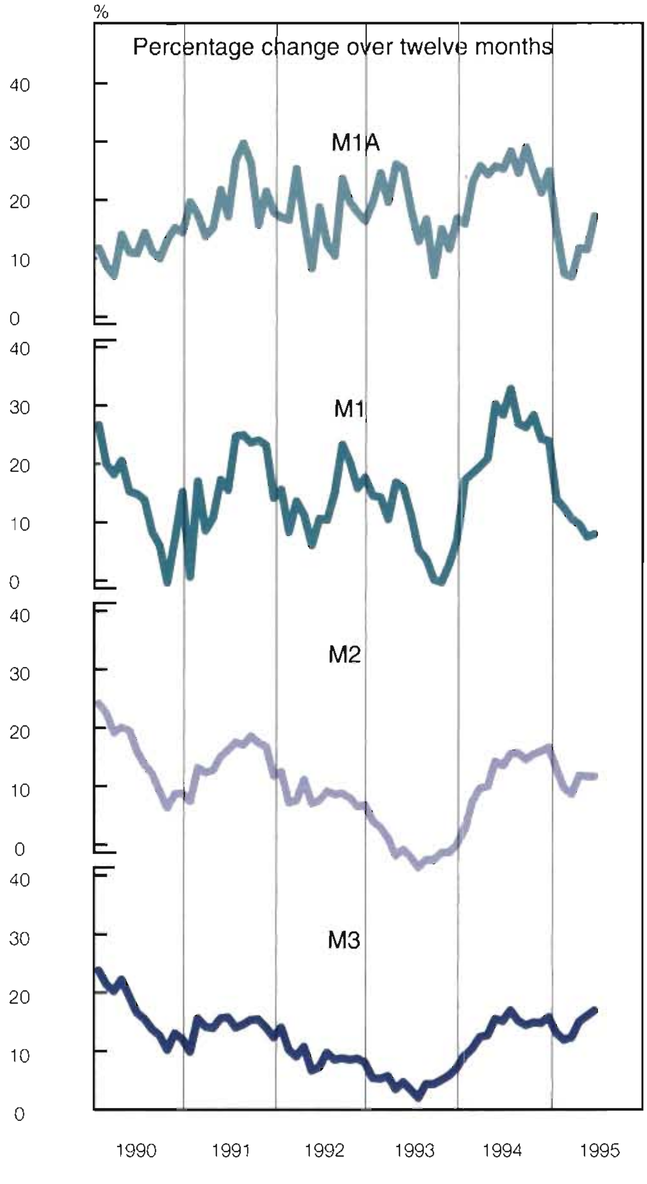
Concurrent with the revival in economic activity, the rate of increase in the *broadly defined money supply (M3)* over twelve months increased from a very low 1,9 per cent in July 1993 to 16,9 per cent in July 1994. This rate of increase then receded to 11,8 per cent in February 1995, before moving sharply upwards to 14,9 per cent in April and 16,8 per cent in June. The monthly values of M3 (seasonally adjusted), which had persistently exceeded the upper limits of the 1994 guideline range, were below the lower limits of the new guideline range for 1995 at first, but from March 1995 they moved above the upper limits. In fact, the seasonally adjusted monthly value of M3 in June 1995 was 5,1 per cent higher than the corresponding value of the upper limit of the guideline range.

The relatively rapid growth in M3 money supply during most of 1994 and the first half of 1995 was to a large extent the result of the accelerated growth in expenditure on consumption, investment and inventory accumulation. The growth in M3 was also in broad correspondence with similar rates of increase in the money supply during the previous upward phases of the business cycle which started in January 1978 and April 1986, respectively. During these economic recoveries, however, the rate of inflation was at a considerably higher level than in the current recovery. In real terms (i.e. adjusted for changes in the consumer price index), the money supply increased much more rapidly in the current upward phase of the business cycle than in the upward phases of 1978-81 and 1986-89. This suggests that factors other than the increase in domestic expenditure also contributed to the acceleration in the growth in M3.

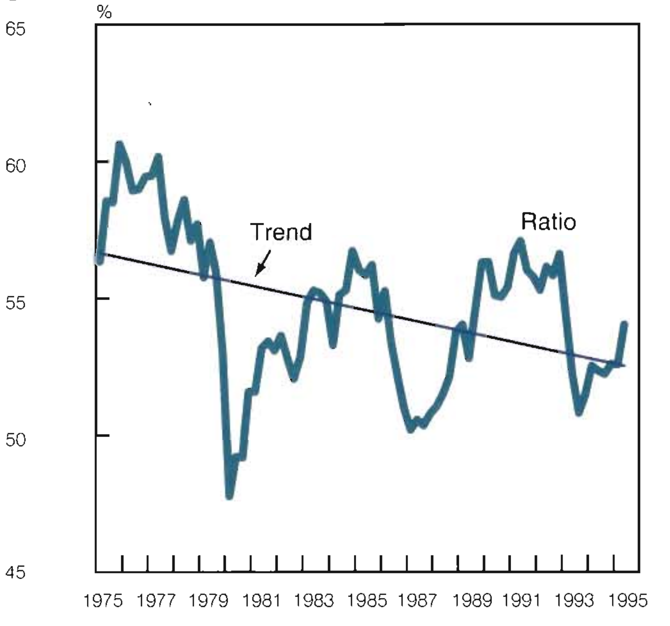
The sharp increase in the demand for money was not only related to the transactions motive for holding money, but probably also reflected the precautionary motive to hold money because of uncertainties related to the political transition. This seems to be substantiated by the slower twelve-month rates of increase after July 1994, when it became apparent that the political problems had been solved peacefully. Other factors which contributed to the comparatively high growth in money supply were a rise in the liquidity preference of the private sector because of uncertainties in respect of interest rate changes and of major price adjustments in the share and bond markets towards the end of 1994 and in the first half of 1995, and reintermediation which took place owing to the decline in the banks' margins between their deposit and lending rates.

Developments in the *narrower monetary aggregates* corresponded fairly closely with that of M3,

Monetary aggregates



Liquidity ratio – M3 as percentage of gross domestic product



but the twelve-month growth rates fluctuated more widely. The higher liquidity preference of the private sector related to political conditions was responsible for much higher rates of increase in these aggregates than in M3 during the first half of 1994. The rates of increase over twelve months in the narrower aggregates also receded in the second half of 1994 and the downward movement quickened significantly in the first quarter of 1995 owing to relatively small increases in these types of deposits combined with their extraordinarily high levels in the first quarter of 1994. Higher rates of growth were generally registered in these aggregates in the three months up to June 1995.

Despite the higher liquidity preference and reintermediation practices, the *income velocity of circulation* of M3 remained fairly stable during 1994 and the first half of 1995. The liquidity ratio (M3 as a percentage of gross domestic product) also remained below its long-term trend line until the first quarter of 1995, clearly illustrating that there was no liquidity overhang in the economy.

In a *statistical or accounting sense*, the increase in M3 in the year ended June 1995 was predominantly due to an increase in the claims of monetary institutions on the private sector. The net foreign assets of monetary institutions also increased over this period, while the net claims on the government sector and net other assets and liabilities contracted.

Credit extension to the private sector

One of the main characteristics of the current upward phase of the business cycle is that the growth in the *credit extension* by monetary institutions to the private sector started to increase relatively early and was considerably higher than in previous upward phases in both nominal and real terms. The twelve-month growth rate in monetary institutions' claims on the private sector increased almost continuously from a lower turning-point of 5,7 per cent in May 1993 to 19,5 per cent in June 1995. From March 1994 these monthly growth rates exceeded the rate of inflation as measured by changes in the consumer price index. In

Table 9. Main counterparts of M3 in the year ended 30 June 1995

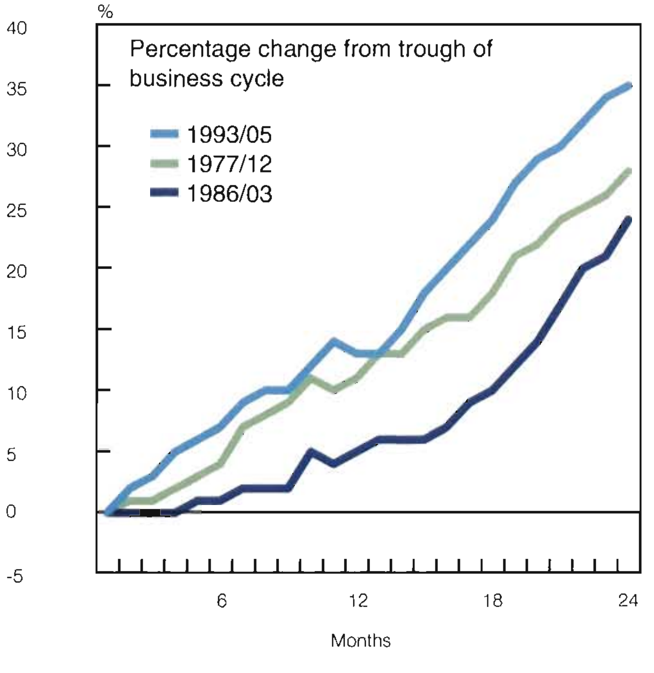
R billions

	1994		1995		Year ended
	3rd qr	4th qr	1st qr	2nd qr	June 1995
Net foreign assets	1,3	4,7	1,6	-3,4	4,2
Net claims on the government sector	-1,4	-5,6	-2,0	2,4	-6,6
Claims on the private sector	14,5	13,6	9,7	9,1	46,9
Net other assets and liabilities	-7,4	-0,7	-2,7	4,2	-6,6
Total change in M3	**7,0**	**12,0**	**6,6**	**12,3**	**37,9**

June 1995 the rate of increase over twelve months in real credit extension to the private sector amounted to 8,6 per cent.

This substantial increase in credit extension to the private sector went hand in hand with the sharp rise in domestic expenditure on consumption and investment. The long downward phase of the business cycle, which had lasted for 51 months, led to a large pent-up demand for durable and semi-durable consumer goods and the need to replace ageing machinery and equipment. Spending consequently rose sharply as consumer and investor confidence strengthened and political fears started to subside. This surge in spending was supported by the use of credit, because increases in income were not large enough to cope with the needs of consumers and investors.

Nominal credit extension to the private sector

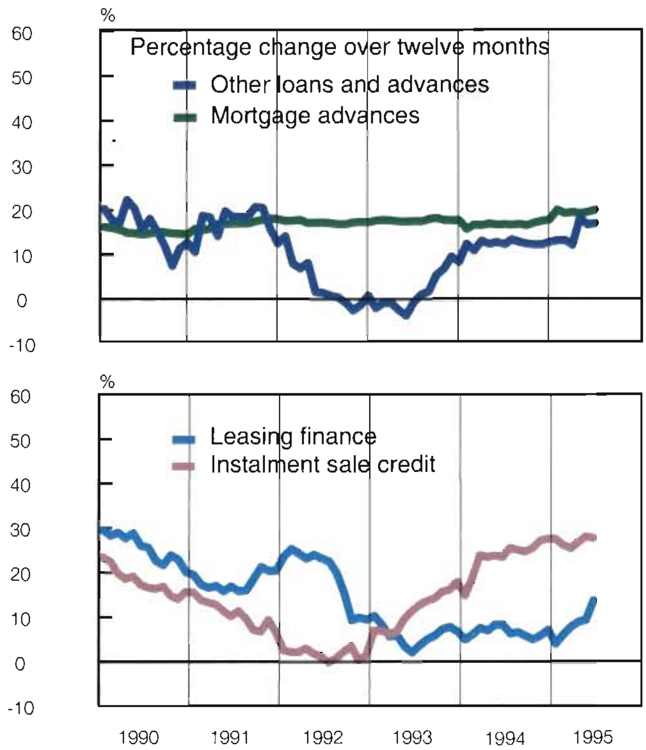


Other factors which contributed to the acceleration of credit extension to the private sector included:

- the active promotion of credit facilities by banks, especially the use of flexible mortgage loans;
- the introduction of in-house credit cards by a large number of retail outlets to encourage consumption expenditure;
- the banks' active involvement in financing some of the large investment projects;
- the need for working capital of small and medium-sized enterprises, in particular, to build up inventories;
- credit facilities being made available to users who were previously unable to draw on such facilities; and
- the continued relatively stable conditions in the credit market with relatively low bad debts incurred by banks.

An analysis of the increase of R46,9 billion in the monetary institutions' claims on the private sector by *type of credit* during the twelve-month period to the end of June 1995 shows that this could mainly be attributed to increases of R20,3 billion in mortgage advances, R13,6 billion in so-called "other loans and advances" (including overdrafts) and R7,1 billion in instalment sales credit. These three types of credit extension were therefore responsible for about 87 per cent of the increase in credit to the private sector during the twelve months ended June 1995. The banks' credit in the form of *investments and bills* also started to increase fairly rapidly from the second half of 1994. Contrary to these developments, only moderate rates of increase were recorded in *leasing finance* of monetary institutions, owing to changes in motor vehicle finance schemes from so-called "company car schemes" (which favoured leasing finance) to "allowance schemes" (which favoured instalment sales finance).

Credit extension to the private sector



This development was mainly responsible for the fact that the rate of increase over twelve months in *instalment sales finance* averaged approximately 25 per cent from the beginning of 1994 to June 1995. Credit extension on instalment sales was also boosted by the substantially higher purchases of new and used motor vehicles and the increase in expenditure on other consumer durables.

Although the actual amount of credit extended in the form of *"other loans and advances"* made a major contribution to the total increase in credit extended to the private sector, the twelve-month rate of increase in this type of credit extension fluctuated around a relatively moderate level of 12,5 per cent in 1994 and the first half of 1995. The flexible mortgage loans supplied by banks encouraged households to shift to this type of credit extension from overdrafts with relatively high costs. "Other loans and advances" to companies and close corporations made the most important contribution to the continued steady growth in this type of credit.

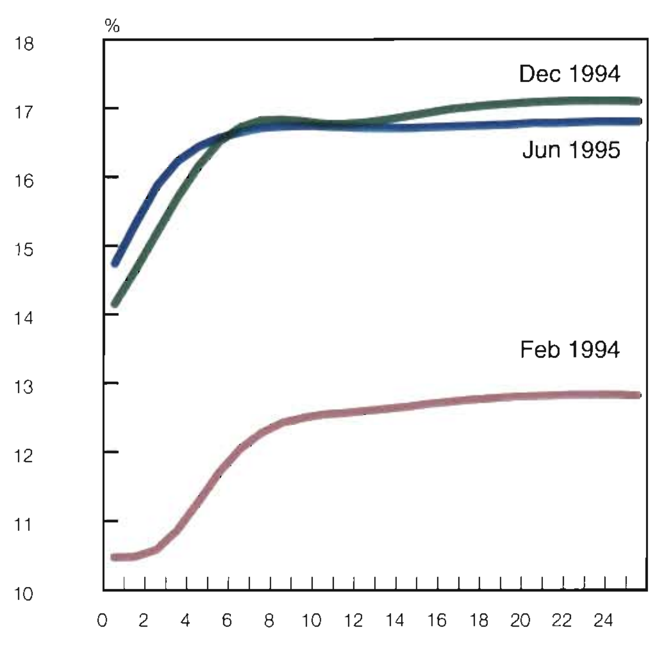
The rate of increase in *mortgage advances,* which had remained on a high level throughout 1994 and had even increased slightly from 17,7 per cent in December 1993 to 17,9 per cent in December 1994, increased further to 19,6 per cent in March 1995 and to 19,5 per cent in June 1995. This remarkable growth in mortgage advances, which has been discernible since the beginning of the 1990s, was to a large extent due to the banks' active promotion of this credit facility on account of risk-return considerations and the low capital requirements applicable to it. In view of the flexibility of some of the mortgage schemes and the comparatively low costs of these advances, mortgage accounts have been used increasingly by many banks' clients to finance purchases of durable and other consumer goods. No less than 81 per cent of total mortgage advances during the twelve months ended June 1995 consisted of advances to individuals.

Interest rates and yields

Changes in market interest rates and yields in the current economic recovery closely resembled their historical cyclical pattern, but the level of real interest rates and yields was considerably higher than in previous upturns of economic activity. At first rates across the maturity spectrum continued to soften after the economy had started to recover. This reflected expected declines in the inflation rate and a not too strict monetary policy. The *yield curve* (the graph which shows the yields on securities of different maturities) accordingly moved downwards, to a lower turning-point in January 1994.

From February 1994 the upturn in economic activity advanced to the stage where market interest rates

Yield curves



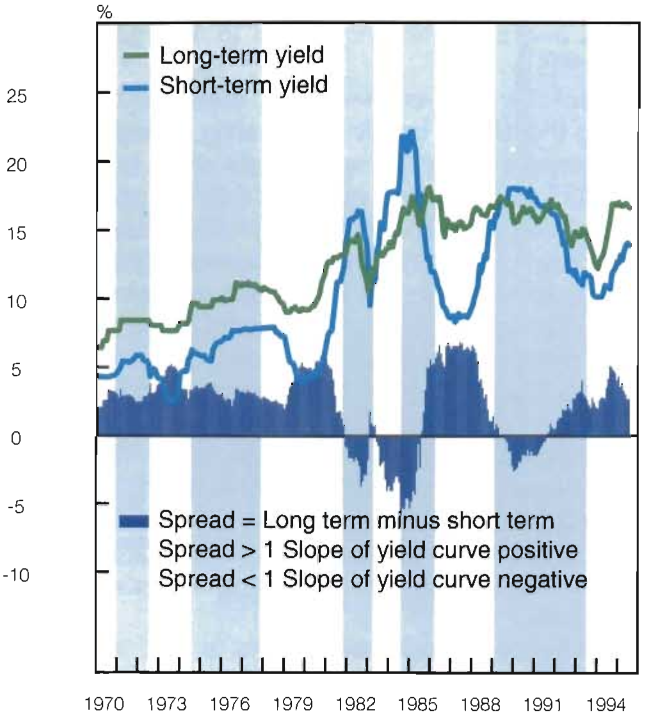
began to firm. This cyclical development was bolstered by uncertainties regarding the political transition in South Africa, rising inflation expectations and a hardening of interest rates in foreign markets. Because long-term rates rose more rapidly than short-term rates, the slope of the yield curve steepened. This change in the shape of the yield curve was not as pronounced as in previous economic upswings (with the exception of the upturn from April 1983 to June 1984), because short-term rates have not softened to the same extent during the current cycle as during previous cycles mostly because of greater emphasis on consistency in monetary policy.

Expectations of a further tightening in the monetary policy stance, less liquid market conditions, an expected increase in the rate of inflation and the increase in Bank rate by one percentage point to 13,0 per cent in September, caused the yield curve to move to even higher levels in the second half of 1994. In this period short-term yields increased more than long-term yields; the yield curve therefore flattened. In the first six months of 1995 long-term yields remained fairly stable, while short-term yields firmed further, especially in the wake of the upward adjustment in Bank rate to 14 per cent effective from 21 February 1995 and to 15 per cent effective from 30 June 1995. The yield curve accordingly flattened even more, but remained fairly steep over the first five years of the maturity spectrum.

International studies have found a close correlation between the shape of the yield curve and business cycles: in many economies with well-developed capital markets a steeply upward sloping yield curve normally indicates imminent boom conditions, a flattening of the yield curve signals slower economic growth and an inverted yield curve a recession. From the graph showing the spread between long- and short-term yields, it seems as if these rules did not apply in South Africa during the period 1970 to 1986. From 1970 to 1982 South Africa was generally characterised by a "normal" upward sloping yield curve which at times only flattened somewhat (i.e. a positive spread between long- and short-term yields, which only declined in certain periods but never became negative). From 1982 to 1986 the yield curve was generally inverted (i.e. a negative spread between long- and short-term yields). In the period 1970 to 1986 as a whole the slope of the curve therefore showed little correlation with lagged changes in the business cycle.

The main reason for the difference in the relationship between the shape of the yield curve and economic activity in South Africa in comparison with most of the industrialised countries during this period was probably the fact that the real interest rate in South Africa was generally negative or substantially lower than in the industrialised countries. Interest rates in this period did not reflect underlying market conditions because of the application of direct policy measures, such as interest rate control, prescribed-

Behaviour of and spread between long- and short-term yields



Dark area: Downward phase of the business cycle.

investment requirements and quantitative restrictions on bank credit extension. From the middle of the 1980s market-related and relatively high positive real interest rates have consistently been maintained in South Africa and the shape of the yield curve and the business cycle, appear to have become more closely correlated. The flattening of the yield curve from the beginning of 1988 preceded the downturn in economic activity by slightly more than one year, while an inverted yield curve existed during much of the recession. The slope of the yield curve then became positive nearly two years before the lower turning-point in economic activity was reached, and steepened significantly during the economic upswing until fairly recently. Towards the end of 1994 the slope of the yield curve started to flatten out, possibly indicating impending slower economic growth.

The recent changes in the shape of the yield curve are clearly illustrated by comparing developments in some interest rates over the maturity spectrum. The tender rate on *three-month Treasury bills*, for instance, rose from 10,15 per cent in February 1994 to 12,69 per cent in December 1994, and further to 13,90 per cent in July 1995. The monthly average *yield on government stock* with a maturity of up to three years also rose from 10,8 per cent in January 1994 to 15,9 per cent in January 1995, and then fluctuated around this level up to July. Similarly, the monthly average yield on government stock with a maturity of ten years or more rose by almost 5 percentage points from 12,2 per cent in January 1994 to 17,0 per cent in January 1995, before declining somewhat to 16,6 per cent in July 1995.

Banks' lending and borrowing rates also hardened during the cyclical upswing. Adhering closely to Bank rate changes, the *prime lending rate* of the banks was raised by 1 percentage point to 16,25 per cent on 26 September 1994, and further to 17,50 per cent on 22 February 1995. The last-mentioned slightly larger increase was due to the extra costs to banks caused by the increase of 1 percentage point of the minimum cash reserve requirement that was introduced by the Reserve Bank. With the further increase in Bank rate at the end of June 1995, the prime lending rate was raised to 18,50 per cent on 3 July 1995. The banks also increased their *predominant rate on mortgage loans* from 15,25 per cent to 16,25 per cent in October 1994, 17,25 per cent in March 1995, and 18,25 per cent in August 1995, in reaction to the increases in Bank rate.

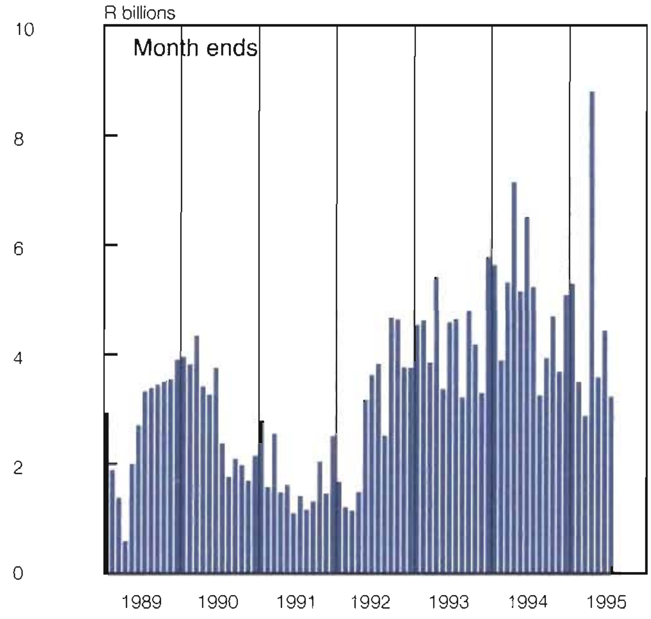
Rates on deposits with banks tended to rise by more than the banks' lending rates during the past year. The predominant retail *rate on twelve-month fixed deposits* with banks, for example, was raised in steps from 10,5 per cent in August 1994 to 13,5 per cent in March 1995, i.e. an increase of 3 percentage points in deposit rates against an increase of 2,25 percentage points in prime lending rates. This deposit rate was raised further to 14,5 per cent in June 1995 before the increase in lending rates. These developments therefore narrowed the banks' interest rate margins and encouraged reintermediation. In June 1995 the twelve-month deposit rate provided investors with a real pre-tax yield of 4,1 per cent.

The maximum *rates laid down in terms of the Usury Act* were also raised from 26,0 to 28,0 per cent in November 1994 in respect of money lending, credit and leasing transactions for amounts up to R6 000 and from 23,0 to 25,0 per cent in respect of amounts of more than R6 000 but not exceeding R500 000. The rates for these two categories were increased further by 1 percentage point from April 1995 to 29,0 and 26,0 per cent, respectively.

Money market

Money market conditions, which had been relatively tight from the second half of 1992 to the first half of 1994, fluctuated considerably in the subsequent twelve months. This was clearly reflected in the amount of accommodation at month-ends, which receded from R6,5 billion at the end of June 1994 to R3,9 billion at the end of September, before increasing again to R5,1 billion at the end of December 1994. The amount of

Accommodation at discount window



accommodation shrank to R2,9 billion at the end of March 1995; it then reached R8,8 billion in April, but eased to R3,2 billion at the end of July 1995.

The greater volatility in money market conditions was directly related to the effects of capital movements on the net foreign assets of the Reserve Bank. At times these changes were counteracted by changes in the other liabilities and assets of the Reserve Bank, but in the first quarter of 1995, for instance, the sharp increase in the net foreign assets of the Reserve Bank was accompanied by a decline in government deposits with the Bank as well as a decrease in the notes and coin in circulation outside the Reserve Bank, which contributed to easier money market conditions. Such developments made it difficult for the Reserve Bank to apply its refinancing apparatus effectively. A large part of the Reserve Bank's operations was accordingly undertaken mainly to counteract temporary fluctuations in the money market shortage.

The net effect of the *Reserve Bank's operations* during the second half of 1994 was nevertheless fairly neutral and the Bank generally allowed the money market shortage to reflect underlying supply and demand conditions. The Reserve Bank mainly used special Treasury bills, adjustments in the asset portfolio of the Corporation for Public Deposits, and the active management of government funds between the Exchequer Account with the Bank and the Tax and Loan Accounts with the private banks, to influence money market conditions in this period. A much more conservative policy stance was, however, adopted towards the end of the first quarter of 1995 when the Bank positioned itself to sterilise excess liquidity by increasing the basic minimum cash reserve requirement of the banks with effect from 21 March 1995. The very large fluctuations in money market liquidity in the second quarter of 1995 were counteracted to some extent by actions such as foreign exchange swap transactions, the issuing of special Treasury bills, further adjustments in the asset portfolio of the Corporation for Public Deposits and the daily management of government deposits with the Reserve Bank and private banks.

Bond market

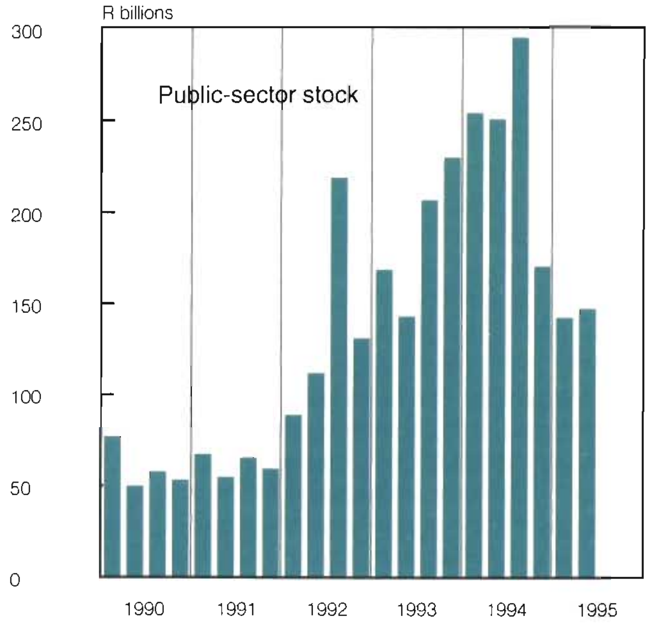
Activity in the primary and secondary bond markets fell back sharply in 1994 and the first half of 1995, mainly on account of the smaller borrowing requirement of the government, uncertainties regarding prospective movements in long-term yields and the relatively liquid position of the private sector. A substantial amount of new funds was also raised on foreign markets by the government and parastatals in the form of public issues, private placements and syndicated loans.

New issues of fixed-interest securities in the *domestic primary bond market* by entities in the *public sector* decreased from R31,7 billion in 1993 to R26,7 billion in 1994. The raising of finance was timed to fund the deficit more evenly during the 1994/95 fiscal year (the year ended March 1995), with the result that new issues came to R11,3 billion in both the first and second half of the fiscal year. In the first quarter of fiscal 1995/96 new issues of public sector stock decreased further to R9,6 billion.

The value of funds acquired by *listed private companies* through new issues of fixed-interest securities (including convertible preference shares, debentures and corporate bonds), which had contracted from R2,9 billion in 1992 to R0,8 billion in 1993, decreased further to only R0,1 billion in 1994. The demand for funds remained low in view of the high liquidity of the corporate sector, and new issues in the domestic market fell away almost completely with the firming of long-term rates during 1994. In the first half of 1995 issues of fixed-interest securities to the value of R0,9 billion were made by listed private-sector companies.

A number of companies did, however, raise capital in foreign markets by means of convertible bonds to the amount of R0,6 billion in 1994 and R1,5 billion in the first half of 1995. Increased foreign demand for issues of convertible bonds by South African companies was a clear indication that international markets are opening up to South African borrowers. International investors began taking positions in South Africa on basis of views that South African corporate earnings offer attractive growth prospects. Capital-raising operations took advantage of this demand and in some instances exchange control approval was given for a certain percentage of proceeds to be held offshore by South African companies in order to fund international expansion.

Stock exchange transactions



In the *secondary bond market* further progress was made towards the licensing of the Bond Market Exchange. In the meantime, the Johannesburg Stock Exchange continued to operate the formal bond trading floor and clearing house. The value of public-sector stock traded on the Johannesburg Stock Exchange reached a new record level of R968 billion in 1994; this was considerably higher than the R746 billion in 1993. During the course of 1994, however, activity began to recede. After having reached a peak of R294,5 billion in the third quarter of 1994, the value of public-sector stock traded receded to R170,1 billion in the fourth quarter of 1994 and further to R142,1 billion and R146,9 billion in the first two quarters of 1995, respectively. This decrease was to a large extent a reflection of the more stable long-term yields during this period.

The value of public-sector stock traded on the Johannesburg Stock Exchange was nonetheless more than three times the total nominal value of all such stocks outstanding in 1994. This high level of liquidity allowed the Reserve Bank to reduce its role as market-maker in the secondary market for government stock.

Gross sales of government stock by the Reserve Bank therefore receded somewhat from a monthly average of R14,9 billion in 1993 to R13,8 billion in 1994 and R7,1 billion in the first half of 1995. In its efforts to fund the government at as low a cost as possible, the Bank's trading in government stock options increased from a monthly average of R5,3 billion in 1993 to R7,4 billion in 1994, before falling back to R5,9 billion in the first half of 1995.

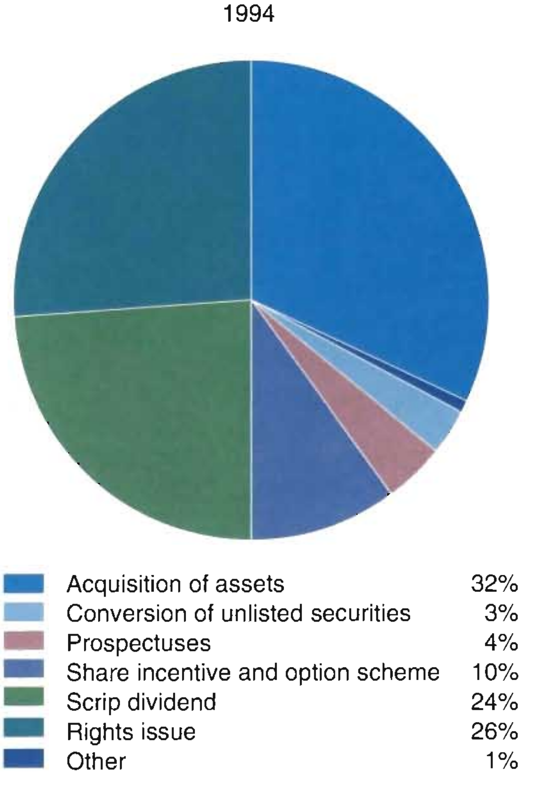
Net purchases of public-sector stock by *non-residents* fell back from R1,5 billion in 1993 to R1,1 billion in 1994. In February 1995 non-residents became net sellers of public-sector stock, probably in anticipation of the abolition of the dual exchange rate system. These sales increased significantly in the week before and after the dismantling of the financial rand system. All in all, non-residents were net sellers of stock to an amount of R363 million in the first quarter of 1995. With the currency remaining relatively stable, the yields on long-term bonds became increasingly attractive to foreigners and in the second quarter they again made net purchases of government bonds totalling R408 million.

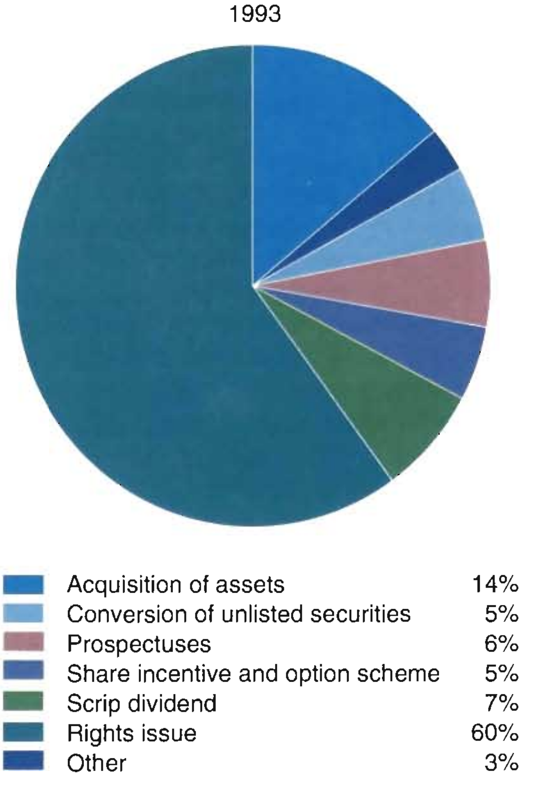
Further progress was also made in the period under review in bringing the South African bond market more in line with international practice. Although the Bond Market Exchange was not yet licensed, a system of manual settlement came into operation in April 1995. All trading is reported to the Bond Market Association for matching, and settlement occurs every Thursday on the principle of simultaneous physical exchange of cheques and scrip. This manual system still has significant disadvantages, such as a two-week settlement period, the possibility of losing scrip, the risk of tainted or stolen scrip entering the market and a large and costly administrative infrastructure. An electronic system will be phased in during the second half of 1995 which should eliminate the physical movement of scrip, lead to faster and more efficient processing, provide delivery against payment and reduce risk.

Equity market

The firming of interest rates, high and rising share prices, and a shortage of scrip favoured share capital issues, but the demand for funds in the *primary equity market* remained low and the value of rights issues of ordinary shares decreased sharply from R5,3 billion in 1993 to R2,7 billion in 1994. In the first six months of 1995 capital amounting to R3,9 billion was raised in this manner, compared with R1,2 billion in the last half of 1994. Despite the significant decline in the value of rights issues in 1994, the total value of capital raised by listed companies declined by only 5,9 per cent from R10,1 billion in 1993 to R9,5 billion in 1994, because funds raised by other means increased strongly. In

New capital raised by method of issue





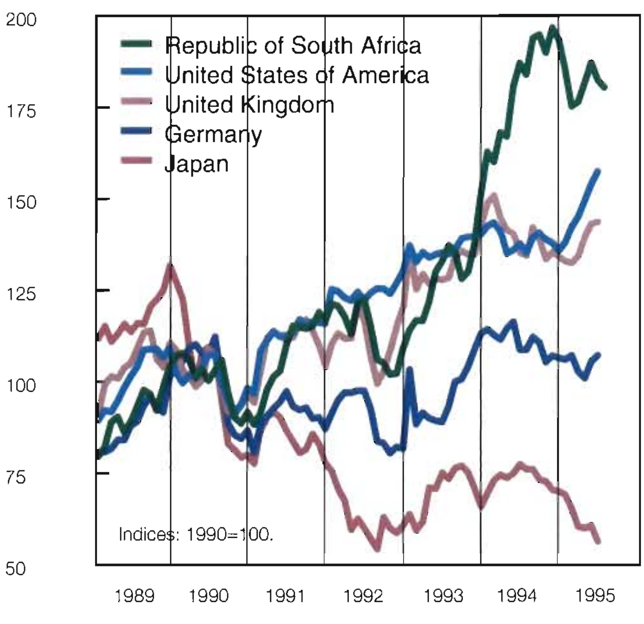
particular, the number of shares issued as scrip dividends increased substantially, mainly as a result of the Secondary Tax on Companies which discouraged companies from paying cash dividends. The proportion of new capital raised in the form of scrip dividends rose from 7 per cent in 1993 to 24 per cent in 1994. The bulk of the capital (86,7 per cent) in 1994 was raised in the industrial and financial sectors.

In the *secondary equity market* the value and volume of shares traded on the Johannesburg Stock Exchange increased sharply, reaching new record levels in 1994. Although the value of shares traded, at R71,5 billion in 1994, was approximately 63 per cent higher than in 1993, it declined during the course of the year from R20,7 billion in the first quarter of 1994 to R15,7 billion in the fourth quarter of 1994. In the first half of 1995 it contracted even further to R14,7 billion in the second quarter. Turnover was affected negatively by the increase in interest rates and yields during 1994, a lacklustre performance of share markets world-wide, and a significant decline in the participation by domestic investors in the equity market.

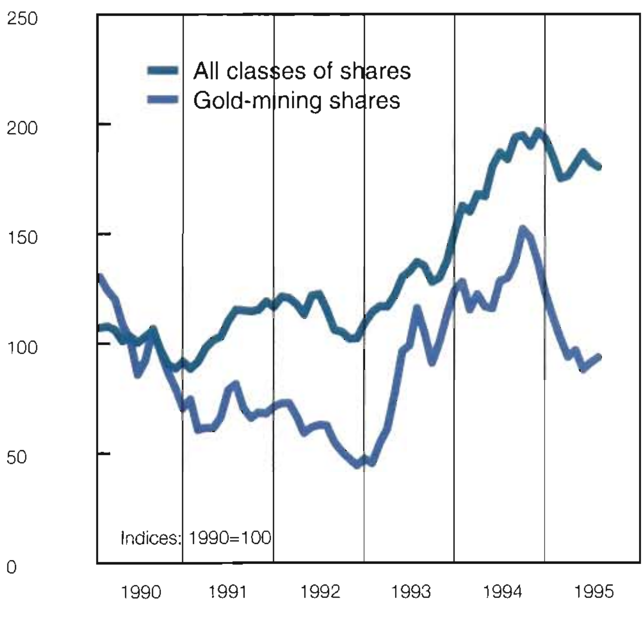
Downward corrections on some of the larger stock exchanges in industrialised countries and uncertainty about socio-political conditions in South Africa made non-residents hesitant to invest on the Johannesburg Stock Exchange in 1994. On balance, they were nevertheless net purchasers of shares to the value of R0,2 billion for the year as a whole. In the first half of 1995, however, they became major participants in the local equity market. Their net purchases of equity on the stock exchange in this period totalled R2,9 billion, despite a temporary drop in purchases with the abolition of the dual exchange rate system. At the same time, the participation of residents receded. As a consequence, gross purchases by non-residents as a ratio of the total value of shares traded increased from 31,4 per cent in 1994 as a whole to 42,9 per cent in the first half of 1995.

The performance of *share prices* on the Johannesburg Stock Exchange compared favourably with previous periods of economic recovery. Share prices on the stock exchange in the current upswing rose before positive growth was recorded in the economy and business and investor confidence improved. However, compared with developments in most of the larger stock exchanges, the trend in share prices on the Johannesburg Stock Exchange in the current upward phase of the business cycle has been much less synchronised with overseas price movements than in previous periods of recovery. In the years before 1993 share price developments in Johannesburg were closely correlated with the stock exchanges of the USA, the United Kingdom and Germany. Recently, however, share prices on the Johannesburg Stock Exchange have increased almost uninterruptedly, by 92,2 per cent from October 1992 to an all-time high in November 1994, while prices on international share markets generally levelled off or even moved downwards.

Share prices of major stock exchanges



Share prices: Johannesburg Stock Exchange



The subsequent slump in share prices on Wall Street, the ripple effects of the Mexican crisis on emerging markets and the earthquake in Japan, nevertheless also had an adverse effect on the Johannesburg Stock Exchange and the average monthly total share price index fell quite sharply (by 10,7 per cent) from November 1994 to February 1995. This downward movement was then reversed by important region-specific factors, such as the expected announcement of the termination of the financial-rand system as well as attempts to encourage foreign investment in South Africa. This was boosted by the inclusion of and large weight (12,9 per cent) accorded to the Johannesburg Stock Exchange in the International Finance Corporation's Emerging Market Index. The average level of all classes of shares accordingly recovered again by 4,0 per cent from February to June 1995.

Unlike the prices of industrial and commercial shares and financial shares, the share prices of gold mines did not form part of this recent recovery. After having reached a new record high in September 1994, lower gold-mining profits, labour unrest on certain mines and lower production due to the mining of lower-grade gold-bearing ore continued to depress the prices of gold-mining shares from October 1994. Despite recovering somewhat in April and June 1995, the level of the prices of gold-mining shares in the latter month was still 40,1 per cent below its upper turning-point of September 1994.

As shown in Table 10, indicators such as the dividend yield, the price-earnings ratio, the earnings yield and the yield gap (monthly average yield on government stock less the dividend yield on all classes of shares), all support the view that equities are relatively expensive.

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

Period		Dividend yield Per cent	Earnings yield* Per cent	Price-earnings ratio*	Yield gap Percentage
1993:	Dec	2,53	5,95	16,81	9,81
1994:	Mar.............	2,30	5,50	18,18	10,69
	June	2,14	5,08	19,69	12,32
	Sept	2,12	5,09	19,65	14,77
	Dec	2,19	5,27	18,97	14,61
1995:	Mar.............	2,50	5,95	16,80	14,22
	June	2,44	5,94	16,84	14,34

* Excluding gold-mining shares.

Important operational and *regulatory changes* were also introduced recently or are envisaged for the near future to improve the functioning of the Johannesburg Stock Exchange, namely:

- the Stock Exchanges Control Act is currently being amended in order to allow the restructuring of the stock exchange by providing for corporate limited liability membership and the ownership of broking firms by non-stockbrokers, the eligibility of foreign stockbrokers to form new stockbroking companies, dual-capacity trading, fully negotiable brokerage, automated trading, internationally competitive transaction costs, an electronic scrip registry and rolling settlement;
- new listing requirements that will force companies to broaden their base of public shareholders and grant the stock exchange greater powers to oblige listed companies to disclose financial information;
- new capital requirements for the members of the stock exchange are being phased in during 1995; and
- the formation of ties between leading international and South African stockbroking firms to enable them to sell specialist services to non-resident investors.

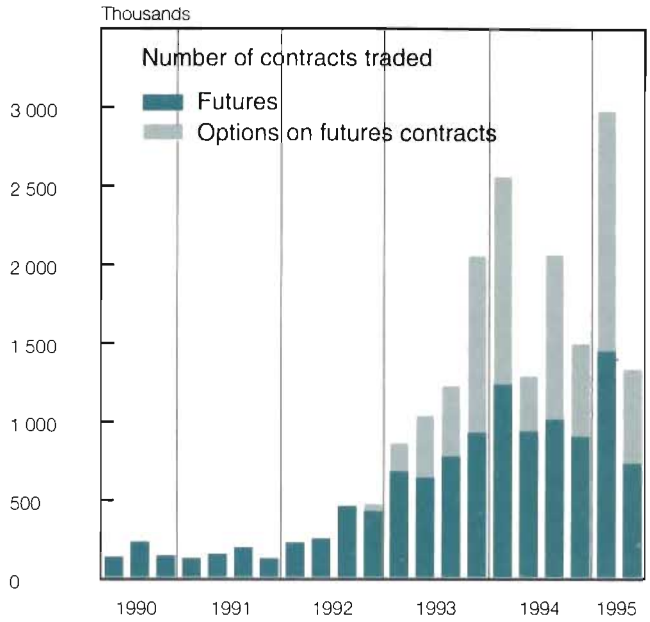
Market for derivatives

The improvement in the economy's growth and the buoyant share market ensured a high level of activity on the South African Futures Exchange throughout 1994. Sporadic political turmoil in the election period, an increasing level of non-resident participation, uncertainty regarding future share price movements, and speculation related to the abolition of the financial rand, kept transaction levels high until the first quarter of 1995. Turnover in *futures contracts* increased from 3,0 million contracts in 1993 to 4,1 million contracts in 1994 and then rose to an all-time quarterly high of 1,4 million contracts in the first quarter of 1995. In the second quarter of 1995 activity fell back to 0,7 million contracts, mainly due to the more stable environment in the foreign exchange market, a decline in non-resident participation and indications of a negative effect of the Barings *débâcle* on derivatives trading, as institutional fund managers sought to evaluate derivative exposure.

Despite the introduction of new futures contracts, equity futures contracts continued to dominate the formal derivative market. Activity on interest rate contracts remained low and the volume of transactions in the new Kruger Rand Futures contract and the new Bank Bill Futures contract was relatively insignificant. Trade in commodity futures contracts commenced on 31 July 1995, with the beef future as the only commodity initially being traded.

The growing importance of *options* as a hedging instrument is clearly illustrated in the growth in the

Futures exchange transactions



number of options on equity futures from 2,1 million in 1993 to 3,3 million contracts in 1994; in the first quarter of 1995 a record number of 1,5 million options were traded, before it fell back to 0,6 million contracts in the second quarter. As in the case of futures contracts, equity options dominated the total position in option contracts, with very little activity in interest-based options on futures contracts. Options in the new commodity futures contract will initially not be available in the formal market and will only be traded in the over-the-counter market.

The Johannesburg Stock Exchange Traded Options Market remained inactive during 1994 and the first half of 1995. The South African Futures Exchange has indicated its willingness to start trading in options on certain equities, and the future of the Traded Options Market is being re-evaluated in tandem with the other changes to the structure of the Johannesburg Stock Exchange.

Mortgage and real estate market

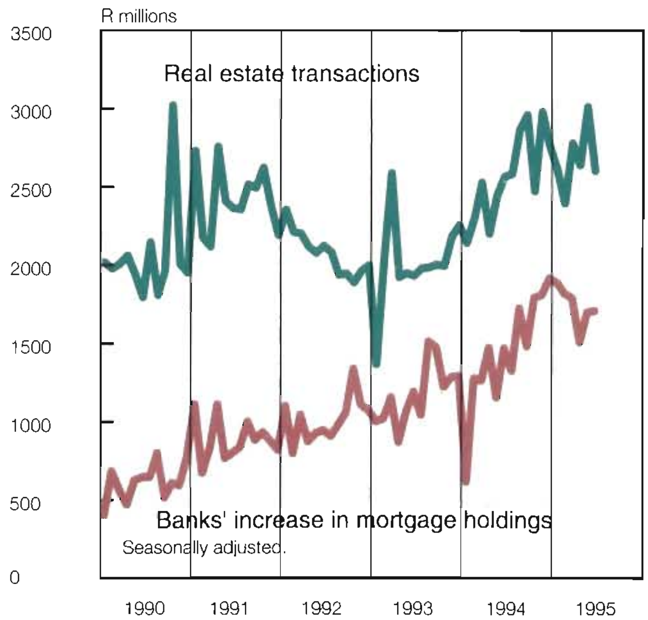
The total holdings of *mortgage loans* by banks and participation mortgage bond schemes increased by 17 per cent from R98 billion in December 1993 to R115 billion at the end of 1994. The holdings of mortgage loans of banks (which were responsible for nearly 90 per cent of the formal market in 1994) increased sharply further from R110 billion at the end of December 1994 to R120 billion at the end of June 1995. The market was kept buoyant during 1994 and the first half of 1995 by the lively housing market, the strong growth in flexible mortgage advances and a significant increase in the commercial and industrial letting market.

In April 1995 a consortium comprising three insurance companies, a pension fund, a bank and the Independent Development Trust established a new home loans bank, the *Credit and Savings Help Bank*. The bank targets low-income groups through the provision of home loans to employer groups, and offers fixed-rate lending for low-income housing with security for the loans backed by cession of employee retirement funds.

The government's *mass housing programme* got off the ground in June 1995 with a new set of subsidies, the creation of housing support schemes and innovative financial support schemes forged with banks. Solutions to the housing crisis are to centre on the housing accord between government, the private sector and individuals. An important priority has been the need to engineer cost-effective ways of financing the housing needs of people who live at or close to the subsistence level.

In terms of these schemes, banks began providing mortgage finance to people in the lower-income groups from June 1995. Loans as small as R10 000 repayable over 20 years are made available, provided cover is available in terms of the mortgage indemnity scheme. A nine-month savings scheme has also been introduced for those people who cannot afford the

Mortgage lending and real estate transactions



minimum deposit. In order to prevent financial hardship which may arise due to interest rate changes, low-cost housing is financed at fixed mortgage rates by banks. The interest rates on the fixed-rate bonds announced in June 1995 will vary between 20 per cent in the case of loans from R50 001 to R65 000, and 22,5 per cent in the case of loans from R10 000 to R25 000.

Individual, consolidation and institutional subsidies have also been introduced to complement the existing project-linked subsidies. Individual subsidies of up to R15 000 will be extended to eligible applicants earning R3 500 a month or less. Consolidation subsidies of up to R7 500 will enable people who have received a serviced site from government to build a small structure. Institutional subsidies will allow the creation of housing co-operatives and housing associations, as well as the provision of rental accommodation.

The value of *real estate transactions* increased sharply (by 27,3 per cent) from R24,1 billion in 1993 to R30,7 billion in 1994; the number of transactions in fixed property rose by 11,5 per cent, while the average value of property was 14,0 per cent higher. Investors in real estate became more cautious towards the end of 1994 and the value of transactions contracted from a peak of R8,4 billion in the third quarter of 1994 to R8,2 billion in the second quarter of 1995. The increase in real estate prices, the continued high nominal and real mortgage rate, and expectations of a further rise in interest rates, were probably mainly responsible for the lower level of transactions in fixed property.

Public finance

Fiscal policy

The government is committed to pursuing policies which will lead to higher investment and employment and to sustainable economic growth within a framework of macro-economic stability. The *prime objective* of fiscal policy in this broader context is to achieve fiscal sustainability in the medium term, including the reprioritisation of government expenditure so as to increase allocations for social services, capital expenditure and the Reconstruction and Development Programme. Equally important are the improved management of the public sector and the efficient use of available resources. The tax system is also undergoing a structural reform to enhance its efficiency and equity, while ensuring that the tax burden does not increase.

The main aim of fiscal policy is gradually to reduce the *government deficit* before borrowing and debt repayment to more manageable proportions over the next five years. This is necessary given the large demand for public services and a tax burden that is already high. A ratio of tax income to gross domestic product of 25 per cent is accepted as the ceiling on the tax revenue of the consolidated central and provincial governments. The present level of taxation in South Africa thus leaves little scope for the planned reduction in the government deficit.

In accordance with the Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa, the main thrust of *tax reforms* will be aimed at enhancing the efficiency of tax administration and collection. Measures taken to improve efficiency in tax collection included the training of revenue officials, the enhancement of customer service and countering tax evasion. In addition, a once-off tax amnesty was provided to persons who were not previously registered as taxpayers.

Another key principle put forward by the Commission was the promotion of investment and equity. Tax aspects regarding the promotion of investment involve the maintenance of an effective corporate tax rate at an internationally competitive level and the elimination of factors which act as disincentives to investment. The Commission further recommended that the Marketable Securities Tax be abolished as soon as possible and that a number of shortcomings of corporate taxation, such as the Secondary Tax on Companies and issues pertaining to corporate group taxation, should be investigated further. Equity is being enhanced through the elimination of all provisions in the various tax statutes which discriminate on the basis of gender, or marital status, or infringe on the right to privacy and freedom of religion.

Owing to the high level of the tax burden, the reduction in the fiscal deficit is to be achieved mainly through a steady lowering of the ratio of *government expenditure* to gross domestic product. A new budgetary process has been set in place to accomplish this through a thorough review and reprioritisation of the activities of the existing spending agencies. The priorities of the Reconstruction and Development Programme will constitute an important guide in this reshaping of the government functions. Three broad guidelines have been laid down which will govern the expenditure side of fiscal policy, namely:

- reducing consumption expenditure by general government relative to gross domestic product, which translates into the containment of non-interest recurrent expenditure in real terms;
- keeping overall wage and salary increases within inflation limits; and
- strengthening of the government's contribution to gross domestic product, to ensure the maintenance of the social and economic infrastructural development.

Various other initiatives were also undertaken by the government to bring these broad objectives into practice and to ensure the efficient application of fiscal policy, including:

- the appointment of a Special Adviser to the Minister of Finance to assist government departments in designing and implementing their restructuring programmes;
- the appointment of the Financial and Fiscal Commission to make recommendations on the future structure of intergovernmental financial relations; and
- the formation of a Cabinet Committee and four task groups to investigate the restructuring of state assets and associated liabilities (including privatisation), to unlock resources which are currently underutilised and to contribute to the empowerment of disadvantaged communities and sectors.

The government is also aiming at the improvement of *debt management* with a view to minimising the cost of debt servicing and smoothing out the issue of government bonds. A reduction in fiscal deficits, together with higher economic growth, should bring about a lowering of the ratio of government debt to gross domestic product. In addition, the practice of issuing long-term government bonds at a large discount will be reviewed because it has had an adverse impact on the transparency of the fiscal accounts. This has impaired the market's ability to assess the actual extent of the government borrowing requirement.

Taking these broad objectives into consideration, the *Budget for fiscal 1995/96* provided for a deficit of R29,7 billion, or 5,9 per cent of the estimated gross domestic product. If loan repayments of nearly R9 billion are taken into account, the gross borrowing requirement for fiscal 1995/96 would be R38,6 billion. The government intends to finance R35,5 billion of this borrowing requirement by issuing government stock. The rest of the shortfall will be met mainly through proceeds from foreign loans, Treasury bills and extraordinary revenue.

Government expenditure was budgeted at R152,6 billion for fiscal 1995/96, which represents an increase of 9,0 per cent on the preceding year's level. As a proportion of gross domestic product, government expenditure was projected to decrease from 31,3 per cent in fiscal 1994/95 to 30,6 per cent in fiscal 1995/96, despite a 0,1 percentage point increase in interest payments on government debt as a percentage of total production. At the same time, a reallocation of other expenditure was provided for in the Budget so as partly to meet the aims of the Reconstruction and Development Programme. This involved a marked move away from expenditure on general government administration, defence and economic services in favour of expenditure on education, health care, social security, welfare, housing and policing.

Total government revenue was projected to rise by 10,3 per cent to R123,0 billion in fiscal 1995/96. This was expected to bring about a slight reduction in the ratio of government revenue to gross domestic product from 24,9 per cent in fiscal 1994/95 to 24,8 per cent in fiscal 1995/96. As part of the general restructuring, the tax proposals in the Budget embraced the following major changes:

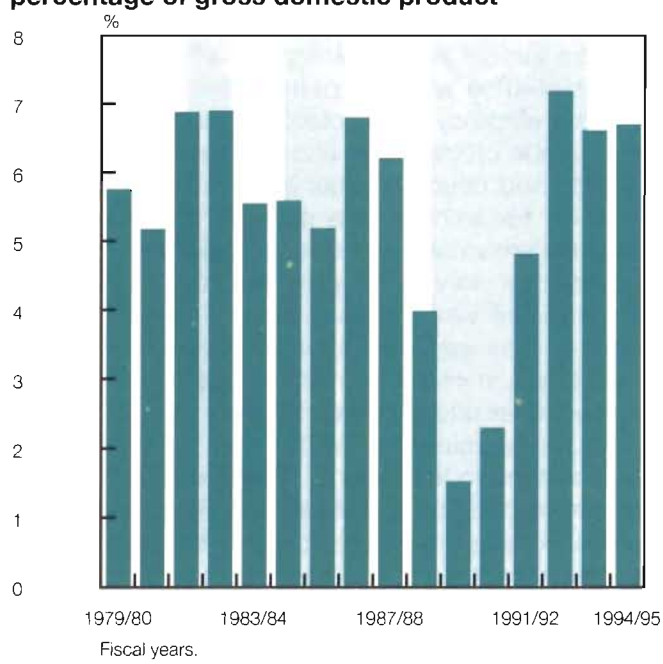
- a single scale of rates for all individuals, reaching a maximum marginal rate of 45 per cent at a taxable income of R80 000;
- an increase in certain excise duties and the fuel levy;
- the removal of the import surcharge on all capital and intermediate goods;
- the abolition of non-resident shareholders' tax to improve the environment for foreign investors;
- the harmonisation of taxes applicable in the former TBVC countries with the rest of South Africa; and
- the introduction of measures to prevent tax avoidance in respect of more than one company car, the accrual and incurring of interest on financial instruments, interest earned by emigrants, the taxation of lump sum payments and the writing-off of the cost price of ships and aircraft.

Public-sector borrowing requirement

Against the background of this broad fiscal policy stance, the *public-sector borrowing requirement* (i.e. the deficit before borrowing and debt repayment of the consolidated central government, provincial governments, local authorities and the non-financial public enterprises) amounted to R29,8 billion in fiscal 1994/95, or R11,2 billion less than in the preceding year. As a ratio of gross domestic product, the public-sector borrowing requirement contracted from 9,5 per cent in fiscal 1992/93 and 10,4 per cent in fiscal 1993/94 to 6,7 per cent in fiscal 1994/95. The exceptionally high borrowing requirements before fiscal 1994/95 were, however, to a large extent due to special non-recurrent transfers. If these transfer payments are excluded, the ratio of the public-sector borrowing requirement to gross domestic product was equal to 7,2 per cent in fiscal 1992/93 and 6,6 per cent in fiscal 1993/94.

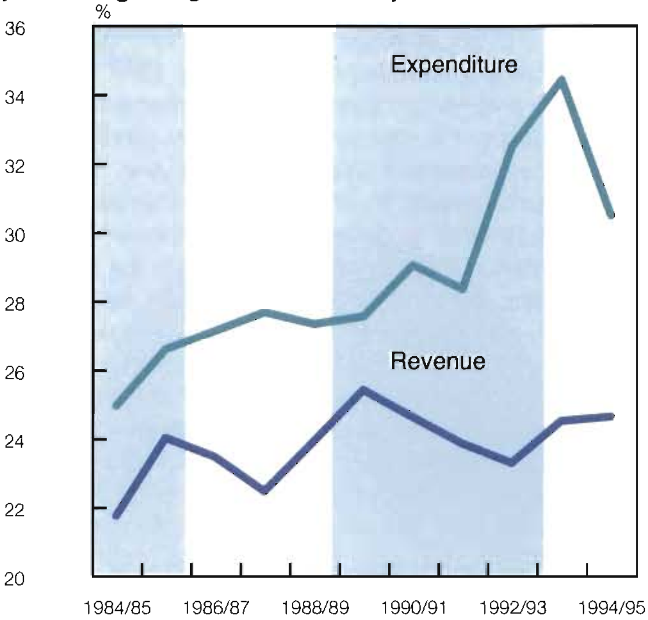
The borrowing requirement relative to gross domestic product therefore improved only slightly in the current period of economic recovery. As illustrated in the accompanying graph, this is not the normal pattern of the public-sector borrowing requirement in an upward phase of the business cycle. In the previous periods of economic recovery, the ratio of the public-sector borrowing generally receded quite sharply to more manageable levels; this ratio then

Public-sector borrowing requirement as percentage of gross domestic product*



Fiscal years.
* Excluding extraordinary expenditure.
Dark area: Downward phase of the business cycle.

Main Budget revenue and expenditure as percentage of gross domestic product



Fiscal years.
Dark area: Downward phase of the business cycle.

usually increased again sharply in economic downswings. The current modest improvement in the ratio of the public-sector borrowing requirement to gross domestic product emphasises the need for structural adjustments in the finances of the government.

The comparatively large public-sector borrowing requirement in fiscal 1994/95 consisted primarily of a deficit of R26,0 billion on the *Main Budget*. The borrowing requirements of provincial governments and extra-budgetary institutions increased in fiscal 1994/95, while the borrowing requirement of local authorities shrank marginally. The moderate contraction in the borrowing requirement during the current economic upswing was mostly due to developments in the Main Budget. This high ratio could particularly be attributed to the continued high level of government issues. As a ratio of gross domestic product, total expenditure on the Main Budget contracted from 32,5 per cent in fiscal 1992/93 to 30,6 per cent in fiscal 1994/95. Government revenue, on the other hand, followed a more conventional cyclical development and the ratio of government revenue to gross domestic product, rose from 23,3 per cent to 24,7 per cent over the same period.

Government revenue

As opposed to many other developing countries, by far the dominant proportion of the government revenue in South Africa consists of *tax revenue*, while transfers and ordinary income from the sale of goods and services are comparatively insignificant. Government revenue in South Africa is therefore highly dependent on the size of the tax base, the rate of taxation and the growth in income, profits, domestic expenditure and imports. Given a fixed tax base and tax rates, changes in government revenue consequently correlate fairly closely with changes in economic activity.

In the current economic upswing government revenue increased at an average annual rate of 16,5 per cent in fiscal 1993/94 and fiscal 1994/95; in the previous three years of economic downswing this rate averaged 8,6 per cent per year. Although this increase in government income was partly related to the acceleration in economic activity, it was also caused by increases in value-added tax rates in fiscal 1993/94, the introduction of a temporary transition levy on income tax in fiscal 1994/95 and higher excise duties levied in both years.

An analysis of South Africa's tax revenue according to *type of tax* (see Table 11), clearly shows that the rise in tax revenue over the past two years was mainly due to increases in the tax on income and profits, taxes on property and domestic taxes on goods and services. On the other hand, the taxes on international trade and transactions increased only moderately in the economic upturn, despite the substantial rise in the volume and value of merchandise imports. The relatively modest growth in this type of taxation was caused by the phasing-out of the surcharge on imports. An increasingly larger portion of the income on customs duties also accrued to other members of the Southern African Customs Union.

At 52 per cent of total government receipts in fiscal 1994/95, *income tax* collections remained the largest revenue source. In tapping this source, the government has relied increasingly on income tax on

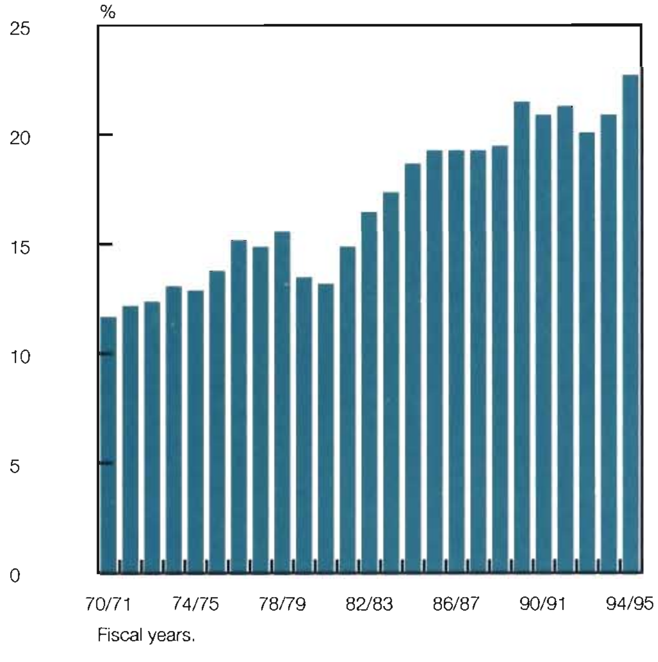
Table 11. Rate of increase in tax revenue according to type of tax

Per cent

Type of taxation	1992/93	1993/94	1994/95
Taxes on income and profits	7,8	6,6	20,1
Taxes on property	26,0	22,9	32,3
Domestic taxes on goods and services	3,4	31,4	12,9
Taxes on international trade and transactions*	7,5	13,0	3,8
Stamp duties and fees	6,7	12,3	11,0
Total tax revenue	**7,0**	**16,7**	**14,5**

* Before income accruing to other members of customs union.

Total taxation of households as percentage of households' total current income



individuals and this tax as a proportion of gross domestic product rose from only 4,5 per cent in fiscal 1981/82 to 9,7 per cent in fiscal 1994/95. Contrary to this development, company tax as a ratio of gross domestic product declined from 6,5 per cent to 3,3 per cent over the same period. The reliance on income tax on individuals as a source of revenue has reduced the scope for further tax increases. Only a relatively small proportion of the population contributes to this source of revenue and, although the top marginal tax rate for individuals is more or less in line with rates that apply in other countries, the income level at which South Africa's rate is levied is very low.

The total *tax burden on individuals* has also increased to very high levels. This is clearly illustrated by the rapid rise in the ratio of direct and indirect taxes to the current income of households from 11,8 per cent in fiscal 1970/71 and 13,3 per cent in fiscal 1980/81 to 22,8 per cent in fiscal 1994/95. This ratio is, of course, an average for the total population, including the unemployed and households dependent on earning income in the informal sector. The tax burden on households involved in the formal sectors of the economy therefore increased to considerably higher levels. Moreover, the rise in direct and indirect taxes paid by households do not take into account the increasingly larger amounts that had to be spent on so-called user costs for the provision of services that were previously provided free of charge by the government.

Government expenditure

Considerable *fiscal restraint* was applied by the government in the past two years. This is clearly reflected in an average annual rate of increase in government expenditure of 10,1 per cent in fiscal 1993/94 and fiscal 1994/95; in the preceding three fiscal years the rate of increase in government expenditure averaged 18,3 per cent per year. A part of this improvement in the growth of government expenditure was, of course, due to the lower average rate of inflation that has been registered in the past two fiscal years. What made this achievement remarkable, however, was the fact that large special transfers were made in fiscal 1993/94 for shortfalls on government pension funds and on the Gold and Foreign Exchange Contingency Reserve Account with the Reserve Bank, while in fiscal 1994/95 considerable additional costs were incurred on the country's constitutional transition.

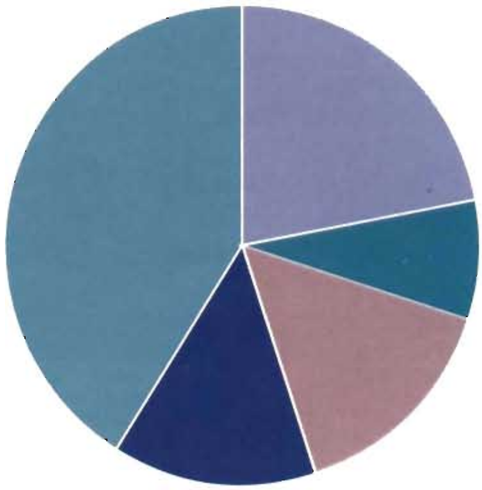
Not only were the rates of increase in government expenditure curbed, but resources were also reallocated towards social spending and the basic needs of people. This is clearly reflected in a *functional classification* of government expenditure. Outlays on social services (education, health, social security and welfare, housing and recreation and culture), for instance, rose from 41 per cent of total government expenditure in fiscal 1990/91 to 44 per cent in fiscal 1994/95. This increase occurred mainly at the expense of a reduction in the relative shares of protection and economic services, while a rise in interest payments on government debt led to a decline in the discretionary expenditure of the government.

An *economic classification* of government expenditure shows that the restraint in fiscal 1993/94 was mainly directed towards containing capital expenditure. This has been a practice followed by the government already since the early 1980s. As a result, the ratio of government's capital expenditure to gross domestic product contracted from 2,4 per cent in fiscal 1980/81 to 1,3 per cent in fiscal 1994/95. From fiscal 1980/81 to fiscal 1993/94, current government expenditure as a percentage of gross domestic product rose from 17,4 to 30,8 per cent. However, in fiscal 1994/95 the growth in the current expenditure of government was also restricted, causing this ratio to recede to 29,3 per cent.

Particularly disturbing has been the consistent rise in the *costs of servicing government debt* since the early 1980s. As a ratio of gross domestic product, interest payments by the government rose from 1,7 per cent in fiscal 1980/81 to 5,3 per cent in fiscal 1994/95. These figures do not even include the discount incurred on the issuing of marketable government securities, which has risen sharply in recent years. This increase in interest payments came about notwithstanding the success achieved in establishing a highly liquid market in government stock, which

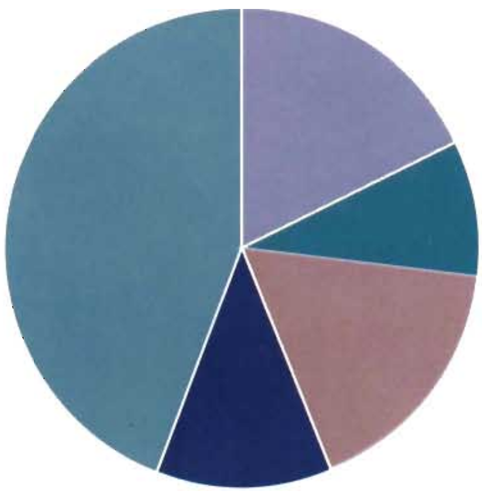
Functional classification of government expenditure as percentage of total government expenditure

1990/91



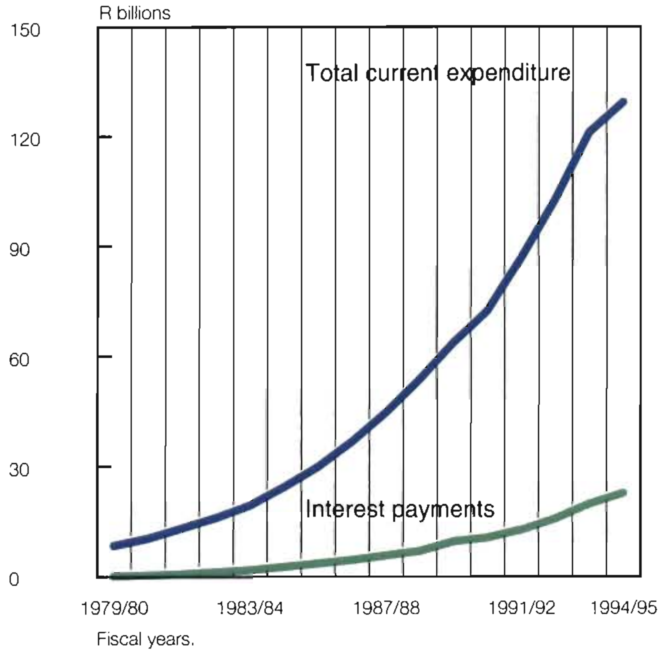
Protection	22%
General	8%
Interest	15%
Economic	14%
Social	41%

1994/95



Protection	18%
General	9%
Interest	17%
Economic	12%
Social	44%

Current expenditure of Main Budget



lowered the yield on government stock by several basis points and mainly reflected the sharp increase in government debt and the generally high level of long-term interest rates.

Financing of government deficit

As in the past, newly issued *long-term government stock* remained the main borrowing instrument used to finance the government's deficit before borrowing and debt repayment in fiscal 1994/95. Most of this stock was again taken up by the Public Investment Commissioners and the non-monetary private sector. In the past few years the government has become increasingly dependent on funds from the Public Investment Commissioners to finance the deficit: the Public Investment Commissioners' contribution to the funding of the deficit increased from 34,3 per cent in fiscal 1991/92 to 67,4 per cent in fiscal 1994/95. This source of funding the deficit could become less reliable in future because the Public Investment Commissioners are now allowed to invest in a variety of financial instruments.

The non-monetary private sector also took up a relatively large part of the government issues of domestic marketable stock. However, the abolition of the prescribed investment requirements applicable to insurers and private pension funds from October 1989, has since then resulted in a significant reduction in the

Table 12. Financing of the government deficit in fiscal 1994/95

	R millions
Government stock:	
Public Investment Commissioners	16 639
Monetary institutions	2 603
Non-monetary private sector	15 603
Total, including discount	34 845
Less: Discount on government stock	10 764
Plus: Premium on consolidation of stock	1 321
Total	25 402
Treasury bills	-148
Foreign loans	2 604
Non-marketable securities	-265
Loan levy	-710
Money market instruments	1
Extraordinary receipts	31
Increase in available cash balances	-953
Total net financing	**25 962**

share of government stock taken up by the non-monetary private sector. Monetary institutions also took up a significant proportion of the government stock issue in fiscal 1994/95, mainly in the form of short-term stock.

Government stock issues to the various institutions were made at substantially lower coupon rates than the ruling market interest rates; the discount on *government stock* accordingly rose from 6,5 per cent of the net increase in government stock in fiscal 1993/94 to 30,9 per cent in fiscal 1994/95. This development was due to the fact that market interest rates rose sharply in fiscal 1994/95, while the government continued to issue the same benchmark stock to ensure liquidity in the market. In fiscal 1994/95, however, a premium was also earned on the consolidation of some government stock issues. The net discount of R9,4 billion on government stock issues nevertheless added another 2,1 percentage points to the ratio of government debt to gross domestic product at the end of March 1995. The practice of issuing stock at low coupon rates marginally alleviated interest commitments in the short term, but the increase in paper needed to finance the deficit and the eventual higher liability are deferred only until the maturity date of the stock.

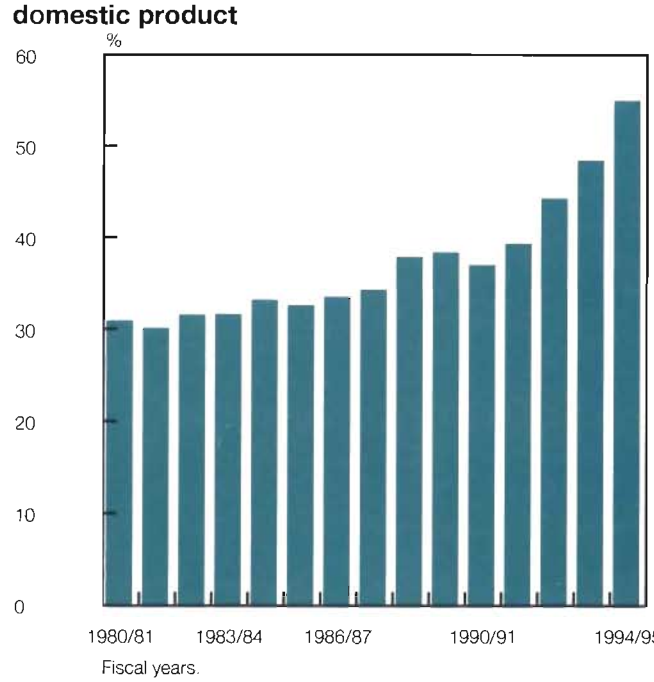
As a further measure to avoid increasing the cost of debt servicing and to attract institutional investors, a new *variable-rate stock*, which is a capital market instrument with money market features, was introduced in October 1994. This stock has a maturity of four years and a coupon rate that is derived quarterly from the ruling Treasury bill tender rate through the addition of a premium. Although the variable-rate stock was issued to satisfy the needs of institutional investors, insurers and private pension funds held only R0,4 billion out of a total R5,2 billion issued by the end of June 1995. The Public Investment Commissioners and the monetary sector held nearly two-thirds of the outstanding variable-rate stock on this date.

In financing the government deficit, *Treasury bills* to the value of R1 880 million were sold to non-residents during fiscal 1994/95, whereas residents were large net sellers of these bills. As indicated above, the government also succeeded in December 1994 – for the first time since 1991 – in making a major issue of government stock, amounting to US$750 million, in the *global bond market*. This was followed by another stock issue of ¥30 billion in May 1995 in the Samurai market.

Government debt

The relatively large financing requirement of the government, the discount on government stock, and the inclusion of the debt of the TBVC countries and self-governing states, led to a further sharp increase in government debt (defined as the debt under the control of the Exchequer consisting of Treasury bills, marketable and non-marketable stock, foreign loans

Total government debt as percentage of gross domestic product

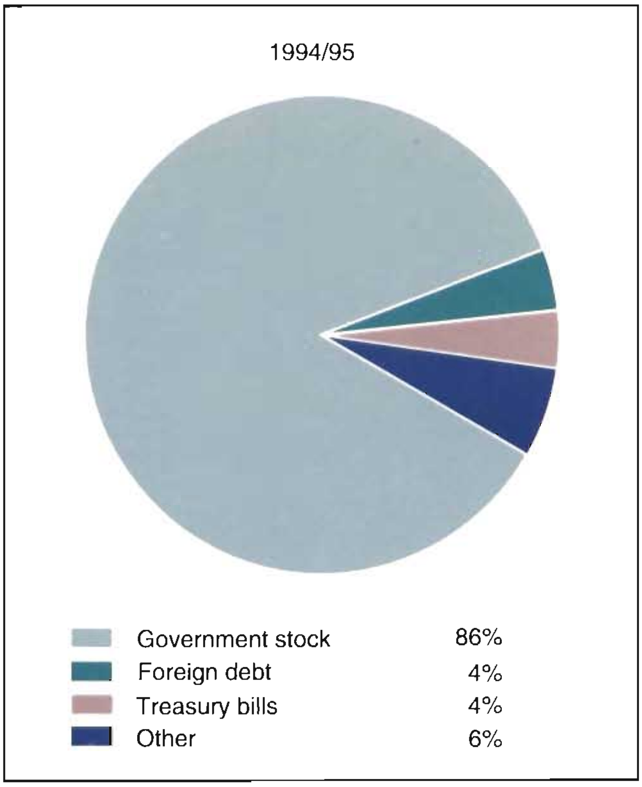


and credits, loan levies, the balance on the Gold and Foreign Exchange Contingency Reserve Account, and loans of the former TBVC countries and self-governing states) of R53,2 billion to R245,3 billion at the end of fiscal 1994/95. As a ratio of gross domestic product, government debt has increased sharply in recent years from a lower turning-point of 37,2 per cent at the end of fiscal 1990/91 to no less than 55,1 per cent at the end of fiscal 1994/95.

This sharp upward movement in government debt is clearly unsustainable. The unsustainability of the rise in South Africa's government debt is also clearly illustrated by the increase in the gap between real long-term yields on government stock and the growth rate in real gross domestic product, the high level of the Exchequer deficit before borrowing, the high tax burden and the high ratio of interest payments to total government expenditure. The South African government is aware of the importance of restricting the growth in government debt and is planning for a reduction in the annual financing requirement in the medium term. The proceeds of the privatisation of certain state assets may also be utilised to redeem outstanding government debt.

The *composition of total government debt* changed significantly in the 1990s. The share of government stock in total government debt increased from 78 per cent at the end of fiscal 1990/91 to 86 per cent at the end of fiscal 1994/95, while the share of Treasury bills receded from 8 to 4 per cent over the same period. The share of foreign debt also increased over this period, owing to a loan obtained from the International Monetary Fund in fiscal 1993/94 and the new stock issued in the global bond market during fiscal 1994/95.

Composition of total government debt as at the end of 1994/95



The Public Investment Commissioners, insurers and pension funds remained the dominant holders of government stock; their relative share of total domestic marketable stock, however, contracted from 72,2 per cent at the end of fiscal 1990/91 to 61,8 per cent at the end of fiscal 1994/95. Over the same period the holdings of registered government stock by monetary institutions increased from only R10,3 billion to R25,2 billion. This increase included the R7,5 billion strip coupon that was issued to the Reserve Bank in fiscal 1993/94 in partial redemption of the shortfall on the Gold and Foreign Exchange Contingency Reserve Account. Monetary institutions' share in the total of government stock outstanding nevertheless receded from 12,5 per cent in March 1991 to 12,0 per cent in March 1995. Non-residents held, directly and through nominee companies, 3,8 per cent of the total domestic stock of the government at the end of December 1994.

The recent two issues of government stock on the international capital markets led to a sharp increase in the *average maturity* of the total foreign marketable stock from 20 months at the end of fiscal 1989/90 to 42 months at the end of June 1995. Contrary to this development, the average maturity of domestic marketable stock declined from 130 to 114 months over the same period.

Exchequer account in the first quarter of fiscal 1995/96

Total *Exchequer issues* to government departments (after the usual adjustment to reflect cash flows) in the first quarter of fiscal 1995/96 were 19,8 per cent higher than in the corresponding quarter of the preceding fiscal year. This increase in Exchequer issues markedly exceeded the growth rate of 9,0 per cent in expenditure that had been envisaged in the Budget for the full fiscal year. As a proportion of total projected government expenditure for fiscal 1995/96, Exchequer issues came to 26,7 per cent in the first quarter; this is somewhat higher than the average ratio of 24,1 per cent in the first quarters of the preceding five fiscal years.

Exchequer receipts (excluding a transfer of R1,2 billion from the Central Energy Fund in April) in the first quarter of fiscal 1995/96 increased by 22,9 per cent compared with the corresponding quarter of fiscal 1994/95. This increase was markedly higher than the budgeted increase in government revenue of 10,3 per cent for the fiscal year as a whole.

The *deficit before borrowing and debt repayment* in the first quarter of fiscal 1995/96 amounted to R12,4 billion, or to about 10,6 per cent of gross domestic product. This deficit, together with the discount of R3,0 billion on new government stock issues, was financed as follows:

	R millions
Government stock (including discount on new issues)	13 444
Non-marketable securities	-31
Money market instruments	2
Foreign loans	1 301
Treasury bills	2 748
Extraordinary receipts	1 203
Changes in cash balance (increase -, decrease+)	-3 242
Less: discount on new government stock	2 979
Total financing	**12 446**