Annual Economic Report

1997

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-seventh ordinary general meeting to be held on 26 August 1997.

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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Introduction

The economic recovery which started in the second quarter of 1993 began to show signs of hesitation in the second half of 1995 and the slightly weaker growth tendency, which then became evident, lasted throughout 1996 and the first half of 1997. From the second half of 1996, declining real gross domestic expenditure strengthened the popular presumption that the recovery had lost some of its earlier vigour and that the economy had entered a downward phase of the business cycle.

Notwithstanding this evidence pointing to a slowdown in the economy, the level of real gross domestic product in the first half of 1997 was still approximately 2 per cent higher than in the first half of 1996. The overall growth rate slowed down slightly, but the economy was still expanding. A technical analysis of business cycle developments could find no conclusive evidence that the recovery had run its course and that the cycle had passed through an upper turning-point. In fact, the majority of indicators sensitive to business-cycle movements are still rising faster than their long-term trend growth. Output growth in the non-primary sectors also showed remarkable resilience in the second quarter of 1997.

Weaker growth in production in the first half of 1997 was predominantly confined to the primary sectors of the economy. Whereas robust growth in agricultural production buoyed overall economic activity in 1996, the return of agricultural output to volumes more attuned to the long-term growth trend of the agricultural sector had a generally contractionary effect on overall economic growth. Mining output was also lowered sharply during the past thirty months as gold-mining production declined to its lowest level in forty years. In contrast, the value added of the non-primary sectors was still expanding over the past eighteen months, albeit at somewhat less vigorous rates than during 1995.

The slowdown in general economic activity was confined more to a deceleration in aggregate domestic demand than in aggregate production. Total real spending in the domestic economy began to decline in the third quarter of 1996 and kept on declining until the first quarter of 1997, but then increased moderately in the second quarter. Growth in real private consumption expenditure and real gross domestic fixed investment tapered off in 1996 and the first half of 1997, while cutbacks were made to net inventory investment. In typical counter-cyclical fashion, real consumption expenditure by general government expanded in 1996 and the first half of 1997. This neutralised the potentially contractionary effects of slower growth in aggregate private-sector spending to some extent. The projection of government spending for the remainder of the current fiscal year nevertheless indicates that the growth in consumption expenditure by general government will not be maintained at the high levels of the past eighteen months. One of the key assumptions of the macroeconomic strategy for *Growth, Employment and Redistribution*, namely a gradual reduction of government consumption expenditure relative to gross domestic product, is therefore likely to be attained.

The upward thrust in spending by general government over the past eighteen months was also responsible for a further weakening of the domestic savings rate. The domestic savings rate fell short of the contemporaneous investment rate, as well as of the investment rate required for boosting output growth to a level that would effectively confront the problem of unemployment. One way of relaxing the constraint of inadequate domestic saving on long-term economic growth is to attract foreign saving by creating a more investor-friendly environment in South Africa. A stronger savings effort by the public sector is a key element in the process of bringing about such an investor-friendly environment.

Stronger output growth in the non-primary sectors of the economy in the second half of 1996 had a mildly positive influence on the overall level of formal-sector employment in the fourth quarter of 1996. Significantly, this increase came entirely from increased hiring by private-sector organisations. Unfortunately, this rise in employment was not strong enough to prevent the average level of employment in 1996 from falling below the average level of 1995, thereby aggravating the unemployment problem. Part of the solution to this problem undoubtedly lies in the present emphasis on human capital development through investment in training, education and health care. Of equal importance would be for economic growth to accelerate and for the wage determination process to account for productivity improvements and to be sensitive to changes in the underlying conditions of supply and demand in the labour market.

The labour policy framework of government was strengthened substantially over the past year. The Report of the Labour Market Commission was released, the Labour Relations Act promulgated, the Green Paper on Skills Development published and the draft Basic Conditions of Employment Bill made available for discussion. These will be followed later in the year by the Presidential Jobs Summit where the issues of employment creation and unemployment will be debated. Sustainable employment creation will ultimately be largely dependent on the inducement to invest in the South African economy and the resultant economic growth.

As a consequence of the consistent adherence to a counter-inflationary monetary policy, the rate of increase in the consumer and production price indices has declined to considerably lower levels since the early 1990s. Improved industrial relations in recent years and a slowdown in the growth of unit labour costs contributed to the process of adjustment to lower price inflation. The lower rate of inflation has, however, been reversed by mounting price-raising factors since April 1996, but these have been curtailed by various events in recent months. Among the factors pointing towards a continued slowdown in consumer price inflation are the relative strength of the rand from January 1997, lower international crude-oil prices, the general slowdown in aggregate domestic demand, lower worldwide inflation and ongoing tariff reductions which facilitate increased price competitiveness in the South African economy.

The decline of overall real domestic expenditure from the second half of 1996 coincided with a slowdown in the growth of the value and the volume of merchandise imports in the first half of 1997. The consequent improvement of the current account of the balance of payments was reinforced by the broadening and the diversification of the country's export base. Partly in response to the repeal of trade sanctions, but more importantly because of the increased competitiveness of South African manufacturers in world markets, export volumes have expanded and contributed materially to the narrowing of the deficit on the current account since 1995. Total export earnings have unfortunately been adversely affected by a decline in the price of gold since the beginning of 1997. Furthermore, the disparity between payments for services to the rest of the world and receipts for services rendered to non-residents has widened over the past eighteen months. This was a consequence of the strong inflows of capital through the bond and share markets and the reciprocal rise in interest and dividend payments to other countries.

The net inflow of capital, which faltered during 1996 and reverted to net outflows during certain quarters, regained considerable momentum later in the year as conditions in the foreign exchange market generally became more tranquil. Keen buying interest in the domestic bond and equity markets was shown by non-resident investors during the first half of 1997. To a significant degree, these portfolio investments formed the hedged counterpart of Eurorand bond issues, thereby assuming the character of longer-term capital which represents a more permanent investment in the economy. Government borrowing in the international capital markets and the restructuring of state assets, which allowed a consortium of non-resident companies to acquire an equity interest in Telkom, added to the strong inward movement of capital in the first half of 1997. Despite the inflow of foreign capital into the economy the foreign debt of South Africa relative to gross domestic product remained modest according to international standards.

A surplus in the overall balance of payments since the last quarter of 1996 has reversed the downward movement in the country's gold and other foreign exchange reserves. This created a more positive sentiment in the foreign exchange market and the rand generally firmed from the end of October 1996. A modest downward movement of the nominal effective exchange rate of the rand since mid-March 1997 nevertheless ensured that the real effective exchange rate of the rand remained well below the average level recorded in the corresponding period of the previous year. In this manner South African producers gained in price competitiveness in the international goods and services markets.

When international foreign exchange markets became increasingly volatile and the rand came under repeated speculative attacks in the course of 1996, the Reserve Bank occasionally stepped in and added liquidity to the market. These interventions were not intended to defend the exchange rate at any particular level; rather they were primarily aimed at creating conditions in which the exchange rate could adjust smoothly to a new equilibrium level. During the first half of 1997 Reserve Bank intervention went in the opposite direction: the Bank became a net buyer of foreign currency in the spot and forward markets. As a consequence, the net and gross gold and other foreign reserves increased while the net foreign-currency open position of the Reserve Bank was reduced by about a quarter from the end of December 1996 to the end of June 1997.

Monetary conditions during 1996 and the first half of 1997 were affected by the vacillating investor sentiment towards South Africa which resulted in ebbs and flows in international capital movements. Unlike 1995, when monetary policy had to be tightened in order to contain the inflationary potential of a strong inflow of capital, the Reserve Bank increased Bank rate on two occasions in 1996 by one percentage point at a time to counteract negative investor sentiment and resultant losses of net international reserves. A positive change in investor sentiment occurred late in 1996, restoring stability in the domestic foreign exchange market and increasing the official gold and other foreign reserves to a more comfortable level in the first half of 1997. Liquidity conditions in the money market also became much easier in the second quarter of 1997.

Notwithstanding the tightening of monetary policy in 1996, the expansion of money and bank credit aggregates remained buoyant during most of 1996 and early 1997. A clear abatement of the growth in M3 and in credit extension to the private sector in the fourth quarter of 1996 was relatively short-lived and the expansion of money and credit totals rebounded in the first quarter of 1997. The quarter-to-quarter growth of M3 slowed down again in the second quarter of 1997, but credit extended to the private sector proceeded to expand at a brisk rate, ostensibly unaffected by the relatively high levels of interest rates. The year-on-year growth in M3 nevertheless continued to exceed the upper limit of the guideline range for acceptable monetary growth which had been set between 6 and 10 per cent for the current guideline year.

The expansion of the narrower monetary aggregates was even stronger than that of M3 as the investor public in general and institutional investors in particular developed a preference for more liquid assets in relatively volatile financial and foreign exchange markets. The firm growth in the narrower aggregates was reinforced by the relatively attractive returns offered by banks on short-term deposits for the funding of their lending activities, the increased confidence in money as a store of wealth owing to the decline in inflation and the increased use of banking facilities by a growing portion of the population.

The accounting counterparts of the increase in M3 showed divergent movements between the foreign and domestic components during 1996. Whereas the net foreign assets of monetary institutions declined substantially in 1996 as a consequence of the turbulence in the foreign exchange market, net domestic credit extension to the private sector increased strongly. The growth in banks' claims on the private sector was slightly more concentrated in credit extended to households than in credit extension to the corporate sector. Within the household sector a sizeable portion of the increase in outstanding bank credit was in the form of mortgage advances. Net claims of the banks on the government sector contributed to the acceleration in monetary growth in the first quarter of 1997, but then subsided in the second quarter. Bank credit extension to the private sector increased at a quickening pace in the first two quarters of 1997.

The changes in the external value of the rand and the fluctuations in non-resident participation in the domestic securities markets also had a profound impact on trading in the bond, share and derivatives markets over the past eighteen months. Steps that were taken in recent years to improve the efficiency of trading systems in these markets facilitated unprecedented growth in non-resident participation in the South African bond and share markets. Net buying of domestic securities, especially in the first half of 1997, became highly popular when sentiment towards investment in the country turned positive as the rand strengthened and the credibility of financial policy seemed to be growing.

Developments in the foreign exchange market and the rise in inflation during 1996 also left their mark on the level and the structure of interest rates. Long-term bond yields rose sharply from halfway through the first quarter of 1996 to the end of the second quarter, but then fluctuated in a narrow range from July. A relatively short upward movement in yields occurred in the last two months of 1996, but yields then generally moved downwards over the first six months of 1997.

Conditions in the money market reflected the shortfall in the availability of liquidity throughout 1996 and the first half of 1997. The amount of accommodation that the Reserve Bank provided to banks, on balance, rose from the first quarter of 1996 to the first quarter of 1997, leading to an increased use of second-tier accommodation in the last quarter of 1996, which then subsided in the first quarter of 1997. A broadly similar movement to that of the yields on long-term government bonds was displayed by interest rates in the money market, which rose from January to May 1996, but declined during the third quarter of the year before rising firmly towards the year-end. They then subsided over the first half of 1997 as liquidity in the money market improved and market expectations that Bank rate might soon be lowered grew stronger. On the whole, short-term interest rates displayed somewhat less flexibility than long-term rates, leading to a steepening of the downward gradient of the yield curve. These indicators could, among others, indicate the advent of a slowdown in domestic economic activity.

The price index of all classes of shares also showed limited upward or downward movement from February to October 1996, but then fell sharply towards December. With investor sentiment turning positive early in 1997, the market steadied at first, but later increased more forcefully; the all-share price index therefore reached a new all-time high in June. The prices of gold-mining shares, however, declined almost persistently from May 1996 to June 1997.

The national government's fiscal policy stance has become considerably more disciplined since fiscal 1993/94. The deficit before borrowing and debt repayment on the accounts of the national government, relative to gross domestic product, has been lowered consistently and is budgeted to decline even further in fiscal 1997/98. Equally significant is that the primary surplus on the accounts of the national government (i.e. the excess of current revenue over expenditure without interest payments) was budgeted to increase further in the current fiscal year. The healthier state of public finances is also reflected in a budgeted decline in the ratio of total government debt to gross domestic product in fiscal 1997/98. Earlier concerns about the possible explosive growth of this ratio had obviously been unfounded. Government is also succeeding in reprioritising expenditure objectives in order to meet the most urgent basic needs of society without having to resort to imprudent increases in overall public expenditures. The strong commitment demonstrated by the government to adhere as closely as possible to the guiding principles of sound public finance has contributed to the strengthening of investor confidence and the increased net inflows of capital from abroad since the fourth quarter of 1996.

Domestic economic developments

Gross domestic production

Following the prolonged contraction in output volumes from 1989 to 1993, aggregate real gross domestic product has now completed four years of expansion. Growth initially accelerated from 1½ per cent in 1993 to 2½ per cent in 1994 and 3½ per cent in 1995, but then slowed down to 3 per cent in 1996. A mild contraction at an annualised rate of 1 per cent followed in the first quarter of 1997, but growth turned positive again at an annualised rate of approximately 2½ per cent in the subsequent quarter. Annualised growth nonetheless fell from 3½ per cent in the second half of 1996 to 1 per cent in the first half of 1997. Despite the slowdown in growth, the overall level of real gross domestic product in the first half of 1997 was still slightly more than 2 per cent higher compared with the first half of 1996.

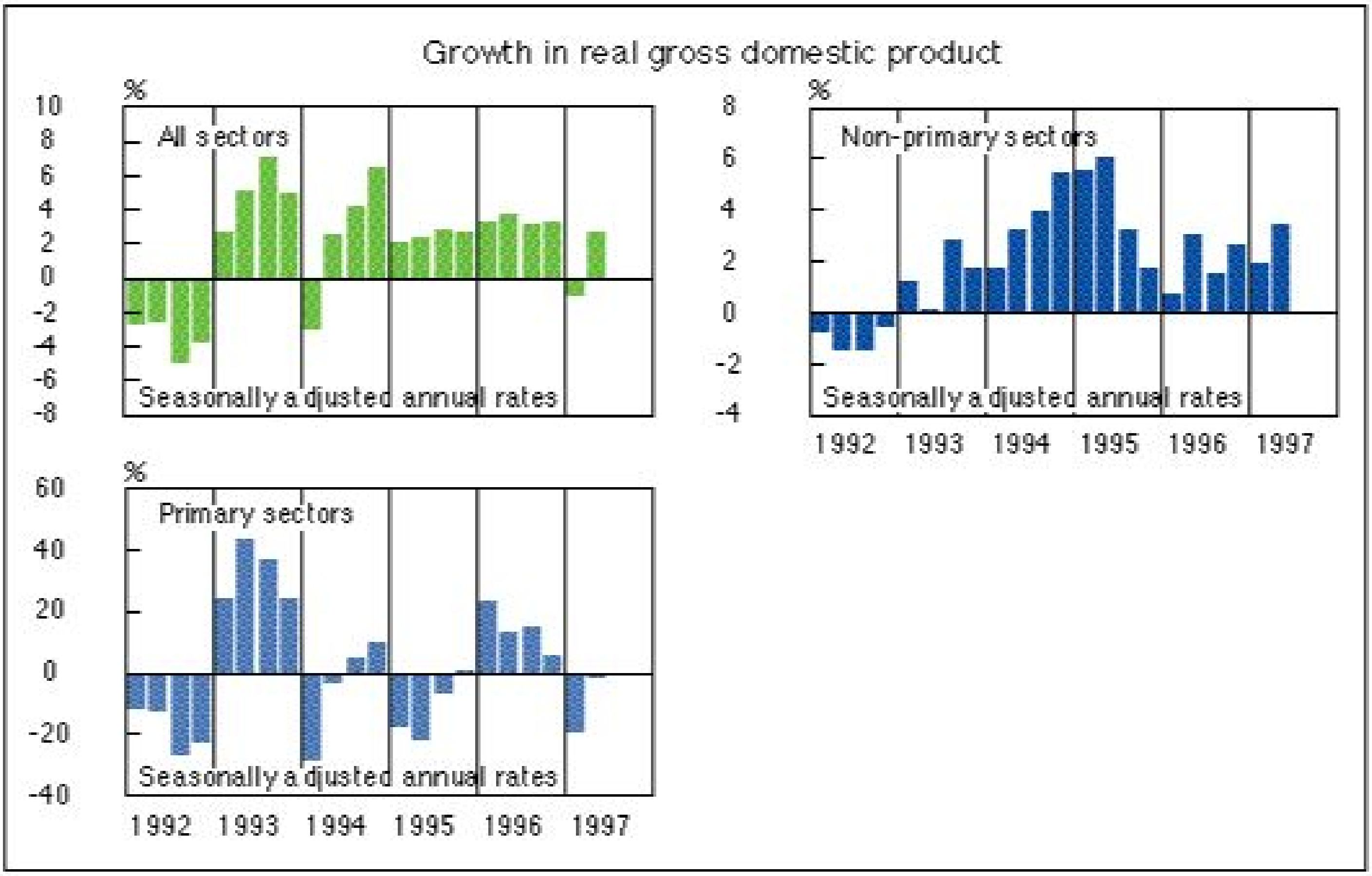


Table 1. Real gross domestic product

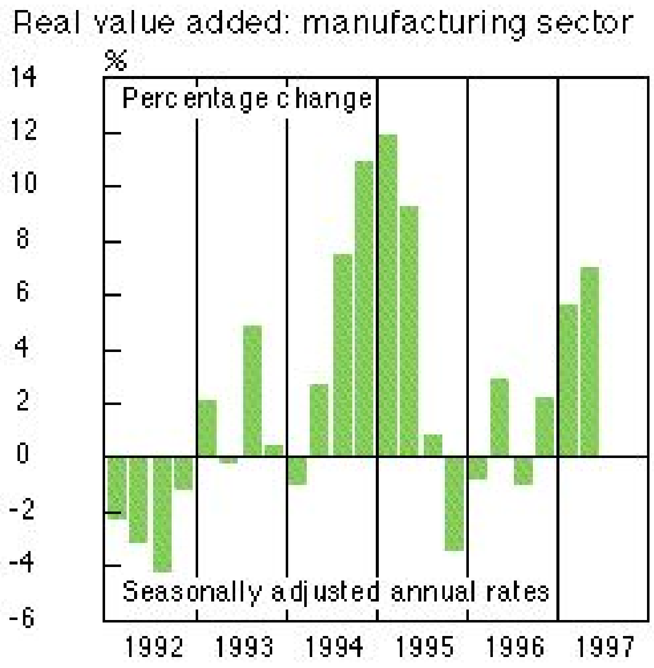
Percentage change at seasonally adjusted and annualised rates

Sectors	1995			1996			1997
	1st half	**2nd half**	**Year**	**1st half**	**2nd half**	**Year**	**1st half**
Primary sectors	-12	-8½	-7½	14½	12	8	-9
Agricultural	-22	-25	-15	51½	44½	26	-21
Gold mining	-19	-3	-10½	-6½	-5	-5½	½
Non-gold mining	8½	5	4½	4	-4½	2	½
Non-primary sectors	5½	3½	4½	1½	2	2	2½
Secondary sectors	9	2	6½	½	1½	1	4½
Manufacturing	11	2	7½	-½	1	½	5
Electricity, gas and water	4	3½	3½	5½	5½	5	5
Construction	2	2	1½	2	1	2	1½
Tertiary sectors	3½	4½	3½	2	2½	3	1
Commerce	6	8½	6½	2	2	3½	0
Transportation and communication	6½	6	5	2	2½	3	2
Financial services	3	3½	3½	3	3½	3½	2½
Total	**3½**	**2½**	**3½**	**3**	**3½**	**3**	**1**

The main source of growth in 1996 was the recovery in *agricultural production*. Real value added in this sector, which had contracted by 15 per cent in 1995, rebounded by 26 per cent in 1996 when exceptionally favourable climatic conditions were experienced. The inherent volatility of agricultural production manifested itself again in the first half of 1997 when production levels normalised somewhat and the real value added by the agricultural sector declined at an annualised rate of about 21 per cent.

The real *value added by gold mines* fell by 5½ per cent in 1996 as gold output reached its lowest level in forty years and increased only fractionally by ½ per cent, seasonally adjusted and annualised, in the first half of 1997. The contribution of gold mining to the gross domestic product at factor cost declined to only 2½ per cent in the first half of 1997 compared with an average share of 8½ per cent in the period 1960 to 1990. The mining of ore with a lower gold content and the declining quantities of gold-bearing ore brought to the surface were the main reasons for the continued decline in real value added by the gold-mining sector.

Real output in the *non-gold mining sector* expanded by about 2 per cent in 1996, largely on account of relatively strong world demand for minerals and coal, less adversarial industrial relations and increased labour productivity. During the second half of 1996 a number of factors began to impact adversely on mining production: international commodity prices weakened, industrial relations became more strained and the marketing of diamonds outside the conventional distribution channels resulted in a reduction in South Africa's diamond production. On the positive side, the commercial extraction of crude oil off the South Cape coast commenced in the second quarter of 1997. This resulted in the real value added by the non-gold mining sector to increase by about ½ per cent between the second half of 1996 and the first half of 1997.



Unlike the high degree of volatility in agricultural production volumes and the generally steady decline in mining output, the *real value added in the non-primary sectors* has consistently recorded growth from quarter to quarter since the beginning of 1993. The year-to-year growth in the real value added by these sectors accelerated from ½ per cent in 1993 to 2½ per cent in 1994 and 4½ per cent in 1995. Growth in the non-primary sectors then slowed down to a year-to-year rate of 2 per cent in 1996, but accelerated slightly to a seasonally adjusted and annualised rate of 2½ per cent in the first half of 1997.

Real output in the *manufacturing sector* grew by only ½ per cent in 1996 compared with 7½ per cent in 1995 owing partly to slowdowns in private household expenditures and cutbacks in inventory accumulation. This deceleration in the pace of manufacturing production stopped towards the end of 1996 and annualised growth at a rate of 5 per cent was registered in the first half of 1997. An important reason for this recovery of manufacturing production was the strong demand for exports of manufactured goods, which had been prompted by the increased price competitiveness of South African manufacturers following the depreciation of the rand from February to October 1996. Manufacturing output was bolstered further by strong income growth in emerging economies, continued increases in investment demand in the domestic economy and a decline in the number of workdays lost on account of labour disruptions during the first half of 1997.

The real value added by the sector supplying *electricity, gas and water* rose at a year-to-year rate of 5 per cent in 1996 and at a seasonally adjusted and annualised rate of 5 per cent in the first half of 1997. The supply of electricity to predominantly underdeveloped areas that were not previously serviced by Eskom played a part in the expansion of output in this sector. The growth in electricity supply also came from strong electricity demand in neighbouring countries, sustained relatively high levels of aggregate demand in the domestic economy and the commissioning of electricity-intensive plants for the beneficiation of metals and minerals.

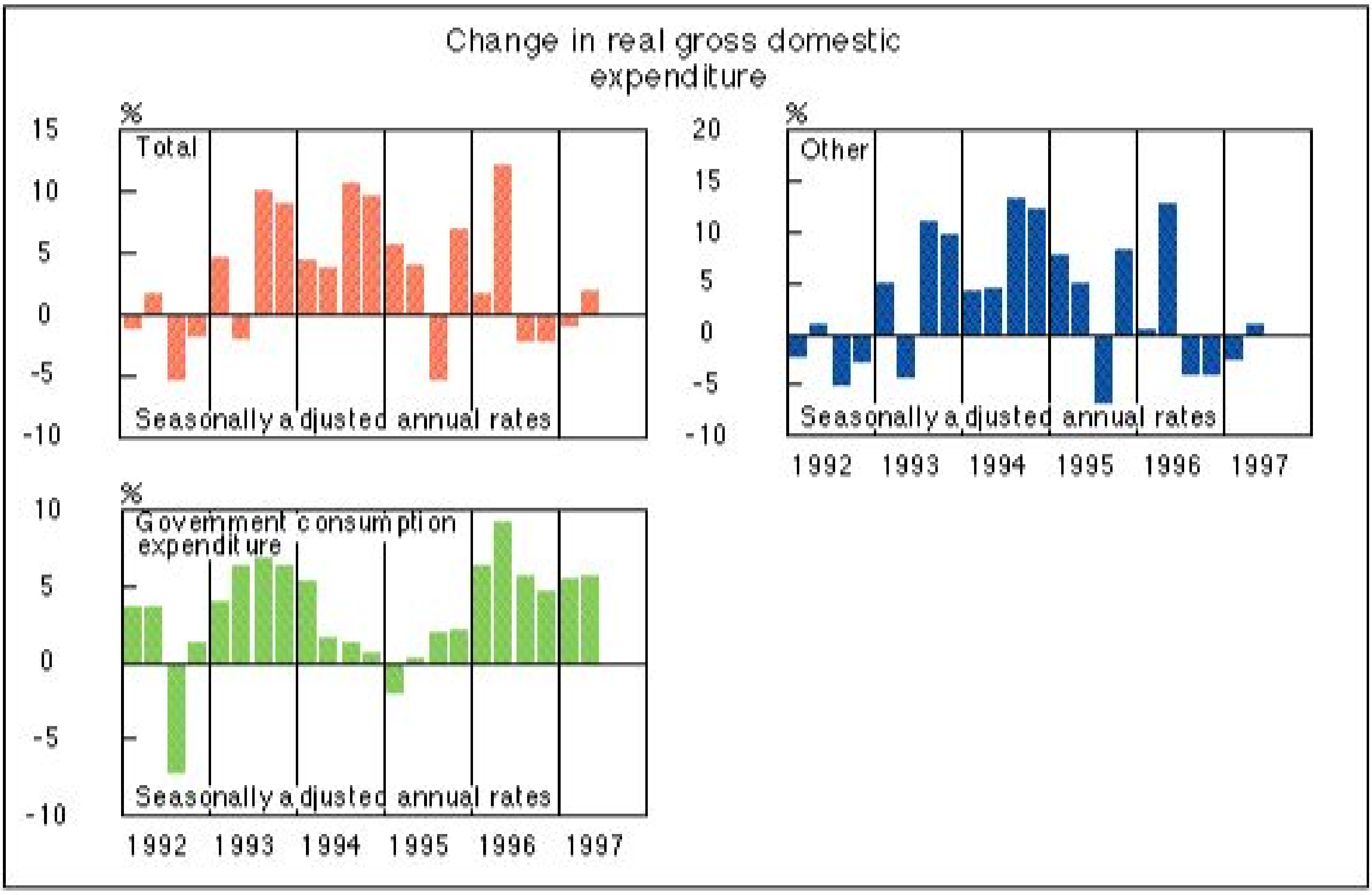
In the *construction industry* the real value added increased by about 2 per cent in 1996 and at a seasonally adjusted and annualised rate of 1½ per cent in the first half of 1997. Building and civil construction works generally benefited from a slight improvement in the real investment demand for new buildings, as well as from additions and alterations to existing buildings and construction works. Moderate future support for growth in the construction sector is expected to come from accelerated development of economic, social and household infrastructure, which forms part of government's overall development initiatives.

The real value added by the *tertiary sectors* increased by 3 per cent in 1996, but then slowed down to an average annualised growth rate of 1 per cent in the first half of 1997. The recent slowdown in the growth of these sectors was the net result of barely positive growth in the real value added by the commercial sector and slower increases in the real value added by the transport, storage and communication and the financial services sectors. Declining production in the primary sectors of the economy and the slackness of aggregate domestic demand were primarily responsible for the current growth pause in the services sectors.

Real gross national product increased at an average annualised rate of 3½ per cent between 1993 and 1996. It then remained approximately unchanged in the first half of 1997, essentially because of increased net factor payments to the rest of the world and a deterioration in the terms of trade largely counteracted the increase in the real gross domestic product. The recent slowdown of growth notwithstanding, real gross national product *per capita* in the first half of 1997 was still about 3½ per cent higher than in 1993.

Gross domestic expenditure

Aggregate real gross domestic expenditure increased by 6½ per cent in 1994 and by 5 per cent in 1995, but then slowed to 3 per cent in 1996 - a rate that is closer aligned with the current potential growth rate of aggregate output in the South African economy. In reality, quarter-to-quarter growth in total real gross domestic expenditure turned negative in the third quarter of 1996 and kept on declining until the first quarter of 1997. A modest recovery then followed in the second quarter of 1997; this notwithstanding real gross domestic expenditure still declined at a seasonally adjusted and annualised rate of about ½ per cent in the first half of 1997.



The recent slowdown in aggregate domestic spending came from slower growth in current spending among private households, somewhat weaker - but still generally firm - growth in gross domestic fixed capital outlays and sizeable cutbacks in inventory investment. The effect of these slowdowns was partly counteracted by a rapid acceleration in consumption expenditure by general government. All things considered, the recent decline in aggregate-spending growth, coupled with a small reduction in the still positive output growth, helped to improve the overall expenditure-income balance, thereby reducing the inflation potential of the South African economy.

Table 2. Real gross domestic expenditure

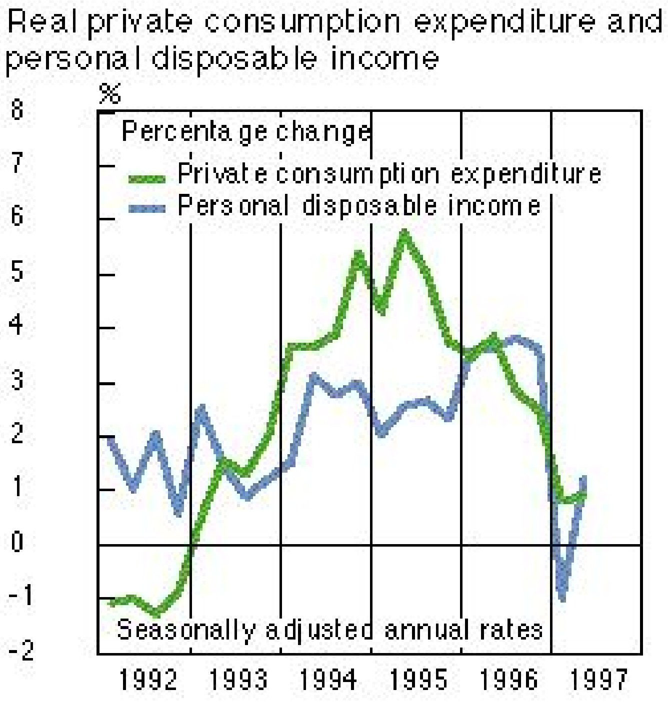
Percentage change at seasonally adjusted and annualised rates

Components of gross domestic expenditure	**1995**			**1996**			**1997**
	1st half	**2nd half**	**Year**	**1st half**	**2nd half**	**Year**	**1st half**

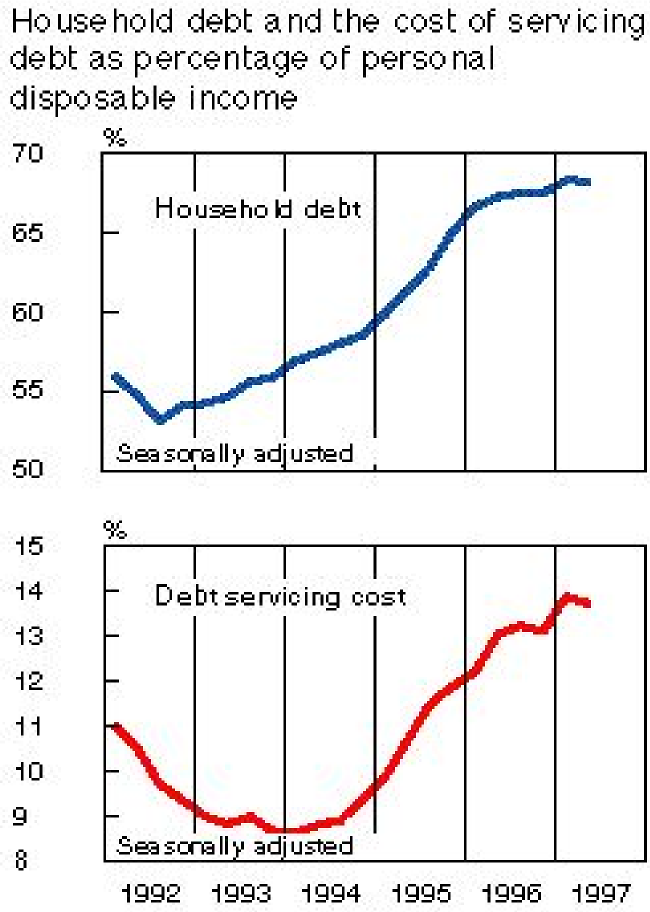
Private consumption expenditure	5	5	4½	3½	3	4	1½
Government consumption expenditure	-½	1½	½	6	6½	5	5½
Gross domestic fixed investment.	9½	8½	10½	7	4½	7	2½
Inventory investment (R billions)*	9,1	3,5	6,3	4,0	1,6	2,8	-2,0
Gross domestic expenditure	**6**	**0**	**5**	**5½**	**1½**	**3**	**-½**
* 1990 prices, annualised							

Private consumption expenditure

Real outlays on *aggregate private consumption* rose at year-to-year rates of 4½ per cent in 1995 and 4 per cent in 1996, but then slowed down to an annualised growth rate of only 1½ per cent in the first half of 1997, recording a level that was about 2 per cent higher than in the first half of 1996. The slowdown in the growth of real private consumption expenditure was evident in all the main categories of this spending aggregate and was most likely caused by slower growth in real personal disposable income from the beginning of 1997, concerns about future employment security and the high level of household debt and debt servicing costs in relation to personal disposable income.



From the beginning of the economic recovery in 1993, household incomes grew more slowly than the expansion in household consumption expenditure. Households therefore resorted increasingly to debt financing to support their increasing average propensity to consume. The ratio of total household debt to personal disposable income accordingly rose rapidly from the middle of 1993. Despite tentative indications that the growth in household debt might be slowing down, the debt-to-income ratio of households continued to rise in the first half of 1997 to an approximate level of 68½ per cent at the end of June.



The strong preference of households for debt financing can be explained by a variety of macro- and socioeconomic factors, which include:

- higher income and wealth, greater security of income and the consequent increase in consumer confidence among new entrants to the labour market, which in recent years have stimulated the overall ability and willingness of households to spend and borrow;
- the mass marketing of credit to individuals who have not been bank customers before;
- the increase in credit cards issued by banks and certain retail stores; and
- the availability of easily accessible mortgage facilities which allowed for the financing of recurrent household spending against the surety of real estate.

Because the rise in the debt-to-income ratio of households coexisted with relatively high levels of nominal interest rates, it is becoming an increasingly restrictive factor for sustainable growth in household spending. The combination of these two forces resulted in private households having to earmark approximately 14 per cent of disposable income in the first half of 1997 for the payment of interest on household debt. A growing portion of household income is therefore not available for spending on goods and services or for saving. Higher interest rates, of course, also increased the net income of some households through higher interest receipts and may conceivably have increased household spending. However, the overall effect of high interest rates is widely perceived to be negative for consumption expenditure because net savers are likely to increase their current expenditure more slowly than debt-strapped households will decrease theirs.

Consumption expenditure by general government

The rise in real consumption expenditure by general government accelerated from a year-to-year rate of ½ per cent in 1995 to 5 per cent in 1996, and then proceeded at an even higher seasonally adjusted and annualised rate of 5½ per cent in the first half of 1997. The growth acceleration in the first half of 1997 brought aggregate real consumption expenditure by general government to a level that was about 6 per cent higher than in the first half of 1996. For fiscal 1996/97, the growth in real government consumption expenditure was a high 6 per cent.

The strong growth in consumption expenditure by general government over the past eighteen months shifted the ratio between this expenditure category and gross domestic product to 21½ per cent in the first half of 1997, well in excess of the average ratio of 15 per cent calculated for the period 1960 to 1996. In the macroeconomic strategy for *Growth, Employment and Redistribution* (the GEAR strategy) the desired ratio for 1997 was indicated as 19,5 per cent and 18,1 per cent was projected for the year 2000.

The strong expansion of consumption expenditure by general government came mainly from increased real outlays on intermediate goods and services, apart from labour services, which reflected social service delivery on a more generous scale than before. Contrary to this, the growth in employee remuneration slowed down owing to somewhat smaller salary increases and the early retirement of numerous senior government officials.

Gross domestic fixed investment

Aggregate real gross domestic fixed investment increased by 10½ per cent in 1995 and 7 per cent in 1996, but growth in this spending aggregate then declined to a seasonally adjusted and annualised rate of 2½ per cent in the first half of 1997.

The growth in real gross domestic fixed investment in the *private sector* accelerated to 13 per cent in 1994 and 1995 and then declined to a still relatively high rate of 6½ per cent in 1996. From the beginning of 1997 the growth in private-sector fixed investment continued at a somewhat more sedate annualised rate of 3½ per cent. In the agricultural sector, where fixed investment responded strongly to unprecedented high output levels in 1996, real fixed investment spending declined to levels that could be expected during a normal growing season. Fixed capital formation by private manufacturing concerns also slowed down in 1997, essentially because of the completion of some of the megaprojects and the decline in the utilisation of production capacity in 1996.

The creation of new production capacity by private manufacturing concerns is expected to continue in the near term as government's Manufacturing Development Programme gains ground. Among the supply-side measures introduced as part of this Programme with the specific objective of promoting industrial investment are:

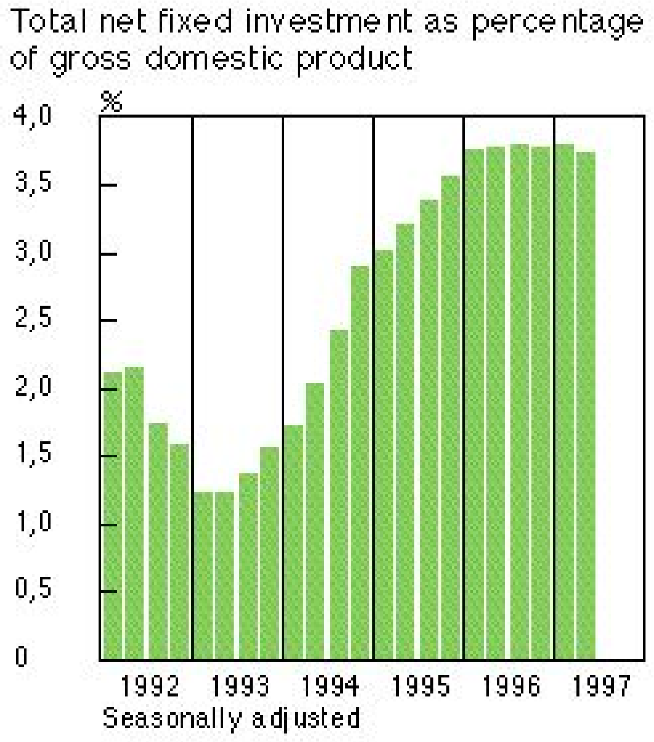
- an accelerated depreciation allowance for the expansion or establishment of small, medium and large enterprises;
- a programme for the development of new small and medium-sized enterprises in manufacturing with assets of R3 million or less; and
- a tax holiday of up to 6 years for new enterprises with assets in excess of R3 million.

Private-sector real fixed investment also remained fairly robust in other areas of the business sector, notably in the wholesale, retail, catering and accommodation sectors, where new outlets were established and additional capacity created to accommodate a steady increase in foreign tourists visiting the country.

Real fixed investment by *public authorities* increased by 4½ per cent in the calendar year 1996 and then continued to grow at an annualised rate of about 4 per cent in the first half of 1997. All three tiers of government contributed to the continued growth in investment spending, which was primarily dedicated to infrastructural development. The current, rather mild, upward trend in fixed investment by the public authorities is likely to be strengthened within the next fiscal year by the creation of adequate and efficient infrastructural facilities for industrial and regional development and for addressing backlogs in social service delivery.

Real fixed investment spending by *public corporations* increased by 10 per cent in 1996, but then declined at a seasonally adjusted and annualised rate of 2½ per cent in the first half of 1997. The recent decline notwithstanding, fixed capital outlays by these corporations remained at a high level, reflecting the efforts made by the parastatal utilities Eskom and Telkom to extend their services to less-developed regions that were previously not included in their services networks.

The growth in aggregate gross domestic fixed investment since 1993 succeeded in reversing the decline in the ratio of net domestic investment to gross domestic product, which had been evident since 1989. Total real net fixed investment, as a percentage of gross domestic product, increased from 1 per cent at the beginning of 1993 to almost 4 per cent in the first half of 1997. Notwithstanding this increase, domestic fixed investment is still regarded as too low in light of South Africa's development needs. Gross domestic fixed investment constituted about 17 per cent of gross domestic product in the first half of 1997, compared with a ratio of about 25 per cent which was indicated by research findings as the ratio necessary to ensure the absorption of the entire increment of the economically active population into gainful employment and to gradually reduce unemployment over time.



Inventory investment

Aggregate inventory investment at constant prices amounted to R6,3 billion in 1995, R2,8 billion in 1996, but then declined at an annualised value of R2,0 billion in the first half of 1997. Because these net changes in inventory levels became progressively smaller and later turned negative, the contributions to growth in aggregate real gross domestic product made by inventory investment declined from ½ percentage point in 1995 to *negative* contributions of 1 percentage point in 1996 and 2½ percentage points in the first half of 1997.

The decline in net inventory investment from the beginning of 1997 was the result of a sharp decline in strategic oil reserves, the reduction of inventory levels in the agricultural, mining and manufacturing sectors and slower inventory accumulation in the trade and services sectors. Despite the decline in inventory investment, the ratio of non-agricultural inventories to the non-agricultural gross domestic product was still relatively high at an average level of about 23 per cent in the first half of 1997 - compared with a level of 20½ per cent in 1993. Likewise, the ratio of commercial and industrial inventories also maintained an average level of 18 per cent in the first half of 1997 compared with a ratio of 16 per cent in 1993.

The slower pace of inventory accumulation in 1996 and 1997 can be attributed to a number of factors. The relatively high level of inflation-adjusted interest rates undoubtedly raised the cost of carrying inventories and thereby provided an incentive for manufacturers and distributors to economise on inventory holdings. The decline in the real exchange value of the rand and the attendant increase in the prices of imported goods simultaneously brought with it the need to manage inventory levels more carefully and more closely in accordance with changing orders. Furthermore, expectations of a slowdown in final demand inhibited inventory accumulation. However, because of the relative mildness of the slack in aggregate final demand, inventory levels appeared to be somewhat higher than what would have been the case during a downturn in the business cycle.

Factor income

The increase in aggregate *nominal factor income* at current market prices slowed down marginally from 12½ per cent in 1995 to 12 per cent in 1996, but then declined more meaningfully to a year-on-year rate of 10 per cent in the first half of 1997. This slower increase in factor income in 1997 was essentially the result of lower growth in the aggregate remuneration of employees and the gross operating surpluses of business enterprises.

The year-on-year rate of increase in the *total remuneration of employees* moderated from 10½ per cent in 1996 to 10 per cent in the first half of 1997. This moderation was apparent in all the main sectors of the economy, but was somewhat more obvious in the sector transport, storage and communication and in the financial services sectors. Fierce competition in an increasingly globalised environment compelled financial institutions to become more cost conscious and to rationalise their staff complements.

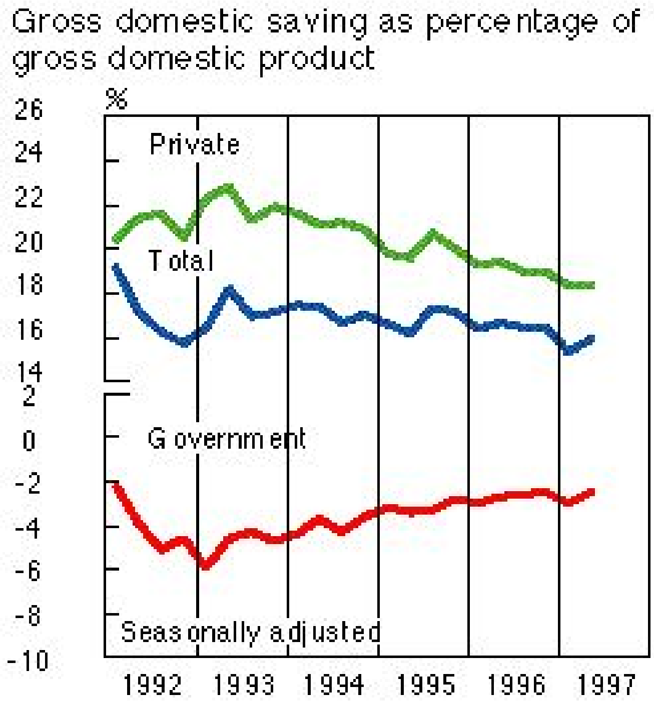
The growth in *aggregate operating surpluses* fell from 15 per cent in 1996 to 9½ per cent in the first half of 1997. The generally weaker growth of total gross operating surpluses from the beginning of 1997 was particularly pronounced in the primary sectors. The gross income of farmers, which had increased sharply in 1996, declined in the first half of 1997 owing to declines in production and unseasonal rain in the second quarter, which hampered the harvesting of summer crops. Profitability in the gold-mining sector was badly affected by the fall in the gold price, the strong rand and the decline in gold output. The growth in the operating surpluses of the non-primary sectors also slowed down in the first half of 1997. Although discernible in all the major sectors of non-primary economic activity, the slowdown in the growth of operating surpluses was particularly prominent in the commercial sector, reflecting the slowdowns in the volume of retail sales and motor car sales.

Domestic saving

The national savings rate, as measured by the ratio of gross domestic saving to gross domestic product, deteriorated consistently from 17 per cent in 1995 to 16½ per cent in 1996 and 15½ per cent in the first half of 1997. The quantum of saving in the first two quarters of 1997 also fell well short of total gross investment in the economy; 6 per cent of total gross domestic investment accordingly had to be financed through an inflow of foreign capital into the economy.

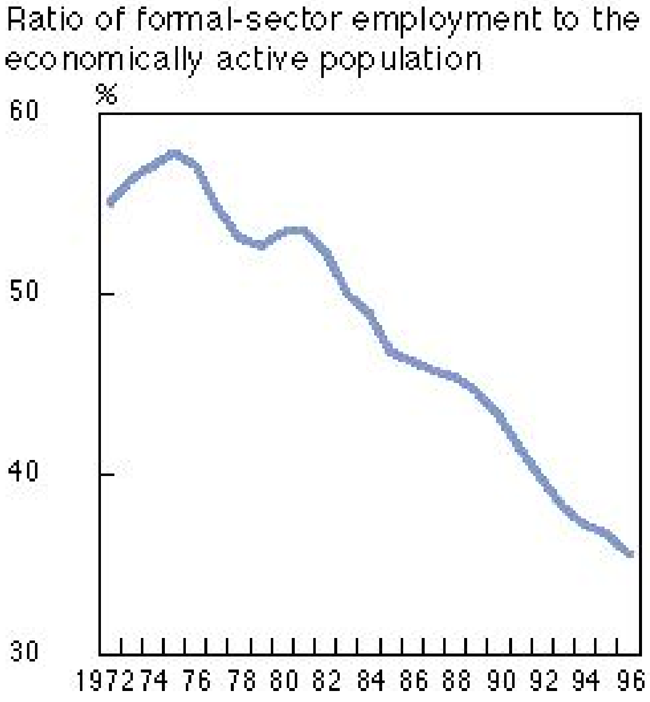
The deterioration in the savings rate from the middle of 1996 was primarily due to an increase in the *dissaving by general government*, although the savings ratio of the private sector also declined moderately. Net *dissaving* by general government, as a percentage of gross domestic product, increased from 3½ per cent in 1996 to 4 per cent in the first half of 1997. The rapid acceleration of recurrent expenditure by general government, which rose much faster than current revenue of government, was by far the most important cause for the weakening of the government's saving contribution to total saving. It should be noted that a reduction in government dissaving, or an increase in government saving, is generally seen as the surest way to improve the savings performance of an economy.

Private-sector net saving as a percentage of gross domestic product declined from 7 per cent in 1996 to 6 per cent in the first half of 1997. In the corporate sector, the savings performance weakened somewhat as operating surpluses grew more slowly than in the past and the incentive to retain surpluses in the corporations was weakened owing to the lowering of the Secondary Tax on Companies. *Household savings* relative to gross domestic product remained virtually unchanged from 1996 to the first half of 1997. From 1993 to 1996 and the first half of 1997 net saving by households, as a percentage of personal disposable income, fell from 5 per cent to 1½ per cent.



Employment

The rising levels of real output since 1993 have not been accompanied by sustained increases in *total employment in the formal non-agricultural sectors* of the economy. In fact, total formal-sector employment outside the agricultural sector increased only once during the past seven years when the average level of employment rose marginally by 0,7 per cent in 1995. The extent of the change in employment during the 1990s was such that the average level of employment in the formal non-agricultural sectors fell by 6,9 per cent between 1989 and 1996, indicating a loss of about 392 000 formal-sector job opportunities. As a percentage of the total economically active population, formal-sector non-agricultural employment declined from 45 per cent in 1989 to 36 per cent in 1996.



In the fourth quarter of 1996, the seasonally adjusted level of total formal-sector employment outside agriculture increased at an annualised rate of 0,4 per cent, or by about 4 000 positions. This was the first quarter-to-quarter increase in employment since the fourth quarter of 1995. This increase notwithstanding, the average level of total employment still declined at a year-to-year rate of 1,1 per cent in 1996.

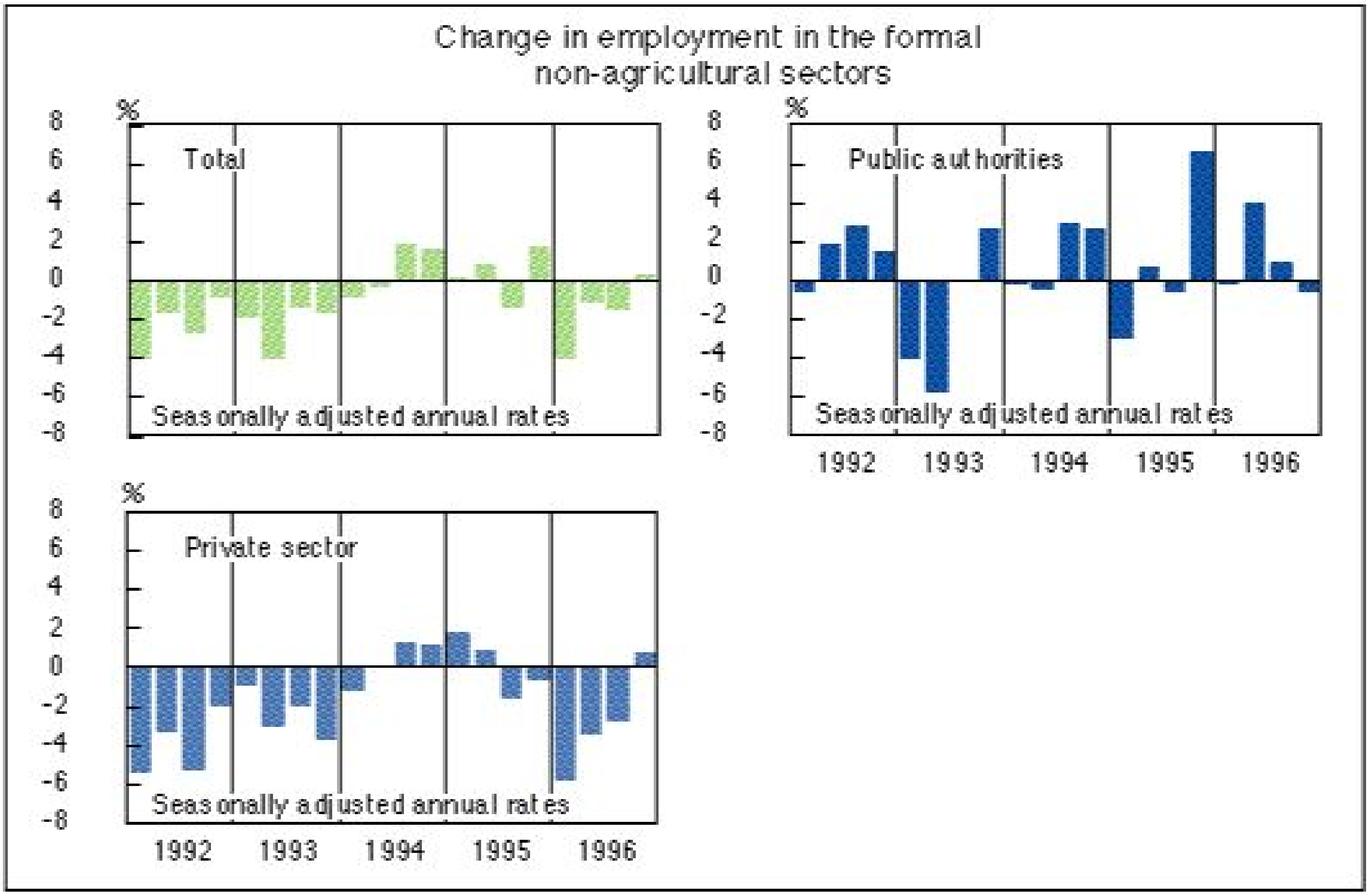
Employment in the non-agricultural *private* sector of the economy, which accounted for about 70 per cent of total employment in the non-agricultural sectors in 1989, declined to 65 per cent of total employment in 1996, primarily on account of the loss of jobs in the mining, construction and manufacturing sectors. Employment losses in these three sectors were responsible for 93 per cent of all employment losses over the period 1989 to 1996. The largest number of job losses occurred in the mining sector, principally because of the relative weakness of the gold price, the closure of certain mines, constantly rising production costs and the lack of buoyancy in most international commodity prices.

In contrast to the decrease in the relative contribution of private-sector employment to total non-agricultural employment, the *public secto*r absorbed an additional 110 000 employees at an average annualised growth rate of 1,0 per cent over the period 1989 to 1996. In 1996 the average level of public-sector employment increased at a year-to-year rate of 2,0 per cent, which was more than the average yearly growth of 1,4 per cent from 1996 to the year 2000 envisaged by the GEAR strategy.

Table 3. Change in formal non-agricultural employment from 1989 to 1996

Sector	Change in number of people employed	Percentage change
Mining	-233 576	-29,3
Manufacturing	-144 793	-9,2
Electricity	-12 615	-24,0
Construction	-90 532	-21,7
Trade	-38 925	-5,1
Finance	34 604	19,2
Public authorities	110 093	6,4

Unemployment, according to the 1995 October Household Survey, was equal to 29,3 per cent of the economically active population, while the rate of unemployment for unskilled people was estimated at 34 per cent. Among those who had successfully completed at least twelve years of schooling the unemployment ratio was much lower at 18 per cent. This difference between unemployment among unskilled and skilled workers suggests that part of the solution for the phenomenon of unemployment lies in the current emphasis that is placed on education and training.



Several developments during the past year had an influence on the labour market and has changed, or may in future change, the capacity of the economy to create employment in sufficient numbers to reduce unemployment. The most important among these are:

- the Labour Market Commission's Report published in June 1996, which recognised the need for reforms in the labour market in order to promote wage flexibility and thus enhance the labour-absorption capacity of the economy;
- the GEAR strategy which stated specific targets for employment growth, while acknowledging that wage moderation in the context of a national social agreement will contribute towards growth, job creation and social benefits for workers;
- the new Labour Relations Act enacted on 11 November 1996, which laid down new rules of conduct for labour market participants;
- the publication in March 1997 of the Green Paper on skills development, which proposed, *inter alia*, the introduction of a training levy to be paid by all employers;
- the publication of the draft Basic Conditions of Employment Bill in April 1997, the objective of which is to advance economic development and social justice by establishing and enforcing minimum conditions of employment; and
- ongoing trade liberalisation and tariff reduction, which are creating opportunities and challenges for all participants in the economic process.

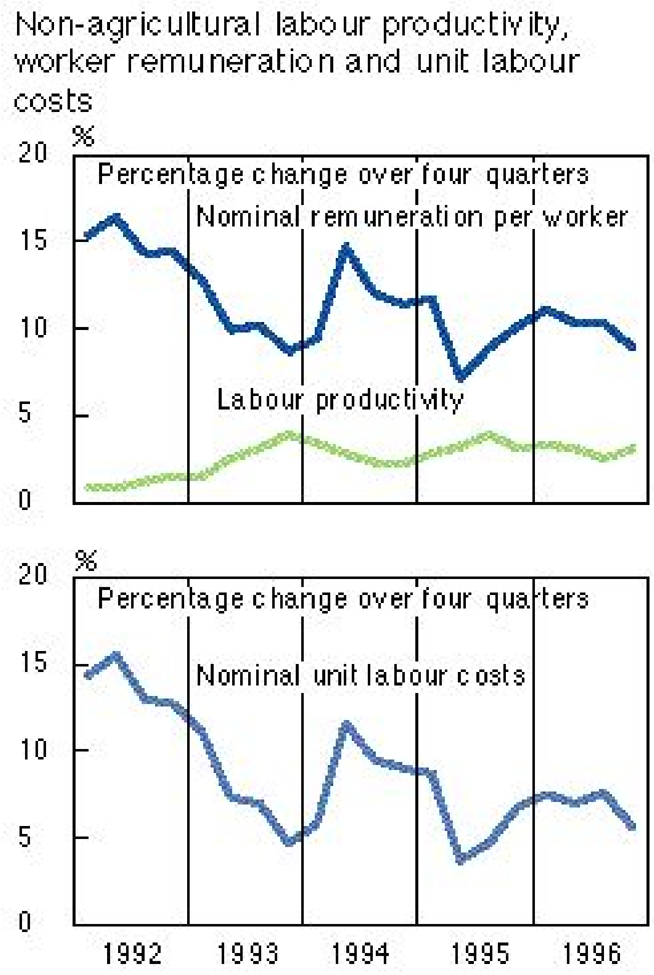
In addition to the strengthening of the government's policy framework, the causes of slow employment growth and rising unemployment will be discussed further at a Presidential Jobs Summit as proposed in the 1996 Report of the Labour Market Commission. The summit is scheduled for October 1997 and will focus on "jobless growth" and the design of additional strategies in terms of which the labour absorption capacity of the economy is likely to be strengthened.

Labour costs and productivity

The year-to-year rate of increase in *nominal* remuneration per worker in the total non-agricultural sectors of the economy decelerated, on balance, from 18,2 per cent in 1989 to 11,9 per cent in 1994 and 9,4 per cent in 1995, before accelerating to 10,2 per cent in 1996. The lower rates of increase in the average nominal remuneration per worker have been a delayed response to declining consumer price inflation which, in turn, resulted from the consistent application of counter-inflation monetary policies since the late 1980s. The long time delay in the response of employee remuneration to the tightening of monetary conditions was essentially a consequence of the inertia of inflation expectations.

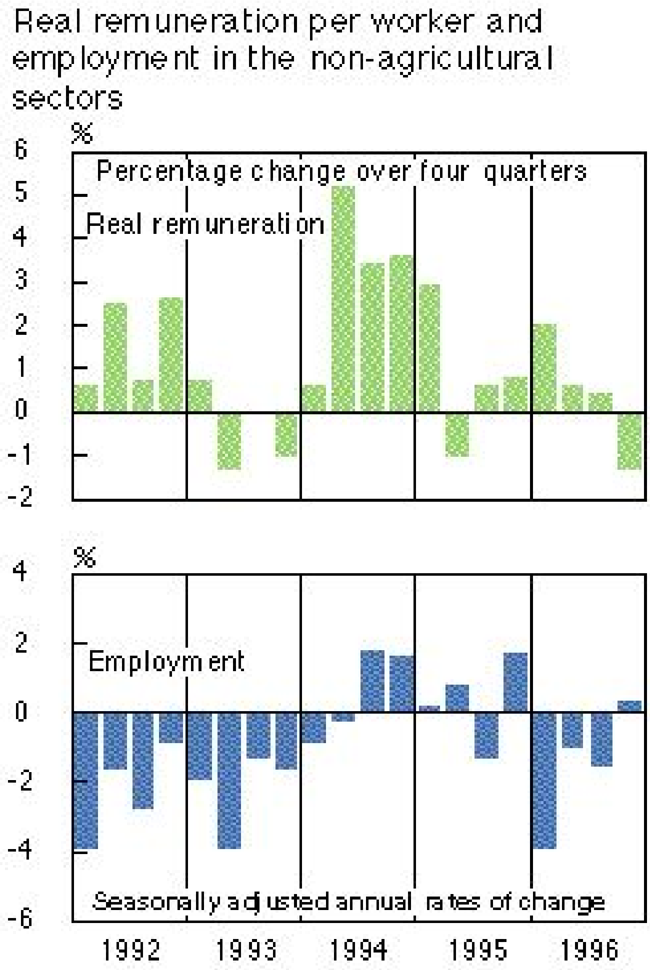
The rise in the *nominal remuneration per worker in the private sector* accelerated from 10,0 per cent in 1994 to 11,2 per cent in 1995 and then slowed down to 10,7 per cent in 1996. The rate of increase in *nominal remuneration per worker in the public sector* slowed down from a rate of 14,9 per cent in 1994 to 6,5 per cent in 1995 - the lowest rate of increase since 1972 - but accelerated again to 8,9 per cent in 1996. Although there has been a marked difference in the volatility of the rates of change in private-sector and public-sector employee remuneration in recent years, the average compound rates of increase over the period 1989 to 1996 for each sector amounted to approximately 12 per cent per year.

The year-to-year rate of increase in the *real remuneration per worker* in the non-agricultural sectors of the economy (as deflated by the price deflator for the non-agricultural gross domestic product) slowed down from 3,2 per cent in 1994 to 0,8 per cent in 1995 and 0,5 per cent in 1996. Theoretically, in a situation where the unemployment rate exceeds the so-called non-accelerating inflation rate of unemployment (NAIRU), the high unemployment rate is supposed to exert downward pressure on changes in real wages. Even in the absence of a formal estimate of the NAIRU, it can safely be assumed that unemployment in South Africa is inordinately high. Nevertheless, real remuneration per worker in the non-agricultural sectors of the economy increased at a positive compound rate of one per cent per year during the period 1989 to 1996. The potential inflationary impact of this was, fortunately, curbed by growing labour productivity. Increased sensitivity of real wage change to the underlying conditions of supply and demand in the labour market within a regulatory framework that provides stability and protection to workers may contribute towards reinforcing the recent downward tendency in inflation.



The year-to-year rate of increase in *labour productivity* accelerated from 0,3 per cent in 1991 to high rates of increase of 2,7 per cent in 1994, 3,3 per cent in 1995 and 3,0 per cent in 1996. These positive rates of increase in output per worker have coincided with large-scale retrenchments of workers since the beginning of the 1990s. Ideally, rising productivity levels should be accompanied by growing employment numbers if the problem of unemployment is to be confronted effectively.

The recent improvements in labour productivity and the lower rates of increase in remuneration per employee caused the rate of increase in *nominal unit labour costs* to adjust downwards. The year-to-year rates of increase in nominal unit labour costs declined, on balance, from 17,2 per cent in 1990 to 5,9 per cent in 1995. The higher rate of increase in nominal remuneration per worker and the marginal slowdown in productivity growth then resulted in a higher rate of increase of 7,0 per cent in nominal unit labour costs in 1996.



Despite the recent improvements in productivity and the slowdown in nominal wage growth, the generally weak competitive position of the South African economy is apparent when changes in nominal unit labour costs and productivity are compared with changes in unit labour costs and labour productivity in the country's main trading partner countries. Unit labour costs in South Africa increased approximately 7½ times as fast as the arithmetic average of the rates of increase in unit labour costs in the main trading partner countries during the first half of the 1990s. Over the same period, the growth in labour productivity in South Africa was only about 60 per cent of the arithmetic average of productivity growth in the trading partner countries. The continuation of these trends could have serious consequences for the authorities' objective of accelerating non-gold export growth, while simultaneously attracting inward foreign investment to strengthen the growth potential of the economy. In this regard it remains important to increase the productivity of labour and management and to maintain sound fiscal and monetary policies to ensure financial stability and avoid seeking competitiveness in export markets by repetitive depreciations of the rand.

Table 4. Comparison of nominal unit labour costs and labour productivity in manufacturing in selected countries

Average annual increase at compound rates

	1970-1995		1990-1995	
	Unit labour costs	**Labour productivity**	**Unit labour costs**	**Labour productivity**
France	5,8	3,1	0,5	2,7
Germany	3,9	2,2	2,7	1,9
Japan	3,5	3,6	1,7	0,9
South Africa	**12,8**	**1,0**	**10,1**	**1,8**
Taiwan	6,2	4,8	1,0	5,4
United Kingdom	8,0	3,4	1,8	3,8
United States of America	3,6	2,8	0,3	3,6
Source: National Productivity Institute				

Inflation

The consistent application of a counter-inflationary monetary policy, together with other policy developments such as improved fiscal discipline, trade liberalisation and growing competition in the domestic goods markets, improved industrial relations and some moderation of nominal wage growth have jointly and separately contributed to a decline in price inflation since the beginning of the 1990s. The general downward tendency in inflation has, however, been arrested by mounting shorter-term inflationary pressures since April 1996, which emanated from:

- the depreciation of the rand, since February 1996, through its impact on the prices of imported goods and services;
- persistently strong growth in the money supply and domestic credit extension;
- rising food prices since the second half of 1996;
- persistently high inflation expectations, leading to demands for generous salary and wage increases; and

- higher rates of increase in nominal unit labour costs since the third quarter of 1995.

The influence of these inflationary factors has been curtailed in recent months by the strengthening of the nominal effective exchange rate of the rand from January to March 1997, lower international crude-oil prices in the second quarter of 1997, lower worldwide inflation and the slowdown in the growth of aggregate domestic demand in the first half of 1997. The government's Budget for fiscal 1997/98 is also generally supportive of the counter-inflationary monetary policy and assisted in lowering expectations of inflation and the inflation potential of the economy.

The year-to-year increase in the *all-goods production price* index declined from 9,6 per cent in 1995 to 6,9 per cent in 1996 - well below the average annual rate of increase of 8,5 per cent for the period 1990 to 1996. The seasonally adjusted and annualised quarter-to-quarter rate of increase in the all-goods production price index declined more spectacularly from 14,3 per cent in the first quarter of 1995 to 5,1 per cent in the first quarter of 1996 as favourable climatic conditions resulted in lower rates of increase in food prices. The inflationary forces which came into play from the beginning of 1996 then increased the quarter-to-quarter growth in the all-goods production price index to 12,7 per cent in the fourth quarter of 1996, before it fell back to 8,4 per cent in the first quarter of 1997. Measured over periods of twelve months, the rise in the all-goods production price index was recorded at 5,3 per cent in April 1996, before it accelerated to 9,6 per cent in March 1997. It declined again to 8,8 per cent in April 1997 and to 8,4 per cent in May.

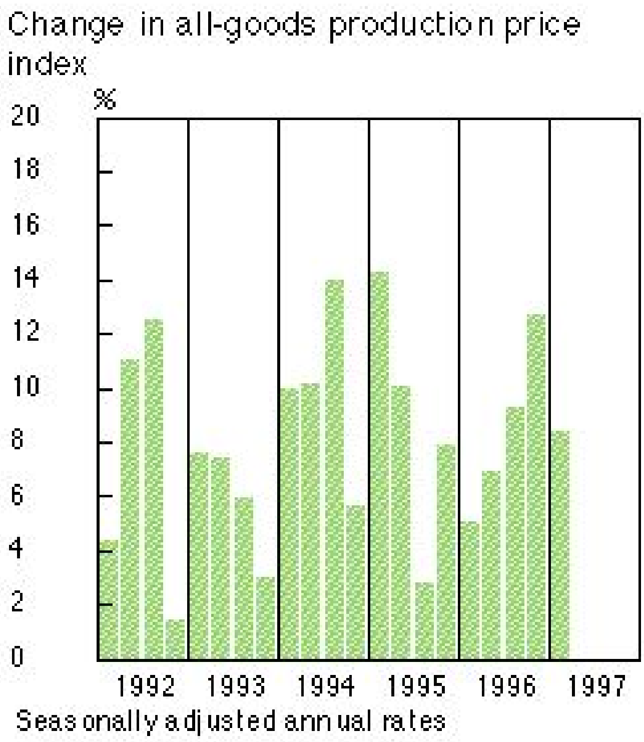
Table 5. Changes in production prices

Percentage change at seasonally adjusted annual rates

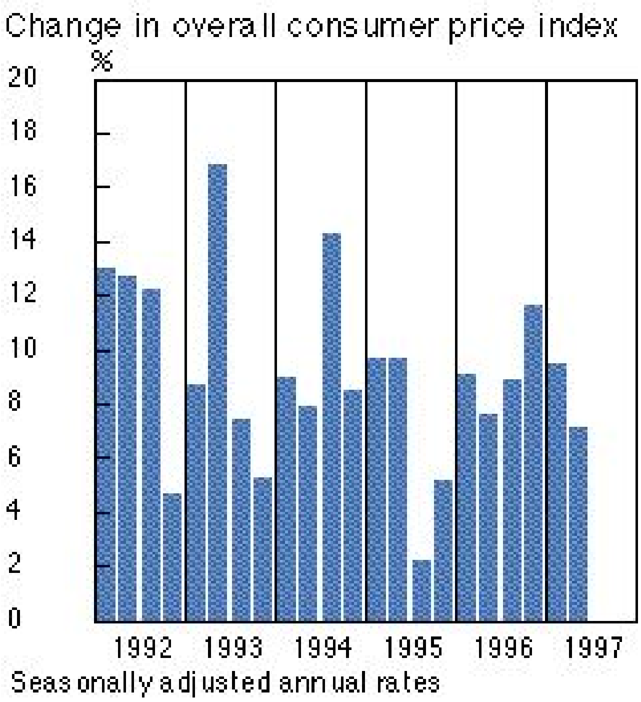
		Domestically produced goods	**Imported goods**	**All goods**
1995:	1st qr	13,6	15,4	14,3
	2nd qr	10,0	10,5	10,1
	3rd qr	3,7	-0,5	2,8
	4th qr	9,8	2,8	7,9
1996:	1st qr	4,8	6,0	5,1
	2nd qr	6,8	7,3	6,9
	3rd qr	11,4	2,9	9,3
	4th qr	11,4	18,1	12,7
1997:	1st qr	7,2	12,4	8,4

The year-to-year increase in the prices of *domestically produced goods* declined from 9,9 per cent in 1995 to 7,5 per cent in 1996. The seasonally adjusted and annualised quarter-to-quarter rate of increase in the prices of domestically produced goods declined from 13,6 per cent in the first quarter of 1995 to 4,8 per cent in the first quarter of 1996, but then accelerated to 11,4 per cent in the third and fourth quarters of 1996. This growth rate subsequently declined to 7,2 per cent in the first quarter of 1997.

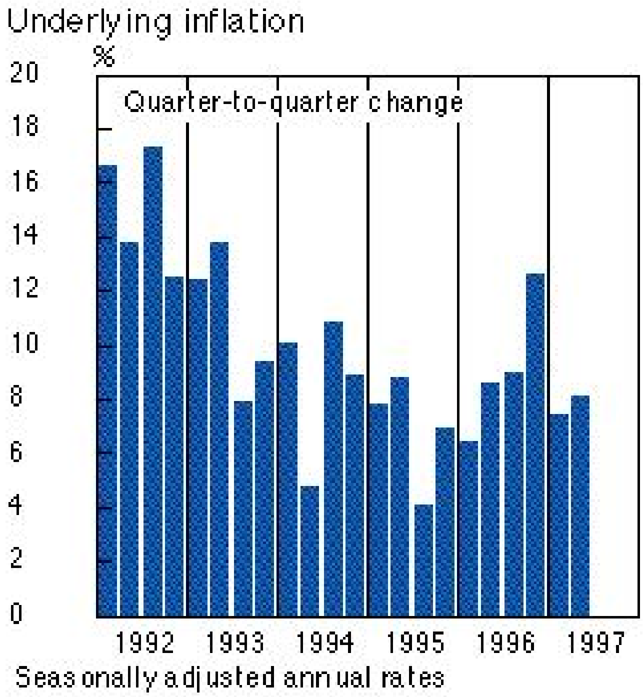
The increase in the *prices of imported goods* slowed down from a year-to-year rate of 7,6 per cent in 1995 to 5,3 per cent in 1996. The seasonally adjusted and annualised quarter-to-quarter rate of change in the prices of imported goods fell steeply from an increase of 15,4 per cent in the first quarter of 1995 to a decline of 0,5 per cent in the third quarter of that year as the rand generally strengthened against other currencies and inflation subsided in most of the trading partner economies. The quarter-to-quarter change in the prices of imported goods subsequently accelerated in a fluctuating manner to a relative high of 18,1 per cent in the fourth quarter of 1996. This rate of increase subsequently declined to 12,4 per cent in the first quarter of 1997 as the rand again strengthened from October 1996 to March 1997 and the cost-raising effects of the earlier depreciation of the rand began to dissipate.



Consumer price inflation, as measured by year-to-year changes in the *overall consumer price index*, slowed down from 8,7 per cent in 1995 to 7,4 per cent in 1996. The seasonally adjusted and annualised quarter-to-quarter rate of increase in the consumer price index fell from 14,3 per cent in the third quarter of 1994 to 2,2 per cent in the third quarter and 5,2 per cent in the fourth quarter of 1995. This slowdown was primarily the result of the importation of food products at prices lower than domestic prices and a sharp deceleration in the increase of prices of new motor vehicles. During 1996 the quarter-to-quarter change in the consumer price index accelerated to reach a nine-quarter high of 11,6 per cent in the fourth quarter, but then slowed down again to 9,5 per cent in the first quarter of 1997 and 7,1 per cent in the second quarter. Measured over periods of twelve months, the overall consumer-price inflation rate reached its lowest level since June 1972 when it declined to 5,5 per cent in April 1996. This rate of increase then accelerated to 9,9 per cent in April 1997 - the highest rate since June 1995 - but subsequently declined to 9,5 per cent in May and 8,8 per cent in June.



Underlying inflation (i.e. the change in the overall consumer price index excluding the prices of food and non-alcoholic beverages, the costs of home ownership and value-added tax), which specifically captures the fundamental inflation pressures in the economy, decelerated from a rate of 18,4 per cent in 1991 to 7,5 per cent in 1996. The seasonally adjusted and annualised *quarter-to-quarter* underlying inflation accelerated from 4,1 per cent in the third quarter of 1995 to 12,6 per cent in the fourth quarter of 1996. It then decelerated to 7,4 per cent in the first quarter of 1997, before accelerating again to 8,1 per cent in the second quarter. Underlying inflation, as measured by the percentage change over periods of twelve months, accelerated from a most recent low of 6,3 per cent in May 1996 to a three-year high of 9,7 per cent in February 1997, before declining to 9,5 per cent in May 1997 and 8,9 per cent in June.


Underlying inflation
%
Quarter-to-quarter change
20
18
16
14
12
10
8
6
4
2
0
1992
1993
1994
1995
1996
1997
Seasonally adjusted annual rates

Foreign trade and payments

Policy issues and trade reforms

The successful transition to an all-inclusive democratic system of government opened South African markets to active participation by foreign competitors. South African institutions simultaneously began to branch out and broaden their activities into markets from which they had been precluded before. This process of reintegration into the international financial and trading network was actively encouraged by the South African authorities. Trade and industrial policy reforms, organisational and regulatory changes in the financial markets and the gradual relaxation of exchange controls were all aimed at strengthening the competitiveness of domestic producers and service providers and facilitating the integration of South Africa into the global economy.

Trade and industrial policies, which were previously highly protective, inward orientated and primarily focused on self-sufficiency were fundamentally restructured to nurture a more outward orientation and an economy capable of competing effectively in export markets. An agreement was concluded with the World Trade Organisation (WTO), formerly the General Agreement on Tariffs and Trade, in 1994 whereby the South African government committed itself to the reduction and restructuring of import tariffs, the removal of import surcharges and the phasing out of the General Export Incentive Scheme (GEIS). The import surcharges were abolished with effect from 1 October 1995, whereas all GEIS concessions were finally repealed on 11 July 1997. In the GEAR strategy the government called for an accelerated programme of tariff reduction to counter the inflationary effects of the weakening rand. The proposed tariff reduction programme will ensure a lowering of the average import-weighted tariff level on manufactured goods from 15 per cent in 1994 to 8 per cent in 1999.

The reform of the *exchange control regime* began in real earnest with the abolition of the financial rand mechanism on 13 March 1995. An announcement followed on 13 July 1995 to the effect that South African insurance companies, pension funds and unit trusts would be allowed to acquire foreign assets to the value of 5 per cent of their total assets, provided these were offset by a non-resident acquisition of domestic assets to ensure the foreign-reserve neutrality of such a transaction. The Reserve Bank also indicated its objective of reduced involvement in the forward foreign currency market by announcing that forward cover to authorised dealers would thereafter only be provided against documentary evidence of foreign financing transactions. Further relaxations followed during 1996, mostly dealing with institutional investment in foreign assets, the local borrowing capacity of foreign-controlled organisations and direct investment in countries outside the Rand Monetary Area.

Table 6. Average import weighted tariff in manufacturing*

Per cent

	1994	**1996**	**1999**

Electrical machinery	8	3	3
Other machinery and equipment	5	1	1
Motor vehicles, parts and accessories	51	40	33
Industrial chemicals	6	3	2
Other chemical products	7	3	2
Clothing	74	67	51
Other textiles	33	34	26
Footwear	40	39	29
Total (all sectors)	**15**	**10**	**8**
Source: Industrial Development Corporation and Department of Trade and Industry			
* Excluding surcharge on imported goods			

The healthier position of the overall balance of payments from the fourth quarter of 1996 created circumstances that were favourable for the further relaxation of exchange controls. In his Budget speech in Parliament on 12 March 1997 the Minister of Finance announced a number of wide-ranging reforms to the exchange control system. As far as the current account of the balance of payments was concerned, these relaxations included:

- the abolition of most of the quantitative limits on various current account transactions;
- an increase in the annual travelling allowances of South African residents; and
- allowing South African corporates to retain foreign currency earnings abroad for a period of up to thirty days, instead of seven days.

As far as capital account transactions were concerned, the relaxations included the following:

- corporates would be allowed to invest up to R30 million per new investment in countries outside the Common Monetary Area, while in respect of investments into the Southern African Development Community (SADC) an amount of up to R50 million per new investment would be allowed;

- South African subsidiary companies operating overseas would thenceforth be allowed to raise offshore financing based on the strength of the South African balance sheets of parent companies;
- South African long-term insurers, pension funds and unit trusts were authorised to transfer capital abroad in 1997 equal to 3 per cent of the net inflow of funds to these institutions during 1996, subject to the overall limit of 10 per cent of total assets;
- qualifying institutional investors were allowed to invest 2 per cent of their net domestic income surpluses during 1996 in securities listed on stock exchanges in SADC countries, but still subject to the overall limit of 10 per cent of total assets; and
- private individuals who are taxpayers in good standing with the tax authorities were permitted from 1 July 1997 to invest up to R200 000 abroad, or to maintain foreign currency deposits to the same amount with authorised foreign exchange dealers.

Another important step in the liberalisation of the foreign exchange market was taken in November 1996 when the Reserve Bank terminated its involvement in the foreign-currency forward market for transactions with a maturity of longer than twelve months. This step formed part of the Bank's strategy to progressively distance itself from the forward market, while encouraging the development of a private market for forward transactions in which the Bank might intervene on its own initiative from time to time.

The authorities' approach to the removal of exchange controls was one of gradually liberalising controls in a sequence of carefully planned steps which created new opportunities for capital account transactions by residents. This approach, together with the imposition of upper monetary limits to these transactions, minimised the risk of substantial amounts of capital flowing out of the country after each relaxation. With the disruptive effect of destabilising capital movements reduced to a minimum, the authorities are now well positioned to continue with their step-by-step approach by raising the upper limits until they no longer form binding constraints.

Balance on current account

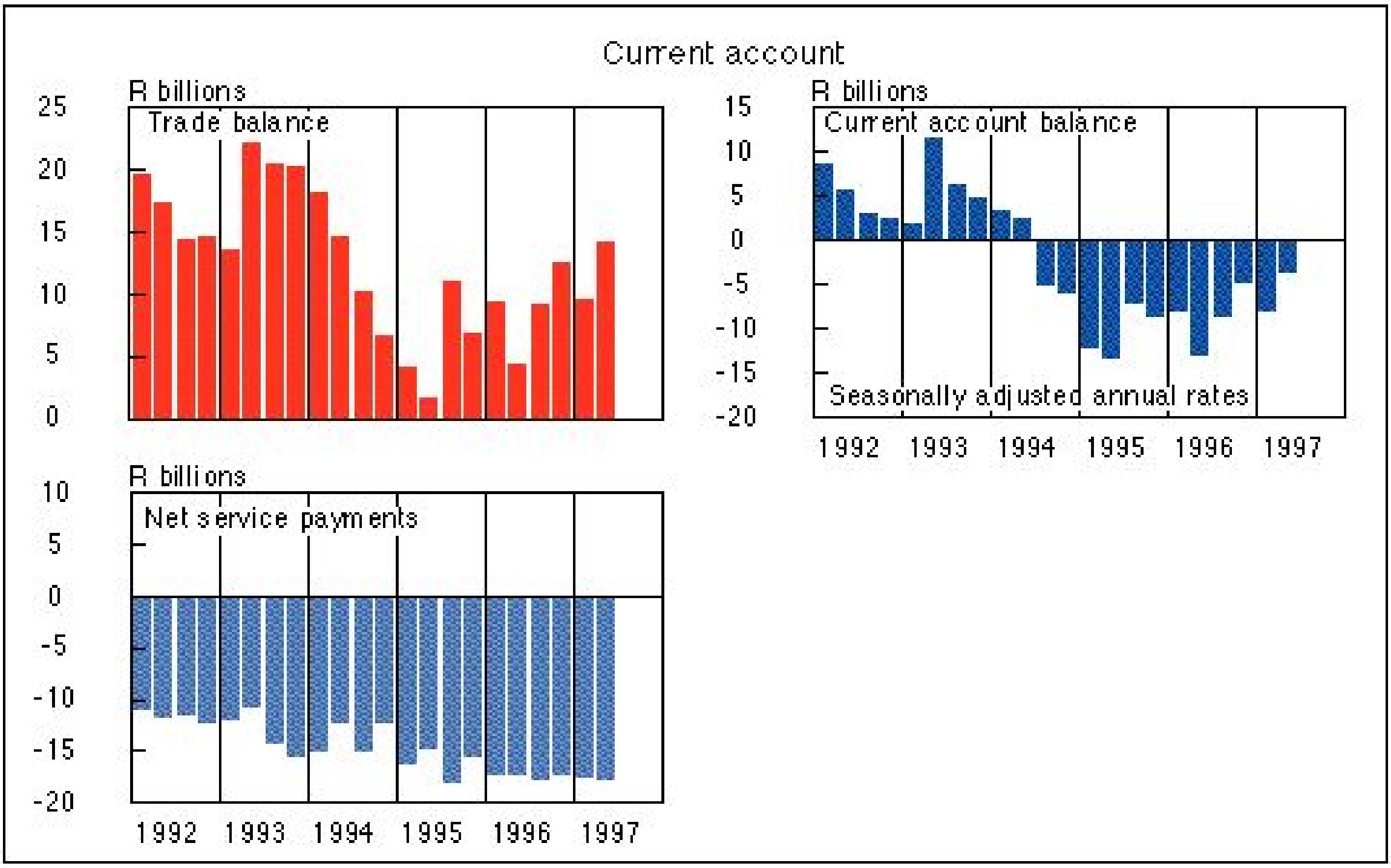
Export growth gathered strong momentum in the second half of 1996 as a response to the depreciation of the rand from the first quarter of 1996. Other factors that contributed to the robust growth of exports were the broadening of the export base owing to the completion of large-scale export-oriented manufacturing plants and the rebound in agricultural exports. Access to new markets and strong growth in emerging economies strengthened the demand for South African exports further. As a consequence, the deficit on the current account of the balance of payments shrank from R10,2 billion in 1995 to R8,5 billion in 1996, or from 2,1 per cent of gross domestic product in 1995 to 1,6 per cent in 1996. In the first half of 1997 the current account deficit contracted to a seasonally adjusted and annualised value of R5,7 billion or 1,0 per cent of gross domestic product compared with R10,3 billion, or 2,0 per cent of gross domestic production in the first half of 1996.

Table 7. Balance of payments on current account

Seasonally adjusted and annualised rates

R billions

	1996				1997	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Merchandise exports	88,5	93,1	102,6	111,0	105,6	116,9
Net gold exports	24,9	25,3	28,7	26,2	26,8	24,5
Merchandise imports	-104,1	-114,1	-122,2	-124,8	-122,9	-127,2
Net service and transfer payments	-17,1	-17,2	-17,7	-17,1	-17,4	-17,6
Balance on current account	**-7,8**	**-12,9**	**-8,6**	**-4,7**	**-7,9**	**-3,4**

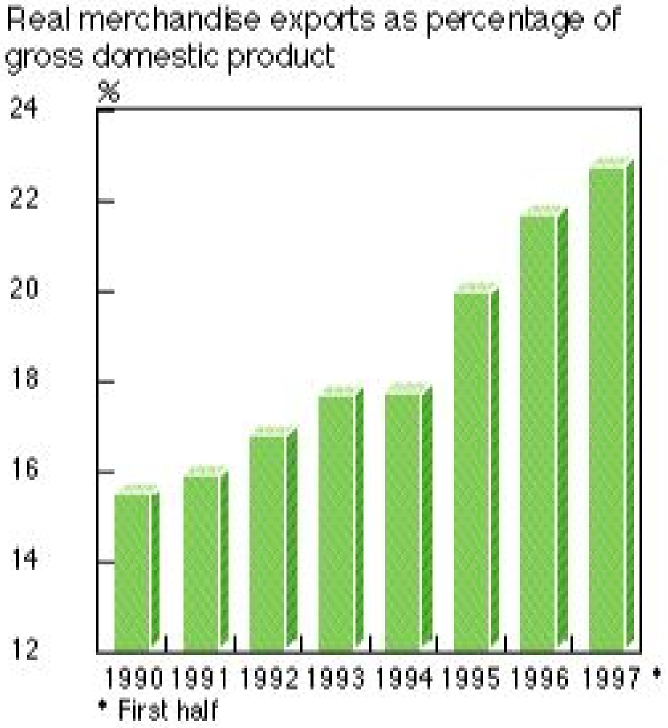


Merchandise exports

The contraction in the deficit on the current account of the balance of payments in 1996 and the first half of 1997 was to a large extent the result of robust growth in the *value of merchandise exports*. Apart from a brief decline in the first quarter of 1997, the seasonally adjusted and annualised value of merchandise exports increased consistently from R60,0 billion in the first quarter of 1994 to R116,9 billion in the second quarter of 1997. The year-to-year change in the value of merchandise exports was from R81,3 billion in 1995 to R98,8 billion in 1996, or 21½ per cent. This was followed by an increase of 22½ per cent in the first half of 1997 over the first half of 1996. Increases in the unit values of merchandise exports and in the physical quantity of goods exported both contributed to the strong growth in export values.

The level of *export prices* measured in domestic currency rose by 8,2 per cent in 1996. As the nominal effective exchange rate of the rand declined on average by 13,0 per cent over the same period, manufacturers seem to have used the depreciation of the rand as an opportunity to reduce the foreign-currency prices of their export goods to increase market share. Declining international commodity prices, however, also restrained the growth in the aggregate export-price level, but a rebound in commodity prices from the beginning of 1997 gave rise to a moderate increase of 9½ per cent in export prices in the first six months of 1997 over the corresponding period of the previous year.

The *physical quantity of South Africa's merchandise exports* expanded by 12,1 per cent in 1996 and by 12 per cent in the first half of 1997 relative to the first half of 1996. The absence of an established foothold in some emerging markets and the lack of flexibility in existing long-term contracts, which prevented short-term adjustments to a portion of export volumes, prevented the export response to the depreciation of the rand from being even stronger. In fact, the volume of merchandise exports has grown at an average annual rate of 13 per cent since 1995, which exceeded the growth of 6 per cent in the volume of international trade, thereby indicating that South African producers have increased their share in international markets. As a ratio of real gross domestic product, real merchandise exports came to an all-time high of almost 22 per cent in 1996, which was almost twice as high as the average ratio of 11,5 per cent recorded from 1960 to 1990.



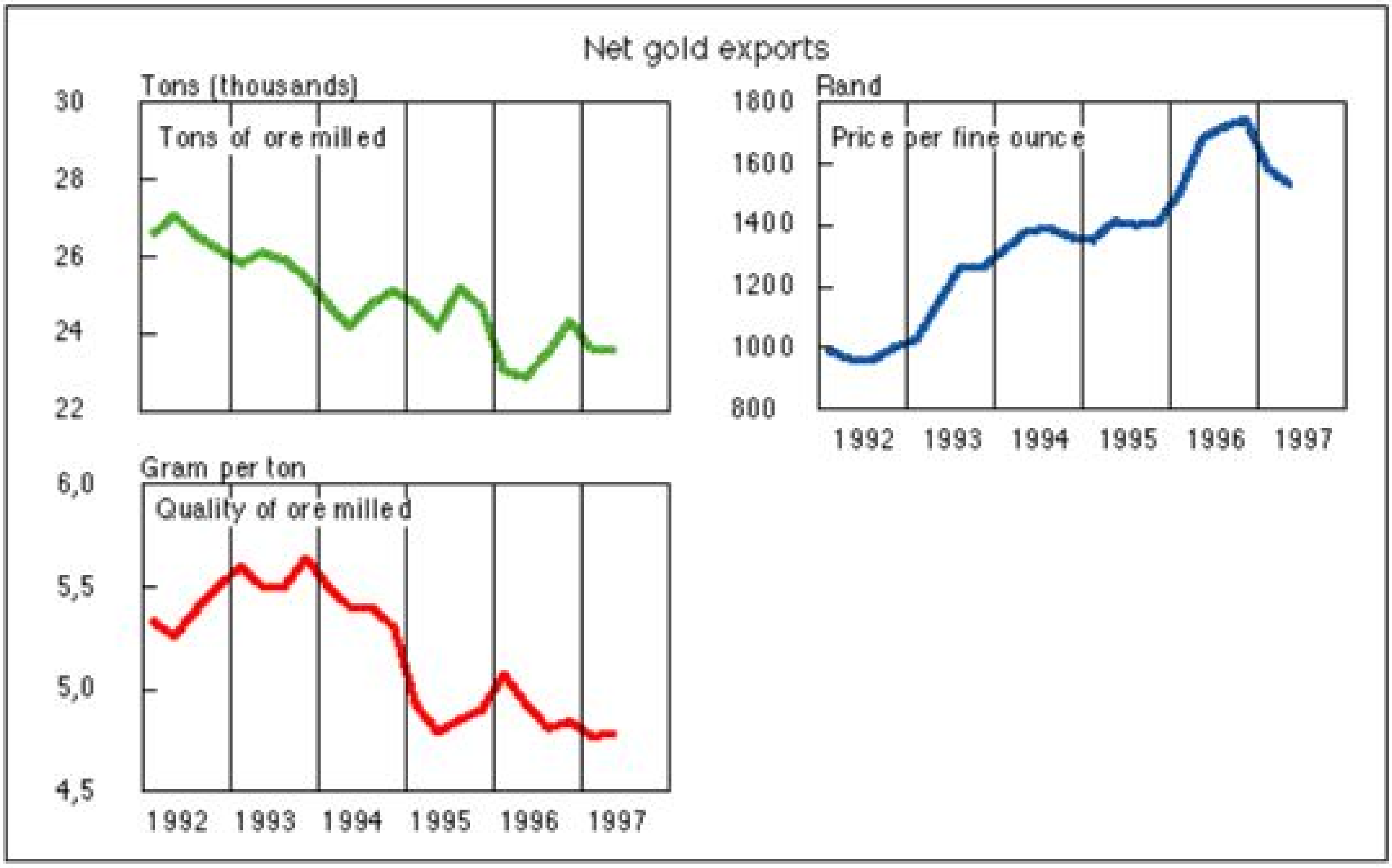
Although all the main sectors of economic activity shared in the expansion of export volumes from the beginning of 1996, the main contribution was made by the manufacturing sector, as is substantiated by an annualised increase of 30,2 per cent in the value of manufactured exports from the fourth quarter of 1995 to the second quarter of 1997. Strong increases were recorded in especially the subcategories of machinery and electrical equipment, vehicle and transport equipment and chemical products. The more prominent factors contributing to this rapid growth in the exports of manufactured goods were:

- the consecutive phases of the motor industry development scheme and the now abandoned General Export Incentive Scheme;
- the increased competitiveness of South African manufacturers, as is evident from the decline in the average nominal and real effective exchange rates of the rand;
- the growing labour productivity in manufacturing;
- better access to new technology and markets through inward and outward foreign direct investment, licensing and cooperation agreements;
- the completion of a number of export-oriented "mega investment projects", such as Columbus Stainless Steel and Alusaf's aluminium smelter;
- access to markets that were previously largely closed to South African exporters; and
- steady growth in most of the emerging economies.

Net gold exports

South Africa's *gold production* declined from 619 tons in 1993 to 524 tons in 1995. It then declined further by 5,2 per cent to 497 tons in 1996 - the first time since 1956 that the country's annual production of gold had declined below 500 tons. In the first half of 1997 gold production declined again to an annualised level of 485 tons. Gold production has been affected by dwindling volumes of ore milled and declines in ore quality. Easily accessible and payable ore deposits had largely been exhausted, whereas new deposits were found at levels deep below the surface which raised the limits at which mining operations could profitably take place.

The supply of newly mined gold on the international market was augmented by production increases in North and South America and in Australia which exceeded, in absolute terms, the fall in South Africa's output in 1996. In addition to the price-depressing effect of increased output, sentiment in the gold market was adversely affected by widespread concern about the development of the European Monetary Union (EMU) and the perception that some central banks might sell gold to meet the criteria for membership of EMU, or because of the need for lower international currency reserves post-EMU. A series of official transactions by the central banks of Belgium, the Netherlands and Australia, as well as protracted discussions within the International Monetary Fund about the possibility of selling 5 per cent of its gold reserves to provide debt relief to some heavily indebted countries had negative consequences for the price of gold. Forward selling by producers, a decline in investors' interest in light of low world inflation and attractive yields on financial assets, strengthened the downward bias in gold-price movements further.



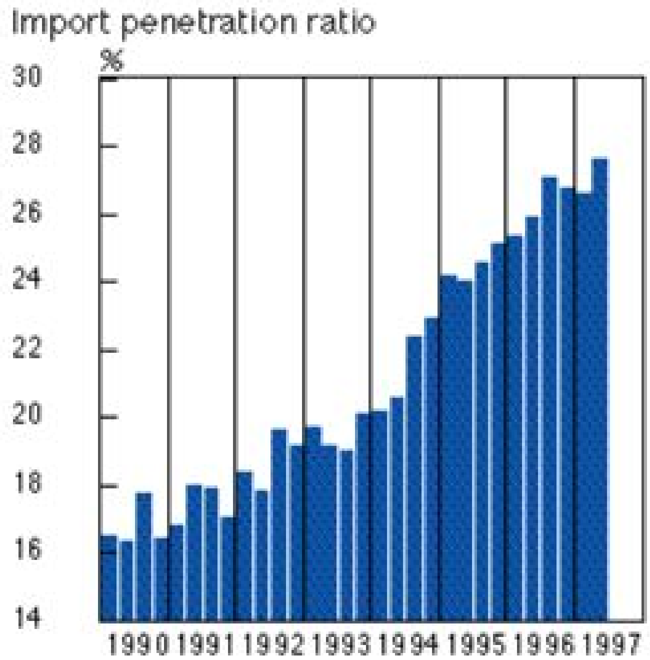
Although the average annual London fixing price of gold rose marginally from a level of US$384 per fine ounce in 1995 to US$388 in 1996, the average monthly gold price declined almost without abating from US$405 per fine ounce in February 1996 to US$369 per fine ounce in December 1996. In the first half of 1997 the average fixing price of gold retreated to US$347 per fine ounce; by July it had receded to US$324 per fine ounce - its lowest level since January 1993. Largely on account of the depreciation of the rand since February 1996, the price of gold per fine ounce in rand rose from an average of R1 393 in 1995 to R1 664 in 1996. The relative strength of the rand in the first quarter of 1997 then caused the price of gold to decline to an average level of R1 559 per fine ounce in the first six months of 1997. The value of aggregate *net gold exports* accordingly fell from R26,3 billion in 1996 to an average annualised level of R25,7 billion in the first half of 1997.

Merchandise imports

Declining real gross domestic expenditure since the third quarter of 1996 and generally rising prices of imported goods consequent to the depreciation of the rand, led to a slowdown of the strong growth in the *value of merchandise imports* which had been in evidence since 1993. After having risen at year-to-year rates of 27½ per cent in 1994 and 28½ per cent in 1995, the value of merchandise imports increased by 18½ per cent in 1996 and by 14½ per cent when the first half of 1997 is compared with the first half of 1996.

The *physical quantity of imports*, which has been rising strongly since 1994, increased further at a year-to-year rate of 10½ per cent in 1996. However, from the third quarter of 1996 the persistent quarter-to-quarter decline in aggregate real gross domestic expenditure resulted in a smaller demand for imported goods; in the first half of 1997 the physical quantity of merchandise imports was only ½ per cent higher than in the second half of 1996.

Changes in real gross domestic expenditure are usually accompanied by changes in the same direction in the volume of merchandise imports, especially when the changes in real gross domestic fixed investment and inventories are the main causes of change in aggregate domestic expenditure. The strong growth in domestic expenditure since 1993 and the relatively modest response of aggregate domestic output to this strong domestic demand occasioned an increased share of domestic expenditure having to be met by the importation of goods. The so-called import penetration ratio (i.e. the ratio of imported goods at constant prices to total real gross domestic expenditure) accordingly increased from 19 per cent in the third quarter of 1993 to 27,1 per cent in the third quarter of 1996. Part of this increase was probably related to the repeal of trade sanctions, the lowering of import tariffs and increased competition, which compelled many domestic industries to replace technologically dated production equipment with technologically advanced machinery and equipment. Real aggregate domestic expenditure slowed down more than import volumes from the third quarter of 1996, resulting in the import penetration ratio rising from 26,9 per cent in the second half of 1996 to 27,1 per cent in the first half of 1997.



The average level of import prices rose by 7 per cent in 1996. As the nominal effective exchange rate of the rand declined by more than the rise in the average price of imported goods, it would appear as if the price-raising effect of the depreciation of the rand was fairly limited and that foreign suppliers were prepared to lower their export prices in order to protect their share in the domestic market. With the rand strengthening in the first quarter of 1997 and inflation staying low in the main trading partner countries, the prices of imported goods showed little change over the first half of 1997.

Net service and transfer payments to non-residents

The service and transfer account of the balance of payments has deteriorated continuously since 1991, but at a somewhat more subdued rate in 1996 and the first half of 1997. Net service and transfer payments to non-residents rose from R16,0 billion in 1995 to R17,3 billion in 1996 and to a seasonally adjusted and annualised level of R17,5 billion in the first half of 1997. As a ratio of gross domestic product, net payments for services and transfers to non-residents declined marginally from 3,3 per cent in 1995 to 3,2 per cent in 1996 and the first half of 1997.

The increased deficit on the services account was essentially caused by *service payments* to non-residents, which increased more rapidly than receipts for services rendered to non-residents. Payments for services rendered by non-residents rose as a result of higher freight and insurance charges stemming from the recent strong growth in the value and volume of merchandise imports. Interest and dividend payments to the rest of the world also increased firmly on account of the recent surge of inward investment through the domestic bond and share markets, either through outright purchases of securities or as part of asset swap transactions. Total interest and dividend payments to non-residents as a percentage of total export proceeds accordingly increased from 8,5 per cent in 1996 to 9,9 per cent in the first half of 1997.

Receipts for services rendered to non-residents continued to benefit from increased spending by foreign tourists visiting South Africa. The popularity of the country as a tourist destination was boosted by the depreciation of the rand; the number of tourist entering into South Africa increased from 3,9 million in 1994 to 4,9 million in 1996. The relaxation of exchange control measures, which allowed for the acquisition of foreign assets by institutional investors through the asset-swaps mechanism, resulted in an increased return flow of interest and dividend receipts from abroad.

Capital account

The negative investors' sentiment towards South African assets and the volatility in the domestic foreign exchange market from February to October 1996 brought the strong inflow of capital (not related to reserves) down from R19,2 billion in 1995 to R3,9 billion in 1996, or from 4,0 per cent of gross domestic product in 1995 to 0,7 per cent in 1996. This change in sentiment could be attributed to rumours concerning the health of President Mandela, concerns about the likely impact of the early removal of remaining exchange controls on residents, concerns that sound macroeconomic management could be compromised and fears that the growing political consensus which had developed since 1994 might disintegrate.

It was only after Bank rate had been increased on two occasions during 1996 and the decline in the exchange rate of the rand had been brought to an end in October 1996 that net capital inflows regained some of their earlier vigour. The announcement of the GEAR strategy and the reconfirmation of relatively favourable credit ratings for South Africa by prominent international credit rating agencies also strengthened investors' confidence. A net inflow of capital (not related to reserves) of R3,3 billion was recorded in the fourth quarter of 1996 in comparison with only R0,6 billion in the preceding three quarters. It subsequently strengthened to R16,7 billion in the first half of 1997.

The net inflow of *long-term capital*, i.e. capital with an original maturity of longer than one year or with an indefinite period was valued at R15,1 billion in 1995, but only R4,9 billion in 1996. What is more, long-term capital inflows declined throughout 1996 and became negative to the amount of R1,3 billion in the second half of the year compared with a net inflow of R6,2 billion in the first half. Following this net outflow of long-term capital in the second half of 1996, the positive turn in investors' confidence then prompted a net inflow of long-term capital amounting to R20,5 billion in the first half of 1997.

Table 8. Net capital movements not related to reserves

R billions

	1996			**1997**
Long-term capital	**1st half** **half**	**2nd half** **half**	**Year**	**1st half**
Public authorities	1,4	1,9	3,3	12,4
Public corporations	1,9	1,7	3,6	7,5
Monetary sector	-0,6	-0,6	-1,2	-0,4
Non-bank private sector				
Net purchases of shares	4,3	1,0	5,3	10,4
Other	-0,8	-5,3	-6,1	-9,4
Total	**6,2**	**-1,3**	**4,9**	**20,5**

Short-term capital				
Public sector	0,1	0,1	0,2	-0,3
Monetary sector	2,5	8,3	10,8	7,9
Non-bank private sector	-7,5	-4,5	-12,0	-11,4
Total	**-4,9**	**3,9**	**-1,0**	**-3,8**
Total net capital movements	**1,3**	**2,6**	**3,9**	**16,7**

The net inflow of *long-term capital* in 1996 largely reflected an increase in foreign borrowing by the *public sector*, which more than compensated for outflows of long-term capital from the private sector. This process continued in the first half of 1997.

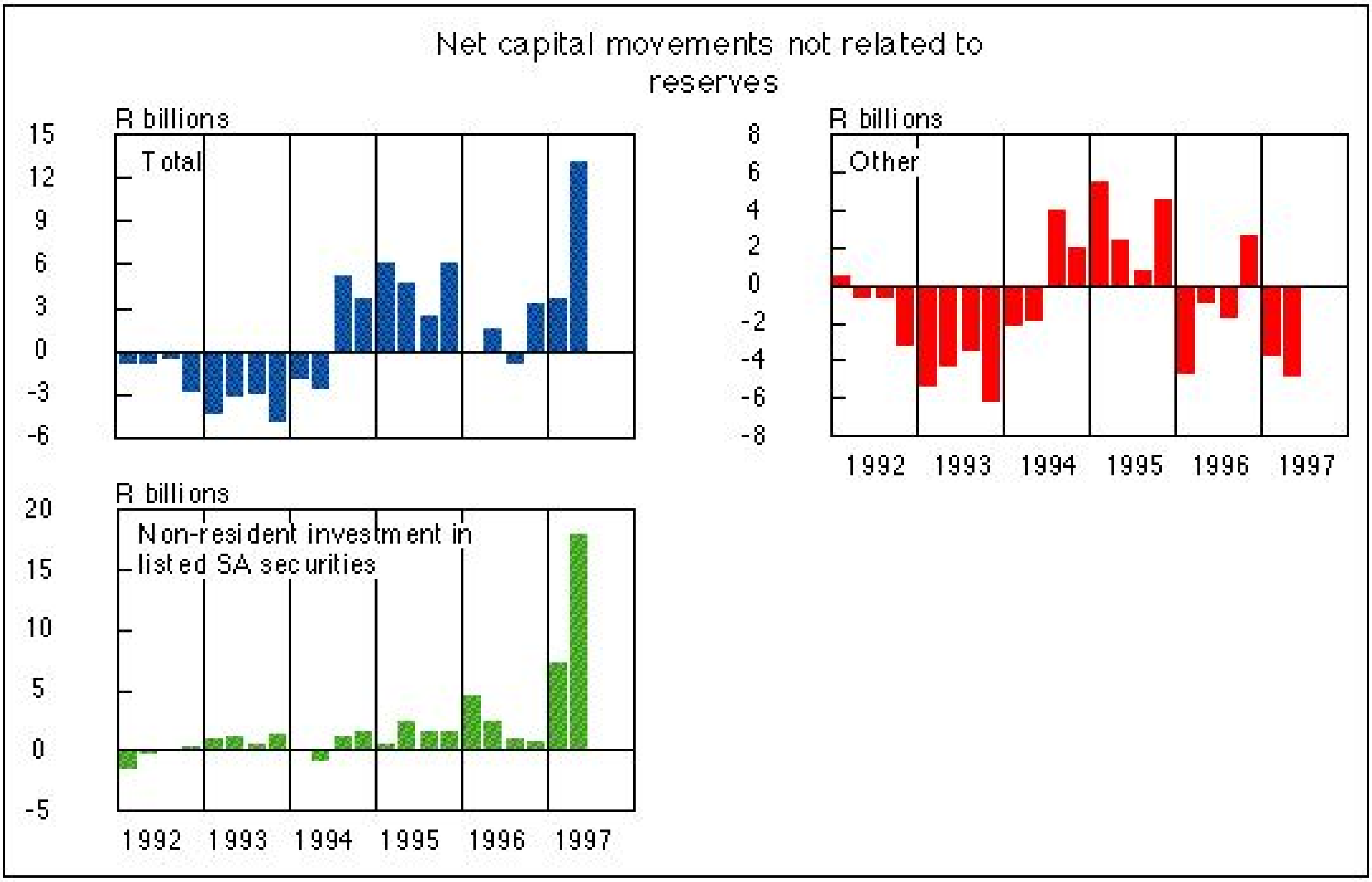
Government borrowing in foreign capital markets in 1996 comprised the ten-year Euro-sterling bond issue of 100 million British pounds in January 1996, the seven-year Eurobond issue of 500 million German marks - which was essentially aimed at refinancing a maturing bond issue - and a ten-year bond issue of US$300 million in the United States market in October 1996. This was followed in June 1997 by a seven-year Japanese bond issue of ¥40 billion and a twenty-year bond issue of US$500 million in the United States market. The total sum of capital raised through these issues over the past eighteen months amounted to R7,2 billion.

Public corporations also acquired funds from non-residents in 1996 and the first half of 1997, either in the form of new loans raised in foreign markets or in the form of net purchases by non-residents of public corporations' loan stock in the domestic bond market. In total, the net inflow of long-term capital from abroad to public corporations amounted to R3,6 billion in 1996 and R7,5 billion in the first half of 1997. Included in the total for the first half of 1997 was the payment by a consortium of non-resident companies for the acquisition of a 30 per cent equity interest in the telecommunications company, Telkom.

The volume and the volatility of non-resident investment in bonds issued by the national government and by public corporations were influenced by developments in the *European market for rand-denominated bonds*. These bonds are issued for funding purposes by international organisations with high credit ratings who then swap their rand proceeds for other currencies, normally with leading banking institutions in Europe. The European banks invariably hedge the rand exposure acquired through the swaps with the outright purchase of bonds in the South African bond market, often as part of a swap transaction with a local institutional investor. The outright purchase of bonds is recorded as a reserve-positive net inflow of capital into the economy, if it does not form part of an asset swap transaction.

At the end of 1995, Eurorand bonds outstanding amounted to R3,7 billion. Despite the weakness of the rand and the heightened volatility in the foreign exchange market in the ensuing nine months, the Eurorand bond market maintained the activity levels of the previous year, resulting in the outstanding amount of bonds increasing by R3,9 billion to R7,6 billion at the end of September 1996. When stability returned to the domestic foreign exchange market, Eurorand activity flared up and by the end of June 1997 the outstanding amount of bond issues stood at R21,7 billion. A large portion of these bonds is held by individual retail investors in European countries. As indicated above, Eurorand bond issues were partly reserve positive in that they gave rise to net inflows of capital into the economy. At worst, they were reserve neutral if they had formed part of an asset swap transaction.

The inward movement of international *long-term capital to the domestic private sector* declined throughout 1996 and became negative in the second half of the year; a net inflow of R2,9 billion in the first half of 1996 was followed by a net outflow of R4,9 billion in the second half. The net outward movement of capital from the private sector in the second half of 1996 reflected the repayment of foreign debt obligations which fell due, an increase in the acquisition of assets held abroad by South African non-bank private-sector organisations and a decline in the net purchases by non-residents of shares listed on the Johannesburg Stock Exchange. In the first half of 1997 a net inward movement of long-term capital to the amount of R0,6 billion was recorded, mainly owing to the relative strength of the rand, which encouraged strong non-resident buying of shares listed on the Johannesburg Stock Exchange.



Gross cross-border movements of capital, but not the *net* movements, were strongly influenced over the past eighteen months by asset swap transactions between South African institutional investors and foreign counterparties. Asset swap transactions to an amount of R7,3 billion were concluded in 1996 and a further amount of R13,1 billion was transacted in the first half of 1997, bringing the total foreign asset holdings of domestic insurers, pension funds and unit trusts to R27,4 billion or 3,9 per cent of the value of their total assets. This indicates that the asset swap allowance of 10 per cent of the total assets of institutional investors was still not fully utilised. A reluctance on the part of South African institutional investors to accept discounts on the prices of domestic assets and the recent relative strength of the rand might have contributed to the seeming decline in the attractiveness of the asset swap mechanism as a means of investing a portion of assets abroad.

Short-term capital movements (not related to reserves, but including unrecorded transactions) changed from a net outflow of R4,9 billion in the first half of 1996 to a net inflow of R3,9 billion in the second half of the year. The principal contributing factor to the reversal of short-term capital flows in the second half of 1996 was a sharp increase in the offshore borrowing activity of private banking institutions; the banks increased their short-term foreign liabilities by R8,3 billion in the second half of 1996. They were motivated in their decision-making by the shortage of liquidity in the domestic money market and the perceived attractive costs of foreign short-term credit facilities relative to the costs of short-term funds in the domestic market.

An outflow of short-term capital of R3,8 billion was recorded in the first half of 1997. The proximate cause of this outflow was the outward movement of short-term capital from the non-bank private sector. Many private-sector companies capitalised on the higher external value of the rand and repaid part of their uncovered foreign short-term liabilities. The banks were also much less inclined to avail themselves of short-term foreign financing facilities because domestic money market liquidity improved substantially in the second quarter of 1997.

Foreign debt

As a result of the increase in South Africa's net borrowings in offshore capital markets, the country's foreign-currency-denominated debt rose from US$22,3 billion at the end of 1995 to US$23,6 billion at the end of 1996. This debt exposure was much higher than the nadir of US$16,7 billion reached at the end of 1993 and about the same as when the Debt Standstill was declared at the end of August 1985. Despite an increase in the net purchases of bonds by non-residents in the domestic bond market, the country's rand-denominated foreign debt declined (in dollar terms) from the equivalent of US$10,7 billion at the end of 1995 to US$9,3 billion at the end of 1996. Total outstanding foreign debt accordingly declined marginally from US$33 billion at the end of 1995 to US$32,9 billion at the end of 1996.

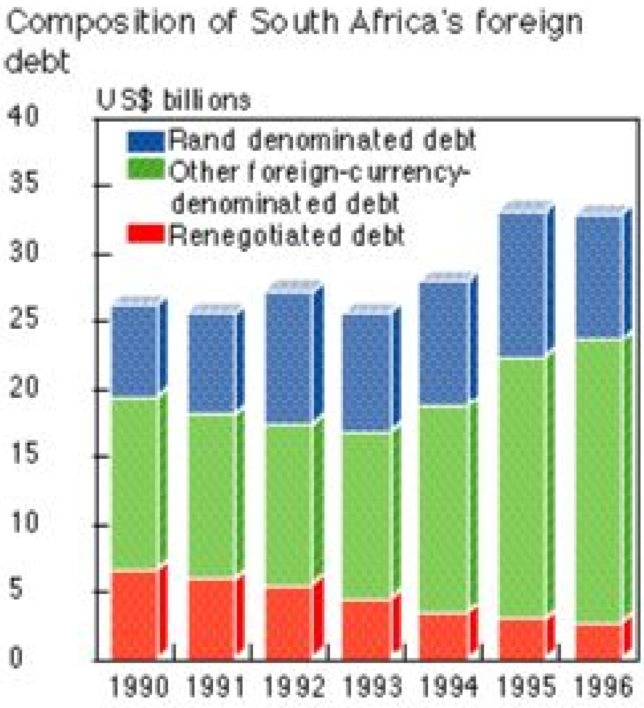
Table 9. Foreign debt of South Africa

US$ billions

	1992	1993	1994	1995	1996
Renegotiated debt[1]	**5,5**	**4,4**	**3,4**	**3,0**	**2,7**
Public sector	1,8	1,3	0,8	1,1	1,3
Monetary sector[2]	2,1	1,6	1,0	0,7	0,3
Other	1,6	1,5	1,6	1,2	1,1
Other foreign-currency-denominated debt	**11,8**	**12,3**	**15,3**	**19,3**	**20,9**
Public sector	4,7	4,7	5,3	6,8	7,3

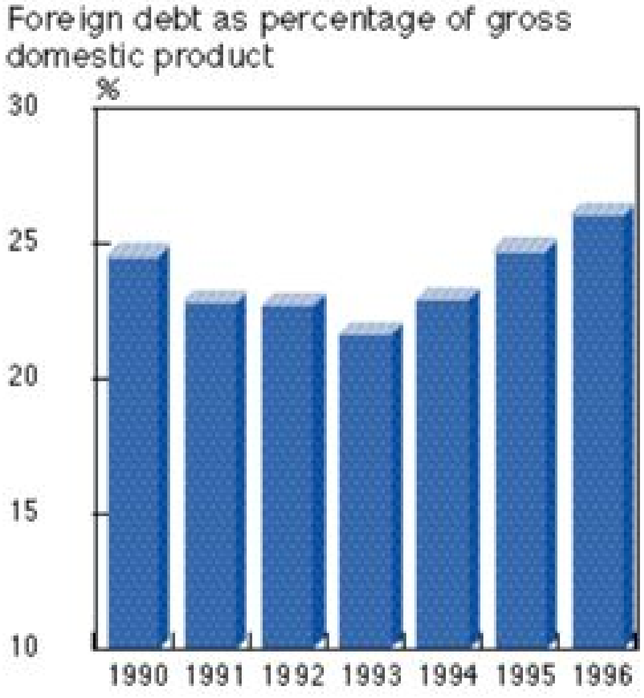
Converted long-term loans	4,8	4,5	3,9	2,9	2,1
Other	2,3	3,1	6,1	9,6	11,5
Total foreign-currency-denominated debt	**17,3**	**16,7**	**18,7**	**22,3**	**23,6**
Rand-denominated debt	**9,9**	**8,8**	**9,2**	**10,7**	**9,3**
Bonds	6,0	6,1	6,7	8,1	7,5
Other[3]	3,9	2,7	2,5	2,6	1,8
Total foreign debt	**27,2**	**25,5**	**27,9**	**33,0**	**32,9**
1 Debt renegotiated in terms of the 1994 Debt Arrangement with foreign creditors					
2 Including onlending to other sectors					
3 Including blocked and freely transferable funds, but excluding equity					

Foreign debt which had been renegotiated in terms of successive standstill arrangements with foreign creditors declined by US$0,3 billion in 1996 to US$2,7 billion at the end of that year. Valued at exchange rates prevailing on 31 August 1985, the outstanding amount of renegotiated debt has been reduced by US$11 billion since the end of August 1985. Actual repayment of debt and conversions of renegotiated debt into long-term loans and equity in terms of the various standstill agreements were the main instruments used for the reduction of renegotiated debt.



In contrast to the decline in renegotiated debt, other foreign-currency-denominated loans increased from US$19,3 billion at the end of 1995 to US$20,9 billion at the end of 1996. This was due to borrowings in the United States, Japanese and European markets by the national government and increased short-term borrowings by the banking and non-bank private sectors.

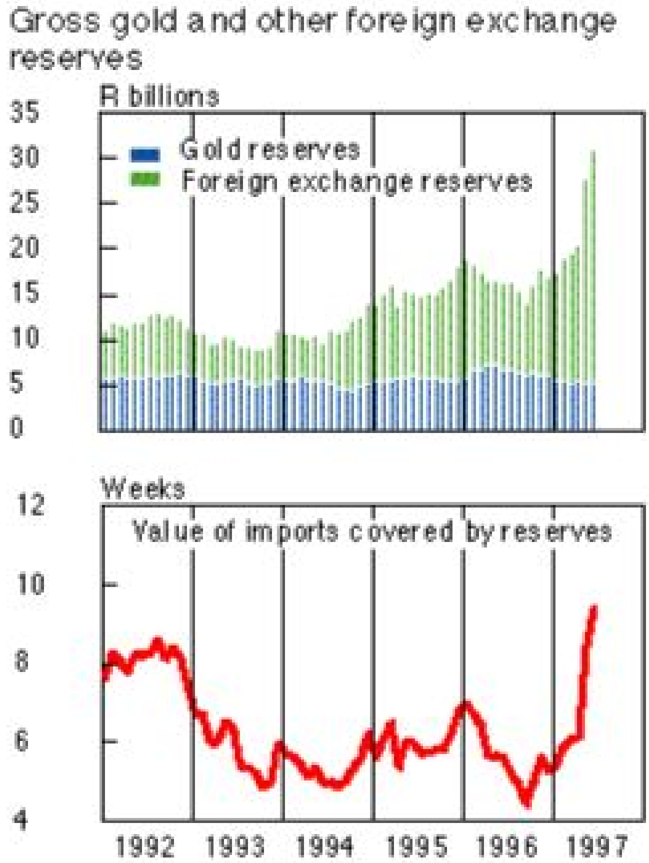
The value of South Africa's total foreign debt measured in rand increased from R120,5 billion at the end of 1995 to R154,2 billion at the end of 1996. As a *percentage of gross domestic product* it rose from 24,7 per cent in 1995 to 26,1 per cent in 1996 and as a *percentage of total export proceeds* it declined from 96,7 per cent in 1995 to 96,2 per cent in 1996, both ratios being relatively low according to international standards. The maturity structure of foreign-currency-denominated debt deteriorated somewhat during 1996: short-term debt (i.e. debt maturing within twelve months) constituted 37 per cent of total outstanding foreign-currency-denominated debt at the end of 1996 in comparison with a ratio of 31 per cent at the end of 1995.



Foreign reserves

After a substantial decline in 1993, and a further decline in the first half of 1994, *net gold and other foreign reserves* recovered along with the strong inflow of capital from abroad in the second half of 1994 and in 1995. The decline in the net inflow of capital in the first three quarters of 1996, together with the shortfall on the current account of the balance of payments, then caused the net gold and other foreign reserves to decline by R7,8 billion in the first three quarters of 1996. The tide turned in the fourth quarter of 1996 when the deficit on the current account of the balance of payments almost disappeared and a strong inflow of mainly short-term capital resulted in the net foreign reserves rising by R3,2 billion. The total net gold and other foreign reserves increased further by R14,3 billion in the first half of 1997.

The country's total *gross gold and other foreign exchange reserves* reached a peak of R19,0 billion at the end of January 1996, equal to about 7 weeks' worth of imports of goods and services. However, these reserves came under pressure in the remainder of 1996, falling by almost 27 per cent to the end of September 1996 when they were equal to 4½ weeks' worth of imports of goods and services. The subsequent improvement in the overall balance of payments position, strongly supported by government borrowing activity in the international capital markets and the sale of Telkom shares to non-resident parties, allowed for the gross reserves to increase by an amount of R17,2 billion between the end of September 1996 and June 1997. This increase almost doubled the gross gold and other foreign reserves to a value at the end of June 1997 that was approximately equal to 9½ weeks' worth of imports of goods and services.



In preparing for the further liberalisation of exchange controls, the Reserve Bank announced on 22 July 1997 that a three-year syndicated loan to the amount of US$1,75 billion had been negotiated with a number of international banking institutions. Apart from having a longer maturity than traditional, bilateral foreign credit facilities, this medium-term revolving credit facility is less expensive and has greater transparency in the global financial markets. The total amount of credit facilities available to the Reserve Bank came to R20,5 billion at the end of July 1997, of which only R3,2 billion had been activated by the Bank.

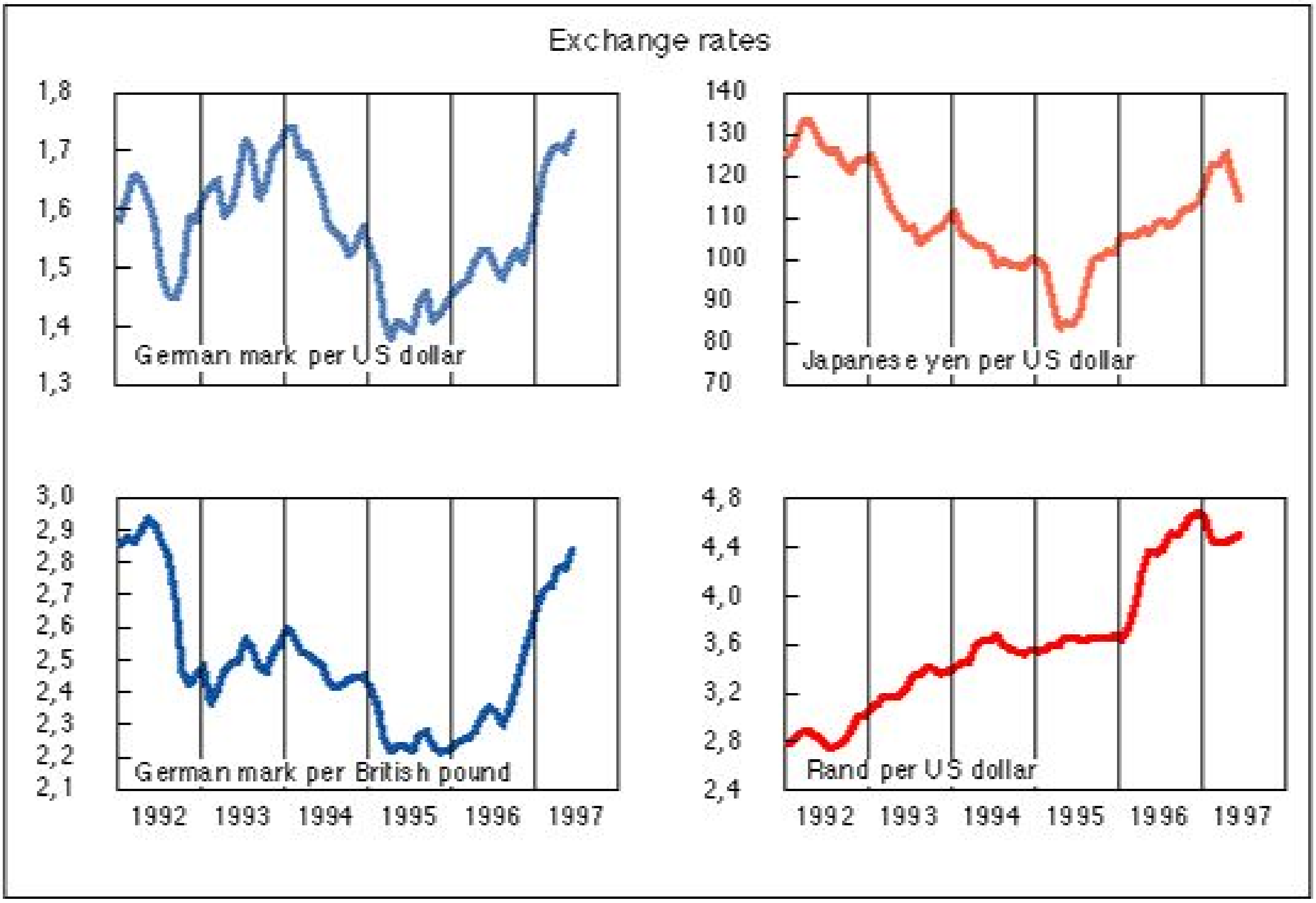
Foreign exchange market

International foreign exchange markets were characterised during 1996 and 1997 by a general realignment of the major currencies. From April 1995 to April 1997 the United States dollar strengthened in nominal terms by 19 per cent on a trade-weighted basis, whereas the nominal effective exchange rate of the Japanese yen declined by almost 30 per cent over the same period. In the fourth quarter of 1996 the exchange rate of the British pound strengthened by 10 per cent in nominal terms, before weakening again in January 1997.

The recent exchange rate movements could be attributed to, among others, the continued disparities in the relative cyclical positions of the major economies, interest rate differentials and-less-than perfect attempts at harmonising financial policies among the major advanced economies. In particular, the appreciation of the United States dollar was underpinned by the continued relatively strong performance of the United States economy and the relatively high interest rates on dollar-denominated assets.

The steady appreciation of the rand in the market for foreign exchange over the period May 1995 to January 1996 came to an end in the middle of February 1996. Apart from developments in the international financial markets, which included a steep rise in the yield on long-term bonds of the United States Federal Government in February 1996, the sudden weakness of the rand was a combination of the following:

- large-scale speculation, initially triggered by unfounded rumours about the health of President Mandela;
- the perception among some market participants that the rand had become overvalued towards the end of 1995 and in January 1996;
- a strong demand for spot dollars from importers who had left a substantial portion of their future foreign-currency commitments uncovered in the period following the initial depreciation of the rand;
- a delay in repatriating foreign export proceeds by exporters after the rand had begun to decline; and
- underlying fundamental factors, such as high inflation in South Africa relative to inflation in the main trading-partner economies.



The depreciation of the rand was later also affected by concerns about political stability and fears that fiscal policy might be less prudent than before. The nominal effective exchange rate of the rand consequently declined by 5,4 per cent in the second half of February 1996 and by 3,7 per cent in March. In April 1996 the average weighted value of the rand depreciated by 8,2 per cent before the market calmed down in May and June. Further speculative attacks followed, causing the rand to decline by 5,5 per cent between the end of September and the end of October 1996. Some stability was restored in the foreign exchange market in November and December 1996 and in these more orderly trading conditions the nominal effective exchange rate of the rand increased slightly towards the end of the year. The depreciation of the rand from the end of 1995 to the end of 1996 nevertheless still amounted to 21,9 per cent.

When market sentiment turned positive about investing in South African assets, the nominal effective exchange rate of the rand strengthened by 9,8 per cent from the end of 1996 to 13 March 1997. As from that date, the rand lost some of its strength and depreciated somewhat - the overall appreciation from the end of December 1996 came to 4,9 per cent by 31 July 1997.

The steep decline in the value of the rand during 1996 and the occasional paucity of liquidity in the market for foreign exchange prompted the Reserve Bank to intervene from time to time and to provide liquidity to the market. The objective of these interventions was not so much to defend the rand at any predetermined level, but more to reduce short-term volatility and to ensure a smooth adjustment to the implicit long-run equilibrium value of the rand. In addition to intervening in the spot exchange market, the Bank also provided forward foreign exchange, thereby increasing the net open forward position of the Bank from US$8,1 billion at the end of February 1996 to US$22,2 billion at the end of 1996. Since the beginning of 1997 the more tranquil state of the market has created opportunities for the Reserve Bank to become a net purchaser of spot dollars (thereby preventing an even steeper appreciation of the rand) and to reduce the net foreign-currency open position to US$16,8 billion at the end of June 1997. A general downward re-rating of the credit risk of emerging economies by some international portfolio investors, along with the relaxation of exchange controls on residents and the decline in the price of gold, elicited renewed speculative selling of rand in July 1997. The Reserve Bank adjusted its interventionist strategies accordingly and made foreign currency available to the market.

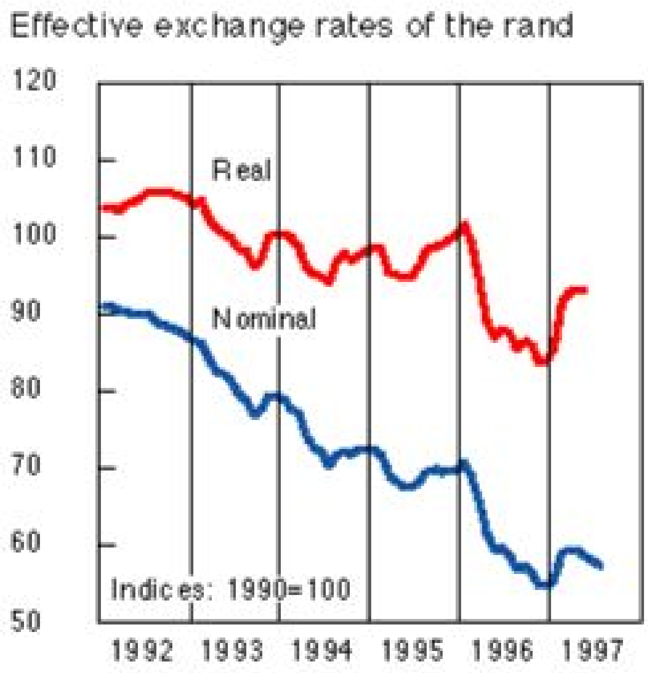
Table 10. Changes in the exchange rates of the rand

Per cent

	31 Dec '95 to 1 Dec '96	31 Dec '95 to 14 Feb '96	14 Feb '96 to 31 Oct '96	31 Oct '96 to 31 Dec '96	31 Dec '96 to 31 Jul '97
Weighted average	-21,9	1,0	-23,5	1,0	4,9
US dollar	-22,1	0,1	-23,1	1,2	1,5
British pound	-28,9	0,8	-27,4	-2,8	4,9
German mark	-15,7	2,5	-20,9	4,1	19,6
Japanese yen	-12,1	3,9	-18,4	3,7	2,8
Netherlands guilder	-15,4	2,5	-20,7	4,1	20,0
Italian lira	-24,9	-0,1	-26,3	2,1	18,8

The weakness of the rand in the period from February to October 1996 was aggravated by persistent rumours about imminent changes in exchange control measures which created biased expectations of future movements in the exchange rate and opportunities for destabilising speculation. As could be expected under such circumstances, the average net daily turnover in the market for foreign exchange increased from a level of US$4,9 billion in 1995 to US$6,0 billion in 1996. Within 1996, the net average daily turnover increased from US$5,5 billion in January to US$7,3 billion in February and to an all-time high of US$8,2 billion in April. During the remainder of that year the net average daily turnover moved around a level of US$5,6 billion per day before rising to US$7,4 billion in February 1997. In the ensuing four months average turnover was reduced to US$6,8 billion per day. Non-resident market participants became increasingly active in the domestic market for foreign exchange; the increase in non-resident activity by far exceeded that of residents in the market. In fact, the activity level of residents declined steadily during the course of 1996 and the first half of 1997.

The competitiveness of South African exporters of goods and services, as reflected by changes in the inflation-adjusted effective exchange rate of the rand, improved fairly substantially as a result of the decline in the nominal effective exchange rate of the rand in 1996. Following a marginal increase of 0,2 per cent in 1995, the average real effective exchange rate of the rand declined by 8,2 per cent in 1996. The GEAR strategy was developed around a hypothetical decline in the real effective exchange rate of 8,5 per cent in 1996. Despite the recent strengthening of the rand in 1997, the real effective exchange rate in the first half of 1997 was still about 2,1 per cent below its value in the corresponding period of 1996 compared with a desired decline of 0,3 per cent indicated by the GEAR strategy for 1997 as a whole.


Effective exchange rates of the rand
120
110
100
90
80
70
60
50
Real
Nominal
Indices: 1990=100
1992
1993
1994
1995
1996
1997

Monetary developments and interest rates

Monetary policy and financial stability

Monetary policy directed towards the attainment of overall financial stability is widely acknowledged as a necessary precondition for sustained economic growth and employment creation. In pursuing the objective of greater financial stability and ultimately of relative price stability, the Reserve Bank adopted a medium-term orientation in the conduct of monetary policy as far back as the late 1980s. This approach focuses closely on the objective of financial stability and to a much lesser extent on the need to counteract cyclical movements in output and employment through appropriate adjustments in monetary policy variables. Earlier experience with attempts to stabilise business cycle movements by means of pre-emptive adjustments of official interest rates was disappointing as these adjustments were seldom timed correctly and most of the time imparted an inflationary bias to the economic process.

The Reserve Bank is therefore not applying monetary policy as a short-term counter-cyclical instrument, but aims to create a consistently stable financial environment in the interest of sustainable economic growth. A fiscal policy posture that is supportive of the stability objective would, of course, relieve the task of monetary policy by reducing the upward pressures on interest rates, thereby strengthening confidence in the authorities' macroeconomic strategies. The emphasis on fiscal discipline since 1994, as is evident from the decline in the budget deficit of the national government relative to gross domestic product, has greatly assisted in the harmonisation of monetary and fiscal policies towards attaining the objective of overall financial stability. This has increased the credibility of the government's macroeconomic policy framework and should continue to keep expectations of inflation in check, while causing general price increases to subside gradually.

The substantial progress made by monetary policy towards greater price stability during the past decade when inflation was brought down from 18,6 per cent in 1986 to below 10 per cent per year since 1993, came under threat when the economy entered a phase of economic expansion during the second quarter of 1993. The growth in the M3 money supply and in credit extended to the non-bank private sector by monetary institutions accelerated rapidly during 1994 to rates that exceeded the long-term growth potential of the economy by a fairly substantial margin. The Reserve Bank had little option but to assume a cautious counter-inflationary policy stance and the first increase of one percentage point in Bank rate from 12 per cent to 13 per cent was introduced on 26 September 1994. This increase was followed by two further increases to bring Bank rate to a level of 15 per cent at the end of June 1995. It then remained at this level for the rest of 1995 and the first quarter of 1996.

In an attempt to bring some stability to the foreign exchange market and to contain the inflationary potential of the weakening rand, the Reserve Bank increased Bank rate from 15 per cent to 16 per cent on 29 April 1996 and became a net seller of foreign exchange during the first half of 1996 in order to alleviate a severe shortage of liquidity in the market for foreign currency. This intervention drained liquidity from the domestic money market, increased the amount of accommodation provided to the banks at the discount window, increased upward pressure on money market rates and generally raised the cost of funding the lending operations of the banks, thus narrowing the margin between their lending rates and their average funding costs. Although Bank rate was left unchanged, the banks then found it necessary to increase their lending rates by one percentage point on 20 May 1996 in order to partly relieve the pressure on their margins.

Liquidity in the domestic money market improved during May and June 1996 and money market interest rates declined somewhat during this period. In these circumstances the Reserve Bank was prepared to provide marginal support to a downward adjustment in the banks' lending rates by announcing a reduction of 0,75 percentage points in the cost of accommodation at the discount window against collateral of second-tier assets on 25 June 1996. Accommodation at the discount window was consequently made available at slightly less onerous rates in case money market conditions should again become relatively tight. This step allowed the banks the necessary latitude to lower their lending rates as from 1 July 1996.

The continued weakness of the rand and further speculative attacks against the currency from July to October 1996, together with persistently high growth in the money supply and credit extension to the private sector by the monetary sector, the relatively low level of the official gold and other foreign reserves and the emergence of renewed inflationary pressures in the wake of the depreciation of the rand, served as the background to a second increase in 1996 in Bank rate of one percentage point on 21 November. This resulted in an increase in Bank rate to 17 per cent, which was meant to dampen the inflationary pressures arising from the depreciation of the rand in accordance with the Reserve Bank's overall counter-inflationary strategy.

The commitment of the Reserve Bank to establish relative price stability was emphasised again on 14 March 1997 with the announcement of the guidelines for acceptable growth in the quarterly average value of the M3 money supply. These guidelines were left unchanged for the third consecutive year at between 6 and 10 per cent. When announcing the guidelines, the Governor reiterated that the mission of the Reserve Bank was the protection of the value of the rand and that financial stability and inflation containment would remain the overriding objectives of monetary policy in 1997. The Governor further indicated that the challenge for 1997 would be to contain the rate of consumer price inflation at a level below 10 per cent.

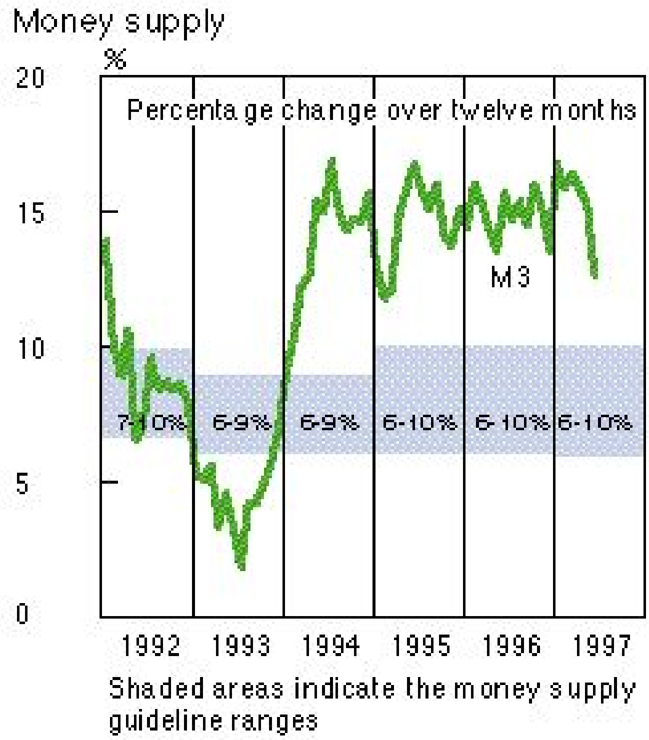
The importance of maintaining domestic financial stability was strongly demonstrated by developments in the foreign exchange market during 1996. South Africa had to take cognisance of the fact that concern among global financial market participants about the perceived inability of domestic policies to ensure financial stability could easily develop into speculative attacks on the currency of any delinquent country. At the same time it became clear that the increased exposure of the South African financial system to global markets was certain to pose new challenges for the management of overall monetary conditions. Of particular and continuing concern was the inflexible response of domestic money market rates to inflows and outflows of international capital and changing conditions in the money market generally. A preferred situation would be for the impact of a change in domestic money market liquidity to occur unambiguously through a change in borrowing costs at the short end of the yield curve.

To address some of the shortcomings of the current financial system, a new integrated national payments system with real-time gross settlement options is scheduled for implementation in 1998. The substantial increase in all financial market transactions and the greater participation by non-residents have exerted severe pressure on the existing national payments, clearing and settlement system. The new system is being developed at the initiative of the Reserve Bank in collaboration with the banking sector and will be compatible with global network systems for payments and clearing operations.

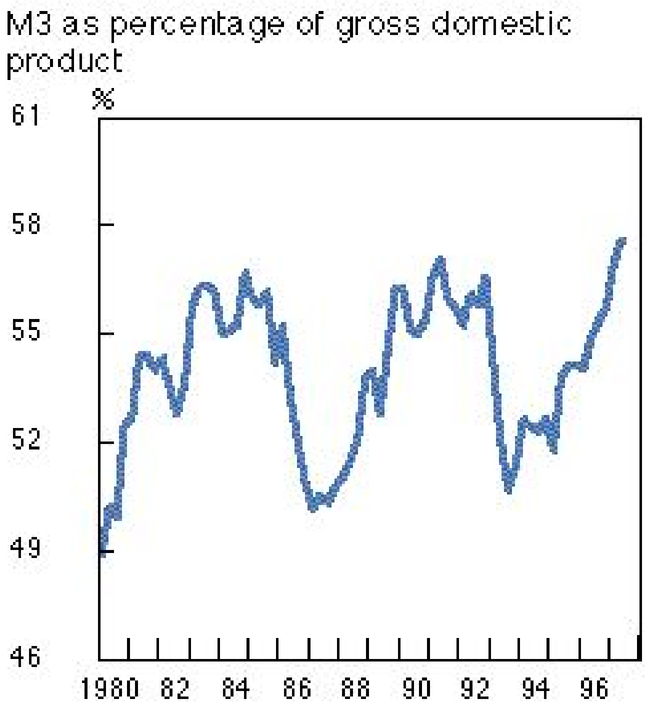
The increasing reintegration of South Africa into the world economy also facilitated the country's deeper engagement with the SADC, within which South Africa manages the Financial and Investment Sector. Priority is currently given to the development of the internal financial systems of member countries within a consistent and compatible framework that could allow for the co-ordination of macroeconomic policies at some later stage. The new national payments, clearing and settlement system, which is currently being implemented in South Africa is also intended to serve as a framework for an integrated cross-border settlement system for the entire SADC region.

Money supply

The broadly defined monetary aggregate, M3, has now been increasing at rates well in excess of 10 per cent per year for almost 3½ years. The average twelve-month rate of increase in M3 furthermore, accelerated progressively from 4,6 per cent in 1993 to 13,8 per cent in 1994, 14,6 per cent in 1995, 14,9 per cent in 1996 and 15,5 per cent in the first six months of 1997. However, the growth over twelve months in M3 tapered off during the first half of 1997 from 16,8 per cent in January to 12,7 per cent in June. Apart from a brief interlude of two months at the beginning of 1995, the seasonally adjusted month-end values of the broad money supply consistently exceeded the upper limits of the guideline "cone" set for growth in M3 over the past 3 years, despite regular year-end rebasing. During 1996 the quarter-to-quarter seasonally adjusted and annualised percentage change in M3 increased from 13,7 per cent in the first quarter to 21,2 per cent in the second quarter, before subsiding to 18,6 per cent and 7,6 per cent in the third and fourth quarters respectively. In the first quarter of 1997 it rebounded sharply to 18,1 per cent, but then declined moderately to 16,4 per cent in the second quarter. Because of these sharp increases in M3, the ratio of M3 to gross domestic product (i.e. the inverse of the income velocity of money) increased to its highest value since 1980. This ratio was recorded at 57,6 per cent in the second quarter of 1997, compared with the previous highest value for the post-1980 period of 57,1 per cent, which was attained in the second quarter of 1991.

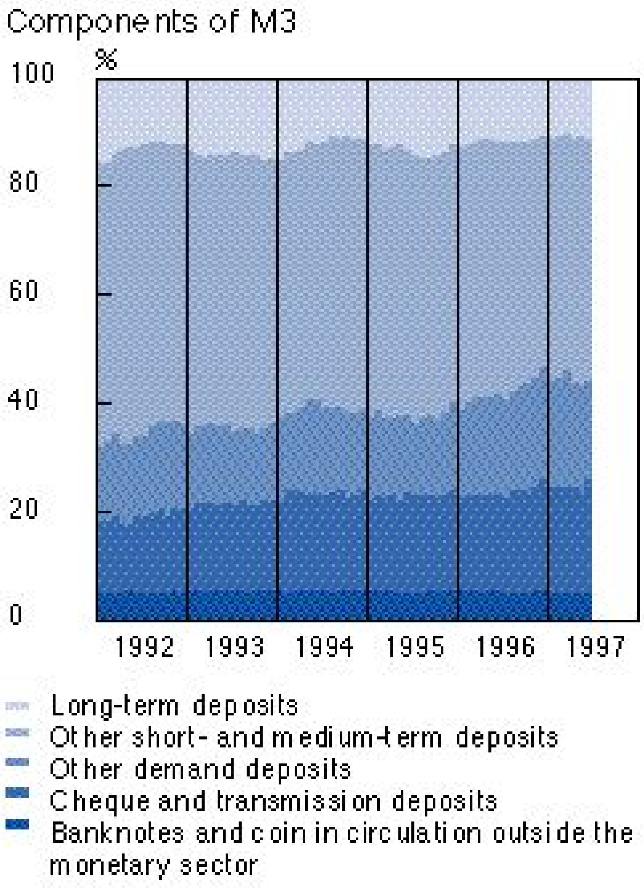


As the money supply in South Africa is largely demand determined, the buoyancy of economic conditions since the resumption of positive economic growth in 1993 contributed to the strong growth in the broad money supply over the past 3½ years. *Bank deposits held by the "business sector"* (defined as companies, close corporations and local authorities) increased at an annualised rate of 22,0 per cent from December 1993 to June 1997, i.e. at a substantially faster rate than the increase of 14,9 per cent per year recorded in M3 over the same period. The strong demand for transaction balances is revealed even more clearly by growth in the business sector's holdings of cheque, transmission and other demand deposits, which rose as a percentage of their total deposit holdings from 42,4 per cent at the end of 1993 to 48,4 per cent at the end of June 1997.



Lively conditions in the domestic financial markets, along with the relatively high inflation-adjusted deposit rates offered by monetary institutions, also contributed to the persistently high growth rate in the money supply. *Deposit holdings of insurers and pension funds*, for example, increased at an annual rate of 27,3 per cent from the end of 1993 to June 1997.

Deposit holdings of individuals increased at an average annual rate of 10,4 per cent from December 1993 to June 1997, i.e. well below the average rate of 14,9 per cent at which M3 increased over this period. Moreover, individuals reallocated their deposit holdings away from long-term deposits, which declined at an average annual rate of only 2,2 per cent from December 1993 to June 1997, to cheque, transmission and other demand deposits, which grew at an average annual rate of 19,4 per cent over the same period. The changing savings profile of private households is reflected in a decline in the average value of individuals' deposit holdings as a percentage of personal disposable income from 34,2 per cent in the fourth quarter of 1993 to 33,7 per cent in the second quarter of 1997.



Investors' preference for bank deposits with different maturities was also reflected in substantial changes in the *composition of M3*. Cheque, transmission and other demand deposits increased, on balance, from 31,2 per cent of the aggregate M3 money supply at the end of December 1993 to 39,3 per cent at the end of June 1997, owing, *inter alia*, to the stronger liquidity preference of investors and the relatively high interest rates payable on such deposits. Other short- and medium-term deposits as a percentage of aggregate M3 declined from 48,6 per cent to 44,7 per cent over the same period, whereas the percentage share of long-term deposits fell back from 15,2 per cent to 11,5 per cent. The divergent growth rates of the different types of deposits culminated in substantially higher average growth rates in the more narrowly defined monetary aggregates as indicated in Table 11.

Table 11. Percentage change in monetary aggregates over twelve months

Per cent

		M1A	M1	M2	M3
1993:	Dec	16,63	6,74	3,95	7,01

1994:	June	25,12	28,19	17,44	15,01
	Dec	24,77	23,74	20,61	15,72
1995:	June	17,02	7,78	15,60	16,82
	Dec	16,77	19,26	13,85	15,16
1996:	Jun	14,70	28,66	17,91	15,74
	Dec	21,88	30,90	15,75	13,61
1997:	Jun	24,52	19,08	13,04	12,67

The *main counterpart*, in a statistical or accounting sense, of the increase in the M3 money supply in the twelve months until the end of June 1997 was bank credit to the private sector. In fact, the change in bank credit to the private sector accounted for more than the total increase in M3. Among the other "statistical causes" of the increase in M3, were net claims by monetary institutions on the government sector, which increased slightly over the twelve months from June 1996 to June 1997, while the net foreign assets of the monetary sector and its "net other assets and liabilities" shrank somewhat over the same period.

Table 12. Main counterparts of the change in M3 in the year to 30 June 1997

R billions

	1996		**1997**		**Year to June 1997**
	3rd qr	**4thqr**	**1st qr**	**2nd qr**	
Net foreign assets	-3,1	-5,3	-2,2	6,9	-3,7

Net claims on the government sector	-2,1	0,1	4,6	-3,2	-0,6
Claims on the private sector	14,4	11,3	16,1	13,8	55,6
Net other assets and liabilities	-5,1	4,8	-1,1	-11,3	-12,7
Total change in M3	**4,1**	**10,9**	**17,4**	**6,2**	**38,6**

Credit extension

The well-developed and sophisticated South African banking system encountered few problems in adapting to recent changes in the socio-political environment and in catering for the growing number of new participants in the modern segment of the economy. The reintegration of the banking system into the global financial network has been relatively smooth and the local banks have positioned themselves well to withstand the increased competition coming from foreign banks entering the domestic credit market. These developments, together with firm growth in nominal domestic expenditure over the twelve months to June 1997 and the rapid expansion of activity in the securities markets, contributed to the robust expansion of bank credit extension in the face of relatively high real lending rates.

Table 13. Credit extended by monetary institutions as percentage of nominal gross domestic product at market prices

Per cent

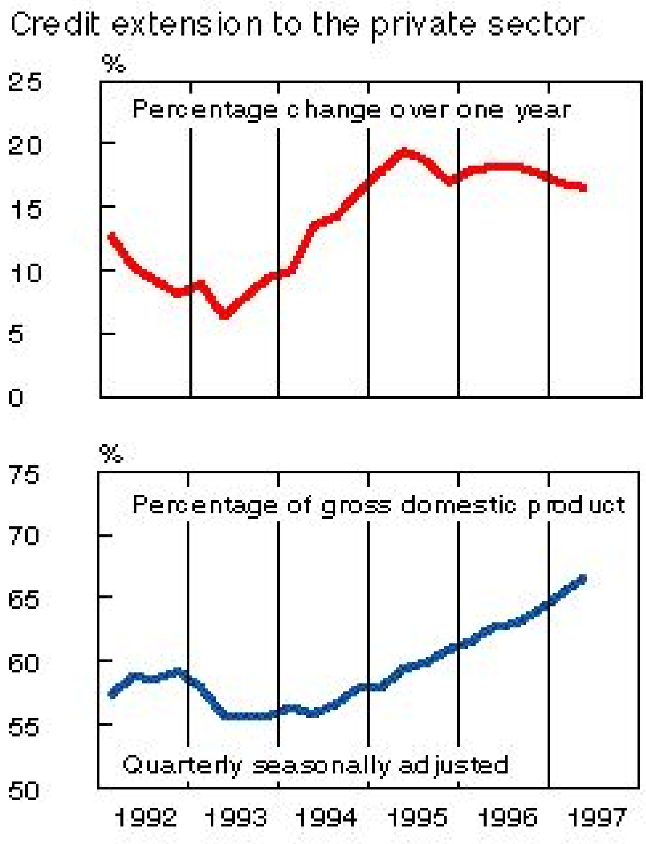
	December 1993	**December 1996**	**June 1997**
Claims on domestic private sector			
Non-mortgage loans	34,6	38,7	39,2

Mortgage loans	25,3	28,9	28,3
Total	59,9	67,6	67,6
Gross claims on government sector	7,0	7,3	7,3
Total gross claims on government and private sector	**66,8**	**74,9**	**74,9**

Total *gross domestic credit extended* by the monetary sector as a percentage of nominal gross domestic product at market prices increased from 66,8 per cent at the end of 1993 to 74,9 per cent at the end of 1996, before stabilising around this relatively high ratio during the first half of 1997. These high ratios emphasise the importance of the banking sector as a source of finance in the South African economy. The lending operations of the banking sector are mostly directed at the non-bank private sector. The gross claims of the banking sector on the government sector are small in comparison with its claims on the non-bank private sector.

The increase in bank penetration as indicated by the ratio of total credit extended by banks as a percentage of nominal gross domestic product at market prices, shows that credit extension has grown at a substantially faster rate than real and nominal gross domestic product during the three years up to the end of December 1996, before subsiding slightly relative to nominal gross domestic product in the first half of 1997. The rate at which the growth in bank credit extension is outpacing growth in aggregate real output may indicate some deterioration in the quality of the loan portfolio of banks, which may eventuate in an increase in bad debt under less favourable macroeconomic conditions.

Notwithstanding the high level of bank penetration in the economy, certain sections of the population still have only limited recourse to the credit facilities of the formal banking sector and have to rely predominantly on the *services of informal money lenders*. The activities of these micro-financiers are relatively small compared with the size of the formal banking sector. Their activities are not within the ambit of the bank supervisory legislation, but the introduction of appropriate legal measures which would allow the micro-finance sector to become self-regulatory, is currently under consideration.



The growth in *total domestic credit extension* also remained strong from the end of 1993 to the first half of 1997. The twelve-month rate of increase in total bank credit extension accelerated from 9,5 per cent in December 1993 to 19,9 per cent in December 1994, but then slowed down to 13,2 per cent in December 1995 because the monetary institutions' net claims on the government sector actually declined from the end of December 1994 to the end of December 1995. Subsequently, the twelve-month growth in total bank credit extension accelerated again to 17,1 per cent in December 1996 and 21,6 per cent in February 1997, before slowing down to 15,5 per cent in June 1997. The high growth in total domestic bank credit extension since the beginning of 1996 has been mainly due to the rapid extension of credit to the non-bank private sector, although the net claims of the monetary sector on the government sector also increased over this period.

Credit extension by the monetary institutions to the *non-bank private sector* accelerated rapidly after the upturn in economic activity in mid-1993. The twelve-month rate of increase in bank credit extension accelerated from 9,7 per cent in December 1993 to a monthly average rate of 13,7 per cent in 1994, 18,2 per cent in 1995, 17,9 per cent in 1996 and 16,8 per cent in the first half of 1997. The persistently high rate of increase in credit extension to the private sector was probably fuelled by an increase in the number of households utilising the formal banking sector for the first time, buoyant growth in domestic expenditure, the high level of activity in the financial markets, the switching of foreign trade financing from offshore to domestic sources of credit, as well as distress borrowing by struggling business concerns in recent times.

During 1996 the quarter-to-quarter seasonally adjusted annualised percentage change in nominal credit extension to the private sector increased from 20,1 per cent in the first quarter to 22,4 per cent in the second quarter before subsiding to 16,6 per cent in the third quarter and 11,8 per cent in the fourth quarter. It then rebounded to 17,0 per cent in the first quarter of 1997 and 21,0 per cent in the second quarter.

The forces driving the growth in bank credit, however, seemed to have diminished somewhat in the second quarter of 1997 as the twelve-month rate of increase in credit extension to the private sector by monetary institutions slowed down from 17,3 per cent in February to 16,3 per cent in June 1997. The relatively high rates of increase in credit extension to the private sector in the year ended June 1997 coincided with an increase in the consumer price inflation rate until April 1997, with the result that the increase over twelve months in the monetary institutions' *real credit extension to the private sector* declined from 10,0 per cent in December 1995 to only 5,8 per cent in March 1997. It then accelerated again to 6,9 per cent in June 1997 as credit extension to the private sector persisted to expand at a high rate and year-on-year consumer price inflation subsided.

An analysis of the banks' *claims on the private sector by type of credit* shows that the increase in *mortgage loans* accounted for 41,5 per cent of the increase in total credit extension to the private sector during the period December 1993 to June 1997. *"Other loans and advances"* contributed 36,4 per cent to this increase, *instalment sale credit* 14,5 per cent and *investments and leasing finance* 8,8 per cent. In contrast, *bills discounted* declined by 1,2 per cent over this period as the role of liquid bankers' acceptances was reduced by the removal of not only their liquid asset status in terms of the Banks Act, but also their status as collateral for overnight loans at the discount window.

The growth over twelve months in *mortgage advances* by banks to the private sector has slowed down continuously from September 1996, despite the ease of access to some mortgage schemes and the comparatively low interest rates charged on these advances. It is particularly noteworthy that the twelve-month growth rate in mortgage advances to households during June 1997 amounted to 12,9 per cent, while that to companies amounted to 28,2 per cent. During the same month the use of this credit facility by households represented 63 per cent of total household indebtedness to banks, while in the case of companies it amounted to 13,2 per cent of total corporate indebtedness to banks. Banks are still encouraging the use of mortgage facilities on account of the low capital requirements that they are subject to and the perceived low credit risk of such loans.

Table 14. Credit extended to the private sector: Households

Percentage change over twelve months

Type of credit	1996				1997	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Instalment sales	28,5	26,7	22,6	18,5	30,3	24,1

Leasing finance	19,6	21,2	8,5	4,6	17,5	13,4
Mortgage advances	15,9	15,3	15,9	14,5	13,9	12,9
Overdrafts	12,1	3,9	14,1	14,7	13,0	18,3
Credit cards	46,7	38,3	33,3	26,9	22,4	10,6
Other loans and advances	24,6	25,3	19,0	14,8	15,4	13,1
Total	**18,3**	**16,7**	**16,8**	**15,0**	**16,0**	**14,6**

The rate of increase over twelve months in *"other loans and advances"* (including overdrafts), rose sharply from 13,4 per cent in November 1995 to 23,8 per cent in October 1996. It fluctuated around a high level of 21,0 per cent in the first half of 1997 and amounted to 23,0 per cent in June 1997. The growth over twelve months in *instalment sale credit* peaked at 30,7 per cent in January 1996 and gradually fell back to 18,1 per cent in March 1997 and 14,3 per cent in June. The twelve-month rate of increase in l*easing finance* declined from 18,8 per cent in January 1996 to only 8,9 per cent in June 1997. The lower rates of increase in both instalment sale credit and leasing finance during the first half of 1997 could largely be ascribed to a slowdown in the purchases of new and used motor vehicles, trucks, buses and other commercial vehicles. The purchases of industrial, commercial and office equipment were still relatively high in the first six months of 1997. However, new business payouts by the banks in respect of instalment sale credit and leasing finance slowed down from an average of R10,4 billion per quarter in 1996 to R9,4 billion in the first quarter of 1997 and R9,6 billion in the second quarter.

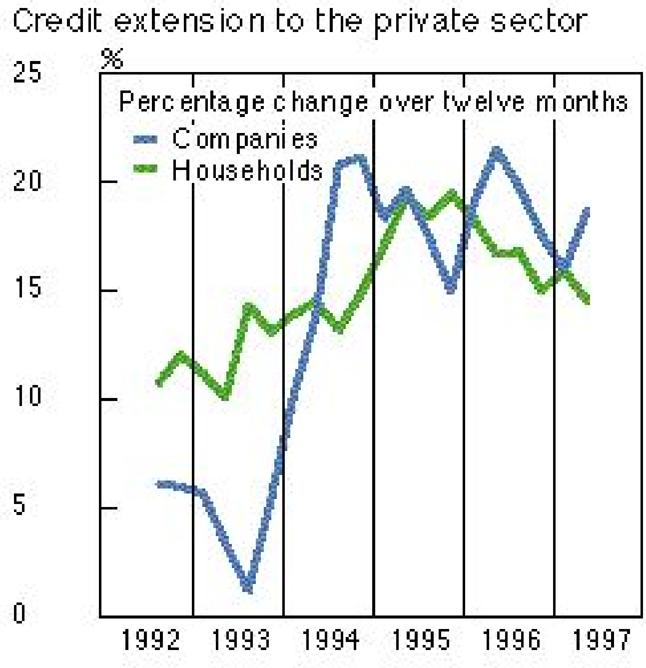
Table 15. Credit extended to the private sector: Companies

Percentage change over twelve months

Type of credit	**1996**	**1997**

	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Instalment sales	29,1	26,9	25,6	23,9	7,1	5,2
Leasing finance	16,2	14,1	26,8	24,9	12,3	6,1
Mortgage advances	22,7	25,7	26,8	32,0	30,6	28,2
Overdrafts	25,7	36,5	17,4	18,2	26,9	20,4
Credit cards	51,7	30,5	30,2	-0,8	-17,7	-9,1
Other loans and advances	11,0	15,8	20,8	19,7	20,5	32,9
Investments	25,1	16,6	19,3	-0,4	-1,5	9,9
Bills discounted	6,1	4,9	-17,2	-20,5	-16,0	-15,8
Total	**19,1**	**21,5**	**19,8**	**17,6**	**16,0**	**18,7**

Between the fourth quarter of 1994 and the second quarter of 1997 credit to *households*, as a percentage of total credit extended to the private sector increased from 57,4 per cent to 57,6 per cent, while the share of *companies* declined from 42,6 per cent to 42,4 per cent. However, the larger part of overdrafts and "other loans and advances", namely 61 per cent, was utilised by companies. The twelve-month rate of increase in overdrafts utilised by households decreased from 26,8 per cent in January 1996 to 18,3 per cent in June 1997, while the year-on-year rate of increase in "other loans and advances" by households decreased from 22,9 per cent to 13,1 per cent over the same period. During the corresponding period the twelve-month growth rate of mortgage loans utilised by companies declined marginally from 28,7 per cent to 28,2 per cent, while the year-on-year growth rate of "other loans and advances" extended to companies increased from 1,3 per cent to 32,9 per cent. The rate of increase over twelve months in credit extended on credit cards to households fell back from 47,9 per cent in January 1996 to 21,6 per cent in April 1997 and 10,6 per cent in June, while the use of this type of credit by companies fell away almost completely.



Interest rates and yields

The *monthly average yield on long-term government stock* declined relatively sharply in the second half of 1995 as perceptions about political and economic developments in South Africa turned positive and estimates of future inflation were generally lowered. This downward movement in rates was reversed in February 1996 when bond yields in the North American capital markets rose sharply and the rand suffered an abrupt and rather drastic decline in value. Bond yields then rose firmly until May 1996, but fluctuated within a narrow range without any clear upward or downward direction for the remainder of that year. Market sentiment turned bullish again from the beginning of 1997 when it became clear that the exchange value of the rand was in the process of recovering from the setbacks of 1996. The strong output and export responses in the second half of 1996 to the earlier depreciation of the rand, the steady improvement in the gold and foreign exchange reserves of the country and later also general satisfaction with the financial policies of government, further bolstered confidence. The yield on long-term government bonds gradually drifted downwards in the first half of 1997 to reach an average value of 14,72 per cent in June 1997 - the lowest average monthly value since February 1996.

Table 16. Interest rates and yields

Per cent

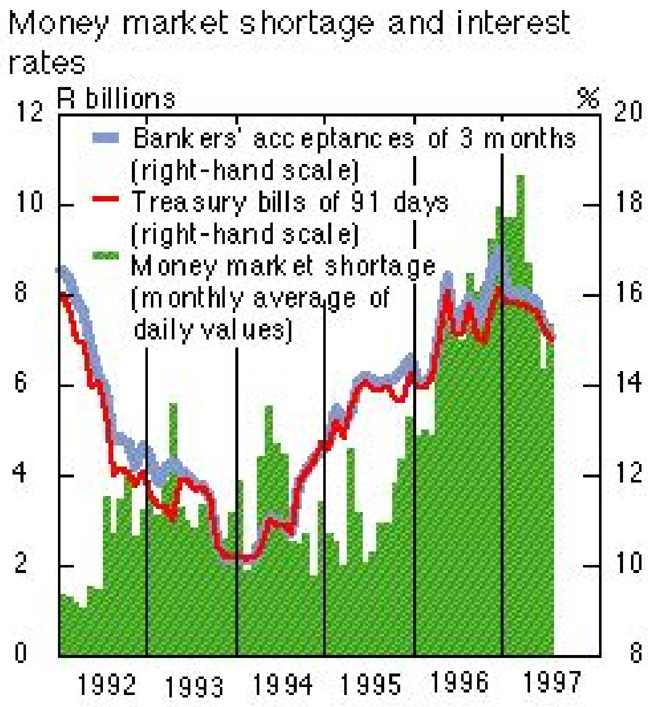
Period		Monthly average yield on long-term government bonds		3-month bankers' acceptances*	Prime overdraft rate*	Predominant rate on	
		Nominal	Real			Mortgage loans	12-month fixed deposits
1996:	Apr	15,78	9,8	15,20	19,50	18,25	13,50
	May	16,53	10,1	16,40	20,50	19,25	14,50
	Jun	15,78	8,3	15,20	20,50	20,25	15,00
	Jul	15,39	7,7	15,55	19,50	19,25	14,25
	Aug	15,82	7,7	15,95	19,50	19,25	14,25
	Sep	15,42	6,5	15,30	19,50	19,25	15,00
	Oct	15,80	6,1	15,80	19,25	19,00	15,00
	Nov	16,18	6,4	16,55	20,25	19,00	14,50
	Dec	16,19	6,3	17,00	20,25	20,00	14,50
1997:	Jan	15,82	5,9	16,15	20,25	20,00	14,50
	Feb	15,03	4,8	16,00	20,25	20,00	14,50
	Mar	15,16	5,1	16,05	20,25	20,00	14,50
	Apr	15,24	4,9	15,95	20,25	20,00	14,50
	May	15,08	5,1	15,85	20,25	20,00	14,50

	Jun	14,72	5,5	15,30	20,25	20,00	14,50
	Jul	14,21	...	15,05	20,25	20,00	14,50
* at month-ends							

In *real terms* the monthly average yield on long-term government stock increased from 6,4 per cent in January 1996 to 10,1 per cent in May as nominal rates rose strongly and consumer price inflation over twelve months subsided. With the subsequent acceleration in consumer price inflation and the decline in the nominal yield on long-term government bonds since the beginning of 1997, the real yield fell back to 5,5 per cent in June 1997. At this level, real yields on long-term government bonds was only slightly higher than those of long-term bonds of the United States Federal Government. The small differential of 1,4 percentage points between the two real yields may signal that differences in country and currency risks have not been adequately accounted for in the pricing of bonds in the United States and South African markets. Alternatively and more plausibly, the small differential in real yields may indicate that expectations of future inflation in South Africa are lower than indicated by the current rate of inflation, and that long-term interest rates adjusted for expected inflation are consequently higher than real rates calculated by using observed inflation.

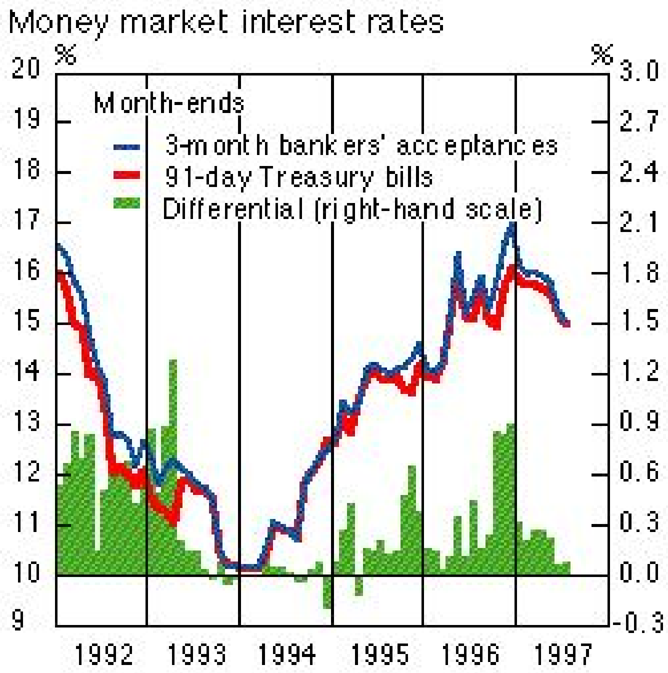
Money market interest rates rose throughout the first five months of 1996, declined sharply in June 1996, showed no clear upward or downward tendency from July to September, increased again in the fourth quarter of 1996, but then declined steadily in the first six months of 1997. The *rate on bankers' acceptances of three months*, which represents the general movement in money market rates fairly well, increased from 14,10 per cent at the end of January 1996 to 16,40 per cent at the end of May, but declined to 15,20 per cent at the end of June when it became clear that Bank rate was not about to be raised at that stage beyond the level of 16 per cent.

During the third quarter of 1996 the rate on bankers' acceptances fluctuated around a slightly higher level than in June, but moved upwards to 15,80 per cent at the end of October in reaction to the weakening of the rand, expectations of higher inflation and market speculation of a tightening of monetary policy. Money market conditions tightened from the beginning of the fourth quarter of 1996 and Bank rate was raised to 17 per cent on 21 November. Reflecting these developments, the rate on bankers' acceptances moved higher to 16,55 per cent at the end of November 1996 and 17,00 per cent at the end of December. This upward trend was reversed in January 1997 when the rate on bankers' acceptances fell back to 16,15 per cent at the end of that month. Somewhat easier money market conditions during the second quarter of 1997 and market expectations of a relaxation of monetary policy assisted the downward movement of the rate on bankers' acceptances of three months to 15,30 per cent at the end of June.

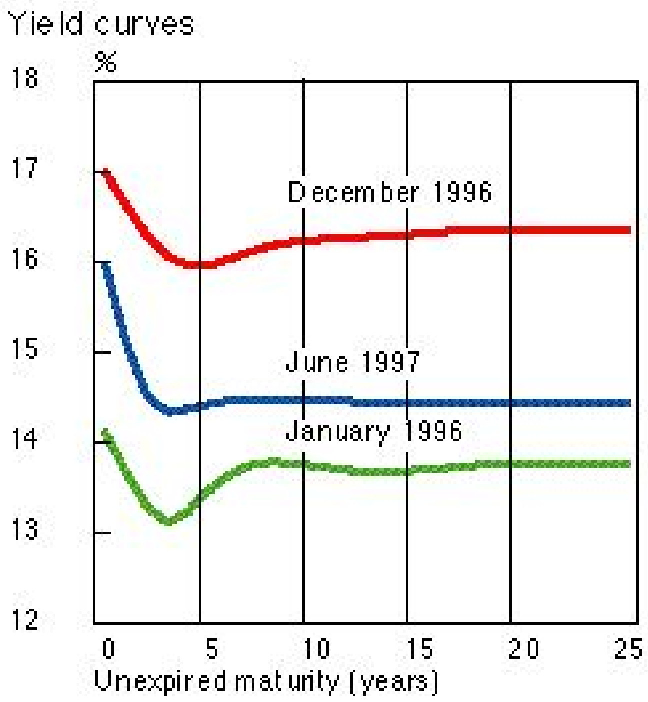


The *tender rate on Treasury bills of three months*, which usually follows movements in other money market rates closely, increased from 12,62 per cent at the end of January 1995 to 14,22 per cent at the end of December 1995. This trend was temporarily interrupted during the first two months of 1996, after which the upward movement was resumed and the tender rate on Treasury bills reached 16,06 per cent at the end of May 1996. It softened again to 14,94 per cent towards the middle of July. In the second half of 1996 the tender rate on Treasury bills once again responded to the tight conditions in the money market and the weak exchange value of the rand and moved higher to 15,79 per cent at the end of August. It drifted lower from 15,06 per cent at the end of September to 14,95 per cent at the end of October 1996.

The most important forces behind this somewhat contradictory behaviour of the tender rate on Treasury bills in relation to the rate on bankers' acceptances were, amongst others, the special status enjoyed by short-dated Treasury bills, the limited availability of liquid assets in the market and the relatively strong demand by banks for high-quality paper which could be lodged as collateral against borrowing at the discount window. The limited availability of assets qualifying as first-tier collateral at the discount window towards the end of October 1996 created a strong demand for Treasury bills among banks. This demand for Treasury bills explained the decline in the tender rate on Treasury bills which occurred at the end of September and at the end of October 1996 and mirrored the increase in the volume of borrowing at the discount window against collateral of second-tier assets at the end of November. The tender rate on Treasury bills of three months began to move in harmony again with other money market rates as from the first quarter of 1997. The average month-end margin between the tender rate on Treasury bills of three months and the rate on bankers' acceptances with a maturity of three months, which had widened from 0,28 percentage points in the third quarter of 1996 to 0,86 percentage points in the fourth quarter of 1996, narrowed to 0,26 percentage points in the first quarter of 1997 and 0,18 percentage points in the second quarter. This narrowing of the differential was mainly a consequence of the more readily available supply of assets qualifying as first-tier collateral at the discount window.

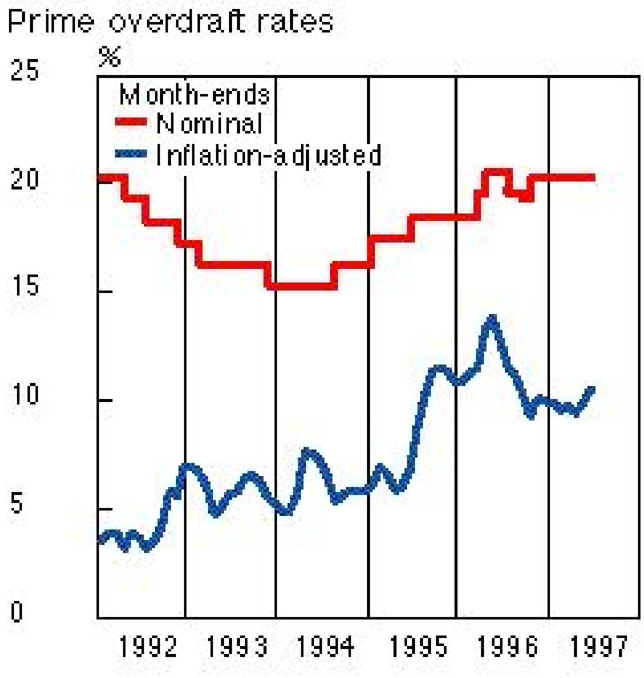


The steep decline in long-term yields in the second half of 1995 coincided with short-term rates which generally maintained the level they had reached in June of that year, thereby causing the *yield curve* to become flatter than before and in January 1996 slightly inverted. A yield curve with a shape like this is often interpreted as a portent of an imminent slowdown in real economic activity. The yield curve subsequently shifted higher over the full maturity spectrum, but with the rise in short-term interest rates exceeding that of long-term yields, it became even more inverted in December 1996 than in January. Since January 1997 the yield curve has shifted downwards; it subsequently became more inverted in June 1997 than in December 1996. This time the increased inversion came from the relative flexibility at the long end of the maturity spectrum: long-term yields declined more than short-term interest rates in the first six months of 1997. The recent shape of the yield curve could be signalling expectations of an imminent relaxation of monetary policy, lower inflation in the medium- to long term and a forthcoming slowdown in the rate of expansion of overall economic activity.



The *prime overdraft rate* of banks increased from 18,50 per cent to 19,50 per cent on 29 April 1996 in response to the first increase in Bank rate for 1996. To alleviate pressure on the margin between their lending and deposit rates, the banks increased their prime overdraft rate even further to 20,50 per cent in May, even though Bank rate was left unchanged at the time. Only after the Reserve Bank had announced a reduction in the cost of accommodation at the discount window against collateral of second-tier assets and conditions in the money market had become somewhat less tight, did the banks lower their prime overdraft rates by one percentage point to 19,50 per cent in July 1996. When the financial services levy was abolished in October 1996, the banks announced another cut in their prime overdraft rates to 19,25 per cent. On 21 November, when Bank rate was increased for the second time in 1996, the banks' prime overdraft rates increased once again by one percentage point to 20,25 per cent. No adjustment in the prime overdraft rate was made during the first half of 1997.

The *inflation-adjusted prime overdraft rate* increased from 10,9 per cent at the end of January 1996 to 13,8 per cent at the end of May, but then declined to 9,3 per cent at the end of October, only to rise again to 10,1 per cent at the end of November after the upward adjustment in Bank rate. The real prime overdraft rate then declined to 9,4 per cent at the end of April 1997, but rose again to 10,5 per cent at the end of June.



The *predominant rate on mortgage loan*s of banks followed the changes in the prime overdraft rate of banks closely. After having remained unchanged since July 1995, the mortgage rate was raised by one percentage point to 19,25 per cent in May 1996 and further to 20,25 per cent in June. The mortgage rate was then lowered twice in the second half of 1996, first to 19,25 per cent in July and then to 19 per cent in October. It was increased again to 20,00 per cent in December following the increase in the prime overdraft rates of banks in November 1996.

The *predominant retail rate on twelve-month fixed deposits with banks*, which is regarded as indicative of deposit rates in general, was increased from 13,50 per cent to 14,50 per cent in May 1996 and even further to 15,00 per cent in June. This rate was subsequently lowered to 14,25 per cent in July 1996 and increased to 15,00 per cent in September, only to be lowered again to 14,50 per cent in November. This deposit rate presented savers with a pre-tax inflation-adjusted yield of only 5,3 per cent in June 1997.

The standard interest rate applicable to loans granted from the State Revenue Fund was adjusted frequently during the course of 1996, but amounted to 16,50 per cent in December. This rate was then increased to 16,75 per cent with effect from 1 January 1997. After six further changes it was set at 15,00 per cent as from 1 July 1997. The maximum permissible finance charges rates, as laid down by the Usury Act, remained unchanged from September 1995 to February 1997 before being increased by one percentage point in March 1997. Since this increase, these rates have amounted to 29 per cent per annum in respect of money lending, credit and leasing transactions for amounts of more than R6 000 but less than R500 000, and 32 per cent in respect of amounts up to R6 000.

Financial markets

Regulatory, institutional and organisational changes in financial markets

Rated against financial markets in the advanced economies, the South African financial markets are well equipped with sound payment and accounting systems and employ state-of-the-art technology. Steps are nevertheless continuously being taken to further strengthen the regulatory and institutional framework of the South African financial services industry in order to open the domestic system to increased competition and to become fully integrated into the global financial markets. These steps are invariably aimed at improving the efficiency of the trading, clearing and settlement procedures which protect the integrity and transparency of the price formation process.

Important changes brought about by government during 1996 and the first half of 1997 included the following:

- amending the Insurance Act to enable long- as well as short-term insurers to hold foreign assets in relation to domestic liabilities, and to regulate investment activities in derivative instruments;
- amending the Pension Funds Act to effect increased member participation in the management of funds and to establish a Pension Funds Adjudicator as a mechanism to resolve disputes;
- promulgating the Unit Trust Control Amendment Act of 1996, enabling the unit trust industry to launch money market unit trust funds as from 1 May 1997 so as to give investors improved access to higher yielding wholesale money market instruments, and prompting banks to introduce additional money market products for investors;
- subscribing from 2 August 1996 to the Special Data Dissemination Standard (SDDS) of the International Monetary Fund, which ensured that investors have ready access to timeously released macroeconomic statistics;
- lowering of the rate of marketable securities tax and stamp duty on share transactions from 0,50 per cent to 0,25 per cent from 1 April 1997, but withdrawing the exemption in respect of purchases of shares by non-resident investors and arbitrage transactions from 1 July 1997;
- allowing institutional investors to make foreign acquisitions during 1997, the maximum amount being equivalent to 3 per cent of their net inflow of funds during calendar 1996 and a further 2 per cent for the purchases of stock listed on SADC stock exchanges within a limit of 10 per cent of total assets;
- allowing the 10 per cent limit applicable to acquisitions of foreign assets to apply to all assets under management in any specific unit trust scheme; and
- allowing South African individuals to invest up to R200 000 in a foreign country or in a foreign-exchange denominated account with a South African authorised dealer in foreign exchange, as from 1 July 1997.

The largely self-regulated private exchanges also effected significant changes during 1996 and the first half of 1997. The process of deregulating the Johannesburg Stock Exchange (JSE), which commenced on 8 November 1995 and the phasing-in of the electronic Johannesburg Equities Trading System as from 8 March 1996, which culminated in the closure of the open outcry trading floor on 7 June 1996, contributed to the JSE meeting the needs of the new political era in South Africa and that of international investors. Some of the other accomplishments thus far were:

- new listings requirements which facilitate black empowerment;
- corporate limited liability membership;
- the introduction of new capital adequacy requirements;
- dual capacity trading;
- replacement of a fixed tariff scale by fully negotiated brokerage; and
- removal of citizenship requirements for members.

However, outstanding issues and changes still to be implemented include:

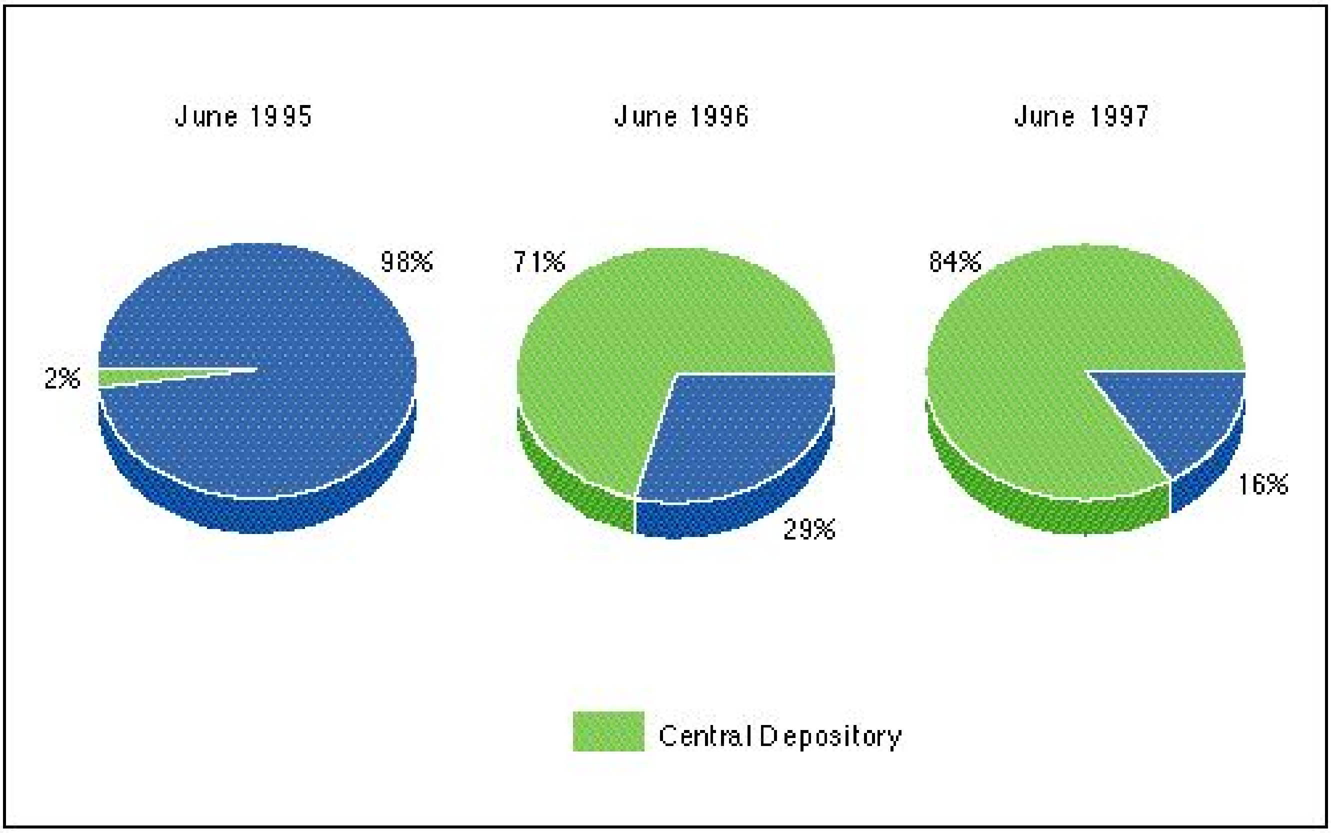
- the establishment of an electronic scrip registry and central depository for shares;
- immobilisation and dematerialisation of scrip to facilitate rolling contractual settlement within a period of less than five days after a transaction was concluded;
- compliance with the "G-30 Requirements" on clearing and settlement;
- further upgrading of the equity trading system; and
- legislation and procedures for dealing with insider trading, on which the King Task Group reported in March 1997.

The main purpose of these operational and regulatory changes was to make the JSE globally competitive and to make the exchange more amenable to the mobilisation of capital for development purposes. The share market has accordingly become more accessible to new and small investors and economic empowerment is visible from the growth in the number of black-controlled and -managed listed companies.

Although the South African bond market is very liquid and actively traded, further steps are in progress to enhance competitiveness and compliance with international standards. The role of the South African Reserve Bank as the sole official market-maker in government bonds is under investigation, and the Bond Exchange of South Africa will introduce a new bond settlement system with effect from 17 November 1997. This will replace the current system of settlement on the second Thursday after a transaction had taken place to a system, with the standard system where transactions in bonds are always settled within three days after the transaction. Notwithstanding the shortening of the settlement period, the forward market and repurchase transactions will be encouraged and bond transactions concluded for non-standard settlement dates (periods in excess of three days) will continue to be recognised.

The *Central Depository Limited* is a key element in the settlement system and the eventual immobilisation and dematerialisation of all listed bonds in South Africa. At the end of June 1997, 84 per cent of the domestic marketable stock debt of the government had already been lodged with the Central Depository. Government issues represented 83 per cent and public-sector enterprise issues 14 per cent of the R290 billion in bonds lodged with the Central Depository.

Government stock lodged with the Central Depository Limited



The South African Futures Exchange (Safex) has become one of the more advanced *formal derivatives markets* in the world. The exchange offers financial and commodity futures and options on financial futures with complex risk management, allowing offset between interrelated products. An electronic trading system complementing its clearing and settlement system was introduced and futures trades and options were brought onto the Automated Trading System.

Safex adjusted its interest rate product range in August 1996 and the *Krugerrand futures and options contracts* were delisted due to illiquidity. Safex and the Chicago Mercantile Exchange both introduced *rand-dollar futures contracts* on 7 May 1997, in addition to similar contracts which have already been trading on the financial division of the New York Cotton Exchange since April 1997. Trade in *commodity futures* on Safex's Agricultural Markets Division is likely to benefit from the deregulation of agricultural markets.

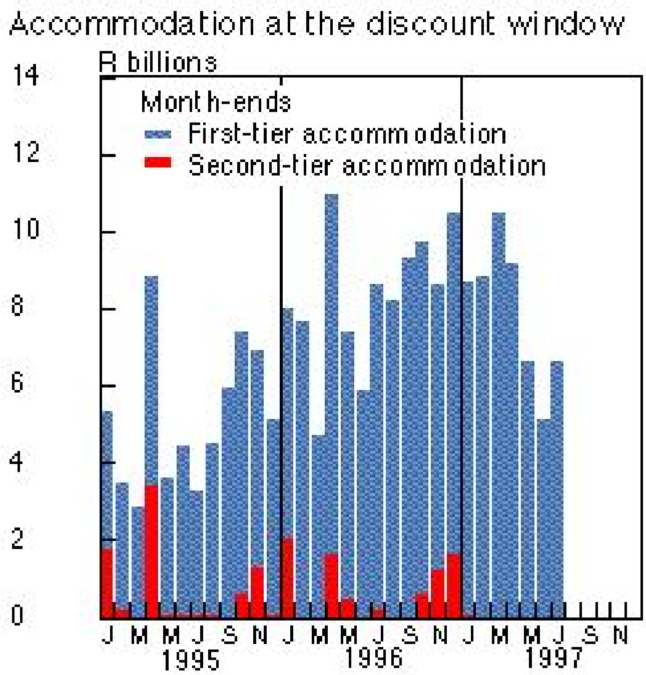
Money market

Money market conditions started tightening during the third quarter of 1995 and occasionally became very tight during 1996. The liquidity shortage in the market increased even further in the first quarter of 1997, before easing considerably in the second quarter. Measured in terms of *average daily values*, the money market shortage was most pronounced during the period November 1996 to March 1997 when the average monthly shortage exceeded R9 billion and reached a record level of R10,6 billion in

March 1997. Somewhat easier conditions prevailed during April, May and June 1997 when the average amount of accommodation extended to the market receded to R8,7 billion, R7,6 billion and R6,3 billion respectively.

In view of the persistently large money market shortages, the banks were at times forced to make use of accommodation at the discount window against collateral of second-tier assets. This was especially the case in the fourth quarter of 1996. The supply of high-quality assets, which could serve as collateral for first-tier accommodation, subsequently improved in the first quarter of 1997 and much less use has been made of second-tier accommodation since January 1997.

The tight conditions that prevailed in the money market throughout 1996 could mainly be attributed to a net decrease of R10,8 billion in the *net foreign assets of the Reserve Bank* over the full calendar year, reinforced by a mostly seasonal increase of R2,8 billion in *notes and coin in circulation outside the Reserve Bank* in the fourth quarter of 1996. These flows were reversed in the first quarter of 1997 when an increase of R1,2 billion in the net foreign assets of the Reserve Bank and a net decline of R1,3 billion in the value of notes and coin in circulation outside the Reserve Bank added liquidity to the market. The additional liquidity was, however, largely drained from the market through surpluses recorded on account of the Reserve Bank's involvement in forward foreign exchange transactions. The easier money market conditions that prevailed in the second quarter of 1997 were mainly due to a further strengthening by R5,9 billion of the net foreign asset position of the Reserve Bank. This was, however, partly counteracted by an increase of R1,8 billion in *government deposits with the Reserve Bank*, which had a tightening effect on money market liquidity.

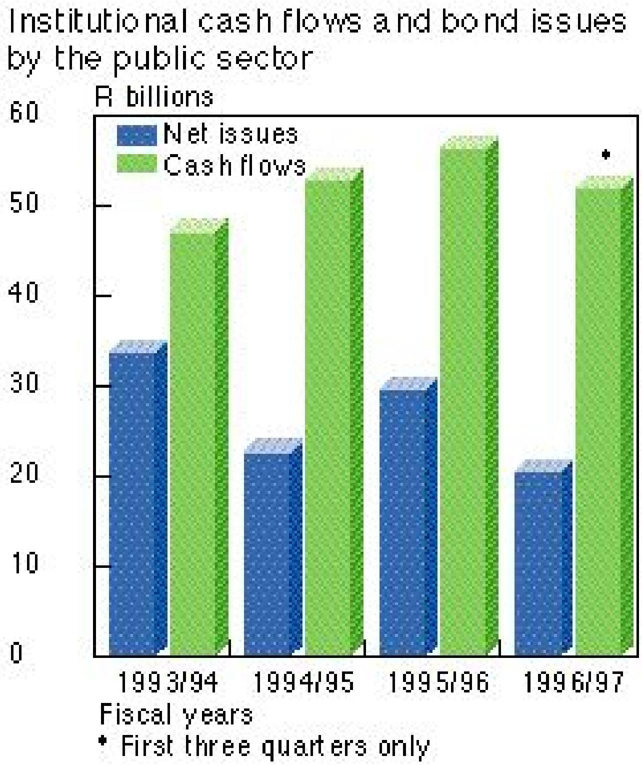


The *Reserve Bank's operations* in the money market during most of 1996 were generally neutral and directed towards the smoothing of changes in liquidity that were perceived to be of a temporary or short-term nature. Measures such as transfers of government deposits between the Exchequer Account with the Reserve Bank and the government's Tax and Loan Accounts with private banks were occasionally used to adjust the money market shortage, but the shortage was allowed to remain broadly reflective of the underlying supply of and demand for liquidity in the market. The Bank's interventions in the money market in the first half of 1997 were similarly directed towards permitting the money market shortage to signal the underlying pressures prevailing in the market. When the market appeared to become exceedingly tight, the Bank acted to relieve pressure by entering into foreign currency swap arrangements with banks and by buying assets for the portfolio of the Corporation for Public Deposits. The strong increase in liquidity in May 1997, arising from the sale of a minority interest in Telkom to a consortium of non-resident companies was partly sterilised by means of open-market sales of bonds and other short-term measures with a similar impact, such as foreign currency swaps between the Reserve Bank and private banks. During the period May to July 1997 R1,5 billion of zero-coupon government bonds held by the Reserve Bank were also converted into interest-bearing government bonds, which were then sold from the Bank's monetary policy portfolio.

Bond market

Net issues of fixed-interest securities in the domestic primary bond market in 1996 and the first half of 1997 declined from levels that had prevailed earlier as the public sector borrowing requirement shrank and high liquidity levels in the corporate sector obviated the need to mobilise capital through the issuance of fixed-interest securities by companies. After having been relatively subdued in 1996, non-resident participation in the domestic secondary bond market recovered strongly in the first half of 1997 when the rand strengthened and investors' confidence in macroeconomic management in South Africa turned increasingly positive.

Net issues of fixed-interest securities in the *domestic primary bond market* by *public-sector borrowers* declined from R29,5 billion in fiscal 1995/96 to R20,5 billion in fiscal 1996/97. However, net issues increased from R0,6 billion in the fourth quarter of 1996 to R8,2 billion in the first quarter of 1997 as the strengthening of the rand and declining yields on long-term bonds created circumstances that were more conducive to the issuance of fixed-interest securities. The aggregated institutional cash flows in the 1996/97 fiscal year (i.e. the domestic current income surplus of long-term insurers, official and private self-administered pension and provident funds and the net sales of units by unit trusts) exceeded the financing needs of public-sector bodies by a significant margin, thereby allaying concerns about the full crowding-out of private-sector investment activity by the public sector.

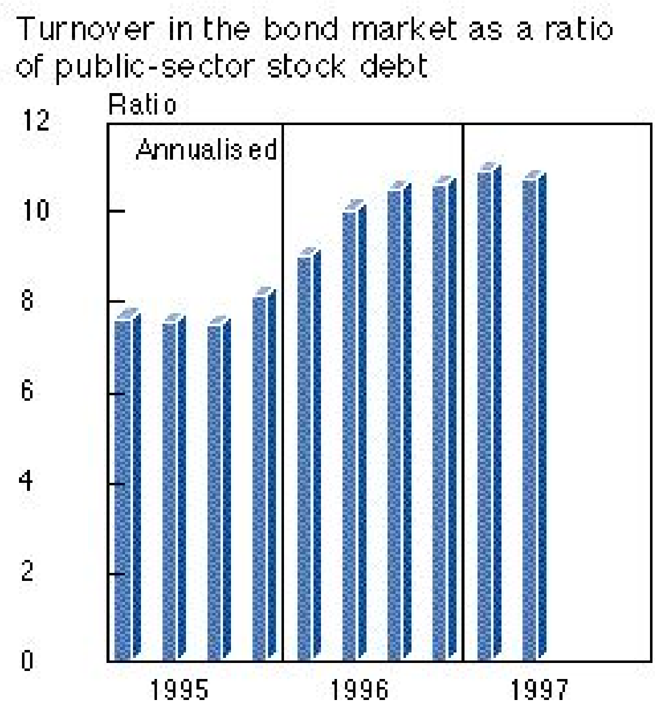


Capital mobilised by *listed private-sector companies* through rights issues of fixed-interest securities (including convertible preference shares and debentures) amounted to R2,2 billion in 1996 compared with R0,9 billion in 1995. The relative unattractiveness of the primary fixed-interest securities market for funding of the corporate sector could be attributed to the high level of liquidity in the corporate sector and the comparatively lower costs of funding through other means of finance. Despite declining long-term interest rates and yields, no new issues of fixed-interest-bearing securities were made by the corporate sector in the first half of 1997.

The South African government formally normalised relations with the *international bond markets* in December 1994 through a US dollar-denominated global bond issue to the value of R2,7 billion. This was followed by a further stock issue amounting to R1,3 billion in the Japanese Samurai market in 1995 and a total of R3,4 billion in 1996 through three issues denominated in British pounds, German marks and US dollars respectively. Apart from funding the government's budget deficit, these issues were meant to facilitate the reintroduction of South Africa into the international financial markets, expand the investor base and maturity profile of government debt and to set benchmarks for subsequent borrowing by South African public-sector corporations and private-sector companies.

The amount of capital raised by *non-financial public-sector enterprises* in offshore markets declined from R1,4 billion in 1995 to R0,6 billion in 1996. *Private-sector companies* raised capital in the international financial markets by means of convertible bonds to the amount of R1,9 billion in 1995. In 1996, however, no such issues were made, most likely on account of the decline in the external value of the rand. Even when the rand strengthened over the first half of 1997, South African corporates still abstained from issuing *foreign currency denominated bonds* in the international primary bond markets. However, Eskom ventured into the *Eurobond market* by issuing rand-denominated stock to the value of R150 million in April 1997. The inactivity of South African companies in the international capital markets could mainly be attributed to the slowdown in the growth of private-sector investment activity, the high levels of liquidity in the corporate sector and concerns that the rand might weaken in excess of the interest rate differential between domestic and foreign borrowings in the long run.

Activity in the *secondary bond market* has increased markedly since the second half of 1995 as yields on long-term bonds began to decline; the value of bonds traded on the Bond Exchange of South Africa increased by 51 per cent in 1996. The value of bonds traded rose further to an all-time quarterly high of R883,0 billion in the first quarter of 1997, before falling back to R833,6 billion in the second quarter. The strong growth in the turnover in the bond market resulted in the annualised *liquidity ratio* (measured as the nominal value of public-sector bonds traded domestically relative to the nominal value of stock outstanding) rising from 8,1 in the fourth quarter of 1995 to 10,6 in the fourth quarter of 1996 and 10,7 in the second quarter of 1997.

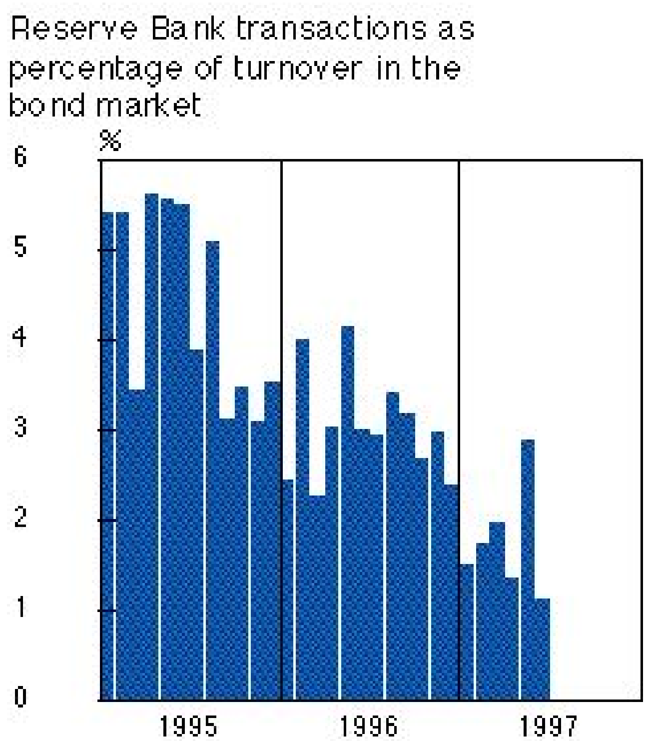


The *Reserve Bank's purchases and sales of government bonds* as a percentage of total purchases and sales of bonds in the secondary bond market declined from an average of 8 per cent in the fourth quarter of 1994 to 4,4 per cent in 1995, 3 per cent in 1996 and 1,7 per cent in the first half of 1997. Reserve Bank trading in government bond *options* declined even more strongly by 50 per cent from 1995 to 1996 and by 80 per cent from the first half of 1996 to the first half of 1997. These changes clearly indicate the Bank's reduced role as an official market-maker in the domestic secondary bond market.

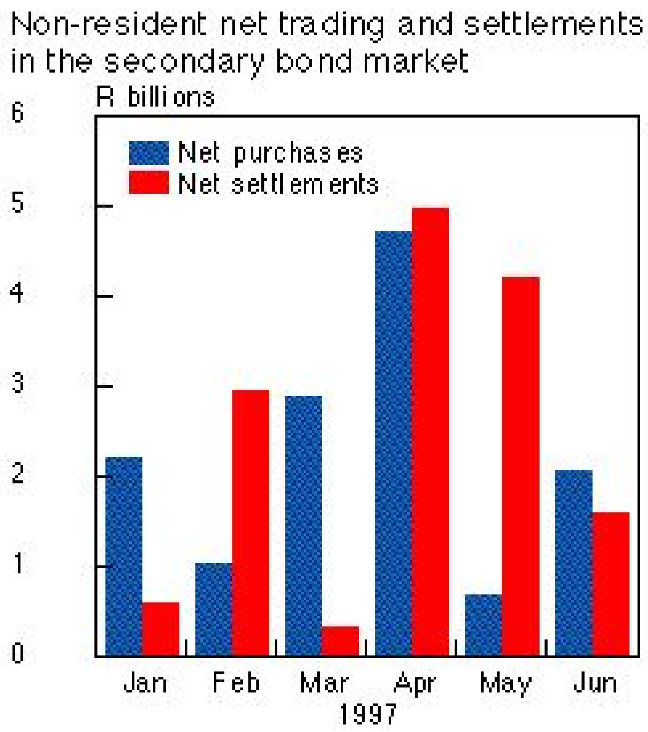
Table 17. Bond market activity

R billions

Period		Secondary market	
		Bonds traded on the Bond Exchange	Net purchases by non-residents on the Bond Exchange
1996:	1st qr	753,2	2,4
	2nd qr	780,7	0,4
	3rd qr	808,5	-0,6
	4th qr	680,0	1,2
1997:	1st qr	883,0	6,1
	2nd qr	833,6	7,4



Non-resident purchases and sales of bonds in the domestic secondary bond market as a percentage of the total purchases and sales of bonds increased from 2,4 per cent in the fourth quarter of 1995 to 5,7 per cent in 1996 and 10,5 per cent in the first half of 1997. The value of net purchases of bonds by non-residents rose from R3,4 billion in 1996 to R13,5 billion in the first half of 1997. Attractive yields in the domestic bond market relative to those available elsewhere and a positive outlook on the relative strength of the rand were primarily responsible for the interest shown by non-residents in South African bonds. Actual cross-border movements of capital in the first half of 1997 were, however, strongly influenced by a marked disparity from month to month between non-resident net purchases of bonds and the actual settlement of trades (see accompanying graph). Non-resident interest in the domestic secondary bond market is also reflected in a rise in transactions between non-residents from R129,7 billion in the second half of 1996 to R306,9 billion in the first half of 1997.



Share market

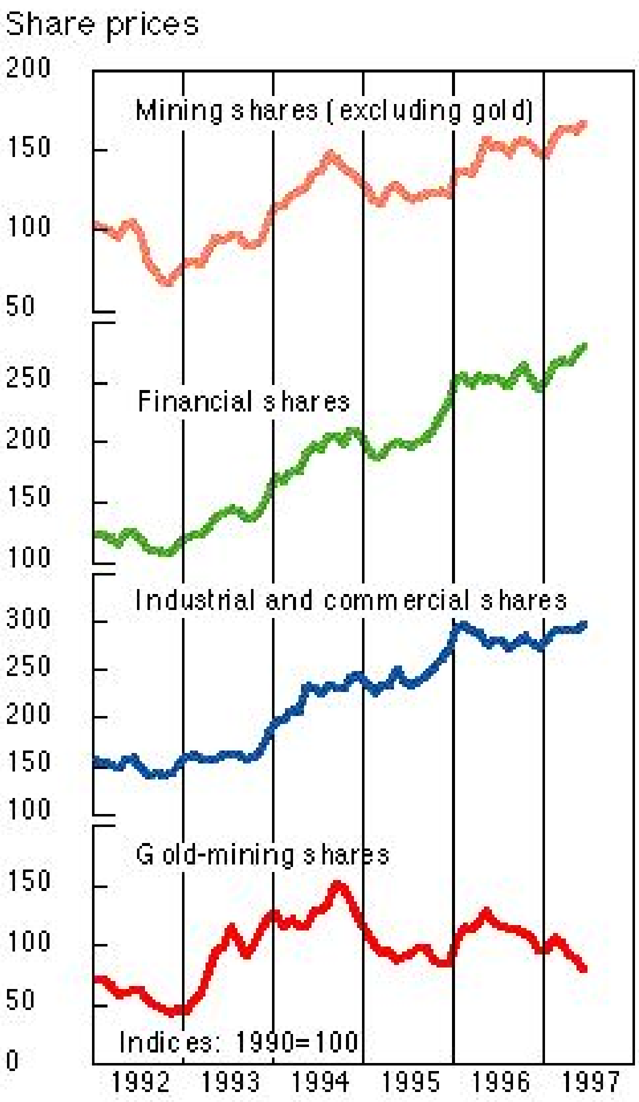
Capital raised in the *primary share market* by companies listed on the Johannesburg Stock Exchange increased strongly from R18,9 billion in 1995 to R26,4 billion in 1996. This tendency continued into the first half of 1997 when new capital mobilised by listed companies came to R20 billion in comparison with an amount of R9,6 billion raised in the first half of 1996. A total of 28 new listings in 1996 and a further 8 in the first six months of 1997 served as further proof of the importance of the share market as a source of funding.

Funds raised through *rights issues of ordinary shares* increased from R5,9 billion in 1995 to R7,6 billion in 1996 and then to R4,8 billion in the first half of 1997 compared with R3,2 billion in the first half of 1996. Although the rate of Secondary Tax on Companies was lowered from 25 per cent to 12,5 per cent in March 1996, *scrip dividend issues* (shares issued to the holder *in lieu* of a cash dividend) remained a popular method of raising capital. These issues increased in value from R5,4 billion in 1995 to R6,9 billion in 1996; they amounted to R2,7 billion in the first half of 1997. Capital mobilised for the procurement of assets (shares issued for the acquisition of assets not already listed) increased strongly from R1,7 billion in 1995 to R6,4 billion in 1996 and R8,6 billion in the first half of 1997 alone. The industrial and financial sectors benefited most from the capital raised in the primary share market; if funds raised through fixed-interest securities are also taken into consideration, 61 per cent of new capital raised over the eighteen months to June 1997 was allocated to industrial companies and 27 per cent to financial companies.

The value of shares traded in the *secondary share market* increased from R63,2 billion in 1995 to R117,1 billion in 1996 and were valued at R92,3 billion in the first half of 1997 in comparison with R54,6 billion in the first half of 1996. This strong growth in turnover was achieved in spite of the weakening rand in 1996 and the consequent slump in the foreign-currency prices of listed shares, high bond yields and rising international share prices, whilst the performance of domestic share prices was lacklustre. The annualised value of shares traded during the period as a percentage of total market capitalisation at the end of the period increased from 7,4 per cent in December 1995 to 11,2 per cent in December 1996 and then to 17,9 per cent in June 1997. This improvement in market liquidity was essentially a consequence of a sharp increase in the number of shares traded, rather than the share prices which rose fairly modestly from December 1995 to June 1997.

Non-residents traded actively in the secondary share market during 1996 and the first half of 1997. Net purchases of shares by non-residents increased from R4,8 billion in 1995 to R5,3 billion in 1996 and then to R11,7 billion in the first half of 1997 when the monthly average value of the dollar index of share prices rose by 15,1 per cent between December 1996 and June 1997.

Share prices on the Johannesburg Stock Exchange increased, on balance, by 124,1 per cent from October 1992 to February 1996. The price index of all classes of shares then reached a plateau and a net gain of only 1,3 per cent was recorded from February 1996 to October. A sharp but relatively short contraction followed and the average monthly value of all classes of shares declined by 6,3 per cent to December 1996. Share prices steadied again in the first half of 1997, increasing by 10,6 per cent from December 1996 to a new all-time high in June 1997. These movements in the average prices of all classes of shares were mainly determined by the movements in the prices of *industrial and commercial shares* and *financial shares*. *Gold-mining shares,* which had increased by 52 per cent from November 1995 to May 1996, declined by 38 per cent to June 1997. This decline was mainly due to a fall of US$52 per fine ounce in the average monthly gold price from May 1996 to June 1997 and the gradual strengthening of the rand against the US dollar which also caused the rand price of gold to fall steeply.



The monthly average *dividend yield* on all classes of shares increased from 2,08 per cent in January 1996 to 2,46 per cent in January 1997, but then receded to 2,37 per cent in June as share prices generally strengthened. The monthly average *earnings yield* (excluding gold-mining shares) similarly increased from 5,50 per cent in January 1996 to 7,01 per cent in December, but then fell back to 6,87 per cent in June 1997. The *difference* between the monthly average yield on long-term government bonds and the dividend yield on all classes of shares increased from 11,69 percentage points in January 1996 to 13,73 percentage points in December, but then narrowed to 12,35 percentage points in June 1997. The *price-earnings ratio* of all classes of shares, apart from gold-mining shares, fell from 18,2 in January 1996 to 14,3 in December as share prices receded, but then rose slightly to 14,6 in June 1997 as share prices recovered in the first half of 1997.

Table 18. Dividend yield, earnings yield, price-earnings ratio and yield differential on all classes of shares

Period		Dividend yield Per cent	Earnings yield* Per cent	Price-earnings ratio*	Yield differential Percentage points
1996:	Jan	2,08	5,50	18,17	11,69
	Feb	2,11	5,69	17,57	11,99
	Mar	2,21	6,07	16,48	12,83
	Apr	2,15	5,91	16,93	13,63
	May	2,21	6,05	16,54	14,32
	Jun	2,23	6,11	16,36	13,55
	Jul	2,24	6,12	16,34	13,15
	Aug	2,37	6,57	15,22	13,45
	Sep	2,31	6,40	15,64	13,11
	Oct	2,28	6,31	15,84	13,52

	Nov	2,39	6,82	14,67	13,79
	Dec	2,46	7,01	14,27	13,73
1997:	Jan	2,46	6,89	14,51	13,36
	Feb	2,37	6,68	14,96	12,66
	Mar	2,40	6,62	15,11	12,76
	Apr	2,41	6,66	15,01	12,83
	May	2,40	6,70	14,93	12,68
	Jun	2,37	6,87	14,55	12,35
* Excluding gold-mining shares					

Market for derivatives

The uncertainties in the foreign exchange market and the high level of activity and price movements in the underlying securities markets impacted positively on the formal derivatives market. Trading activity was brisk and non-resident participation increased strongly.

The combined *turnover in options and futures contracts* rose from 7,2 million contracts in 1995 to 9,3 million contracts in 1996. A further 5,8 million contracts were concluded in the first half of 1997. *Non-resident participation* as a percentage of total open interest increased from an average of 7,4 per cent in the first three quarters of 1996 to 12,9 per cent in the fourth quarter and 21,6 per cent in the first half of 1997. The number of *options on futures contracts* traded rose by 43,2 per cent from 1995 to 1996 and was 31 per cent higher in the first half of 1997 than in the first half of 1996. In contrast, the number of *futures contracts* increased by a relatively modest 15,3 per cent between 1995 and 1996 and by 11,2 per cent when the first half of 1997 is compared with the first half of 1996.

Since their introduction on the *South African Futures Exchange* in May 1997, the number of *rand-dollar futures contracts* traded to the end of June amounted to 105 contracts worth a nominal value of US$10,5 million. This initial lack of volume could be attributed mainly to the exclusion of residents from this market and more particularly to the existence of an increasingly efficient forward market in foreign exchange. In 1996 the trade in *maize commodity futures* came to only 2 641 contracts, or 264 100 metric tons, but then escalated to 4 987 contracts in the first half of 1997 as agricultural marketing control arrangements were gradually phased out and potential market participants became more acquainted with the advantages and mechanisms of this market.

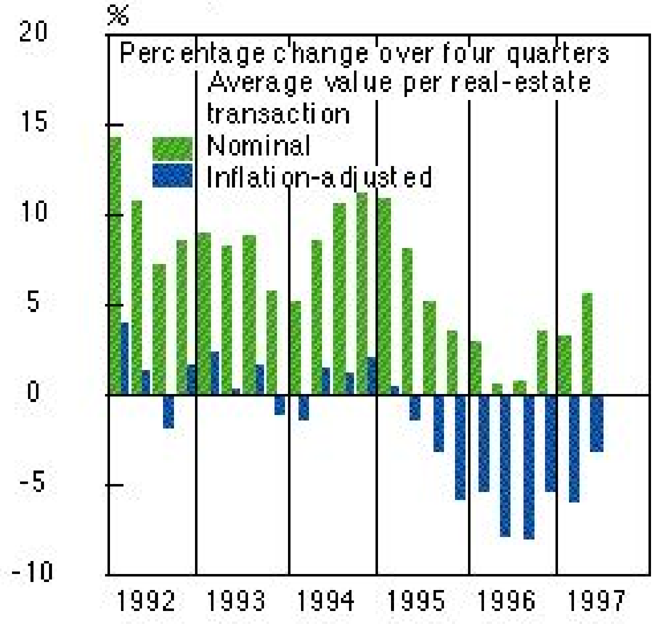
Mortgage and real-estate market

Although financing in the mortgage market levelled off during 1996 and the first half of 1997, it remained buoyant. The *rate of increase over twelve months in the outstanding mortgage loans of banks* receded from an average of 17,4 per cent in 1996 to 15,9 per cent in the first half of 1997. The total amount of mortgage loans outstanding to banks nevertheless increased from R130,3 billion at the end of 1995 to R152,4 billion at the end of 1996 and R161,8 billion at the end of June 1997. Total *capital repayments* on outstanding mortgages increased by 22,7 per cent in 1996 and by 23,7 per cent in the first half of 1997 compared with the first half of 1996.

Although complete information on the government's housing programme is not yet available, current indications are that progress has been made with the *low-cost housing programme*. A total of 658 599 subsidies had been approved and reserved in the period 15 April 1994 to the end of June 1997, but some of these subsidies still had to materialise in the delivery of houses. In this period about 30 per cent of the target of one million homes had been achieved if houses under construction are also taken into consideration.

Activity in the *real-estate market* was relatively subdued in 1996. The relatively high cost of mortgage finance, the introduction of a tax of 17 per cent on the net rental income received by or accrued to pension, provident and retirement annuity funds, together with high levels of crime in the major urban areas impacted negatively on the real-estate market during 1996. However, the real-estate market improved slightly from the fourth quarter of 1996. The rate of increase over one year in the average nominal value per real-estate transaction which had fallen from 10,7 per cent in the first quarter of 1995 to 0,2 per cent in the third quarter of 1996, accelerated to 5,5 per cent in the second quarter of 1997. This still implied a decline in the inflation-adjusted value of the average real-estate transaction. The share price index of listed real-estate companies, which had declined by 18,4 per cent from January 1996 to January 1997, subsequently recovered and rose by 6,1 per cent from January to April 1997, but then retreated in June to about the same level as in January.

Real-estate prices



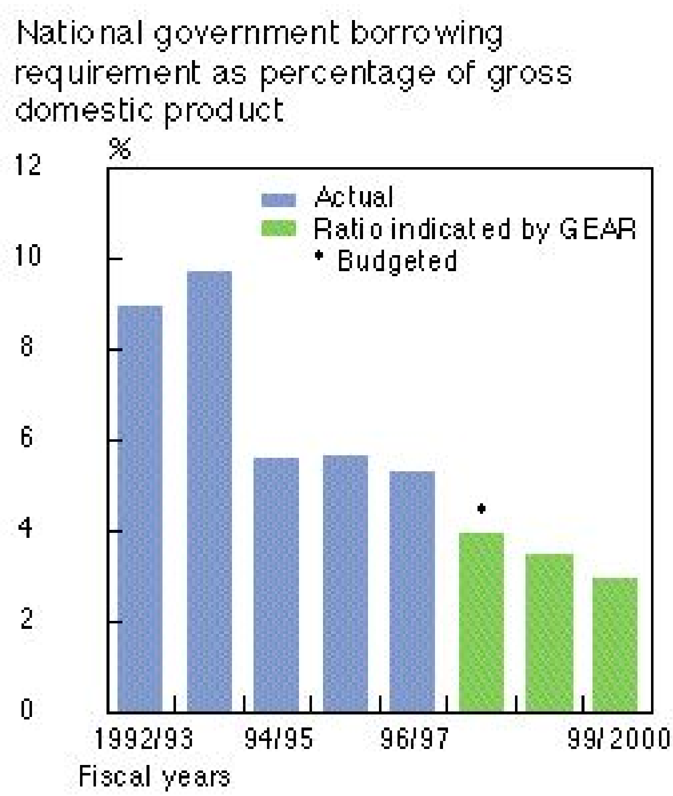
Public finance

Fiscal policy

The overriding objectives of the government's fiscal policy were clearly articulated in the GEAR strategy announced on 14 June 1996. These were:

- to reduce the overall budget deficit of the national government to 4 per cent of gross domestic product in fiscal 1997/98 and further to 3 per cent in fiscal 1999/2000;
- to avoid permanent increases in the overall tax burden and to limit the ratio of tax to gross domestic product to about 25 per cent;
- to reduce consumption expenditure by general government relative to gross domestic product to about 18 per cent by the year 2000; and
- to strengthen the general government's contribution to gross domestic fixed investment by allowing government real-investment growth to continue at an average annual rate of 7 per cent until the year 2000.

The steps considered necessary to achieve these objectives were expected to reduce government dissaving as a percentage of gross domestic product to about 0,6 per cent by 2000.



In presenting his Budget to Parliament on 12 March 1997, the Minister of Finance recommitted the government to the objectives of the GEAR strategy and described this strategy as a reform programme directed towards attaining the government's long-term vision for the elimination of poverty in a rapidly growing economy. The Minister said that fiscal 1997/98 would be a year of consolidation and that the government's financial policy would be guided by the need for accelerated social service delivery, the promotion of economic growth and job creation and the containment of inflation. This would require:

- the creation of a competitive fast-growing economy which will ensure sufficient jobs for all workseekers;
- the redistribution of income and opportunities in favour of the poor;
- the creation of a society in which sound health, education and other services are available to all; and
- the nurturing of an environment in which homes are secure and places of work productive.

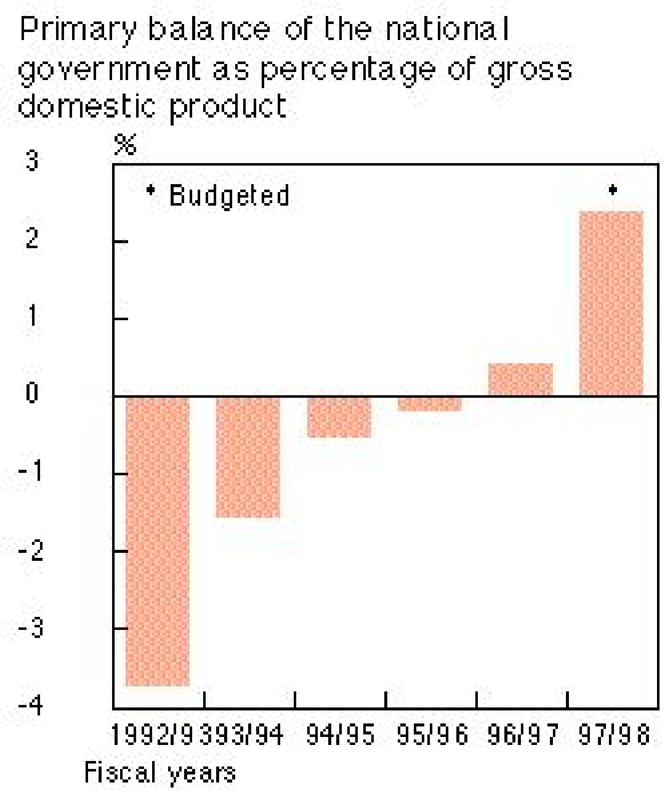
The Minister also made it clear that the success of the Reconstruction and Development Programme (RDP) is dependent on the successful implementation of the GEAR strategy. The RDP was designed as a policy programme to meet the basic needs of people, to develop human resources and to redress inequities inherited from the previous sociopolitical dispensation. A fund was established to mobilise resources for special initiatives aimed at meeting these objectives. Capacity constraints in government departments subsequently led to the accumulation of large amounts of unspent money in the RDP fund. The government responded promptly to this impasse by closing the RDP Office in 1996 and by integrating the various projects into the budgets of the various line departments involved. The role of the RDP fund was changed to that of a conduit for international development assistance towards earmarked projects and programmes. The redistributive thrust towards increased spending on social services was subsequently achieved through the direct allocation of funds to line departments within a long-term fiscal planning framework.

As part of the implementation of the GEAR strategy, government has also prepared a protocol on corporate governance of all state entities. This protocol contains a programme of asset restructuring that could lead to changes in the ownership of state entities. The nature of restructuring, as agreed with organised labour, may involve the total sale of an asset, a partial sale to strategic equity partners or the sale of the asset with government retaining a strategic interest. Significant progress was made with the restructuring of state assets over the past fiscal year in that:

- a local investment house with a foreign equity partner was appointed as an adviser to government in the restructuring of state assets;
- the protocol on corporate governance of all state entities was completed;
- principles were drafted to guide the establishment of a fund to finance the economic empowerment of previously disadvantaged people;
- a framework for share participation by employees of public-sector enterprises was completed; and
- guidelines were designed for the bidding process to be followed when state assets are sold.

During fiscal 1996/97 the government succeeded in privatising five regional radio stations for an amount of R451,1 million, which is to be utilised to reduce government debt. In May 1997 the government also sold an equity stake of 30 per cent in Telkom to a consortium of non-resident companies for an amount of R5,6 billion. This was the largest single foreign direct investment into South Africa yet. Of the total acquisition price, an amount of R1,2 billion was used to reduce government debt and R4,4 billion went to the recapitalisation of the company.

To give effect to the policy recommendations contained in the GEAR strategy, the Budget of the national government for fiscal 1997/98 provided for a deficit equivalent to 4,0 per cent of gross domestic product after a deficit ratio of 5,6 per cent had been registered in the previous fiscal year. The less inflationary posture of fiscal policy is also revealed by the recent improvement of the "primary" fiscal balance of the national government, which is determined by excluding interest payments on government debt from government expenditure and subtracting the remainder of total expenditure from government revenue. The primary balance in recent years improved from a deficit of 3,7 per cent of gross domestic product in fiscal 1992/93 to a surplus of 0,5 per cent in fiscal 1996/97 and is budgeted to improve further to a surplus of 2,4 per cent of gross domestic product in fiscal 1997/98. These changes ensured a fiscal policy that was becoming increasingly supportive of the policy objective of overall financial stability. Earlier fears that the growth of government debt relative to gross domestic product could become explosive were therefore unfounded.



Government expenditure

Total expenditure (excluding net lending and extraordinary transfers) *by the national government* in fiscal 1996/97 amounted to R177,0 billion, which was 15,4 per cent higher than in fiscal 1995/96. This growth in government expenditure was more than the increase of 10,4 per cent allowed for when the Budget was presented to Parliament and also more than the average rate of increase of 13,6 per cent in the three preceding fiscal years.

The increase in total expenditure in fiscal 1996/97 was in part a result of an increase of 13,9 per cent in *recurrent expenditure* which, in turn, was heavily concentrated in increased spending on goods and services. A rise of 13,4 per cent in interest payments in fiscal 1996/97 and increased outlays on employee remuneration were among the main contributors to the rise in recurrent expenditure by the national government. When allowance is made for price increases, the increase in *real recurrent expenditure* by the national government came to 6,3 per cent in fiscal 1996/97.

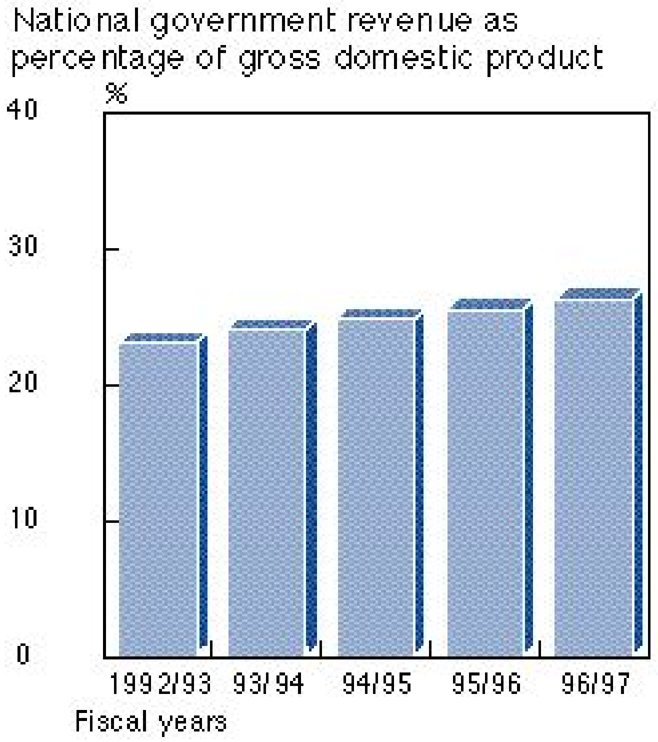
Government revenue

Government revenue in fiscal 1996/97 amounted to R145,9 billion or 26,2 per cent of gross domestic product. This was higher than the ratio of 25,5 per cent recorded in fiscal 1995/96 and also more than the ratio of 25 per cent of gross domestic product that was indicated by the GEAR strategy. The increase in government revenue relative to the previous fiscal year amounted to 14,7 per cent, which allowed government to finance 82,4 per cent of its expenditure by means of tax and non-tax revenue. This was the highest ratio of own financing relative to total expenditure since fiscal 1991/92.

Table 19. Increase in tax revenue according to type of taxation

Per cent

Type of taxation	**1992/93**	**1993/94**	**1994/95**	**1995/96**	**1996/97**
Taxes on net income and profits	7,8	6,6	23,0	16,7	18,5
Taxes on property	26,0	22,9	32,3	10,1	4,6
Domestic taxes on goods and services	5,0	31,9	8,2	15,5	9,0
Taxes on international trade and transactions	7,4	22,5	5,5	3,5	15,7
Other taxes	5,8	12,9	20,1	1,0	17,2
Total tax revenue	**7,0**	**16,7**	**16,5**	**15,8**	**14,4**



An analysis of *tax revenue by type of taxation* shows that the rise in tax revenue over the past five fiscal years was mainly the result of strong growth in taxes on net income and profits. The rate of increase in revenue from taxes on net income and profits accelerated noticeably from 16,7 per cent in fiscal 1995/96 to 18,5 per cent in fiscal 1996/97. In contrast, the rate of increase in revenue from taxes on goods and services slowed down from 15,5 per cent in fiscal 1995/96 to 9,0 per cent in fiscal 1996/97. Nevertheless, taxes on goods and services still contributed 37,2 per cent to total government tax revenue in fiscal 1996/97. Revenue from taxes on international trade and transactions was somewhat subdued in fiscal 1994/95 and fiscal 1995/96 on account of the phasing-out of the surcharge on imports and the increasing portion of the income from customs duties accruing to the other members of the South African Customs Union. It did, however, increase strongly in fiscal 1996/97 due to vigorous growth in the volume and value of merchandise imports.

Taxes on net income and profits remained the main source of government revenue, contributing 58,1 per cent to ordinary revenue in fiscal 1996/97. Individuals accounted for 73,3 per cent of the total taxes on net income and profits. The relatively strong growth in nominal incomes over the past three fiscal years resulted in the relative contribution of taxes on net income and profits to total government tax revenue increasing from 52,7 per cent in fiscal 1993/94 to 56,1 per cent in fiscal 1995/96 and further to 58,1 per cent in fiscal 1996/97.

Borrowing requirement

The government's current expenditure exceeded current revenue by R17,1 billion in fiscal 1996/97, which was equivalent to 3,1 per cent of gross domestic product. If capital outlays are added to this dissaving, the amount to be borrowed increased to R31,2 billion, or 5,6 per cent of gross domestic product. This deficit was financed as follows:

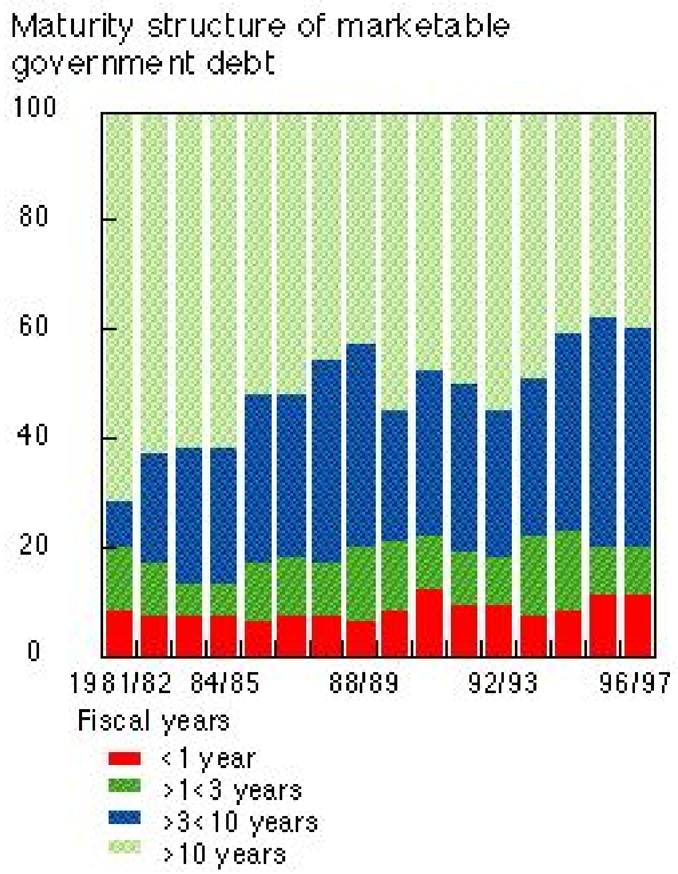
		R billions
Government stock		21,2
Monetary institutions	2,9	
Non-monetary private sector	19,5	
Public Investment Commissioners	5,0	
Discount on government debt	-6,2	
Treasury bills		5,6
Foreign loans		1,3
Decrease in available cash balances		5,8
Other		-2,7
Total net financing		**31,2**

As in previous years, newly issued *long-term government stock* remained the most important instrument used by government to finance its revenue shortfall. An amount of R19,5 billion of new issues of long-term government bonds was absorbed into the portfolio of the non-bank private sector and an additional amount of R2,9 billion went into the portfolios of monetary institutions. Unlike fiscal 1995/96 when the *Public Investment Commissioners* were net sellers of government stock as part of their asset diversification strategy, in fiscal 1996/97 they invested an amount of R5,0 billion in newly issued government stock. The outstanding amount of *Treasury bills* increased by R5,6 billion in the past fiscal year. These bills were highly popular among monetary institutions for use as collateral against borrowing at the Reserve Bank discount window in a year of continuously tight money market conditions. The monetary institutions' holdings of Treasury bills accordingly increased from R7,2 billion at the end of fiscal 1995/96 to R13,4 billion at the end of fiscal 1996/97.

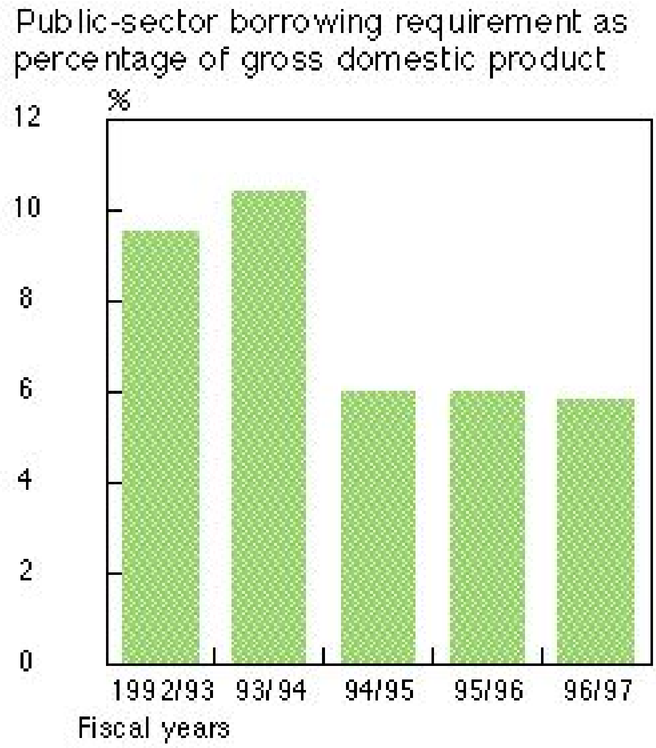
The borrowing activities of the government over the past fiscal year resulted in an increase in the total debt of the national government from R278,9 billion at the end of March 1996 to R310,0 billion a year later. Slightly faster growth in the nominal gross domestic product, however, resulted in a slight decline in the ratio of government debt to gross domestic product from 56,0 per cent at the end of fiscal 1995/96 to 55,8 per cent at the end of fiscal 1996/97. This was the first decline in the ratio of accumulated government debt relative to gross domestic product since fiscal 1990/91.

Although the ratio of marketable *government debt with a maturity longer than ten years* relative to total marketable government debt increased from 38 per cent in fiscal 1995/96 to 40 per cent in fiscal 1996/97, the average maturity of domestic government debt remained broadly unchanged at 115 months over the past two completed fiscal years. The average maturity of government's foreign stock debt was extended from 40 months at the end of March 1996 to 61 months at the end of March 1997.

In the longer term, the proportion of long-term marketable debt (i.e. debt with a maturity longer than ten years) to total marketable debt declined from 72 per cent in fiscal 1981/82 to 38 per cent in fiscal 1995/96 and 40 per cent in fiscal 1996/97. In contrast, the ratio of *marketable debt with a maturity of between three and ten years* to total marketable debt increased from 8 per cent to 40 per cent. *Marketable debt with a maturity of less than three years* as a percentage of total marketable debt fluctuated around an average level of 19 per cent over this period.



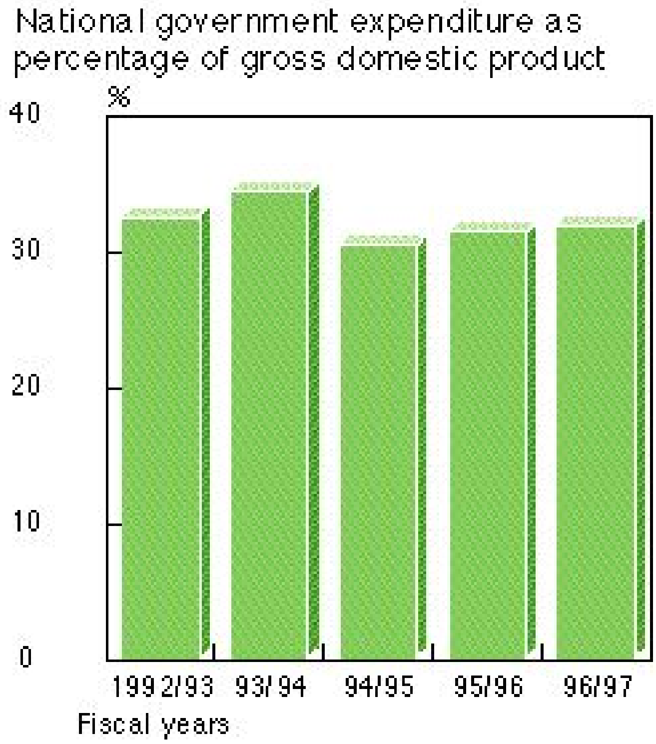
When the definition of national government is broadened to include extra-budgetary institutions, social security funds, provincial governments, local authorities and non-financial parastatal corporations, the overall *public-sector borrowing requirement* amounted to R32,6 billion in fiscal 1996/97 compared with R30,2 billion in fiscal 1995/96. As a percentage of gross domestic product, the public-sector borrowing requirement was 5,9 per cent in fiscal 1996/97, considerably down from 10,4 per cent in fiscal 1993/94 and the lowest ratio achieved since fiscal 1991/92 when it was equivalent to 5,4 per cent of gross domestic product.



The financial position of the *provincial governments* has deteriorated over the past year from a small surplus of R24 million in fiscal 1995/96 to a deficit of R1,3 billion in fiscal 1996/97. The borrowing requirement of *local authorities* also increased from R0,5 billion in fiscal 1995/96 to R0,8 billion in fiscal 1996/97. Together with the dissaving at the national government level, the overall dissaving by *general government* (i.e. the total of national, provincial and local governments, extra-budgetary institutions and social security funds) came to R16,4 billion in fiscal 1996/97 or 2,9 per cent of gross domestic product, compared with R11,7 billion or 2,4 per cent of gross domestic product in fiscal 1995/96. The GEAR strategy indicates the virtual elimination of general government dissaving by fiscal 1999/2000.

The Budget for fiscal 1997/98

It was estimated in the Budget that *total government expenditure* would increase by 6,1 per cent to R186,7 billion in fiscal 1997/98. This projection envisaged a decline in the ratio of total government spending to gross domestic product from 31,8 per cent in fiscal 1996/97 to 30,0 per cent in fiscal 1997/98. Included in the projection of total expenditure was an estimate of expected *interest payments* on government debt amounting to R38,5 billion. An amount of R148,2 billion would thus be available for non-interest recurrent and capital expenditure, implying an increase of only 5,3 per cent over its counterpart for fiscal 1996/97. *Capital expenditure* was estimated to decline from R14,6 billion in fiscal 1996/97 to R13,2 billion in fiscal 1997/98, or from 2,6 per cent of gross domestic product to 2,1 per cent.



The Budget estimates allowed for expenditure amounting to R4,4 billion on projects pertaining to the Reconstruction and Development Programme which had been started in fiscal 1996/97 but had not been completed at the end of the year. The Budget estimates for the current fiscal year made no provision for any such amounts to be carried forward into subsequent fiscal years, implying that *newly approved government expenditure* in fiscal 1997/98 is R4,4 billion less than indicated by the budgeted spending projection.

As indicated in Table 20 the proportion of total expenditure allocated to the provision of social services and interest payments was expected to increase in fiscal 1997/98 at the expense of the respective shares of protection, economic and general administration services.

Table 20. Functional classification of national and provincial expenditure items*

	Percentage of total expenditure		**Percentage change in nominal expenditure**
	1996/97 Revised estimates	**1997/98 Budget**	**1997/98**

General government services and unallocatable expenditure	**7,6**	**7,0**	**-1,8**
Protection services	**15,9**	**15,7**	**5,3**
Defence	6,7	5,7	-9,4
	6,4	6,9	14,4
Social services	**45,9**	**46,9**	**8,9**
Education	22,1	21,3	2,8
Health	10,4	10,7	9,5
Social security and welfare	9,3	9,8	12,2
	0,9	2,2	152,4
Economic services	**11,0**	**10,0**	**-3,2**
Export trade promotion	1,1	0,8	-26,7
Interest	**19,6**	**20,4**	**11,3**
Total	**100,0**	**100,0**	**...**
Source: Budget Review 1997			
* Incorporating spending by national government and provincial governments. Spending estimates of provincial governments are still preliminary.			

Total revenue was budgeted to increase by 11,2 per cent to R162,0 billion in fiscal 1997/98. Measured as a percentage of gross domestic product, total government revenue was projected to decline from

26,2 per cent in fiscal 1996/97 to 26,0 per cent in fiscal 1997/98. The desired ratio of tax revenue to gross domestic product indicated by the GEAR strategy is 25 per cent.

The Budget provided for additional net revenue to be raised through the *collection of arrear taxes and increased efficiency in tax administration*. The improvements in tax administration are largely the result of the merging of the office of the Receiver of Revenue and the Customs Revenue Services into the South African Revenue Service (SARS) in April 1996 and steps taken to grant some autonomy to the SARS. The additional amounts expected to be raised through the increased efficiency of the tax system were not specified separately in the budget accounts, but were incorporated in the estimates of the respective tax categories.

To achieve the revenue estimates, the Budget proposals included various other measures:

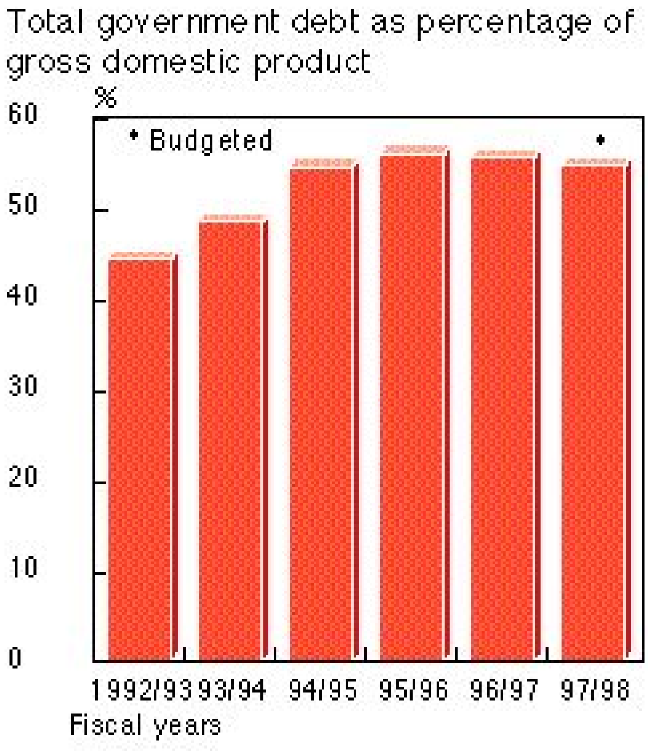
- Modifications to income tax on individuals to alleviate the burden of taxation and compliance on taxpayers in lower-income categories. These included a reduction in the number of tax brackets from 8 to 7, the lowering from 41 per cent to 32 per cent of the marginal tax rate applicable to taxpayers with annual taxable incomes ranging from R40 000 to R45 000 and the raising of the threshold at which an individual does not have to submit a tax return from R50 000 to R60 000.
- Changes regarding the tax treatment of company cars, travelling allowances and holiday accommodation provided by employers to employees. Steps would be taken to curb the abuse of such fringe benefits as tax avoidance instruments.
- The broadening of the tax at a rate of 17 per cent on gross interest and net rental income of retirement funds to include dividends received by retirement funds from property unit trust schemes.
- Increasing the excise duties on tobacco products and alcoholic and certain other beverages.
- Lowering the rate of marketable securities tax by half and abolishing the remaining levy on financial services.
- Equalising the taxation of lump sum payments from public and private pension funds from 1 March 1998, subject to the protection of rights acquired previously.

The net result of the budgeted expenditure of R186,7 billion and the estimated revenue of R162,0 billion (excluding extraordinary revenue of R3,1 billion) was a *deficit before borrowing and debt repayment* of R24,8 billion in fiscal 1997/98, or 4,0 per cent of the estimated gross domestic product. After taking the scheduled loan redemptions of R12,1 billion into consideration, the gross financing requirement for fiscal 1997/98 amounted to R36,9 billion. This was expected to be financed as follows:

	R billions
Government stock (excluding discount)	27,7
Short-term loans	2,0
Foreign loans	4,0
Transfer from IMF Deposit Account at SARB	1,4
Transfer from Strategic Fuel Fund	1,3

Proceeds from the sale of state assets	0,5
Total financing	**36,9**

The net addition to total government debt during 1997/98, also taking into account the responsibility for repaying part of Namibia's public debt and the discount on the issue of new government stock, is expected to raise the total outstanding government debt from R310,0 billion at the end of March 1997 to R340,8 billion at the end of March 1998. It is estimated that the ratio of government debt to gross domestic product could decline from 55,8 per cent at the end of March 1997 to 54,8 per cent at the end of March 1998.



Exchequer account in the first quarter of 1997/98

Total *Exchequer issues* to government departments (adjusted to reflect cash flows) amounted to R47,1 billion in the first quarter of 1997/98, which was 15,4 per cent higher than in the corresponding quarter of fiscal 1996/97. This increase in Exchequer issues exceeded the growth rate of 6,1 per cent which had been envisaged in the Budget for the fiscal year as a whole. As a proportion of the estimated government expenditure for the full fiscal year 1997/98, Exchequer issues came to 25,2 per cent; this is above the ratio of 23,5 per cent recorded in the corresponding period of the previous fiscal year and slightly higher than the average ratio of 25,1 per cent recorded over the previous two fiscal years.

Exchequer receipts (excluding extraordinary receipts) amounted to R34,2 billion in the first quarter of fiscal 1997/98, indicating a year-on-year rate of increase of 12,2 per cent which is higher than the growth rate of 11,2 per cent foreseen in the Budget for the full fiscal year.

The net result of these increases in government revenue and expenditure was a *deficit before borrowing and debt repayment* of R13,0 billion in the first quarter of fiscal 1997/98. The actual deficit in the first quarter of 1997/98 was equal to about 52,3 per cent of the deficit budgeted for the year as a whole. In the previous fiscal year, the comparable percentage was 33,8 per cent. The deficit before borrowing and debt repayment in the first quarter of fiscal 1997/98, together with the discount on new stock issues, was financed as follows:

	R millions
Domestic government stock (including discount on new stock issues)	10 408
Foreign loans	1 200
Treasury bills	3 112
Non-marketable securities	-34
Redemption of Namibian debt	-236
Redemption of TBVC* debt	-20
Extraordinary receipts	2 415
Transfer from IMF accounts	345
Increase in available cash balances	-2 512
Less: Discount on government stock	1 719
Total net financing	**12 959**

* Former independent republics of Transkei, Bophuthatswana, Venda and Ciskei.

The government successfully launched two bond issues in the international bond markets during June 1997. One issue was made in the Samurai market for Yen 40 billion at a yield of 3,37 per cent, which was 93 basis points higher than on comparable stock of the Japanese government. The other bond was issued in the United States market for US$500 million at a yield of 8,56 per cent, which was 183 basis points higher than the yield on comparable stock of the United States Federal Government.