Annual Economic Report

1999

South African Reserve Bank

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Introduction

Economic activity had already been slowing down when the financial problems in Southeast Asia began to spread to South Africa in the first half of 1998. The contagion effects of the problems in Asia and the worsening economic situation in Russia confronted policy-makers in South Africa with two risks that had to be weighed against each other.

On the one hand, with economic activity already slowing down and inflation expectations on the wane, there was the risk that a tightening of monetary conditions could compress domestic demand and weaken the prospects for a short-term cyclical recovery in the economy. On the other hand, the turmoil in the financial markets posed a threat to financial stability which, if not attended to, could impair the long-term growth capacity of the economy.

In the end, the potential threat to financial stability and concern about the long-term well-being of the economy convinced policy-makers that steps had to be taken that would stabilise financial conditions with as little delay as possible. Interest rates accordingly rose over the full spectrum of maturities from April to August 1998. Business and consumer confidence wilted, and real output, which had been sluggish in the first half of 1998, fell in the third quarter of 1998 so that for the year as a whole, real gross domestic product rose by just ½ per cent.

The downward adjustment in production volumes in the second half of 1998 was concentrated in the goods-producing or tradables industries. This slump in production had as much to do with the fall in external demand as with weak demand conditions in the domestic economy. The services sectors as a group, which are far less susceptible to changes in international trading conditions than the goods-producing industries, continued to grow throughout 1998 and the first half of 1999, albeit at a gradually slower pace.

By the end of 1998 there were tentative signs that the worst of the international financial crisis was over. Economic conditions in Asia began to settle down. Output growth in that region gained some momentum and the demand for commodities and manufactured goods from South Africa picked up. As a result, real gross domestic production recovered somewhat in the fourth quarter of 1998 and increased further during the first half of 1999. There was also evidence that the downward trend in real value added by the manufacturing sector had flattened out in the first half of 1999.

Despite the tightening of monetary conditions, growth in domestic final demand was fairly robust in the second half of 1998, due entirely to a surge in fixed capital formation by public corporations. All the other components of gross domestic expenditure either declined or increased at modest rates. By the first half of 1999, however, some of the expansion programmes of the public corporations had apparently run their course and aggregate real gross capital formation declined steeply, pulling real gross domestic expenditure down too. This decline in aggregate spending substantially improved the overall balance between aggregate supply and demand in the economy.

The acceleration of capital spending by public corporations in 1998 lifted gross fixed capital formation as a percentage of gross domestic product to its highest level since 1991. Nonetheless, the 1998 ratio was still not high enough to raise long-term economic growth sustainably to levels which would absorb all new entrants to the labour market. The investment ratio was also below the investment rate in other fast-growing emerging-market economies.

The gross saving ratio has improved slightly since the second half of 1998, mainly due to an improvement in general government finances. Household saving remained constrained by high levels of household debt and slow growth in real disposable income. Corporate saving was under pressure from slower growth in operating surpluses. Gross saving, which is meant to provide the wherewithal for capital formation, consequently remained too low to meet the growth needs of the South African economy. As long as the gross saving ratio of the economy remains at its current low level, further large foreign direct investment inflows will be a prerequisite for faster economic growth and development.

The improvement in output growth from the end of 1998 caused formal-sector employment to rise slightly from the end of 1998 to the end of the first quarter of 1999. Despite this increase, declines in employment in the course of 1998 brought the number of the gainfully employed to its lowest level in twenty years. The most severely affected sectors were the mining industry, where one in every seven workers lost his job over the past year, and the construction industry where activity was severely curtailed by the rise in mortgage rates.

Against the backdrop of declining employment, industrial activity picked up and the number of workdays lost to strikes and other work stoppages rose sharply in 1998. Most of the strikes were related to demands for higher wages. Employers, faced by a general deterioration in business conditions, resisted these demands. The outcome was a decline in the average settlement rate negotiated in collective bargaining arrangements and a slowdown in the growth in nominal earnings. Output per worker improved until the early months of 1999, but at a far less impressive rate than in 1997.

The slowdown in the growth in workers' nominal earnings was sufficient to ensure some deceleration in the growth of the nominal cost of labour per unit of output. This, of course, contributed meaningfully to the relatively subdued rate of domestically generated inflation. Inflation pressures were also contained by the relative strength of the rand over the past twelve months or so, and through some absorption of cost increases by domestic producers. Overall consumer-price inflation, from one quarter to the next, decelerated quite substantially over the past year, mainly because of declining home mortgage rates. Core inflation slowed down too, but not nearly as conspicuously as overall consumer price inflation.

South Africa's balance of payments was profoundly influenced by the developments in the emerging-market economies during the past eighteen months. The deficit on the current account widened abruptly in the second half of 1998 as the weak demand from crisis-affected countries in Asia and the sharp rise in the imports of capital goods combined to exacerbate the excess of imports over exports.

When the emerging-market economies began to recover in the first half of 1999, demand from Asia and exports to that region rose strongly. This coincided with steep declines in domestic business-sector fixed capital formation and households' spending on durable goods, which led to a decline in the effective demand for imports. These developments turned the deficit on the current account into a small surplus in the first half of 1999.

Net international capital flows into South Africa declined strongly in the second half of 1998, reflecting the global reversal of portfolio flows back to the mature financial centres of the world. Inward foreign direct-investment flows also diminished in the second half of 1998 and eventually developed into some disinvestment from the economy in the fourth quarter. By contrast, outward direct investment from the economy continued at a steady pace throughout the past four quarters as South African companies expanded their operations in other parts of the world.

In the first half of 1999 there was a resumption of inward direct-investment flows into the economy and portfolio outflows through the domestic bond market were reversed into fairly robust inflows. The resumption of stronger capital flows, together with the small surplus on the current account, led to a meaningful increase in the net international reserves of the country.

With less pressure on the foreign exchange market, the nominal effective exchange rate of the rand appreciated moderately in the first six months of the year. The Reserve Bank maintained a presence as a relatively minor buyer of foreign exchange in the spot market, but refrained from any aggressive intervention in the market for forward foreign exchange. In this way the Bank's net open forward position in foreign currency was reduced noticeably. Import cover, based on total gross international reserves, improved to approximately 12 weeks' worth of imports, compared with 10 weeks at the end of 1998.

The dollar value of the total external debt of the country declined from the end of 1997 to the end of 1998. Although the ratio of outstanding external debt to gross domestic product increased somewhat because of the depreciation of the rand in 1998, it can still be regarded as low by emerging-market standards. The unexpired maturity of external debt shortened slightly during 1998.

The twelve-month growth in the M3 money supply, which had consistently exceeded the upper limit of the medium-term guideline range for monetary growth, moved into the lower end of the 6 to 10 per cent range in the first half of 1999. Annualised quarter-to-quarter rates of growth remained below the twelve-month rate, suggesting that the twelve-month rate might slow further. That would bring the growth in M3 even more in line with monetary growth consistent with low inflation and steady economic growth.

The growth from quarter to quarter in credit extension to the private sector broadly mirrored the changes in M3 and slowed down markedly from the second half of 1998. The demand for credit weakened in all the major categories: mortgage advances, instalment sale credit, leasing finance and "other loans and advances" all had a hand in the slowdown in bank credit to the private sector. Credit used mainly by private households – which generally had been slowing down from 1996 – rose at rates far lower than those of the categories used mainly by the corporate sector. It was only in the first half of 1999 that the growth in bank credit extension to companies began to slow down decisively. The slower growth in corporate credit demand can mainly be explained by the weakness of domestic economic activity.

Price movements in the South African securities markets had been severely disrupted by the international financial turmoil of 1998. Market movements became highly volatile and began to correspond more closely with movements in emerging markets than with those in mature markets. Money-market interest rates had increased sharply when the rand was under almost incessant downward pressure around the middle of 1998. This helped stabilise the foreign exchange market and, in a more general sense, all the other financial markets. From October 1998, when it became clear that overall macroeconomic balance was no longer under threat, money-market interest rates fell steadily to below pre-crisis levels.

The Reserve Bank has been cautious in its management of domestic money market liquidity over the past ten months or so. On two occasions – in January 1999 when there were problems in Brazil and again in May when the political situation in Russia threatened to destabilise emerging markets – the decline in short-term interest rates was halted temporarily. From the end of June 1999 to the third week of July the Bank signalled to the market its preparedness to accept a slight acceleration in the pace of decline in money market interest rates. The private banks lowered their lending rates along with the decline in money market rates, and by the middle of July 1999 the predominant prime overdraft rate had fallen to a level lower than when the markets were initially disrupted in April 1998.

Bond yields moved in tandem with money market interest rates between April and August 1998 as non-resident investors reduced their holdings of rand-denominated bonds. When the markets began to settle down, bond yields resumed their downward trend, but by the middle of July 1999 they were still higher than where they had been in April 1998. Changes in nominal interest rates usually reflect changes in expectations about inflation, real interest rates and risk premiums. The rise in nominal bond yields from the early months of 1998 was apparently driven mainly by a reassessment of risk associated with investment in South Africa and, possibly, by higher expectations of inflation.

The share market recovered in the first half of 1999, after it had fallen sharply between May and September 1998. Most of the share price losses had been recovered by June 1999, but the all-share price indicator was still 14 per cent lower than when it peaked in May 1998. In dollar terms, the decline in share prices was 28 per cent from May 1998 to June 1999. Despite this fall in equity values, non-resident investors maintained a strong presence as buyers of shares on the Johannesburg Stock Exchange throughout 1998 and the first half of 1999.

Non-resident buying in the domestic bond market vacillated over the past eighteen months. In the first four months of 1998, non-resident investors bought aggressively in the domestic market, but they turned to net selling in the rest of the year. Apart from reducing the risk of a rand depreciation, foreign portfolio investors probably also sold in the domestic market during the last three quarters of 1998 to reduce their exposure to emerging markets generally. The South African bond market is among the most liquid of all emerging debt markets and is easy to enter and to exit.

In the primary fixed-interest securities market, the current income surplus of institutional investors continued to exceed by a fair margin the financing needs of the public sector. Public-sector funding activities evidently were not the cause of the volatility and high level of interest rates in the secondary capital market over the past year. Speculative transactions and changing views about future inflation, exchange rates and monetary conditions, were far more important factors in determining the movement of bond yields than the public-sector's demand for funds.

The national government's fiscal policy stance was disciplined in the 1998/99 fiscal year and is expected to remain so in the current fiscal year. The national government budget deficit declined to an estimated 2,9 per cent of gross domestic product in the past fiscal year. The upwardly revised estimate of gross domestic product helped government to meet the budget deficit target of 3,0 per cent sooner than had initially been indicated. But the contributions made by strong rises in revenues as a result of better tax administration, and better expenditure control in spending departments, were far more important determinants of the process of deficit consolidation.

Of particular significance was the improved control at provincial government level which resulted in the consolidated balance of provincial governments moving into surplus in fiscal 1998/99. Equally significant was that the primary surplus on the accounts of national government (i.e. the deficit recalculated by excluding interest payments from total expenditure) increased further in the past fiscal year.

Mainly as a result of the deficit reduction, the national government managed to slow the growth in outstanding government debt to limits that may now be regarded as sustainable. From the end of fiscal 1994/95 the ratio of national government debt to gross domestic product increased only slightly, and the increase was almost entirely due to losses incurred through the provision of cover against exchange-rate risk by the Reserve Bank. Earlier concerns about the possible explosive growth in the debt ratio had now been completely allayed. Government has also successfully reprioritised its expenditure objectives in order to meet the most urgent needs of society without having to resort to excessive increases in public spending.

Domestic economic developments

Gross domestic product

After sluggish growth in the first half of 1998, gross domestic production contracted in the second half when the sharp rise in interest rates stifled business and consumer confidence. Real gross domestic product fell at a seasonally adjusted and annualised rate of 2½ per cent in the third quarter of 1998. Although a modest recovery occurred in the fourth quarter of 1998, real gross domestic product for the year as a whole rose by just ½ per cent.

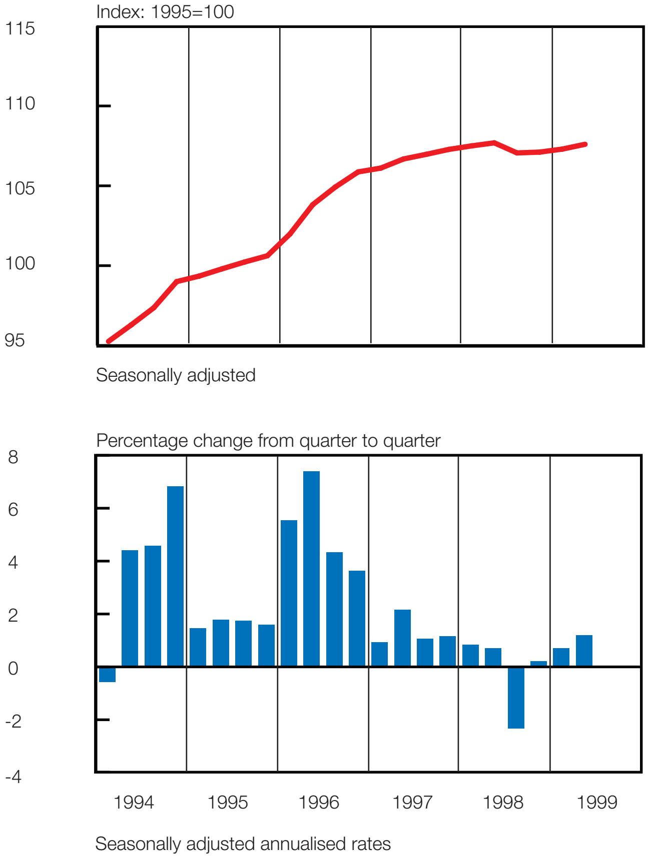
The small increase in gross domestic product in 1998 meant that this was the second, consecutive year of economic slowdown, with growth having slowed down from more than 4 per cent in 1996. Average growth nevertheless remained positive during the current downward phase of the business cycle. As indicated in the accompanying table, output volumes shrank during the two previous downswing phases of the business cycle: from the third quarter of 1984 to the first quarter of 1986 real gross domestic product declined at an annualised rate of 2 per cent and from the second quarter of 1989 to the second quarter of 1993, at an annualised rate of ½ per cent. During the current downward phase of the cycle, output still expanded at an annualised rate of about ½ per cent until the middle of 1999.

The tentative recovery in the last quarter of 1998 appears to have continued in the first half of 1999, but failed to gather any additional momentum. *Agricultural output,* which had been declining throughout 1998, increased moderately in the first half of 1999 as the real value added by livestock and horticultural farmers improved. *Mining production,* which had been declining from quarter to quarter since the first half of 1998, struggled under weak international demand and a slump in international commodity prices. Led by an improved situation in coal and platinum mining, the real value added by non-gold mining companies strengthened somewhat in the first half of 1999. *Gold production* fell further to output levels approaching those of the first half of the 1950s. Although efficiency in gold-

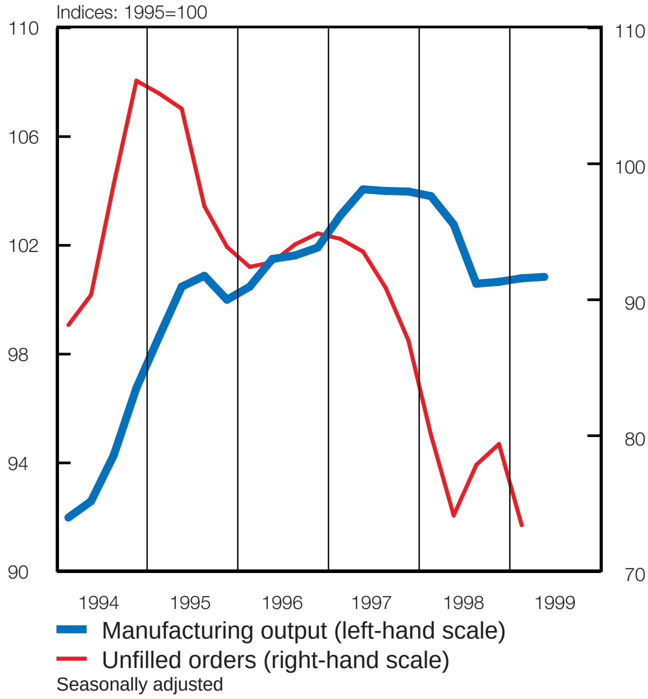
Table 1. Changes in real gross value added
Annualised percentage change in seasonally adjusted quarterly data

	Phases of the business cycle				
	Downswing	Upswing	Downswing	Upswing	Downswing
	3rd qr 1984 to 1st qr 1986	2nd qr 1986 to 1st qr 1989	2nd qr 1989 to 2nd 1993	3rd qr 1993 to 4th qr 1996	from 1st qr 1997
	7 quarters	12 quarters	12 quarters	14 quarters	10 quarters
Primary sectors	4	½	-1	2	-½
Agriculture	20	3	-3	6½	1½
Mining	-1	-1½	0	-1	0
Secondary sectors	-4½	3	-2½	3½	0
Manufacturing	-4	4½	-2½	3½	-½
Electricity, gas and water	4½	4½	2	5½	½
Construction	-6½	½	-4	2½	1½
Tertiary sectors	-1	3	½	4	1½
Commerce	-7	3	-1	3½	-1
Transportation and communication	-1½	3½	½	7	6
Financial services	2	2½	½	5	3
General government	1	3½	1½	1½	-½
Gross domestic product	**-2**	**3**	**-½**	**3½**	½

Real gross domestic product



Manufacturing output and unfilled orders

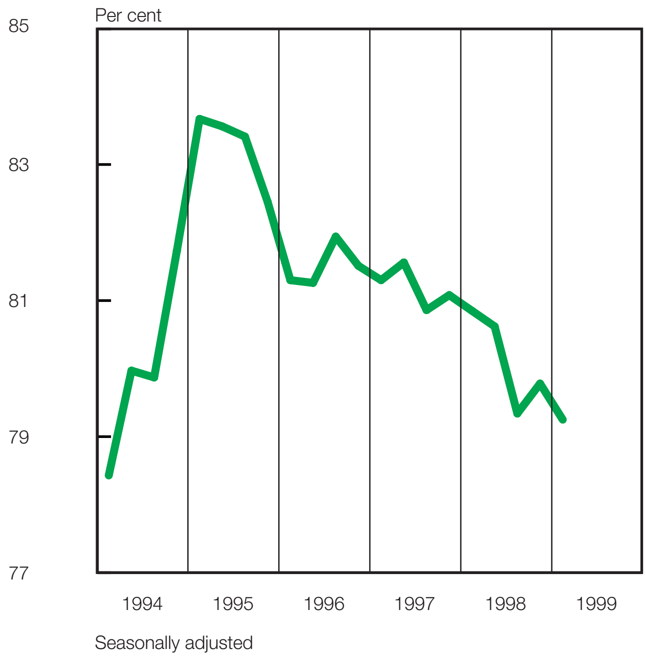


mining operations has improved impressively during the past few years, the recent fall in the dollar price of gold limited the growth potential of the South African gold-mining industry.

Real manufacturing production flattened out in the first half of 1999, after it had decreased at an annualised rate of more than 5 per cent in the second half of 1998. Stronger export demand for South African manufactured goods, motor vehicles in particular, and the improved price competitiveness of domestic producers were probably the main reasons for the slight improvement in manufacturing output volumes. The subdued overall demand for manufactured goods was reflected in the falling ratio of unfilled orders to sales of manufacturers during the first half of 1999 and a steady decline in the utilisation of existing production capacity.

Output by the *construction industry,* which had risen by about 2 per cent in 1998, was adversely affected in the second half of that year by the slowdown in private-sector demand for residential and non-residential buildings. Construction activity remained flat in the first half of 1999 and real value added by building contractors was slightly lower than in the second half of 1998.

Utilisation of production capacity in manufacturing



The lack of consumer confidence and the decline in aggregate domestic demand are reflected in the real value added by the *commercial sector,* which contracted throughout 1998 and in the first half of 1999. Growth in the real value added by the *transport, storage and communication sector* continued briskly in the first half of 1999, mainly because of the steady expansion of communication services to areas and communities that had previously been underserviced. Real value added by the *finance, insurance, real-estate and business services sector* increased at a lower rate in the first half of 1999 than during the second half of 1998, mainly because of the steep decline in real-estate transactions and the shrinking of real value added by the real-estate sector.

Disparate growth rates among the various sectors of economic activity during the 1990s resulted in rather profound changes in the relative importance of the main sectors of economic activity. For example, the relative share of value added by the tertiary sectors rose from 55½ per cent of total value added in 1990 to 65 per cent in the first half of 1999. Over the same period, the relative share of the primary sectors declined from 14 per cent to 10½ per cent and that of the secondary sectors from 30½ per cent to 24½ per cent. The growing significance of the services industries in the domestic economy is consistent with trends observed in the advanced economies of the world.

The growth in *real gross national income* was held back by a relatively severe deterioration in the international terms of trade, which reflected the decline in international commodity prices and the rise in the price of oil in recent months. As a consequence, real gross national income declined at an annualised rate of about 1½ per cent in the first half of 1999, taking income *per capita* to a level that was about 4 per cent lower than the latest high point in the second quarter of 1997.

Composition of gross domestic product

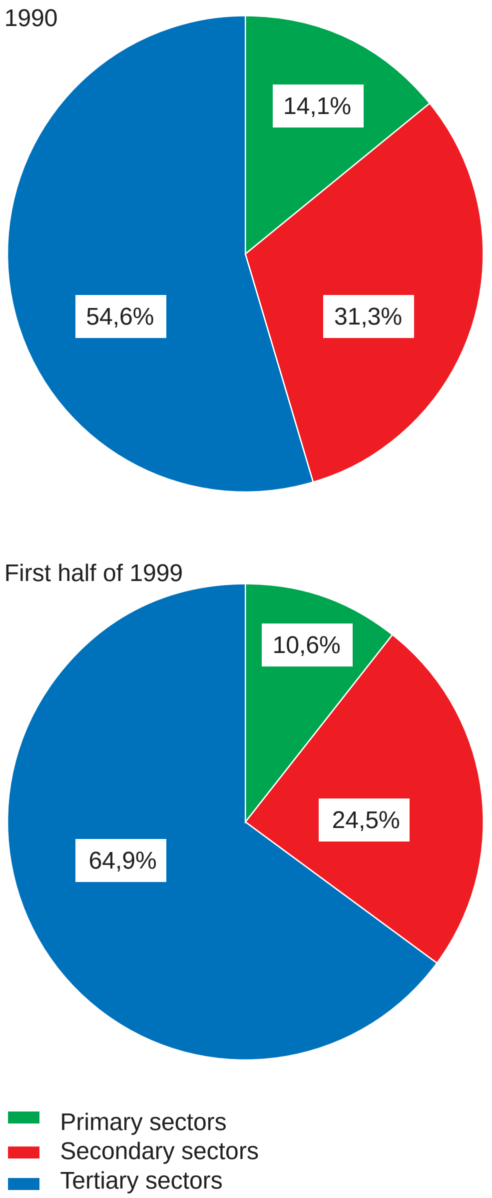


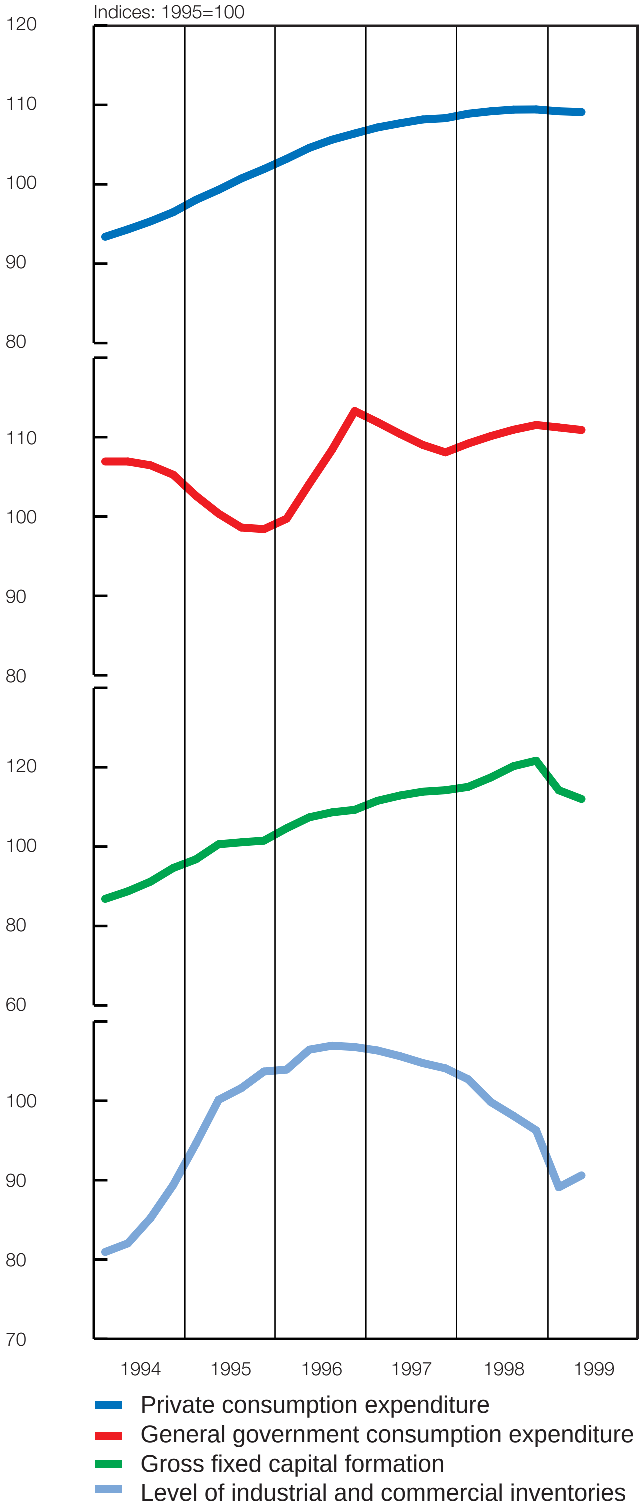
Table 2. Real gross domestic product
Percentage change at seasonally adjusted and annualised rates

	1997	1998			1999
		1st half	2nd half	Year	1st half
Primary sectors	2	-½	-7	-½	1
Agriculture	2½	½	-13½	-1	4
Mining	1½	-1½	-2	-½	-1
Secondary sectors ..	2½	-½	3½	-1	0
Manufacturing	2½	-1½	-5	-2	0
Electricity, gas and water	4	2	0	½	0
Construction	2½	2½	1½	2	-½
Tertiary sectors	2½	2	1	1½	½
Commerce	½	-1	-3	-1½	-½
Transportation and communi-cation	6½	6½	4½	6	1½
Financial services............	4½	4½	3½	3½	1
Non-agricultural sectors............	2½	1	-½	½	0
Total	**2½**	**1**	**-1**	**½**	**½**

Gross domestic expenditure

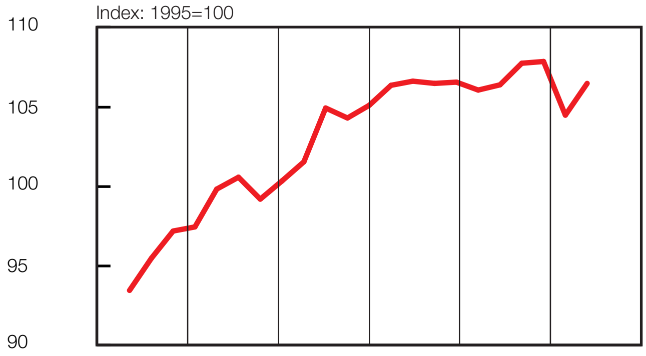
Despite the tightening of monetary conditions around the middle of 1998, gross domestic expenditure remained firm in the second half of the year and rose by ½ per cent for the year as a whole. This was entirely due to a surge in public-sector fixed capital formation. Most of the other components of aggregate domestic expenditure decelerated from the second half of 1998 and inventories continued to be reduced. The slowdown in spending growth gradually broadened and intensified so greatly that there was a sharp decline in gross domestic expenditure in the first half of 1999.

Components of gross domestic expenditure

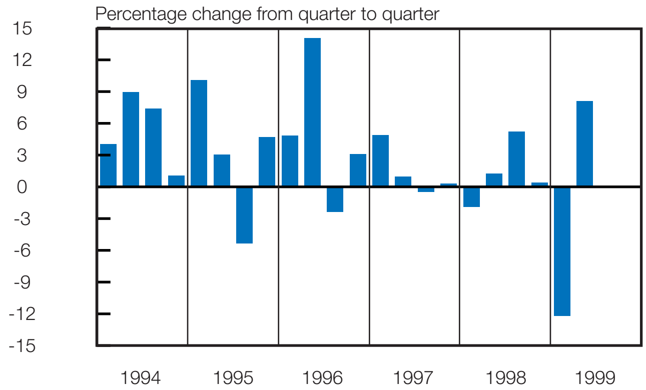


Seasonally adjusted

Real gross domestic expenditure



Seasonally adjusted



Seasonally adjusted annualised rates

Final consumption expenditure by households

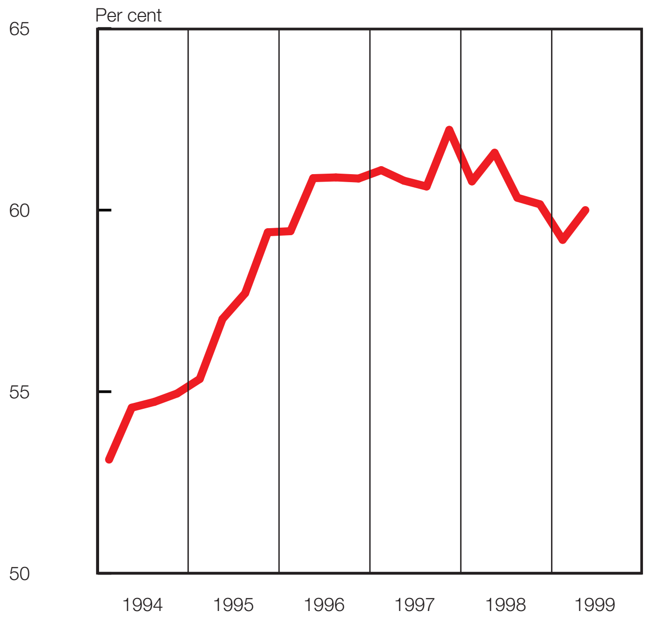
The growth in real final consumption expenditure by households had slowed down progressively in the course of 1998 and then declined in the first half of 1999 – the first decline in real household spending since the fourth quarter of 1992. Spending on durable goods fell sharply as households postponed purchases, especially of new motorcars. Spending on semi-durable goods was flat in the first half of 1999, but spending on more essential non-durable goods and services still increased at a modest rate.

Table 3. Real gross domestic expenditure
Percentage change at seasonally adjusted and annualised rates

Components	1997	1998			1999
	Year	1st half	2nd half	Year	1st half
Private consumption expenditure.............	2½	1½	½	1½	-½
Government consumption expenditure...........	3½	2	3	½	-½
Gross fixed capital formation................	5	4	8½	5	-12½
Inventory investment (R billions)*	-1	-5,9	-4,2	-5,0	-2,0
Gross domestic expenditure...........	**2½**	**-½**	**3**	**½**	**-4½**

* 1995 prices, annualised

Household debt as percentage of household disposable income



Seasonally adjusted

The fall in private consumption expenditure in the first half of 1999 was the result of weak consumer confidence which could be attributed to

- declining employment in the formal sectors of the economy;
- low income growth;
- the decline in equity values in the second half of 1998 and households' negative perceptions of wealth;
- the effect of the high level of interest rates in the second half of 1998; and
- the desire among many households to reduce an inordinately heavy debt burden.

Table 4. Real private consumption expenditure
Percentage change at seasonally adjusted and annualised rates

Components	1997	1998			1999
	Year	1st half	2nd half	Year	1st half
Durable goods..............	½	-3	-12	-6	-15
Semi-durable goods.......................	3	4	1½	2½	0
Non-durable goods	3	0	½	1	½
Services	3	3	3½	3	2
Total	**2½**	**1½**	½	**1½**	**-½**

The steep rise in interest rates in the second half of 1998 led to a marked rise in the debt service costs of households from 11½ per cent of disposable income in the first half of the year to 14 per cent in the second half. This meant that households had much less capacity to spend, while at the same time the savings ratio came under pressure as households attempted to maintain past spending habits. The success achieved in containing debt growth, either through retiring existing debt or through refraining from entering into new debt commitments, was reflected in a decline in the ratio of household debt to household disposable income from 61½ per cent in the first half of 1998 to 59½ per cent in the first half of 1999. The conversion of a mutual long-term insurance company into an incorporated business concern in December 1998 made a notable contribution to the reduction of households' debt burdens over the past year.

Final consumption expenditure by general government

Growth in real final consumption expenditure by general government had slowed down quite significantly from the beginning of the current downturn in economic activity in 1996 and eventually turned negative in the first half of 1999. Government consumption expenditure declined at an annualised rate of about 1 per cent from the beginning of the downward phase of the business cycle until the middle of 1999. As a result, the ratio of final consumption expenditure by general government to gross domestic product increased from 19 per cent in 1996 to 20½ per cent in the first half of 1999.

The decline in real consumption outlays by general government in the first half of 1999 emanated from savings generated on government's overall remuneration bill. These cost savings were partly neutralised by increased spending on intermediate goods and services, mainly on social upliftment programmes in areas such as health care and education.

Gross fixed capital formation

Real gross fixed capital formation held up well in the second half of 1998, but declined steeply in the first half of 1999. The abrupt reversal of growth in real fixed capital formation was influenced decisively by the investment activities of public corporations.

An increase in capital formation by *public corporations,* which almost doubled the annualised level of fixed investment spending by these corporations in the second half of 1998, was essentially due to the acquisition of new aircraft by South African Airways and accelerated spending by Telkom on the expansion of the telecommunications network. Real fixed capital formation by public corporations fell back by more than 40 per cent (at an annualised rate) in the first half of 1999 when South African Airways completed its expansion programme and Telkom maintained its capital expenditure at about the same level as that of the second half of 1998.

The acceleration in fixed capital formation by public corporations in 1998 lifted gross domestic fixed capital formation as a percentage of gross domestic product from 16 per cent in 1997 to 16½ per cent in 1998. Even at this ratio, gross fixed capital formation is well below the long-term average of 22 per cent of gross domestic product. According to standard growth accounting procedures this ratio is too low to set the economy on a higher growth path and also falls short of the investment ratio in many rapidly growing emerging-market economies.

Real gross fixed capital formation by *private-sector* companies declined throughout 1998 and in the first half of 1999. Investment activity diminished in all the major sectors of the economy, except for mining, and the manufacturing sector where the depreciation of the rand in 1998 strengthened the ability to compete in export markets. Steep declines in investment activity in the commercial sector and in private residential development were observed in the first half of 1999, following the completion of a number of regional shopping centres, casinos and hotels in the second half of 1998. Investment in private residential development also declined in the first half of 1999, primarily in response to the rapid rise in the cost of mortgage bond financing in 1998.

Table 5. Real gross fixed capital formation by type of organisation

Percentage change at seasonally adjusted and annualised rates

Components	1997	1998			1999
	Year	1st half	2nd half	Year	1st half
Private business enterprises.................	4½	-3½	-6	-3	-2½
Public corporations......	9½	48½	93½	51½	-41
Public authorities..........	4½	4	½	2½	-5½
Total	**5**	**4**	**8½**	**5**	**-12½**

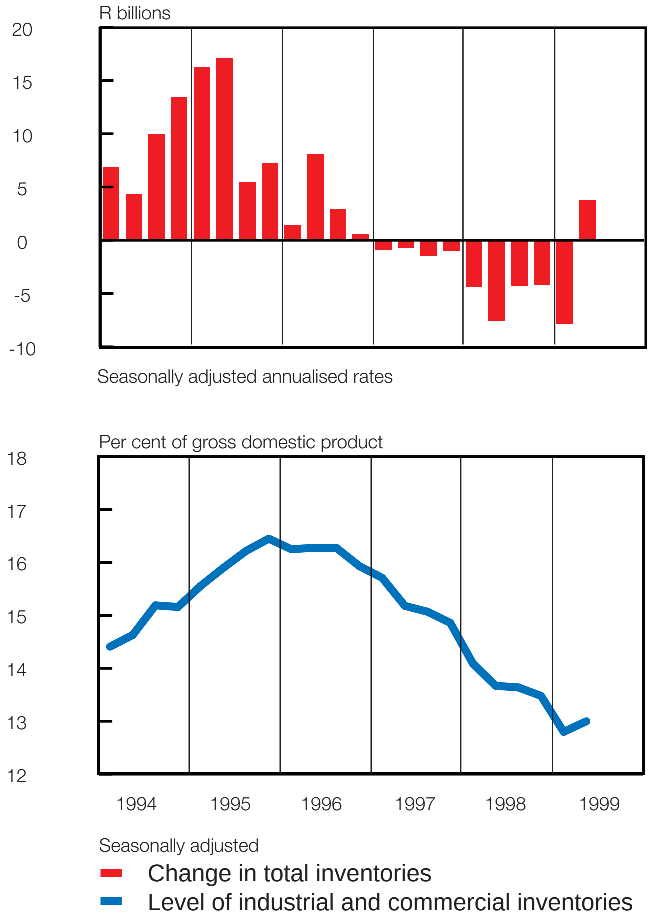
Real gross fixed capital formation by *general government,* which had increased at a low rate in the second half of 1998, declined in the first half of 1999. The decline was essentially confined to the national and provincial governments; local authorities increased their level of capital spending somewhat, mainly on infrastructural developments.

Change in inventories

Inventory levels were again reduced in 1998, partly in response to the expected slowdown in domestic demand, but also as a result of rapidly climbing interest rates which raised the cost of carrying inventories. As a consequence, the ratio of industrial and commercial inventories relative to non-agricultural gross domestic product reached an all-time low of 13 per cent in the first half of 1999, compared with 16½ per cent at the beginning of the current downward phase of the business cycle. The decline in the inventory ratio is not only a cyclical phenomenon, but is also the continuation of a long-term shift in inventory management towards more efficient and cost-saving practices.

The decline in inventory levels in the first half of 1999 occurred mainly in mining inventories, agricultural stocks-in-trade and manufacturing inventories. There were some involuntary increases in the retail and motor trade, and transport, storage and communication sectors, but these were not capable of stemming the continuing decline in overall inventory holdings. Inventory disinvestment in 1998 and the first half of 1999 reduced the growth in the real gross domestic product by 1 percentage point. The need to restore inventories in anticipation of a recovery in aggregate demand may therefore bring about a quick reversal of the short-run growth prospects of the economy.

Inventories



Factor income

The growth in aggregate nominal factor income slowed down during the current downward phase of the business cycle from 12½ per cent in 1996 to 7 per cent in the first half of 1999. Moderation of growth trends in both employee remuneration and the gross operating surpluses of business enterprises contributed to the slower growth in aggregate factor rewards.

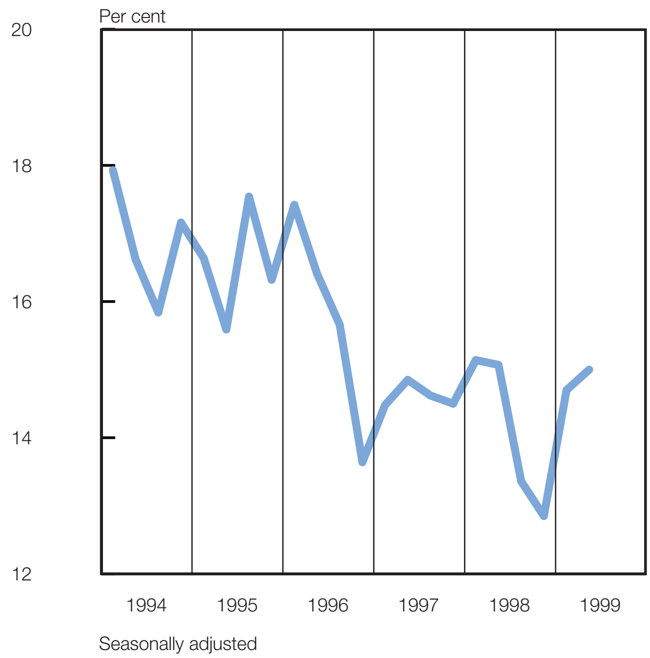
The year-on-year rate of increase in the total *compensation of employees* declined from 9½ per cent in 1998 to 8½ per cent in the first half of 1999. This slowdown was apparent in all the main sectors of the economy, but was slightly more pronounced in the trade and transport sectors, whereas employee compensation actually declined in the mining sector. Despite this slowdown, aggregate compensation of employees grew faster than the rate of increase in consumer prices during the first half of 1999.

The growth over one year in *aggregate nominal operating surpluses* fell from 11½ per cent in 1997 to 6½ per cent in 1998 and to about 5½ per cent in the first half of 1999. Most of the major sectors of the economy experienced slower growth in operating surpluses, but the manufacturing sector was affected more severely than the other sectors. Domestic cost pressures, weak domestic demand, greater competition from outside the country and the decline in external demand for South African manufactured goods in the second half of 1998 probably compressed the operating surpluses in manufacturing more than in the other sectors of the economy. Operating surpluses in the mining sector maintained a fair measure of buoyancy. Despite low international commodity prices, the cost-saving measures taken by many mining companies and forward sales of output, especially of gold, helped sustain the long-term viability of most sectors of the mining industry.

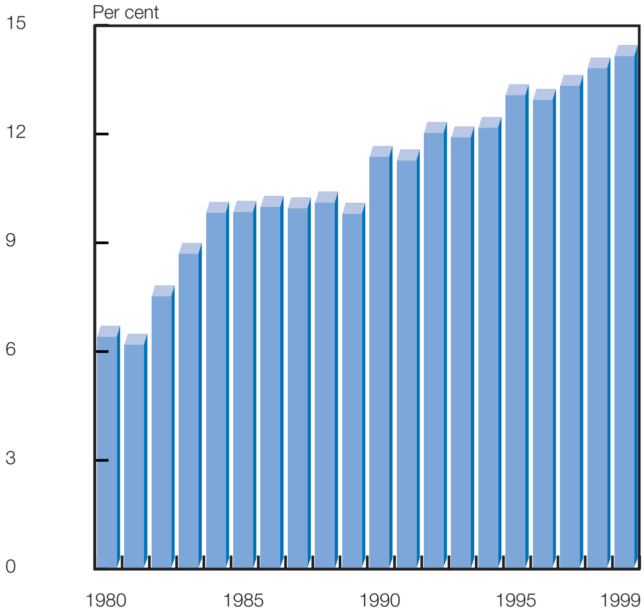
Gross saving

South Africa's gross saving as a percentage of gross domestic product has deteriorated consistently since the middle of the 1980s. In the current downward phase of the business cycle, gross saving declined from 16½ per cent of gross domestic product in 1996 to an all-time low of only 13 per cent in the fourth quarter of 1998. In the first half of 1999 gross saving as a percentage of gross domestic product improved slightly to 15 per cent. This improvement was the net outcome of slightly better corporate savings, lower net dissaving

Gross saving as percentage of gross domestic product



Household tax burden*



Fiscal years

* Direct taxes on households as percentage of current household income

by general government and continued weakness in the savings behaviour of households.

Household saving as a percentage of gross domestic product declined from 1 per cent in 1998 to about ½ per cent in the first half of 1999. Household saving was constrained by the high level of outstanding consumer debt and the strong rise in debt service cost from the middle of 1998. At the same time the burden of direct taxation on households rose from 15½ per cent of household disposable income in 1997 to 17 per cent in the first half of 1999.

Net saving by the corporate sector as a percentage of gross domestic product improved from 3 per cent in the second half of 1998 to 4½ per cent in the first half of 1999. Slow growth in dividend payments and increased retainment of corporate profits probably contributed most to the improvement in the corporate saving ratio. For many years, corporate saving used to be the mainstay of the national saving performance. Improved saving by the corporate sector should therefore be an integral part of any attempt to bolster domestic saving.

Net dissaving by general government relative to gross domestic product improved from 5 per cent in 1997 to 3 per cent in the first half of 1999. This was a clear reflection of government's resolve to adhere to sound public-finance policies and followed its strenuous efforts to contain general government spending and improve the efficiency of tax collection. The ratio of total tax income of general government to gross domestic product rose from 25 per cent in 1997 to 26 per cent in 1998 and 28 per cent in the first half of 1999, leaving little scope for an increase in tax rates to address the shortfall between government current revenue and expenditure.

Employment

Formal non-agricultural employment (after adjustment for seasonal fluctuations) increased in the first quarter of 1999 for the first time in 11 quarters. Employment declines during 1998 nevertheless still caused the number of people employed in the non-agricultural sectors of the economy to decline by 42 000 or 0,8 per cent in the year to March 1999.

The decline in formal-sector employment in 1998 was the continuation of a long-term decline dating back to 1989. Accumulated job losses from the third quarter of 1989 to the end of the first quarter of 1999 reached almost 850 000 and reduced the number of the gainfully employed to a level last seen in 1979. If the potential workers who have taken steps to look for work were taken into account, the unemployment rate was estimated at 22,9 per cent in October 1997.

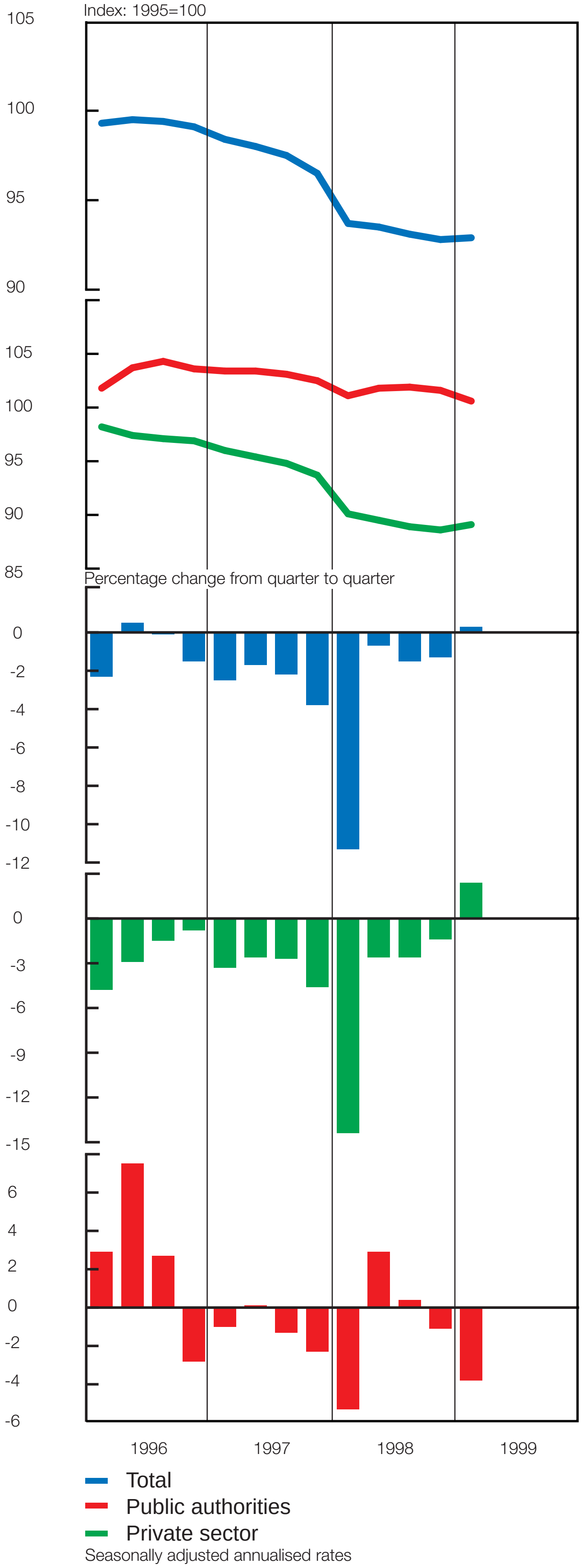
The reduction in formal employment in 1998 can *inter alia* be attributed to the slowdown in world economic activity following the disruption of international financial markets in 1997 and 1998, the pressure under which domestic producers had to operate in order to remain competitive in an integrated international economy and the current cyclical downswing in domestic economic activity.

Employment creation was further inhibited by declining international commodity prices, especially the price of gold which declined to a 20-year low by the middle of 1999. The rising wage and non-wage costs of labour, together with ongoing rationalisation in the public sector, can also be cited as factors which aggravated the employment situation in South Africa.

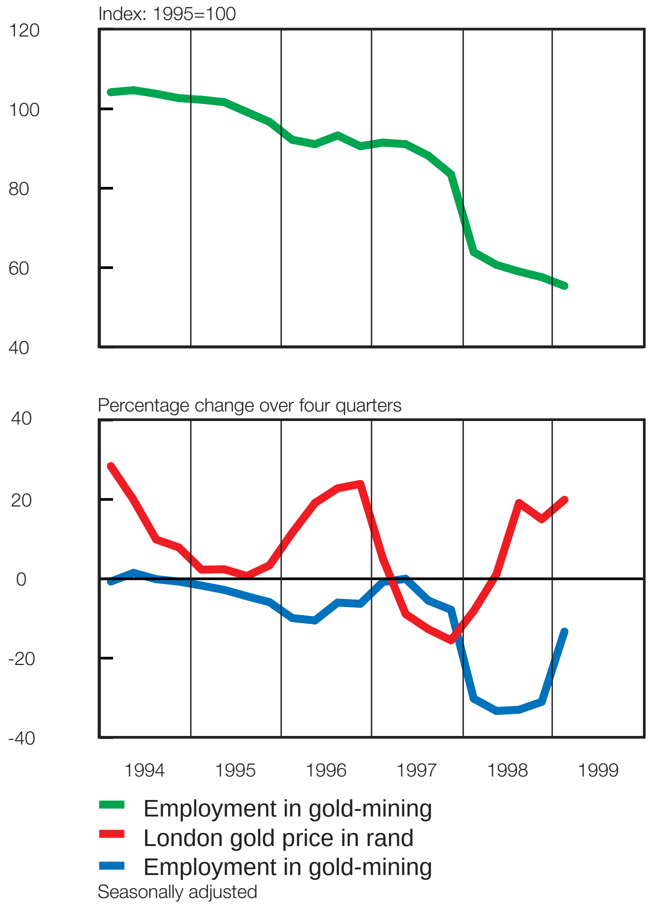
The employment situation in the *private sector* seems to have been improving since the middle of 1998. The pace of decline in private-sector employment (seasonally adjusted and annualised) at first slowed down from 2,6 per cent in the third quarter of 1998 to 1,4 per cent in the fourth quarter. Then private-sector employment increased at an annualised rate of 2,4 per cent in the first quarter of 1999. Employment increases were particularly prominent in the trade, catering and accommodation services and the non-gold mining sector.

Job losses in the year to March 1999 occurred in all the subsectors of the private sector, with the exception of trade, catering and accommodation services where personnel complements expanded by almost 9 per cent. By contrast, almost 14 per cent of the available jobs in the gold-mining sector were abolished in the year to March 1999. Activity in the construction sector was hit hard by high financing costs in 1998 and more than 16 per cent fewer employment opportunities were available in this sector at the end of March 1999 than a year earlier.

Non-agricultural employment



Relationship between changes in the gold price and changes in gold-mining employment

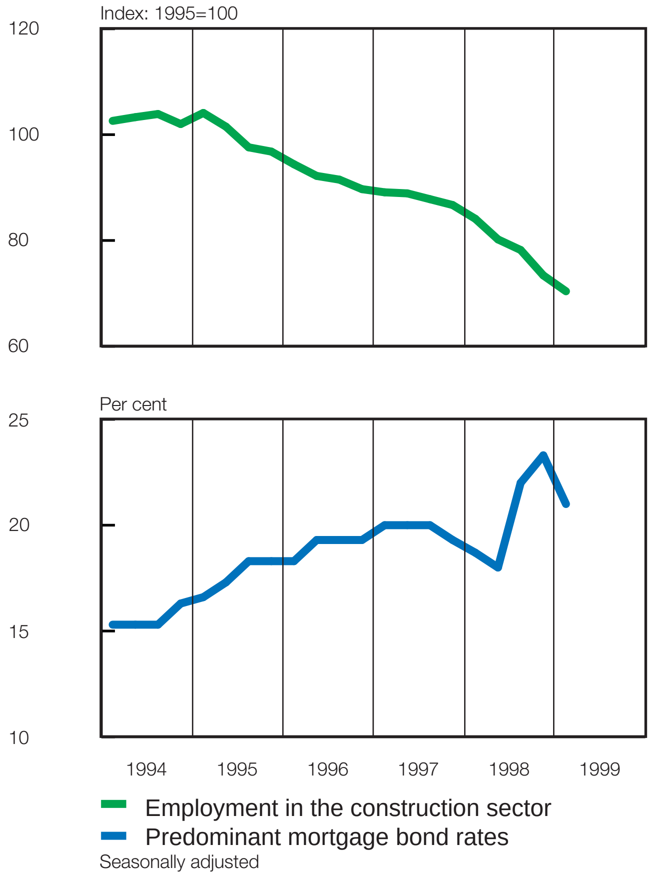


Employment in the *public sector,* which had risen in the middle quarters of 1998, started to decline towards the end of 1998 in most government structures, except in tertiary training institutions and some public corporations where staff numbers increased slightly. Employment in the public sector as a whole contracted by 0,4 per cent in the year to March 1999.

Several developments initiated during 1998 may in due course influence the economy's capacity to create jobs. The most significant among these are

- the Employment Equity Act which is directed at the elimination of unfair discrimination in employment practices;
- the Basic Conditions of Employment Act which provides a legal framework for regulating the minimum working conditions of South African workers; and
- the Skills Development Act which will strengthen education and training efforts in order to meet the skills shortage in different sectors of the economy and to increase investment in training.

Employment in the construction sector and mortgage bond rates



Some additional initiatives were also taken in an effort to increase the economy's employment-creating capacity. The Presidential Jobs Summit was held on 30 October 1998 with the intention of bringing together the government, the business community and organised labour in an effort to establish formal structures for addressing the unemployment problem. Job-creating initiatives emanating from the Summit which have already been implemented are the establishment of a Job Creation Trust Fund from the proceeds of a one-day wage donation by certain trade union members, and the creation of an Employment Trust Fund which is funded by the financial donations of various private-sector institutions.

Labour costs and productivity

The growth in *nominal remuneration per worker* in the non-agricultural sectors of the economy slowed down in the middle quarters of 1998 but accelerated sharply in the fourth quarter. In the first quarter of 1999 the growth in nominal remuneration apparently resumed its downward momentum. The fourth-quarter acceleration should therefore be seen as a one-off event due mainly to the bunching of bonus and overtime payments and remuneration increases for certain categories of public-sector employees who previously used to receive their regular pay rises in July.

Average nominal remuneration per worker in the formal economy increased by 7 per cent in the year to March 1999, significantly lower than the increase of 10,7 per cent in 1997. Actual wage moderation was even more impressive than indicated by the decline in the calculated growth rates, because growth in average worker earnings in the year to March 1999 was somewhat upwardly biased by the retrenchment of workers at the lower end of the pay scale. Wage moderation over the past two and a half years has also been indicated by the average settlement rate in collective bargaining agreements which declined from 9,7 per cent in 1997 to 8,6 per cent in 1998 and 8,1 per cent in the first half of 1999.

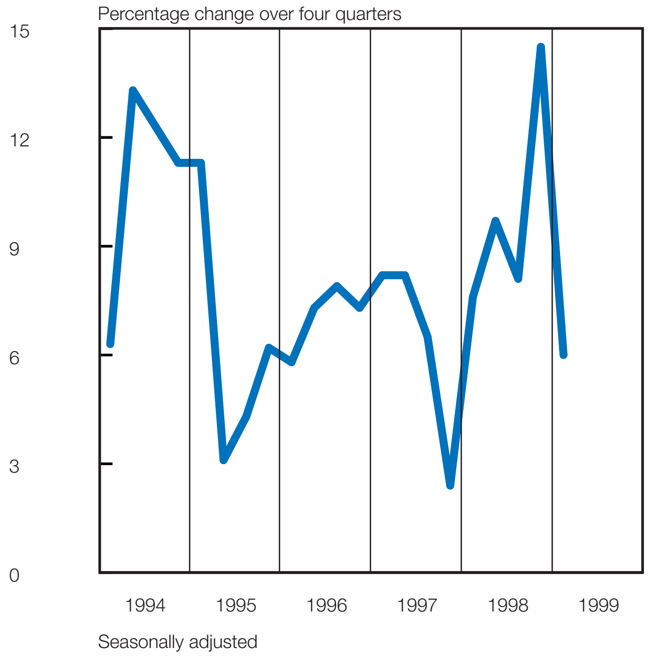
The growth in nominal remuneration per worker continued to exceed the growth in output prices up to early 1999, but at a diminishing margin. The ratio of remuneration per worker to output prices accordingly rose by only 0,9 per cent in the year to March 1999 compared with growth of 2,4 per cent in 1997. Furthermore, the potential inflationary effect of these increases was curbed by growing labour productivity as employers and employees both realised the need for cost containment in order to preserve price competitiveness.

The number of workdays lost to strikes rose from 0,7 million in 1997 to 2,3 million in 1998. Industrial action diminished in the first quarter of 1999 and the number of workdays lost fell to 25 000 compared with 288 000 in the corresponding quarter of 1998. Then the nationwide strike by transport workers caused the number of workdays lost to climb to 410 000 in the first half of 1999 – 32 per cent higher than the 310 000 workdays lost during the first half of 1998. The majority of strikes were related to demands for higher remuneration. In general, employers resisted extreme wage demands and the settlement rates which were eventually agreed upon contributed to the recent slowdown in the growth in average worker remuneration.

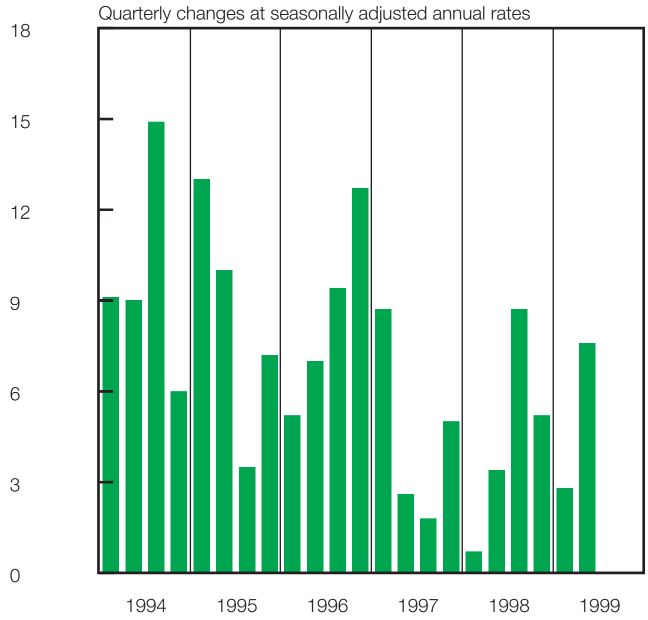
As a consequence of the slowdown in output growth and the increase in industrial action, the growth in *output per worker* in the formal non-agricultural sectors of the economy receded from 4,2 per cent in 1997 to 0,9 per cent in the year to March 1999. To a large extent, the recent productivity improvement probably reflected the contraction in employment numbers more than anything else, but there were also some efficiency gains throughout the economy. Of particular significance was that growth in aggregate output in the first quarter of 1999 was accompanied by an increase in the level of employment in the formal private non-agricultural sectors of the economy.

The slowdown in average remuneration per worker led to lower growth in nominal unit labour costs from

Non-agricultural nominal unit labour costs



Production price index



6,3 per cent in 1997 to 6,0 per cent in the twelve months to March 1999. This slowdown helped contain inflationary pressures in the economy and augurs well for future declines in production price and core inflation.

Inflation

The longer-term downward trend in inflation continued when average consumer price inflation declined from 8,6 per cent in 1997 to 6,9 per cent in 1998 – the lowest rate of increase in consumer prices in any year since 1972. Production price inflation fell back too; from 7,1 per cent in 1997 to 3,5 per cent in 1998.

Towards the middle of 1998 the slowdown in inflation was brought to an end and upward inflationary pressures were exerted by the second-quarter depreciation of the rand and a rise in mortgage bond rates. The tightening of monetary policy and the subsequent weakening of domestic demand growth, together with the reduced pricing power of domestic producers, nevertheless prevented these potentially inflationary forces from developing into a spiral of cost and output price increases.

The quarter-to-quarter increase in the *all-goods production price index* nevertheless declined from 8,1 per cent in the third quarter of 1998 to 2,8 per cent in the first quarter of 1999. This slowdown was brought about by a significantly lower rate of increase in the prices of imported goods. Inflation in the prices of domestically produced goods has accelerated somewhat from the third quarter of 1998. Overall quarter-to-quarter production price inflation picked up again to 7,6 per cent in the second quarter of 1999 as a rise in the prices of imported goods joined forces with the rise in the prices of domestically produced goods.

The annualised quarter-to-quarter increase in the *prices of imported goods* declined sharply from a post-depreciation high of 25,1 per cent in the third quarter of 1998 to a decrease of 5,0 per cent in the first quarter of 1999, but then rose to 12,7 per cent in the second quarter. Two factors continued to exert downward pressure on imported inflation and partly offset the upward pressure caused by the strong rise in the price of crude oil in the first half of 1999. First, the exchange rate of the rand was relatively stable and tended to appreciate most of the time from August 1998. Second, production or wholesale prices in the major countries supplying South Africa generally declined over the past year.

The rate of increase in the *prices of domestically produced goods* fluctuated between 3,8 per cent and 6,4 per cent over the past four quarters. In the first half of 1999 the rates of increase were above those in the second half of 1998, signalling some acceleration of inflation in the prices of domestically produced goods. The acceleration in the prices of imported intermediate goods probably offset the modest inflation-reducing effects of the slowdown in the growth in unit labour costs over the past four quarters.

Quarter-to-quarter increases in *consumer prices* slowed down from 17,3 per cent in the third quarter of

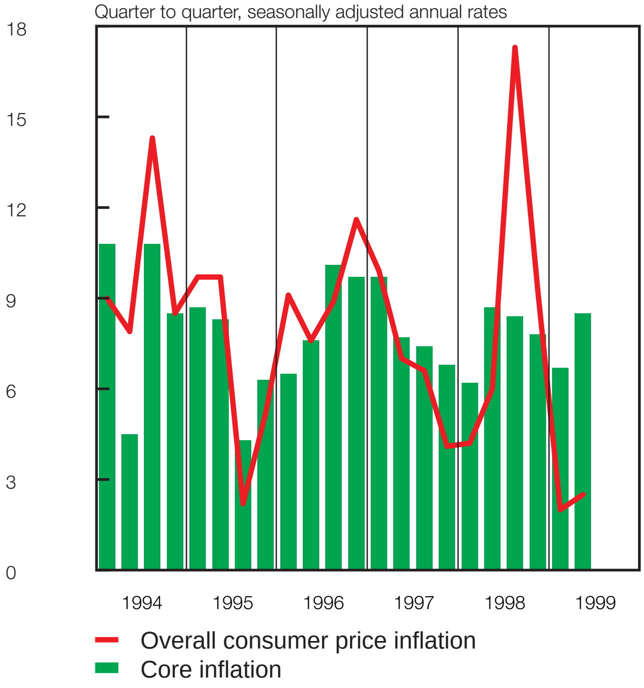
Table 6. Inflation
Quarter-to-quarter changes at annualised rates

		All-goods production price index	Overall consumer price index	Core consumer price index
1998:	1st qr	0,8	4,2	6,2
	2nd qr.......	3,7	6,0	8,7
	3rd qr........	8,1	17,3	8,4
	4th qr........	4,7	9,3	7,8
1999:	1st qr	2,8	2,0	6,7
	2nd qr.......	7,6	2,5	8,5

1998 to 2,0 per cent in the first quarter of 1999 and 2,5 per cent in the second quarter. This deceleration was particularly evident in the prices of services which rose at an annualised rate of 29,4 per cent in the third quarter of 1998, but declined by 4,1 per cent in the second quarter of 1999. The fall in mortgage bond rates was the main cause of the slowdown of inflation in services prices.

Core inflation (which excludes from consumer price inflation the increases in the prices of certain food products, interest rates on mortgage bonds, overdrafts and loans, value-added tax and property taxes) also tapered off marginally from the third quarter of 1998. Core inflation was 8,7 per cent at an annualised rate in the second quarter of 1998 and 8,5 per cent in the second quarter of 1999. Measured over periods of twelve months, core inflation accelerated, on balance, from 7,1 per cent in April 1998 to 8,0 per cent in June 1999. Ample unutilised capacity in the manufacturing sector is likely to prevent renewed inflationary pressures from arising when there is a recovery in aggregate demand growth.

Overall and core inflation



Foreign trade and payments

Balance on current account

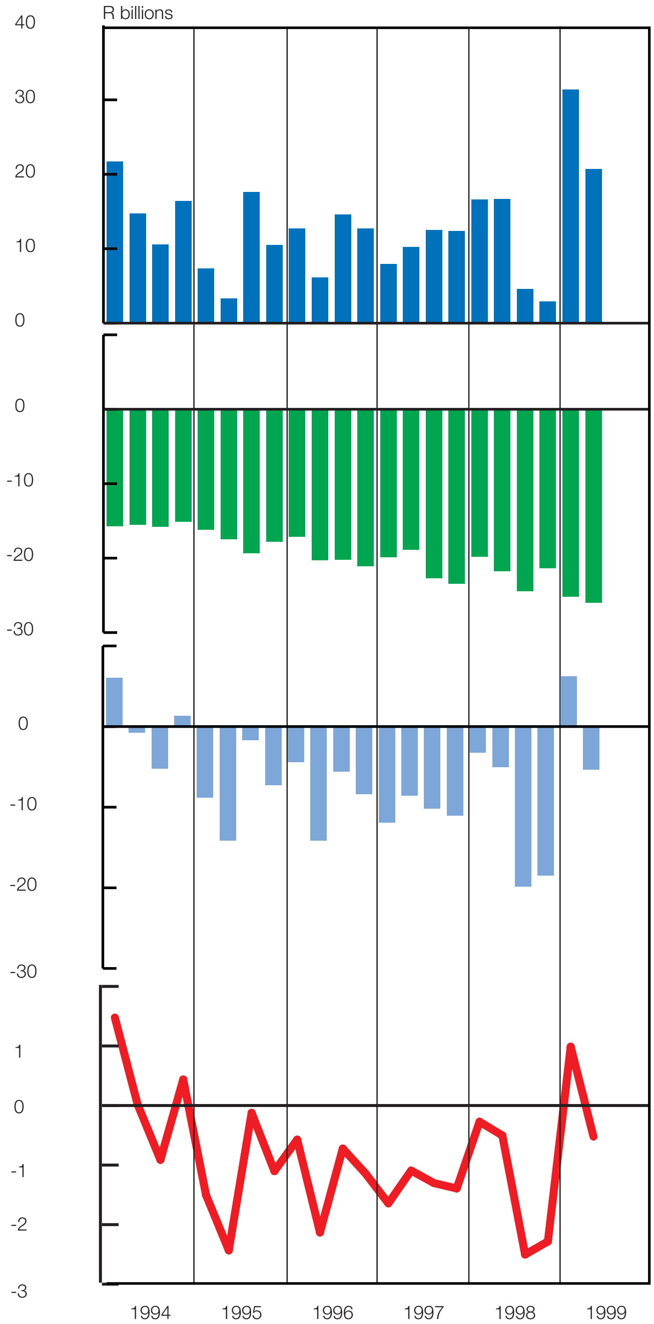
Adverse conditions in world financial markets had a profound effect on the current account of the balance of payments in the second half of 1998. The deficit on the current account (seasonally adjusted and annualised) widened abruptly from R4,1 billion in the first half of 1998 to R19,1 billion in the second half. Owing to the weak demand for South African exports and the buoyant demand for imported goods, the current account deficit came to R11,6 billion for the 1998 calendar year as a whole, slightly more than the R10,4 billion deficit recorded in 1997. By contrast, higher export proceeds and a contraction in aggregate domestic expenditure and imports changed the deficit on the current account to a surplus in the first six months of 1999.

As a ratio of gross domestic product, the deficit on the current account increased from 0,6 per cent in the first half of 1998 to 2,6 per cent in the second half. The *surplus* on the current account equalled 0,1 per cent of gross domestic product in the first half of 1999.

Table 7. Balance of payments on current account
Seasonally adjusted and annualised
R billions

	1998		1999
	1st half	2nd half	1st half
Merchandise exports	131,7	138,4	145,1
Net gold exports	24,3	27,6	24,3
Merchandise imports	-139,3	-162,2	-143,3
Net service, income and current transfer payments	-20,8	-22,9	-25,5
Balance on current account	**-4,1**	**-19,1**	**0,6**

Current account



Merchandise exports

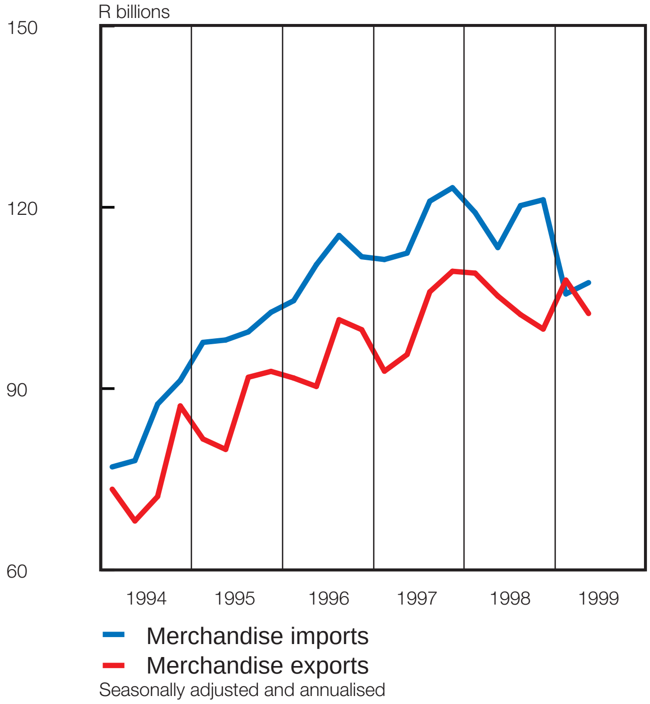
Merchandise exports, which had increased from a seasonally adjusted and annualised average value of R131,7 billion in the first half of 1998 to R138,4 billion in the second half, rose to R145,1 billion in the first half of 1999. The share of total South African exports destined for Asian countries (including Japan), which had declined from 21,4 per cent in the third quarter of 1997 to 15,1 per cent in the fourth quarter of 1998, recovered to 19,2 per cent in the first half of 1999. South African exporters to some extent, also offset the impact of the contraction in Asian economies by redirecting trade flows to markets less affected by the crisis. The rand value of exports destined for North and South America increased by almost 20 per cent from 1997 to 1998. Exports to Europe, which had remained at a high level during 1997 and 1998, grew strongly in the first half of 1999.

The average rand price of exported goods increased by about 11 per cent in 1998. This increase largely reflected the sharp depreciation of the rand in the second half of 1998 which counteracted the decline in international commodity prices. The rate of increase in the physical quantity of merchandise exports, which had amounted to 15,2 per cent in 1995 and 10,7 per cent in 1996, slowed down to 5,4 per cent in 1997 and 3,1 per cent in 1998 as world economic activity lost some of its earlier vigour. The growth in the volume of merchandise exports then accelerated to 4,1 per cent in the first half of 1999 when reform measures began to improve economic conditions in emerging markets and the real depreciation of the rand began to take effect.

The share of mining exports in total merchandise exports declined continuously from 47,9 per cent in the first half of 1998 to 43,7 per cent in the second half. As stability returned to Asian economies and international commodity prices flattened out in the first half of 1999, the share of mining exports in total merchandise exports increased slightly to 44,3 per cent. In particular, significant increases were recorded in the exports of mineral products, base metals and articles of base metals over this period. Exports of manufactured goods as a percentage of total exports remained relatively unchanged during 1998 before increasing in the first half of 1999. The subcategory “vehicles and transport equipment”, recorded an increased share of total exports, whereas the share in total exports of chemical products shrank over the same period.

Manufactured goods and net gold exports as a percentage of total exports of goods

Merchandise exports and imports at constant 1995 prices



Merchandise imports

The value of *merchandise imports* (seasonally adjusted and annualised) increased sharply from an average of R139,3 billion in the first half of 1998 to R162,2 billion in the second half, before contracting to R143,3 billion in the first six months of 1999. The high value of merchandise imports in the second half of 1998 could be related to, among other things, the lower external value of the rand and a steep increase in the physical quantity of imported goods, in particular telecommunications equipment and high-value aircraft. In total, the value of imported goods increased from R133,1 billion in

1997 to R150,8 billion in 1998 or by 13,3 per cent. In the first half of 1999 the value of imports declined by 11,7 per cent from the second half of 1998.

Having increased, on average, by less than 2 per cent in the first half of 1998, import prices in terms of rand rose by 4,2 per cent in the second half following the depreciation of the rand. Notwithstanding higher international prices of crude oil, the steady appreciation of the rand and falling output prices in trading-partner countries caused rand import prices in general to rise only slightly in the first half of 1999.

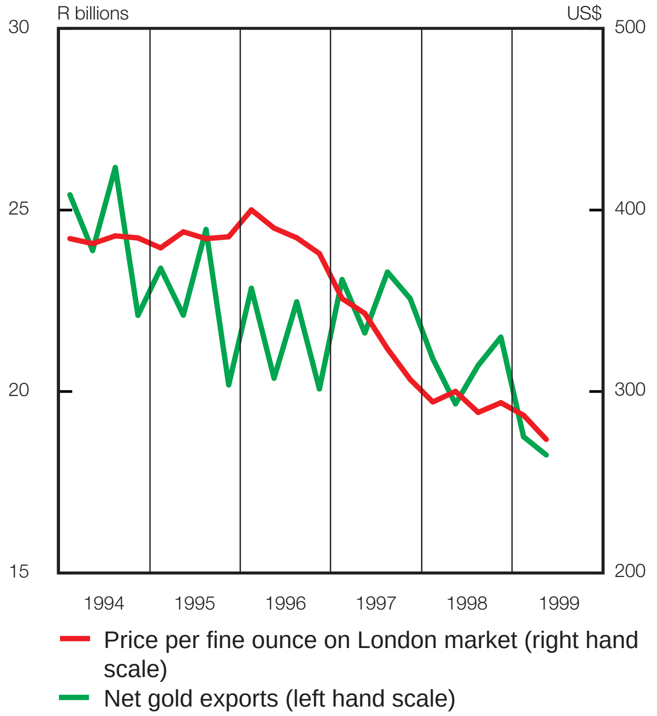
The physical quantity of merchandise imports, which had increased, on average, by 16,3 per cent during the period 1994 to 1996, rose by 5,8 per cent in 1997 and 1,3 per cent in 1998, but then declined by 11,5 per cent in the first half of 1999. The slower growth in the volume of merchandise imports from 1997 coincided with the current downswing in general economic activity, whereas the contraction in the first half of 1999 was directly related to the steep decline in fixed capital formation by public corporations and the private business sector. An analysis of imports reveals that the share of capital goods imported was greater than the share of intermediate goods in 1998 when the public corporations were rapidly expanding their productive capacity. From the fourth quarter of 1998 the share of capital goods in overall merchandise imports diminished along with the decline in real gross domestic fixed investment.

Net gold exports

The seasonally adjusted and annualised average value of net gold exports increased from R24,3 billion in the first half of 1998 to R27,6 billion in the second half, but declined to R24,3 billion in the first half of 1999. For the 1998 calendar year as a whole, net gold export proceeds amounted to R25,9 billion. The depreciation of the exchange rate of the rand in 1998 contributed most to the increase in the value of gold exports. The realised price of gold per fine ounce increased from an average of R1 558 per fine ounce in 1997 to R1 708 in 1998, or by 9,6 per cent, whereas the physical volume of gold exports declined by 8,6 per cent over the same period. South Africa's gold production fell from 494 tons in 1997 to 464 tons in 1998 and to 428 tons (at an annualised rate) in the first half of 1999.

The average fixing price of gold on the London market declined from US$331 per fine ounce in 1997 to US$294 in 1998 or by 11,2 per cent. On 7 May 1999 the Bank of England announced plans to sell, on behalf of the British Treasury, 125 tons of gold in the 1999/2000 financial year and a further 290 tons in the ensuing years. The average fixing price of gold on the London market reacted to this announcement and declined from US$283 in April to US$261 in June 1999. On 6 July 1999, the day of the first gold auction by the Bank of England, the London

Gold price and net gold exports



fixing price of gold fell to a twenty-year low of US$256 per fine ounce. Forward sales by some South African producers nevertheless caused the average price realised by the gold-mining industry to amount to US$289 per fine ounce in the second quarter of 1999.

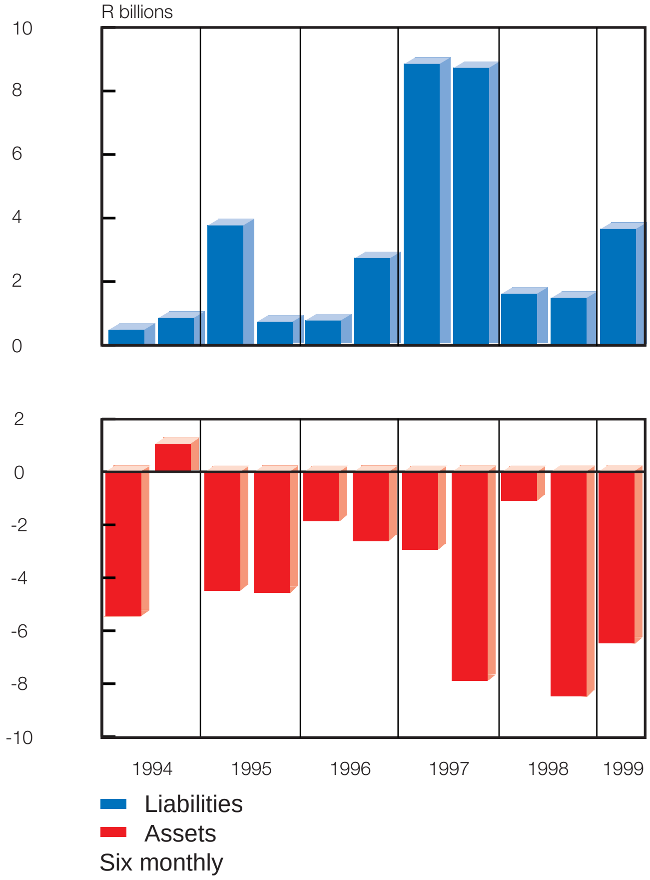
Net service, income and current transfer payments

Net service, income and current transfer payments to non-residents increased from a seasonally adjusted and annualised average of R20,8 billion in the first half of 1998 to R22,9 billion in the second half. Net payments on the services, income and current transfer accounts increased as the rand depreciated in the third quarter. Towards the end of 1998 a decline in payments for transportation and travel, as well as an increase in travel receipts, were recorded. Net service, income and current transfer payments increased to R25,5 billion in the first half of 1999, largely as a result of higher interest payments, payments for transportation services and current transfer payments.

Capital transfer and financial account

The capital transfer and financial account deteriorated into a deficit situation in the second half of 1998, but strengthened appreciably in the first half of 1999,

Direct investment



especially when inflows of portfolio capital regained most of their former vigour.

Foreign direct investment in South African assets declined sharply from R17,6 billion in 1997 to R3,1 billion in 1998. This decrease could mainly be attributed to a general contraction in financial flows to emerging markets as a group, and a steep decline in the proceeds accruing from the partial privatisation of public enterprises. In the first half of 1999, foreign direct investment in South African assets rose to R3,7 billion in comparison with R1,6 billion in the first half of 1998.

The acquisition of foreign direct investment assets by South African entities amounted to R9,6 billion in 1998 compared with R10,8 billion in 1997. The direct outward investments were dominated by the acquisition of offshore assets by South African banks during 1998. In the first half of 1999, direct outward investment remained high when South African companies expanded their foreign interests by R6,5 billion.

The positive sentiment of non-resident investors towards South Africa led to inflows of portfolio capital of R51,6 billion in 1997 and R49,0 billion in the first half of 1998. In August 1998 the Russian government suspended payments on short-term government debt and imposed a moratorium on commercial debt repayments to non-residents. Like most other emerging markets, South Africa was affected by the situation in Russia and the inflow of portfolio capital shrank to only R1,4 billion in the second half of 1998.

Strong inflows of portfolio capital were resumed when non-resident investors increased their holdings of domestic portfolio assets by R37,1 billion in the first half of 1999. Apart from purchasing assets on the South African securities markets, non-resident portfolio investors also acquired assets by means of the asset swap mechanism.

Outward portfolio investments in foreign assets by resident investors rose from R21,0 billion in 1997 to R30,0 billion in 1998. An additional amount of R15,2 billion was invested in foreign portfolio assets during the first half of 1999. These outflows resulted mainly from asset swap arrangements.

There was an outflow of capital from South Africa of R3,8 billion in the category “other identified investments” in the first half of 1998. This was followed by an inflow of R10,3 billion in the second half of 1998, and another outflow of R4,6 billion in the first half of 1999. The inflow in the second half of 1998 emanated mainly from an

Portfolio investment

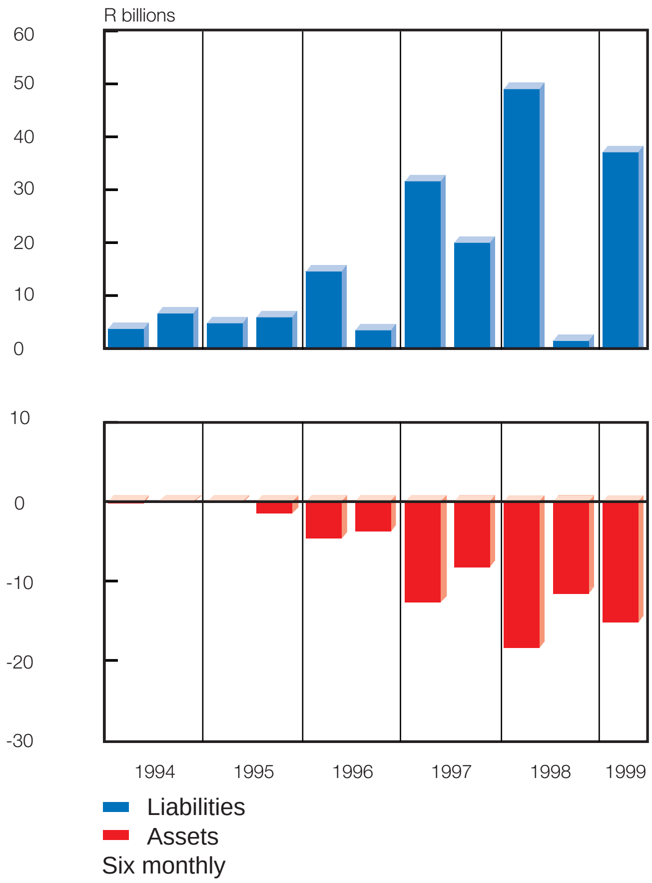


Table 8. Net financial transactions not related to reserves
R billions

	1998		1999
	1st half	2nd half	1st half
Liabilities			
Direct investment	1,6	1,5	3,7
Portfolio investment	49,0	1,4	37,1
Other investment	-3,8	10,3	-4,6
Total liabilities	**46,8**	**13,2**	**36,2**
Assets			
Direct investment	-1,1	-8,5	-6,5
Portfolio investment	-18,4	-11,6	-15,2
Other investment	- 5,2	2,3	-4,2
Total assets	**-24,7**	**-17,8**	**-25,9**
Total financial transactions*	**8,3**	**-0,4**	**7,4**

* Including unrecorded transactions

Table 9. Foreign debt of South Africa
US$ billions at end of year

	1994	1995	1996	1997	1998
Renegotiated debt	**3,4**	**3,0**	**2,7**	**2,5**	**2,3**
Public sector	0,8	1,1	1,3	1,2	1,2
Monetary sector	1,0	0,7	0,3	0,2	0,1
Non-monetary private sector	1,6	1,2	1,1	1,1	1,0
Other foreign-currency denominated debt	**18,3**	**22,4**	**23,3**	**22,7**	**22,4**
Bearer bonds	2,7	3,8	4,0	4,0	4,4
Converted long-term loans	3,8	2,9	2,1	1,3	0,8
Public sector	3,4	4,5	4,7	4,2	3,3
Monetary sector	3,9	4,9	6,6	7,5	8,8
Non-monetary private sector	4,5	6,3	5,9	5,7	5,1
Total foreign-currency denominated debt	**21,7**	**25,4**	**26,0**	**25,2**	**24,7**
Rand-denominated debt	**8,0**	**9,9**	**8,5**	**14,0**	**14,1**
Bonds	5,3	7,3	6,3	10,4	9,2
Other	2,7	2,6	2,2	3,6	4,9
Total foreign debt	**29,7**	**35,3**	**34,5**	**39,2**	**38,8**

accumulation of claims by non-residents on residents, which arose from delays in settling bond sales. In addition, there was an increase in non-resident deposits with the domestic banking sector. "Other inward investment" also increased on account of an increase in foreign liabilities caused by the financing of imported aircraft during the third and fourth quarters of 1998. The settlement of bond transactions that had previously been left unsettled contributed to the outward movement of "other" investment capital in the first half of 1999.

Investments made by South African enterprises in other foreign assets which are not classified as direct or portfolio investments, increased by R9,0 billion in 1997 and R5,2 billion in the first half of 1998, but then declined by R2,3 billion in the second half of 1998. The return flow of capital to South Africa in the second half of 1998 was reversed when South African banks and other firms once again acquired "other" foreign assets amounting to R4,2 billion in the first half of 1999.

Foreign debt

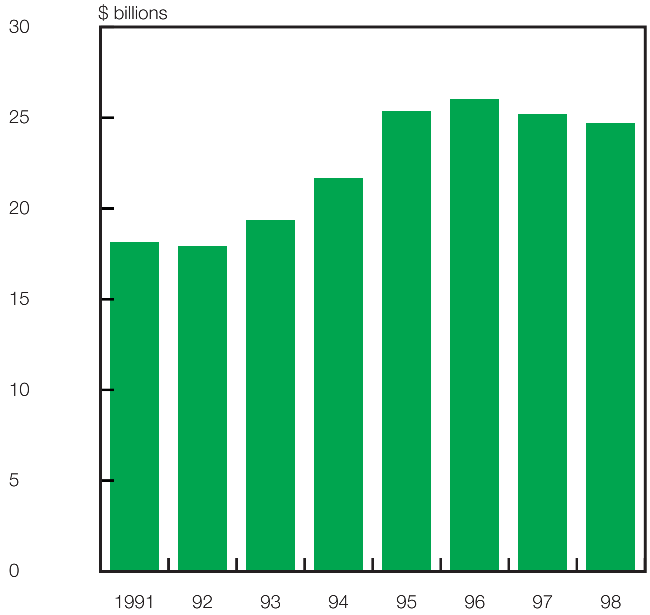
South Africa's total outstanding foreign debt declined from US$39,2 billion at the end of 1997 to US$38,8 billion at the end of 1998. Foreign-currency denominated debt declined from US$25,2 billion to US$24,7 billion, whereas rand-denominated debt increased from US$14,0 billion to US$14,1 billion over the same period.

South Africa's renegotiated debt (i.e. debt negotiated in terms of successive standstill arrangements with foreign creditors) declined by US$0,2 billion to US$2,3 billion at the end of 1998. Valued at the exchange rates prevailing on 31 August 1985, the outstanding amount of renegotiated debt has been reduced by $11,3 billion since the debt standstill was declared at the beginning of September 1985. The reduction in renegotiated foreign debt resulted mainly from debt repayment by domestic debtors.

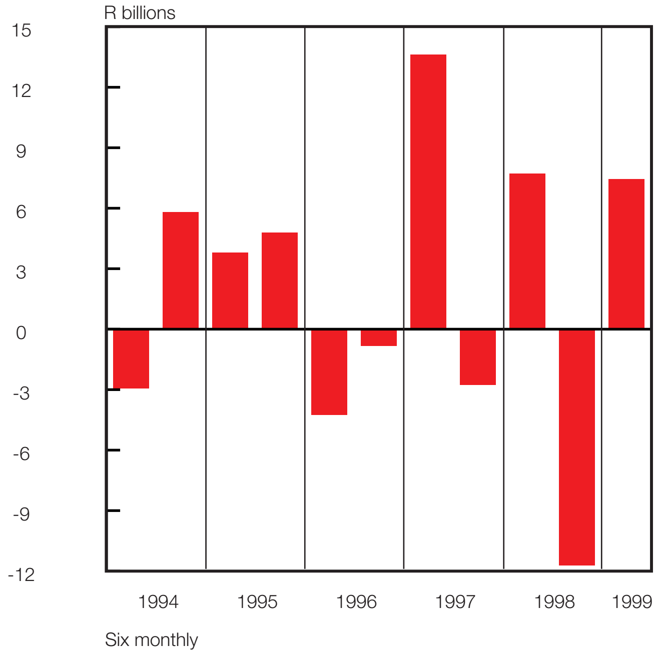
Other foreign-currency denominated debt declined from $22,7 billion at the end of 1997 to $22,4 billion at the end of 1998. An increase of US$1,3 billion in the other foreign-currency denominated debt of the monetary sector was more than offset by a decline of $0,9 billion and $0,6 billion in the other foreign-currency denominated debt of the public sector and the non-monetary private sector, respectively. The final repayment of the drawing against the Compensatory and Contingency Financing Facility of the International Monetary Fund was made during 1998. The non-monetary private sector reduced its utilisation of foreign trade financing facilities and other short-term debt by $0,7 billion in 1998.

As a result of the depreciation of the external value of the rand, the country's total foreign debt, measured in rand, increased from R190,8 billion at the end of 1997 to R227,7 billion at the end of 1998. As a ratio of gross domestic product, total debt rose from 26,6 per cent in 1997 to 29,1 per cent in 1998. The maturity

Total foreign-currency denominated debt



Changes in net foreign reserves



structure of foreign-currency denominated debt deteriorated somewhat; debt maturing within twelve months as a percentage of total outstanding foreign-currency denominated debt increased from 56,0 per cent at the end of 1997 to 57,5 per cent at the end of 1998.

Foreign reserves

The joint effect of deficits on the current account and the capital transfer and financial account was a decline of R11,7 billion in the country's net gold and other foreign reserves in the second half of 1998.

The net international reserves began to improve markedly only after stability had been reintroduced to Southeast Asian financial markets and an international rescue package had been arranged for Brazil. Net international reserves then increased by R7,5 billion in the first half of 1999.

South Africa's gross gold and other foreign reserves declined by R11,9 billion in the second half of 1998, but improved again as conditions in the international financial markets stabilised during the first half of 1999. Relative to the value of imports of goods and services, the country's total gross international reserves at the end of June 1999 were equivalent to 12 weeks' worth of imports of goods and services, compared with about 10 weeks at the end of December 1998. The non-borrowed international reserves of the Reserve Bank improved consistently from R13,5 billion at the end of December 1998 to R19,0 billion at the end of June 1999. The gross international reserves of the Bank increased from R31,6 billion to R35,1 billion over the same period.

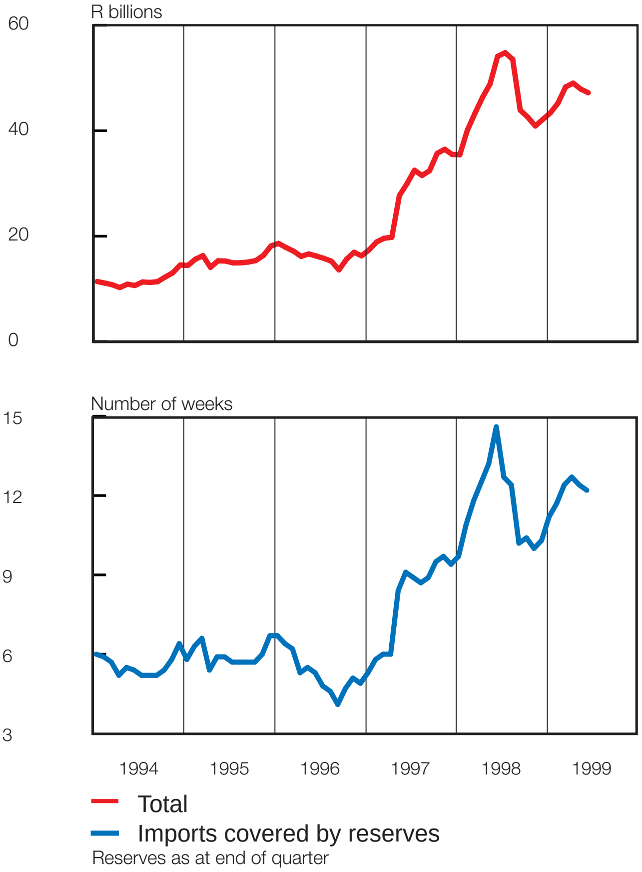
The *net open foreign currency position of the South African Reserve Bank* (i.e. the Bank's net forward position in foreign currency reduced by its net holdings of international reserves) declined from US$16,3 billion at the end of December 1997 to US$12,8 billion at the end of April 1998. During May 1998, when the pressure on the rand intensified, the Bank's net open

Table 10. Changes in gold and other foreign reserves

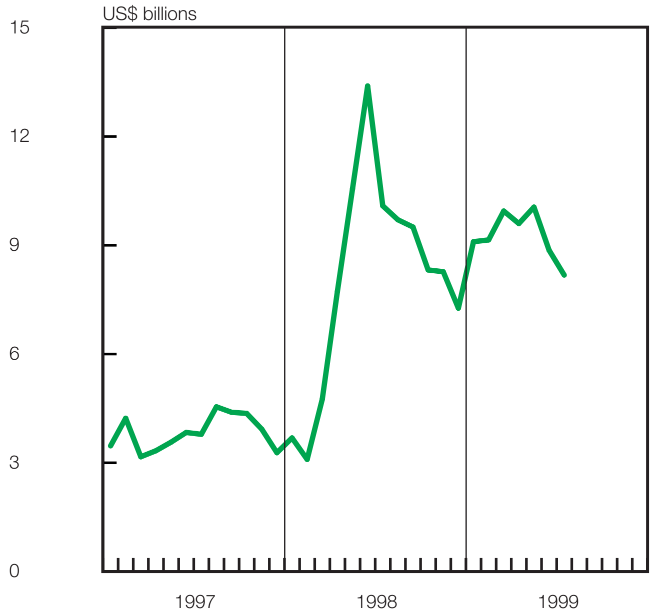
R millions

	1998		1999
	1st half	2nd half	1st half
Net gold and other foreign reserves...........	7 711	-11 728	7 452
Liabilities related to reserves......................	4 170	359	-2 118
SDR allocations and valuation adjustments..	6 725	-560	-250
Gross gold and other foreign reserves...........	18 606	-11 929	5 084

Total gross gold and other foreign reserves



Average net daily turnover in the South African foreign exchange market



foreign currency position rose to US$17,9 billion and continued to increase to a level of US$23,2 billion at the end of September 1998. When calmer conditions returned to the market for foreign exchange during October 1998, the Bank's net open foreign currency position started to decline gradually to reach a level of US$17,5 billion at the end of July 1999. The delivery of the proceeds of the government's foreign bond issues against the Bank's forward book contributed substantially towards the decline in the negative net forward position in foreign currency of the Bank.

Exchange rates

The exchange rate of the rand could not escape the selling pressures arising from uncertainties about financial stability in emerging-market economies. The depreciation of the Indonesian rupiah and a number of other currencies, in addition to the news of serious inadequacies in the Russian financial system, had a marked effect on the exchange value of the rand from May to August 1998.

The Reserve Bank initially reacted to the downward pressures mainly by providing dollars in the forward market. Partly because of this intervention the *average daily turnover* in the domestic market for foreign exchange expanded from US$7,7 billion in April 1998 to US$13,4 billion in June or by 74 per cent, but declined again to US$10,1 billion in July and US$9,7 billion in August 1998.

Despite the intervention by the Reserve Bank, the selling pressure in the foreign exchange market was so severe that the nominal effective exchange value of the rand deteriorated by 23,4 per cent from 22 May 1998 to 28 August. From the end of May 1998 to the end of August the rand depreciated by 20,3 per cent against the US dollar, 20,9 per cent against the German mark, 22,3 per cent against the British pound and 18,7 per cent against the yen.

A fair measure of stability returned to the South African foreign exchange market during the last four months of 1998 and the average daily turnover in the foreign exchange market declined gradually to US$7,3 billion in December. The nominal effective exchange rate of the rand subsequently strengthened by 6,7 per cent from the end of August 1998 to the end of December, assisted by the closing of short positions by currency speculators and a contraction in the overall deficit on the balance of payments in the fourth quarter of 1998.

Foreign investment sentiment towards emerging markets again turned negative as the series of financial market crises spread to Latin America in January 1999. The Brazilian authorities were forced to abandon the exchange rate peg with the US dollar and the real

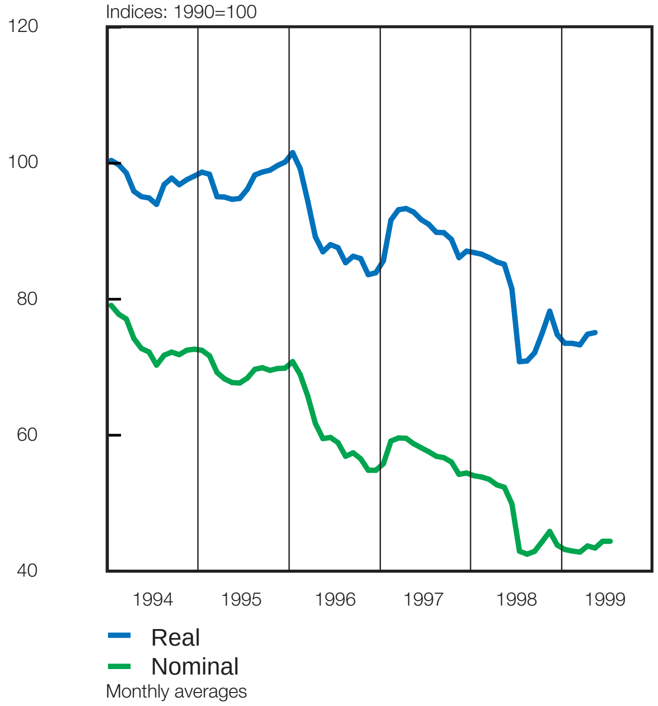
Table 11. Exchange rates of the rand
Percentage change

	31 Dec 1997 to 22 May 1998	22 May 1998 to 28 Aug 1998	28 Aug 1998 to 31 Dec 1998	31 Dec 1998 to 31 July 1999
Weighted average	-4,0	-23,4	9,4	-1,8
US dollar...............	-4,3	-23,7	13,7	-4,7
British pound........	-2,8	-24,9	13,5	-2,4
Euro*	-5,3	-22,6	7,2	3,9
Japanese yen.......	0,0	-19,6	-9,8	-3,4
Emerging markets				
Indonesian rupiah	80,0	-23,3	-16,6	-18,5
Malaysian ringgit...	-6,4	-14,9	2,2	-4,8
Philippine peso.....	-8,5	-12,9	0,7	-6,3
Singaporean dollar	-6,6	-17,1	5,4	-2,7
Taiwanese dollar...	-1,5	-21,0	5,2	-4,8

* The German mark was included in the four-currency basket prior to 1 January 1999

depreciated by 40,5 per cent against the dollar from 11 January 1999 to 1 March. The nominal effective exchange rate of the rand fell by 6,8 per cent from the end of December 1998 to 15 January 1999.

Exchange rates of the rand



Afterwards, the rand recovered swiftly and traded within a relatively stable range of R5,97 to R6,27 against the dollar until the end of June 1999. Potentially disruptive exogenous shocks, such as continued instability in some emerging-market economies and the sudden decline in the gold price, were nevertheless followed by a sizeable surplus on the financial account of the balance of payments in the first half of 1999. This improvement in investor sentiment towards South Africa also reflected the positive outcome of the country's second democratic election in June 1999.

The *inflation-adjusted effective exchange rate* of the rand declined by 14,1 per cent from December 1997 to December 1998, before strengthening again by 3,4 per cent in the six months to June 1999. On balance, the international competitiveness of South African producers is expected to benefit from the net depreciation of the rand during the past year and a half.

Monetary developments and interest rates

Monetary policy

From about 1989 the main objective of monetary policy has been to secure a stable financial environment within which economic decisions will no longer be influenced by high and variable inflation. The Reserve Bank has therefore not applied monetary policy as a short-term counter-cyclical instrument, but rather it has aimed at creating financial stability which is seen as a necessary precondition for growth and development in the long run.

To achieve the objective of low and stable inflation, the Reserve Bank adopted a policy framework which was initially anchored by the setting of guidelines for growth in the broad money supply (M3). In later years, the predictability of the relationship between growth in the money supply and growth in aggregate nominal income became less certain. As changes in the money supply became a less reliable indicator of changes in nominal income in the short to medium term, the Bank decided to attach less significance to the growth in M3. Instead, movements in other financial and economic indicators were also thoroughly assessed during deliberations on policy issues. Because changes in money and credit totals are major determinants of inflation in the long run, they were nevertheless still seen as important variables which should be closely monitored by decision makers.

Monetary policy over the past sixteen months or so was strongly influenced by developments in the foreign exchange market, but sight was never lost of its overriding objective of financial and overall price stability. In the second quarter of 1998 non-resident investors reduced their holdings of South African bonds. This led to an excess supply of rand in the foreign exchange market – a situation that was exploited by highly leveraged international investors and other currency speculators who sold rand to establish short positions which would allow them to profit from a fall in the foreign exchange value of the rand.

The Reserve Bank, which had allowed its official lending interest rates to decline from October 1997 to April 1998, intervened in the foreign exchange market by buying rand in the spot and forward markets during May and June 1998. However, the selling pressure was so severe that the average nominal effective exchange rate of the rand depreciated sharply. In the end, liquidity conditions in the money market tightened so severely that the Bank's official money-market lending rate – the rate on repurchase transactions – rose by more than 700 basis points from April to August 1998. This helped to stabilise the foreign exchange market and prevented a continuous spiral of depreciations and price increases from developing.

By about the middle of October 1998 the international financial markets had apparently stabilised and no longer posed as strong a threat to domestic financial stability. This gave the Reserve Bank some leeway to assume a more accommodative stance in the money market. Interest rates have fallen steadily since October 1998 and the repurchase rate at the end of July 1999 was lower than at its pre-crisis level.

During the second quarter of 1999 the Bank acted in a manner which caused the daily liquidity requirement of banks to increase steadily. The higher dependency on Reserve Bank credit was expected to make interest rate movements more sensitive to the signals transmitted by the Bank to the private banks through the repurchase auction system, and reduce possible distortions in the pattern of short-term interest rates.

The signalling mechanism of the Bank was explained to money-market participants when the Governor held a meeting with representatives of the private banks on 23 June 1999. It was explained to the banks that the size of the daily liquidity requirement should not be regarded as an important indicator of Reserve Bank policy intentions. Instead, the Bank signals its intentions to the market through the amount of liquidity provided at the daily auction of repurchase transactions relative to the estimated overall liquidity needs of the market.

To improve the transparency of Reserve Bank signals, the signalling procedures were explained as follows:

- Full provision of the estimated daily liquidity requirement of banks will indicate a neutral position in terms of which the Reserve Bank endorses the direction and the extent of the change in the repurchase rate at the latest repurchase auction.
- Marginal underprovision of the estimated daily liquidity requirement in the market when interest rates are declining indicates that the Reserve Bank is of the opinion that the repurchase rate should stop declining and be maintained at the prevailing level. Conversely, a marginal overprovision of the estimated daily liquidity requirement will indicate that a previously rising repurchase rate should stabilise at the prevailing level.
- Significant under- or overprovision of the estimated daily liquidity requirement will indicate that the Reserve Bank would prefer seeing the repurchase rate moving to a higher or lower level. The magnitude of the under- or overprovision would indicate to the market the extent of the desired movement of the repurchase rate; i.e. the larger the amount of under- or overprovision, the larger the desired adjustment of the repurchase rate.

- Auctions with a predetermined fixed interest rate will be employed only in exceptional circumstances when the Bank wishes to achieve an immediate and substantial change in money market rates, for example to absorb a sudden and large external shock such as the market turmoil experienced in May 1998.

Money supply

The year-on-year growth in the M3 money supply, which had accelerated rapidly when the instabilities in other emerging markets spilled over into South Africa, has moderated noticeably in recent months and moved back within the 6 to 10 per cent range for the first time since 1993.

There was a strong increase in the demand for money when the turmoil in emerging markets erupted. With asset prices declining sharply, investors' asset portfolios were adjusted in a way that increased their holdings of short-dated assets and low-risk depository type investments relative to their holdings of long-dated fixed-interest securities and equity investments. When the financial markets began to stabilise in the fourth quarter of 1998, and the downswing in economic activity lowered the demand for transaction balances, the growth in the M3 money supply slowed down noticeably.

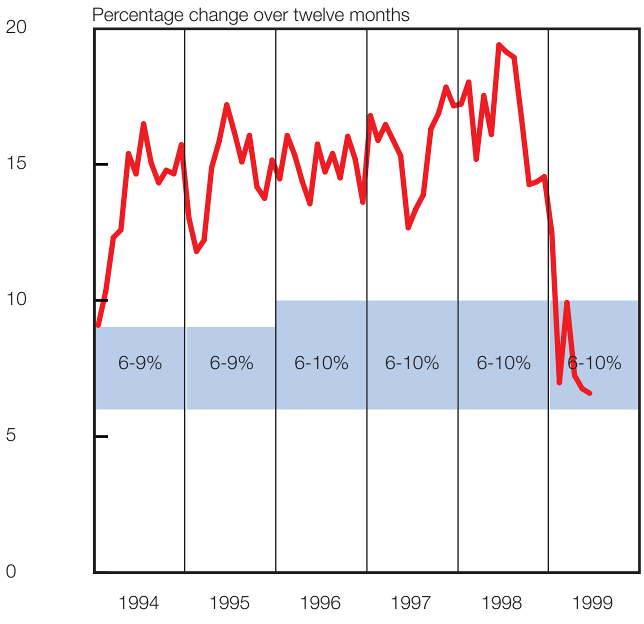
The quarter-to-quarter seasonally adjusted and annualised change in M3 increased from 14,4 per cent in the second quarter of 1998 to 18,7 per cent in the third quarter, before slowing down to 9,7 per cent in the fourth quarter and more meaningfully to 0,5 per cent in the first quarter of 1999 and 1,6 per cent in the second quarter. The growth over twelve months in M3 reached a peak of 19,4 per cent in June 1998, afterwards declining to 12,5 per cent in January 1999 and 6,6 per cent in June. In the five months to June 1999, the growth over twelve months in M3 has been within the guideline range of between 6 and 10 per cent that the Reserve Bank had indicated as one of a set of longer-term indicators guiding monetary policy decision-making.

The initial strengthening of the demand for money in the second and third quarters of 1998 was accom-

Table 12. Growth in monetary aggregates
Percentage change over twelve months

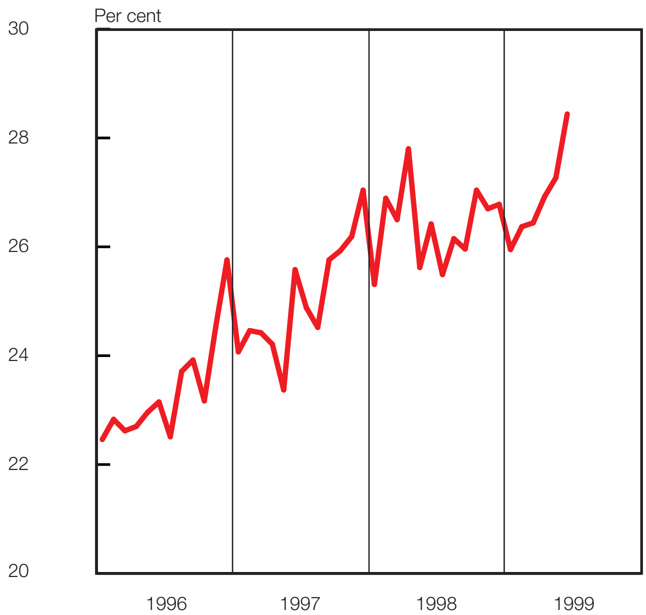
	M1A	M1	M2	M3
1998: Jun	23,3	35,3	21,4	19,4
Sep	17,6	33,6	18,8	16,7
Dec	13,5	23,6	13,6	14,6
1999: Jan	15,3	22,0	12,0	12,5
Feb	4,9	14,8	5,8	7,0
Mar	9,7	20,3	8,7	9,9
Apr	3,9	15,9	7,8	7,2
May	13,6	15,4	7,4	6,8
Jun	14,8	8,5	6,6	6,6

M3 money supply

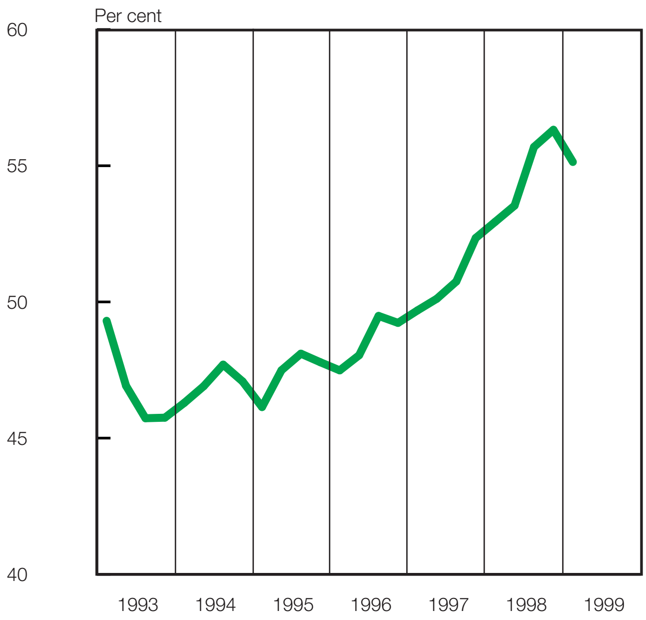


Shaded areas indicate the money growth guideline ranges

M1A as percentage of M3



M3 as percentage of gross domestic product



panied by a stronger preference among the general public for relatively liquid assets. Cheque and transmission deposits, together with other demand deposits, accordingly accounted for 47,8 per cent of the overall increase in M3 from the end of June 1998 to the end of December of that year. In the first half of 1999, when domestic economic activity was rather subdued and the financial markets far more stable than before, the liquidity preference of the general public became less intense. The decline in liquidity preference is reflected in the sharp deceleration in the twelve-month growth of M1 from 35,3 per cent in June 1998 to 8,5 per cent in June 1999.

The growth in M3 still outpaced the growth in nominal gross domestic product up to the fourth quarter of 1998, raising the ratio of M3 to gross domestic product to 56,3 per cent – the highest value since 1980. Subsequently, the ratio of M3 to nominal gross domestic product declined to 54,6 per cent in the first quarter of 1999 and 53,5 per cent in the second quarter. Conversely, the income velocity of money at first declined to 1,78 in the fourth quarter of 1998, but the slowdown in money growth was mirrored in a rise in income velocity to 1,87 in the second quarter of 1999. Relative stability of the income velocity of money is generally viewed as a precondition for a monetary policy regime anchored to steady growth in the stock of money.

In 1998 and the first half of 1999 the growth in the M3 money supply was largely fuelled by growth in credit extension to the private sector. In fact, the increase in bank credit extended to the private sector during the twelve months to June 1999 was greater than the increase in M3.

Credit extension

Total *domestic credit extension* (i.e. credit extended to the domestic private sector and net claims on the government sector) increased by R52,2 billion in the twelve months to June 1999, compared with an increase of R81,5 billion in the previous twelve months to June 1998. The decline in the amount of additional credit extension was caused by the reversal of banks' net claims on the government sector, which increased by R17,8 billion in the twelve months to June 1998, but then shrank by R0,4 billion in the twelve months to June 1999. In April 1998 the banking sector's portfolio of government stock was, of course, expanded by the appointment of private banks as primary dealers and market makers in government securities.

The growth in credit extended by banks to the private sector also slowed down in the year to June 1999. The quarter-to-quarter seasonally adjusted and annualised growth in bank credit extended to the private sector fell from 26,4 per cent in the second quarter of 1998 to 10,1 per cent in the first quarter of 1999 and 8,4 per cent in the second quarter. Growth has generally slowed down in all the major components of private-sector credit in the first half of 1999, but the types of credit mostly used by households grew at lower rates than those used predominantly by the corporate sector.

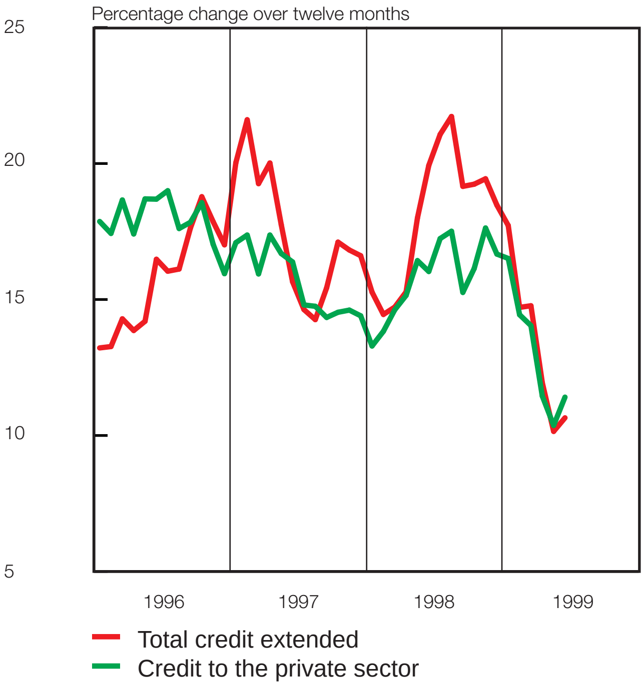
An analysis of banks' claims on the private sector shows that the rate of growth over twelve months in mortgage advances decreased from 11,2 per cent in

Table 13. Accounting counterparts of change in M3

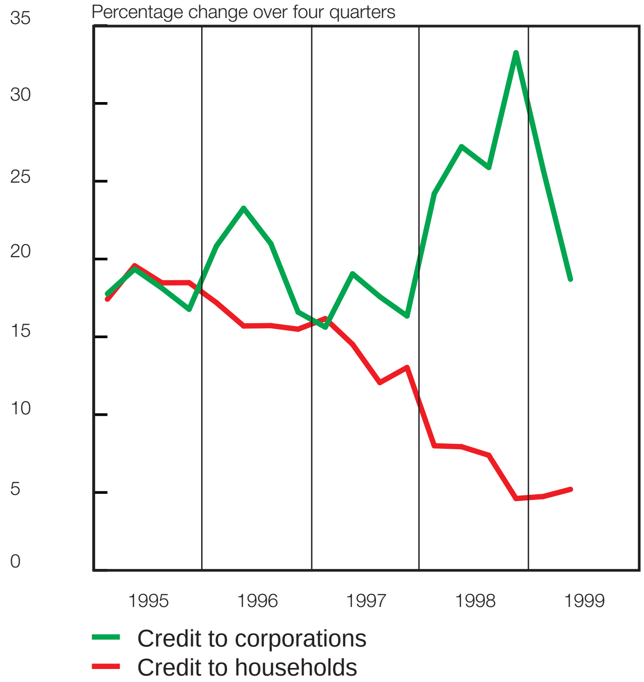
R billions

	Year to end June		
	1997	**1998**	**1999**
Net foreign assets........	-4,2	0,8	-14,9
Net claims on			
government sector....	-0,6	17,8	-0,4
Gross claims............	2,6	8,2	10,1
Deposits (increase-, decrease+)................	-3,2	9,6	-10,5
Claims on the private sector	55,9	63,7	52,6
Net other assets	-12,5	-15,8	-10,3
Total change in M3	**38,6**	**66,5**	**27,0**

Credit extended by monetary institutions



Credit extension to households and corporations



June 1998 to 7,2 per cent in March 1999 and 4,7 per cent in June – the lowest rate on record. The share of mortgage advances in the overall stock of outstanding private-sector credit accordingly declined from 40,8 per cent in June 1998 to 38,3 per cent in June 1999, reflecting the growing aversion to debt financing among households and the weak state of the real-estate market and the home-building industry.

The potential to use mortgage credit became increasingly limited as real-estate values declined and mortgage rates rose. Under the new bank supervisory regulations that came into effect on 1 October 1998, an increase in risk weighting was assigned to that portion of new mortgage loans which exceeded 80 per cent of the value of the property collateralised. Some banks reacted to these measures by raising their interest rates on new home loans which exceeded that limit, thus lowering the demand for housing finance even further.

Credit extension to the private sector in the form of "other loans and advances", which are mostly used by the corporate sector, remained robust up to March 1999 and only began to show some signs of slowing down in the second quarter of 1999. The rate of increase over twelve months in this credit category fluctuated between 25,4 per cent and 32,2 per cent in the ten months to March 1999, but declined to 19,3 per cent in May, before increasing again to 22,5 per cent in June.

The strong growth in "other loans and advances" can be partially explained by the high turnovers in the securities markets, and price volatility which created opportunities for speculation. Furthermore, the depreciation of the rand in the second quarter of 1998 caused additional demand for credit as foreign-trade financing was switched from offshore to domestic credit sources. Corporate restructurings also provided a steady demand for bank credit under the heading "other loans and advances".

During the first quarter of 1999 the slowdown in economic activity and the delayed impact of the sharp rise in bank lending rates began to reduce the growth in the private sector's demand for credit. This could have been reinforced by foreign-trade financing moving back to external sources as the rand strengthened against most other currencies. It seems as if corporate restructuring activities are still continuing, thus adding to the private sector's demand for bank credit during the second quarter of 1999.

The growth in other credit categories, which are accessed mainly by households, slowed down perceptibly during the twelve months to June 1999. The growth over twelve months in *instalment sale credit* fell from 9,2 per cent in June 1998 to 2,7 per cent in March 1999 and 0,2 per cent in June, mainly reflecting the decline in real private consumption expenditure on durable goods during this period. *Leasing finance,* which had recorded negative annual

Table 14. Credit extension to the private sector
R billions

	Invest-ments and bills discounted	Instalment sale credit	Leasing finance	Mortgage advances	Other loans and advances	Total
June 1998	26,2	51,6	21,8	188,0	173,4	461,0
September 1998	22,2	51,5	21,8	192,3	181,4	469,2
December 1998	25,5	51,6	21,9	195,4	195,7	490,1
March 1999	29,7	52,0	21,7	196,7	200,8	500,9
April 1999	29,0	51,9	21,8	196,9	200,0	499,6
May 1999	30,3	51,8	21,7	196,6	201,6	502,0
June 1999	30,5	51,7	22,0	197,0	212,5	513,7
Percentage change from June 1998 to June 1999	**16,6**	**0,2**	**0,9**	**4,7**	**22,5**	**11,4**

growth rates in the eighteen months to February 1999, increased by only 0,9 per cent in the year to June. The fastest-growing component of private-sector credit has been investments which increased by 28,8 per cent in the year to June 1999. However, leasing finance and investments are small components of banks' claims on the private sector – together they constitute less than 9 per cent of banks' total claims on the private sector.

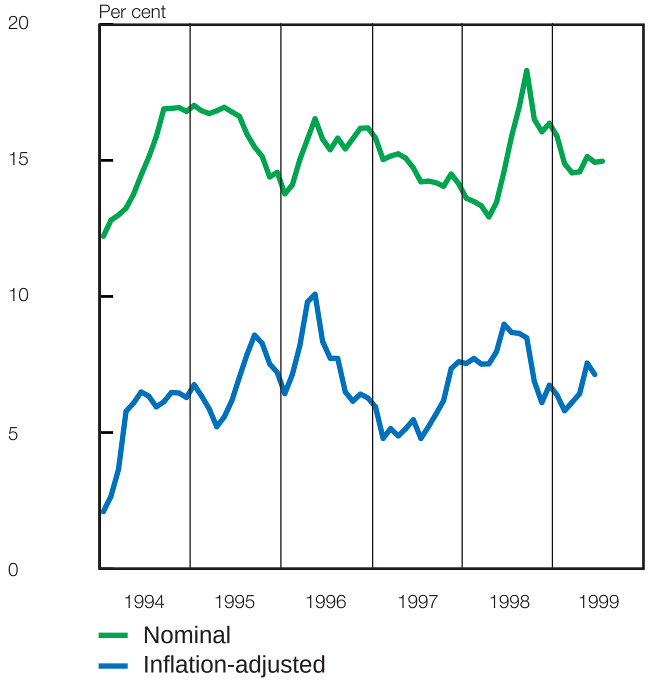
Interest rates and yields

The general downward movement in bond yields from December 1996 was interrupted from time to time by the problems in the economies of East Asian countries. Eventually these problems led to a change in investor perceptions and sentiment which were transmitted through the large-scale withdrawal of portfolio investments from emerging markets, including South Africa. This halted the decline in the *monthly average yield on long-term government bonds,* which at its low point in April 1998 stood at 12,9 per cent. The domestic financial markets came under intense pressure from the net sales of bonds by non-residents. The *daily* average bond yield then increased strongly from a low of 12,67 per cent on 17 April 1998 to 16,44 per cent on 6 July. After a brief lull, bond yields again increased strongly to an all-time high of 20,09 per cent on 28 August 1998 in the wake of the unilateral debt moratorium declared by the Russian Federation.

The flow of funds back to the major international financial centres, in particular the United States of America, caused a sharp decline in the developed markets' nominal interest rates and relative yields during the turmoil in the second and third quarters of 1998. This helped to restore more stable conditions in most of the emerging markets. Asset prices began to recover in South Africa and the monthly average yield on long-term bonds fell back from 18,3 per cent in September 1998 to 15,9 per cent in January 1999.

In the first half of 1999 the general downward movement in South African bond yields gained further momentum as non-residents became net buyers of domestic securities, in part because of the relative stability of the exchange value of the rand. After the

Yield on long-term government bonds



problems in Brazil had temporarily halted the decline in bond yields, the daily average bond yield declined decisively from 16,59 per cent on 15 January to its latest low of 14,29 per cent on 5 March. An upward correction followed when bond yields increased to 15,54 per cent on 28 May because of pre-election nervousness, the weak gold price and a pause in the decline of money market rates when concerns about Russia and Latin America again threatened financial stability. After the elections, bond yields resumed their downward movement and the monthly average yield declined to 14,9 per cent in June.

The *monthly average inflation-adjusted yield on long-term government bonds* rose strongly from an average level of 7,6 per cent in the first four months of 1998 to a high of 9 per cent in June, along with the increase in nominal bond yields. Bond yields and consumer price inflation then increased in almost similar proportions during the third quarter of 1998. From the fourth quarter of 1998 the reduction in nominal bond yields exceeded the reduction in consumer price inflation and the inflation-adjusted average bond yield declined to an average of 6,5 per cent in the eight months to June 1999, i.e. lower than its pre-crisis level.

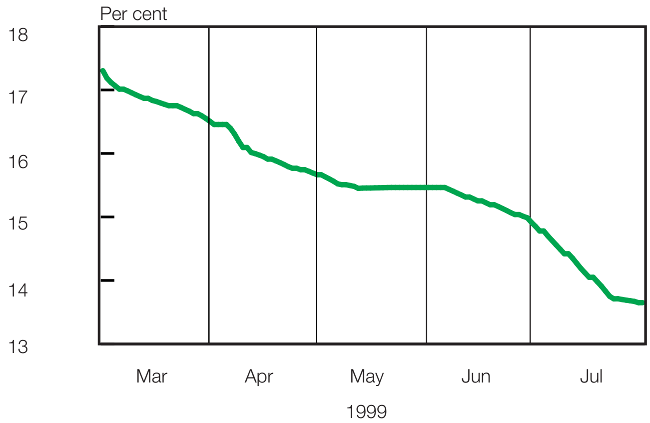
The reassessment of risk and the volatility of portfolio investment flows impacted on the pricing of bonds in emerging and mature markets during 1998, causing South African bond yields to diverge from those of the United States and to correspond more closely, instead, with those of other emerging markets. The nominal and inflation-adjusted interest rate differentials between government debt in South Africa and the United States widened when the crisis erupted, but narrowed again as the international financial markets settled down.

At the height of the crisis, when the Russian government unilaterally declared a moratorium on the repayment of rouble-denominated debt, the *repurchase rate* of the Reserve Bank rose to 21,86 per cent on 28 August 1998, compared with 14,79 per cent where it had been on 11 May. The repurchase rate then held steady at 21,86 per cent until there was clear evidence that the crisis was over.

By the middle of October 1998 financial markets around the world were settling down. Initially, the Reserve Bank began providing an increased portion of the daily liquidity needs of the banks and, later, moved to full liquidity provision. The repurchase rate responded and entered a period of gradual decline from 13 October 1998. Apart from two relatively brief periods – in January with the problems in Brazil and in May when political stability in Russia was under threat – rates declined steadily until June 1999. By 30 July 1999 the repurchase rate had declined by 820 basis points to 13,66 per cent – lower than its pre-crisis level in May 1998.

From the end of June 1999 the Reserve Bank signalled to the banks its preparedness to accept a

Repurchase rate of the Reserve Bank



somewhat faster decline in the repurchase rate. The market responded in the desired way and the repurchase rate declined by 7 basis points per day from the end of June to 22 July 1999. On 26 June 1999, the Reserve Bank once again signalled to the market, but this time indicated that the pace of decline of the repurchase rate should slow down. The provision of liquidity was restricted for one day to R10 million below the estimated requirement, leading to a steady decline of one basis point per day in the repurchase rate over the ensuing period.

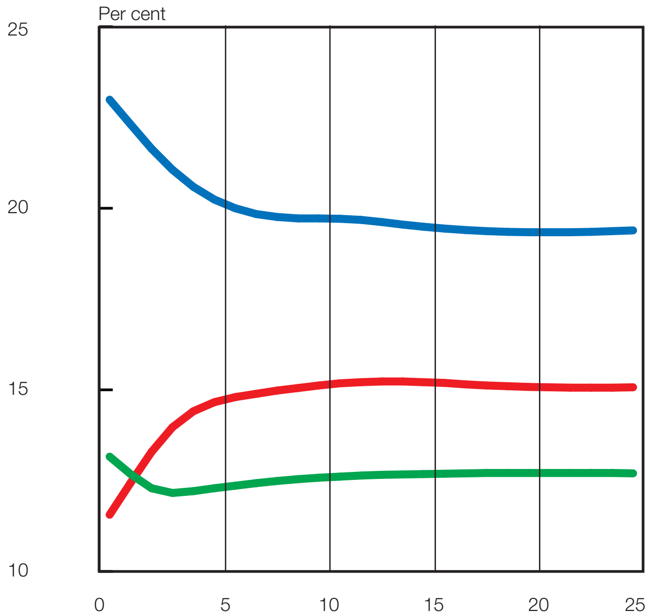
As financial stability improved, the Reserve Bank reduced the differential between the marginal lending rate and the repurchase rate from 20 per cent to 15 per cent on 20 April 1999. This step was widely interpreted as an endorsement by the Reserve Bank of the downward trend in short-term interest rates.

The tender rate on three-month *Treasury bills* declined by 1 056 basis points from 22,30 per cent on 17 September 1998 to 11,74 per cent on 23 July 1999. There were occasional interruptions in the downward movement of the tender rate on Treasury bills, but these were related more to transitory uncertainties about developments in global markets than to market fundamentals. The longest reversal in the downward movement of the Treasury bill rate lasted 22 days and raised the rate by 44 basis points from 13,26 per cent on 13 May 1999 to 13,70 per cent on 3 June.

The rate on *bankers' acceptances* with a maturity of three months declined by 985 basis points from 21,60 per cent on 16 September 1998 to 11,75 per cent on 28 July 1999 – a level lower than where it had been when the crisis erupted in May 1998.

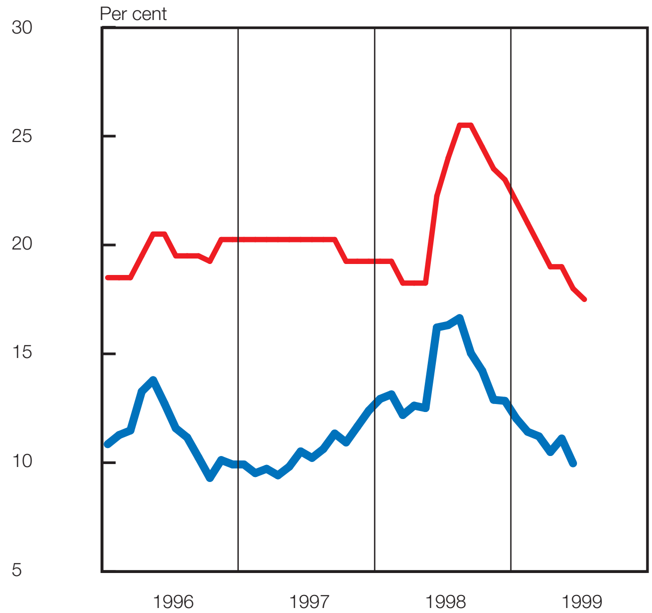
From the second half of April 1998 to the end of August the *yield curve* shifted higher across the full maturity spectrum. At the same time, the tight

Yield curves



Unexpired maturity (years)
- 16 April 1998
- 31 August 1998
- 30 July 1999

Prime overdraft rate



- Nominal
- Inflation adjusted

monetary conditions caused a steep inversion at the short end of the yield curve. When rates started declining again in September 1998, the decline in short-term yields exceeded that in long-term yields, resulting in a flattening of the yield curve. In April 1999 short-term yields declined to levels below those of long-term yields and the yield curve assumed a slightly upward slope. The yield curve normalised further towards July 1999 as short-term interest rates and yields continued to decline more than long-term yields.

Taking its cue from the Reserve Bank's repurchase rate, the banks' prime overdraft rate was lowered in ten steps from a peak of 25,5 per cent in August 1998 to 16,50 per cent in August 1999. It took the prime overdraft rate some five steps and 2½ months during the crisis period to rise from 18,25 per cent on 9 June 1998 to 25,50 per cent on 28 August 1998, and it has taken approximately 8 months to retrace this upward movement to roughly its initial position. Two further downward adjustments brought the prime rate to 16,50 per cent by the beginning of August 1999.

The *predominant rate on mortgage loans* closely followed the changes in the prime overdraft rate of banks over the past sixteen months. When monetary conditions tightened, this rate increased to an all-time high of 24 per cent in September 1998. Afterwards, the subsequent easing of financial market conditions caused a full reversal of the upward movement and the predominant rate on mortgage loans declined gradually to reach 16,5 per cent in August 1999; i.e. its lowest level since February 1995. Subdued conditions in the home-loan market during the period of escalating interest rates led to increased competition between mortgage lenders and some dispersion in mortgage rates with the introduction of products specifically catering for risk-averse borrowers.

The *predominant rate on twelve-month fixed deposits with banks* traced a path broadly similar to but well below that of mortgage rates. Turmoil-related events in the financial markets induced banks to increase this rate from 12,5 per cent in June 1998 to 16,5 per cent in August. This increase was more than fully reversed when it declined to 11 per cent in July 1999 – its lowest level since August 1994. The disparate changes in the mortgage and deposit rate at first widened the then existing differential of 550 basis points between these two rates by more than 200 basis points. However, by July 1999 the differential had narrowed to 650 basis points.

Financial markets

Financial market globalisation and structural change

In South Africa the deepening of financial markets and the progressive liberalisation of the financial sector are continuous processes which involve inter alia measures to

- strengthen the regulatory and supervisory framework;
- advance accountability and disclosure;
- enhance accessibility for non-resident and resident investors;
- improve the financial infrastructure; and
- facilitate South Africa's repositioning in the international financial markets.

Important contributions during 1998 and 1999 through *government's legislative process* included the following:

- The Unit Trust Control Amendment Act, No. 12 of 1998. This allows foreign collective investment schemes to promote their business in South Africa with the approval of, and subject to conditions determined by, the Registrar.
- The Safe Deposit of Securities Amendment Act, No. 38 of 1998, which provides for the establishment of a central securities depository.
- The Insurance Amendment Act, No. 49 of 1998, which prevents foreigners (as defined in the Act) from conducting unauthorised insurance business in South Africa.
- The Long-term and Short-term Insurance Acts, Nos. 52 and 53 of 1998, which provide for consumer protection and enable insurers to operate internationally.
- The National Payment System Act, No. 78 of 1998, which provides for the regulation and supervision of payment, clearing and settlement systems.
- The Insider Trading Act, No. 135 of 1998, which is regulated by the Insider Trading Directorate of the Financial Services Board and provides for criminal and civil law penalties for the use of material, undisclosed price-sensitive information.
- The Companies Amendment Act, No. 37 of 1999, which enables companies to acquire their own shares subject to solvency and liquidity criteria and requires the disclosure of beneficial shareholders by nominee companies.
- The Collective Investment Schemes Control Bill of 1999, which is intended to regulate and supervise the business of collective investment schemes.

In line with the international trend towards integrated markets, the Johannesburg Stock Exchange (JSE), the Bond Exchange of South Africa and the South African Futures Exchange agreed in principle to merge with the primary aim of establishing an internationally competitive *exchange*. Electronic clearing and settlement will be introduced with the launch of the STRATE system (Share Transactions Totally Electronic) and the phased dematerialisation of shares and their registration in a central securities depository. The objective is to conform to G-30 recommendations by reducing settlement risk through delivery against payment linked to the National Payment Clearing and Settlement System. Moreover, the JSE has successfully forged links with other exchanges in the Southern African region, and now shares with the Namibian Stock Exchange (NSE), a system for trading, clearing and settlement which was installed in November 1998.

The depth, breadth and stature of the *South African bond market* were elevated by the development of the eurorand bond market, the introduction of primary dealers and bond auctions and the successful introduction of the first domestic medium-term note programme by the Industrial Development Corporation. During 1998 and the first half of 1999 the diversity of *financial instruments* was broadened and aligned more closely with developments in the international capital markets. Issuers introduced highly flexible debt instruments and mortgage-backed securities were issued in the market for home loans.

A number of new financial instruments also originated in the market for derivatives. Trade in equity options was introduced in September 1997, only to be replaced by individual equity futures and options on such futures in February 1999. Warrants on equity indices, including index tracking certificates, were introduced in September 1998. The restructuring of share indices by the JSE led to the replacement of futures and options on the mining companies index with futures on the resources companies index in March 1999. In addition, a three-month Johannesburg Inter-bank agreed rate (JIBAR) futures contract introduced in June 1999 would eventually replace the 91-day bankers' acceptance futures contract.

A number of South Africa's largest and best-established companies pursued dual listings. *Primary listings on foreign bourses* afforded them access to international capital while inclusion in leading international indices raised their profile. South African investors pursued exposure to offshore markets and *diversified* their *portfolios* to such an extent that local offshore-investing unit trusts reached their exchange control limits.

Money market

Heavy selling of bonds by non-resident investors and the repatriation of the proceeds of these transactions caused money market conditions to become fairly tight in the second quarter of 1998, but conditions eased considerably from the third quarter of 1998 to the first quarter of 1999. This was reflected in the average daily liquidity requirement of private banks, which increased from R4,6 billion in March 1998 to R12,0 billion in June, but then declined steadily to R4,8 billion in March 1999.

The easing in money market conditions from the middle of 1998 can largely be attributed to the liquidity that was injected through the deficits arising from Reserve Bank involvement in the forward foreign exchange market and increases in the net foreign assets of the Bank. Fluctuations in the amount of notes and coin in circulation outside the Reserve Bank also added or drained liquidity from time to time.

During the early part of the second quarter of 1999 there was a further easing of liquidity conditions in the money market, again mainly originating from increases in the net foreign assets of the Reserve Bank and deficits on forward-book transactions. There was real concern that political instability in Russia could destabilise other emerging markets, including South Africa. At about the same time, the gold price declined sharply. Against the backdrop of these uncertainties, the Reserve Bank intervened in the market to absorb liquidity and to increase the dependency of the private banks on central bank funding. These measures were considered necessary for efficient liquidity management and for enhancing the sensitivity of money market interest rates to signals sent by the Reserve Bank through the repurchase auction system.

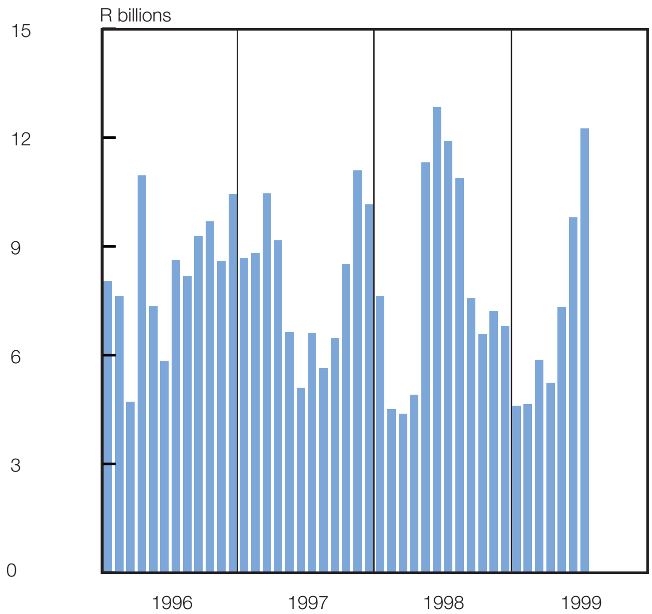
As part of its liquidity management operations the Reserve Bank increased the amount of its own outstanding debentures and conducted reverse repurchase transactions with maturities of 28 days with private-sector parties. The Bank also acted to mop up the liquidity injected through the forward foreign exchange market by entering into foreign-currency swap arrangements with private banks. Later surpluses arising from the Bank's transactions in the forward foreign exchange market drained liquidity from the money market lately.

Bond market

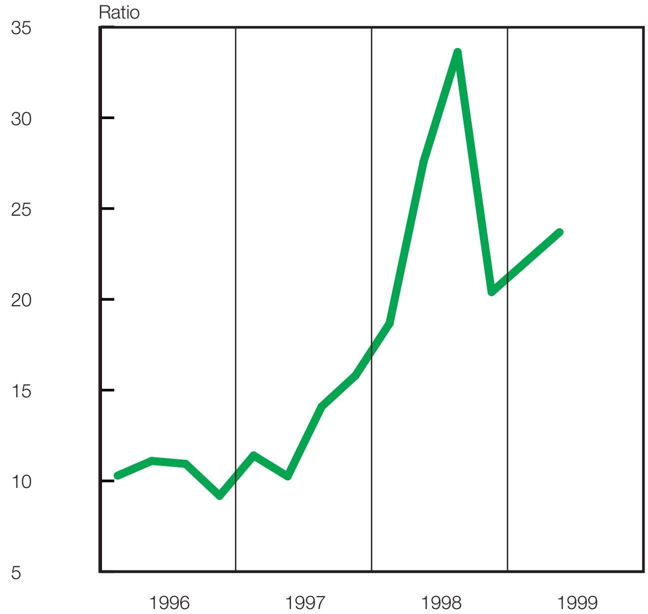
Turnover in the domestic *secondary bond market*, measured as the value of bonds traded on the Bond Exchange of South Africa, amounted to unprecedentedly high values of R8,5 trillion in 1998 and R4,1 trillion in the first half of 1999. This increase in activity almost doubled the annualised *liquidity ratio* (the value of bonds *traded* relative to the value of bonds *listed* on the Bond Exchange) from 12,6 in 1997 to 24,9 in 1998. The liquidity ratio reached an all-time high of 33,6 in the third quarter of 1998.

Foreign participation in the domestic secondary bond market, measured as the *gross* transactions value of non-residents' purchases and sales as a

Liquidity requirement



Bond market liquidity*



Annualised
* The value of bonds traded relative to the value of bonds listed on the Bond Exchange

percentage of total purchases and sales of bonds, increased from 14,0 per cent in 1997 to 16,2 per cent in 1998. On a *net* basis, non-residents bought bonds to the value of R16,3 billion in the first four months of 1998. During the crisis period from May to August 1998, they reduced their holdings of South African bonds by R18,9 billion, but when conditions settled down, outflows receded to R7,1 billion in the last four months of 1998. This was followed by net inflows of R5,9 billion in the first half of 1999 as non-resident investor sentiment towards emerging markets improved.

In the *domestic primary bond market,* fiscal policy limited the potential for *crowding out* the private sector and public corporations from the fixed-interest securities market. This is evident from *contractual savings* (measured as the aggregate domestic current income surplus of long-term insurers and pension funds and the net sales of units by unit trusts) which have continued to exceed the financing needs of the public sector by a substantial margin in the past three fiscal years.

Net issues of fixed-interest securities in the domestic primary bond market by *public-sector borrowers* declined by more than a third to R13,1 billion in the fiscal year 1998/99 from R20,4 billion in each of fiscal 1996/97 and 1997/98, bearing testimony to the discipline exercised by government in the management of public-sector revenue and spending. Government bonds with a nominal value of R5,6 billion were *auctioned and allotted* in the first three months of the current fiscal year, compared with issues of R8,4 billion in the corresponding period of the fiscal year 1998/99.

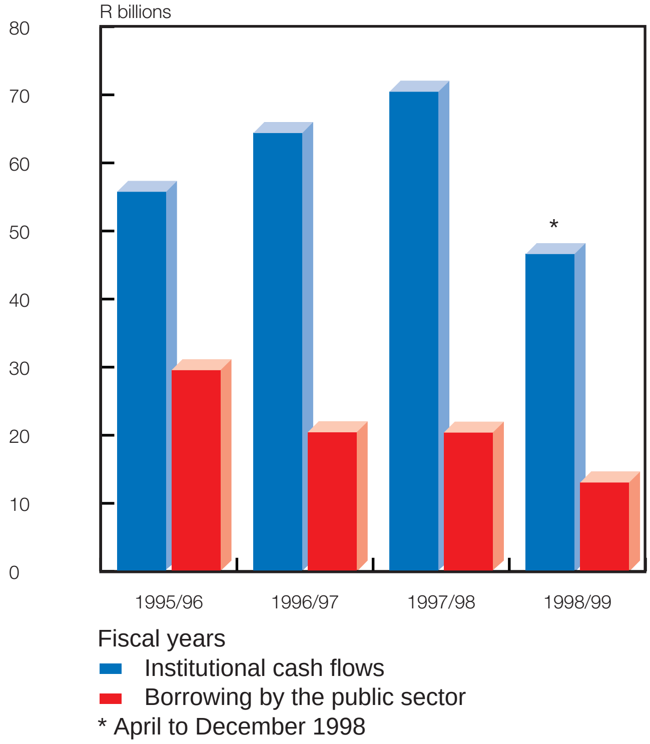
Government last borrowed in the *international financial markets* in June 1997. The financial problems in emerging markets then led to perceptions of heightened risk and an increase in the cost of borrowing, which was reflected in widening yield spreads. Furthermore, uncertainty about future movements in the exchange rate of the rand temporarily precluded borrowing. However, the national government borrowed about R6,3 billion through two foreign-currency denominated bond issues in May 1999. South African public corporations also borrowed R1 billion through issuing *rand-denominated* bonds in the Eurobond market in March 1999.

Private-sector companies raised only a limited amount of capital in the domestic primary bond market in the eighteen months to June 1999. Listed *fixed-interest securities issued* on the Bond Exchange of South Africa increased by R239 million but only R30 million was raised through *rights issues of preference shares and debentures* by companies listed on the Johannesburg Stock Exchange.

Share market

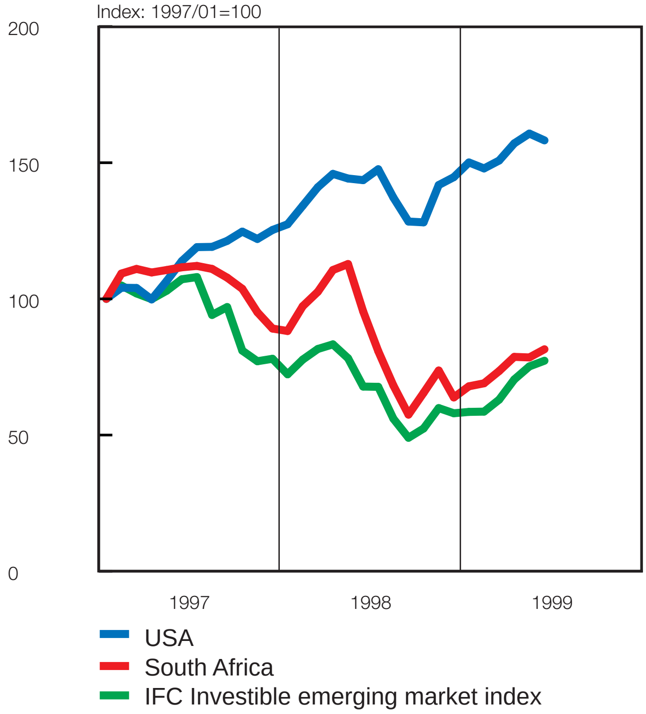
The international financial crisis in 1998 affected share prices in emerging markets far more than in mature markets. In South Africa the monthly average price

Institutional cash flows vis-à-vis borrowing by the public sector

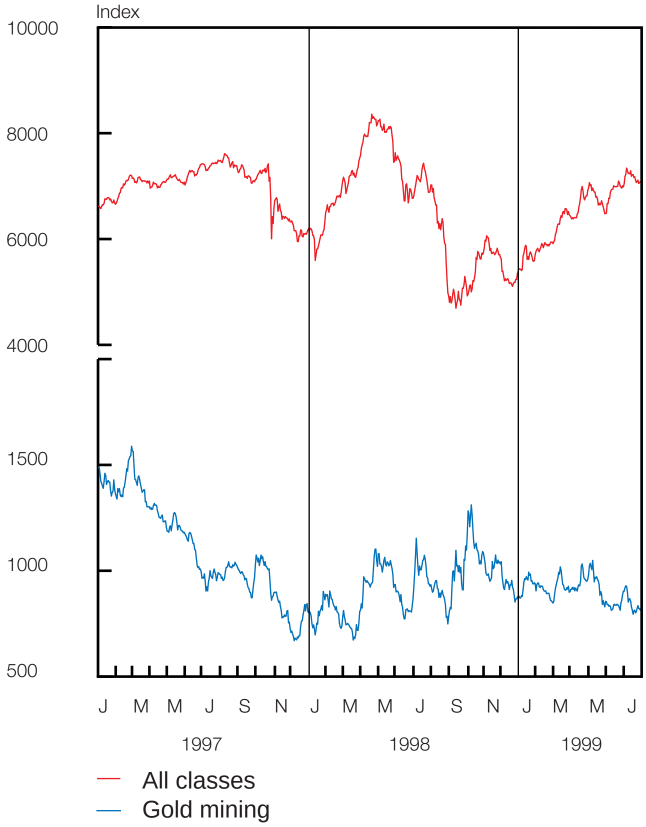


* April to December 1998

Share price movements in dollar



Share price movements



level of all classes of shares fell by 39 per cent from May to September 1998. Then the conditions in the international financial markets settled down and the average monthly value of the all-share price index on the JSE increased by 41 per cent from September 1998 to June 1999, albeit with occasional interruptions because of concerns about the external value of the rand and pre-election nervousness. In June 1999, however, the average monthly all-share price index was still 14 per cent lower than in May 1998. Converted to US dollars this implied a decline of 28 per cent.

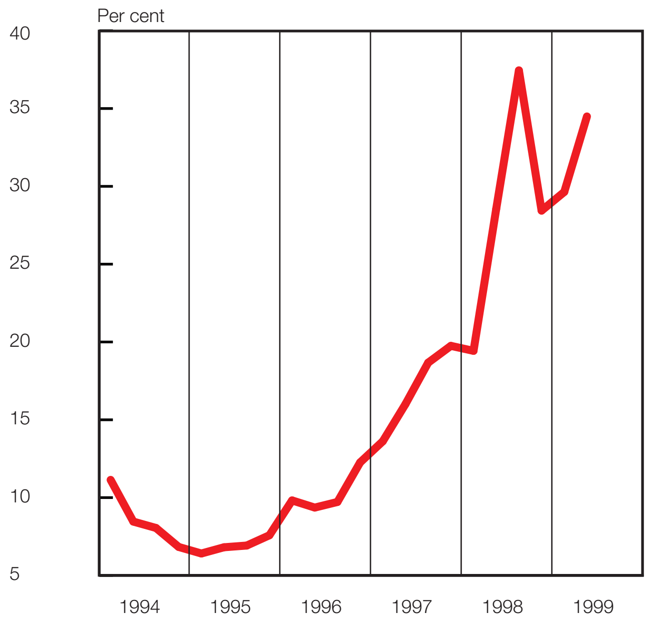
Gold-share prices exhibited a high degree of volatility. The *monthly average price of gold-mining shares* increased, on balance, by 43 per cent from December 1997 to May 1998 and then fell by 25 per cent to August 1998. After that, the gold-mining index rose sharply by 35 per cent to October 1998 but then faltered and declined by 25 per cent to June 1999 when the dollar price of gold fell to a 20-year low.

The heightened volatility in share prices boosted *turnover* in the *secondary share market.* The value of shares traded increased by 54 per cent from R207 billion in 1997 to R319 billion in 1998. In the first half of 1999 the value of shares traded at R202 billion had increased by 28 per cent over the first half of 1998. *Share market liquidity* (measured by annual turnover as a percentage of market capitalisation) accordingly increased from 17 per cent in 1997 to 28 per cent in 1998 and reached an all-time monthly high, on an annualised basis, of 41 per cent in March 1999.

Non-residents' purchases and sales broadly kept pace with the total turnover of listed shares on the Johannesburg Stock Exchange. On a *net* basis, non-resident investors increased their holdings of South African shares by R42,3 billion in 1998 as a whole, compared with R26,2 billion in 1997. There was some slowing down in the pace of non-residents' acquisitions from the third quarter of 1998, but they still increased their exposure to South African equities to the value of R15,4 billion in the first half of 1999.

Private-sector companies increasingly turned to the *primary share market* as a preferred source of finance. *New listings* almost doubled from 54 in 1997 to 101 in 1998. These listings included the demutualisation of Sanlam in November 1998. Another 49 companies listed in the first half of 1999. The total *value of equity capital raised* on the Johannesburg Stock Exchange, at R88,4 billion in 1998, was about 76 per cent more than the R50,3 billion raised in 1997. The value of capital raised receded to R22,9 billion in the first half of 1999.

Share market liquidity*



Annualised
* Turnover as a percentage of market capitalisation

Market for derivatives

Emerging-market contagion not only boosted activity and price volatility in the securities markets but also affected the *formal derivatives market*. Uncertainties about future share price movements induced investors to trade in *equity related contracts*, which accounted for about 99 per cent of all trades in financial instruments on the South African Futures Exchange. The value of these derivative contracts as a ratio of turnover on the Johannesburg Stock Exchange remained fairly stable in the twelve months to June 1999.

The combined trading volume of *interest rate and equity futures and options on futures contracts* rose from 11,6 million in 1997 to 16,1 million in 1998, and amounted to 9,9 million in the first half of 1999. Trading volume was largely supported by *non-resident participation* as the derivatives market also became better integrated into the international financial markets. Participation by non-residents increased from an average of 9 per cent of open interest in 1996 to respectively 24 per cent and 30 per cent in 1997 and 1998, before increasing sharply to an all-time high of 51 per cent in June 1999.

Trading in *warrants*, though small in terms of the number of underlying shares compared with the shares traded in the secondary share market, amounted to 1,2 billion contracts in 1998 and 0,5 billion contracts in the first half of 1999.

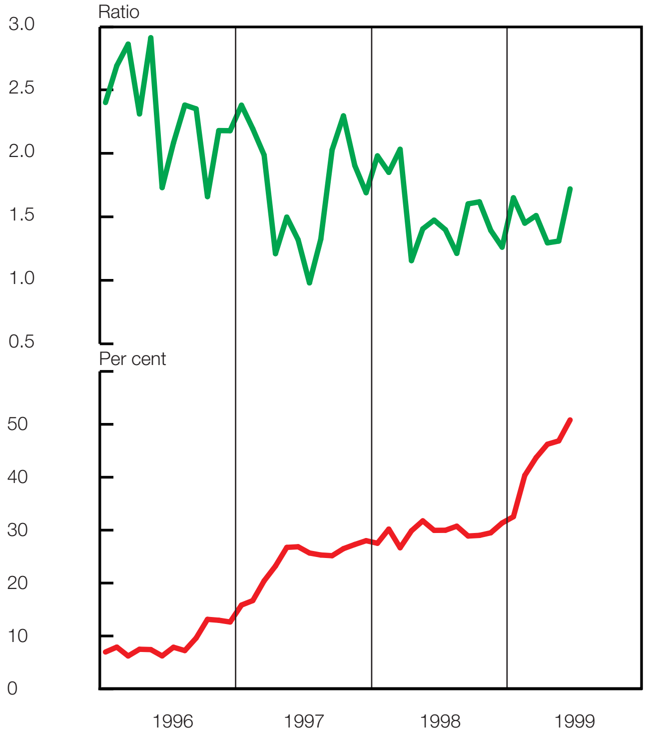
Trading in *commodity futures contracts and options on such contracts* mainly consisted of *maize futures,* which represented 85 per cent of all commodity-related trading in the eighteen months to June 1999. The change from centralised to deregulated marketing, together with the implied price volatility, boosted trading in agricultural commodity contracts. The total number of commodity contracts traded nearly quadrupled from 21 830 in 1997 to 80 635 in 1998, and at 87 909 in the first half of 1999 surpassed the total number of trades in 1998.

Real-estate market

The slowdown in real economic activity and high financing costs had a negative impact on the *real-estate market* from the second half of 1998. The slack demand for housing in turn also had a dampening effect on growth in the home loan market.

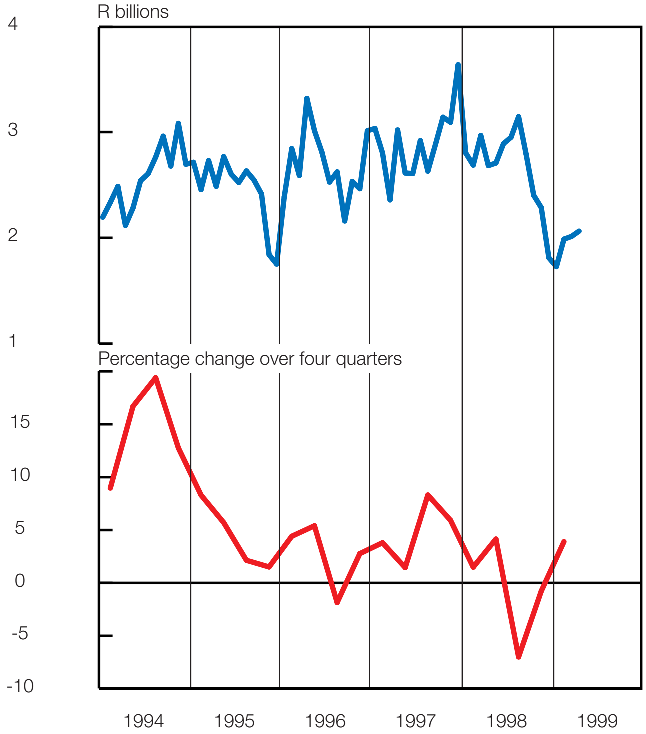
The *value* and *number* of real-estate transactions respectively decreased by 7,5 per cent and 6,6 per cent in 1998 compared with 1997. Sharp declines in

Market for derivatives



Turnover: Safex equity derivative contracts as a ratio of JSE shares
Non-resident participation

Real-estate market



Value of real-estate transactions
Average value per real-estate transaction
Seasonally adjusted

these aggregates occurred mainly in the fourth quarter of 1998. The value of real-estate transactions declined sharply from a quarterly average of R8,5 billion in the first three quarters of 1998 to R6,5 billion in the fourth quarter. Activity then receded even further to R5,7 billion in the first quarter of 1999. The *average nominal value per real-estate transaction* declined in the third and fourth quarters of 1998 relative to its level in the corresponding quarters of 1997. Inflation-adjusted real-estate values declined on average by 5,4 per cent in 1998. In the first quarter of 1999 the average nominal value per real-estate transaction increased modestly by 3,9 per cent relative to the first quarter of 1998, though still significantly lower than the contemporaneous increase in the consumer price index.

Public finance

Fiscal policy

Government's main fiscal objective in recent years has been the transformation of budget procedures and processes and the reprioritising of expenditure. At the same time an efficient tax structure has been created and borrowing contained within sustainable limits. In presenting his Budget to Parliament on 17 February 1999, the Minister of Finance reiterated that government has made major advances in strengthening fiscal discipline since 1994 and that fiscal policy will continue to be built on sound fiscal principles. To this end, the first three-year Medium Term Expenditure Framework (MTEF) was published early in December 1997 to give effect to the policy objectives enunciated in previous policy documents.

As outlined in the Budget Speech, government's key priorities for the next three years include

- investing in people through better schooling, skills development and access to health care and social welfare;
- improving policing, creating more secure correctional facilities and a streamlined criminal and civil justice system;
- building homes, extending municipal infrastructure and improving living conditions;
- targeting support for industrial clusters, small business development and strategic trade linkages;
- extending electrification, telecommunication networks and access to clean water and sanitation;
- targeting poverty relief programmes; and
- implementing commitments arising from the Jobs Summit.

Giving effect to several Jobs Summit commitments, government announced that R1,0 billion of the 1999/2000 budgeted expenditure would be set aside for targeted poverty relief programmes. This will rise to R1,2 billion and R1,5 billion in the following two fiscal years. In total, almost R3,0 billion of total government expenditure is linked directly to job creation programmes, including training the unemployed and providing employment services. Government also announced the Skills Development Levy which will be introduced on 1 April 2000 at a rate of 0,5 per cent of an employer's payroll. Eighty per cent of funds collected through this levy will be distributed to sectoral educational and training authorities to support industrial training schemes, and the remainder will accrue to the National Skills Development Fund. This fund will support training for the unemployed and other special training needs.

For the first time, government published a separate review of the national government expenditure estimates in February 1999. The National Expenditure Survey is a detailed account of spending and service delivery by national government departments and other spending agencies of the national government. The document provides detailed information – not only on the expenditure of the past three years and estimates for the ensuing three years, but also on the links between this expenditure and the output created. This survey serves as a guide to citizens on what government intends to do with the taxpayers' money, thus promoting transparency and the effective use of public money.

The Public Financial Management Bill was enacted on 2 March 1999 and consolidated the different Acts in terms of which the national government departments, the provincial governments and other national entities such as public corporations are governed. The Act aims at improving transparency and financial management in the public sector by making better-quality information available about government finances. It includes a provision for penalties when accounting officers fail to discharge their responsibilities properly. The Act will come into effect on 1 April 2000. A similar Bill covering local government will be tabled later during fiscal 1999/2000.

Improved cash management was also an integral part of government's financial restructuring. The use of electronic payments was promoted and since 1 April 1999, no cheque payment in excess of R10 000 has been allowed without special clearance, reducing both transaction costs and the scope for fraud in the government payment system. As part of a broader risk management strategy, the granting of borrowing powers to government bodies and the issuance of guarantees is now managed in accordance with a set of Cabinet-approved guidelines. Fees are now charged on the issue of guarantees.

High priority is placed on the restructuring of state assets with the aim of reducing government debt, the recapitalisation of public enterprises and the broadening of economic participation. The conversion of the South African Special Risks Insurance Association (SASRIA) into a public company owned by government might yield a dividend declared from the excess reserves. A contract was awarded to a private company for the management of government's interest in diamond mining, including an option to sell after two years. An agreement has been reached according to which a 20 per cent interest in the South African Airways will be sold for an amount of US$230 million to a Swiss airline company. Final bids for the privatisation of government's forestry company (SAFCOL) are expected early in the second half of 1999. Negotiations on the privatisation of some divisions of the technology company (Denel) are also in progress.

Government's funding strategy is aimed at lowering debt service costs over the long term, reducing the risks of adverse interest rate or exchange rate movements and strengthening the depth and liquidity of the South African capital market. To this end, the Department of Finance has launched an investigation into the possibility of consolidating a number of illiquid bonds into streamlined, liquid benchmark bonds. Consideration will also be given to the issuance of floating rate bonds and zero coupon bonds to enhance the diversity of available instruments. The introduction of bonds carrying interest indexed to inflation is also under investigation. Government is proceeding with a European Medium-Term Note programme which will develop the necessary infrastructure and documentation for issuing bonds in European capital markets, giving government the flexibility to raise cash quickly and easily.

National government finance

National government expenditure in fiscal 1998/99 amounted to R204,7 billion, which was 7,9 per cent higher than in fiscal 1997/98. Although this rate of increase was somewhat higher than the 6,1 per cent envisaged in the original Budget proposals, it was substantially lower than the average rate of increase of 11,4 per cent in the preceding five fiscal years. Debt service cost contributed R43,3 billion to national government expenditure compared with the R42,5 billion originally budgeted, whereas transfers to provincial governments amounted to R95,8 billion compared with the R90,4 billion envisaged in the Budget. However, transfers to provincial governments in fiscal 1998/99 included a departmental transfer of R1,5 billion deferred from the previous year and a special capital transfer of R0,9 billion.

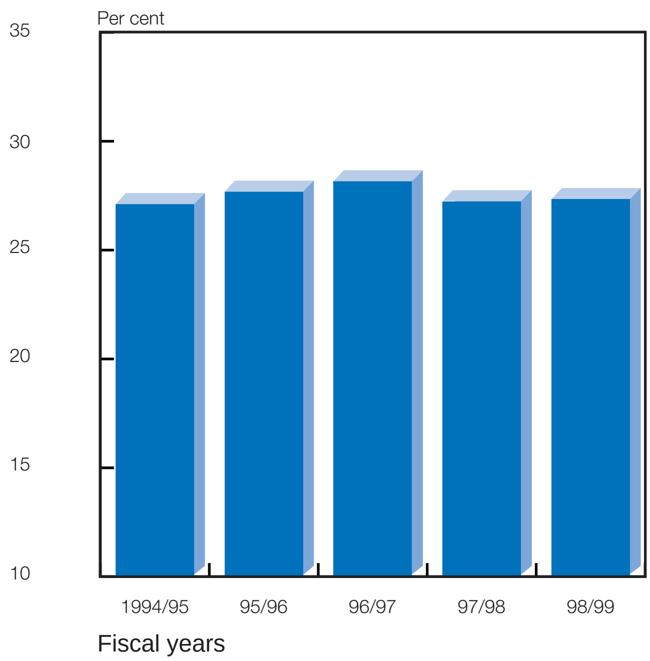
Expenditure levels in 1998/99 benefited from funds recovered from the civil service pension funds. Employers' contributions to the Government Employees' Pension Fund were initially paid at a rate of 17 per cent instead of the 15 per cent as agreed to by employers and employee representatives. The National Revenue Fund was reimbursed with an amount of R1,2 billion, being the difference between the two rates. The containment of the rate of increase in total expenditure was an impressive achievement in view of the subdued state of the domestic economy during the past year. As a ratio of gross domestic product, national government expenditure amounted to 27,4 per cent in fiscal 1998/99 – slightly higher than the level which was recorded in the previous fiscal year.

It was estimated that national government expenditure would increase to R216,8 billion in fiscal 1999/2000 or by 5,9 per cent over actual expenditure in fiscal 1998/99. Further increases to R230,7 billion in fiscal 2000/2001 and R247,3 billion in fiscal 2001/2002 were indicated by the MTEF. This represents an average rate of increase of 6,5 per cent in the three-year medium-term budget period. The debt service cost is expected to increase at a rate of 11,1 per cent in fiscal 1999/2000, but should then fall back to 5,6 per cent in fiscal 2001/2002. The non-interest current expenditure is expected to increase to R158,2 billion in fiscal 1999/2000. Capital expenditure is expected to grow modestly but will be supplemented through investment spending by partnerships formed between government and the private sector.

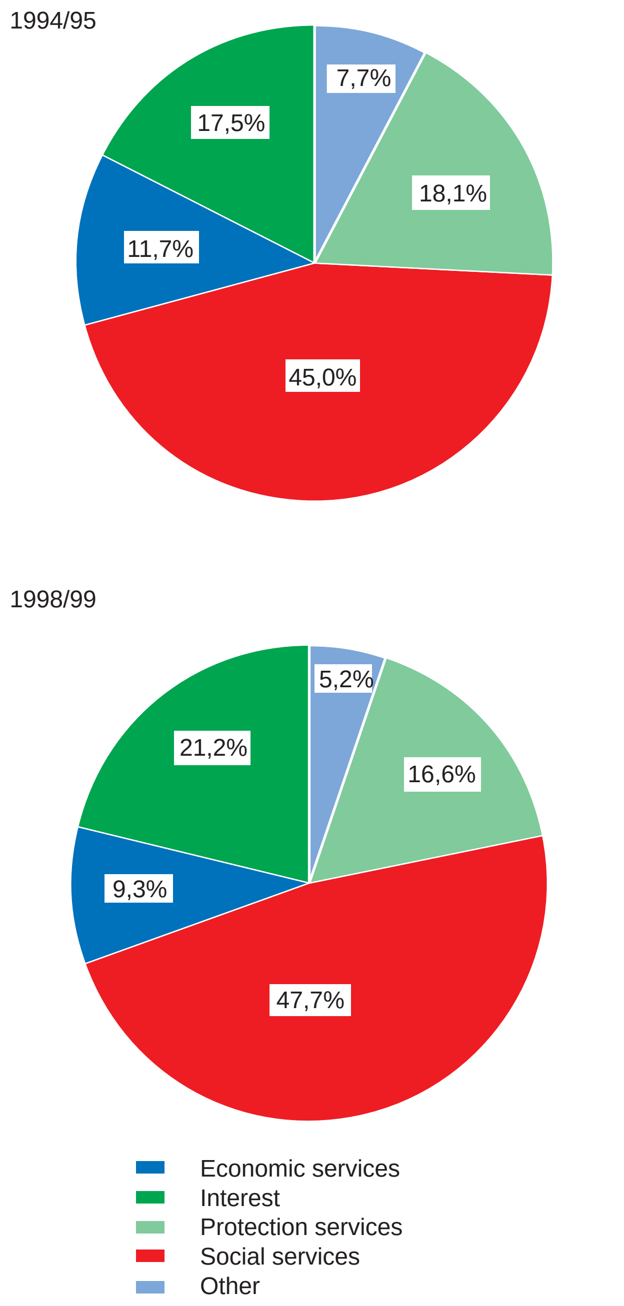
The functional classification of the expenditure of the consolidated national and provincial governments clearly reflects a substantial reprioritisation of expenditure away from general, economic and protection services towards expenditure on social services and interest on government debt. Spending on social services reached the level of 60,5 per cent of total non-interest spending in fiscal 1998/99 and is expected to be maintained at that level.

Revenue received by national government in fiscal 1998/99 amounted to R182,9 billion – an increase of 11,6 per cent over fiscal 1997/98 compared with a budgeted increase of 8,3 per cent. In the current subdued domestic economic conditions, this illustrates the success that the South African Revenue Service has achieved in improving the efficiency of tax administration. As a ratio of gross domestic product,

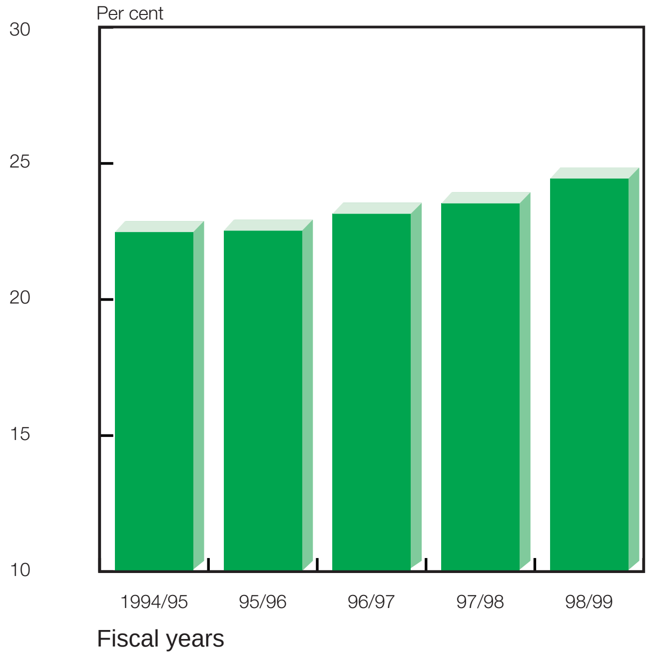
National government expenditure as a ratio of gross domestic product



Functional classification of the expenditure of consolidated national and provincial government



National government revenue as a ratio of gross domestic product



national government revenue amounted to 24,4 per cent in fiscal 1998/99 compared with the 23,5 per cent recorded in fiscal 1997/98.

The higher-than-budgeted rate of increase in national government revenue was brought about by relatively strong inland revenue receipts, in particular the buoyant income tax collections. In fiscal 1998/99 receipts from inland revenue increased at a rate of 11,8 per cent compared with the budgeted growth of 6,9 per cent. By contrast, receipts from customs and excise duties increased at a rate of 10,2 per cent in fiscal 1998/99 compared with a budgeted increase of 18,4 per cent.

Total national government revenue (excluding extraordinary revenue) was estimated to increase to R191,7 billion or by 4,8 per cent in fiscal 1999/2000,

Table 15. National government revenue by type of income in fiscal 1998/99

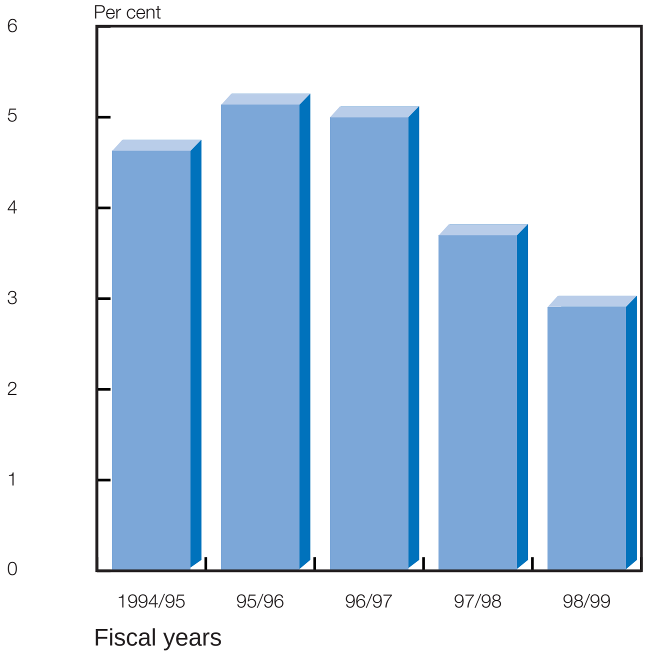
Revenue category	Percentage change*	
	Budgeted	Actual
Inland revenue	6,9	11,8
Income tax	6,3	13,7
Value-added tax	8,4	9,3
Customs and excise duties	18,4	10,2
Customs duty	10,6	-1,2
Fuel levy	19,2	12,8
Other excise duties	11,9	6,6
Total revenue	**8,3**	**11,6**

* Based on the actual outcome of previous fiscal years

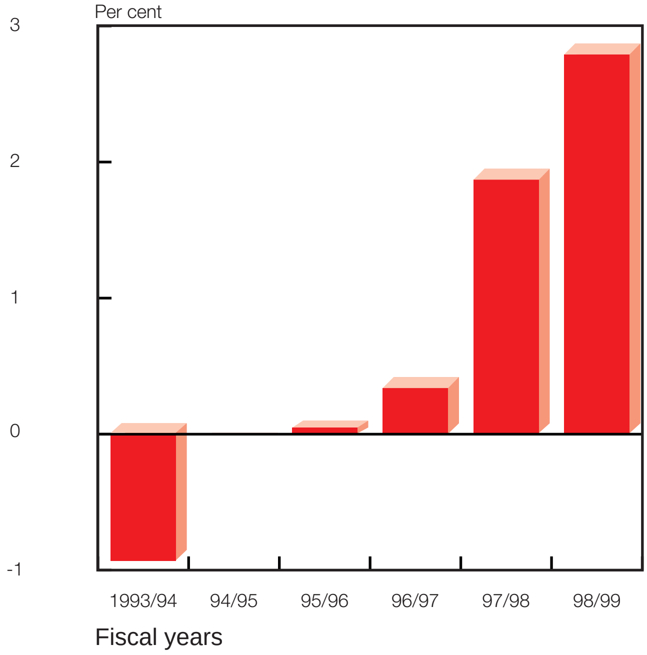
by a further 8,2 per cent in fiscal 2000/2001 and 7,2 per cent in fiscal 2001/2002. Income tax was expected to remain the primary source of revenue for the national government. As a step towards the establishment of an internationally competitive tax structure and in line with the Strategy for Growth, Employment, and Redistribution (GEAR), a reduction in the company tax rate from 35 per cent to 30 per cent was announced in the Budget for 1999/2000. Furthermore, as a direct result of greater tax-collection efficiency, government was able to go beyond eliminating the effects of fiscal drag. The proposed adjustments to the income tax brackets and rates will bring about a general reduction in the tax burden. Other tax relief measures included a reduction in excise duties on soft drinks and selective reductions in transfer duties aimed at encouraging home-ownership.

The higher-than-expected expenditure and revenue for fiscal 1998/99 resulted in a national government deficit before borrowing and debt repayment of R21,8 billion, which was considerably lower than the originally budgeted deficit of R23,7 billion. As a ratio of gross domestic product, the deficit amounted to 2,9 per cent in fiscal 1998/99 compared with a ratio of 3,7 per cent recorded in the preceding fiscal year. This was the lowest ratio recorded since fiscal 1990/91. Government also succeeded in reversing its primary balance (i.e. the deficit recalculated by excluding interest payments from total expenditure) from a deficit of 0,9 per cent of gross domestic product in 1993/94 to a surplus of 2,8 per cent of gross domestic product in 1998/99.

National government deficit as a ratio of gross domestic product



National government primary balance as a ratio of gross domestic product



The net result of the budgeted expenditure and revenue for fiscal 1999/2000 was an estimated deficit before borrowing and debt repayment of R25,1 billion that should decrease to R23,4 billion in fiscal 2000/2001 before increasing to R25,0 billion in fiscal 2001/2002. It was estimated that the primary surplus would continue to improve over the same period.

The deficit before borrowing in fiscal 1998/99, when adjusted for the cash flows associated with late departmental transfers, surrenders by spending departments, and transfers still outstanding, amounted to R21,1 billion. New funds obtained from the issuance of long-term government stock were the main instrument used to finance the deficit of national government. Extraordinary revenue collected from the partial privatisation of the South African Airports Company and the sale of strategic oil stocks added R2,7 billion to meet financing needs. The one-off charge on the free reserves of Sanlam at the date of demutualisation yielded R279 million and was reported as receipts of an extraordinary nature. However, this money will be transferred to capitalise the Umsobomvu Fund as soon as it is established. This fund will serve as a vehicle for financing development and job creation.

In contrast to the preceding fiscal year when the Public Investment Commissioners (PIC) was a net seller of government stock to the value of R1,6 billion, government stock owned by the PIC increased by R10,4 billion in fiscal 1998/99. Steep increases were

Table 16. Financing the national government deficit in fiscal 1998/99
R millions

Financing instrument	Public Investment Commis-sioners	Monetary sector: Reserve Bank	Monetary sector: Corporation for Public Deposits	Monetary sector: Other monetary institutions	Non-monetary private sector[1)]	Total
Government stock	10 434	1 492	-2 149	7 664	7 114	24 555
Treasury bills	0	0	-403	385	1 370	1 352
Foreign loans	0	0	0	0	-20	-20
Non-marketable securities[2)]	0	0	0	0	-322	-322
Extraordinary receipts	0	0	0	0	3 001	3 001
Extraordinary transfers	0	0	0	0	-936	-936
Change in cash balances	0	276	0	-615	0	-340
Total net financing	**10 434**	**1 768**	**-2 552**	**7 434**	**10 207**	**27 290**

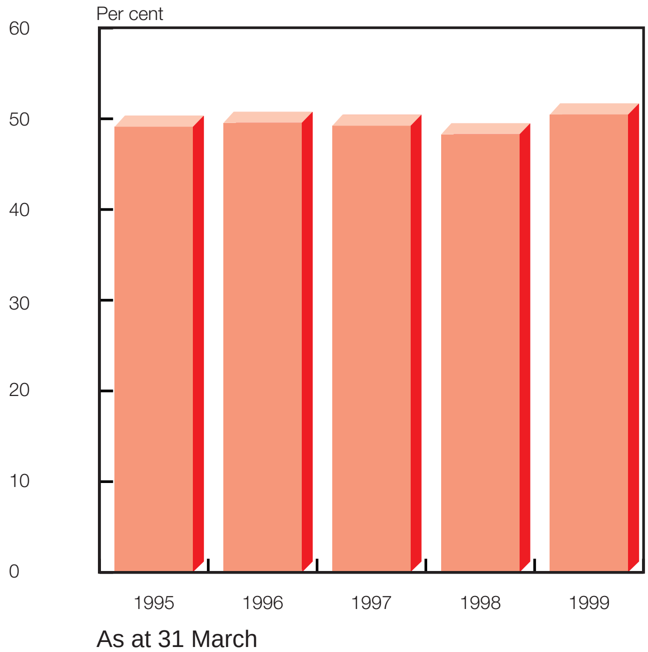
1) Including foreign loans and domestically registered stock owned by non-residents
2) Inlcuding debt of the former Transkei, Bophuthatswana, Venda and Ciskei and self-governing territories as well as Namibian debt assumed by the South African Government

also reported in the holdings of government stock by other monetary institutions (other than the Reserve Bank and the Corporation for Public Deposits) and the non-monetary private sector. According to the consolidated balance sheet of other monetary institutions, their holdings of government stock rose by R7,6 billion in fiscal 1998/99 and those of the non-monetary private sector by R7,1 billion. In December 1998, the final instalment was paid to the International Monetary Fund in terms of the Compensatory and Contingency Financing Facility. The redemption of this foreign loan was financed by a transfer from the IMF account at the Reserve Bank.

In addition to the need to finance the deficit and the discount on the issue of new government stock, the higher rand value of outstanding foreign-currency denominated debt and the inclusion of the deficit of R14,4 billion on the Gold and Foreign Exchange Contingency Reserve Account also added to government debt. All these contributed to an increase in national government debt from R336,2 billion at the end of March 1998 or 48,3 per cent of gross domestic product to R377,7 billion at the end of March 1999 or 50,5 per cent of gross domestic product.

The average maturity of national government's domestic marketable stock debt decreased slightly from 114 months at the end of March 1998 to 113 months at the end of March 1999. However, the average maturity of foreign debt decreased from 88 months at the end of March 1998 to 76 months at the end of March 1999 as no new foreign bonds were issued during fiscal 1998/99. Although the Budget for fiscal 1999/2000 projected that the nominal value of national government debt would increase further over the three-year budget cycle, debt as a ratio of gross domestic product was projected to decrease during the same period.

National government debt as a ratio of gross domestic product

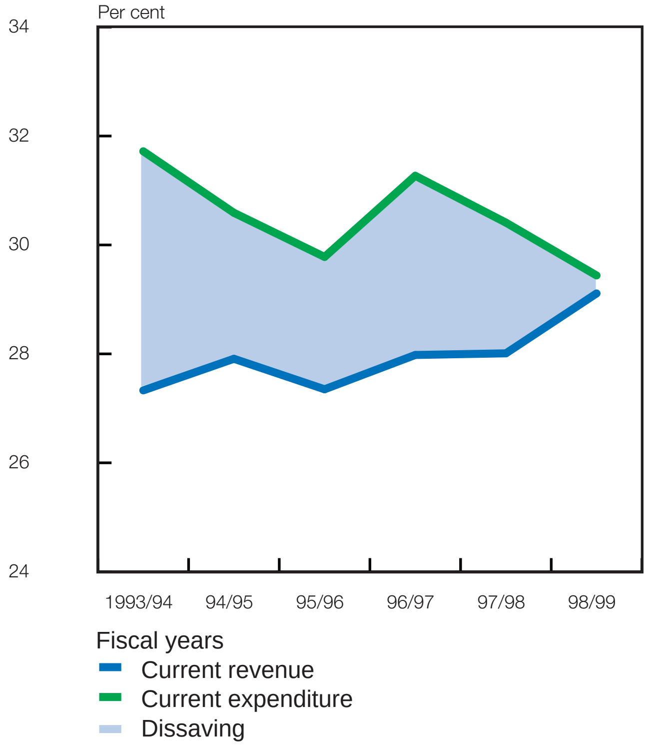


General government

The *borrowing requirement of general government* (i.e. the borrowing requirement of the consolidated central government, provincial governments and local authorities) decreased from R29,7 billion in fiscal 1997/98 to R19,0 billion in 1998/99. As a percentage of gross domestic product, the borrowing requirement of general government amounted to 2,5 per cent in fiscal 1998/99 compared with 4,3 per cent in fiscal 1997/98. The steady decline in this ratio since the all-time high of 9,1 per cent in fiscal 1993/94 is consistent with government's stated objective of decreasing its direct involvement in the economy. In the Budget for 1999/2000 it was projected that the borrowing requirement of general government would average R26,2 billion over the next three years.

Dissaving by general government amounted to R2,4 bilion or 0,3 per cent of gross domestic product in fiscal 1998/99 compared with R19,4 billion or 4,4 per cent of gross domestic product in fiscal 1993/94. This improvement in the savings performance of general government was in accordance with the objective of eliminating general government dissaving by fiscal 1999/2000. Spending containment and solid growth in current revenue were the main factors responsible for the decline in the dissaving ratio of general government.

Dissaving of general government as a ratio of gross domestic product



The improvement in the financial position of general government was particularly evident from a turnaround in the finances of provincial governments, reinforced by the improvement in the financial position of the national government. These improvements by far outweighed the slight deterioration in the financial positions of the extra-budgetary institutions, social security funds and local authorities.

The preliminary outcome indicates that provincial governments recorded a surplus of R3,2 billion in fiscal 1998/99 compared with a deficit of R6,2 billion in the previous fiscal year. This better outcome resulted from the containment of expenditure, the late departmental transfer of R1,5 billion from national to provincial governments and a special capital transfer of R0,9 billion earmarked for the settlement of accumulated debts.

Public-sector borrowing requirement

The *public-sector borrowing requirement* (PSBR, defined as the borrowing requirement of the consolidated general government and non-financial public business enterprises) broadly followed trends similar to the trend of the borrowing requirement of general government. This PSBR amounted to R27,6 billion or 3,7 per cent of gross domestic product in fiscal 1998/99 compared with R32,0 billion or 4,6 per cent of gross domestic product in the previous fiscal year. The borrowing requirement of non-financial public enterprises and corporations increased from R2,3 billion in fiscal 1997/98 to R8,6 billion in fiscal 1998/99. This was mainly related to the intensification of capital expenditure programmes by public corporations, notably South African Airways and Telkom.

National government finance in the first quarter of fiscal 1999/2000

In the April-June quarter of fiscal 1999/2000 national government expenditure amounted to R53,1 billion or 4,6 per cent more than in the same period of the previous fiscal year. After allowing for cash-flow adjustments, this expenditure amounted to R51,4 billion, which was 0,4 per cent higher than in the same quarter a year earlier. The Budget provided for an increase in national government expenditure of 5,9 per cent for the fiscal year as a whole.

Revenue received by national government amounted to R40,0 billion in the April-June quarter of fiscal 1999/2000. This represented an increase of 8,7 per cent on the same period of the previous fiscal year. The Budget envisaged an increase of 4,8 per cent on the actual collections of the previous fiscal year. The rate of increase in the receipts from inland revenue was 8,6 per cent compared with a budgetary provision of

Table 17. Financing the national government deficit in April-June 1999

Financing instrument	R billions
Government stock (including discount)	6,6
Less: Discount on new government stock	1,0
Net receipts from government stock	**5,6**
Treasury bills	1,0
Foreign loans	6,3
Non-marketable securities	-0,3
Change in available cash balance	-1,5
Total net financing	**11,1**

5,2 per cent. Receipts from customs and excise duties increased at a rate of 9,0 per cent compared with the 1,8 per cent foreseen at the time of the Budget. After including the cash-flow adjustment for funds surrendered by spending departments and other receipts, national government revenue amounted to R40,3 billion in the April-June quarter of fiscal 1999/2000.

The net result of the expenditure incurred and revenue receipts in the April-June quarter of fiscal 1999/2000 was a deficit before borrowing and debt repayment of R13,1 billion, which was lower than the deficit recorded in the same period of the previous fiscal year. After adjustments for cash flows, the deficit amounted to R11,1 billion.

As indicated in Table 17, the deficit adjusted for cash flows in the April-June quarter of fiscal 1999/2000 was financed mainly through the issuance of government stock. However, the domestic demand for financing was reduced by the proceeds from two foreign currency denominated bond issues. The 7-year Eurobond issue to the value of euro500 million and the 10-year dollar bond issue to the value of US$500 million yielded R6,3 billion to the Exchequer account. These issues lengthened the average outstanding maturity of foreign government debt from 76 months at the end of March 1999 to 81 months at the end of June 1999 and completed the foreign borrowing programme envisaged in the Budget for fiscal 1999/2000.