2. ECONOMIC OUTLOOK

OVERVIEW [1]

Government's macroeconomic policy aims to secure sustained economic growth, thereby extending income earning opportunities to the poor and reducing inequality within a sound fiscal and financial framework.

1997/98

The Government's projections for the fiscal year 1997/98 were an inflation rate of 8,5 per cent and growth of 2,5 per cent. Inflation was lower than anticipated bringing benefits to savers and those on fixed income, and stability to the currency. The rand has held its value in difficult circumstances, reflecting growing international confidence in the South African economy. Although growth is now anticipated to be lower than projected as a result of lower consumption and investment growth, both are expected to recover during 1998.

Prospects

Since October 1997 the South African economy has suffered from the decline in the gold price, and the downward revision of international price and growth forecasts as a result of the Asian crisis. Falling prices, internationally, will benefit the local economy through lower domestic inflation. Inflation is projected to fall to 5½ per cent for 1998/99 and 1999/00 and further to 5 per cent in 2000/01. Weaker export demand and stronger import growth will result in a widening of the current account deficit, but capital flows are anticipated to more than cover the deficit. GDP growth forecasts remain at 3 per cent for 1998/99, rising to 4 per cent for 1999/00 and 5 per cent for 2000/01. The fiscal framework published in the Medium Term Budget Policy Statement has been adjusted to take account of the lower inflation forecasts.

Government is confident that adherence to sound fiscal and macroeconomic policy, the structural changes in progress and the lower inflation outlook will contribute to a marked strengthening of economic performance during 1998/99.

	Forecast	Outcome	Forecast	Revised	Forecast	Forecast	Forecast
	1996/97		1997/98		1998/99	1999/00	2000/01
GDP (R billion)	561	556	622	613	669	734	810

[1] All information in this chapter is based on data obtained from the Reserve Bank and the Bureau of Economic Research, University of Stellenbosch.

Real GDP growth	3¾	3	2½	1½	3	4	5
GDP inflation	8¼	8,5	9	8½	6	5½	5
CPI inflation	7½	8,1	8½	8	5½	5½	5

OUTPUT AND DEMAND

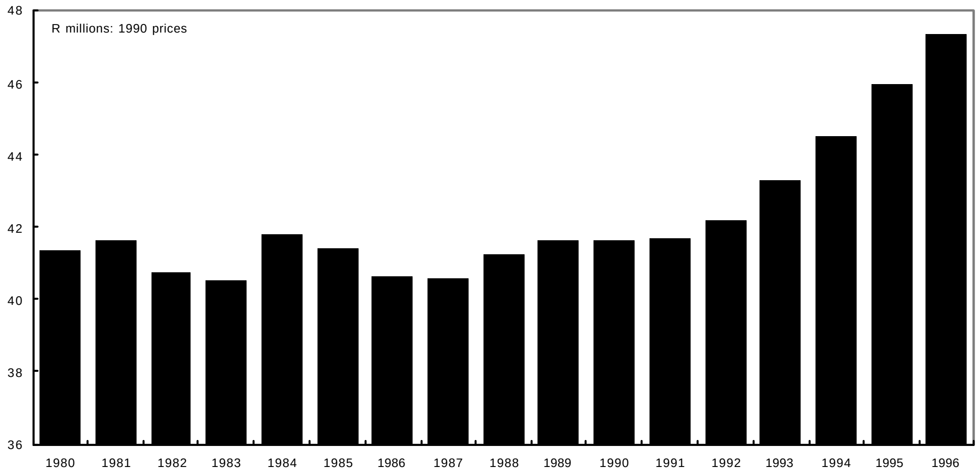
Output

Productivity

Productivity growth has accelerated dramatically in recent years, from an average of less than 1 per cent in the 1980s and 2 per cent in the early 1990s to 3,3 per cent in 1995, 3,6 per cent in 1996 and an annualised 4,1 per cent in the third quarter of 1997.

Productivity gains have not been uniform between the sectors. Labour productivity in the manufacturing sector grew by an average of 5,5 per cent in 1995 and 1996 compared with average growth of only 2,1 per cent during 1993 and 1994. Labour productivity in the mining sector increased by 10 per cent during 1992 and 1993 but then declined by an average 0,7 per cent during 1994 and 1995, before gaining 3,2 per cent in 1996.

Figure 2.1: Output per worker



Growth in 1997

The South African economy has continued to grow in 1997 and is now entering its sixth year of economic expansion. Since the trough in 1992, total output has increased by 14,9 per cent and is 8,9 per cent higher than the previous peak in 1989. A positive and sustainable growth path has developed which stands in sharp contrast to the large output fluctuations evident for the pre-1992 period. The international reintegration of the South African economy as well as political and social reforms, has created an environment for sustained export growth, healthy net capital inflows, and improved investor confidence. The Growth, Employment and Redistribution (GEAR) strategy, which confirms Government's commitment to outward orientated development, sound fiscal policy and the delivery of services through infrastructural investments, has further enhanced the prospects of the economy.

Real GDP growth was 1,7 per cent for 1997 compared to 3,4 per cent for 1995 and 3,2 per cent for 1996. This lower growth can be ascribed to the slowdown in gross domestic expenditure (GDE) from 2,7 per cent in 1996 to 1,4 per cent in 1997. In particular, the decline in private consumption growth as well as a sizeable decumulation of inventories outweighed the positive contribution to GDP from improved export performance.

Manufacturing

Having stagnated during the 1980s and early 1990s, the manufacturing sector's contribution to GDP increased to 24,9 per cent in 1997 compared with 24 per cent in 1993. Manufacturing proved to be the major growth stimulus in 1997 with real output growth of well over 3 per cent.

Agriculture

Agricultural production returned to more familiar levels in 1997 from the record output of 1996. Output grew by 29 per cent in 1996 compared with a decline of 14,9 per cent in 1995 and growth of 12 per cent in 1994. The sector's share of GDP increased from 5,1 per cent in 1993 to 5,7 per cent in 1996 before falling back to 5,6 per cent in 1997. Although fears of a possible "El Nino" initially dampened optimism regarding growth prospects, healthy rain falls and dams filled to capacity have reduced fears of a large contraction in agricultural output in 1998.

Mining

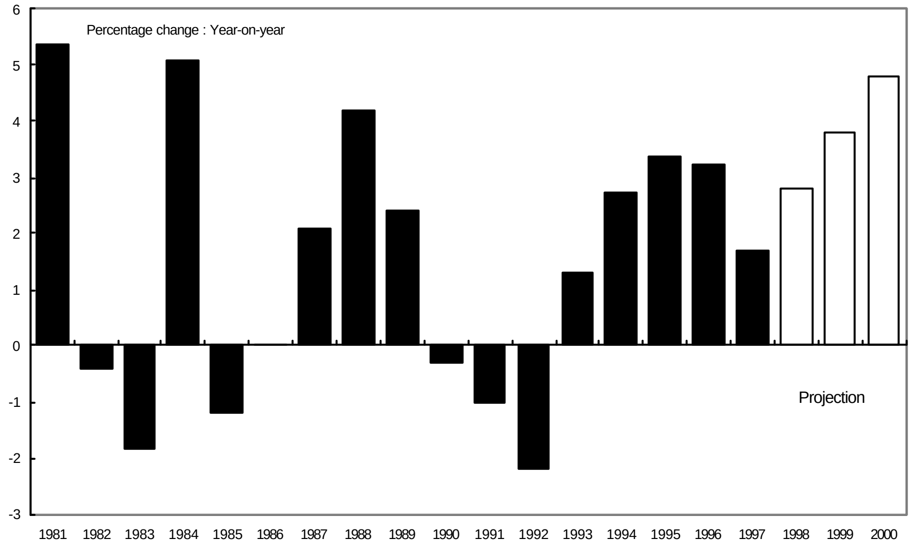
From 1994 to 1996, the mining sector made a negative contribution to output growth. Output declined by 2,5 per cent in 1994, 3,2 per cent in 1995 and 1,4 per cent in 1996. This has resulted in a contraction in mining's contribution to GDP from around 10 per cent in 1993 to 8,6 per cent in 1996. In 1997, the mining sector grew at 1,2 per cent and its contribution to GDP remained at 8,6 per cent. The sharp fall in the gold price towards the end of 1997, together with the experience of declining global commodity price increases suggest a renewed decline in output for 1998.

Demand

Consumption

The easing of private consumption growth, which started in 1996, continued through 1997. Growth in private consumption expenditure, which accounts for over 60 per cent of gross domestic expenditure, has slowed down to an average of 2 per cent in 1997 compared to 4,7 and 3,9 per cent in 1995 and 1996 respectively.

Figure 2.2: Real GDP growth



Real disposable income increased by 2,4 per cent and 4,2 per cent in 1995 and 1996 before slowing to 0,8 per cent in 1997. Further factors contributing to weak consumption growth in 1997 have been high real interest rates, record levels of debt relative to disposable income and the negative wealth effect of weak property and equity prices.

Investment

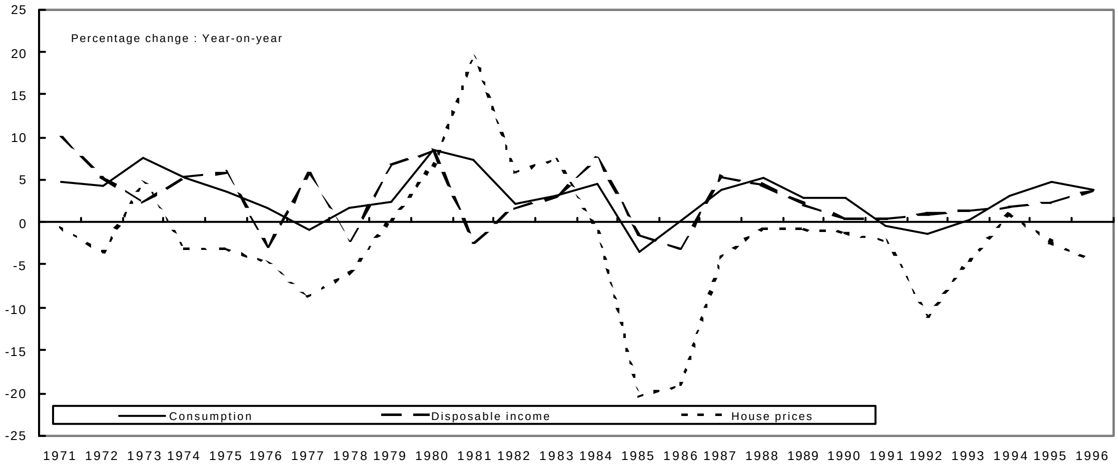
Gross domestic fixed investment growth, after accelerating to 10,3 and 7,8 per cent in 1995 and 1996 eased back to 3,5 per cent in 1997 as a result of the simultaneous completion of several mega-projects and a lower GDP growth. Gross domestic fixed investment by private business enterprises has slowed from an average growth of 13,2 per cent in 1994 and 1995 to 6,1 per cent in 1996 and 3,1 per cent in 1997. This trend is predominantly a reflection of the slowdown of fixed capital formation in the agricultural and private manufacturing sectors.

After contracting in 1994 and 1995, real investment by public authorities accelerated to an average growth rate of 15 per cent in 1996 and 4 per cent in 1997. All three spheres of Government contributed to the continued growth in investment spending, which was focused on infrastructure developments and the elimination of social service backlogs. Real fixed capital formation by public corporations increased by 5,3 per cent in 1997, having risen by 10,6 per cent in 1996.

WEALTH AND CONSUMPTION

The growth in real house prices (an index of wealth) and real private consumption expenditure are closely related, particularly since 1984.

Figure 2.3: Real private consumption, real disposable income and real house prices



The importance of wealth as a determinant of consumption growth is evident from Figure 2.4.The combined effect of wealth and income appears to explain consumption growth much more effectively than income alone.

Figure 2.4: Percentage change in real private consumption - Actual, explained by income and explained by income and real house prices

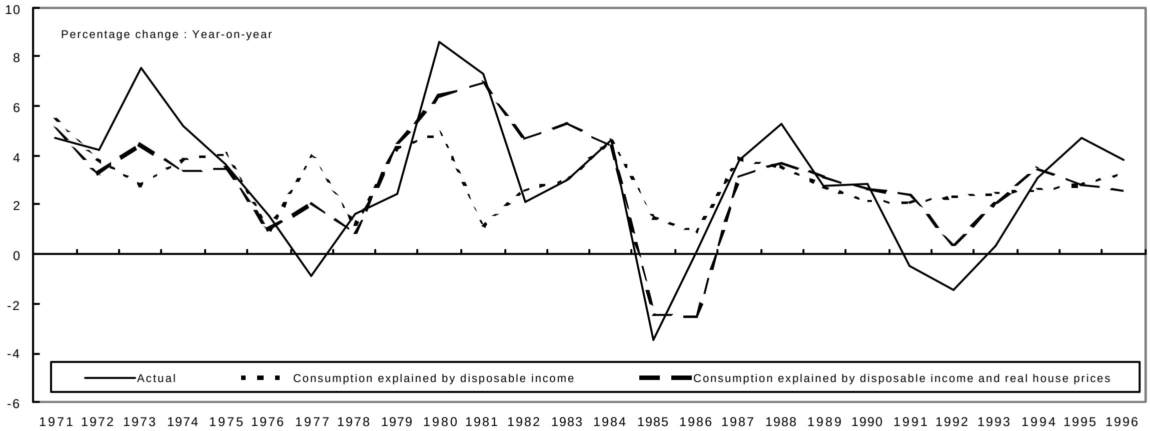


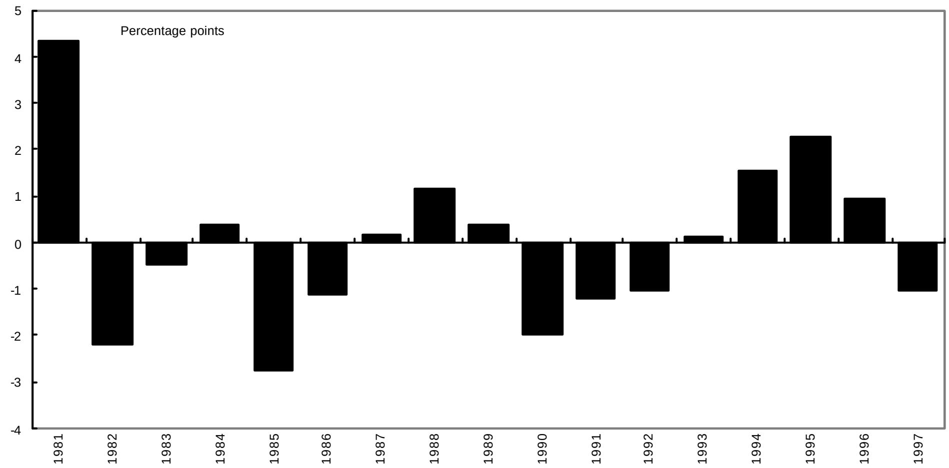
Figure 2.5 shows the ratio of house prices to wages and indicates that from 1984 onwards, houses have become relatively more affordable. While this reflects the fact that house prices have been under pressure over the last ten years, it also means that the prospects for a revival in the residential property market are good, which should support a higher level of private consumption growth in the future.

Figure 2.5: Price Earning Ratio

Inventories

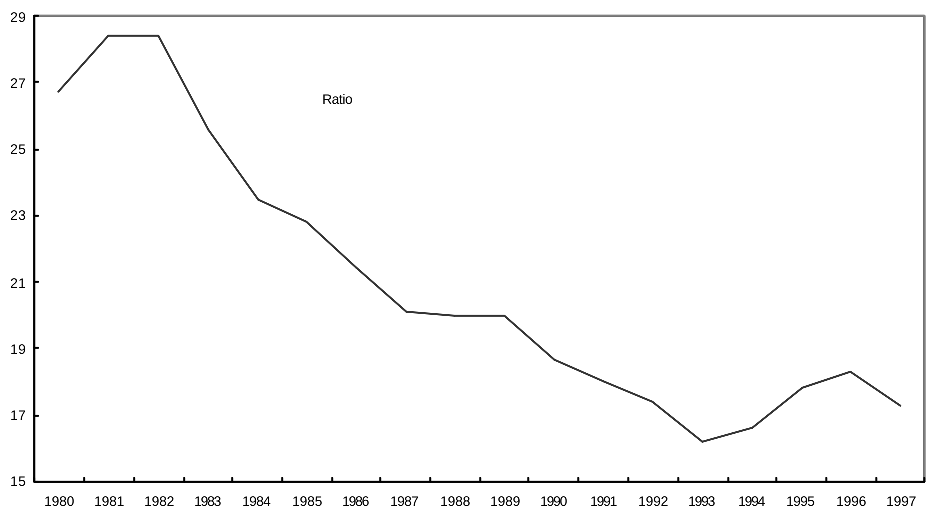
After increasing for 4 consecutive years, there was a decumulation of inventories during 1997. As figure 2.6 indicates, the decline in inventories has been a major contributor to the weaker economic performance of 1997, shaving off GDP growth in excess of 1 per cent. If inventories had stayed at their 1996 levels, the economy would have grown more or less in line with the GEAR forecast of 2,9 per cent in 1997.

Figure 2.6: Contribution of the change in inventory to real GDP growth



As a result of the renewed decumulation of inventories, the ratio of inventories to GDP has again started to decline in 1997. As figure 2.7 shows, South Africa's inventory stock has followed a downward trend similar to that experienced in industrialised countries. Nevertheless, with positive real growth from other demand components, the decline in inventories can be expected to moderate or even reverse during 1998. The change in inventories is therefore expected to make a positive contribution to growth in 1999 and 2000.

Figure 2.7: Industrial and commercial inventories to GDP



Exports

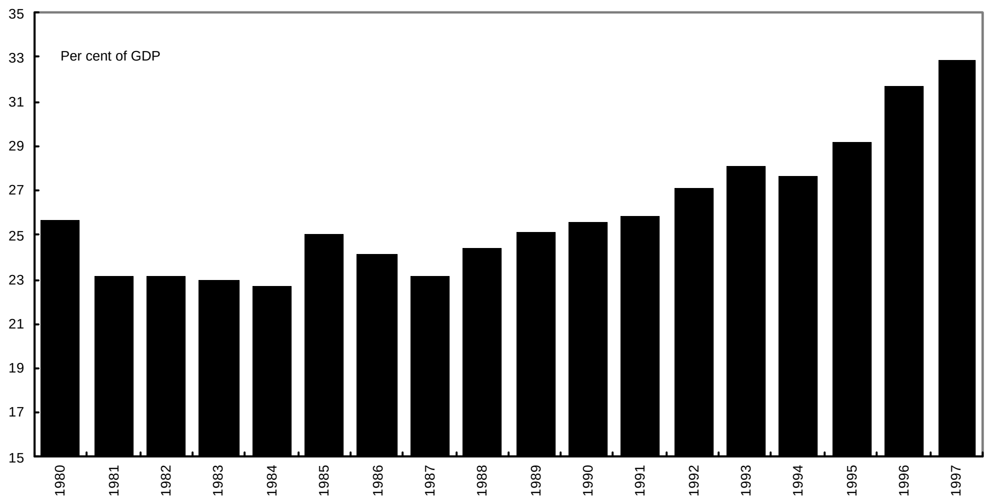
In line with the GEAR strategy, exports have continued to be a major stimulus to economic growth. Real exports of goods and non-factor services increased by 5,3 per cent in 1997 compared to 11 per cent and 10,5 per cent in

1996 and 1995 respectively. The volume of non-gold exports grew by 17,3 per cent in 1995, 13,9 per cent in 1996 and 4,5 per cent in 1997. On average, these growth rates exceed the GEAR projections of 9,1 per cent and 8 per cent for 1996 and 1997. The contribution of exports to GDP has increased from 27,6 per cent in 1994 to 32,8 per cent in 1997.

Imports

Growth in real imports has slowed as a result of a softening in domestic demand. Imports of goods and non-factor services increased by 16,1 per cent and 17,1 per cent in 1994 and 1995 in comparison to growth of 9,2 per cent for 1996 and 4,6 per cent for 1997. As a share of GDP, imports of goods and non-factor services increased from 19,6 per cent in 1990 to 32 per cent in 1997.

Figure 2.8: Exports as a share of GDP



SAVINGS AND INVESTMENT

Recent trends and outlook of savings

The total domestic saving rate fell from 16,9 per cent in 1996 to 15,2 per cent in 1997. This trend is the net result of a weakening of the saving ratio in the private sector, which was not completely offset by a reduction in government dissaving. Net dissaving by the general government remained at 3,5 per cent of GDP.

Policy

Government’s macroeconomic strategy aims to boost the level of domestic saving through structural reforms to increase both private and public savings. Increased private saving is expected to follow improved economic growth.

Government will contribute to improved domestic total savings by reducing public dissaving. Appropriate fiscal targets are at the heart of Government's macroeconomic strategy and aim to eliminate Government dissaving by the turn of the century.

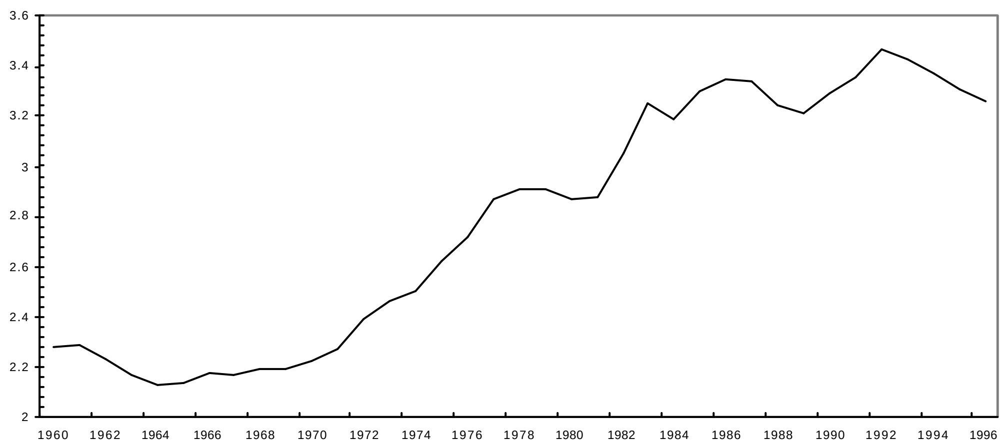
A sustained recovery in the level of domestic saving, brought about by rising real incomes, structural reform of the pension and tax system and the elimination of Government dissaving, supported by a steady flow of foreign investment, lay the basis for higher growth in future years and the achievement of Government's macroeconomic policy objectives.

Investment

Real gross fixed investment in South Africa grew steadily from the immediate post-war period to the 1970s. As a share of GDP, investment rose from 18,5 per cent in 1960 to almost 27 per cent in 1980. After 1980 the level of investment fell dramatically, reflecting both falling levels of foreign investment and the decreasing availability of domestic savings.

During the 1970s the level of investment in South Africa relative to GDP was as high or higher than that of other middle income countries, and at the time was comparable to many of the Asian economies. However, high levels of investment in South Africa did not translate into higher growth. Instead South Africa witnessed a very sharp increase in the capital-output ratio (the volume of investment required to produce a given level of output).

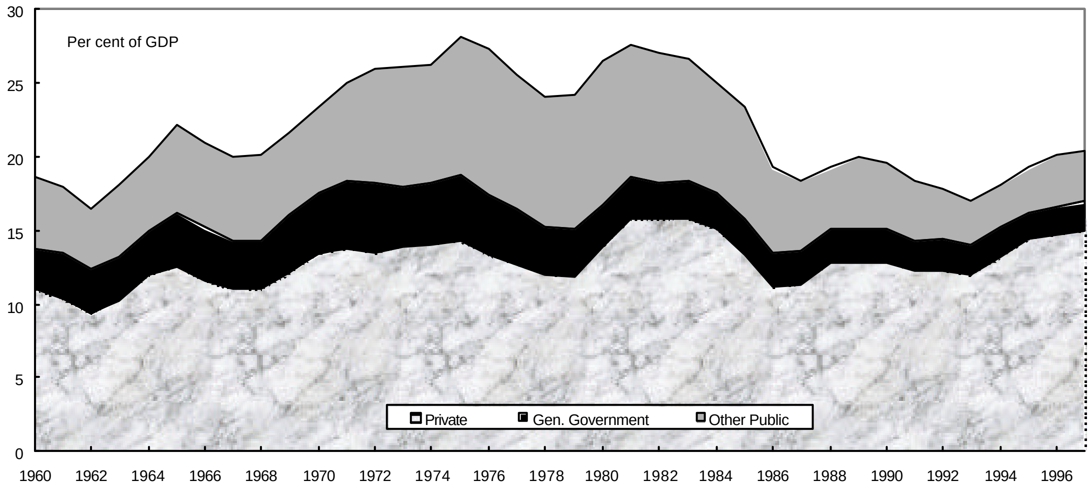
Figure 2.9: Capital Output Ratios



Capital output ratios

The rising capital output ratios during the 1970s reflected the high share of strategic public sector investment in total investment. Although the expansion of public investment stimulated the economy by supporting aggregate demand, it also increased the share of capital stock in sectors with higher than average capital output ratios and higher than average capital-labour ratios, contributing to the slower growth in output and employment. This trend was to some extent replicated in the private sector as a result of policies that introduced a range of implicit and explicit subsidies that encouraged greater capital intensity.

Figure 2.10 : Composition of fixed investment



Recent performance and outlook

The overall trend in real fixed investment was negative from 1990 to 1993 but has recovered to an average annual growth rate of over 7 per cent since then, largely as a result of improved confidence, large public and private investment projects (including Alusaf, Columbus Steel, Namaqua Sands), and an increase in investment spending by general government and public corporations in line with RDP commitments.

As indicated in figure 2.10, the level of private sector investment has increased substantially since 1993, from around 12 per cent of GDP to around 15 per cent in 1997. Government policy aims to ensure a continued increase in investment and a decline in the capital-output ratio.

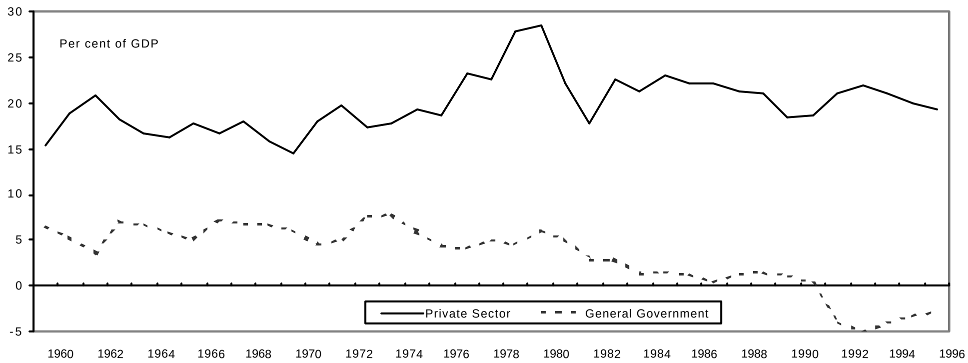
IMPORTANCE OF SAVINGS TO ECONOMIC GROWTH

The success of the GEAR strategy hinges on its ability to stimulate the level of investment in the economy, and to ensure that investment is channelled into more labour-absorbing activities. Studies of the South African economy indicate that aggregate savings (domestic and foreign) need to be raised to 25 per cent of GDP to achieve growth rates of 5 per cent.

Figure 2.11: Domestic savings

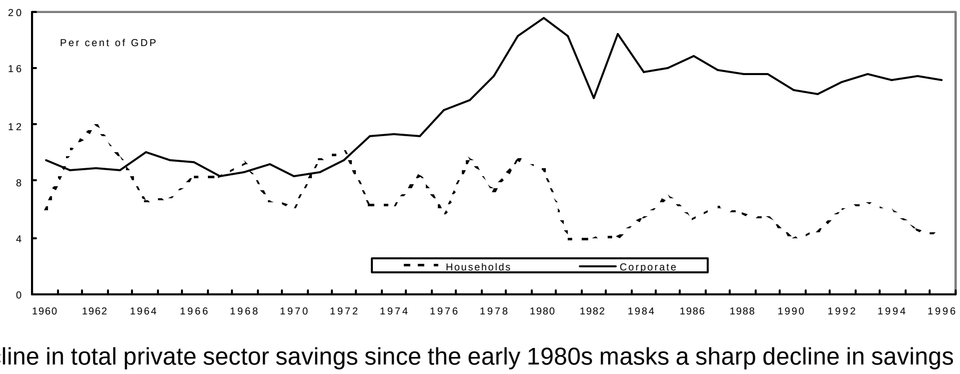
Mobilising international savings through policies that encourage direct foreign investment plays an important role in Government policy. However, foreign savings account for a small proportion of total savings and investment. Few countries have been able to sustain current account deficits in excess of 4 per cent of GDP over substantial periods. A pre-condition for this level of foreign investment is that Government's fiscal stance should be sustainable, reflected for example by a stable or declining debt to GDP ratio. The GEAR assumed, as recent experience demonstrates, that South Africa could attract between 2 and 3 per cent of GDP each year in foreign investment. This requires that the bulk of the increase in investment required to boost the growth rate will need to be funded from a rising level of domestic savings.

Figure 2.12: Composition of domestic savings



Domestic saving in South Africa has declined sharply during the last 10 years as shown in figure 2.11. Whereas total private sector saving has been relatively stable and has only shown a modest decrease in recent years, government saving became negative. The decline in government's contribution to total savings reflects the steady increase in government consumption spending and government borrowing.

Figure 2.13: Composition of private savings



The modest decline in total private sector savings since the early 1980s masks a sharp decline in savings by households and an offsetting increase in corporate savings. Lower personal savings reflects the decline in per capita incomes, increases in the provision of social pensions, a shifting of savings to the corporate sector in response to more favourable after-tax rates of return on contractual savings and financial sector reforms that increased household liquidity.

- ♦ In the coming financial year it is expected that overall real investment spending will gain momentum, with growth to rise from 3,2 per cent during 1997/98 to over 4,5 per cent for 1998/99.
- ♦ Foreign direct investment will continue to strengthen in response to future growth prospects, higher growth rates in the Southern African region, financial market reforms, further easing of exchange controls and favourable investment incentives.
- ♦ Real domestic private investment growth will increase steadily from 2,2 per cent during 1997/8 to 4,5 per cent during 1998/9 as export opportunities expand and domestic demand recovers.
- ♦ Public sector investment spending will continue to rise at an annual rate of over 5 per cent.
- ♦ The elimination of capital subsidies, public spending on labour-intensive social infrastructure, positive real interest rates and the tariff reform program are all designed to ensure that new investment is channelled into more labour-intensive activities than in the past.

INFLATION, FINANCIAL MARKETS AND MONETARY POLICY

Inflation

After falling to 7,4 per cent in 1996 compared to 8,7 per cent in 1995 and 9 per cent in 1994, year-on-year CPI inflation increased to 8,6 per cent in 1997. Inflation for 1997 was below the GEAR forecast of 9,7 per cent in part because of the strength of the rand and high real interest rates.

Inflation peaked at 9,9 per cent in April 1997 before declining to 5,6 per cent in January 1998. The seasonally adjusted month-on-month annualised increase reached its highest level of 10 per cent in February 1997 but then fell quite sharply to 1 per cent and 3,1 per cent in November and December and 2 per cent in January 1998. The average month-on-month annualised rate for the year was 6,1 per cent, which confirms the underlying deceleration in inflation during 1997.

The initial acceleration of the inflation rate can be ascribed to the sharp real depreciation of the rand in 1996. The import component of the producer price index rose by 10,1 per cent in March 1997, leading to a PPI increase of 9,6 per cent for the same month. Producer price inflation then gradually declined to a 27-year low of 4,4 per cent in December and even further to 4 per cent in January 1998.

Since July 1997, consumer inflation has shown a downward trend. This can be ascribed in part to the appreciation of the real effective exchange rate during 1997, which saw imported PPI inflation dropping to a year-on-year low of 0,7 per cent in December 1997. Domestic developments have, however, also played their part. Wage settlements are increasingly related to productivity trends, thus contributing to increases in unit labour costs below inflation.

THE IMPACT OF LOWER INFLATION ON THE BUDGET

Falling inflation impacts on government spending and revenue. Government spending is presented in the budget in rand terms. If actual inflation falls below the budget forecast, real spending ends up higher than expected. Tax revenue, on the other hand, depends on nominal growth and will fall below budget if inflation is unexpectedly low. This has occurred during 1997/98. The combined effect of lower than expected inflation on spending and taxes resulted in a higher budget deficit relative to GDP.

For the 1998/99 and future budgets, Government has revised down the inflation projections relative to the projections published in the Medium Term Budget Policy Statement. This has resulted in an off-setting reduction in the nominal amounts set aside for wages and other inflation linked items. Because debt servicing costs are linked to nominal interest rates, lower inflation implies that the real cost of debt servicing has increased.

Inflation outlook

The inflation rate has remained within the 5-10 per cent band since 1993. This has contributed to a gradual convergence of inflation expectations to a level that presents a sound foundation for greater price stability. Inflation is expected to fall in excess of 2 percentage points in 1998 followed by further declines of ½ per cent per year in the outer years. GDP inflation is therefore projected at 6 per cent in 1998/99, 5½ per cent in 1999/00 and 5 per cent in 2000/01.

DOMESTIC INFLATION, CURRENCY DEPRECIATIONS AND GLOBAL INTEGRATION

Much of the increase in inflation during 1997 can be ascribed to the sharp depreciation of the exchange rate during 1996. Figure 2.14 shows the relationship between exchange rate movements and import prices. In spite of the fluctuations in the real exchange rate, import prices have been fairly stable from 1990 until early 1996. Neither the persistent real appreciation during the early 1990s nor the real depreciation during 1994 and 1995 caused import prices to increase in excess of between 5 and 10 per cent. Only the sharp depreciation of 1996 caused import prices to exit this band, indicating that real exchange rate movements need not have a dominant influence on import prices except when they are particularly severe.

Figure 2.14: Real exchange rate movements and import prices

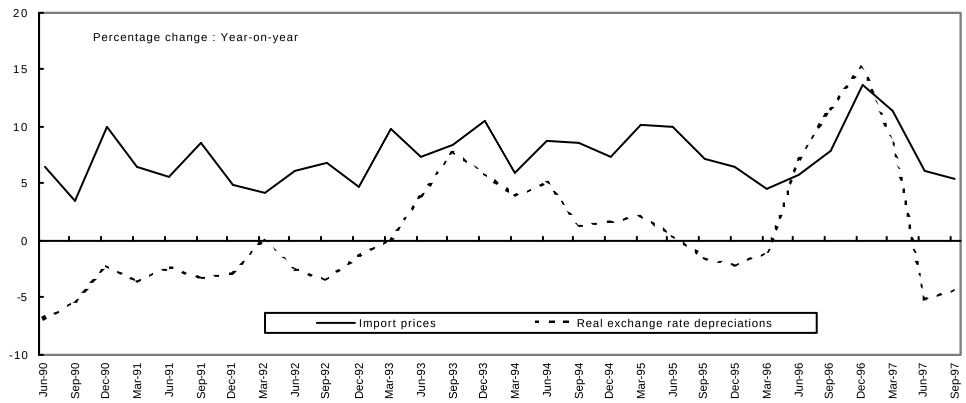
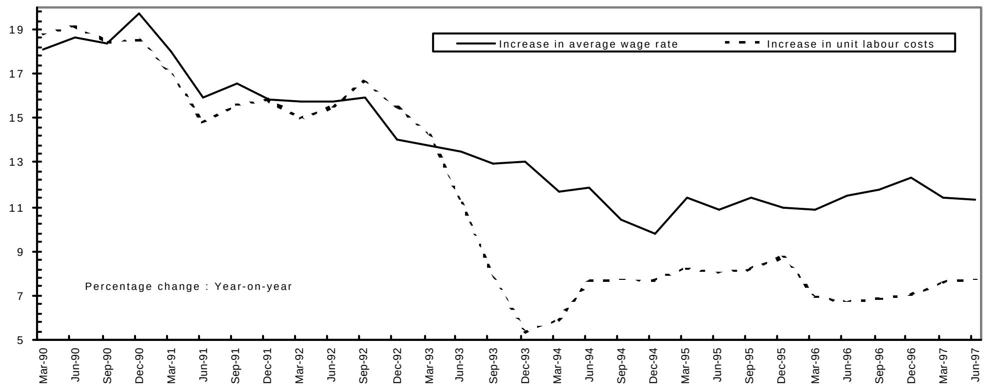


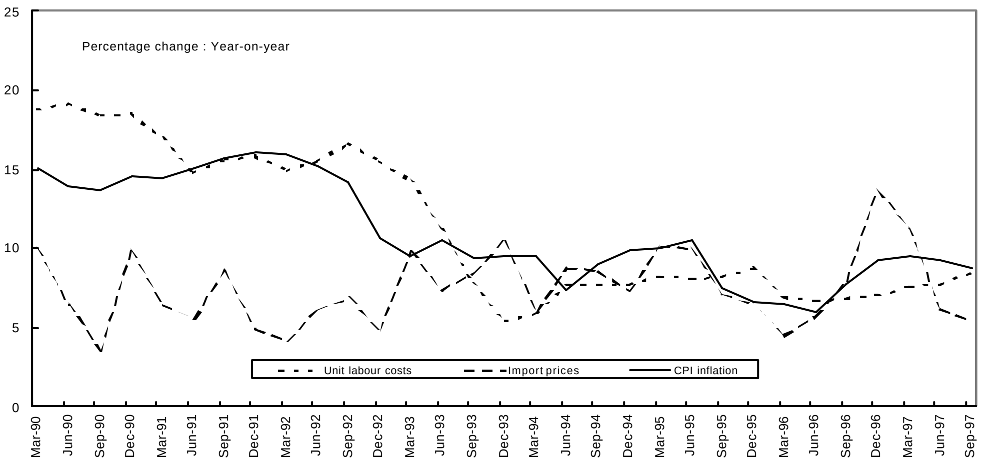
Figure 2.15 indicates that since 1993, productivity gains have compensated for nominal wage increases, resulting in a lower trend growth in unit labour costs.

Figure 2.15: Unit labour cost and inflation



The dynamics of unit labour costs and import prices have important implications for inflation. Up to 1993, CPI inflation follows unit labour costs closely. Domestic cost-push factors have, however, subsided significantly. This can be ascribed to the impact of tariff reform and increased openness of the South African economy, which are improving the productivity and competitiveness of South African businesses.

Figure 2.16: Inflation and its cost drivers

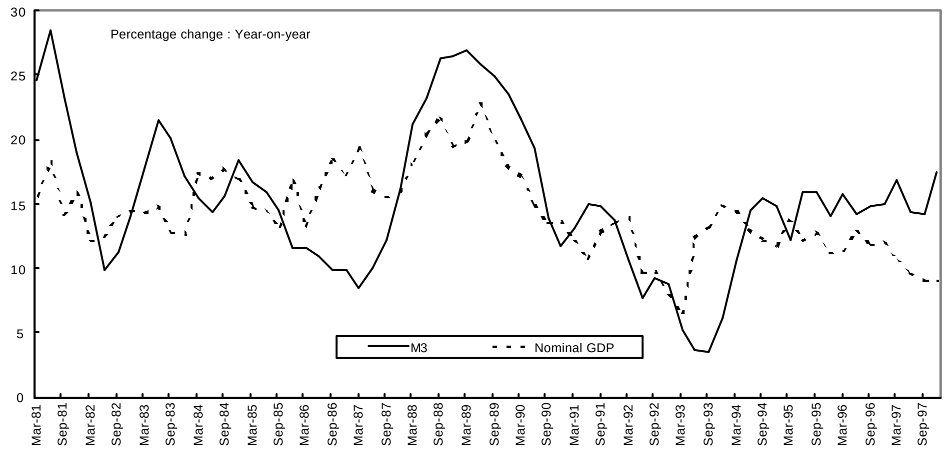


Money supply

M3 growth

The M3 money supply grew faster than nominal GDP in 1997, exceeding the South African Reserve Bank's guidelines from the fourth quarter of 1996 to the fourth quarter of 1997. Annualised growth of M3 from the base of the guideline year amounted to 17,4 per cent, exceeding the upper limit of the guideline range of 10 per cent. Year-on-year growth of nominal GDP amounted to 9,6 per cent while the twelve-month growth rate in M3 came to 17,2 per cent in December 1997. The primary contributor to the high money supply growth remained private sector credit extension, which increased at a twelve-month growth rate of 14,2 per cent in December 1997 before declining to 13 ,8 per cent in January 1998.

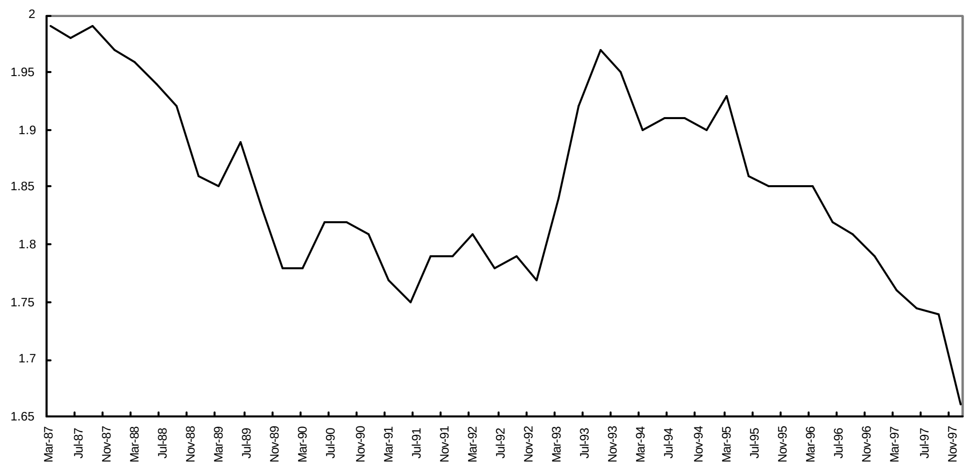
Figure 2.17: Growth in M3 and nominal GDP



Velocity of circulation

The excess growth of money over nominal GDP would raise concern over future inflation were it not for the fact that the relationship between money supply and inflation (which is called the velocity of circulation) has become unstable. Since 1994, money supply growth has consistently exceeded nominal GDP growth, which implies that the velocity of circulation of money has been declining. This trend can be attributed to financial deepening associated with capital mobility and financial/corporate restructuring.

Figure 2.18: Income velocity of circulation of M3



MONETARY POLICY TARGETS

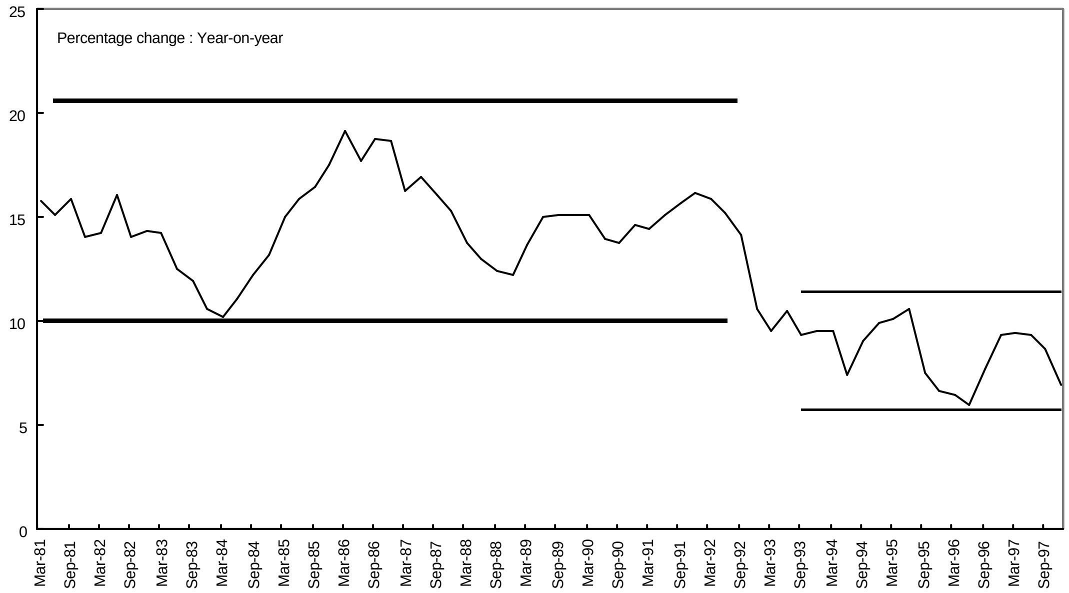
The South Africa Reserve Bank announces monetary guidelines to provide an indication of the direction of monetary policy. It is, however, recognised that changes in interest rates are determined by a consideration of a range of indicators, including excess money supply growth, credit growth, observed inflation, exchange rate developments, real GDP growth and conditions on the balance of payments. The relationship between monetary aggregates and inflation has proven to be rather unstable in South Africa. Since 1995 declining velocity has contributed to low inflation despite excess money supply growth.

Because of the range of determining factors and the absence of defined targets for each of them a lack of transparency is introduced in the process leading to a change in monetary policy. If the level of inflation cannot be accurately predicted by the change in the chosen intermediary variable (M3), which is correctly the case in South Africa, then the target level of inflation is not known, and the direction of monetary policy difficult to determine.

The Department of Finance and the Reserve Bank will continue to investigate the feasibility of establishing defined inflation targets as the focus of monetary policy. A stated inflation target would increase certainty and give greater direction to monetary policy as it would isolate any other considerations of policy makers and clearly define the relationship between changes in the policy instrument and the concerns causing it. The inflation target would be determined by government at a level or band that is achievable within a specified time period. This would enforce the independence of the Reserve Bank regarding the application of its policy instruments. The government would also have a criterion by which to measure the performance of the Reserve Bank and increase its accountability.

Crucial to successful inflation targeting is the ability of the authorities to accurately predict the inflation rate. The volatility of South Africa's inflation rate has been reduced and makes such an exercise more feasible. This increased stability, together with the weakening of the relationship between monetary aggregates and measured inflation, suggests that inflation targeting, in which the authorities forecast inflation and take actions to bring the forecast in line with the targets may have advantages over the present policy.

Figure 2.19: CPI Inflation



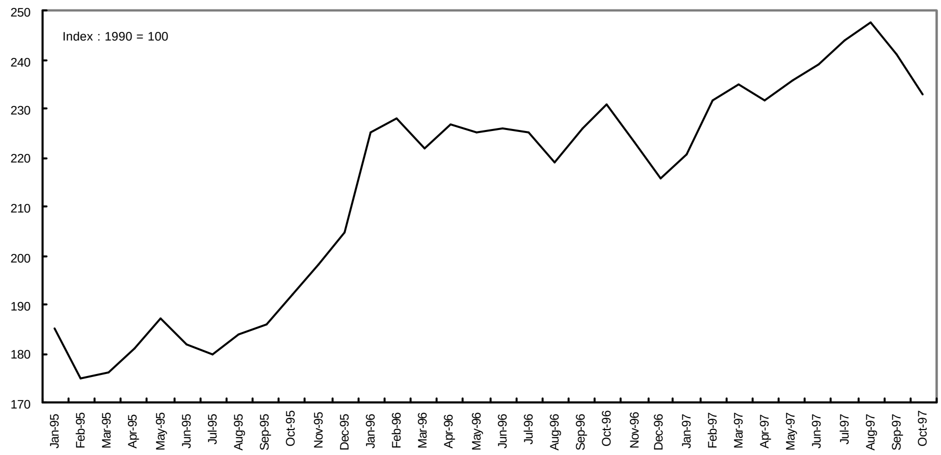
Financial markets

Bonds

South African bonds and equities were attractive investments in 1997, particularly for foreign investors. Non-residents' net purchases of bonds increased from R3,4 billion in 1996 to R14,8 billion in 1997. High real interest rates in the light of declining inflation as well as the perception of an undervalued rand saw substantial capital inflows into the bond market during 1997. The monthly average yields on long-term government stock declined from 16,2 per cent in December 1996 to 14,2 per cent in September 1997. Although rates increased in October in reaction to the turbulence in international financial markets, confidence was quick to return and the rate fluctuated downwards to 13,8 per cent on 31 December 1997. With an anticipated easing of monetary policy, bond yields continued to soften during early 1998.

The latter half of 1997 proved to be a turbulent period for equity investments with movements in share prices on the Johannesburg Stock Exchange responding to increased volatility in global stock markets.

Figure 2.20 : Price index of all classes of shares



Money market rates followed a similar pattern to long bond yields. The rate on three months banker's acceptances declined from 17 per cent in December 1996 to 14,9 per cent at the end of December 1997 and eased further to 14,5 per cent at the end of January 1998.

Money market

Money market conditions fluctuated widely during 1997. The substantial accumulation of net foreign assets by the Reserve Bank during the second quarter of 1997 caused the monthly average of the daily values of the money market shortage to decline from R10,6 billion in March to R6,3 billion in June 1997. While these conditions persisted throughout the third quarter, a drop in the net holdings of foreign reserves by the South African Reserve Bank and a sharp increase in notes and coins in circulation outside the Bank saw a tightening of money market conditions during the fourth quarter of 1997. The daily money market shortage peaked at R12,1 billion on 27 December 1997 before moving back to R10,2 billion on 31 December 1997. A renewed increase in net foreign reserves by the Reserve Bank as well as a decline in notes and coins in circulation outside the Reserve Bank saw a further easing of money market conditions to a shortage of R7,6 billion at the end of January 1998.

Monetary policy

Interest rates

Monetary policy has remained firmly counter-inflationary throughout 1997. While year-on-year inflation started coming down in August and the capital account reflected substantial inflows that caused money market rates to ease, the Bank rate was reduced from 17 per cent to 16 per cent only on 20 October 1997. This resulted in an average annual real Bank rate of around 8,3 per cent for 1997, which is substantially higher than the GEAR assumption of 5 per cent.

Forward book

The net oversold forward position of the Reserve Bank has narrowed significantly during 1997 from a level of US$ 22 billion at the end of 1996 to US$14,5 billion at the end of February 1998. Government and the Bank are determined to manage the open position down, thereby reducing the potential losses to the fiscus while encouraging growth of the private forward market.

NEW OPERATIONAL PROCEDURES OF THE RESERVE BANK

On 9 March 1998, the Reserve Bank changed the procedures for providing cash reserves to banks from a system of overnight loans against specified collateral to one of active liquidity management through regular repurchase transactions between the Reserve Bank and the banks.

Under the old system, the accommodation of the Reserve Bank was at the initiative of banks, driven by their need for liquidity. Because the Reserve Bank provided unlimited accommodation at Bank rate, this system provided no room for active liquidity management other than the infrequent adjustment of the Bank rate and an increased money market shortage. Under the new system, the SARB will dictate the amount of liquidity it is willing to supply and let the market settle around the respective interest rate. Repurchase transactions will now be the main apparatus to regulate liquidity. Banks will not obtain liquidity through overnight borrowing but by tendering on a daily basis for central bank funds through repurchase transactions.

The new system will allow interest rates to reflect market conditions, as banks have to compete for a given amount of liquidity. The repurchase rate (called the repo rate) represents the discount rate at which the SARB is willing to accept repurchase agreements with banks. To ensure an orderly introduction of the system, it was decided to initially keep the repo rate fixed. The Bank rate, on the other hand, will be the interest rate charged on liquidity obtained from the additional lending facility. This rate will always be at a premium to the repo rate.

LABOUR MARKET DEVELOPMENTS

Unemployment

The persistently high level of unemployment is one of the greatest challenges facing South Africa. The number of people without formal sector employment continues to rise as the number of work-seekers that enter the labour force each year exceeds the number of new formal sector employment opportunities. The preliminary 1996 census results suggest that the total population is currently 38 million, and that the demographic transition is well advanced. It now appears that the present generation aged 10-14 represents a demographic peak. The number of young people leaving secondary or tertiary education and entering the labour market each year has increased from perhaps 350 000 in the mid-1980s to around 450 000 today. As the throughput of the school system improves and the demographic peak moves into the labour market, new entrants to the labour market will rise to over 600 000 early in the next century. Without a turn-around in job creation, the existing mismatch between the demand and supply of entry-level jobs will continue to escalate.

Employment targets and performance

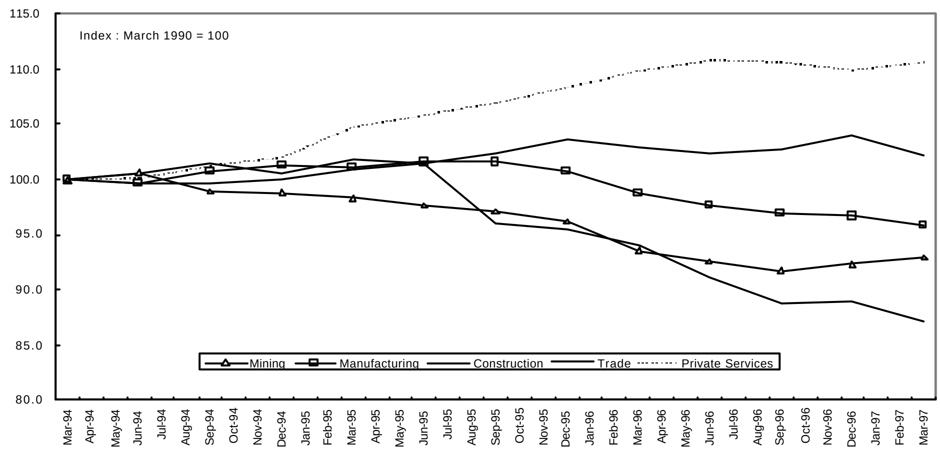
GEAR

The GEAR model projected employment creation rising from 126 000 to 400 000 over the period 1996 to 2000. Non-agricultural formal sector employment was projected to increase at between 1,3 per cent and 4 per cent a year, or to generate between 70 000 (1996) and 250 000 (2000) new non-agricultural formal sector jobs. Employment creation in agriculture and the non-formal sector, combined with increased government spending on labour based projects were projected to create between 60 000 (1996) and 150 000 (2000) new jobs.

Government

Employment creation outside of the non-agricultural formal sector can only be gauged from the October Household Surveys. Detailed information on non-formal and agricultural employment creation since 1995 will thus only be available when the results of the 1996 October Household Survey are published later this year. Preliminary estimates show that Government programs have generated 50 000 employment opportunities in 1996 and that this figure was even higher in 1997.

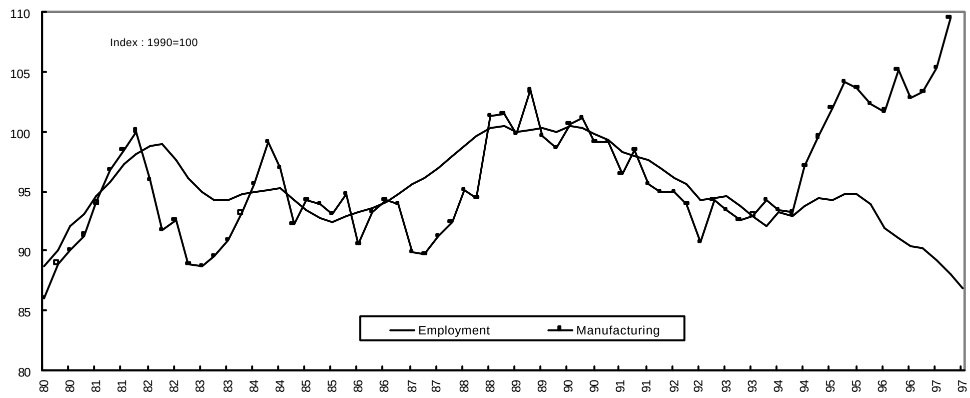
Figure 2.21: Employment trends



Formal sector

Non-agricultural formal sector employment has continued to decline. The average level of non-agricultural formal sector employment declined from 1989 to 1996 at an average annual rate of 1 per cent, indicating a cumulative net loss of about 390 000 formal sector jobs. Further declines in the annualised rates of 3,3 per cent in the first quarter of 1997, 2,4 per cent in the second quarter and 2,2 per cent in the third quarter indicate little change in the trend. The above figure shows that since 1994 the decline has been concentrated in three sectors: manufacturing, construction and mining.

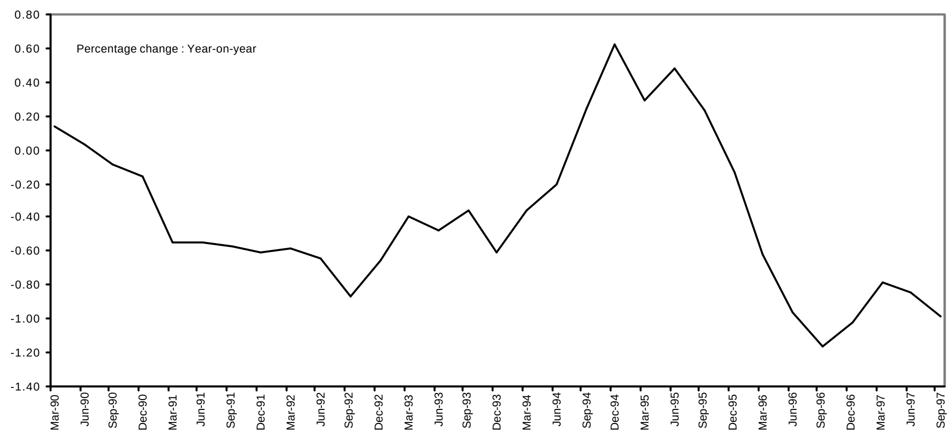
Figure 2.22: Manufacturing output and employment



Manufacturing

The contraction in manufacturing employment is of great concern. Figure 2.22 shows that there has been a dramatic change in the relationship between manufacturing output and employment since 1994. Whereas firms have steadily increased the level of output, employment has declined. Much of this can be explained by the changing composition of manufacturing and the impact of restructuring as firms realign themselves to take advantage of growing export opportunities. The rate of change in manufacturing employment is expected to recover during 1998.

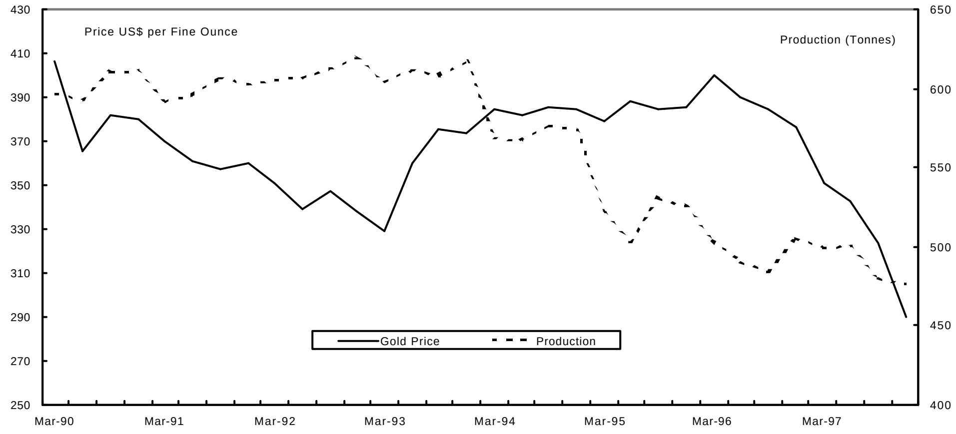
Figure 2.23: Employment growth in manufacturing



Mining

Adjustments in parts of the mining industry are a major contributing factor to the overall decline in employment. The impact of the gold price on gold production and thus employment will continue to affect overall employment growth in 1998.

Figure 2.24: Gold price and production



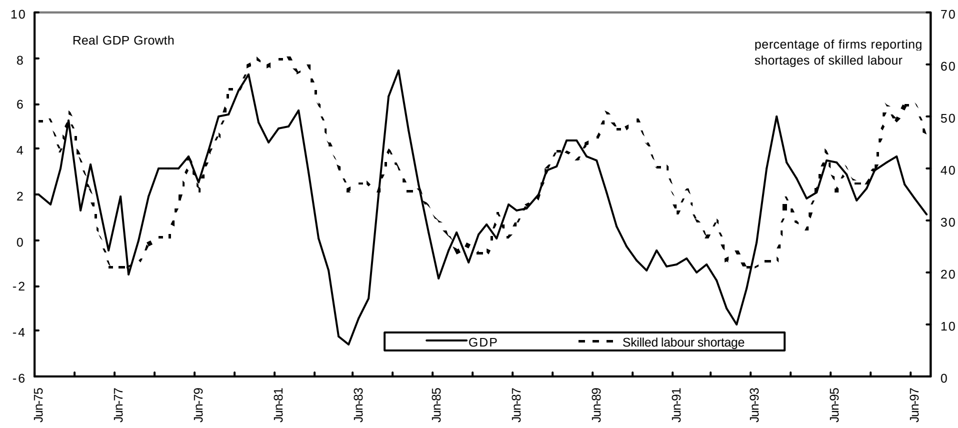
Construction

The decline in measured employment in the construction industry can in part be attributed to the growing use of contract labour and sub-contractors within the sector. This would result in a decline in the level of formal employment recorded, but may not reflect an actual drop in the number of people working.

Between the second quarter of 1994 and the first quarter of 1997 Government created approximately 45 000 new formal sector jobs. Employment in public business enterprises declined by around 5 000.

Labour Supply

Figure 2.25: Skilled labour shortage



South Africa suffers from an abundance of unskilled labour and periodic shortages of skilled labour. In periods of rapid GDP growth the demand for skilled labour rises sharply, and can at times act as a constraint to growth. Whereas skilled labour shortages were a growing concern during 1996, the current slowdown should moderate excess demand. The long-term trend in net emigration, however, continues to act as a drain on the supply of skilled labour.

Wage formation

Wages and inflation

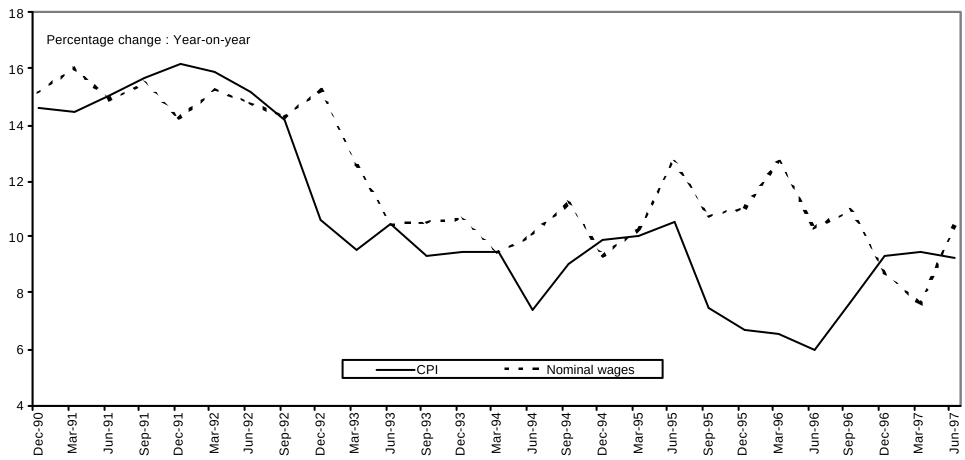
Wage behaviour in South Africa is more strongly influenced by the trend in inflation than underlying demand or supply conditions within the labour market. Nominal wages generally follow the CPI trend with a lag of six months. In the period since 1994, however, nominal wages per worker have typically risen faster than inflation. Nominal wages per worker in the non-agricultural formal sector accelerated slightly from 9,4 per cent in 1995 to 10 per cent in 1996. Nominal wages growth continued to accelerate from a year-on-year change of 8,4 per cent in the fourth quarter of 1996 to 10,9 per cent in the second quarter of 1997 and 9,3 per cent in the third quarter.

As inflation declines, annual wage adjustments are expected to follow productivity trends more closely, contributing to an easing of inflation pressures.

Prospects

Nominal wage increases should decline modestly during 1998, as inflation continues to decline and firms seek to reduce costs in response to cheaper imports and lower export prices. With inflation on a downward trend, real wage settlements in excess of productivity growth will undermine future gains in employment.

Figure 2.26 : Nominal wages and inflation



Unit labour costs and productivity

Productivity growth in South Africa declined from an average of 1,5 per cent a year in the late 1970s to less than 1 per cent during the 1980s. Between 1991 and 1995 it increased by an average of 2 per cent a year, in 1996 it increased at an average annual rate of 3,0 per cent, and at an annual rate of 4,1 per cent in the third quarter of 1997. Productivity growth has also been boosted by a reduction in the number of days lost through industrial action, following the implementation of the Labour Relations Act.

The rate of increase in nominal unit labour costs has been declining steadily since 1993. The decline in unit labour costs from 17,2 per cent in 1990 to 5,9 per cent in 1995 made an important contribution to the slowdown in consumer price inflation. More recently nominal wage growth has outpaced productivity growth: the rate of increase in nominal unit labour cost at first accelerated from 5,9 per cent in 1995 to 6,8 per cent in 1996 and to a year-on-year increase of 7,3 per cent in the second quarter of 1997, but then slowed to 5,1 per cent in the third quarter.

Outlook and policy response

Real wage increases in line with productivity growth will continue to contribute to declining inflation. A recovery in employment levels will however depend on nominal wage settlements adjusting to the lower inflation environment. With producer prices rising at below 4 per cent, nominal wages will need to adjust further if job losses are to be avoided. Further employment declines may also occur within mining as a result of the lower gold price. Manufacturing employment should, however, recover and strengthen during the next three years.

The revised demographic trends must lead to an even greater focus on employment creation within the strategy elaborated in GEAR, which encourages, the creation of a fast-growing, outward orientated economy. Government is also committed to increasing the labour intensity of Government programs, and the extension of direct employment creation initiatives.

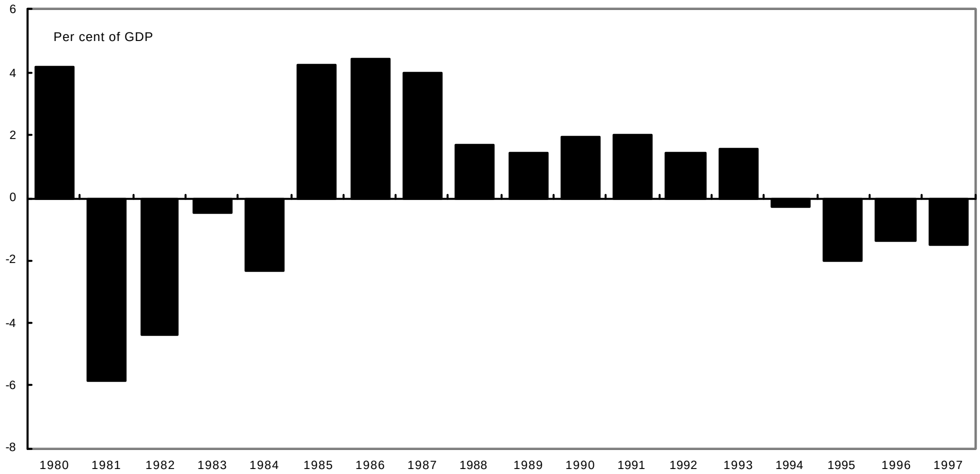
The Presidential Jobs Summit to be held during 1998 will focus attention on further policy reforms. Government will table a framework document at NEDLAC on an approach to enhance employment creation for discussion ahead of the summit.

BALANCE OF PAYMENTS

Current account

The current account balance recorded its fourth consecutive deficit, amounting to R8,8 billion in 1997, compared to R7,3 billion, R9,9 billion and R1,2 billion in 1996, 1995 and 1994 respectively. Nominal merchandise exports grew by 23,5 per cent in 1996 and a further 12,5 per cent in 1997. This performance exceeded the GEAR projections so that the current account deficit of 1,5 per cent of GDP in 1997 came in below the GEAR forecast of 2 per cent.

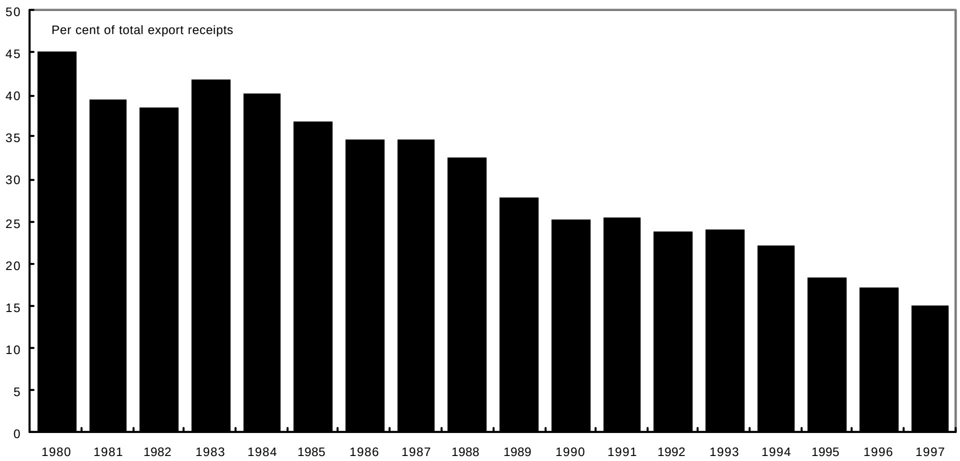
Figure 2.27: Current account balance



Gold

Despite a moderate increase in net export volumes, the value of net gold exports declined from R26,3 billion in 1996 to R25,8 billion in 1997. This was the result of the drop in the average gold price from US$ 388 per fine ounce in 1996 to US$ 331 per fine ounce in 1997. Although gold receipts still contribute revenue in excess of R25 billion to the current account, their share in total export earnings has fallen steadily since 1983.

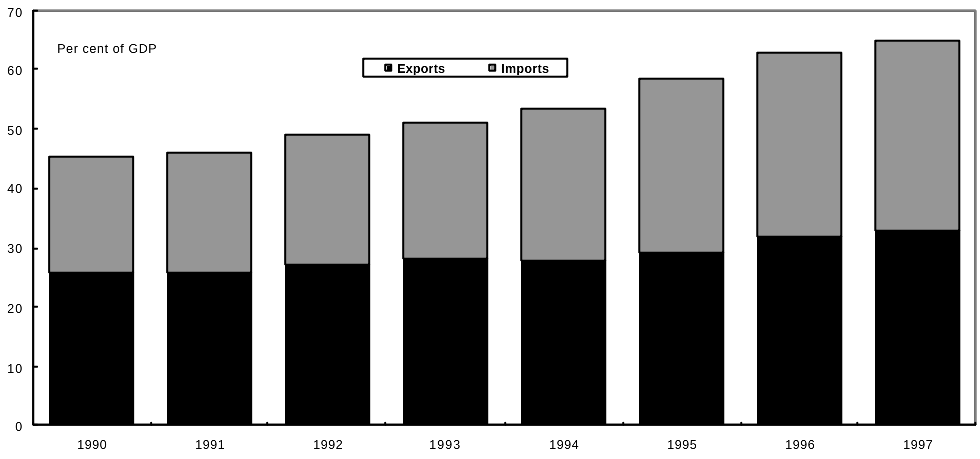
Figure 2.28: Gold as a share of total export receipts



Openness

To raise the country's export growth potential, the GEAR strategy aims to increase South Africa's global competitiveness through, among other things, a reduction in tariffs. Figure 2.29 confirms that increased global integration has contributed to a sizeable increase in trade. Total trade as a share of GDP increased from 45 per cent in 1990 to almost 65 per cent in 1997.

Figure 2.29: Exports and imports



Capital movements and reserves

1997 saw a turnaround in the participation of non-residents on South Africa’s financial markets. This is demonstrated by the sharp appreciation of the rand in the first half and the renewed decline in bond yields after the October stock exchange fluctuations. While net capital inflows not related to reserves amounted to R2,7 billion in 1996, they surged to R16,8 billion in the first half of 1997. Two successful government bond issues in the international capital markets, as well as the sale of a share of Telkom to non-resident investors, also contributed to this capital inflow. In spite of the Asian crisis and its negative effects on confidence in emerging financial markets, net capital inflows increased from R 1,6 billion in the third quarter to R1,9 billion in the fourth. A sound fiscal and financial framework, together with declining inflation and real positive returns on investments, contributed to South Africa’s relative exchange rate stability during a period of considerable international turbulence.

As a result of the substantial net capital inflow, the country’s gross gold and foreign reserves increased by R19,8 billion during 1997 to a level of R36,6 billion at the end of 1997. This is equivalent to the value of about 10 weeks of imports of goods and services.

Outlook

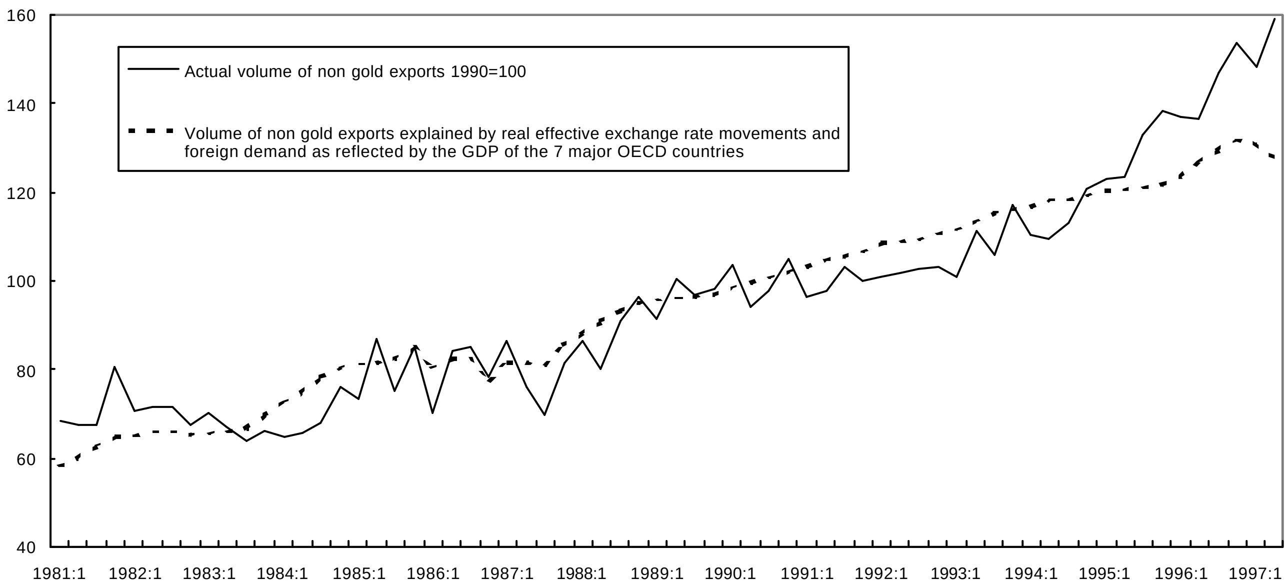
The current account is expected to deteriorate during 1998 as a result of the revival in domestic demand and a depressed gold price. However, continued growth in non-gold exports should confine the deficit to between 1½ and 2 per cent of GDP.

Prospects for capital inflow during 1998 are promising. A sharply falling inflation rate and the likely loosening of monetary policy provide attractive opportunities for bond investors, while the revival of domestic economic growth should see positive sentiments return to the Johannesburg Stock Exchange. The stability of the rand in the light of a substantial depreciation of other emerging market currencies will further enhance South Africa's standing amongst international investors.

EXPORT GROWTH AND OUTWARD ORIENTATION

The improvement in export growth experienced by the South African economy since 1994 can be ascribed to a number of factors including the integration of the South African economy into the global community and the resulting normalisation of relations with trading partners. Buoyant growth in South Africa's major trading partners, together with a competitive exchange rate, further contributed to increased demand for South African goods and services. There has also been greater market penetration by South African businesses. Improved export penetration and exploitation of new markets permit South African exports to grow faster than the world economy. Indeed, South African exports have grown faster since 1995 than can be explained by growth of overseas demand and exchange rate movements.

Figure 2.30: Non-gold export penetration



EXCHANGE RATE DEVELOPMENTS

Currency markets in 1997 were characterised by sharp depreciations of some of the Asian emerging market currencies as well as a strong US dollar. In spite of the global turbulence experienced on stock exchanges and currency markets, the South African currency proved not only to be relatively stable, but its real external value increased relative to 1996.

Nominal effective rate In the first three months of 1997, the nominal effective exchange rate appreciated by 8,7 per cent from its December 1996 level. Because of the sharp depreciation in the later half of 1996, this appreciation still implied a depreciation of 9,4 per cent relative to the March 1996 level. In the remaining months of 1997, the nominal effective exchange rate gradually depreciated to a December 1997 level that was 0,7 per cent lower than the December 1996 level. This resulted in an average effective nominal depreciation for 1997 of 5,4 per cent.

Real effective rate The real effective exchange rate appreciated by 11,2 per cent from December 1996 to April 1997. Compared to April 1996, this implied a 4,6 per cent appreciation. Similar to the nominal rate, a gradual depreciation occurred for the remaining months of 1997. Nevertheless, the real effective exchange rate appreciated on average by approximately 1 per cent in 1997.

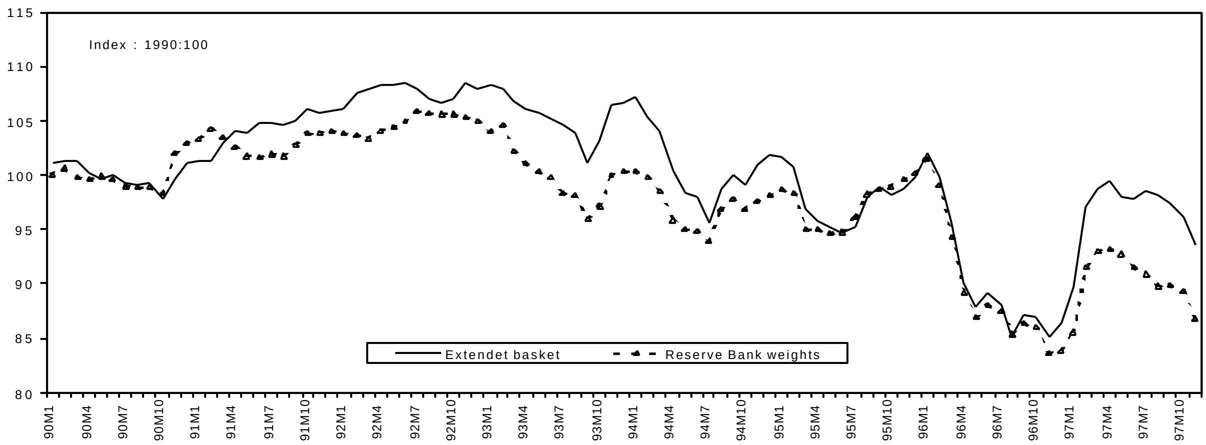
THE REAL EFFECTIVE EXCHANGE RATE AND SOUTH AFRICA'S PRICE COMPETITIVENESS

Productivity increases and the reduction in unit labour costs have contributed to an improvement in the competitiveness of the South Africa economy. The performance of the effective exchange rate, however, plays an important supplementary role in overall competitiveness.

The effective exchange rate as reported by the SARB is a weighted average on the basis of relative trade with South Africa's major trading partners namely the US, the UK, Germany and Japan. This measure does not take into account trade and exchange rate movements of minor trading partners such as other European or Asian countries.

Exports to Asia excluding Japan amount to 13,5 per cent of total export receipts. The sharp real depreciation experienced by these countries implies that South Africa's price competitiveness has been more negatively affected than indicated by the published effective exchange rate series. Figure 2.31 shows this effective rate as well as an alternative real effective exchange rate and highlights that utilising one particular measure of competitiveness can be misleading.

Figure 2.31: Measures of the real effective exchange rate



SARB weights: US (51.7), UK (20,2), Germany (17.2), Japan (10.9)

Alternative weights: Germany (20.78), US (14.81), Japan (14.49), UK (11.55), Italy (8.58), France (6.57), Belgium (4.09), Netherlands (3.40), Switzerland (3.26), Canada (2.31), Hong Kong (2.25), Spain (1.81), Brazil (1.59), Australia (1.47), Others (3.04)

MEDIUM TERM ECONOMIC OUTLOOK

International developments

The turbulence in financial markets, which began in Thailand during mid-1997, eventually spread throughout South-East Asia, Japan and Korea. Banking difficulties, exacerbated by high indebtedness and falling equity prices, aggravated the financial turmoil in this region. The sharp depreciation of the currencies in South-East Asia has important implications for the more mature and healthy economies of the world. Imports from this region have become significantly more price competitive, while the slowdown in regional economic growth dampens the regions demand for international exports. Growing international market integration and the resulting risks of spillover effects on other economic regions have left very few of the major trading countries unexposed.

Uncertainty remains over the exact impact the Asian events will have on global and country specific growth. As a result, there are substantial risks to international and domestic economic forecasts. Growth in major industrial economies is expected at 3 per cent for 1998, followed by 2½ per cent in 1999 and 3 per cent in 2000. However, growth in many of the world’s leading economies could be cut by a full percentage point as a result of the Asian events.

Domestic outlook

Demand

The growth rate in aggregate real gross domestic expenditure is expected to gain significant momentum during 1998 and to show a consistent acceleration from this level throughout the remaining forecast period. A slight improvement in real private consumption expenditure is anticipated for 1998. Consumer sentiment should, however, improve considerably in 1999 and beyond as the prospects for lower inflation, a reversal of the trend in real house prices, increased employment levels and a reduction in domestic interest rates begin to lend support to the recovery phase in consumption expenditure.

Investment

The recent completion of large investment projects induced a consolidation phase for gross domestic fixed investment expenditure in 1997 and 1998. However, a recovery is anticipated in the outer years as public sector investment spending accelerates in accordance with Government’s commitment to the achievement of social welfare and development objectives as outlined by the RDP. In addition, prospects for the expansion of production capacity by private manufacturing look promising not least because of tax incentives and benefits accruing from proposals laid out in Government’s Manufacturing Development Programme. This scheme is specifically aimed at promoting exports and investment spending in the manufacturing sector. The imminent reduction in domestic interest rates and the need to maintain international competitiveness is also likely to bolster capital expenditure over the following three years.

	Revised 1997/98	Forecast 1998/99	Forecast 1999/00	Forecast 2000/01
GDP (R billion)	613	669	734	810
Real GDP growth	1½	3	4	5
GDP inflation	8½	6	5½	5
CPI inflation	8	5½	5½	5

Output

Growth in real GDP is expected to gain momentum in 1998/99 and increase by 2½ to 3 per cent with further acceleration over the following two years on account of continued and accelerated export growth as well as strong private investment growth. Production levels in the manufacturing sector are set to improve further due to the increased price competitiveness of domestic manufacturers and continued export market penetration.

Balance of payments

A resurgence of domestic economic activity will result in cyclical upswings in merchandise imports over the following three years. The combined impact of higher import values and an anticipated lower gold price will detract from the expected strong growth in non-gold export earnings. Nevertheless, the deficit on the current account of the balance of payments is expected to remain below levels of expected net capital inflows. Attractive yields and lower financial risk relative to other emerging markets should see a continued improvement in the level of the country’s gold and foreign exchange reserves.

Inflation

The average inflation rate is set to fall by more than 2 percentage points during 1998 and prospects for a further decline over the remaining two years are also promising. The government’s commitment to sound fiscal management, increased labour productivity and the gradual convergence of actual and expected inflation are the primary attributes supporting this positive outlook.