

Annual Economic Report 1981

A review of economic and financial conditions in the Republic of South Africa presented as background to the Chairman's Address to Stockholders at the Sixty-First Ordinary General Meeting to be held on 25 August 1981.

South African Reserve Bank

Hierdie Verslag is ook in Afrikaans beskikbaar.

Contents

Summary of main economic developments	5
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National accounts	7
Cyclical upswing of 1978-80	7
Lower rate of economic growth in first half of 1981	7
Sustained high level of gross domestic expenditure	8
Real private consumption expenditure	9
Real government consumption expenditure	9
Real gross domestic fixed investment	10
Real inventories	10
Decline in gross domestic saving in first half of 1981	11

Employment and prices	13
Virtually full employment of skilled and semi-skilled labour	13
Lower rate of increase in labour productivity and higher unit labour costs	13
Continued high rate of inflation	14

Balance of payments	17
Deficit on current account	17
Marked decline in net gold output	17
Appreciably lower merchandise exports	18
Substantial increase in imports	18
Sustained rise in net service and transfer payments	18
Net inflow of foreign capital	19
Sharp fall in net gold and other foreign reserves	19
Foreign exchange market	20

Money and banking	21
High rates of growth in monetary aggregates	21
Causes of changes in M2	22
Exceptionally sharp rise in bank credit to the private sector	22
Considerable decline in excess bank liquidity	23
Marked change in money market conditions	24
Rapid rise in short-term interest rates	25
Open-market operations	26

Government finance	27
The fiscal year 1980/81	27
Developments in the first quarter of the 1981/82 fiscal year	29
The 1981/82 Budget	29

Capital market	31
Decline in the general availability of funds	31
Smaller increase in holdings of longer-term funds with non-contractual savings institutions	31
Fixed-interest security market	31
Share market	32
Mortgage and real estate markets	33

Summary of main economic developments

In the course of 1980 and the first half of 1981 important economic and financial changes occurred in the South African economy. Following a period of rapid economic expansion during 1980, physical constraints in the form of scarcities of skilled labour and certain production inputs, and the almost full utilisation of production capacity, caused economic growth to moderate from the beginning of 1981. After rising by about 8 per cent in 1980, the real gross domestic product was nevertheless still about 4½ per cent higher in the first half of 1981 than in the corresponding period of 1980. This represented a most satisfactory growth performance from an already high base.

Aggregate monetary demand increased strongly during 1980 and, as the slack in the economy was taken up, began to exert upward pressure on costs and prices and to contribute to the emergence of a deficit on the current account of the balance of payments. This state of demand inflation continued into 1981, even though the growth in monetary demand tended to show a welcome levelling off in the first half of 1981.

Strains in the labour market, caused by virtually full employment of skilled and semi-skilled labour, were reflected from the end of 1980 in a further decline in unemployment, a relative increase in overtime worked, a higher labour turnover and a rise in unit labour costs. Upward pressure on prices was evident in the persistently high level of the rate of inflation - as reflected in an increase of 14,5 per cent in the consumer price index between June 1980 and June 1981 - despite lower rates of increase in food prices, government-administered prices and prices of imported goods in the first half of 1981.

The current account of the balance of payments showed a deficit of about R3 000 million (at a seasonally adjusted annual rate) in the first half of 1981, after a succession of current account surpluses in the preceding four calendar years. The most important cause of this change was a sharp decline in the price of gold from October 1980, which greatly reduced the value of the net gold output. In addition, imports increased further in response to the cyclically high level of domestic demand at a time when exports were being adversely affected by recessionary conditions in most of the main industrial countries. Although there was a net inflow of capital in the second quarter of 1981, the overall balance of payments was in moderate deficit in the first half of the year. In these circumstances, the net gold and other foreign reserves declined, while the rand, like most other currencies, depreciated sharply against the strongly rising United States dollar.

Conditions in most financial markets tightened noticeably from about the fourth quarter of 1980. This change was reflected in a substantially larger recourse to bank credit as a source of funds and, in the second quarter of 1981, also in a net inflow of foreign capital. The increase in credit extended by the monetary banking sector to the private sector

exerted a strong expansionary influence on the money supply. This increase had been made possible by the expansion of the banks' liquidity base during 1980 as a result largely of the then prevailing balance of payments surplus. For these and other reasons, the monetary aggregates increased at excessive rates during the second half of 1980 and the first four months of 1981, before slowing down noticeably during May and June as the Reserve Bank's restrictive monetary policy increasingly took effect.

While the marked increase in bank credit since September 1980 was directly related to the strong cyclical demand for funds, it also reflected the "re-intermediation" of credit which had previously been extended outside the banking system. "Re-intermediation" was initially fostered by the abolition of the ceilings on bank credit to the private sector on 1 September 1980, and was further encouraged by the decline in the general availability of funds and the resulting increase in interest rates on bankers' acceptances, trade bills and similar money market paper, which narrowed the margin between these rates and the banks' overdraft rates. The banks' large-scale credit extension to the private sector resulted in a substantial increase in required liquid assets from September 1980 and a considerable reduction in their excess liquidity during the first half of 1981.

The strong expansionary influence on the money supply of the increase in bank credit to the private sector was both underpinned and supplemented during the third quarter of 1980 by a sharp rise in the net gold and other foreign reserves. From the fourth quarter of 1980, however, these reserves declined markedly and exerted a contractionary influence on the money supply and bank liquidity. A decline in the monetary banking sector's net claims on the government sector and an increase in the private non-banking sector's long-term deposits with monetary banking institutions made negative contributions to the growth in the money supply during the second half of 1980 and the first half of 1981.

The decline in the monetary banking sector's net claims on the government sector largely reflected a substantial increase in the revenue receipts of the Central Government, which were augmented up to the first quarter of 1981 by the high price of gold and, more generally, by the buoyant economic conditions. It is expected, however, that the sharp decline in the price of gold since October 1980 and a further increase in production costs in the mining industry will substantially reduce government revenue from gold mining during the 1981/82 fiscal year.

The change in the general availability of funds was clearly reflected in the financial markets. Since the fourth quarter of 1980 the various short-term financial markets have remained generally tight and have only infrequently experienced short periods of relative ease. This tightening of market conditions was accompanied by a rapid rise in short-term interest rates from the end of October 1980. In the capital

market, long-term interest rates also started to increase sharply from the last quarter of 1980. At the same time, the share, mortgage and real estate markets were beginning to lose some of their buoyancy of the preceding two years. In the fixed-interest security market, investors' expectations of further increases in long-term interest rates, which had inhibited investment in long-term fixed-interest securities from early 1980, to a large extent abated towards the middle of May 1981, after interest rates had risen to realistic market-related levels, and a climate more conducive to investment in fixed-interest securities came into being.

Although the increase in the money supply during the fourth quarter of 1980 and the first half of 1981 was artificially inflated by the substitution of bank credit for other forms of credit which had previously been obtained outside the banking system, it nevertheless remained excessive by all standards. Reducing the high rate of growth in the money supply, therefore, became one of the main proximate objectives of monetary policy, with the more basic aim of curbing demand inflation and maintaining a sound balance of payments. Owing to the strong monetary expansion caused by the increase in bank credit to the private sector, monetary policy has included measures specifically directed at slowing down the rise in bank credit to the private sector by means of restricting the growth of bank liquidity. Inevitably this policy has resulted in rising interest rates.

In accordance with these monetary policy objectives, Bank rate was raised in four steps from 7 per cent at the beginning of February 1981 to 12½ per cent in July. These increases were made in recognition of the sharp rise in short-term interest rates, and were accompanied by an increase in the commercial banks' prime overdraft rate from 10 to 16 per cent. In order not to increase bank liquidity, accommodation provided by the Reserve Bank through its discount window during the first seven months of 1981 was largely restricted to the alleviation of seasonal shortages of cash in the money market. Only occasionally were the banks provided with cash reserves through the rediscounting of non-liquid money market paper. Accommodation was provided mostly at penalty rates so as to discourage as far as possible recourse to the Bank as lender of last resort.

Short-term capital movements which could contribute to an increase in bank liquidity and the money supply, were discouraged by the Reserve Bank from the fourth quarter of 1980 by the fixing of forward foreign exchange rates in such a way as to make the domestic financing of foreign trade marginally more attractive than foreign financing. Only at the end of July did the Bank begin to provide some encouragement to foreign financing of trade by quoting more attractive forward discounts on US dollars. Open-market operations by the Reserve Bank during the first seven months of 1981 served mostly to iron out seasonal shortages of funds in the money

market. However, during June and July the Bank also sold long-term government stock in the open market, and in this way exerted a contractionary influence on the money supply.

National accounts*

Cyclical upswing of 1978-80

At the end of 1980 the economy had been in a period of cyclical upswing for about three years, one of the longest upswings in South Africa since the end of the Second World War. Following a period of strong economic expansion from the middle of 1979, important production resources, such as skilled labour and production capacity in manufacturing, became almost fully employed towards the end of 1980 and could no longer sustain an economic growth rate as high as that recorded in 1980. Largely as a result of these physical constraints, the economy grew at a lower rate from the beginning of 1981.

The course of the economic expansion from the end of 1977 differed significantly from the average pattern of the four preceding cyclical upswings during the nineteen-sixties and early nineteen-seventies. Firstly, the initial recovery up to the middle of 1979 was much slower than during the preceding cycles. The economy emerged from a protracted period of severe recession with a high rate of inflation and comparatively high personal income tax rates eroding consumers' real spending power, and with production capacity substantially in excess of the requirements of prevailing demand. Economic growth during this period was generated mainly by increased exports and by the effect of a higher gold price on incomes and expenditure. Secondly, once the upswing had gained momentum, it proceeded at a pace during

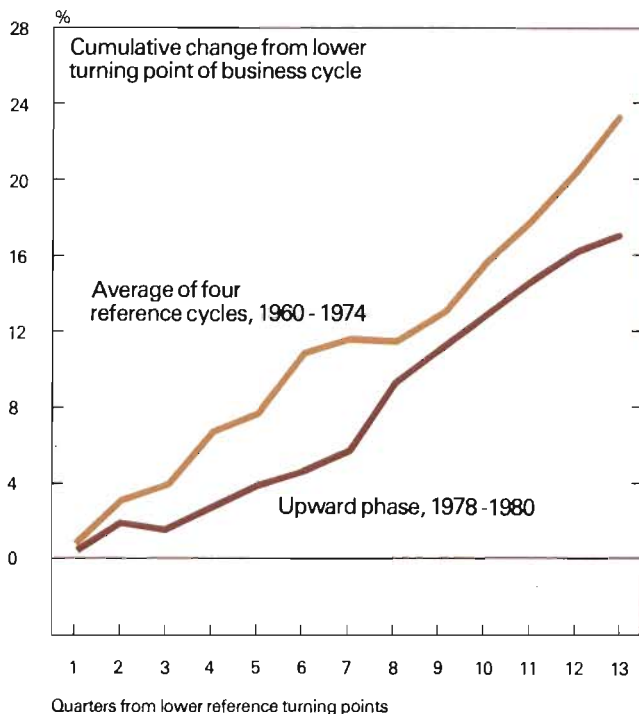
1980 that was unmatched during any one year in the preceding four periods of cyclical upswing. Apart from a continuing high level of exports and a high average price of gold in 1980, consumer expenditure showed a sharp upward trend from the middle of 1979 owing to substantial increases in personal incomes, the ready availability of consumer credit, loan levy repayments and extensive tax concessions to individuals. Furthermore, increased production to satisfy the demand for exports, consumer goods and inventories caused a decline in surplus production capacity and encouraged new fixed investment.

Despite the rapid economic expansion from the middle of 1979, the rate of growth during the period 1978 to 1980 as a whole (as measured by the increase in the real gross domestic product of the non-agricultural sectors of the economy) was lower than the average for the upswings during the four preceding cycles. As shown in the accompanying graph, the cumulative growth during the first twelve quarters that followed the lower turning point of the cycle, still lagged behind the average for the chosen reference cycles.

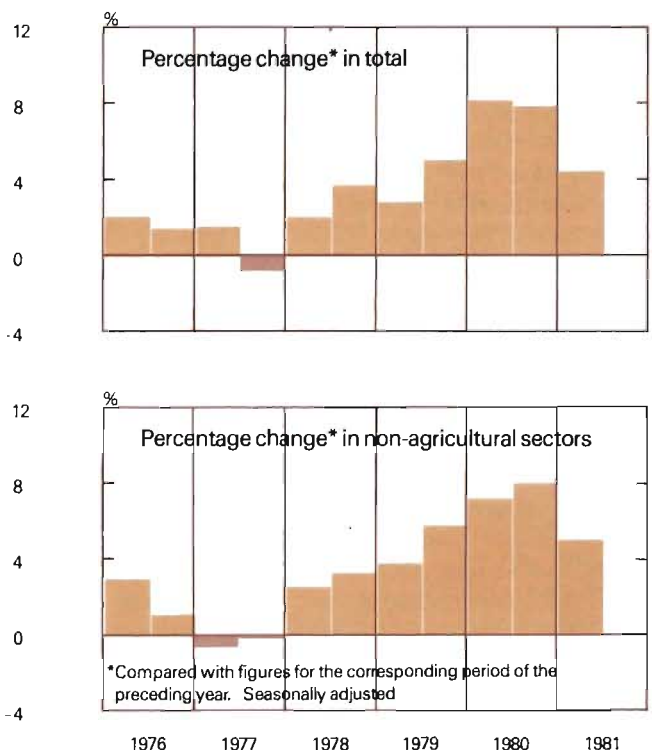
Lower rate of economic growth in first half of 1981

Following an increase of about 8 per cent in 1980, the rate of growth in the real gross domestic product decelerated from the second half of 1980 to the first half of 1981, but the product was still 4½ per cent

Real gross domestic product of non-agricultural sectors



Real gross domestic product



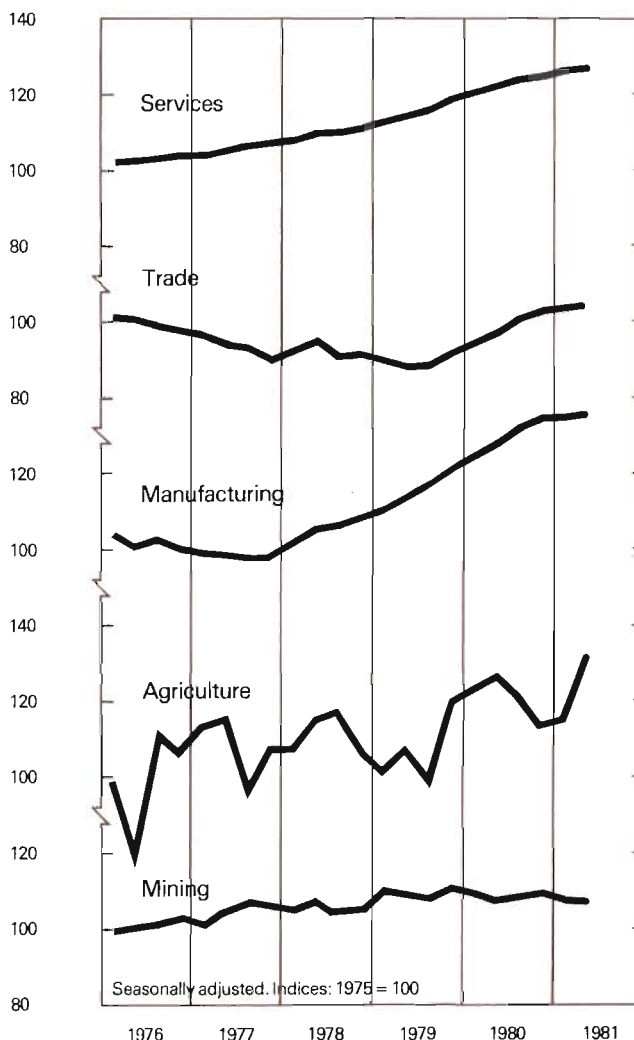
*Quarterly and half-yearly changes are based on seasonally adjusted data.

higher than in the first half of 1980. This slow-down occurred in most sectors of the economy, but was most prominent in manufacturing and commerce. The real value added by manufacturing was to an important extent affected by the high level of utilisation of production capacity, which had risen to about 90 per cent by the end of 1980. Despite virtually no further increase from the second half of 1980 to the first half of 1981, the real product of manufacturing and commerce was still considerably higher in the latter period than in the first half of 1980. The real value added by the gold mining sector continued to decline in the first half of 1981 and the fall in the price of gold from the last quarter of 1980 had apparently not yet resulted in the mining of higher grade ore. The real product of the non-gold mining sector was also lower in the first half of 1981 than in the second half of 1980 as a result of a decline in the foreign demand for metals and minerals. Only in agriculture did the real product increase at a higher rate in the first half of 1981 than in the preceding six months. The acceleration was more pronounced in the second quarter after the harvesting of record summer crops had commenced.

Although real agricultural output is expected to remain at a high level in the second half of 1981, the overall rate of economic growth is unlikely to accelerate during this period. Apart from the effects of the physical constraints referred to above, the rate of increase in monetary demand, which still remained abnormally high during the first half of 1981, is expected to decline during the second half under the impact of the decline in the value of the net gold output and merchandise exports and a lower rate of increase in consumption and investment. A real rate of economic growth of between 4 and 5 per cent is therefore expected in 1981 as a whole.

In contrast with 1980, South Africa's terms of trade deteriorated during the first half of 1981, mainly as a result of the sharp decline in the price of gold. This caused the real gross national product to be only marginally higher in the first half of 1981 than

Real gross domestic product by sector



in the first half of last year. In 1980 the real gross national product rose by no less than 9½ per cent, indicating a considerable increase in the overall real prosperity of South African residents during this period.

Real gross domestic and national product

Percentage change¹⁾

	1979	1980	1981 ²⁾
Agriculture	-2½	13	1
Mining.....	3½	-1	-1½
Manufacturing	9½	12½	7
Construction	3	8½	6½
Electricity, etc.....	1	11	11½
Commerce.....	-3½	11	8½
Services.....	4	5	4
Gross domestic product.....	4	8	4½
Gross national product.....	5½	9½	2

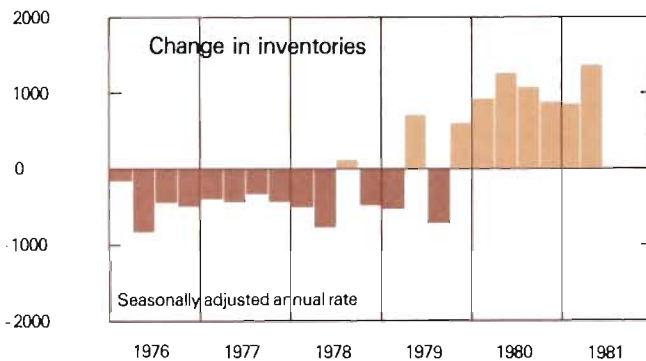
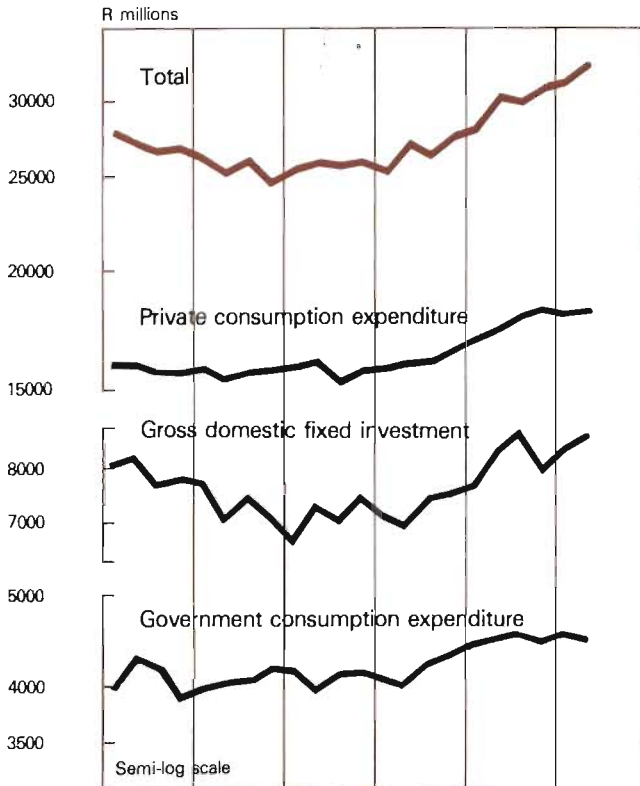
1) Rounded off to nearest ½ per cent.

2) First half of 1981 compared with first half of 1980

Sustained high level of gross domestic expenditure

Real gross domestic expenditure, which had increased by as much as 12 per cent in 1980, rose at a somewhat lower, but still abnormally high, rate in the first half of 1981 than in the preceding six months. Indeed, the level of expenditure in the first half of 1981 was no less than 10 per cent higher than in the corresponding period of 1980. With the exception of an increase in inventory investment, the moderate slow-down in the first half of 1981 was evident in all the other main components of real gross domestic expenditure, namely private and government consumption expenditure and fixed investment. At current prices, gross domestic expenditure ex-

Gross domestic expenditure at constant 1975 prices

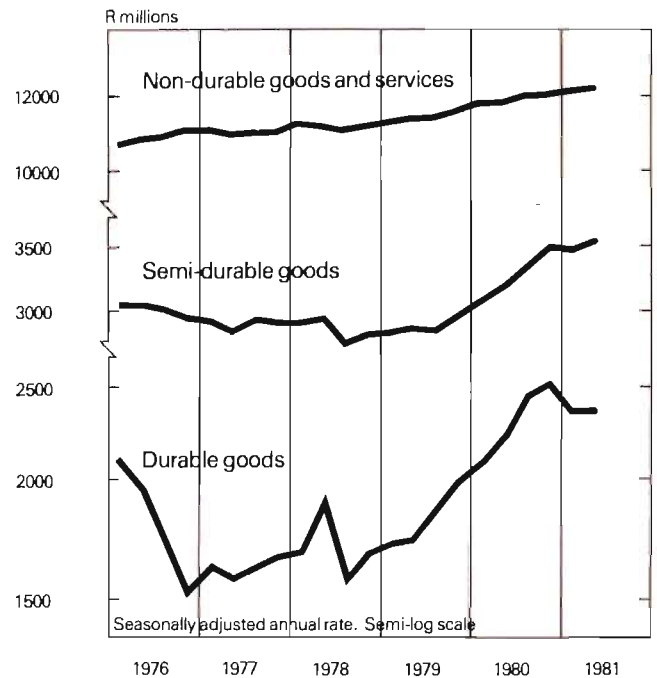


ceeded the gross national product by a considerable margin in the first half of 1981, indicating that a large deficit was recorded on the current account of the balance of payments.

Real private consumption expenditure

Because of the reasons outlined above, real private consumption expenditure rose strongly by 8½ per cent in 1980. However, in comparison with the second half of 1980, the rate of increase decelerated in the first half of 1981 as a result, not only of a scarcity of certain classes of durable consumer goods, but also of some changes in the conditions determining consumer demand. These changes included the reduced availability and the higher cost of consumer credit and the effect of "fiscal drag" and

Private consumption expenditure at constant 1975 prices



the persistently high rate of inflation on real personal disposable income. Despite the lower rate of increase in the first half of 1981, the level of real private consumption expenditure was still about 6 per cent higher in this period than in the first half of 1980.

The lower rate of increase in real consumer outlays in the first half of 1981 was the net result of a decline in expenditure on durable goods, in particular on new motor cars and recreational and entertainment goods, a slower growth of expenditure on services and semi-durable goods, and an unchanged rate of increase in outlays on non-durable goods. The highest rate of increase in this period was recorded in real expenditure on semi-durable goods, mainly clothing and footwear.

Real government consumption expenditure

In accordance with the Government's policy of limiting the growth in public sector expenditure, real government consumption expenditure increased on average by only 1 per cent per annum during the period from 1977 to 1979, but rose at an appreciably higher rate of 5½ per cent in 1980. This rate was, however, still much lower than the rate of increase of 12 per cent shown by real gross domestic expenditure. Moreover, the increase in government **consumption** expenditure was partly offset by a decline in the real **fixed investment** expenditure of general government. No further increase in real government consumption expenditure occurred in the first half of 1981 and the level of such expenditure in this period exceeded that in the first half of 1980 by only 1½ per

cent. Higher real salaries and wages and real defence expenditure were largely responsible for the increase in 1980.

Real gross domestic fixed investment

The upswing in real gross domestic fixed investment, which had commenced in 1978 and had gained considerable momentum in 1979, maintained a strong upward trend during the first three quarters of 1980 and increased by 12½ per cent in the year as a whole. In the fourth quarter of 1980 and the first half of 1981 the rate of increase slowed down, but still remained relatively high, and the level of real fixed capital outlays in the first half of 1981 was still 6½ per cent above that in the corresponding period of 1980. The increase in total real gross domestic fixed investment in 1979 and 1980 was mainly accounted for by the outlays of the private sector and, to a lesser extent, the public corporations. As during the preceding two years, the real fixed capital outlays of public authorities showed almost no change in 1980, but rose sharply in the first half of 1981.

In the private sector, the further increase in real fixed investment in the first half of 1981 was caused by higher outlays in agriculture, manufacturing and private residential construction. Increased fixed

investment in agriculture was encouraged by prospects of record summer crops. In manufacturing, the increase in fixed investment reflected the large number of capital expansion programmes which had commenced earlier and were still in progress, as well as new programmes to create additional production capacity. Fixed investment in private residential buildings rose in response to a continuing strong demand for housing.

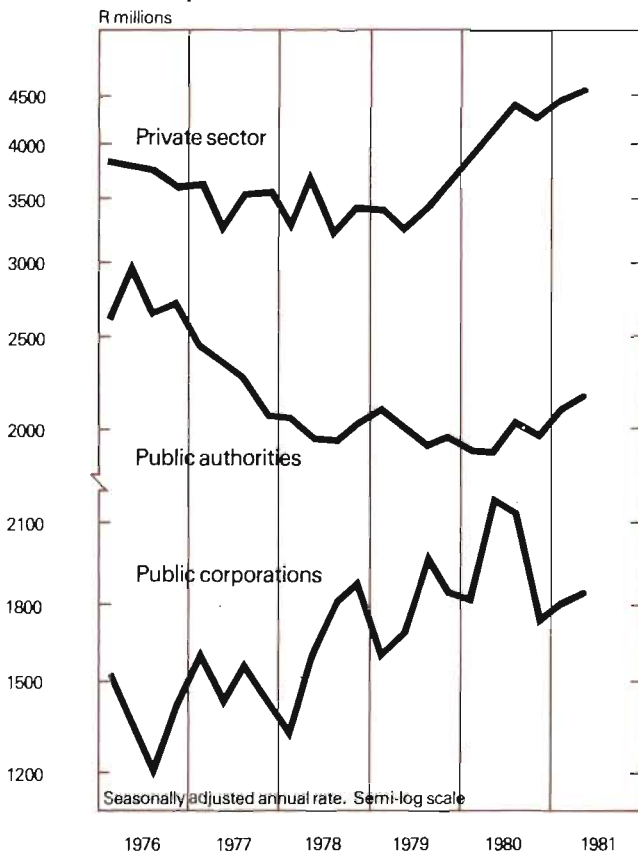
Following an increase of 24½ per cent in 1980, total real private fixed investment rose at a lower rate in the first half of 1981 and attained a level that was about 12½ per cent higher than in the corresponding period of 1980. The slow-down from the second half of 1980 to the first half of 1981 was due, firstly, to the completion of some of the capital expansion programmes which had commenced during the earlier part of the fixed investment upswing. By the second quarter of 1981 production capacity in private manufacturing, as measured by the real net fixed capital stock, had already increased by 9½ per cent from the beginning of the investment upswing in the middle of 1979. Secondly, the expected lower rate of increase in real domestic demand and the actual decrease in real exports, together with a decline in the general availability and higher cost of funds, had some restraining effect on new fixed investment.

Fixed investment in the public sector, which had risen by about 5½ per cent in 1980, did not show any increase in the first half of 1981 compared with the corresponding period of 1980. The real fixed investment of public corporations declined from the second half of 1980 to the first half of 1981, partly as a result of the completion of Sasol's second oil-from-coal plant. The real fixed capital outlays of public authorities, which had remained at a relatively low level from about the middle of 1978 to the first quarter of 1980 as a result of the Government's policy of curtailing public sector expenditure, increased slightly during the remainder of 1980 and at a somewhat higher rate in the first half of 1981. This change was mainly due to large expansion programmes of, and the acquisition of new aircraft by, the South African Railways Administration.

Real inventories

The upward phase of the inventory cycle, which had commenced in the middle of 1979, continued during the first half of 1981. In the latter period substantial further increases were recorded in real strategic and diamond inventories and agricultural stocks-in-trade, but real industrial and commercial inventories remained approximately at the levels of the fourth quarter of 1980. The considerable net addition to total inventories in the first half of 1981 made a significant contribution to the continuing high level of real aggregate domestic demand in this period. Diamond stocks increased on account of weak foreign and domestic demand, whereas the higher agricultural stocks reflected the harvesting of record summer crops. Industrial and commercial inventories did not

Gross domestic fixed investment at constant 1975 prices



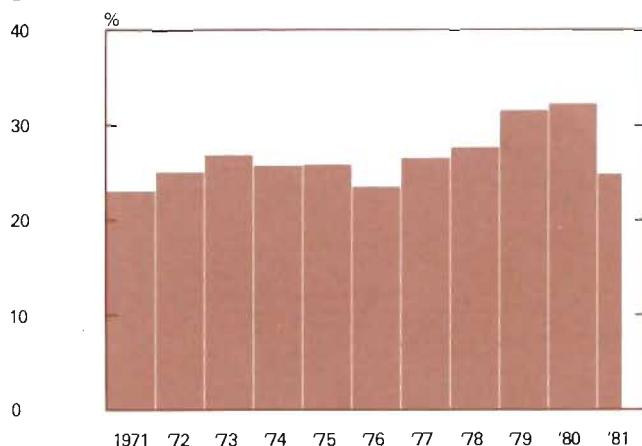
increase in the first half of 1981 because of the continuing high level of consumption and investment demand in the face of the limits imposed on production by the high degree of utilisation of production capacity, the high cost of carrying large stocks, and some manufacturers' and traders' views that in the short run existing stock levels were adequate to meet expected sales.

Decline in gross domestic saving in first half of 1981

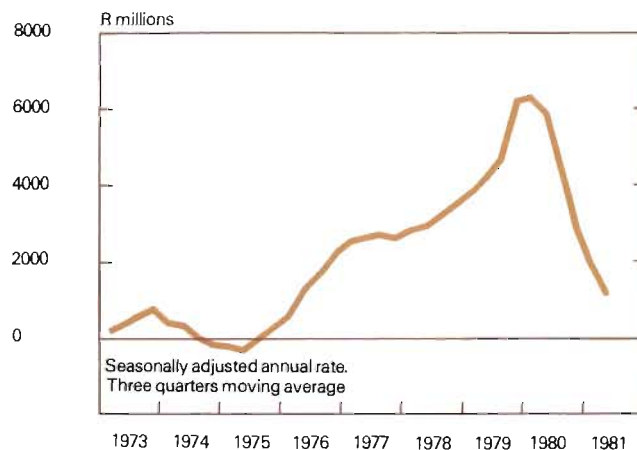
Gross domestic saving almost trebled between 1975 and 1980, or, as a ratio of gross domestic product, rose from 26 per cent in 1975 to 32 per cent in 1980. This increase was one of the main causes of the substantial expansion in the general availability of funds in the economy during this five-year period, and more particularly during 1979 and 1980. However, in the first half of 1981 gross domestic saving declined markedly and amounted to only 25 per cent of the gross domestic product in this period. Corporate and personal saving decreased sharply, but the saving of general government declined only in the second quarter and on balance showed little change during the first half of 1981. Provision for depreciation continued to rise, reflecting the increase in fixed capital assets.

The main reason for the decline in corporate saving in the first half of 1981 was the sharp decline in the price of gold and its effect on corporate income. By the same token, the substantial rise in the price of gold from approximately the middle of 1976 had made an important contribution to the increase in corporate saving during the period from 1976 to 1980, especially during the last two years of this period. As a ratio of gross domestic product, "gross" corporate saving, i.e. before provision for depreciation and inventory valuation adjustments, increased from 14 per cent in 1975 to 23 per cent

Gross domestic saving as percentage of gross domestic product



Excess of gross corporate saving over gross investment in private sector



in 1980. During 1979 and 1980 gross corporate saving exceeded gross investment of companies in the private sector by a substantial margin. The corporate sector, therefore, became a major source of funds for the financing of savings-deficit sectors in the economy and for the reduction of South Africa's net foreign indebtedness. In the first half of 1981 gross corporate saving declined considerably and amounted to only 16 per cent of the gross domestic product.

Personal saving already started to decline in the course of 1980, when the sharp increase in private consumption expenditure, facilitated by the large-scale use of consumer credit, began to exceed the rise in personal disposable income, despite further tax concessions and substantial increases in salaries and wages. The excess of personal disposable income over private consumption expenditure continued to decrease in the first half of 1981. The ratio of personal saving to personal disposable income declined to only 3 per cent in this period, compared with an average ratio of 8 per cent in 1979 and 1980.

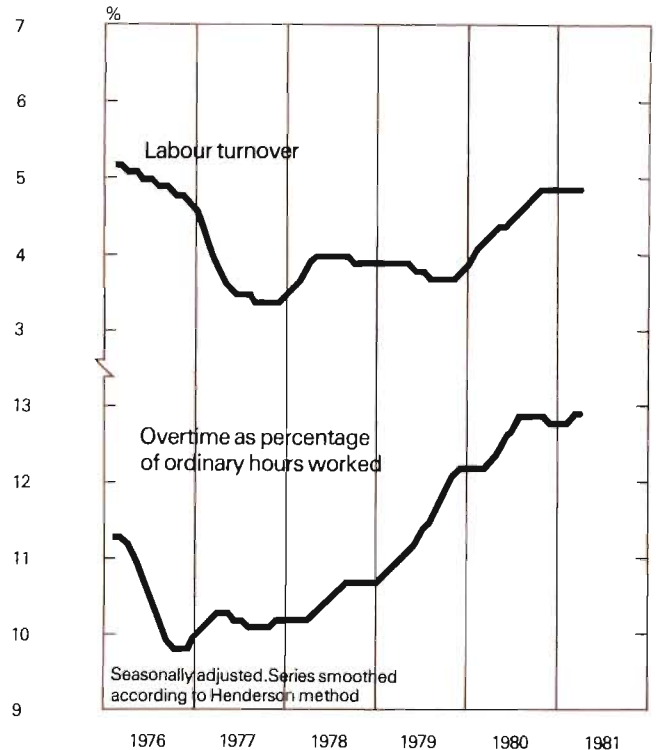
Employment and prices

Virtually full employment of skilled and semi-skilled labour

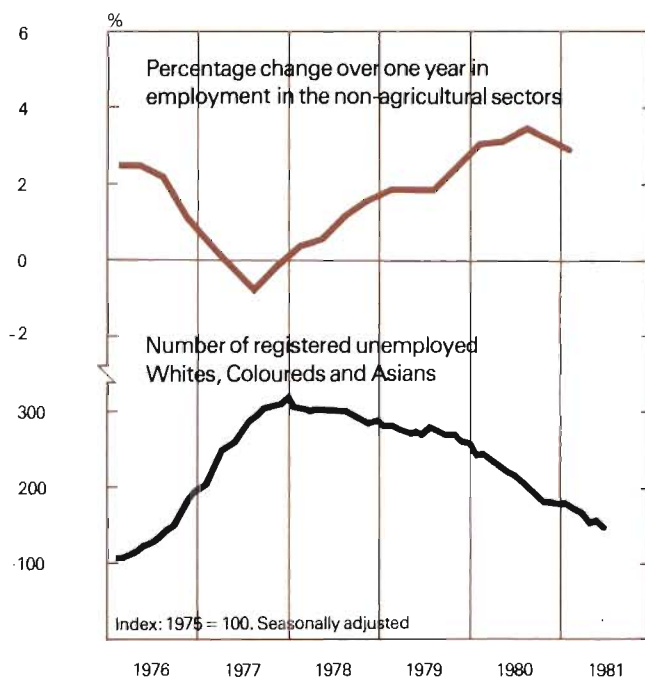
The strong expansion of economic activity generated an increase of 3,3 per cent in non-agricultural employment in 1980. The rate of increase in employment accelerated throughout 1980, but in the first quarter of 1981* it was only marginally higher than in the preceding three months because of the virtually full employment of skilled and semi-skilled labour. Indeed, shortages of skilled labour became a major constraint on the continuation of the high rate of economic growth attained in 1980. By the first quarter of 1981 the ratio of registered unemployed Whites, Coloureds and Asians to the corresponding labour force, which had amounted to 1,6 per cent at its most recent peak in the fourth quarter of 1977, had declined to only 0,8 per cent. The number of registered unemployed Whites, Coloureds and Asians, seasonally adjusted, declined from 32 000 at the end of October 1977 to 17 147 at the end of March 1981 and further to 15 330 at the end of June. The ratio of Black unemployment to the economically active Black population (which includes the larger part of the less skilled labour force) decreased from 12,4 per cent in October 1977 to 7,6 per cent in April 1981.

Some indication of the full employment of skilled and semi-skilled labour was provided by increases in overtime worked and labour turnover. In manufac-

Labour turnover and overtime hours worked in manufacturing and construction



Employment



turing and construction, for example, the ratio of overtime to ordinary hours worked rose from 12 per cent in the fourth quarter of 1979 to 13 per cent in the first quarter of 1981. Labour turnover in manufacturing and construction in relation to the labour force increased from 4 per cent in the fourth quarter of 1979 to 5 per cent in the first quarter of 1981.

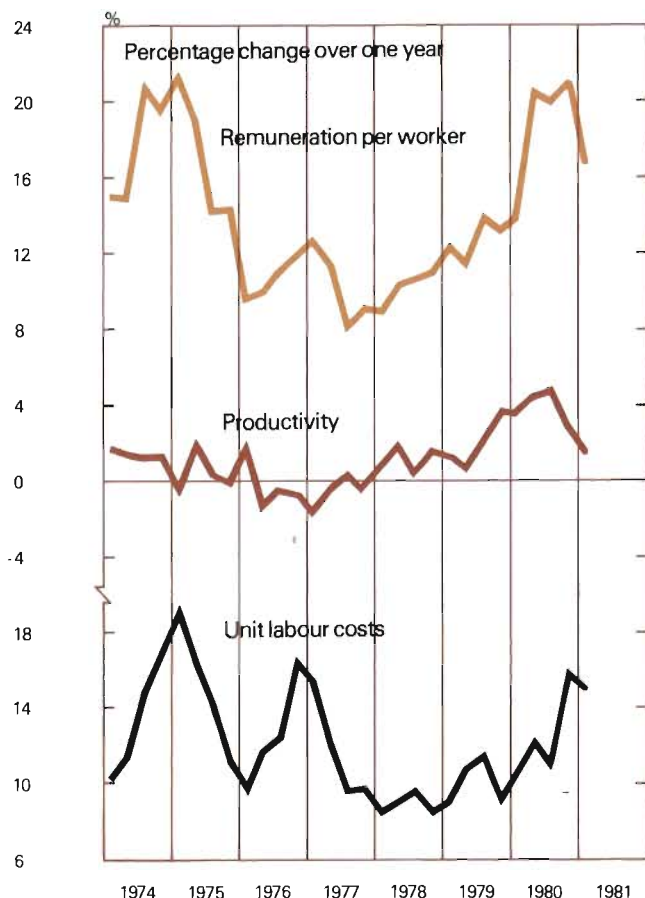
Lower rate of increase in labour productivity and higher unit labour costs

The almost full utilisation of production capacity, the shortages of skilled and semi-skilled labour, and a more rapid labour turnover contributed to a lower rate of increase in labour productivity towards the end of 1980 and in the first quarter of 1981. The real gross domestic product per worker in the non-agricultural sectors of the economy, which had increased by 4 per cent in 1980, was only 1,5 per cent higher in the first quarter of 1981 than in the corresponding quarter of 1980.

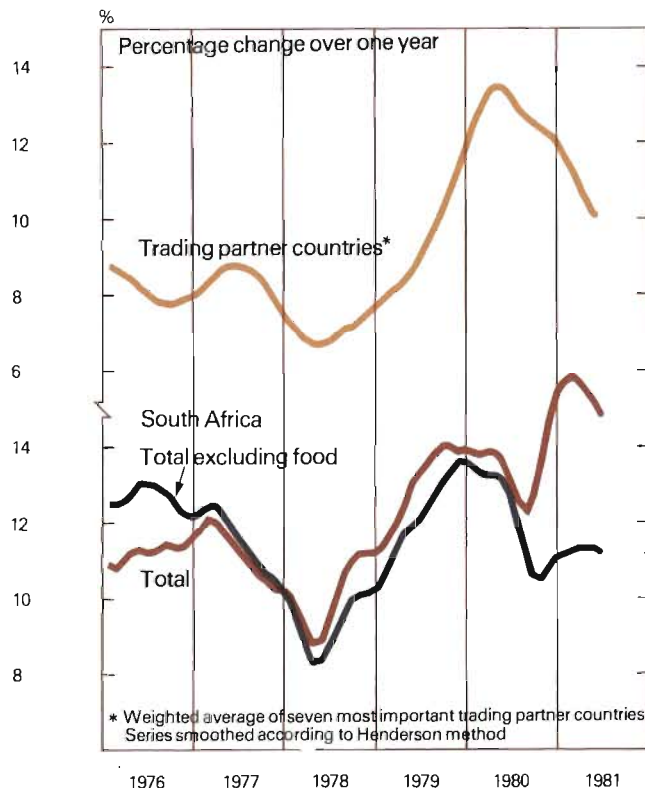
Salaries and wages started to increase at a higher rate from the second quarter of 1980, mainly in response to more active competition for skilled labour and also as a result of the adjustment of salary and wage scales to the high rate of inflation. In 1980 the average remuneration per worker in the non-agricultural sectors of the economy rose by 18,1 per cent, or by 3,5 per cent in real terms, and in the first quarter of 1981 it exceeded the corresponding figure

*Statistics relating to employment and the remuneration of labour are available only up to the first quarter of 1981.

Productivity, remuneration and labour costs in the non-agricultural sectors



Consumer prices



in the first quarter of last year by 17,6 per cent, or 1,5 per cent in real terms.

The combined effect of the more rapid rise in the remuneration of labour and the slow-down in labour productivity was a higher rate of increase in unit labour costs from the middle of 1980. Average unit labour costs in the non-agricultural sectors, which had risen by 12,5 per cent in 1980, were 15,1 per cent higher in the first quarter of 1981 than in the corresponding quarter of 1980. An increase in unit labour costs is a typical phenomenon in the advanced stage of a cyclical upswing and the early stage of a downswing and partly explains the higher rate of price increases during such periods.

Continued high rate of inflation

The substantial rise in the demand for goods and services during 1980 and the sustained high level of this demand in the first half of 1981 increasingly exerted pressure on scarce labour and other resources and thereby added a strong element of demand-pull inflation to the already existing cost-push inflation. The consumer price index accordingly rose quite sharply from quarter to quarter in the course of 1980

and at a seasonally adjusted annual rate amounted to 15,0 per cent in the third quarter and 22,0 per cent in the fourth quarter. Subsequently, in the first and second quarters of 1981, the annual rate declined to 13,1 and 10,4 per cent, respectively. This slow-down resulted mainly from a lower rate of increase in food prices. In 1980 food prices rose by as much as 18,8 per cent and made a major contribution to the increase in the consumer price index. The rate of increase in non-food prices during the first half of 1981 was approximately equal to that in the preceding six months.

If measured from June 1980 to June 1981, however, consumer prices rose by 14,5 per cent and in the first half of 1981 they were on average 15,5 per cent higher than in the corresponding period of 1980. Both these figures were appreciably higher than the increase of 13,8 per cent in 1980.

The seasonally adjusted annual rate of increase in production prices, likewise, slowed down from 17,5 per cent in the second half of 1980 to 12,1 per cent in the first half of 1981. This deceleration was largely attributable to lower rates of increase in the prices of imported goods and to the fact that the rate of increase in government-administered prices was generally lower than that of other production prices. Upward pressure was, however, exerted on production prices by the increase in unit labour costs. From June 1980 to June 1981 production prices, which

had risen by 16,2 per cent in 1980, increased by 14,0 per cent and were on average 14,8 per cent higher in the first half of 1981 than in the first half of last year.

At a seasonally adjusted annual rate, the prices of imported goods increased by 10,3 per cent from the second half of 1980 to the first half of 1981. In the latter period the level of these prices was 11,8 per cent higher than in the first half of 1980. This relatively low rate of increase reflected the strong appreciation of the rand during 1980 and the more moderate price increases in trading-partner countries. The weighted average of consumer price indices in South Africa's seven most important trading partners, which had risen by 12,8 per cent in 1980, was only 10,7 per cent higher in the first half of 1981 than in the corresponding period of 1980.

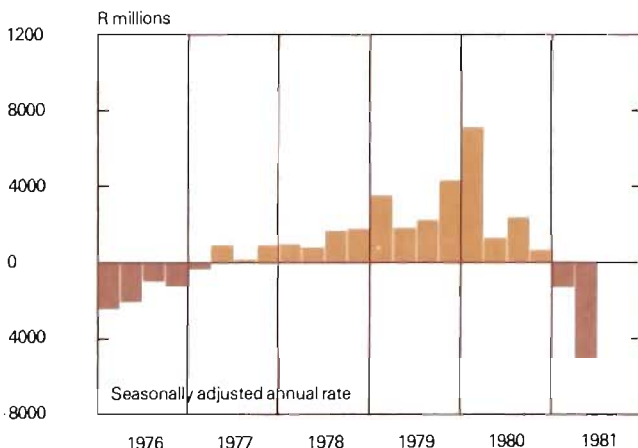
Balance of payments

Deficit on current account

After having remained in substantial surplus during the first three years of the cyclical upswing which began in 1978, the current account of the balance of payments moved into moderate deficit in the first quarter of 1981. This was followed by a substantially larger deficit in the second quarter. At a seasonally adjusted annual rate, the deficit in the first half of 1981 amounted to R3 170 million, or about 5 per cent of the gross domestic product, compared with a surplus of R2 830 million in 1980.

The emergence of a current account deficit was not unexpected. Indeed, in the past deficits were recorded at a much earlier stage during periods of economic upswing. This deviation from the normal cyclical pattern was mainly due to the effect on the value of the net gold output of a quadrupling of the US dollar price of gold from 1977 to 1980, and to a strong rise in merchandise exports that continued until the first quarter of 1980.

Balance on current account



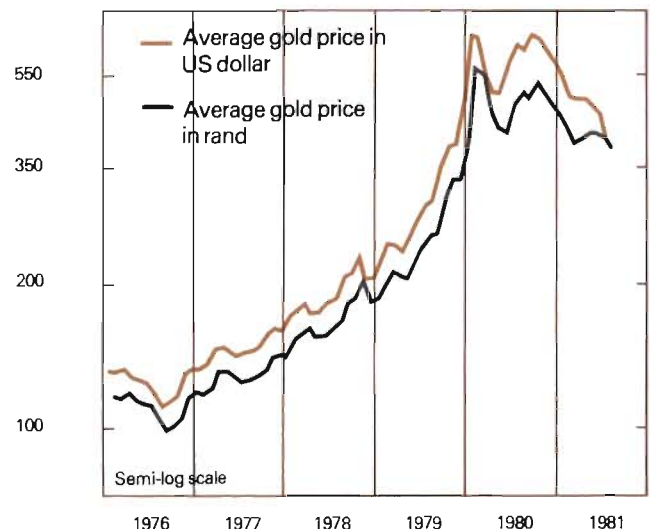
All the main items on the current account contributed to the emergence of a current account deficit in the first half of 1981. Imports maintained a steep upward trend, net service and transfer payments rose further, merchandise exports continued to decline and there was a sharp fall in the net gold output. The strong rise in imports at a time when exports are falling is typical of the advanced stages of economic upswings in South Africa. Since business cycle changes in South Africa lag behind those in the main industrial countries, South Africa's exports are affected by recessionary conditions in trading-partner countries at a time when its imports are still boosted by a cyclically high level of domestic demand.

Marked decline in net gold output

From the end of 1979 wide fluctuations occurred in the price of gold, causing correspondingly large variations in the value of the net gold output and considerable changes in the balance on the current account. For example, international political developments, a sharp increase in oil prices and higher rates of inflation in the major industrial countries caused the price of gold on the London market to rise by 130 per cent within a period of two and a half months to a level of US \$850,00 per fine ounce on 21 January 1980. Subsequently, the gold price declined by 42 per cent to a level of US \$490,00 per fine ounce on 1 May 1980, before rising by 47 per cent to a level of US \$720,50 per fine ounce on 23 September 1980. From the latter date the gold price moved downwards to US \$406,00 on 31 July 1981, a decline of 44 per cent.

In the first half of 1981 the average price of gold on the London market amounted to about US \$499 per fine ounce compared with US \$613 per fine ounce in 1980. Because of a sharp depreciation of the rand against the US dollar, the gold price in terms of rand decreased somewhat less from an average of R477 per fine ounce in 1980 to R400 per fine ounce in the first half of 1981. The volume of the net gold output, which had declined by 6,8 per cent in 1980, mainly as a result of the mining of lower grade ore, was 3,0 per cent lower in the first six months of 1981 than in the corresponding period of 1980. Owing to these changes, the value of the net gold output, at a seasonally adjusted annual rate, amounted to R8 050 million in the first half of 1981, compared with R10 140 million in 1980.

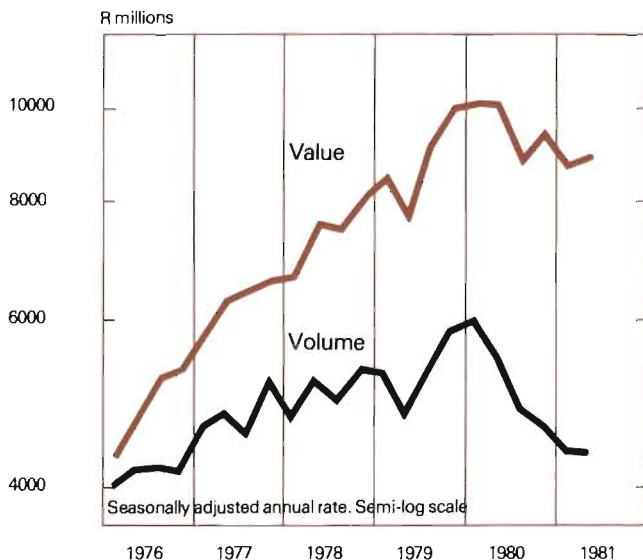
Gold price



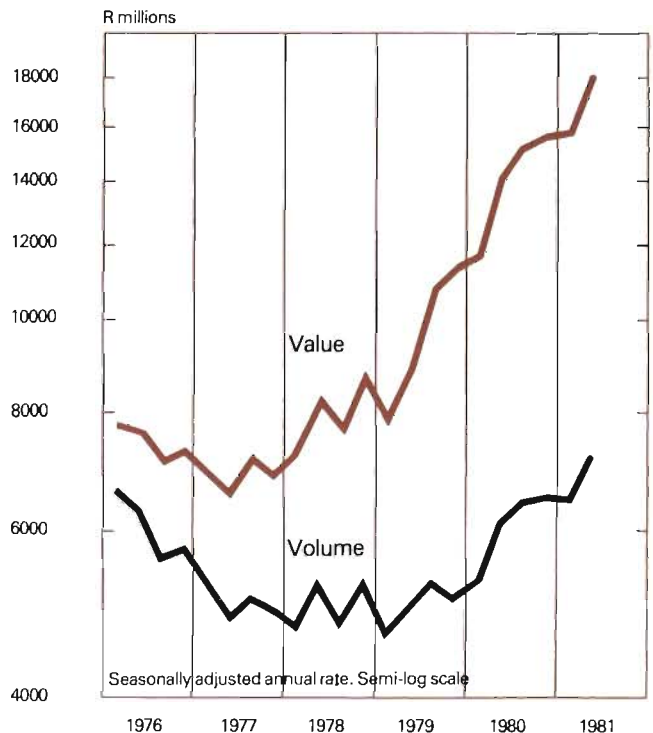
Appreciably lower merchandise exports

The declining trend in merchandise exports from the second quarter of 1980 continued during the first half of 1981, reflecting a cyclical decline in the import demand of trading-partner countries. At a seasonally adjusted annual rate, exports amounted to R8 860 million in the first half of 1981, compared with R9 640 million in 1980. Despite a levelling off in international commodity prices, export prices (excluding the gold price) increased further during the first half of 1981 in terms of rand, mainly as a result of the depreciation of the rand. The lower value of exports was, therefore, confined to a decline in export volumes. In particular, sharp volume declines were recorded in the exports of diamonds, ferro-chrome, nickel and iron ore. These declines were partly countered by an increase in the volume of uranium and coal exports, which are fairly insensitive to cyclical changes, and in the volume of agricultural exports, in particular maize, sugar and wool. The recessionary conditions in most trading-partner countries and their effect on these countries' import demand are expected to prevail throughout 1981. As a result, the declining trend in South African exports is likely to continue during the second half of 1981.

Merchandise exports



Merchandise imports



adjusted annual rate, amounted to R17 000 million in the first six months of 1981.

Both volume and price increases contributed to the rise in the value of imports. However, the rate of increase in import prices decelerated considerably from the middle of 1980, mainly because of more stable oil prices, the appreciation of the rand up to the end of 1980, and lower international inflation rates. Volume increases in the first half of 1981 were evident in all categories of imported goods. However, in line with the anticipated further deceleration in the rate of increase in domestic demand, the growth in imports may be expected to slow down during the second half of 1981.

Sustained rise in net service and transfer payments

The sharp rise in net service and transfer payments to foreigners in 1980 continued in the first half of 1981. At a seasonally adjusted annual rate, these payments amounted to R3 080 million in the first six months of 1981, compared with R2 750 million in 1980. This rise resulted from higher salary and wage payments to foreign migrant workers and increased freight and merchandise insurance payments. Dividend payments to foreigners on their South African investments, which had risen substantially in 1980, declined slightly in the first half of 1981.

Substantial increase in imports

As during the preceding two years, merchandise imports rose sharply in the first half of 1981. This further increase was related to the continuing strong domestic demand and the high import content of domestic expenditure on capital goods, durable consumer goods and inventories. Compared with R14 210 million in 1980, imports, at a seasonally

Net inflow of foreign capital

After a net outflow of funds had been recorded on the capital account of the balance of payments in each of the four years from 1977 to 1980, there was a net inflow of capital of R489 million in the first half of 1981. This inflow, which excludes changes in liabilities related to reserves, consisted of long-term as well as short-term capital. Foreign borrowing by public corporations and a net inward movement of funds to the private sector accounted for most of the long-term capital inflow.

The net outflow of capital amounted to about R2 300 million in 1980 and to no less than R6 240 million in the four-year period from 1977 to 1980. In addition, liabilities related to reserves were reduced by R1 098 million during these four years. This massive outward investment of funds was made possible by the succession of surpluses on the current account of the balance of payments and the general availability of funds in the domestic financial markets. The substantial reduction in South Africa's net foreign indebtedness had the effect of easing the servicing of foreign debt and raising the country's international credit rating. Interest payments on foreign loans as a percentage of total exports, for example, declined from 7,6 per cent in 1976 to 3,3 per cent in 1980. The improvement in South Africa's credit rating was reflected in borrowing rates which showed a narrowing of the margin above the London inter-bank offer rate (Libor) from a maximum of 1,8 per cent in 1977 to 0,9 per cent in 1980.

Net capital movements

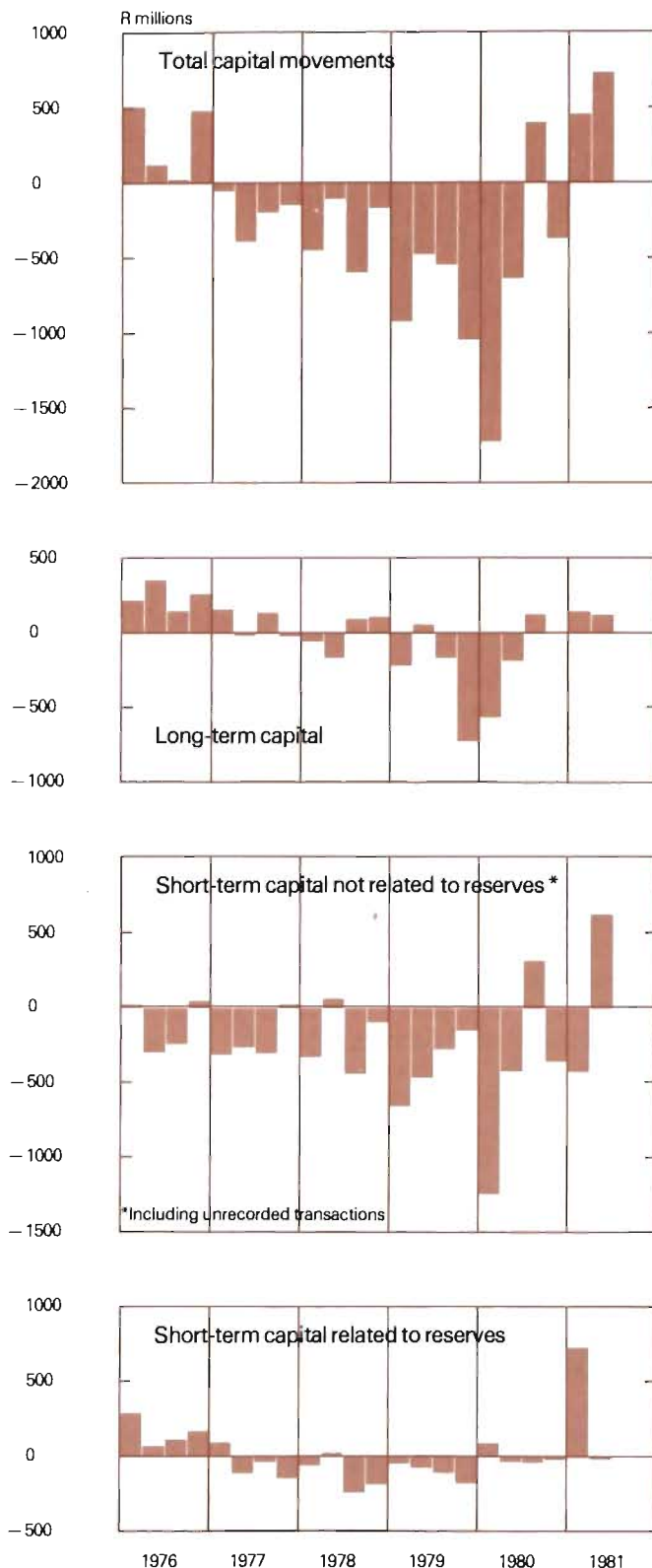
R millions

	1977 to 1979	1980	1981 First half
Long-term capital			
Central government and banking sector	-593	-313	36
Public corporations and local authorities	142	179	161
Private sector	-272	-474	82
Total	-723	-608	279
Short-term capital, excluding changes in liabilities related to reserves and including unrecorded transactions			
	-3 218	-1 691	210
Total	-3 941	-2 299	489

Sharp fall in net gold and other foreign reserves

Balance of payments transactions caused the net gold and other foreign reserves to decline by R923 million during the first half of 1981. This decline followed upon an increase of R531 million during 1980. The fall in the net reserves already started in the fourth

Net capital movements



quarter of last year and amounted to R1 417 million during the nine-month period to the end of June 1981.

In order to cushion the effect of balance of payments transactions on the foreign reserves, the Reserve Bank borrowed on short term abroad. Liabilities related to reserves were increased further by the temporary foreign borrowing of some banks which were experiencing difficulties in complying with the compulsory liquid asset requirements. In total, liabilities related to reserves rose by R710 million during the first half of 1981. Despite this increase, the gross gold and other foreign reserves declined by R538 million during this period to reach a level of R5 255 million at the end of June. The larger part of this decline, however, represented the revaluation of the gold reserves at a lower price. During July the gross gold and other foreign reserves of the Reserve Bank declined further by R78 million to R4 861 million. If an increase in the Bank's liabilities related to reserves and valuation adjustments to the gold as well as the foreign exchange reserves are taken into account, the Bank's net gold and other foreign reserves declined by R725 million during July.

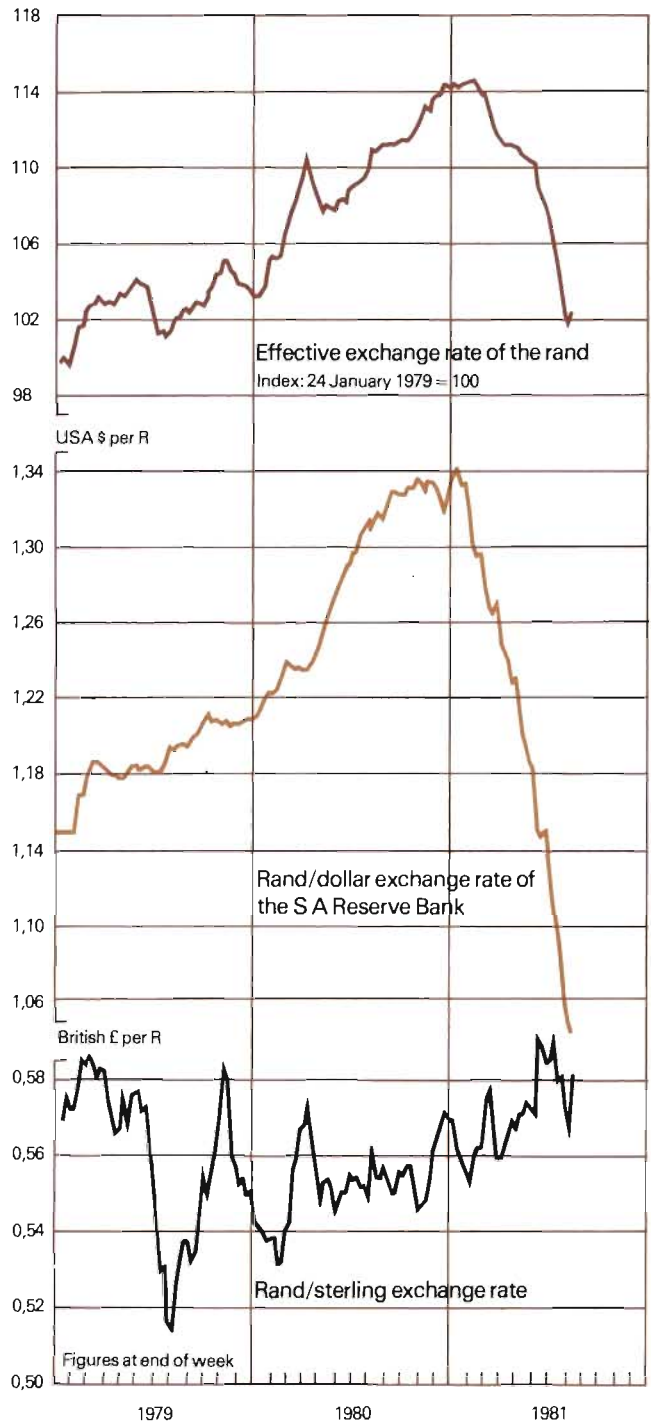
Foreign exchange market

Because of the change in the overall balance of payments and the strength of the US dollar in foreign exchange markets, the appreciation of the commercial rand up to the end of 1980 was reversed in early 1981. The effective exchange rate of the rand, which had increased by 10,9 per cent during 1980, declined by 6,7 per cent during the first half of 1981 and by a further 4,8 per cent during July. The change in the effective exchange rate of the rand during the first seven months of 1981 was dominated by the sharp depreciation of 21,7 per cent of the rand against the US dollar. In addition, the rand depreciated by 7,9 per cent against the Japanese yen, 6,1 per cent against the Swiss franc, and 1,9 per cent against the German mark during this period. However, it appreciated slightly by 0,7 per cent and 0,9 per cent against the British pound and the French franc, respectively.

The financial rand depreciated by 14,0 per cent against the US dollar during the first seven months of 1981. Although sharp fluctuations occurred in the financial rand discount, it narrowed considerably on balance and amounted to 23,5 per cent on 31 July, compared with 30,2 per cent at the end of 1980.

During the first seven months of 1981 the forward exchange rates of the Reserve Bank were fixed in such a way as to make the domestic financing of trade marginally more attractive than foreign financing. In particular, the comparatively low prime overdraft rate during most of this period encouraged the financing of trade by means of bank overdrafts. This policy was followed in order to discourage an inward movement of short-term capital that could contribute to an increase in bank liquidity and the money supply. Towards the end of July, however, the change in the balance of payments and tighter conditions in the domestic money market prompted a

Exchange rates



change in the Reserve Bank's policy. Forward exchange rates were accordingly fixed at levels more favourable for the foreign financing of trade.

Money and banking

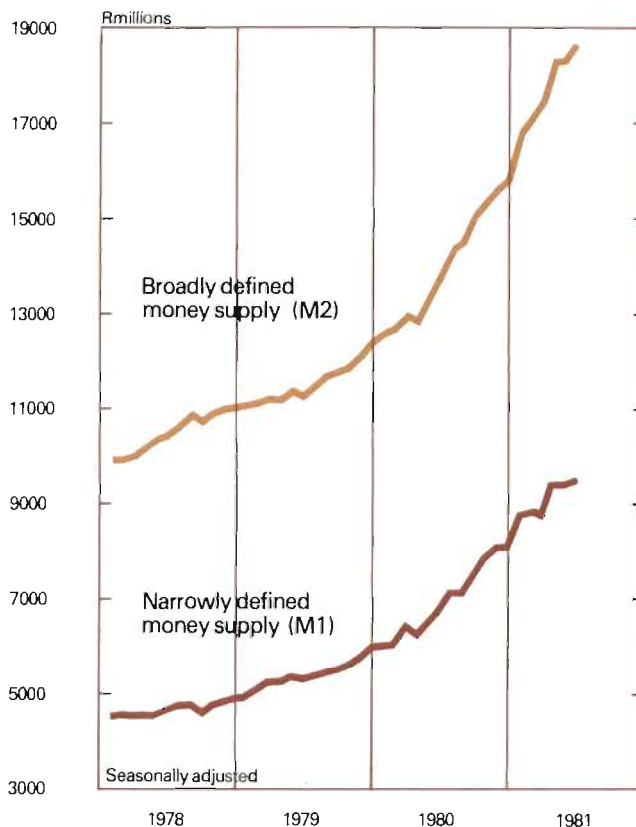
High rates of growth in monetary aggregates

The sharp rise in total monetary demand during 1980 and the first half of 1981 was accommodated by a strong monetary expansion, in particular from the middle of 1980. At a seasonally adjusted annual rate, the broadly defined money supply (M2) increased by 17 per cent in the first quarter of 1980, 27 per cent in the second quarter, 41 per cent in the third quarter, 25 per cent in the fourth quarter, and 46 per cent in the first quarter of 1981, before slowing down to 29 per cent in the second quarter. During the latest months for which figures are available, namely May and June, the seasonally adjusted annual rate of increase amounted to only about 11 per cent.

The narrowly defined money supply (M1) increased by 36 per cent during 1980 and at a seasonally adjusted annual rate of 37 per cent during the first half of 1981. During May and June, however, the seasonally adjusted M1 showed only a marginal increase.

To a large extent the continuance of high rates of growth in the monetary aggregates after September 1980 was due to the process of re-intermediation which followed the abolition of ceilings on bank credit to the private sector in that month and the subsequent return to more normal levels of certain money market interest rates. Examples of this re-intermediation were the substitution of bank credit for other forms of credit that had previously been obtained by borrowers outside the banking system, and the curtailment by the banks of the practice of selling assets under repurchase agreements to the private non-banking sector. For example, total repurchase agreements entered into by monetary banking institutions with the private non-banking sector declined from R1 810 million at the end of 1980 to R1 531 million at the end of June 1981. If the short and medium-dated repurchase agreements are included in M2, on the grounds that they are close substitutes for bank deposits, the seasonally adjusted annual rate of increase in M2 during the first half of

Money supply



1981 would be reduced to 30 per cent. Likewise, if repurchase agreements in the form of so-called "continuous contracts" and "overnight buy-backs" are included in M1, the seasonally adjusted annual rate of increase in this aggregate during the first half of 1981 would be lowered to 28 per cent.

Re-intermediation and a relative shift from long-term deposits to deposits which form part of the

Causes of changes in M2

R millions

	1980			1981	
	1st half*	2nd half*	Year	1st half*	May and June*
Net gold and other foreign reserves	-320	990	531	-1 223	-447
Claims on government sector:					
Gross claims	—	—	585	—	—
Government deposits (increase -, decrease +)	—	—	-992	—	—
Net claims	-9	-393	-407	-29	-215
Claims on private sector	1 340	2 278	3 629	3 572	1 105
Long-term deposits (increase-, decrease+)	-114	-375	-468	-388	-169
Net other assets	—	—	221	—	—
Total	1 302	2 102	3 506	2 744	321

*Seasonally adjusted.

money supply, induced, among other things, by an absolute as well as a relative increase in short-term interest rates, contributed to a decline in the velocity of circulation of the money supply during the last three quarters of 1980 and the first half of 1981. The income velocity of circulation of M2 and M1, as measured by the ratio of the gross domestic product at current prices to these aggregates, declined by 17 per cent and 22 per cent, respectively, from their most recent peaks in the first quarter of 1980 to the second quarter of 1981. The transactions velocity of circulation of M1, or the ratio of bank debits to M1, reached a peak in the fourth quarter of 1979, but subsequently declined by 16 per cent from this peak to the second quarter of 1981.

Causes of changes in M2

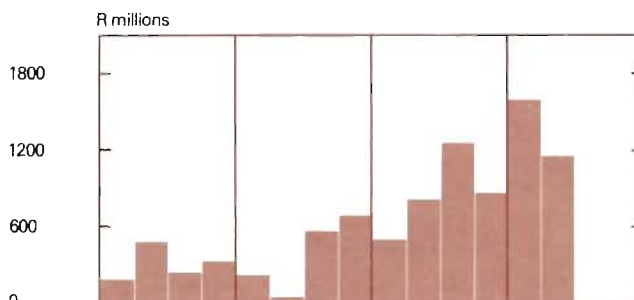
An *ex post* analysis of the statistical "causes" of the increase of M2 is presented in the accompanying table. During the second half of 1980 and the first half of 1981 a strong expansionary influence was exerted on M2 by the exceptionally large increase in bank credit extended to the private sector. Initially, during the second half of 1980, this was accompanied by a considerable increase in the net gold and other foreign reserves. However, from the fourth quarter of 1980, and more particularly during the first half of 1981, when the current account of the balance of payments was in deficit, these reserves declined sharply and exerted a marked contractionary influence on M2.

During both half-year periods a decline in the monetary banking sector's net claims on the government sector and an increase in the private non-banking sector's long-term deposits with monetary banking institutions made small negative contributions to the growth in M2. The decline in net bank credit to the government sector reflected mainly an increase in government deposits that resulted from a marked increase in central government revenue, to which reference will be made in the next section of this review. The rate of increase in long-term deposits decelerated notably during the fourth quarter of 1980 and the first quarter of 1981, a period during which long-term fixed-interest investments generally were inhibited by expectations of further increases in long-term interest rates and by a faster rise in short-term than in long-term interest rates. During the second quarter of 1981, however, these deposits increased again at a higher rate.

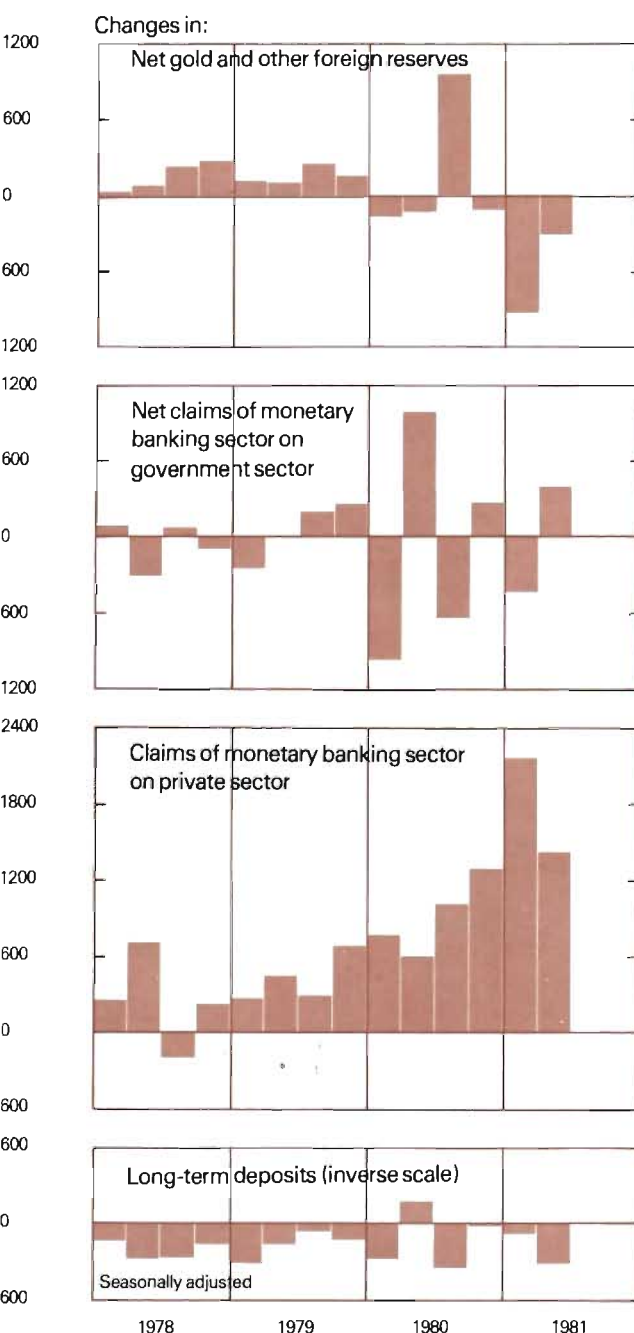
Exceptionally sharp rise in bank credit to the private sector

The increase in credit extended by the monetary banking sector to the private sector started to accelerate sharply from the second half of 1980. At a seasonally adjusted annual rate, the increase amounted to 36 per cent during this period and to no less than 49 per cent during the first half of 1981. This expansion was directly related to the strong cyclical

Changes in broadly defined money supply (M2)



Causes of changes in M2



demand for credit, but to a large extent it also represented the re-intermediation of credit which had previously been extended outside the banking system.

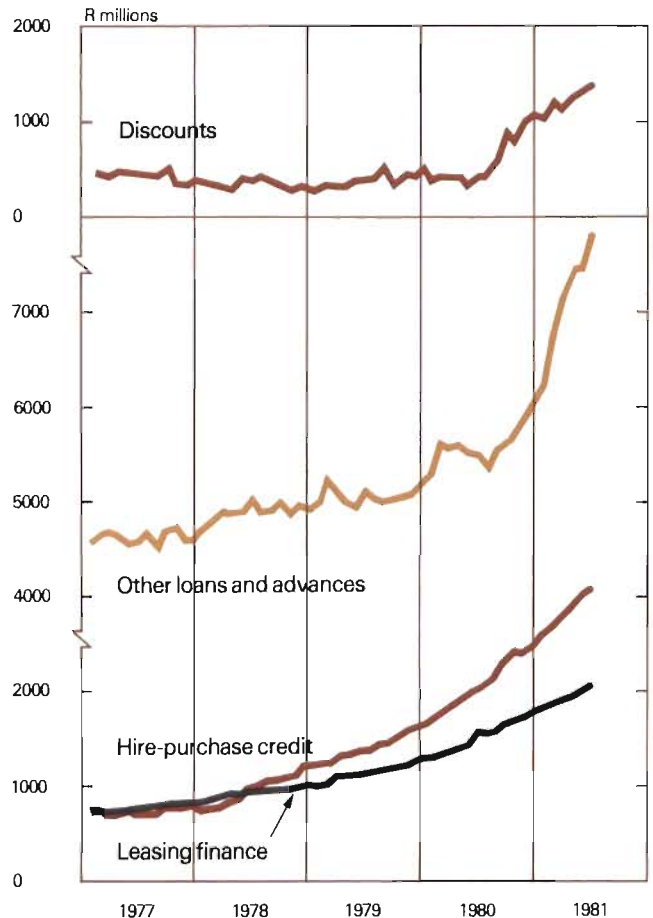
During 1979 and the early part of 1980 **disintermediation** was promoted by a substantial increase in the general availability of funds in the economy, stemming from the effect on incomes and saving of the sharp rise in the price of gold, high export proceeds and generally buoyant economic conditions, and the simultaneous existence of high liquid asset requirements for banking institutions and ceilings on bank credit to the private sector. In addition, relatively high bank overdraft rates compared with interest rates on bankers' acceptances, trade bills and other money market paper, and a rising demand for funds encouraged short-term borrowing outside the banking system. This borrowing included sales of bankers' acceptances and bank-endorsed trade bills and promissory notes to non-bank money market investors. Reflecting this off-balance sheet financing, the contingent liabilities of the banks increased by as much as R1 622 million during the first three quarters of 1980.

From about the fourth quarter of 1980, and especially after the credit ceilings had been abolished in September, a decline in the general availability of funds in the face of a strongly rising demand for funds as well as an increase in interest rates on acceptances, trade bills and other money market paper, which narrowed the margin between these rates and bank overdraft rates, caused a reversal of the process of disintermediation. At first, holdings of money market paper reverted to bank portfolios as the availability of credit outside the banking system declined. This was reflected in a substantial decline in the banks' contingent liabilities. Subsequently, as the margin between interest rates on money market paper and bank overdraft rates disappeared, the demand for credit was satisfied to an increasing extent by the use of bank overdrafts.

Apart from the effect of the process of re-intermediation and the strongly rising demand for bank credit on the banks' overdraft lending, this form of credit extension was inflated during the second quarter and most of July 1981 by the so-called round-tripping. This practice consisted of borrowing on overdraft from banks and investing these funds at higher rates, mostly in bank deposits and negotiable certificates of deposit. Investors were enabled to do so by some interest rates on money market paper, which had risen well above the banks' prime overdraft rate, and by the banks' temporary buying of "wholesale" deposits at rates in excess of their prime lending rates.

As a result of the changes referred to above, the composition of the discounts, loans and advances granted by commercial, merchant and monetary general banks changed considerably from the last quarter of 1980. These banks' loans and advances other than hire-purchase credit and leasing finance, i.e. mainly ordinary bank overdrafts, increased by

Discounts, loans and advances of commercial banks, merchant banks and monetary general banks



R403 million (20 per cent of the increase of R1 985 million in total discounts, loans and advances) during the first nine months of 1980, but then surged ahead by a further R2 240 million (56 per cent of the increase of R4 033 million in total discounts, loans and advances) during the subsequent nine months. The increase in these banks' hire-purchase credit and leasing finance, which had been the main form of bank credit extended to the private sector during the period of disintermediation, amounted to 54 per cent of the increase in total discounts, loans and advances during the first nine months of 1980 and to only 30 per cent during the subsequent nine months. Likewise, the relative importance of bills discounted decreased from 24 per cent to 13 per cent during these two periods. Investments in private-sector securities by the monetary banking sector rose more rapidly from the last quarter of 1980 in response to increased interest rates and the abolition from 1 September last year of the ceilings on this form of credit to the private sector.

Considerable decline in excess bank liquidity

The substantial increase in bank credit from the second half of 1980 was made possible by a continuous rise in the banks' cash reserve and other liquid asset holdings, i.e. their liquidity base. During the second half of 1980 the banks' liquidity base was expanded mainly by increases in the Reserve Bank's net gold and other foreign reserves, the banks' holdings of bankers' acceptances and other private-sector securities ranking as liquid assets, and the banks' credit to the Land Bank. The government sector exerted a contractionary influence on the banks' liquidity base during this period as a result of a decline in the banking system's net credit extension to this sector. During the first half of 1981 the liquidity base was expanded further, mainly by an increase in the banks' holdings of liquid bankers' acceptances and of liquid inter-bank deposits. A decline in the Reserve Bank's net gold and other foreign reserves served to curtail the growth of the liquidity base during this period.

Of the total increase of R1 582 million in the banks' holdings of liquid assets during the twelve months to the end of June 1981, R1 111 million consisted of a rise in holdings of liquid bankers' acceptances. To a certain extent the latter increase formed part of the re-intermediation process, during which the banks were called upon to take over bankers' acceptances previously held outside the banking system. It also suited the banks to hold more acceptances as a means of supplementing their liquid asset holdings. For purposes of complying with the liquid asset requirements, only 20 per cent of the required amount of liquid assets (excluding required cash reserves) may consist of liquid bankers' acceptances. At the end of June 1980 the actual ratio amounted to only 6,1 per cent, but by the end of June 1981 the ratio had risen to 18,2 per cent, which was just short of the 20 per cent limit.

The banks' large-scale credit extension to the private sector resulted in a substantial increase in

required liquid assets from September 1980. Despite the growth in the banks' liquidity base, their holdings of liquid assets in excess of the required minimum were reduced considerably. At the end of June 1980 the ratio of excess liquid assets to the banks' liabilities to the public amounted to 4,3 per cent, but it declined to 2,5 per cent at the end of 1980 and to 2,0 per cent at the end of June 1981.

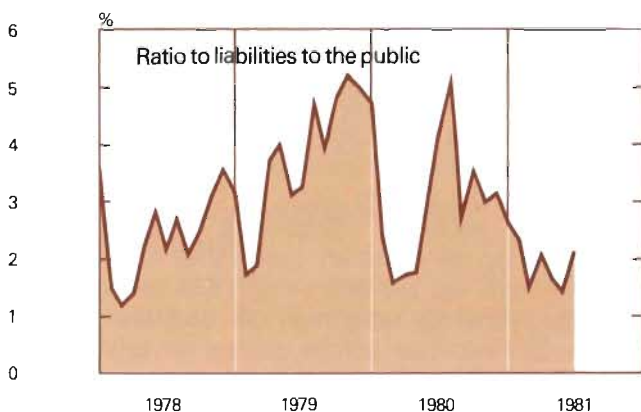
Marked change in money market* conditions

Following a period of abundant liquidity in the money market, conditions in this market started tightening towards the end of August 1980. This change was initiated by a large flow of tax funds to the government and the tighter conditions were sustained by a subsequent increase in the cash reserve requirements for banking institutions and substantial sales of short-term securities by the Reserve Bank. A more fundamental cause, however, was the onset of a period of decline in the net gold and other foreign reserves of the Reserve Bank and in the general availability of funds in the economy. This change became more evident towards the end of the year and resulted in a severe tightening of the market. Since then, the market has remained generally tight and only from time to time has experienced short periods of relative ease.

During the first quarter of 1981, characteristically a period of seasonal tightness, the market was prevented from tightening unduly by steps which had been taken in advance or during this period by the Reserve Bank to alleviate the seasonal shortage of funds. Market conditions were relatively easy during April because of increased government expenditure at the beginning of the new fiscal year. However, from early May, and especially over the May month-end, the market tightened considerably and remained relatively short of funds during June. Temporary foreign borrowing by the banks prevented an undue tightening over the June month-end, but after most of these loans had been repaid in early July, tight conditions reappeared and continued to prevail until early August.

In general, the tighter money market conditions from the end of August 1980 caused the discount houses to rely more heavily and for longer periods at a time on accommodation by the Reserve Bank. Accommodation reached a peak of R669 million at the end of 1980, but amounted to only R192 million at the end of February 1981, owing to the Reserve Bank's new policy of increased seasonal smoothing. After this accommodation had declined during March and had been fully repaid on 9 April, the discount houses were not accommodated again

Excess liquid assets of banking institutions



*The term "money market" is used here in the narrow sense, i.e. it refers mainly to the highly specialised activities of the discount houses and the National Finance Corporation, and to the behaviour of such short-term interest rates as those on call money, Treasury bills, bankers' acceptances and trade bills.

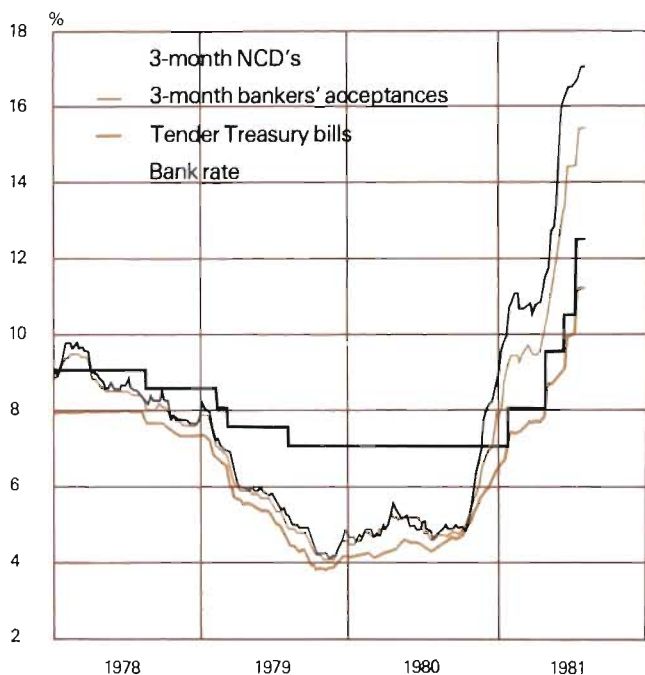
before the end of May. Despite tight market conditions, the discount houses were accommodated only by a fairly small amount at the end of June because the banks borrowed temporarily abroad to supplement their cash reserves and other liquid asset holdings at the month-end. Over the July month-end the market experienced an acute shortage of funds and accommodation to the discount houses amounted to R522 million on 30 July and R307 million at the end of the month. In order to discourage the use of Reserve Bank credit during a period of restrictive monetary policy, accommodation was mostly provided at penalty rates.

Since the beginning of the period of tighter money market conditions at the end of August 1980, the level of call loans to the discount houses has remained more or less unchanged, except for temporary declines on a number of occasions. The banks' free balances with the National Finance Corporation, however, declined to a low level from the end of August and were depleted over several month-ends. On two occasions during the first seven months of 1981 these balances were built up, namely before the tax-payment peak at the end of February and before the issue of new government stock on 15 May.

Rapid rise in short-term interest rates

Reflecting the tightening of the money market, short-term interest rates rose sharply, especially from the end of October 1980. A rapid increase in these rates occurred up to the middle of February 1981, followed by a period of relatively stable rates and the

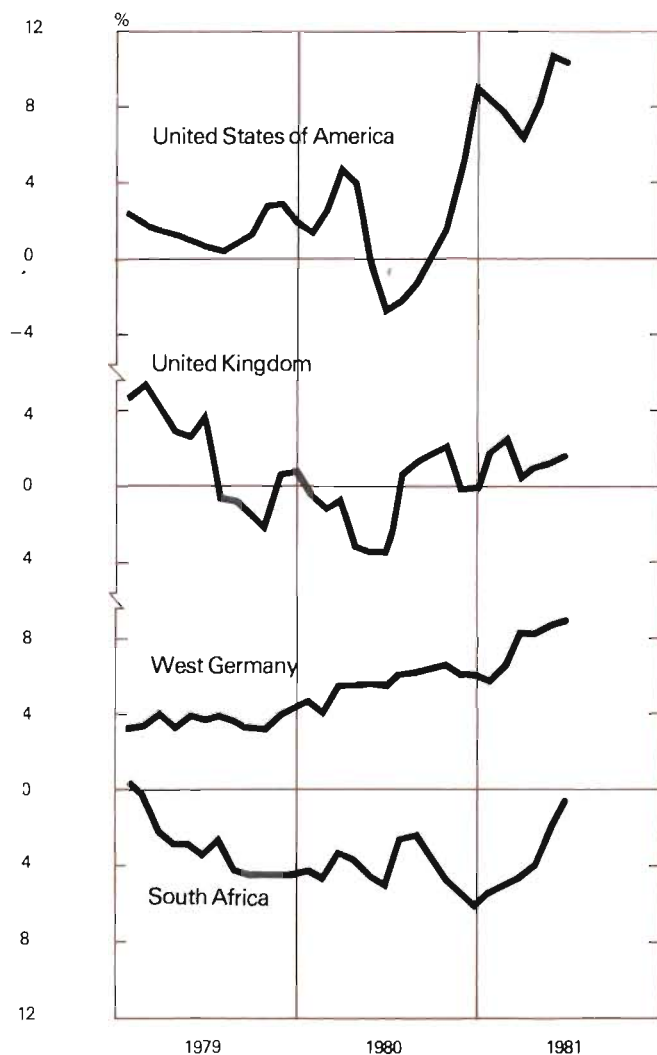
Short-term interest rates



resumption of a strong upward trend in rates in early May. The rate on three-month bankers' acceptances quoted by the discount houses, for example, rose from 4,95 per cent on 24 October 1980 to 9,50 per cent on 13 February 1981 and from 9,60 per cent on 24 April to 15,50 per cent on 7 August. The Treasury bill tender rate increased from 4,80 per cent on 24 October 1980 to 7,50 per cent on 13 February 1981, then rose slightly to 7,74 per cent on 24 April before increasing sharply to 11,26 per cent on 7 August.

In recognition of the more stringent market conditions and the increase in short-term interest rates, and in pursuance of a firmly restrictive monetary policy, the Reserve Bank raised Bank rate from 7 to 8 per cent in the first quarter of 1981 and in two steps to 10,5 per cent in the second quarter. A further increase to 12,5 per cent followed in July. In response to these changes and, more generally, the strong demand for bank credit, the prime overdraft

Real prime overdraft rates of commercial banks



rate of the commercial banks was increased from 10 per cent at the beginning of February this year to 16 per cent at the end of July. Because of more active competition for funds and the greater scope provided by the increased lending rates, the deposit rates of banking institutions were increased on various occasions and by varying percentages from November 1980 to June 1981. The increase in the prime overdraft rate of commercial banks in July, however, was not accompanied by an increase in deposit rates.

Despite the rapid rise in the commercial banks' prime overdraft rate, it exceeded the prevailing rate of inflation only after the recent increase from 14 to 16 per cent in July. In real terms, prime overdraft rates in trading-partner countries are at much higher levels. In June, for example, when the **real** prime overdraft rate in South Africa amounted to about -0,5 per cent, corresponding **real** rates of 1,7 per cent, 8,9 per cent and 10,4 per cent were recorded in the United Kingdom, West Germany and the United States of America, respectively.

Open-market operations

During recent months the open-market policy of the Reserve Bank has been directed mainly at curbing the increase in the monetary aggregates. During the first quarter of 1981, however, the main objective of the Bank's open-market operations was to offset the anticipated marked seasonal tightening of the market. Previously, during the second half of 1980, Reserve Bank debentures and special Treasury bills, of which the maturity would coincide with the large tax payments at the end of February 1981, had been issued. From the end of January the Bank operated as a net buyer of securities in the market and also bought securities under repurchase agreements. In addition, from 23 January the amount of Treasury bills offered at the weekly tender was reduced temporarily so as to effect a net repayment of bills during the period of seasonal tightness.

In the second quarter, normally a period of seasonal ease in the money market, the emphasis in the Bank's open-market operations shifted towards supporting the general monetary policy objective of curbing the high rate of growth in the money supply. Open-market purchases of securities during the period April to July, therefore, amounted to only R53 million, while open-market sales totalled R373 million. The latter consisted mostly of sales of long-term government stock during June and early July. For an extended period up to the middle of May, open-market sales of long-term paper at the continuously rising market rates had been difficult because of investors' expectations of further increases in long-term interest rates. Most of the government stock was sold to the private non-banking sector and in this way a contractionary influence was exerted on the money supply.

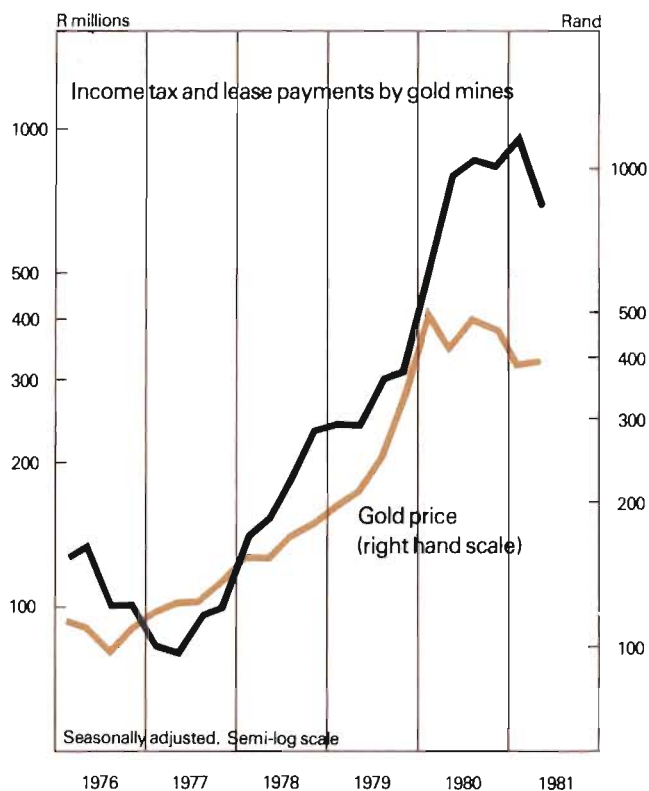
Government finance*

The fiscal year 1980/81

The high price of gold and, more generally, the buoyant economic conditions had a profound effect on government finance during the 1980/81 fiscal year, i.e. the twelve-month period to 31 March 1981. Substantially increased company profits (especially those of gold mining companies), salaries and wages, consumer expenditure and imports all contributed to a marked rise in central government revenue. Total revenue collections rose by no less than 36 per cent, as against a Budget estimate of 11 per cent. In terms of absolute amounts, total revenue exceeded the Budget estimate by R2,4 billion.

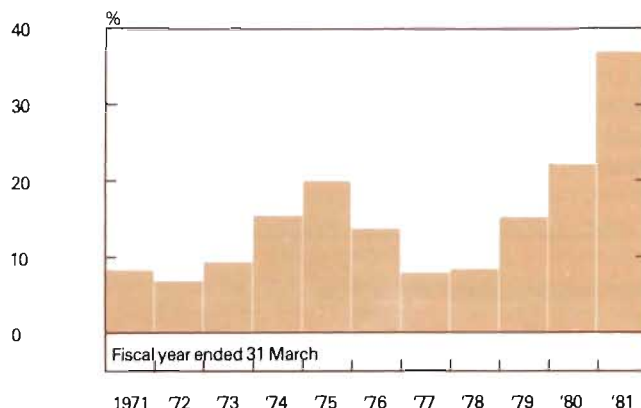
A rise in the average price of gold from R335 per fine ounce in 1979/80 to R448 per fine ounce in 1980/81 caused revenue receipts from the gold mining industry in the form of income tax and mining lease payments to soar from R1,5 billion in 1979/80 to R3,6 billion in 1980/81. In the latter period income tax payments by the gold mining

Income tax and lease payments by gold mines



*For purposes of analysing developments during the 1980/81 fiscal year and the first quarter of the 1981/82 fiscal year, the Exchequer Account was adjusted to take account of changes in the cash balances on and the net borrowing from the Paymaster-General Account and to incorporate the Stabilization Account. Some figures, therefore, do not correspond exactly with those used in the Budget.

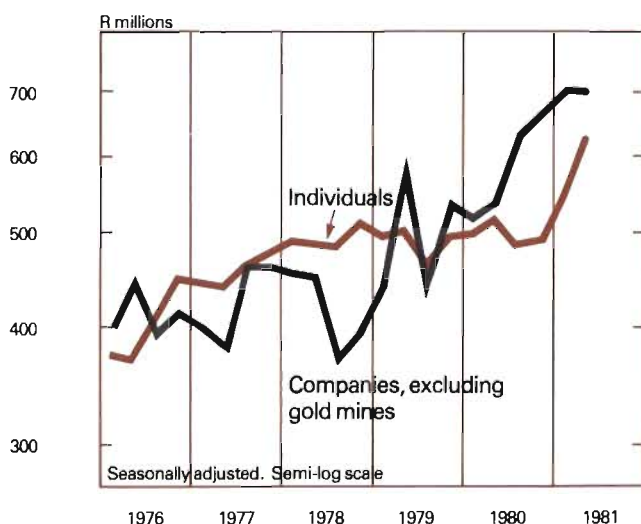
Income tax payments by gold mines as percentage of total income tax collections



companies amounted to R2,8 billion and by itself accounted for 37 per cent of the total income tax revenue of the central government. During the preceding ten fiscal years this ratio had varied between 7 and 22 per cent, indicating the extreme volatility of this component of the government's tax revenue.

Income tax payments by companies other than gold mines rose by 24 per cent in 1980/81, despite a decline in tax payments by diamond mines. Diamond mining sales and profit were affected adversely by a decrease in the overseas demand as a result of slack economic conditions in the major industrial countries of the world. Although fairly extensive tax concessions were granted to individuals, personal income tax collections nevertheless increased by nearly 8 per cent in 1980/81. This increase reflected widespread salary

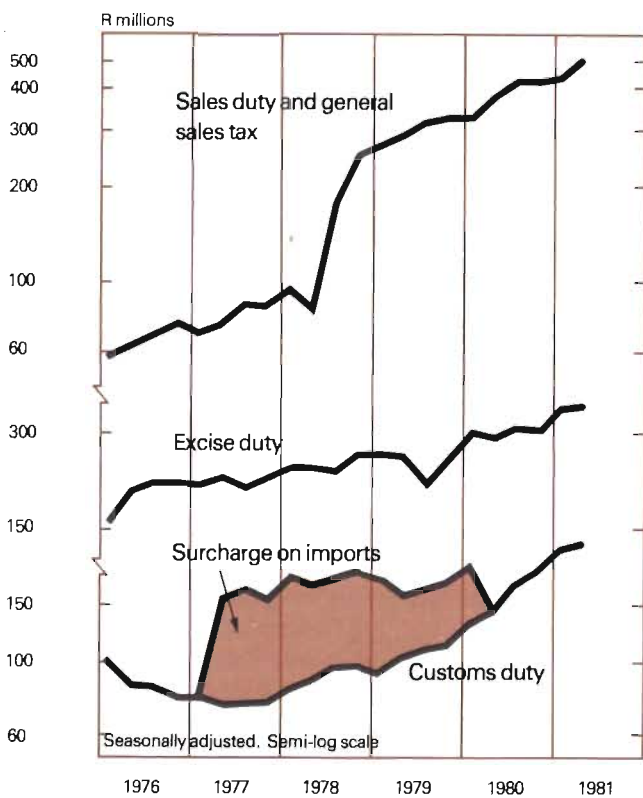
Income tax collections



and wage increases in the economy as well as the effect of the progressive personal income tax scales.

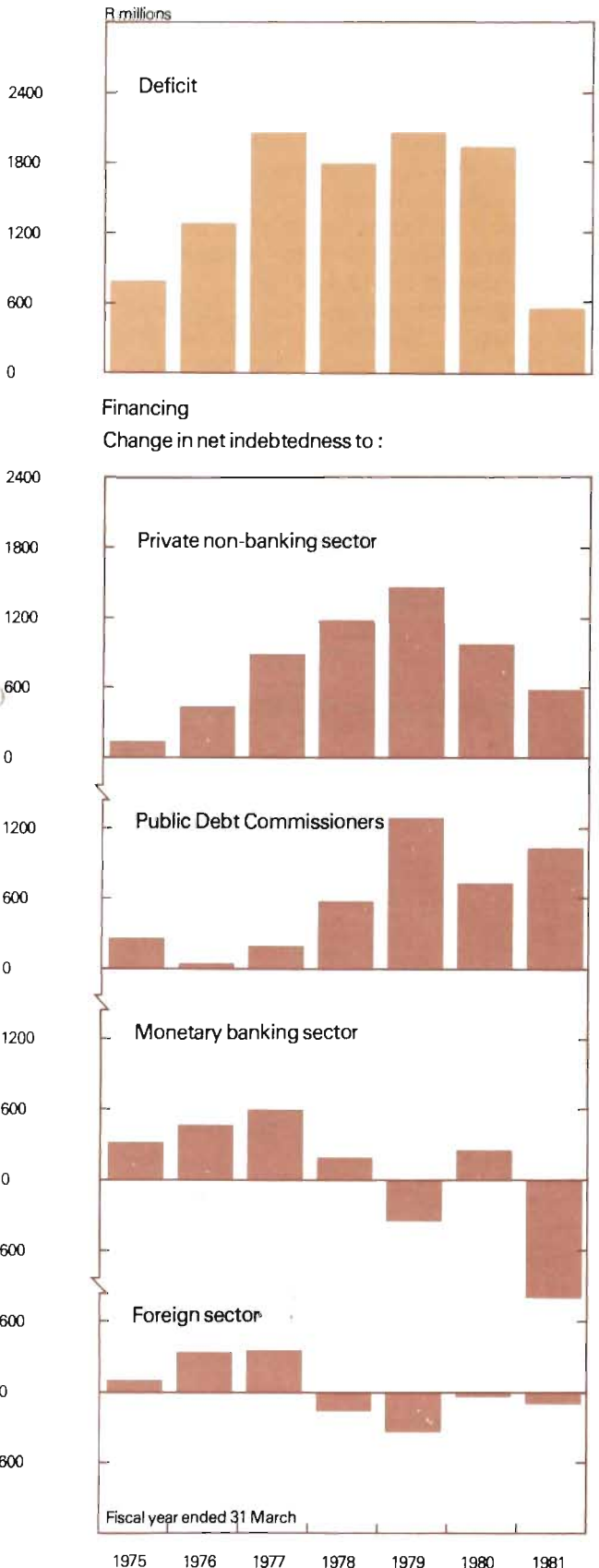
Indirect taxes in the form of customs and excise duties and general sales tax rose sharply by 23 per cent in 1980/81. Customs duty receipts were boosted by the high level of imports, while excise duty and general sales tax proceeds were raised mainly by the substantial increase in private consumption expenditure.

Main components of indirect tax



In 1980/81 the Government continued to pursue a policy of fiscal discipline by limiting the rate of growth in its nominal expenditure to a figure that was only moderately higher than the prevailing rate of inflation. Expenditure by the Central Government, as represented by issues from the adjusted Exchequer Account, increased by 18 per cent in 1980/81, compared with an original Budget estimate of 14 per cent. The difference was accounted for by expenditure approved in the Additional Budget. Including additional appropriations, government expenditure rose at a notably higher rate than the average of 13 per cent for the immediately preceding three fiscal years. However, part of the higher rate of increase was due to more rapid price and cost rises, especially fixed investment costs. In real terms, therefore, a relatively small increase in government expenditure was recorded in 1980/81.

Exchequer Account deficit and financing



Because of the high level of government revenue, the deficit on the adjusted Exchequer Account, excluding borrowing and debt repayment, amounted to only R552 million in 1980/81. This deficit was not only well below the corresponding figure of R1 936 million in 1979/80, but was also the smallest since 1973/74, and in relation to gross domestic product the smallest ever. From the point of view of financing government expenditure, there was little inducement for the Government to borrow in the financial markets. The Public Debt Commissioners' net investment of R1 048 million in government securities was more than adequate to finance the revenue shortfall. Nevertheless, although long-term borrowing was hampered by expectations of further increases in interest rates and a consequent reluctance on the part of institutional investors to acquire new long-term fixed-interest securities, a net amount of R597 million was borrowed from the private non-bank sector for purposes of monetary policy.

The borrowing from domestic non-bank sources enabled the Government to repay foreign debt of R96 million and to reduce the Exchequer's net indebtedness to the monetary banking sector by R997 million. The latter consisted mainly of an increase of R961 million in cash balances with the monetary banking sector. The balance on the Stabilization Account rose by R1 242 million, but the balances on the Exchequer Account and the Paymaster-General Account together declined by R281 million.

Although the net indebtedness of the Exchequer to the monetary banking sector declined during the fiscal year, the net indebtedness of the government sector as a whole increased by R122 million. This difference was accounted for mainly by the use of funds in the Stabilization Account to grant loans to the National Supplies Procurement Fund for the purpose of building up strategic inventories.

Developments in the first quarter of the 1981/82 fiscal year

Following the same pattern as in the preceding fiscal year, issues from the adjusted Exchequer Account increased sharply in the first quarter of the 1981/82 fiscal year and exceeded those in the corresponding quarter of 1980/81 by as much as 23 per cent. Revenue receipts, on the other hand, did not increase as vigorously as previously and were 15 per cent higher than in the first quarter of the 1980/81 fiscal year.

Of the main revenue components, personal income tax receipts and indirect taxes rose sharply, but the increase in company income tax receipts tended to slow down. Revenue receipts (mostly income tax) from gold mining companies were actually lower than in the first quarter of the 1980/81 fiscal year, as the effect of the decline in the gold price on gold mining profits started to assert itself. Income tax receipts from companies other than gold mines increased at a lower rate, apparently

because of a backlog in the processing of tax returns by the receivers of revenue. Although the profits of these companies are expected to rise more slowly during the current fiscal year as a result of the general economic slow-down, the effect of this is likely to be reflected in tax revenue only at a later stage.

The high rate of growth in issues and the slow-down of the increase in revenue resulted in a deficit of R1 348 million on the adjusted Exchequer Account in the first quarter of 1981/82. Borrowing from the private non-bank sector, including a highly successful new issue of government stock in May and subsequent sales by the Reserve Bank of stock issued on tap, amounted to R681 million. In addition, the Public Debt Commissioners invested a net amount of R37 million in government securities. In financing the remainder of the deficit the Government borrowed a net amount of R44 million abroad and the Exchequer's net indebtedness to the monetary banking sector was increased by R586 million. The latter amount accounted for most of the increase of R747 million in the net indebtedness of the government sector as a whole to the monetary banking sector during the second quarter of 1981.

The 1981/82 Budget

In his presentation of the 1981/82 Budget on 12 August, the Minister of Finance concluded that the prevailing economic situation called for a budgetary policy of "consolidation and adjustment". Firstly, this policy would aim at consolidating the economic gains made during the recent cyclical upswing in the economy. Secondly, it would assist in the adjustment to the adverse impact on the economy of the set of conditions created by the prevailing international recessionary tendencies, the abnormally high interest rates in the United States and elsewhere, the substantial appreciation of the US dollar, and the sharp decline in the price of gold.

The Minister stated that although the economy appeared about to follow Western Europe into a downward phase of the business cycle, a policy of outright stimulation of demand through increased deficit spending financed by bank credit could not be pursued. Any premature stimulation of demand, while the economy was still operating at full capacity, would result in an acceleration of the rate of price increases. Inflation remained a major problem and its combating would continue to receive the highest priority. Fiscal and monetary policy would not be able to neutralise the adverse changes in the external circumstances affecting the economy. Accordingly, the balance of payments adjustment process would have to be permitted to proceed and would have to be assisted by fiscal and monetary policies, even if this meant that demand would have to be restrained at a time of slower economic growth.

However, given the expected cyclical slow-down of economic activity and the firm restrictive monetary policy which is at present being applied, government expenditure could be allowed to rise mode-

rately in real terms in the fiscal year 1981/82, provided that it would continue to increase at a lower rate than aggregate real gross domestic expenditure. For the same reasons, the "deficit before borrowing" could be permitted to rise to a more normal figure in relation to the gross domestic product, provided that it would continue to be financed without net recourse to the banking sector.

Against this broad policy background, the Budget provided for expenditure of R15 871 million in the 1981/82 fiscal year, or 16,8 per cent more than in the preceding fiscal year. Aggregate revenue in 1981/82, including a moderate increase in customs and excise duties, was estimated at R13 164 million, or about 1 per cent less than in the preceding fiscal year. The deficit before borrowing was estimated at R2 707 million. This amount, together with loan repayments of R2 842 million, would result in an estimated financing requirement of R5 549 million. It was envisaged that foreign and domestic borrowing would amount to R350 million and R5 159 million, respectively, and that the remaining amount of R40 million would be financed from available cash balances. In the amount to be borrowed domestically, provision was made for reinvestment of loan redemptions and new marketable stock issues of R2 714 million, an increase of R595 million in non-marketable debt, and borrowing of R1 850 million from the Public Debt Commissioners.

As part of the further structural reform of the tax system, the Minister announced the phasing-in of a tax on fringe benefits over the 1982/83 and 1983/84 tax years; the phasing-out of separate taxation of Blacks from 1 March 1982; and an amendment to the PAYE tax-deduction system from 1 March 1982, in terms of which individual taxpayers with taxable incomes of not more than R7 000 per annum will be relieved from rendering income tax returns, provided that such incomes are derived from salaries and wages.

Capital market

Decline in the general availability of funds

In the course of 1980, and more distinctly towards the end of the year, conditions in the capital market were influenced by the decline in the general availability of funds in the economy. In the last quarter of 1980 long-term interest rates, which had been edging upwards from about the second quarter of the year, started to rise strongly. At the same time, the share, mortgage and real estate markets began to lose their buoyancy of the preceding two years. These changes became more pronounced during the first half of 1981.

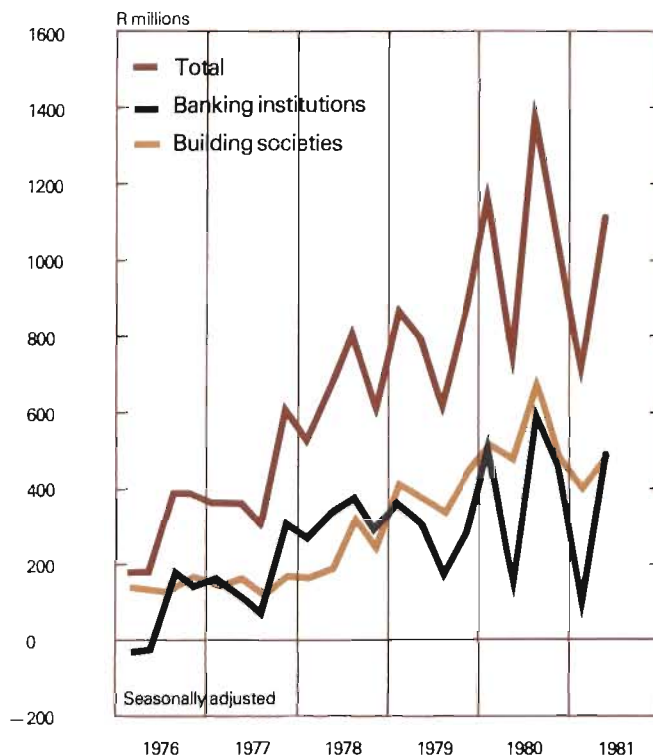
The overall supply of funds continued to be augmented during most of 1980 by the effect on incomes and savings of the high price of gold, the high level of export proceeds and the generally buoyant economic conditions, and by the extension of bank credit. However, in contrast with 1978 and 1979, the supply of funds was increasingly being matched by demand and when supply started to grow more slowly towards the end of 1980, it was actually overtaken by the domestic demand for funds. Apart from a more rapid rise in interest rates, these changes were reflected during the first half of 1981 in, among other things, a decline in the liquidity of some institutional investors and the corporate sector, a smaller flow of non-contractual savings to financial intermediaries, a net inflow of foreign capital, and a greater reliance on bank credit as a source of finance.

Smaller increase in holdings of longer-term funds with non-contractual savings institutions

The increase in holdings of longer-term funds with banking institutions, building societies, participation mortgage bond schemes and government savings schemes, which had accelerated from about R1 630 million in 1977 to as much as R4 400 million in 1980, slowed down considerably during the first half of 1981. At a seasonally adjusted annual rate, the increase during the latter period amounted to R1 100 million. The different groups of institutions were not equally successful in attracting new longer-term funds during this six-month period. The share of banking institutions in the overall intake of new funds declined from 38 per cent in the two years 1979 and 1980 to 32 per cent in the first half of 1981, while the share of building societies remained unchanged at 50 per cent and that of government saving schemes increased from 11 to 15 per cent. Participation mortgage bond schemes attracted a relatively insignificant amount of new funds in 1980, but more recently a renewed interest in the type of mortgage loans granted by them resulted in a somewhat larger intake of funds.

The smaller investment of new longer-term funds with banking institutions and building societies during the first half of 1981 reflected mainly the high level of private consumption expenditure and its effect on deposit-type savings, as well as the effect of the withdrawal of funds which had been invested

Change in holdings of longer-term funds with financial institutions



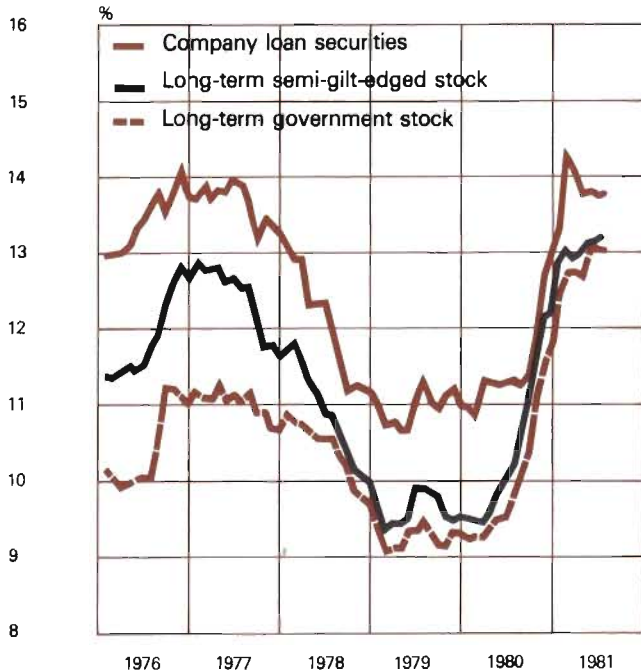
temporarily with these institutions by corporate and institutional investors. These funds were reinvested elsewhere at higher yields or used for the financing of fixed and inventory investment. The building societies were particularly hard hit by the withdrawal of funds which had been placed with them on a temporary basis during 1979 and 1980. During this two-year period private corporate and institutional investors' holdings of funds with building societies increased by R940 million, or from 9 to 14 per cent of the societies' total shares and deposits.

Because of a continuing strong demand for housing loans and an increasing demand for bank credit, deposit-receiving institutions started competing very actively for funds during the latter part of 1980 and this competition gained in intensity in 1981. This gave rise to several adjustments in deposit and related interest rates. From the end of June 1980 to the end of June 1981 increases in deposit rates other than those on ordinary savings deposits ranged from 2,5 to 3,0 per cent, while the corresponding increases in the rates on tax-free investments ranged from 1,0 to 1,6 per cent.

Fixed-interest security market

A comparatively small amount of new funds was raised in the fixed-interest security market during 1980, mainly because of the small borrowing requirement of the Central Government and the high level of liquidity in the corporate sector. More

Secondary market security yields

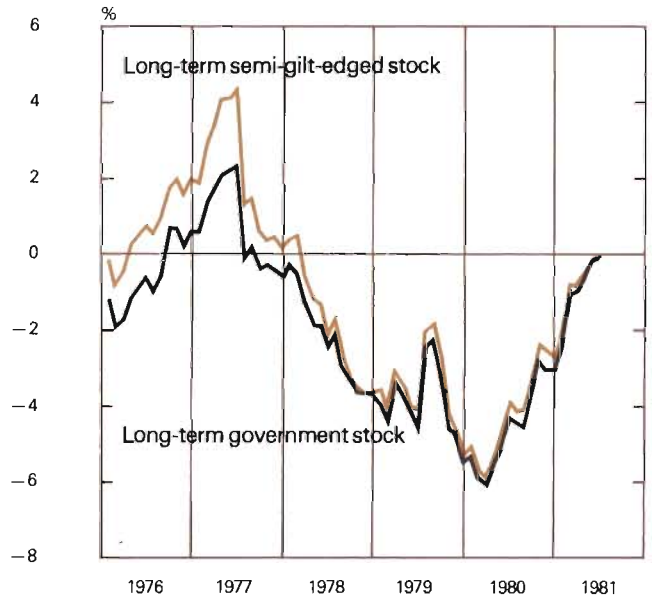


generally, investment in fixed-interest securities was inhibited by investors' expectations of further increases in interest rates. New funds raised by the public sector in the market during the first half of 1981, mostly during the second quarter, amounted to R1 560 million and was more than double the half-yearly average of R724 million in 1980. The private corporate sector raised a relatively small amount of new funds in the fixed-interest security market during the first half of 1981. Following the period of high corporate liquidity, they had not as yet, except for special issues, resorted to any significant extent to borrowing in the form of security issues.

The increase in secondary market yields on long-term fixed-interest securities since early 1980 accelerated sharply from the last quarter of 1980, but most of these yields tended to stabilise during the second quarter of 1981. The monthly average yield on long-term government stock increased from 9,26 per cent in March 1980 to 10,40 per cent in September before rising to 13,02 per cent in July 1981. In the case of long-term semi-gilt-edged stock of the highest grade, the monthly average yield increased from 9,42 per cent in March 1980 to 10,97 in September, and subsequently rose to 13,20 per cent in July 1981. The increase in the monthly average yield on company loan securities during the corresponding periods was from 11,30 per cent to 11,40 per cent and 13,80 per cent, respectively.

Despite the sharp increases in long-term yields during the past year, they have remained negative in real terms, i.e. if they are adjusted for price increases.

Real security yields



As shown in the accompanying graph, real long-term fixed-interest yields have been mostly negative since the commencement of the high-inflation period in 1971. Only for a brief period from 1976 to 1977 were positive real yields recorded.

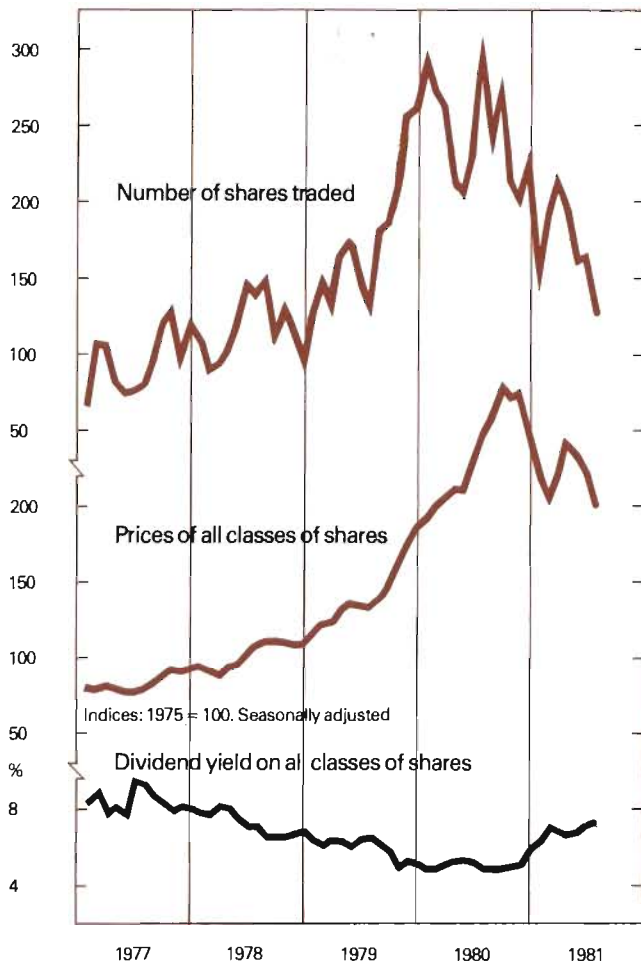
Share market

The sustained increase in stock exchange turnover and share prices from the middle of 1977 came to an end in September 1980. Since then, except for a slight temporary recovery in March and April 1981, turnover and prices have been on a downward course. This change from the last quarter of 1980 coincided with the more rapid rise in interest rates and the decline in the price of gold, and was also related to the anticipated lower rate of growth in real economic activity in 1981. The number of shares traded on the stock exchange was 49 per cent lower in the second quarter of 1981 than in the third quarter of last year, while share prices in July 1981 were on average 33 per cent below the peak in September 1980. Mining share prices, which had shown the largest increase during the period of rising share prices, declined the most during the last quarter of 1980 and the first half of 1981. Gold mining share prices, for example, decreased by 52 per cent from September 1980 to July 1981.

The falling share prices were reflected in an increase in dividend yields. The average dividend yield on all classes of shares, which had declined to 4,75 per cent in September last year, rose to 7,37 per cent in July 1981.

An interesting feature of stock exchange activity in 1980 was the participation by foreign investors

Stock exchange

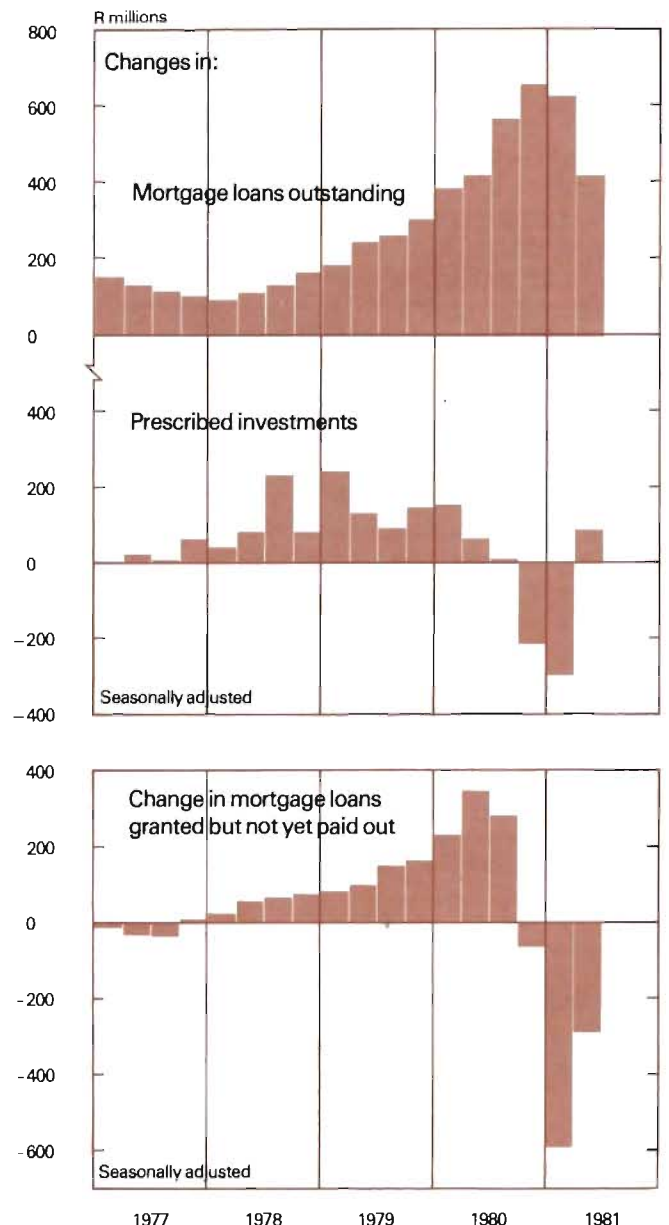


through financial rand transactions. Gross purchases of shares by foreigners accounted for 33 per cent of the total value of shares traded on the stock exchange. Their net purchases of R89 million were, apart from a small amount of R15 million in 1978, the first significant net investment in listed South African shares since 1972. Although gross purchases of shares by foreigners declined during the first half of 1981 in accordance with the generally lower turnover, their net share purchases still amounted to R16 million during this period.

Mortgage and real estate markets

The smaller inflow of new funds caused the building societies to curb their new mortgage lending during the first half of 1981. The average monthly amount of new mortgage loans granted declined from R383 million in 1980 to R158 million in the first six months of 1981. Because of a substantial increase in commitments in the form of new mortgage loans granted but not yet paid out, namely from R880 million at the end of 1979 to R1 635 million at the

Building societies



end of 1980, the societies maintained their new mortgage loan pay-outs at a high level. The average monthly amount of R353 million in the first half of 1981 actually exceeded that of R349 million in 1980. By granting a smaller amount of new loans and by maintaining the amount of loans actually paid out at a high level, the societies were able to reduce their outstanding commitments to R831 million at the end of June 1981. However, in order to continue with relatively large mortgage loan pay-outs in the face of a smaller intake of new funds, the societies had to liquidate part of their holdings of prescribed investments. These investments, which had reached a peak of R2 155 million at the end of August 1980, were reduced to R1 903 million at the end of 1980 and

R1 676 million at the end of June 1981. At the same time, in order to prevent the withdrawal of large amounts of corporate and institutional deposits which they had accepted during the period of high liquidity in 1980, the societies offered interest rates on these deposits which were generally higher than their own lending rates.

In line with the increase in their borrowing rates, the building societies raised their mortgage rates by 0,75 per cent in January and by a further 1,5 per cent in April. After these adjustments, the rates ranged from 11,25 to 13,25 per cent. The further increase in interest rates generally, together with the strong demand for housing finance in relation to the supply of funds and the societies' bidding for "wholesale" deposits at high rates, exerted pressure on the societies to increase their mortgage rates still further. On 13 August it was announced that the mortgage rate will be increased by 1 per cent, with immediate effect on new loans and from 1 October on existing loans.

The dwindling general availability of funds, the curbing of new mortgage lending by building societies, and higher mortgage rates and property prices resulted in a levelling off in real estate transactions during the first half of 1981. The average monthly value of transactions during this period amounted to R491 million and was appreciably below the high level of R552 million to which it had risen in the fourth quarter of 1980. Insurers and privately administered pension funds were important investors in fixed property in 1980. Their holdings of fixed

property increased by R487 million during this period, compared with only R172 million during 1979.

Fixed property market

