Annual Economic Report 1983

South African Reserve Bank

Annual Economic Report 1983

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-third ordinary general meeting to be held on 23 August 1983.

South African Reserve Bank

Hierdie verslag is ook in Afrikaans beskikbaar.

Contents

Introduction

During 1982 and the first half of 1983 the South African economy made considerable progress in adjusting to the changed circumstances brought about by the international recession, the decline in the gold price after January 1980 and, more recently, the severe drought. Evidence to support this view was provided by the dramatic improvement on the current account of the balance of payments, the substantial rise in net foreign reserves from the middle of 1982, the emergence of surplus production capacity, the disappearance of most skilled labour constraints, and some abatement of demand pressures on prices. In this respect, the less accommodative monetary policy which the authorities applied in 1981 and 1982, in co-ordination with a policy of fiscal discipline, achieved important objectives.

Up to the middle of 1983, however, the rate of inflation had not as yet declined to the desired extent. Admittedly, there was some slow-down of the increase in consumer and production prices. And more recently other indicators of inflation, such as the rates of increase in salaries and wages, unit labour costs and import prices, have also begun to point to stronger moderating influences on prices. But despite these favourable indications, the South African rate of inflation remained high and inflationary expectations firmly entrenched. Measured over a twelve-month period, consumer prices increased at a rate of 12,4 per cent in June 1983, about two-and-a-half times as high as the average for South Africa's seven main trading partners.

Acknowledging these facts, including the surplus achieved on the balance of payments, the emphasis in economic policy in 1983 shifted more explicitly towards curbing inflation. To this end, it was deemed desirable to follow a less accommodative monetary policy so as to create an environment, in terms of the availability of money and credit and appropriate interest and exchange rates, that would be conducive to the further reduction of inflationary pressures and the unwinding of inflationary expectations.

Also with a view to curbing inflation, the 1983/84 Government Budget, presented in March 1983, adhered to the now established principle of expenditure restraint and sought to achieve a rate of increase in expenditure that would imply little increase in real terms. Equally important and more pertinent to the strengthening of monetary control, the Budget aimed at a relatively small deficit before borrowing in order to avoid any monetary financing.

Recognising that changes in monetary aggregates may have been distorted by the banks' innovative practices and that care has to be taken in interpreting short-term fluctuations in South Africa's monetary aggregates, as *currently defined and measured at month-ends*, a fairly clear pattern of change was nevertheless observed in the rate of monetary expansion from about the middle of 1982. Under the impact of a considerable improvement in the overall balance of payments and an accompanying increase in net foreign reserves, monetary expansion gathered some pace during the six months to January 1983. During the first half of 1983 the money supply growth rate accelerated further, mainly because of the extent to which the government sector availed itself of net bank credit — a process which served to provide the banks with adequate cash reserves and therefore enabled them to expand their credit to the private sector as well. The end result was that, viewed over a period of twelve months, the increase in the broad money supply (M2) accelerated from 17 per cent at the end of 1982 to 22 per cent in June 1983, a rate of increase which exceeded the rate of inflation by a substantial margin and was not consistent with the policy objective of moderating the continuing high rate of inflation.

Under the influence of the more rapid monetary expansion, interest rates started to decline in the third quarter of 1982. But the steep downward movement to the middle of February 1983 suggests that important other forces were also at work. Not only was there a cyclical weakening of the demand for credit, but expectations of a prospective decline in interest rates, created by an increase in the gold price and a decline in interest rates abroad, also played their part.

This change was also reflected in an easing of money market conditions, apart from intermittent periods of seasonal tightening. The cyclical impact on the demand for funds was also felt in the capital market. A slow-down of the demand for funds for the financing of real economic activity, in combination with the further expansion of liquidity in the economy, found expression in lower long-term interest rates, either in the primary market or through the bidding-up of security prices in the secondary market.

As a result of these sharp declines, short as well as long-term interest rates became significantly negative in real terms in the first half of February 1983. Although some rates began to firm during March, April and May, it was not until June that both short and long-term interest rates increased sharply again — a tendency which then continued into August. The main reason for the change from June onwards was the more consistent application by the authorities of the financing policies announced in the March Budget and the consequent reduction in the net claims of the banking sector on the government sector, which had increased considerably during the preceding three months, even after allowing for seasonal variations.

Although the causality between exchange rates and current balance of payments transactions runs in both directions, the exchange rate of the rand was influenced in a fundamental way by the improvement in the current account balance. At a seasonally adjusted annual rate, this balance had still been negative to the extent of R7,1 billion, or 9 per cent of gross domestic product, in the first quarter of 1982, but the deficit shrunk rapidly and gave way to a surplus of R1,1 billion in the fourth quarter. This fast turnaround was accompanied by expectations of an appreciation of the rand. In conjunction with interest rate differentials, these expectations gave rise to a net inflow of capital from the third quarter. During the period of seven months to January 1983, in which net foreign reserves increased by R2,4 billion, the rand in fact appreciated in effective terms by 10 per cent.

Despite a subsequent net outflow of capital, the rand gained further ground during the six months to July. Fundamentally, this reflected the continued improvement of the current account balance. But it also fitted into a consistent strategy for controlling inflation, in which higher exchange rates would be supportive of tighter monetary control and the accompanying higher interest rates and wider interest rate margins, relative to foreign rates, that would characterise such a situation.

South Africa could, of course, not escape the severe and protracted international recession. In time the initial downward adjustment in the economy turned into a full-scale recession. Real gross domestic product regressed by 1 per cent in 1982 and by a notably higher rate in the first half of 1983. This decline reflected a continuing slack demand for exports and a weakening of aggregate domestic demand. On top of this, South Africa experienced one of the worst droughts ever recorded. Not only was there a sharp decline in agricultural output, but via backward and forward linkages the effect of the drought permeated through the entire economy. Receding real output was accompanied by an actual decline in employment from the second half of 1982 and by rising unemployment.

South Africa, therefore, at the moment finds itself still firmly in a downward phase of the business cycle, characterised by regressing output and rising unemployment. Despite the present relatively low gold price and the severe drought conditions, however, there are indications that the downturn may soon start to level out, if it has not already begun to do so. The economic recovery in the United States is now clearly under way and should increasingly exert expansionary effects on Europe and Japan. The prospects are that South Africa will in due course benefit from this via an export-led recovery. Inevitably, the timing and momentum of this expected new upswing will depend in no small measure on the behaviour of the gold price.

Domestic economic developments

Demand and output

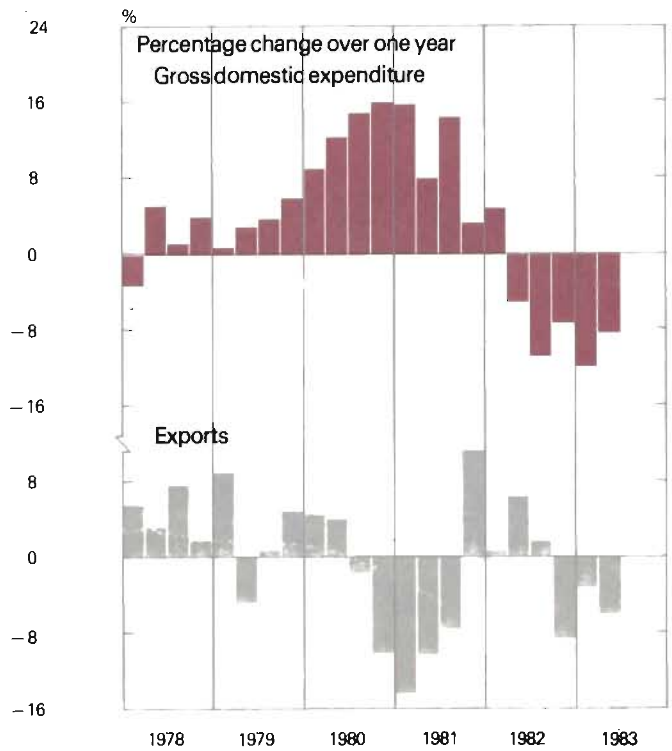
Real aggregate demand showed a pronounced downward tendency during the eighteen months to June 1983. Not only did the demand for exports continue to decline in real terms, but real domestic demand also decreased further. Export demand remained subdued under the influence of the sustained international recession which was only beginning to abate in some of the industrial countries in the first half of 1983. The decline in domestic demand reflected the cyclical downswing, transmitted through falling export proceeds to the South African economy, as well as the influence of the less accommodative fiscal and monetary policies that had been adopted in 1981 to restore balance of payments equilibrium and to moderate the inordinately high rate of inflation. Although external equilibrium had been achieved by the end of 1982, at least as far as the current account of the balance of payments is concerned, the persistently high rate of inflation and the inappropriately low level of net foreign reserves still left little scope for the promotion of economic growth through stimulation of demand.

In addition to the influence of diminishing aggregate demand, real output was affected adversely by one of the worst droughts ever recorded in South Africa. The effect of the drought was not only confined to a sharp fall in agricultural output, but permeated via backward and forward linkages through the entire economy.

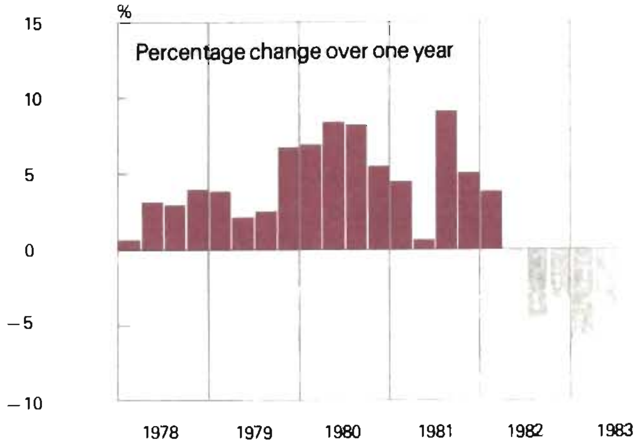
Real gross domestic product declined by 1 per cent in 1982 and regressed further at a seasonally adjusted annual rate of about 6½ per cent in the first half of 1983. The latter figure clearly reflected both the primary and the secondary effects of the marked drop of 34 per cent in real agricultural output. By the second quarter of 1983 overall real gross domestic product had declined by 8 per cent from its cyclical peak in the fourth quarter of 1981, the sharpest drop in any downswing period during the post-war period.

The decline in real output during the eighteen months to June 1983 was evident in virtually all sectors of the economy, indicating widely dispersed recessionary conditions. Exceptions were to be found only in gold mining production, owing to increased production capacity and a rise in the quantity of ore milled; in the output of the sector electricity, gas and water; and in financial and government services, reflecting a high level of financial (including real estate) activity and increased government employment, respectively. Judging by preliminary figures for the second quarter of 1983, the indications are that the declining real output

Real gross domestic expenditure and exports



Real gross domestic product



Percentage change in real gross domestic product

	1981	1982	1983 1st half[1]
Primary sectors	**1**	**−4½**	**−15**
Agriculture	3	−8	−34
Gold mining	−2½	1	3
Non-gold mining	1	−5	−2½
Secondary sectors	**7**	**−2½**	**−10½**
Manufacturing	6½	−3	−13
Electricity, gas and water	11	6	−2
Construction	8	−4	−1½
Tertiary sectors	**4**	**1**	**−2**
Trade	7	−1	−5
Transport and communication	6½	−2	−8
Financial services	3½	3	1½
General government services	1½	3	3
Total gross domestic product.	**5**	**−1**	**−6½**
Non-agricultural sectors	5	−½	−4½

1 Changes from preceding half year at seasonally adjusted annual rates

trend may be levelling out in important sectors such as non-gold mining, manufacturing, construction and trade.

South Africa's terms of trade deteriorated further in 1982, but showed a slight improvement in the first half of 1983. Net factor payments to the rest of the world increased almost throughout this eighteen-month period. If the change in real gross domestic product is adjusted for these changes, real gross *national* product, a measure of national welfare, declined by 3½ per cent in 1982 and at a seasonally adjusted annual rate of 5 per cent in the first half of 1983.

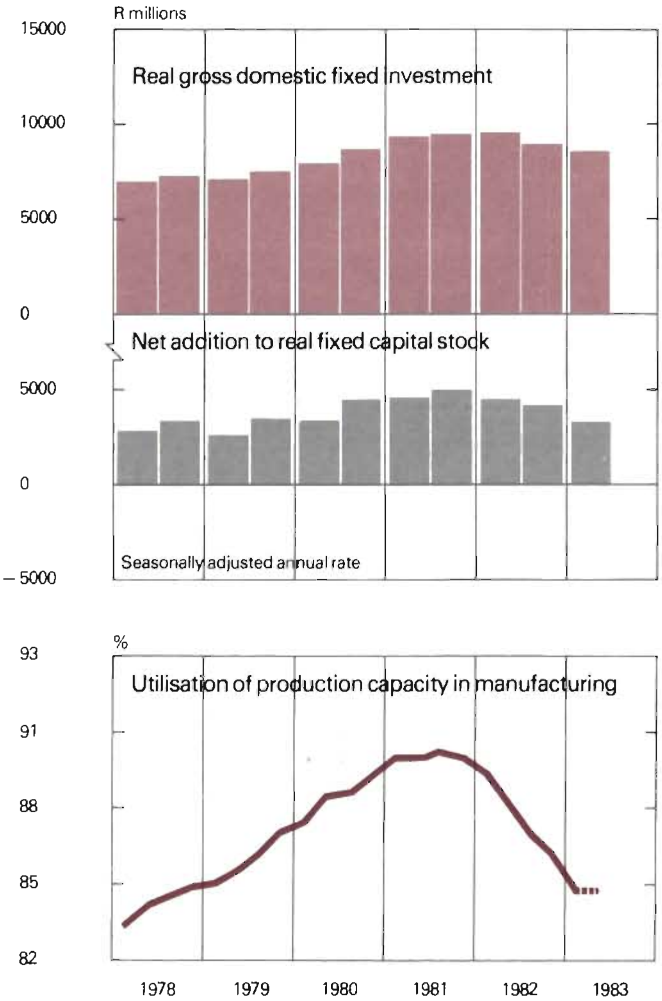
Changes in non-agricultural real gross domestic product and real industrial and commercial inventories during periods of economic upswing and downswing
R millions

	Changes in non-agricultural real gross domestic product	Changes in real industrial and commercial inventory investment
Upswing periods		
4th qtr 1961 to 1st qtr 1965	967	47
1st qtr 1966 to 1st qtr 1967	283	239
1st qtr 1968 to 4th qtr 1970	967	260
4th qtr 1972 to 2nd qtr 1974	625	416
1st qtr 1978 to 3rd qtr 1981	1 542	546
Downswing periods		
2nd qtr 1960 to 3rd qtr 1961	240	−106
2nd qtr 1965 to 4th qtr 1965	141	−97
2nd qtr 1967 to 4th qtr 1967	110	−226
1st qtr 1971 to 3rd qtr 1972	101	−324
3rd qtr 1974 to 4th qtr 1977	254	−366
4th qtr 1981 to 2nd qtr 1983	−410	−559

Changes in components of real aggregate demand

A component of real aggregate demand that responded sharply to the economic downswing during 1982 and the first half of 1983 was inventory investment. Real inventories, which had still increased by R1 960 million in 1981, declined by R1 346 million in the subsequent eighteen months. Industrial and commercial inventories contributed R1 094 million to this decline. The shift from accumulation to liquidation of inventories was a major cause of the drop in real demand and output. As shown in the accompanying table, this shift was more prominent in its effect on output during the current period of economic downswing than during any other upward or downward phase of the business cycle since 1960. The main reasons for the pronounced inventory disinvestment were the increased carrying costs brought about by higher interest rates, and the

Investment, addition to capital stock and utilisation of production capacity



need for a better alignment of industrial and commercial inventories with falling sales.

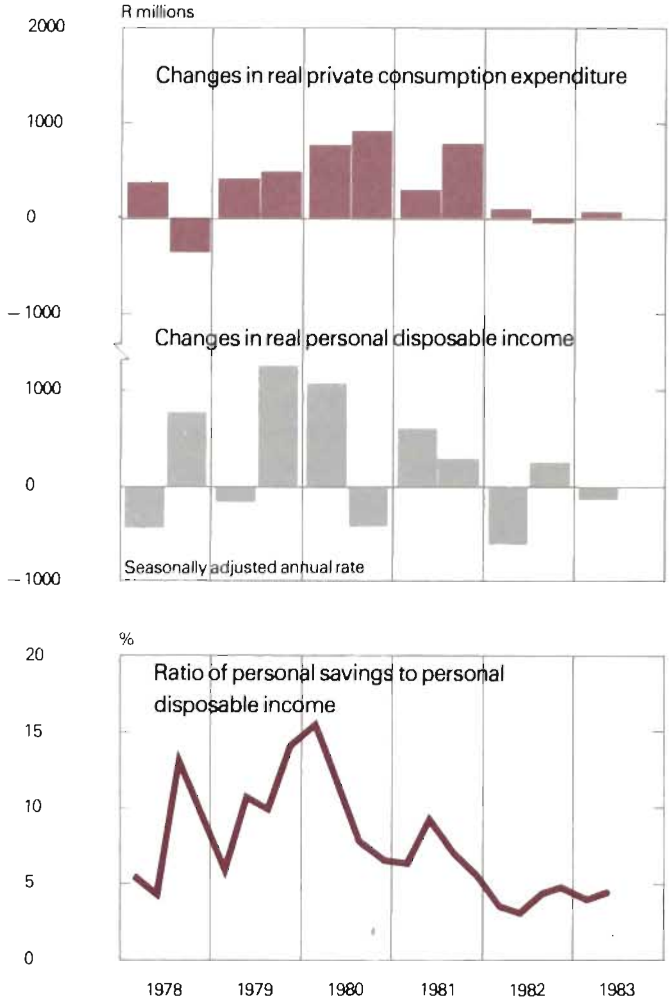
Gross fixed investment was another component of real aggregate demand that declined appreciably during the eighteen months to June 1983. In 1982, real gross domestic fixed investment declined by 1½ per cent and this was followed by a seasonally adjusted annual rate of decline of 8 per cent in the first half of 1983. Declines were recorded in most sectors of the economy and they were generally related to the decline in real inventory investment, the slow-down in consumer demand and higher interest rates. An exception was the rise in real fixed investment in private residential construction owing to a housing backlog and an increased availability of funds in the mortgage market. In addition, because of fairly stable and cyclically insensitive expansion programmes, the Electricity Supply Commission continued to increase its real fixed capital outlays.

An exceptionally large decrease was recorded in the real fixed investment of the manufacturing sector, reflected in the fixed investment programmes of public corporations (in particular Sasol) as well as private concerns. Despite this decline, the production capacity of the manufacturing sector, as measured by the real fixed capital stock, still increased by 5 per cent from the first quarter of 1982 to the second quarter of 1983. With manufacturing production declining steadily over this period, the utilisation of production capacity in total manufacturing declined from 89 per cent in the first quarter of 1982 to approximately 85 per cent in the second quarter of 1983.

Private consumption expenditure was a more stable component of real aggregate demand during 1982 and the first half of 1983. It started to decline only in the second half of 1982 and moved upwards again in the second quarter of 1983. In 1982 as a whole, real private consumption expenditure still increased by 2½ per cent but, at a seasonally adjusted annual rate, the increase slowed down to ½ per cent in the first half of 1983. The more discretionary component of real consumer expenditure, namely outlays on durable and semi-durable goods, declined from the second quarter of 1982, but appeared to have turned around again in the course of the first six months of 1983. The more essential expenditure on non-durable goods and services maintained an upward course during the full eighteen-month period under consideration.

Changes in real private consumption expenditure were mostly related to changes in real personal disposable income and shifts in the personal savings ratio. In 1982 and the first half of 1983, real personal disposable income was affected adversely by a somewhat lower rate of increase in nominal salaries and wages, a decline in net agricultural income, the

Private consumption expenditure and personal disposable income and saving



Percentage change in real aggregate demand

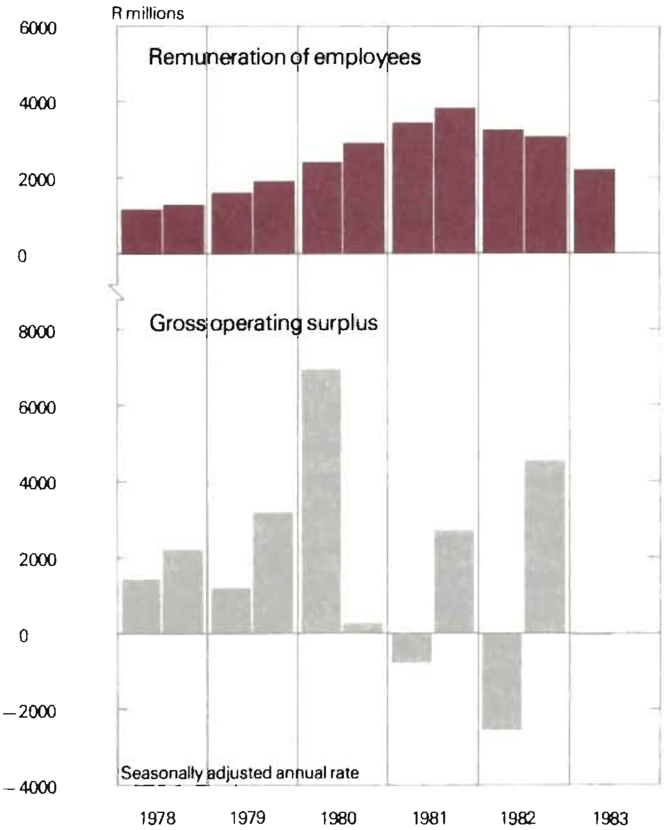
	1981	1982	1983 1st half[1]
Private consumption expenditure	6½	2½	½
Government consumption expenditure	3	4	3½
Gross domestic fixed investment	12½	−1½	−8
Change in inventories[2]	2½	−8	−2
Gross domestic expenditure	10	−5	−8
Exports of goods and non-factor services	−6	–	−11
Less: Imports of goods and non-factor services	13	−15	−18
Gross domestic product	5	−1	−6½

1 Change from preceding half year at seasonally adjusted annual rates.
2 As a percentage of preceding year's gross domestic product.

sustained high rate of inflation and the increasing effect of "fiscal drag" on personal income tax payments. A lack of increase in employment also served to limit the growth in personal income. As shown on the accompanying graph, the rate of increase in real private consumption expenditure generally exceeded the rate of growth in real personal disposable income from 1981, implying a decline in the personal savings ratio. This decrease was directly related to the continued large-scale use of consumer credit for the financing of consumption expenditure, even after the economic downswing had become firmly established. Only during the first half of 1983 was there some renewed strengthening of the propensity to save.

Like private consumption expenditure, real government consumption expenditure was a fairly stable demand component during the eighteen months to June 1983. Although this expenditure component is influenced more by fiscal policy considerations than by cyclical forces, real consumption expenditure in the form of remuneration of employees typically increases during periods of economic downswing. A cyclical easing of labour market conditions allows general government to step up its employment. In real terms, remuneration of government employees indeed increased notably in 1982 and in the first half of 1983. However, because of the further pursuance of a policy of expenditure restraint, this increase did not fully show up in total real government consumption expenditure. The latter increased by 4 per cent in 1982 and at a seasonally adjusted annual rate of 3½ per cent in the first half of 1983.

Changes in factor income

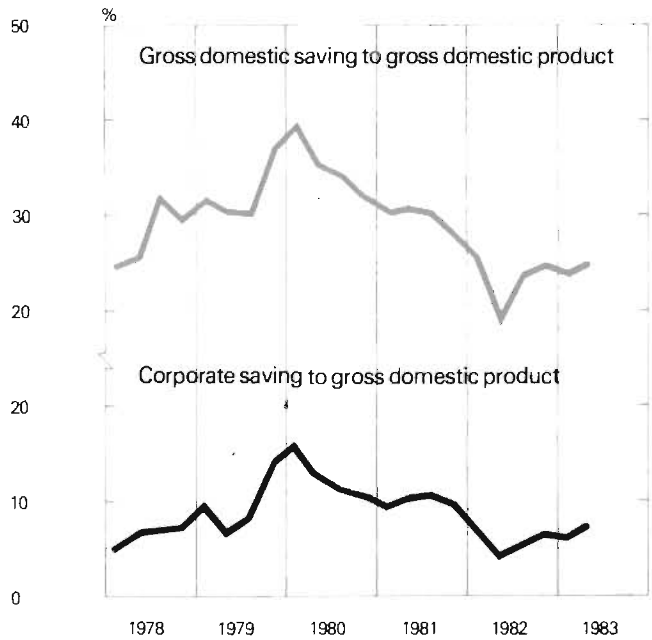


Factor income and saving

Nominal factor income in the form of salaries and wages still increased at the high rate of 19 per cent in 1982. But owing to the general economic slow-down and the accompanying easing of labour market conditions, the further increase in the first half of 1983 decelerated to a seasonally adjusted annual rate of 10½ per cent. The other main component of nominal gross domestic product, namely total gross operating surplus, maintained a low rate of increase of 3 per cent in 1982, but declined at a seasonally adjusted annual rate of 1 per cent in the first half of 1983. These changes clearly reflected the influence of the recession on company profits. The profits of industrial and commercial companies suffered most from these recessionary conditions.

Gross domestic saving increased significantly from a low of 18½ per cent of gross domestic product in the second quarter of 1982 to 25 per cent in the corresponding quarter of 1983. The latter ratio was more or less on par with the long-term average of 26

Savings ratios



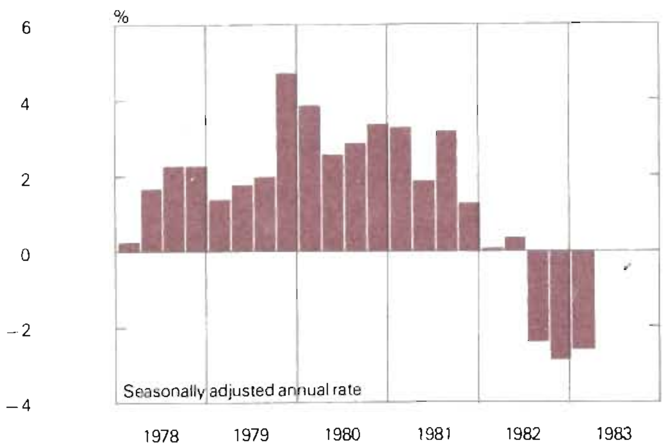
per cent. From the fourth quarter of 1982 gross domestic saving began to exceed gross domestic investment, as reflected also in a decline in South Africa's net foreign indebtedness.

After substantial declines in 1981 as well as the first half of 1982, personal saving recovered moderately because of a slowing down of the increase in nominal private consumption expenditure. The personal savings ratio rose from the very low level of 3 per cent in the first half of 1982 to 4 per cent in the first half of 1983. As in the case of personal saving, the sharp decline in corporate saving in 1981 and the first half of 1982 gave way to a moderate increase during the subsequent twelve months. Increased corporate saving was generated mainly by the gold mining industry. The saving of general government followed the opposite course. A smaller increase in the second half of 1982 was succeeded by a notable decline in the first half of 1983, reflecting the divergence of growth rates in current expenditure and receipts.

Employment*

From the second half of 1982 the weakening of real economic activity came to be reflected in a decline in employment. At a seasonally adjusted annual rate, the increase in employment slowed down to 0,4 per cent from the second half of 1981 to the first half of 1982, before giving way to a decline of 1,8 per cent in the second half of the year. In the first quarter of 1983 the decline continued at roughly the same pace as in the preceding two quarters.

Changes in non-agricultural employment



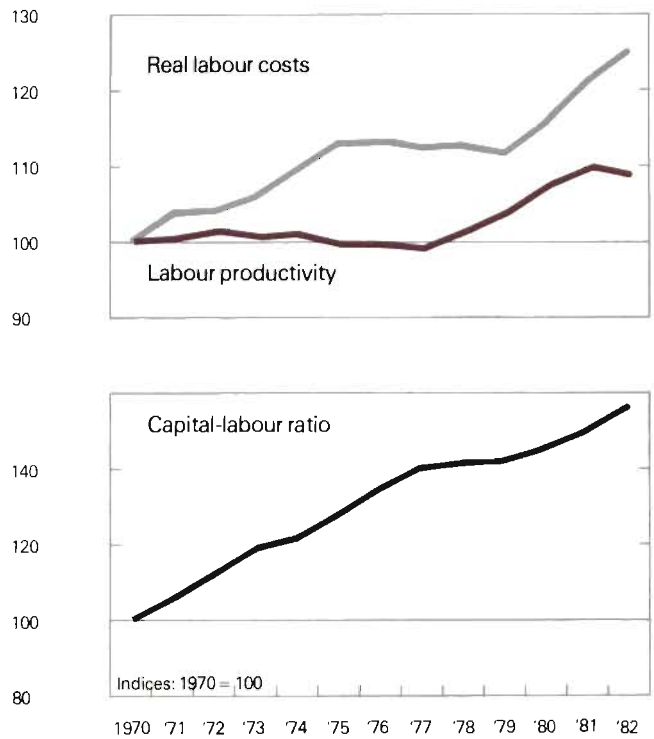
*Employment and labour remuneration statistics refer to the non-agricultural sectors of the economy and are available only up to the first quarter of 1983.

Private-sector employment already started to decline in the fourth quarter of 1981, but the effect of this on aggregate employment was masked for some time by the further increase throughout 1982 in public authority employment. The latter increase, however, levelled off in the course of the year, and in the first quarter of 1983 public authorities merely maintained their employment at the preceding quarter's level.

The counterpart of these employment changes was an appreciable increase in unemployment. Seasonally adjusted, the number of registered unemployed Whites, Coloureds and Asians increased from its most recent trough of 14 905, or 0,7 per cent of the corresponding labour force, in August 1981 to 40 012, or 1,8 per cent of the labour force, in June 1983. As a ratio of the economically active Black population, Black unemployment rose from a trough of 7,3 per cent in November 1981 to 8,3 per cent in April 1983.

The recent increase in unemployment is largely a cyclical phenomenon, but the present unemployment level also reflects the influence of secular forces. One of these may be singled out for further attention. Between 1970 and 1982 there was a significant relative shift towards greater capital rather than labour intensity in the creation of domestic output. The capital-labour ratio implicit in domestic output increased by as much as 56 per cent between 1970 and 1982. A major

Labour productivity and costs and capital-labour ratio



incentive for such a shift was provided by the rise in the relative cost of labour, to the extent that the increase in real labour costs exceeded that in labour productivity, particularly since this was mostly accompanied by relatively low, and at times even negative, real rates of interest. Between 1970 and 1982 real wages and salaries per worker rose at an average annual rate of 1,9 per cent, while the corresponding rate of increase in labour productivity (real gross domestic product per worker) amounted to only 0,4 per cent.

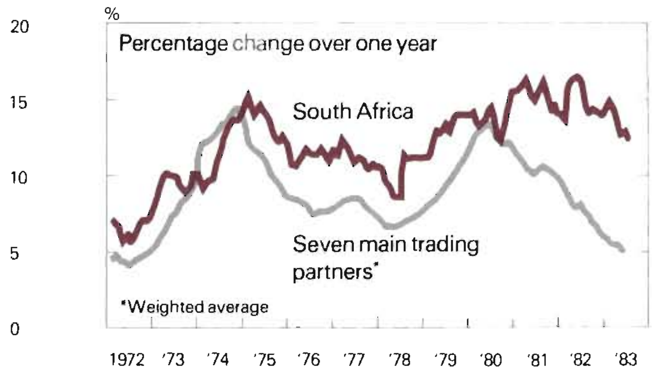
In a short-term context, the discrepancy between real wage cost and labour productivity increases was particularly pronounced in 1982. Real salaries and wages per worker rose by 3,4 per cent, the increase in nominal terms being 18,6 per cent, but labour productivity declined by 0,8 per cent. The fairly large increase of 4,5 per cent in real unit labour costs implied by these changes was partly due to the normal lack of synchronisation in the cyclical behaviour of labour costs and productivity. Salary and wage adjustments tend to follow the general business cycle with a certain time lag. Labour productivity, on the other hand, slackens immediately during periods of downswing and rebounds during periods of upswing, because labour utilisation tends to vary less than output over the cycle. But apart from cyclical influences, the observed discrepancy was also directly related to the effect of relatively monetary ease and strong inflationary expectations on salary and wage adjustments and negotiations, the latent scarcity of highly skilled labour, and non-economic considerations such as the desirability of narrowing the wage gap between higher and lower skills.

In the first quarter of 1983 labour productivity was 1,9 per cent lower than in the corresponding quarter of 1982. On the same basis, real salaries and wages per worker increased by 4,3 per cent.

Inflation

Measures of inflation such as consumer and production price indices indicate that, by the middle of 1983, prices had as yet reacted only moderately to the economic slow-down which had commenced in the third quarter of 1981. Measured over a twelve-month period, the increase in consumer prices decelerated from 14,6 per cent in June 1981 to 13,9 per cent in December 1982 and to 12,4 per cent in June 1983. The corresponding slow-down of the increase in production prices was from 14,3 per cent in June 1981 to 14,1 per cent in December 1982 and to 10,7 per cent in June 1983. At its present lower level, the rate of increase in consumer prices was still substantially out of line with the weighted average of 5,2 per cent in May 1983 for South Africa's seven main trading partners, even if allowance is made for the lagging of the business cycle in South Africa.

Consumer prices

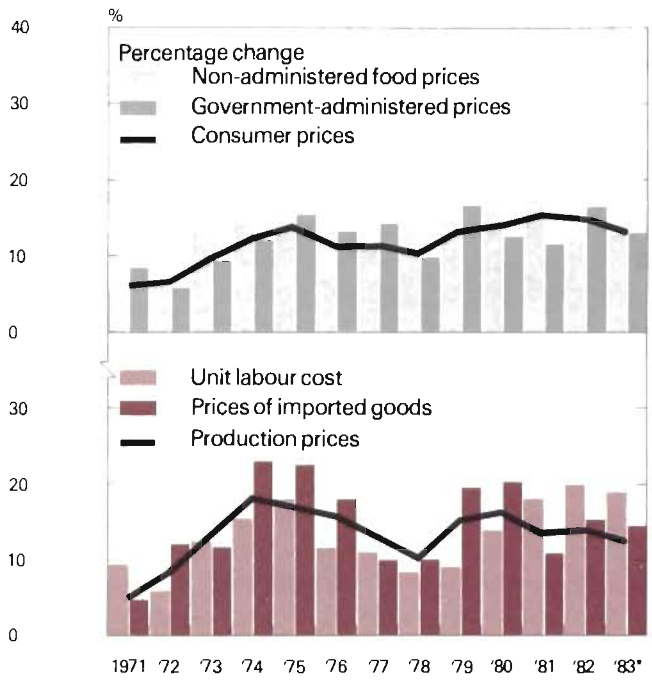


Various factors prevented a more pronounced fall in the rate of price increases. Foremost among these were the still relatively high rate of increase in the money supply and the lagged and widely dispersed primary and secondary inflationary effects of the substantial depreciation of the rand in terms of other currencies of about 22 per cent between the end of 1980 and the middle of July 1982, when a low-point was reached. Another and closely related factor was the retrospective inflation-related adjustments in several prices and costs. Although not formally linked, salary and wage adjustments tend to be based on the rate of inflation in the preceding period and, within an environment of relative monetary ease and persistently high inflation, earlier real wage reductions are very often corrected at some later stage. These considerations probably accounted for nominal and real salary and wage adjustments in 1981 as well as in 1982 that were conspicuously high in historical perspective. Together with the decline in labour productivity, these adjustments resulted in a sharp rise in unit labour costs in both these years. Adjustments based on preceding currency depreciation and inflation applied also to a range of government-administered prices and tariffs as well as to housing, transport and other costs of consumer services.

Other factors contributing to the sustained high rate of inflation included the effect of the drought on food prices and the fact that the moderate appreciation of the rand from the middle of 1982 had not yet come to be fully reflected in import prices. Furthermore, typical responses to the sustained strong inflationary expectations, such as a general downward rigidity of prices, weaker consumer resistence to price increases and indiscriminate consumer spending financed by credit in one form or another, also made their contribution.

On the positive side, it has to be recognised that most of these inflation-generating influences have recently begun to show some moderation. For

Inflation indicators



*First six months of the year

example, since July 1982 the depreciation of the rand has been reversed. In addition, the rates of increase in nominal salaries and wages, unit labour costs, administered prices and import prices have tended to slow down. At the same time, there have been signs of larger cost absorption in company profits, which may help to restrain price increases. In a somewhat longer-term perspective, the authorities' firmer resolve to control monetary expansion should serve to temper inflationary expectations and their effects on prices.

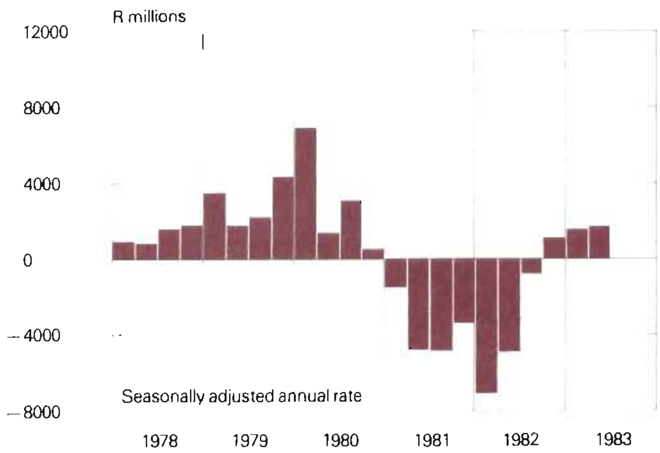
Foreign trade and payments

Rapid improvement in balance of payments on current account

During 1982 and the first half of 1983, the weakening of aggregate demand produced jointly by natural downward cyclical forces and less accommodative fiscal and monetary policies, brought about an unusually sharp decline in imports. Contributions to the easing of balance of payments strains also came from the other main current account items. Although exports tended to stabilise at the level to which they had moved in the fourth quarter of 1981, a renewed rise in the gold price caused the net gold output to resume an upward course from the middle of 1982.

The effect of these changes was a rapid improvement in the current account balance. In terms of a seasonally adjusted annual rate, the balance had still been negative to the extent of R7,1 billion (9 per cent of gross domestic product) in the first quarter of 1982, but the deficit declined progressively and gave way to a surplus of R1,1 billion in the fourth quarter. Subsequently, the surplus grew, at a seasonally adjusted annual rate, to R1,8 billion (2 per cent of gross domestic product) in the second quarter of 1983. Over a relatively short period of five quarters, therefore, the current account balance showed a favourable swing of no less than R8,9 billion.

Balance on current account



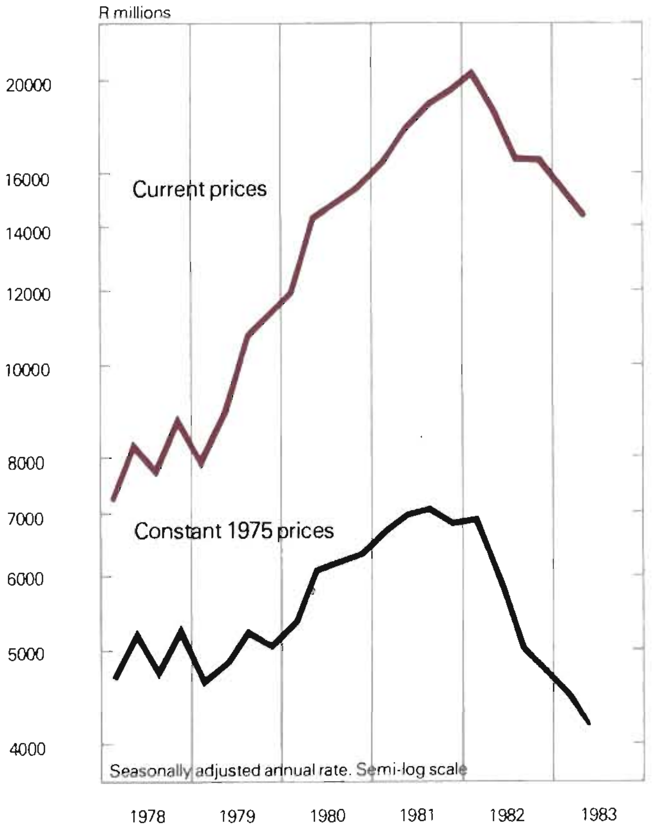
Movements in main current account items

As shown in the accompanying table, the sharp decline in merchandise imports made the largest contribution to the improvement in the current account balance from the second quarter of 1982. This decline was directly related to the levelling-off in nominal domestic expenditure. In particular, fixed investment and expenditure on consumer durables with a high import content declined, while at the same time inventories were being run down at a rapid pace. Expenditure and import decisions were also influenced by the effect on

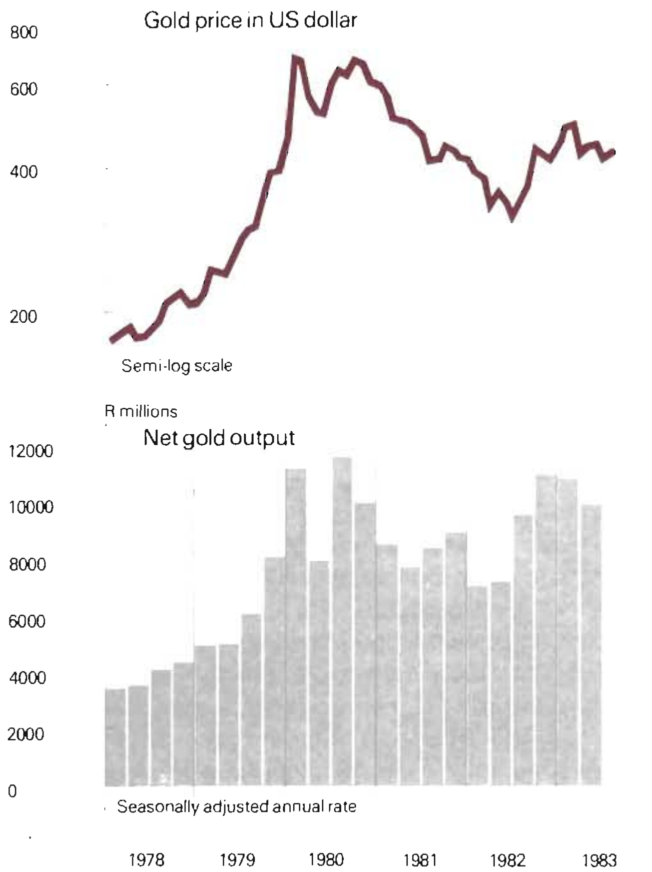
Current account of balance of payments
Seasonally adjusted annual rates
R millions

	1982				1983	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Merchandise exports	9 914	10 034	10 185	10 435	10 120	10 100
Net gold output	6 970	7 085	9 482	10 971	10 800	9 880
Merchandise imports	–20 437	–18 634	–16 485	–16 460	–15 390	–14 310
Net service and transfer payments	–3 519	–3 464	–3 952	–3 805	–3 860	–3 880
Balance on current account	–7 072	–4 979	–770	1 141	1 670	1 790

Merchandise imports



Gold price and net gold output



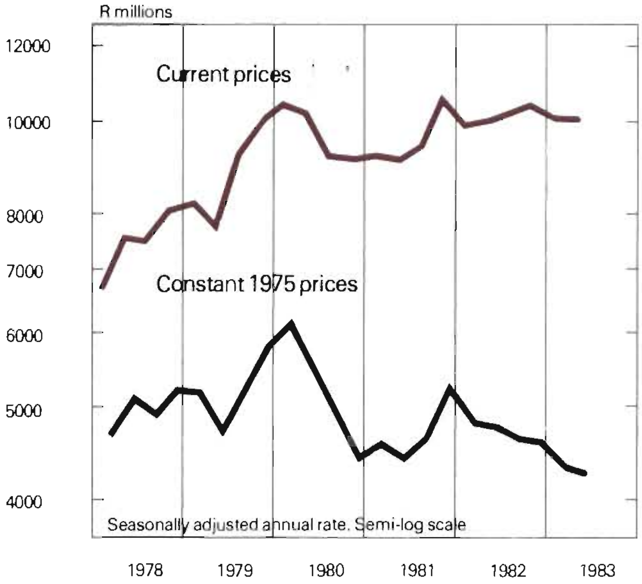
import prices of the depreciation of the rand during 1981 and the first half of 1982. This effect was enhanced by the imposition in February 1982 of a surcharge of 10 per cent on certain classes of imports.

Between the first quarter of 1982 and the second quarter of 1983 the seasonally adjusted value of merchandise imports declined by 30 per cent. In volume terms, the fall was even larger, namely 42 per cent, indicating a further rise in rand import prices. However, with the slow-down of inflation in the industrial countries and the appreciation of the rand from the middle of 1982, the rate of increase in import prices moderated considerably from the fourth quarter of 1982. In addition, the effect of the import surcharge on prices was reduced by its lowering in two steps from 10 to 5 per cent.

The increase in the net gold output was the second most important cause of the improvement in the balance of payments on current account. A rise in the gold price from the second half of 1982 was mainly responsible for the higher value of the net gold output. However, some contribution also came from a volume increase, reflecting a rise in production capacity and in the quantity of ore milled. The gold price recovered strongly from an average of US $315 per fine ounce in June 1982 to US $492 per fine ounce in February 1983, but subsequently it fell back to US $423 per fine ounce in July. The initial recovery was related partly to the international debt crisis, but also to the sharp decline in short-term interest rates in the United States, and expectations of economic recovery, eventual higher inflation and a weaker dollar. A setback for gold came towards the end of February when the price fell by about US $100 per fine ounce, after the OPEC cartel had reached agreement to lower its oil price. Since then, the dollar has strengthened considerably and the gold price has fluctuated around the lower level.

Merchandise exports[2] continued to be affected adversely by the protracted international recession. Although economic recovery took hold in the United States and to a lesser extent also in the United Kingdom and Western Europe, it was not yet reflected in the volume of South African exports during the first half of 1983. After a sharp decline during 1980, the *volume* of merchandise exports followed a moderately downward course during 1982 and the first half of 1983. Nevertheless, the *value* of merchandise exports

Merchandise exports

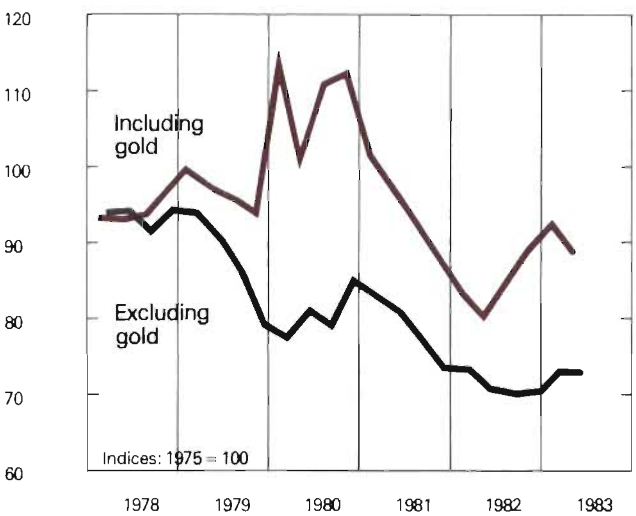


moved upwards in the course of 1981 and remained at this higher level during 1982 and the first half of 1983. The implied increase in export prices resulted mainly from the depreciation of the rand from the beginning of 1981 to the middle of 1982. Subsequently, export prices maintained a slight upward trend, despite the appreciation of the rand, owing to a rise in international commodity prices.

The relative movements of export and import prices found expression in an improvement of South Africa's terms of trade from the first quarter of 1983. If the price of gold is included, the improvement was somewhat greater and already commenced in the third quarter of 1982.

Net service and transfer payments continued their upward trend during 1982 and the first half of 1983. However, the composition of these payments changed notably during this period. Reflecting the decline in imports, freight and merchandise insurance payments became relatively less important, while interest and dividend payments increased in absolute as well as relative terms.

Terms of trade



Net capital movements

Net capital movements during 1982 and the first half of 1983 mirrored current account changes as well as perceptions based on such changes. The substantial deficit on the current account in the first half of 1982, which implied an excess of gross domestic investment over gross domestic saving, required foreign capital to fill the domestic savings gap. A substantial amount of long-term foreign loans was indeed contracted by the Central Government, government enterprises, public corporations and private-sector companies. Simultaneously, however, the depreciation of the rand at the time, together with expectations of a further exchange rate decline, discouraged the use of short-term foreign trade credits. This showed up as a sizeable net outflow of short-term capital. Overall there was a net inflow of capital of R404 million during the first half of 1982, but this amount was insufficient to counterbalance the current account deficit of R2 572 million in this period.

During the second half of 1982 the rapidly shrinking current account deficit absorbed less liquidity from the

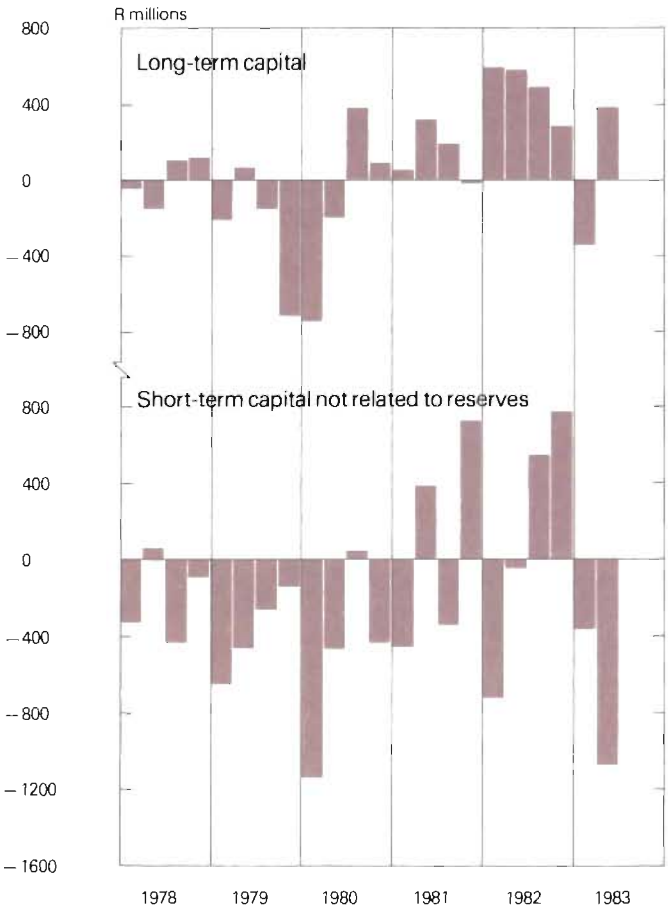
Net capital movements not related to reserves
R millions

	1982		1983
	1st half	2nd half	1st half
Long-term capital			
Central government and banking sector	658	507	348
Public corporations and local authorities	117	218	206
Net sales by foreigners of securities quoted on the Johannesburg Stock Exchange	−109	−153	−735
Other	509	206	208
Total long-term capital	1 175	778	27
Short-term capital not related to reserves, but including unrecorded transactions	−771	1 315	−1 437
Total	**404**	**2 093**	**−1 410**

domestic economy, and in this way diminished the inducement to raise long-term foreign capital. Accordingly, the net inflow of long-term capital assumed notably smaller proportions. At the same time, however, the increase in the gold price and, more generally, the improvement in the current account gave rise to an actual and expected further appreciation of the rand. Borrowers were able, therefore, to arrange short-term credits at lower interest rates abroad, without having to take out forward exchange cover. In these circumstances, a substantial net inflow of short-term capital into South Africa occurred. The total net inflow of foreign capital of R2 093 million during this period was markedly higher than the current account deficit of R348 million.

The surplus on the current account in the first half of 1983 was accompanied by a small overall net inflow of long-term capital. As in 1982, a substantial amount of long-term loans was raised abroad by the central government and banking sector, public corporations and the private sector. But the larger part of this amount was offset by a considerable outflow of long-term capital, amounting to R735 million, in the form of net sales by foreigners to South African residents of quoted South African securities after the gold price had declined sharply in late February and following the abolition of exchange control over non-residents in early February. The fall in the gold price from late February reversed previously existing expectations that the rand would continue to appreciate. This prompted South African importers and borrowers to take out forward exchange cover, the cost of which had the effect of eliminating the margin between the lower interest rates abroad and the higher South African rates. In this way, the inducement to use foreign credits was reduced and a large net outflow of short-term capital occurred. The total net capital outflow of R1 410 million during the first six months of 1983 was slightly larger than the seasonally unadjusted current account surplus of R1 239 million in this period.

Net capital movements



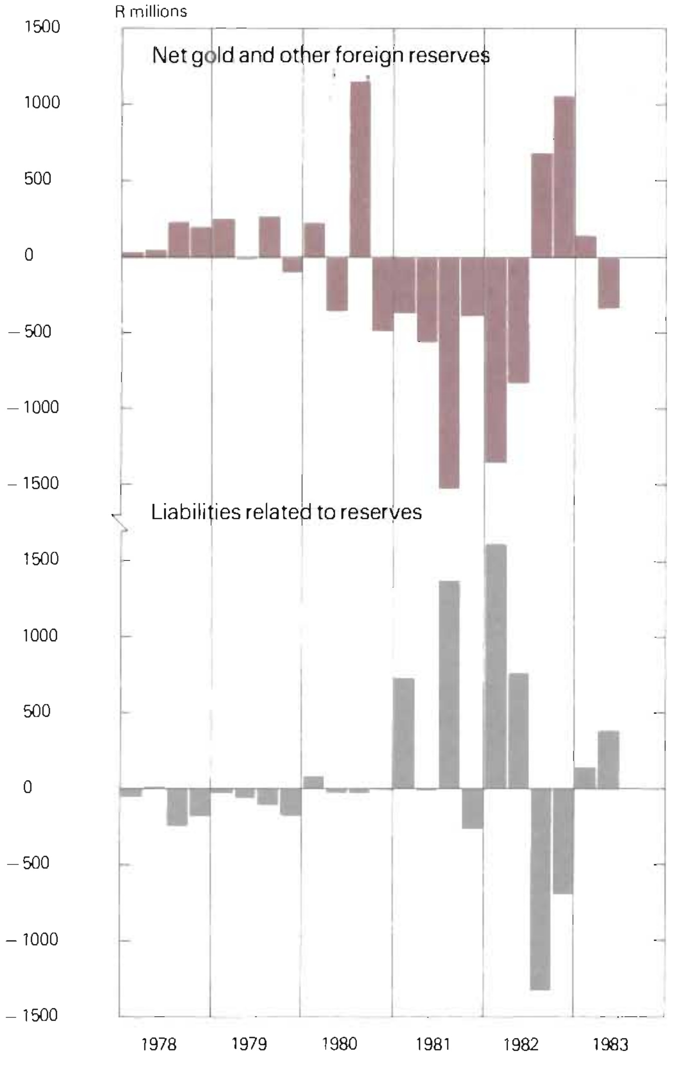
Foreign reserve management

Although offsetting changes usually occur in the current account balance and net capital flows, the volatility of these changes resulted in sharp fluctuations in net foreign reserves during 1982 and the first half of 1983. A decline of R2 168 million in these reserves during the first half of 1982 was followed by an increase of R1 745 million during the second half and a small decline of R171 million during the first half of 1983.

These wide swings required active foreign reserve management by the Reserve Bank. In addition to short-term foreign borrowing by the commercial banking system, the Reserve Bank had to increase its liabilities related to reserves during the first half of 1982 in order to acquire additional foreign exchange for the financing of balance of payments transactions. Total reserve-related liabilities of the banking system increased by R2 369 million during these six months. The subsequent sharp rise in net foreign reserves during the second half of 1982 largely took the form of a reduction of R2 039 million in reserve-related liabilities. During the first half of 1983 these liabilities were increased again by R542 million to support the level of foreign exchange reserves.

In addition to varying reserve-related liabilities as a means of adjusting foreign exchange reserves, the Reserve Bank in July 1982 also converted part of the gold component of its foreign reserves into foreign exchange through swap transactions with foreign financial institutions. In terms of these arrangements, gold was sold at market-related prices for cash and repurchased forward at the same time. As a result, the Bank's foreign exchange reserves were increased, while its gold holdings were reduced.

Changes in net foreign reserves and liabilities related to reserves



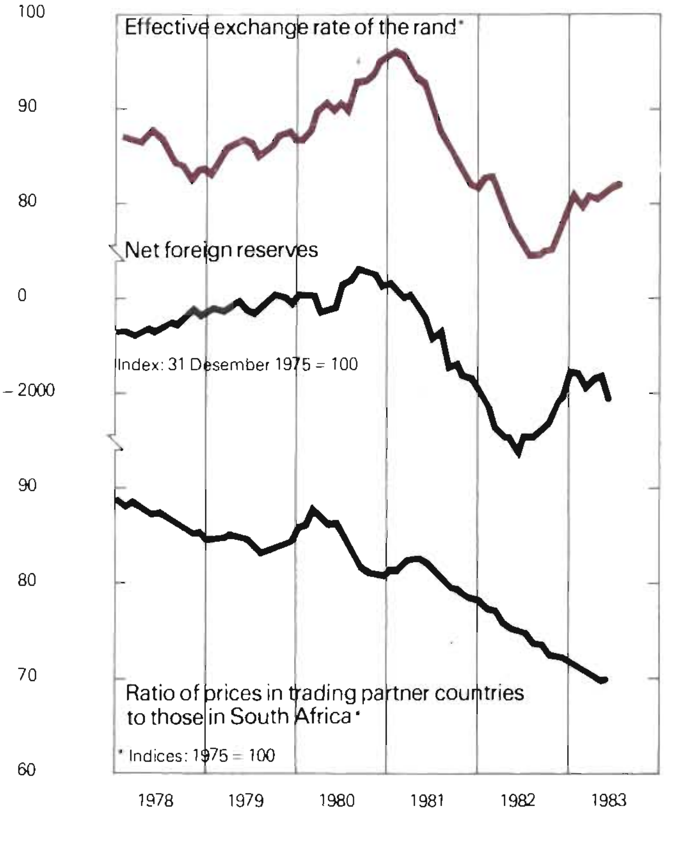
Exchange rates

Exchange rate movements during 1982 and the first half of 1983 were fundamentally related to current balance of payments transactions. The further deterioration of the current account balance in early 1982 was accompanied by a continuation of the depreciation of the rand that had begun in early 1981, while the subsequent improvement of the current account during the remainder of 1982 and during the first half of 1983 came to be reflected in an appreciation of the rand.

Apart from the effect of the current account changes, capital flows also influenced exchange rate movements during 1982 and the first half of 1983. In turn, these flows occurred in response to changing margins between South African interest rates and rates abroad and changing perceptions of prospective exchange rates. Variations in exchange rate expectations were related mainly to changes in the current account and factors affecting the current account, such as the gold price. As was indicated earlier, the combined influence of the current account changes and net capital movements was reflected in a marked decline in net foreign reserves during the first half of 1982, a sharp increase during the second half and a small decrease during the first half of 1983. Exchange rate movements conformed basically to these changes — a further depreciation of the rand during the first half of 1982 was followed by an appreciation during the second half and only a small further appreciation during the first half of 1983.

In a short-term context, changes in purchasing power parities apparently had little influence on recent exchange rate changes. As shown in the accompanying graph, there was no consistent observable correlation between recent changes in the effective exchange rate of the rand and in price movements in trading-partner countries relative to those in South Africa. This phenomenon is probably explained by the fact that South Africa is still largely an exporter of primary commodities, the prices of which are determined

Effective exchange rate, net foreign reserves and price ratios



mostly in international markets. Exports of manufactured commodities, which are more sensitive to changing purchasing power parities, in 1982 constituted only 10 per cent of total exports, including gold sales. In the longer term, however, exchange rate deviations from purchasing power parities will have an important adverse influence on the competitive position of South African producers in foreign markets or on their ability to compete with imported goods. To the extent that prices of primary and other products are determined in international markets, such deviations will seriously erode the profits of South African producers.

The exchange rate variations emanating from changes in the overall balance of payments position, would have been much larger had it not been for Reserve Bank intervention in the foreign exchange market. By using its own reserves and varying its reserve-related liabilities, the Bank affected the supply of foreign exchange in the market and in this way influenced the exchange rate.

From the beginning of 1981, when the rand started to depreciate, to the middle of 1982, the effective exchange rate of the rand declined by 22 per cent. Between the latter date and the end of July 1983 the rand appreciated in effective terms by 11 per cent. The accompanying table shows that, with few exceptions, the bilateral exchange rates with trading-partner countries broadly followed the same course. The exceptional strength of the US dollar in foreign exchange markets is also illustrated in this table.

A major recent development in the South African exchange market was the abolition of foreign exchange control over non-residents on 7 February 1983. This measure implied the disappearance of the financial rand and the dual exchange rate system which had existed in one form or another since exchange control over non-residents was first introduced in South Africa in 1961. The fundamental long-term objective of this step was to establish a unitary exchange rate system and to demonstrate not only South Africa's desire but also its ability to provide an equitable and profitable investment climate to foreign capital. The timing of the move was, however, influenced by the fact that the net foreign reserves had been increasing strongly for about seven months and by the need to improve control over the money supply. Although the change was initially accompanied by a decline of 4,7 per cent in the effective exchange rate of the rand, this rate almost immediately recovered to its former level and it continued to rise further during the ensuing period.

Changes in the exchange rates of the rand
%

	From 31 Dec. 1980 to 30 June 1982	From 30 June 1982 to 31 July 1983
Effective exchange rate...	−21,7	10,6
US dollar	−34,7	4,0
British pound	−10,6	19,1
German mark	−18,6	12,1
Swiss franc	−22,8	5,6
Japanese yen	−18,4	−1,4
French franc	−2,3	21,4

Money and credit

Short-term instability of monetary aggregates

As in other countries with well developed financial markets, South Africa has for a number of years experienced several innovations and modifications in its financial system. These have caused, among other things, the measured monetary aggregates to show irregular short-term changes and have also affected the measured amount of credit intermediated by the banking system. Innovative banking practices in South Africa and their influence on short-term movements in monetary aggregates were discussed at some length in the 1982 *Annual Economic Report*.

During 1982 and the first half of 1983 money supply figures, as measured at month-ends, continued to reflect the influence of these practices and other incidental events. The most recent example of month-end distortions was the artificial inflation of the money supply figures at the end of May 1983 by the temporary creation of bank credit amounting to at least R500 million over the month-end for the purpose of financing a heavy over-subscription of two security issues.

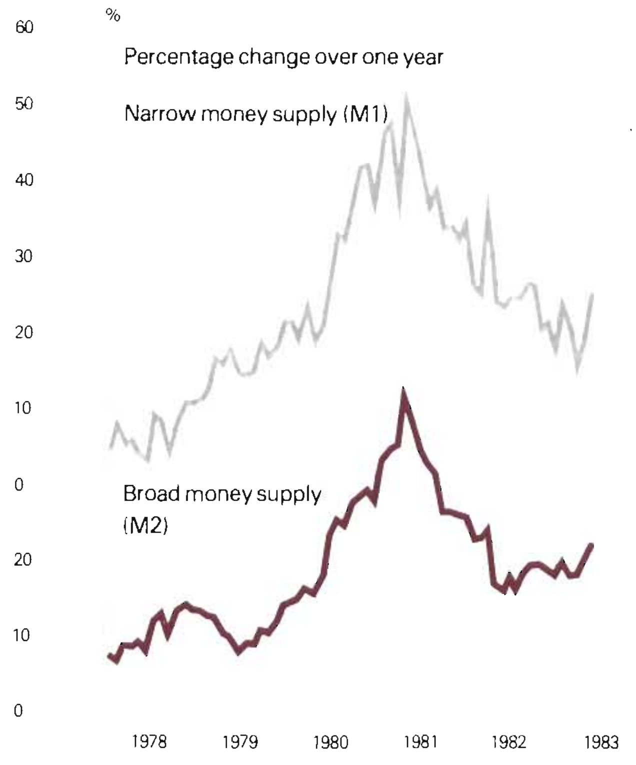
At a seasonally adjusted annual rate, quarterly increases in the broad money supply (M2) varied between 9 and 28 per cent during 1982 and the first half of 1983. If this instability in the behaviour of M2 is translated into changes in income velocity, quarterly variations ranged from a decline of 6 per cent to an increase of 5 per cent during the eighteen-month period under consideration. Such variation in a relationship that is normally much less volatile underscores the argument that the money supply *as currently defined and measured at month-ends,* is subject to unpredictable and uneven influences in the short run. The implication of this is that *short-term* changes in the South African monetary aggregates have to be interpreted with care for purposes of monetary analysis and policy formulation.

Money supply changes

Because of the short-term volatility of monetary aggregates, it is necessary for analytical purposes to view changes in the money supply over a somewhat longer period. In terms of changes over a twelve-month period, the increase in the broad money supply (M2) slowed down from a peak of 42 per cent in April 1981 to 15 per cent in July 1982. From the point of view of monetary policy, this reduction represented a most gratifying achievement.

During the following six months, i.e. the period up to January 1983, under the impact of a considerable improvement in the overall balance of payments and an accompanying rise in net foreign reserves, the rate of monetary expansion accelerated moderately. Part of the expansionary influence of the balance of payments surplus was offset by a gradual slowing down of the increase in bank credit to the non-bank private sector and a shift to long-term deposits, initially in response to expectations of a decline in interest rates and later on to a widening of the margin between short and long-term deposit interest rates. But to a large extent the expansionary impact of the increase in net foreign reserves was deliberately and effectively neutralised by large-scale sales of government securities by the Reserve Bank outside the banking sector. These operations were reflected in an increase in government deposits and a decline in net bank credit to the government sector. Nevertheless, despite these offsetting forces, the increase in M2 accelerated to 19 per cent in January 1983 (measured over a twelve-month period).

Money supply



This somewhat more rapid monetary expansion contributed to a sharp decline in interest rates from the third quarter of 1982 to the middle of February 1983. Another major reason for this decline was the downward pressure exerted on interest rates by the continuing cyclical downswing in the economy. In addition, expectations of a prospective decline in interest rates also played their part. These expectations were created by the increase in the gold price and, more generally, by the improvement in the balance of payments as well as by the decline in interest rates abroad.

From February 1983 M2 showed wide monthly fluctuations and during the first half of the year it increased at a seasonally adjusted annual rate of 27 per cent. Viewed over a longer period of twelve months, the increase in M2 amounted to 22 per cent in June. This rate of increase, which was clearly excessive and not in accordance with the declared policy of the monetary authorities, resulted from a sequence of unforeseen destabilising events.

Towards the end of February the gold price declined sharply and this had the effect of changing substantially perceptions of prospective interest and exchange rates. Together with the earlier abolition of exchange control over non-residents, these changes resulted in a reversal of the net inflow of capital, causing a decline in net foreign reserves. Apart from the repatriation of funds by foreign investors, the outflow of funds represented the switching from foreign to domestic financing of trade, which had its counterpart in a faster increase in bank credit extended to the non-bank private sector. The banking system's cash base remained largely intact, despite the effect of the decline in net foreign reserves, because of accommodation provided by the Reserve Bank to relieve the money market shortages which inevitably developed in these changed circumstances.

From the beginning of 1983 drought conditions intensified and drought relief and other unforeseen payments placed an additional burden on government expenditure towards the end of the fiscal year. In the end, part of this additional expenditure was financed by an expansion of net bank credit to the government sector during March. With the beginning of the new fiscal year on 1 April, government expenditure, including further drought relief, increased considerably, resulting in further substantial monetary financing by the government sector during the second quarter. The contractionary effect of the decline in net foreign reserves from the end of January to the end of June was, therefore, more than offset by the more rapid domestic credit expansion.

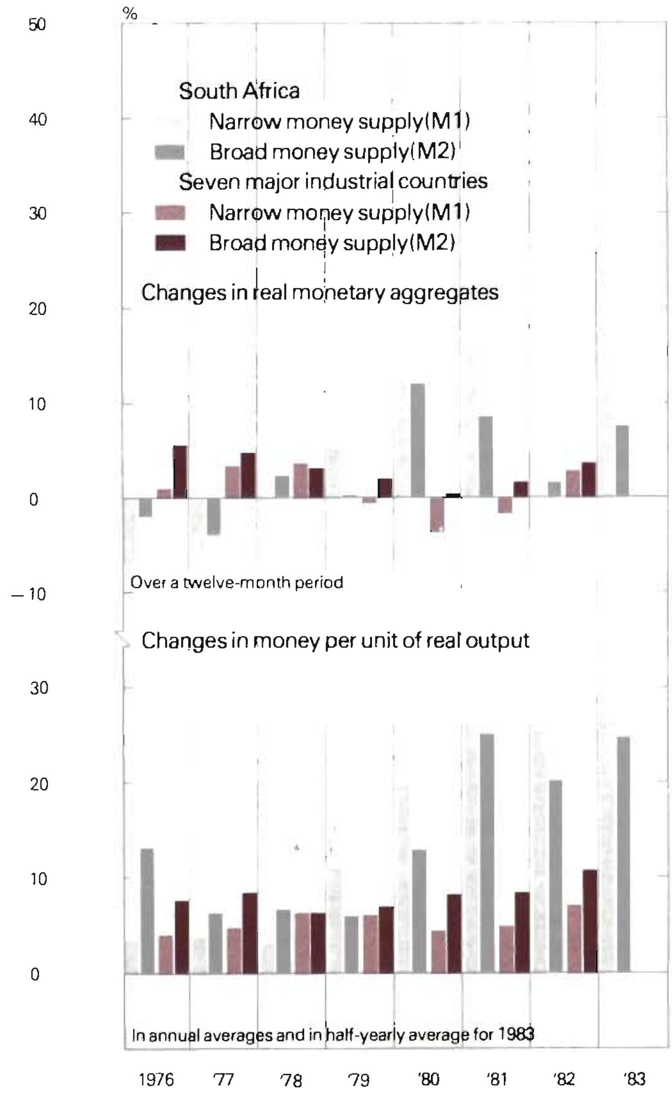
In these circumstances, and particularly in view of the extensive accommodation provided by the Reserve Bank at times of financial stringency, interest rates either remained at the low levels to which they had declined by February 1983 or increased only moderately in March, April and May. From June, however, the situation changed fundamentally as the government sector ceased to use net new bank credit to finance its "deficit before borrowing". The rate of increase in the money supply accordingly showed a welcome decline and this was accompanied by a distinct upward movement in interest rates. At the end of July most interest rates were again positive in real terms, which in itself was indicative of monetary conditions more consistent with a greater degree of price stability.

Monetary change in longer-term and international perspective

During each year from 1979 the rates of increase in both M1 and M2 were consistently higher than the rate of inflation. Wide margins were recorded in both 1980 and 1981. During 1980, for example, the rates of growth in M1 and M2 exceeded the inflation rate by margins of 22 and 14 percentage points, respectively. Subsequently, however, these margins narrowed considerably to 2 and 3 percentage points for M1 and M2, respectively, during 1982, but by June 1983 they had widened again to 16 percentage points in the case of M1 and 9 percentage points in the case of M2.

The growth in the real money supply in South Africa during recent years has been markedly different from that in the major industrial countries, especially since

Indicators of monetary change

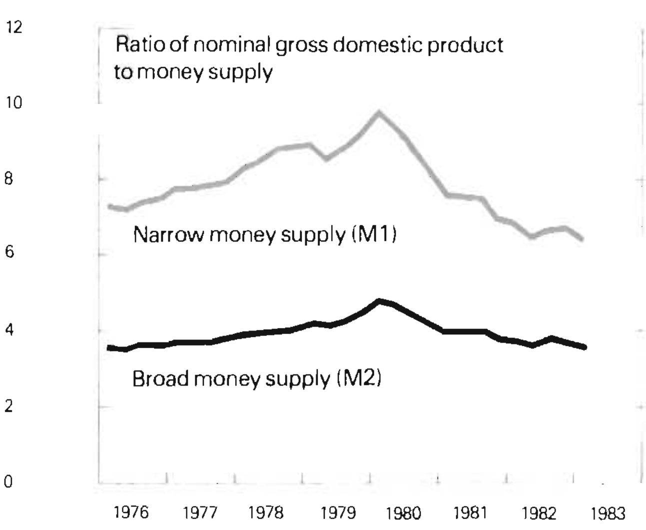


1979 when most of these countries opted for quantitative targets to facilitate control over the growth in the money supply as the main element in their strategies against inflation. As shown on the accompanying graph, the narrow money supply in the seven major industrial countries declined in real terms from 1979, while the real broad money supply showed only small annual increases.

Using changes in money holdings per unit of real output as a broad measure of change in monetary conditions, the accompanying graph indicates a much greater monetary expansion in South Africa after 1979 than in the seven major industrial countries. Annual increases in the money supply in relation to the growth in real economic activity soared in 1981 to 32 per cent in the case of M1 and to 25 per cent in the case of M2. In interpreting the annual variations during this period, however, account should be taken of the artificial "inflation" of the money supply figures in 1981 produced by the "re-intermediation" of credit following the abolition of bank credit ceilings in 1980.

The acceleration of monetary expansion from 1979 in relation to both price movements and real economic activity was initially, i.e. until the middle of 1980, accompanied by an increase in the income velocity of money. This increase reflected the cyclical upswing at the time in terms of lower liquidity preferences, increased spending propensities, and actual and expected increases in inflation rates. More important, however, it was symptomatic of the process of "disintermediation" of credit transactions under the then existing regime of bank credit ceilings and a low and distorted interest rate structure. The subsequent sharp decline in the income velocity of money during the rest of 1980 and during 1981 predominantly reflected the reverse process of "re-intermediation", referred to above. By 1982 the income velocity of money had fallen below its long-term trend and a clearer link with cyclical changes had been re-established. The considerable further decline in velocity during 1982, a period during which the growth in the money supply decelerated, indicates that the further increase in the demand for money was accompanied by a reduced propensity to spend. The same applied to the first half of 1983, when the growth in the money supply accelerated again.

Income velocity of money

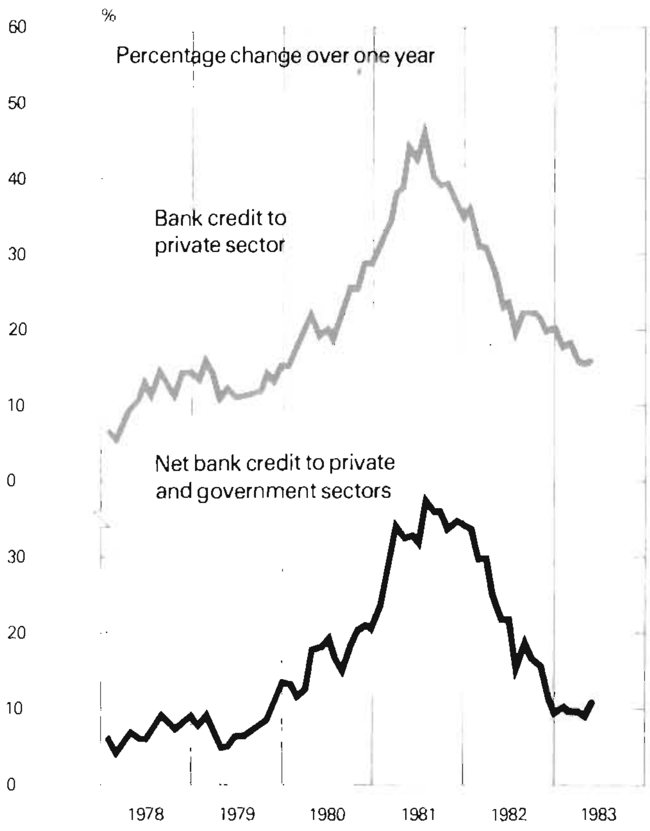


Credit intermediated by the banking system

Like the monetary aggregates, credit intermediated by the banking system is also subject to irregular short-term changes caused by innovative banking practices. Changes in bank credit, therefore, also have to be viewed over a somewhat longer period of time for purposes of analysis and interpretation.

Measured over a period of twelve months, the increase in bank credit to the non-bank private sector reached a peak of 47 per cent in July 1981, but slowed down with only minor temporary interruptions to 35 per

Domestic credit extension



cent at the end of 1981, 20 per cent at the end of 1982 and 18 per cent in June 1983. This deceleration coincided with the economic downswing from the third quarter of 1981, indicating in general terms a weakening of the private sector's demand for credit for the financing of domestic expenditure.

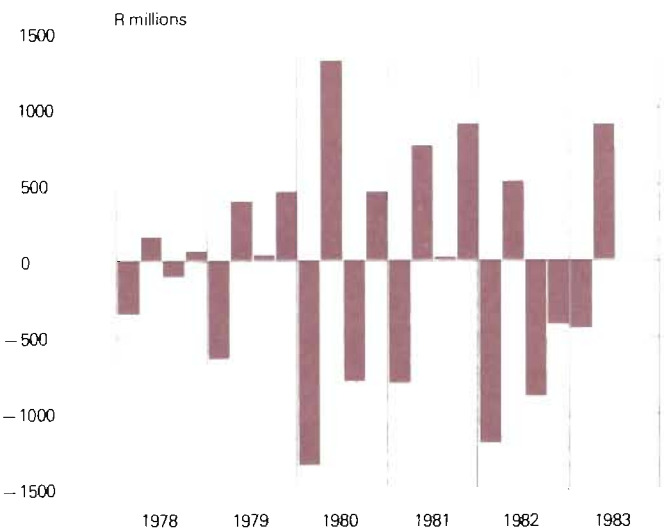
During 1982 this weakening of demand was evident in all the main categories of credit, but especially in credit extended by the Land Bank. The latter reflected a decline in agricultural inventories and a smaller demand for production credit by farmers in the prevailing drought conditions. The discounts, loans and advances of commercial, merchant and general banks rose at an appreciably slower rate during the second half of 1982, when there was a notable shift from domestic to foreign financing of trade. This process was reversed during the first half of 1983, but the effect on the rate of increase in overall bank credit to the private sector was more than offset by actual declines in Land Bank credit and the commercial, merchant and general banks' investment in private-sector securities.

Net bank credit to the government sector declined by R2 038 million during 1982. Of this amount, more than R1 328 million represented a decline during the second half of the year. During this period the Reserve Bank sold substantial amounts of government securities outside the banking sector in order to neutralise the expansionary influence on the money supply of the increase in net foreign reserves. During the first half of 1983, however, net bank credit to the government sector, seasonally unadjusted, increased by an amount of R428 million that was concentrated in the second quarter. As already indicated, this monetary financing of the government sector's deficit resulted from a steep rise in expenditure during the first quarter of the new fiscal year, i.e. the second quarter of 1983.

During 1982 the money supply was also expanded by losses on forward exchange contracts incurred by the Reserve Bank on behalf of the Government. These losses represent a claim of the Bank on the Government and may for analytical purposes be included in the banking sector's net claims on the government sector and in total domestic credit.

In the accompanying table the increase in the broad money supply (M2) is analysed in terms of the "statistical contributions" of its different counterparts. During 1982 the increase in domestic credit exceeded the growth in M2 by a considerable margin. This margin was offset mainly by a decline in net foreign reserves. But during the first half of 1983 the situation was reversed. Considering seasonally adjusted contributions to the change in M2, the increase in M2 exceeded the domestic credit expansion and the difference was accounted for by a rise in net foreign reserves. However, part of the expansionary effect on M2 of the increase in both domestic credit and net foreign reserves was neutralised by a rise in long-term deposits.

Changes in net bank credit to government sector



Changes in bank credit and the broad money supply (M2)
%

	1982	1983 1st half
Change in M2[1]	17,4	26,6
Contributions to change in M2[2]:		
Bank credit to private sector	21,7	19,4
Net credit to government sector	−10,0	4,1
Claims in respect of forward exchange losses	9,0	−0,1
Total domestic bank credit	20,7	23,4
Net foreign reserves	−2,1	5,1
Long-term deposits[3]	−0,4	−1,8
Other items	−0,8	−0,1
Total	**17,4**	**26,6**

1 At a seasonally adjusted annual rate in the first half of 1983.
2 Figures for the first half of 1983 are based on seasonally adjusted changes.
3 Increase −, decrease +

Financial markets and interest rates

Money market conditions

Although the Reserve Bank provided substantial accommodation to the discount houses and, on occasion, directly to banking institutions during most of 1982 and the first half of 1983, there were distinct phases of easing and tightening of money market conditions in the course of this period, mainly owing to seasonal influences. During the first half of 1982 the decline in net foreign reserves caused money market institutions to make considerable use of Reserve Bank accommodation. The increase in net foreign reserves during the second half of the year was not, however, fully reflected in easier market conditions since it was approximately counterbalanced by the Reserve Bank's sales of government securities in the financial markets. On balance, therefore, the underlying market situation did not change significantly from the first to the second half of the year. The degree of tightness increased specifically over the February and August month-ends, when tax payments to the Government reached seasonal peaks. On the other hand, a seasonal easing of the market occurred during the second quarter and most of the fourth quarter because of more rapid increases in government expenditure.

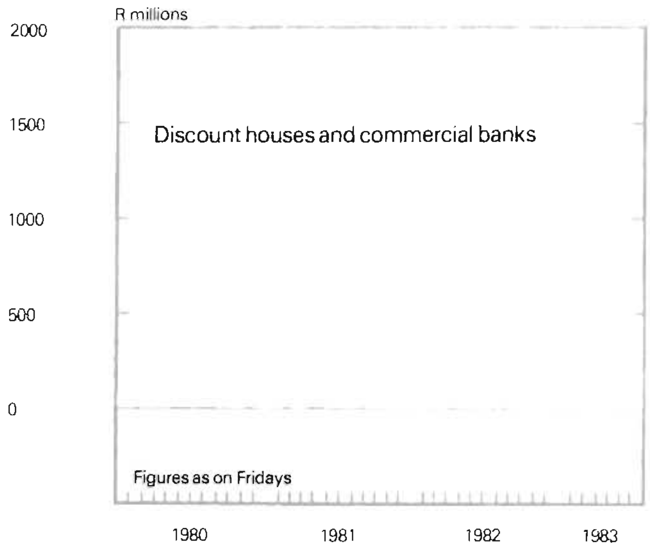
During the first half of 1983 money market conditions continued to be influenced fundamentally by changes in net foreign reserves. Conditions tightened significantly during periods of declining net reserves, namely during February, March and June. A flow of tax funds to the Government was mainly responsible for a seasonal tightening over the February month-end, whereas during most of the second quarter the seasonal increase in government expenditure had the opposite effect.

The discount houses were accommodated by the Reserve Bank for fairly long periods over month-ends during the first seven months of 1982 and they remained indebted to the Bank almost continuously from late August 1982 to the end of July 1983. In addition to accommodating the discount houses, the Reserve Bank provided direct accommodation to banking institutions over the month-ends of February, March and May 1983.

Reserve Bank operations in the financial markets

Reserve Bank operations in the financial markets during the nineteen months to the end of July 1983 consisted partly of various measures to prevent seasonal and other short-lived influences from causing unduly large fluctuations in short-term interest rates. In addition, the Bank engaged in operations aimed at monetary control and particularly at offsetting influences contributing to an undue expansion of the money supply.

Accommodation by Reserve Bank



Recent measures to iron out unduly large short-term fluctuations in money market conditions and short-term interest rates included, firstly, the lowering on a number of occasions of the liquid asset requirements for banking institutions, at times in the form of reductions in the required balances with the Reserve Bank and/or the National Finance Corporation. The purpose of these adjustments was to free either cash reserves or other liquid assets which could be used by the banks to meet seasonal pressure on their cash resources. Such relaxations were made on 30 March and 27 September 1982 and again on 18 July 1983. In addition to this short-term objective, the relaxation of the liquid asset requirements formed part of a longer-term transition from a liquid asset to a cash reserve system of credit control.

Secondly, at the end of each of the first four months of 1983 the Reserve Bank arranged for deposits of the National Finance Corporation to be placed with the discount houses in order to alleviate the shortage of funds in the money market. Over the March month-end the Public Debt Commissioners also placed deposits with the discount houses.

Thirdly, from the beginning of April 1983 the amount of Treasury bills offered at the weekly tender was varied in accordance with prevailing market conditions.

Fourthly, in addition to providing direct accommodation to banking institutions, the Reserve Bank bought securities under repurchase agreements from banks. The Bank entered into such agreements at the end of October 1982, at the end of June and during July 1983.

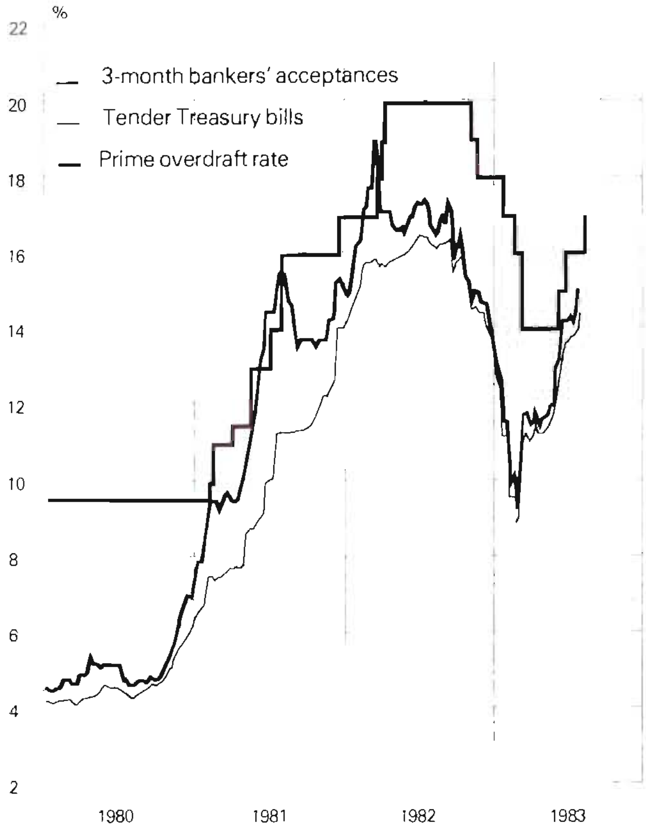
Fifthly, the Bank in February 1983 sold short-term government stock from its own portfolio on a tender basis to money market institutions. In addition, the Bank on a number of occasions sold special Treasury bills, of which the maturity was scheduled to expire at the time of tax payment peaks.

Sixthly, in July 1983 the Bank offered to buy government stock with a short unexpired maturity prior to the redemption date.

Lastly, the Bank regularly altered its cost of accommodation to discount houses and banks.

In a distinctly different context, Reserve Bank operations in the financial markets also consisted of sales of government securities outside the banking sector or of sales to the non-bank private sector through the intermediation of discount houses, banking institutions and stockbrokers. At times, these sales were aimed at exercising a contractionary influence on the money supply so as to neutralise the expansionary effect of an increase in net foreign reserves. At other times, the Bank sought to assist the Government in its borrowing programme in order to avoid monetisation of the government deficit. Most of the government securities sold in this way were obtained on tap from the Treasury specifically for the purpose of resale in the market.

Short-term interest rates



Short-term interest rate movements

Movements in short-term interest rates from the beginning of 1982 reflected not only the more fundamental changes, but at times also the expectations of prospective changes in money market conditions. The rate on three-month bankers' acceptances reached a peak of 19,0 per cent in March 1982, but then declined almost immediately to a somewhat lower level around which it fluctuated during the next six months. On 24 September it amounted to 17,35 per cent and subsequently it declined to 9,90 per cent on 18 February 1983, before fluctuating upwards to 16,45 per cent on 12 August. The Treasury bill tender rate followed a more even upward course to 16,35 per cent on 24 September 1982, before it declined to 9,56 per cent on 18 February 1983. Subsequently, it increased to 15,82 per cent on 12 August. The banks' prime overdraft rate rose to a level of 20 per cent in March 1982 and remained unchanged until November. In conformity with the decline in other short-term interest rates, it was lowered in five steps to 14 per cent on 7 March 1983, but it was increased again in two steps to 16 per cent during the second half of June and later in two steps to 18 per cent in August.

Capital market developments

In the capital market the increased availability of funds relative to demand, together with expectations of a downward movement in interest rates, found expression in a decline in interest rates from about the third quarter of 1982. In addition to the cyclical decline in the demand for funds for the financing of receding real economic activity, the further increase in general liquidity resulted in available funds being used more extensively for transactions in financial assets. Security prices were bid up in the secondary security markets and this had the effect of strengthening the downward movement in interest rates.

In the market for fixed-interest securities, new funds raised by the public sector in the banking and non-bank private sectors increased from R2 165 million in 1981 to R6 451 million in 1982. Further net new issues of R1 500 million were made during the first half of 1983. The substantially larger figure for 1982 included the overfunding of the Central Government's deficit before borrowing for purposes of monetary stabilisation by an amount of about R2 000 million and the conversion of bank credit of R1 010 million to the Land Bank into bills. The non-bank private sector's demand for public-sector securities came predominantly from insurers, private pension funds and building societies. Private-sector companies listed on the stock exchange raised only R35 million in the fixed-interest security market, an amount that was almost negligible in relation to the figures of R597 million and R278 million for 1980 and 1981, respectively. Net new issues of fixed-interest securities by listed companies during the first half of 1983 amounted to R182 million.

Increased transactions in financial assets were well reflected in activity in the secondary market for fixed-interest securities. For example, the value of public-sector stock traded on the stock exchange soared from R5 100 million in 1981 to R16 640 million in 1982 and to R13 178 million in the first half of 1983.

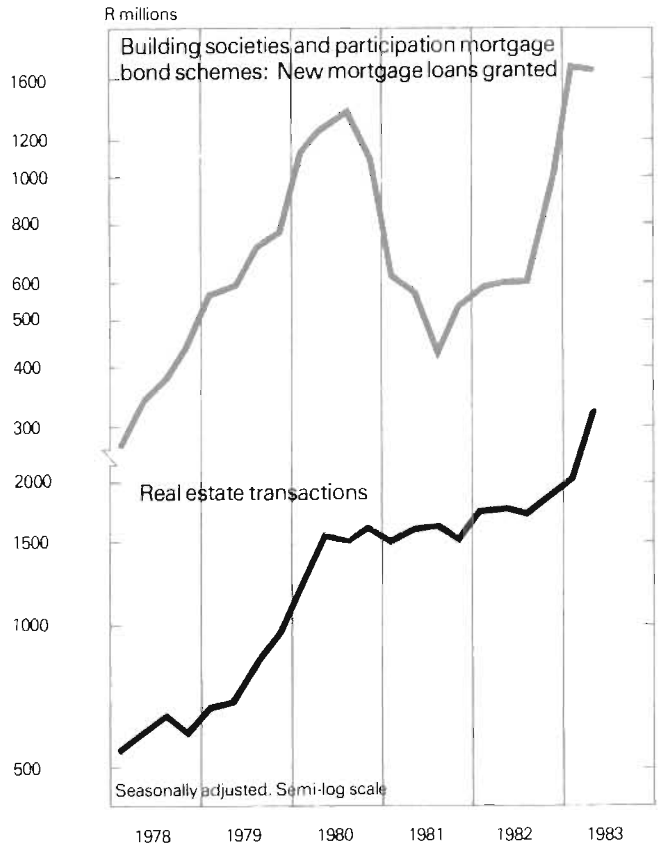
New funds raised in the share market by companies listed on the stock exchange amounted to R84 million in 1982 and R50 million in the first half of 1983, compared with notably larger amounts of R488 million and R454 million in 1980 and 1981, respectively. Apart from a cyclical decline in financing requirements, the small amount of new funds acquired by companies through issues of shares and fixed-interest securities, indicates that companies relied to a greater extent on bank credit. Bank credit, including leasing finance, to companies by commercial banks alone increased by R1 145 million during 1981, R1 843 million during 1982 and R907 million during the first half of 1983, compared with an annual average increase of R190 million during the period 1978 to 1980. This shift towards bank credit in corporate financing was apparently in response to the prevailing high rate of inflation as well as uncertainties about the future rate of inflation and its effect on long-term interest rates, which caused some hesitancy on the part of companies to engage in long-term commitments. In addition, the decline in share prices until the middle of 1982 discouraged equity issues.

Turnover in the share market increased in 1982. The value of shares traded on the stock exchange rose from R2 498 million in 1981 to R2 795 million in 1982 and to R2 585 million in the first half of 1983 alone.

In the mortgage market, new mortgage loans granted by building societies and participation mortgage bond schemes increased from R2 133 million in 1981 to R2 670 million in 1982 and further to a seasonally adjusted figure of R3 300 million in the first half of 1983 alone. The increased general availability of funds found expression in the mortgage market in a substantially larger flow of funds to mortgage market intermediaries. Building societies' and participation mortgage bond schemes' intake of new funds, for example, rose from R1 736 million in 1981 to R1 983 million in 1982 and to a seasonally adjusted figure of R2 757 million in the first half of 1983 alone.

Accompanying the increase in mortgage lending, the sustained upward trend in the value of real estate transactions gained further momentum towards the end of 1982 and the first half of 1983. An increase of 13

Mortgage loans and real estate transactions



per cent in 1982 was followed by a further rise, at a seasonally adjusted annual rate, of 38 per cent in the first half of 1983. In comparison with alternative investment outlets, the real estate market was well supported by investors during the eighteen months to June 1983. In addition to contributing to the rising trend in transactions in financial assets, the increased availability of funds, therefore, found its way into a higher real estate turnover.

Long-term interest rate movements

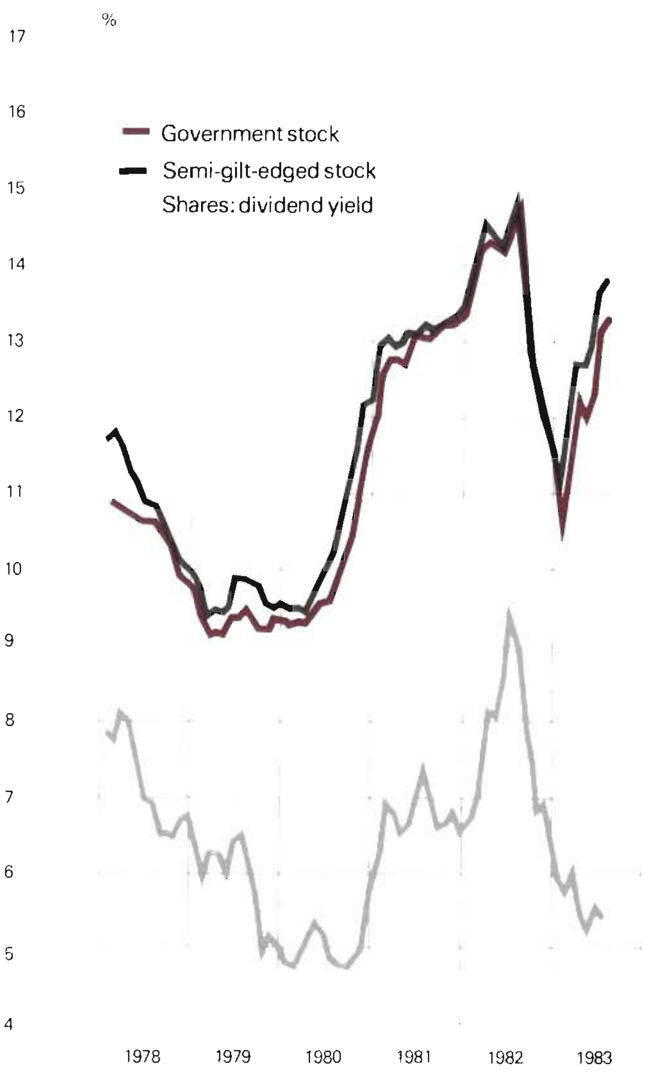
Like short-term interest rates, long-term rates began a cyclical decline in the third quarter of 1982. Until early February 1983 this downward trend was strengthened by interest rate expectations and the somewhat more rapid monetary expansion during the second half of 1982 and January 1983. Under the influence of wide month-to-month fluctuations in the net foreign reserves and other factors influencing the general availability of funds, long-term rates fluctuated slightly upwards until May, before increasing significantly during June and July.

The monthly average yield on long-term government stock rose to a peak of 14,7 per cent in July 1982, declined subsequently to 10,6 per cent in January 1983 and increased again to 13,3 per cent in July. Likewise, the monthly average yield on semi-gilt-edged stock of the highest grade declined from a peak of 14,8 per cent in July 1982 to 11,2 per cent in January 1983, before increasing to 13,8 per cent in July.

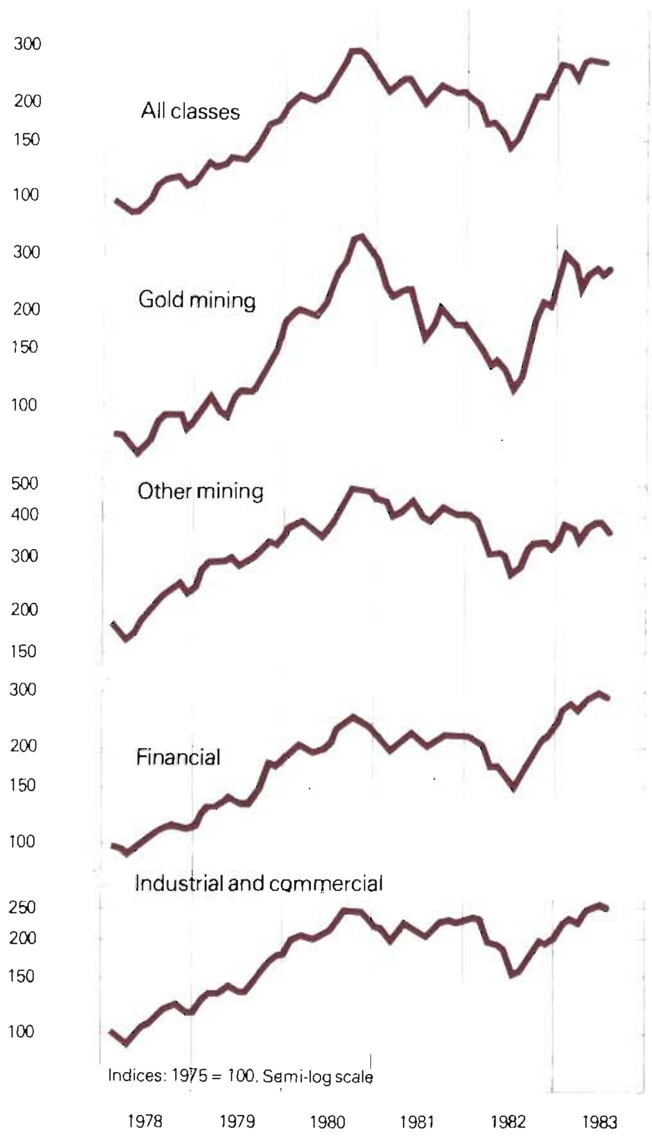
Reflecting mainly a sharp rise in share prices that coincided with the shift of emphasis to transactions in financial assets, the average dividend yield on all classes of shares declined from a peak of 9,4 per cent in June 1982 to 5,5 per cent in July 1983. During this period share prices increased, on average, by 88 per cent. This upward movement was evident in all classes of share prices. Gold mining share prices increased by 135 per cent, other mining share prices by 35 per cent, financial share prices by 94 per cent, and industrial and commercial share prices by 61 per cent.

The building societies' range for new home mortgage rates rose to a peak of 14,25 – 16,25 per cent in July 1982, but was lowered to 14,0 – 15,0 per cent in April 1983 for loans up to R60 000, with a rate of 15,25 – 15,5 per cent applying to loans above R60 000. In July the latter rate was raised by up to 1,5 per cent, followed in August by a general increase of 0,5 per cent in some societies' complete range of home mortgage rates. Participation mortgage bond schemes lowered their mortgage rate from a peak of 19,2 per cent in November 1982 to 15,1 per cent in April 1983, but by July the rate of some schemes had again risen to 16,1 per cent.

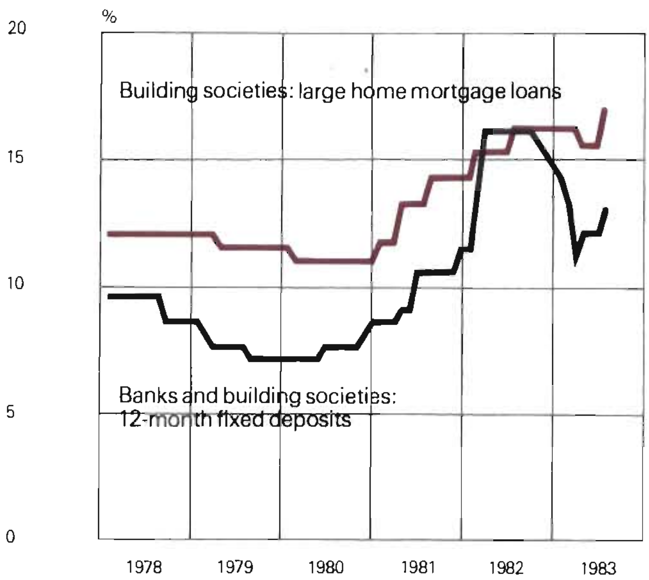
Long-term yields



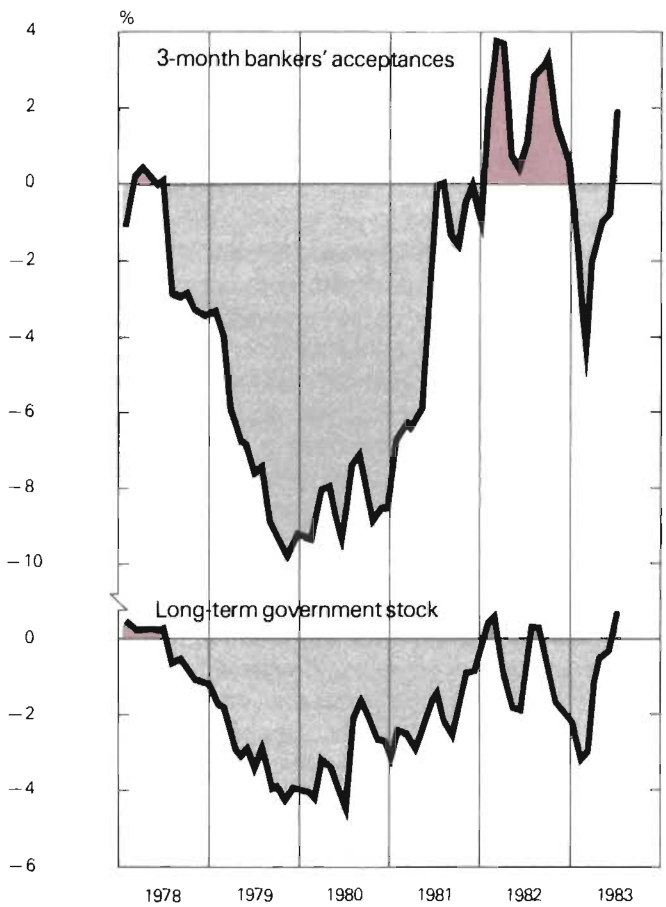
Share prices



Long-term interest rates



Real interest rates



Variations in the lending rates of banks and building societies were related to adjustments in borrowing rates. Rates on the wide range of deposits (including building society shares) were, however, not always adjusted simultaneously and to the same extent. An indication of the movements in deposit rates is provided by the predominant rate on twelve-month deposits with banks and building societies. This rate increased to a peak of 16,0 per cent in the first half of 1982, before declining to 10,5 – 11,0 per cent in March 1983. Subsequently, it was raised in steps to 13,0 per cent in July.

At their levels in early 1983, most long-term as well as short-term interest rates were negative in real terms. As mentioned earlier, this was indicative of monetary conditions that were incompatible with a greater degree of price stability. Owing to the subsequent upward movement of interest rates, most rates again became positive in real terms in July. However, compared with South Africa's main trading-partners, in which great success in bringing down inflation rates had already been achieved, these positive real rates were still very low.

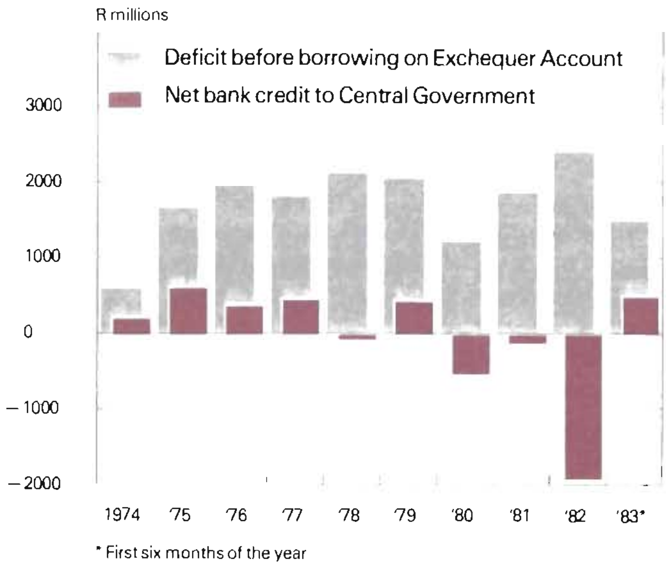
Government finance

Financing operations of Central Government

Net bank credit extended to the broader government sector during 1982 and the first half of 1983 was largely related to the financing of the Central Government's revenue shortfall, as reflected in the deficit before borrowing on the Exchequer Account*. During 1982 net bank credit to the Central Government declined by R1 927 million, representing 95 per cent of the fall in net credit to the entire government sector. Subsequently, during the first half of 1983 the rise of R482 million in net bank credit to the Government exceeded the increase in the amount extended to the government sector as a whole.

The decline in net bank credit to the Government during 1982 reflected the "overfunding" of the Exchequer Account deficit. Government debt management forms part of broad monetary policy and, as was pointed out earlier, government securities were sold on a large scale outside the banking sector during 1982 in order to neutralise the expansionary effect on the money supply of a rise in net foreign reserves. Borrowing of R2 960 million from the non-bank private sector alone exceeded the deficit of R2 418 million in 1982. In addition, a net amount of R838 million was borrowed from the Public Debt Commissioners and R546 million was raised by means of net foreign borrowing.

Monetary financing of Exchequer deficit



* First six months of the year

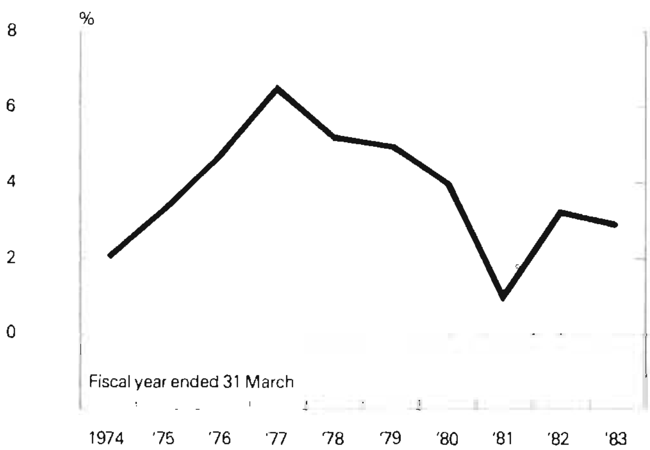
* The Exchequer Account is adjusted for changes in the balance on the Paymaster-General Account, mainly to bring Exchequer issues more in line with actual government expenditure.

During the first half of 1983 the situation was quite different, when the steep rise in government expenditure during the second quarter accounted for a sizeable Exchequer deficit of R1 486 million. During the first four months of 1983 the non-bank private sector did not make any contribution to the financing of this deficit, partly because of the repayment of loan levies to companies in January 1983. Another reason was that expectations of a renewed increase in interest rates emerged after February and discouraged investment in long-term securities. Some interest was, however, displayed in short and medium-term paper, but mostly by the banking sector. During May and June the non-bank private sector again made a substantial contribution to the financing of the Exchequer deficit. During June two successful tender issues of government stock were made and a large amount of government stock obtained on tap from the Treasury was sold by the Reserve Bank in the market. Although the non-bank private sector and the Public Debt Commissioners contributed R305 million and R820 million, respectively, to the financing of the Exchequer deficit in the first half of 1983, net bank credit of R482 million was also used. Foreign loans to a net amount of R121 million were repaid during these six months.

Government expenditure

From the point of view of monetary policy, the financing of the Government's revenue shortfall has become of major importance. To avoid monetary

Ratio of Exchequer deficit to gross domestic product

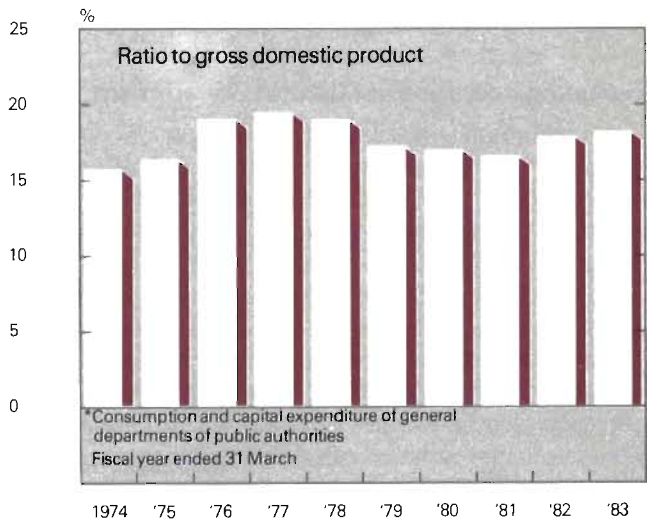


financing, it has been necessary to keep the deficit before borrowing to relatively small dimensions. In relation to gross domestic product, the deficit assumed notably smaller proportions from the 1980/81 fiscal year onwards, amounting to 0,9 per cent in that year and to 3,2 per cent and 2,9 per cent in 1981/82 and 1982/83, respectively.

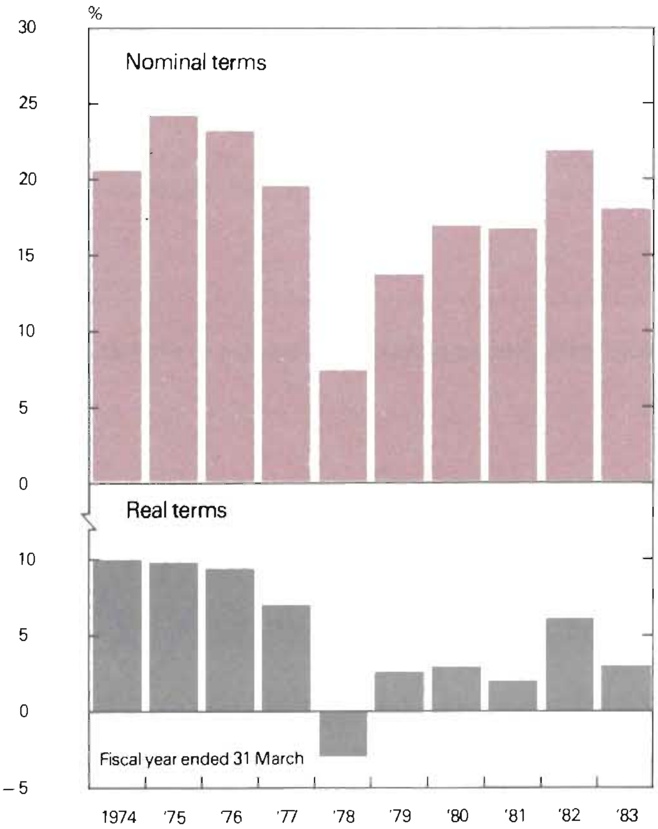
In the absence of any major increase in tax rates, the deficit could be maintained at relatively low levels only by conscious expenditure restraint. From the 1977/78 fiscal year the increase in government expenditure was limited to fairly low figures in real terms. However, in 1981/82 and 1982/83 the increase in nominal as well as real terms rose significantly above the level established during the preceding four years. Increasing demands on the Budget came from defence, education, housing and infra-structural development. More recently, drought relief payments also contributed to the increased expenditure.

Nominal government expenditure, as measured by departmental issues from the Exchequer Account, increased by 22 per cent and 18 per cent in 1981/82 and 1982/83, respectively. The somewhat lower rate of increase in 1982/83 was partly due to the substitution of direct capital market borrowing for funds which had previously been appropriated through the Budget. Despite this somewhat lower rate of increase in Budget expenditure, the ratio of consumption and capital expenditure of the general departments of public authorities to gross domestic product rose slightly from 17,8 per cent in 1981/82 to 18,2 per cent in 1982/83.

Total expenditure of general government*



Changes in Central Government expenditure



Government revenue

Government revenue has shown extremely volatile movements during recent years. Among the reasons for this revenue instability have been the wide swings in the price of gold and their effects on revenue from gold mining. Large variations in the prices of other metals and minerals have caused wide fluctuations also in income tax receipts from non-gold mining companies. Income tax receipts from non-mining companies and individuals have been somewhat more stable, but have nevertheless shown fairly large annual variations. Indirect tax components, such as customs and excise duties, have also been subject to large irregular annual changes.

The volatility of the main revenue components made it more difficult in some years, notably in 1981/82, to realise original Budget estimates of the deficit before borrowing. But in other years, such as 1980/81 and 1982/83, fortuitous increases in revenue had the effect of reducing anticipated deficits or counterbalancing excesses of expenditure over original Budget estimates.

Immediately before the 1982/83 fiscal year, indirect taxes were raised in order to reduce the deficit before

Changes in revenue components
%

Fiscal years	Income tax				Customs and excise duties
	Indivi-duals	Non-mining-companies	Gold mines	Other mines	
1973/74–1978/79 ..	17,2	13,4	26,6	17,3	14,7
1979/80	−1,5	18,3	75,3	121,8	9,9
1980/81	7,6	31,9	139,4	−25,1	34,9
1981/82	51,3	29,1	−44,8	−50,4	30,6
1982/83	35,5	17,3	−17,1	90,8	−2,4

borrowing to manageable proportions in the coming fiscal year. Specifically, the general sales tax was increased from 4 to 5 per cent in February 1982 and, at the same time, a surcharge of 10 per cent was levied on certain classes of imports. These measures were supplemented by an increase in company taxes as part of the 1982/83 Budget proposals. When it became clear in the course of the fiscal year that the revenue shortfall was widening because unforeseen expenditure had pushed the actual expenditure level above the Budget estimate, the general sales tax was increased to 6 per cent in September 1982. The subsequent higher sales tax yield, together with higher revenue from gold mining (owing to the increase in the gold price from July 1982) and higher than expected income tax receipts from individuals (as a result of a further sharp rise in salaries and wages in 1982/83 and the effect of "fiscal drag") kept the deficit of R2 373 million close to the original Budget estimate.

The 1983/84 Central Government Budget

The Central Government's Budget for the 1983/84 fiscal year was presented to Parliament on 30 March 1983. In his assessment of the implications of the prevailing economic situation for fiscal and monetary policy in the year ahead, the Minister of Finance posed the question whether the time had not arrived for a policy of deliberate "reflation" or "stimulation" of the economy as a whole, in particular since the real growth rate had become negative and the balance of payments had begun to show a surplus. Such an approach would imply some combination of materially higher government spending and tax reductions, a higher rate of increase in the money supply, lower interest rates and presumably some depreciation of the rand. However, the Minister came to the conclusion that any such policy would be inappropriate since it would increase the rate of inflation, harm the balance of payments, weaken the rand, reduce the net foreign reserves and damage South Africa's credit rating abroad. For these reasons, it would in the longer term undermine and not promote real economic growth.

Although the earlier strategy of "consolidation and adjustment" had largely achieved its objectives, there still existed an urgent need to curb inflation and to continue repaying short-term foreign debt with a view to rebuilding the net foreign reserves. This was deemed an essential part of the preparation for the next cyclical upswing in the economy.

According to the Minister, the prevailing economic situation called for a fiscal-monetary policy "mix" which would provide for continued restraint on government spending, a relatively small Budget deficit before borrowing, and effective control over the money supply. As far as interest and exchange rates were concerned, the authorities would as far as possible adhere to their policy of relying on market forces to determine realistic rates within the framework of the overall financial strategy.

It was pointed out by the Minister that the approach outlined by him did not mean that economic policy would remain static in the months ahead, but that policy would be adjusted continuously to changing circumstances. Adjustments had in fact been made throughout the past two years. For example, when the existing conservative policy measures had increasingly taken effect in the latter part of 1982 and the balance of payments had improved, while the recessionary tendency in the economy had continued, monetary policy had consciously been eased by permitting a certain increase in liquidity and a substantial decline in interest rates. However, in the Minister's opinion the authorities had for the time being gone as far as they should in this direction.

In line with this approach, total government expenditure was estimated to rise by only 10,3 per cent to R21 176 million during the 1983/84 fiscal year. Total revenue for 1983/84 was estimated at R19 094 million, or 9,6 per cent more than the revised estimates for 1982/83. The 1983/84 deficit before borrowing was estimated at R2 082 million, equivalent to about 2,4 per cent of the expected gross domestic product. The proposed financing of the Budget deficit is shown in the accompanying table.

1983/84 Budget
R millions

Revenue	19 094
Expenditure	21 176
Deficit, before borrowing	2 082
Financing (net of debt repayment)	
Public Debt Commissioners	1 500
New stock issues	930
Issues of non-marketable domestic securities[1]	−296
Foreign loans	−52
Total	**2 082**

1. Including loan levies.