South African Reserve Bank

Annual Economic Report

84

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-fourth ordinary general meeting to be held on 28 August 1984

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Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

A major feature of the South African economy during 1983 and so far in 1984 has been the economic upswing from about April 1983. Although the increases in real ouput, income and employment associated with this recovery were highly desirable and beneficial in their own right, the upswing has proved to be unsustainable in the face of adverse extraneous developments and undesirable internal spending excesses. Accordingly, the authorities have been required to take strong remedial policy action in order to help bring about the necessary short-term adjustments in the economy with a view to achieving balanced and sustainable economic growth in the longer term.

The upswing had its origin in developments during the second half of 1982 and in early 1983, which created a set of circumstances normally associated with an export-led recovery. In early 1983 the gold price had risen from its low of less than US $300 per fine ounce in June 1982 to more than $500 per fine ounce, the previously existing deficit on the current account of the balance of payments had already been transformed into a surplus and this improvement of the current account had been accompanied by a net inflow of capital and a rise in net foreign reserves. The rand had accordingly begun to appreciate and interest rates had declined sharply. Although the impending export-led recovery was still narrowly based on an increase in the gold price, the expectations were that the base would soon be broadened by the beneficial effect of the economic recovery in the United States and other industrial countries on South African exports.

In the second half of February 1983, however, the gold price declined precipitously by more than US $100 per fine ounce. This meant that the base for a new economic upswing had largely fallen away, but a climate conducive to economic recovery had already been created and remained largely intact. Not even the fact that the economic upswing in the industrial countries turned out to be weaker than anticipated and the adverse effects of the prevailing drought could suppress the optimistic business mood and high degree of consumer confidence. This situation was in part due to the favourable financial conditions prevailing at the time, including low rates of interest and an increase in wealth resulting from the preceding rise in security and real estate prices. Moreover, from March onwards, government expenditure started to rise rapidly, causing the "deficit before borrowing" to be financed partly by bank credit and the rate of growth in the money supply to accelerate.

In addition to a considerably higher rate of increase in real government consumption expenditure, the increase in real private consumption expenditure began to accelerate significantly from the first quarter of 1983. What started off as an impending export-led recovery, therefore, turned into a consumption-led economic upswing. It was not before the fourth quarter of 1983 that the upswing gathered support from an increase in the volume of South African exports. Throughout the ensuing period to June 1984 real private as well as government consumption expenditure continued to rise at an accelerating rate and remained the main driving force of the upswing. This increase in consumption accounted almost entirely for the rise of 10½ per cent in real gross domestic expenditure from the second quarter of 1983 to the second quarter of 1984.

The positive effects of the upswing were visible in an increase of 7½ per cent in the real gross domestic output of the non-agricultural sectors of the economy from the first quarter of 1983 to the second quarter of 1984. Owing to a decline in real agricultural output, the recovery in *total* real output from its low in the second quarter of 1983 was about 6½ per cent. Another positive effect was the reversal of the decline in non-agricultural employment in the middle of 1983 and a concomitant decrease in unemployment.

The first six months of the economic upswing, namely the second and third quarters of 1983, were also characterised by a number of other favourable developments. Firstly, the current account of the balance of payments, which had begun to show a positive balance in the fourth quarter of 1982, remained in surplus and the rand continued to appreciate moderately in terms of other currencies. Secondly, after the Government had succeeded from June 1983 onwards to finance its growing deficit before borrowing without further resort to bank credit, the rate of growth in the broad money supply (M3*) started to slow down. This deceleration even continued beyond the first six months of the upswing and was evident also during the ensuing period. Lastly, the rate of inflation, as measured by increases in both consumer and production prices, slowed down distinctly from the second quarter of 1983.

In the fourth quarter of 1983, however, clear signs that the upswing could not be sustained began to emerge. The most important of these were the reappearance of a large deficit on the current account of the balance of payments, a renewed depreciation of the rand and an acceleration in the rate of inflation. To a large extent these developments were due to unfavourable extraneous developments, but they also reflected undesirable domestic changes. In early October, the gold price declined sharply further in response to the strengthening of the US dollar. At the same time, the drought of the previous

* See definition in the money and bank credit section of this review.

season caused net agricultural exports to turn negative in the fourth quarter. The influence of these exogenous changes on the balance of payments was supplemented by a more rapid rise in imports in the fourth quarter, a symptom of the strong expansion of gross domestic expenditure during the upswing. The increase in domestic demand also played its part in the acceleration of the inflation rate, partly through its effect on the exchange rate. The only positive factor contributing to sustainable economic growth was an increase from the fourth quarter of 1983 in the volume of merchandise (non-gold) exports, resulting from a more widespread economic upswing in the industrial countries.

The unfavourable symptoms of the unsustainable upswing were even more conspicuous in the first quarter of 1984 and were strengthened by the persistence of the drought in the summer rainfall areas of the country. In his 1984/85 Budget Speech at the end of March, the Minister of Finance stressed the need for a temporary pause in the process of economic expansion in order, as a first priority, to strengthen the balance of payments and prevent an undue acceleration of the inflation rate. To help achieve these objectives, the Budget was designed to improve the "mix" of fiscal and monetary policy by providing for only a moderate increase in government expenditure and for upward tax adjustments as means of holding down the deficit before borrowing.

Developments in government finance during the second quarter of 1984 were not in accordance with the intentions of the Budget. Government expenditure increased at an exceptionally high rate and the deficit before borrowing assumed unduly large proportions. For this reason, it was announced in May that the general sales tax, which had been raised earlier in February 1984, would be increased further on 1 July, but with the exclusion of certain basic foodstuffs from the tax.

Monetary policy was also tightened from June 1983 onwards and interest rates began a new upward movement that was to last for some time. Towards the end of the first quarter and during the second quarter of 1984, interest rates were allowed to rise still further in response to new adverse extraneous developments and the rising domestic demand for credit. Illustrating these changes, the prime overdraft rate of the clearing banks rose from 19 per cent in November 1983 to 20 per cent in December and to 21 per cent in March 1984. From April onwards the Reserve Bank's operations in the financial markets were aimed specifically at countering the expansionary effect of the increase in government expenditure and the large deficit before borrowing in the government sector's financial accounts.

An exceptional strengthening of the dollar in July was accompanied by a marked decline in the gold price and a substantial drop in the effective exchange rate of the rand. These developments served to emphasize once again that domestic expenditure could not be sustained at the high level to which it had increased without weakening the balance of payments and contributing to a decline in the exchange rate and a higher rate of inflation. Unless counteracted by appropriate monetary and fiscal policies, the depreciation of the rand by itself would in due course lead to an acceleration in the rate of inflation.

For these reasons, the authorities in early August adopted a more restrictive policy stance, after the Reserve Bank had already in July raised its rediscount rates and induced all short-term interest rates to rise by about 1 per cent. As regards fiscal policy, the Government reaffirmed its intention to curtail public sector spending in order to prevent the deficit before borrowing from becoming excessive. The further tightening of monetary policy took the form of an increase of 3 per cent in the Reserve Bank's rediscount rates for discount houses and broadly corresponding increases in the Bank's rates on its overnight lending to discount houses and other banking institutions. In addition, the so-called LADOFCA-rates (maximum finance charges) were raised by 5 per cent in order to achieve an appropriate alignment of interest rates. Following these steps, the minimum overdraft rate of the clearing banks was raised from the 22 per cent to which it had risen in July, to 25 per cent. Furthermore, the more restrictive fiscal and monetary policy stance was supplemented by tighter hire-purchase restrictions.

Domestic economic developments

Upswing in economic activity as reflected in domestic demand and output

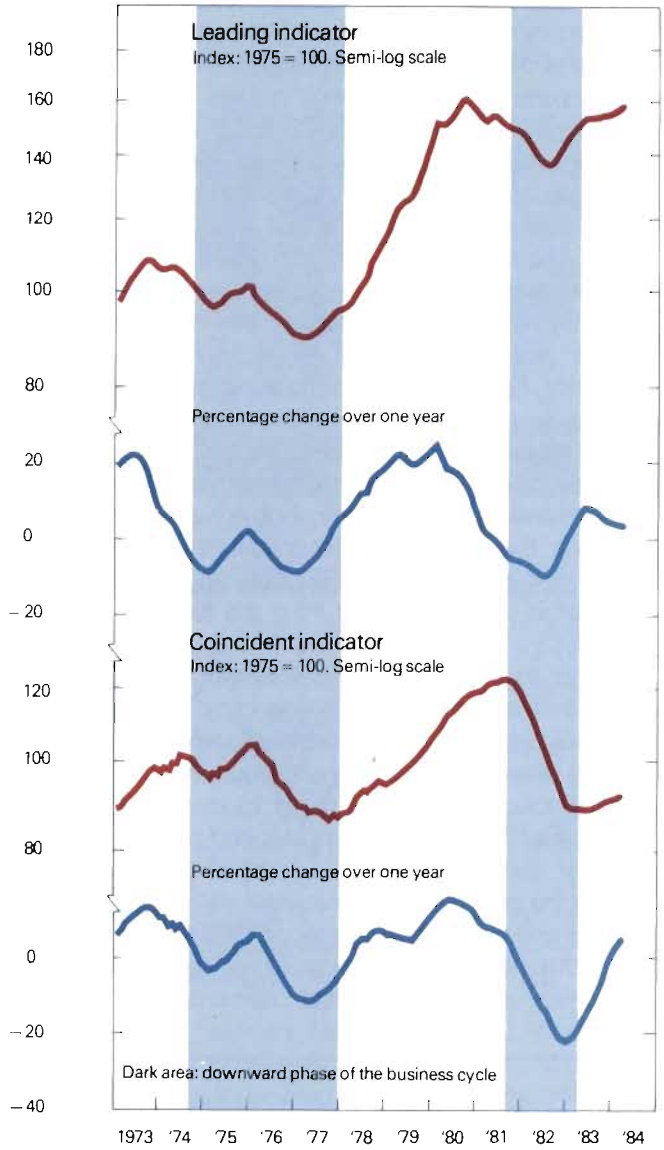
The economic downswing from about August 1981 came to an end in March 1983. Since then, the economy has been in a moderate upswing, at least until the middle of 1984. The composite leading business cycle indicator on the accompanying graph predicted the upswing with a fair degree of accuracy and at present signals a renewed economic downturn in the second half of this year. The prospect of a downturn is in accordance with the views expressed earlier on that the upswing has proved to be unsustainable. It also logically reflects the anticipated effect of the recent change in economic policy stance.

As discussed earlier, the economic upswing started off as a narrowly based export-led recovery but, following the sharp decline in the gold price in the first quarter of 1983, it turned into a consumption-led upswing. Although real gross domestic expenditure continued to decline in the first three months of the recovery period, its consumption components, namely private and government consumption expenditure, already showed a sharp rise in this period. At a seasonally adjusted annual rate, the combined increase in real private and government consumption expenditure accelerated from 1/2 per cent in the first quarter of 1983 to 8 per cent in the second quarter, largely because of an exceptionally strong increase in government consumption expenditure. However, the effect of this consumption increase on total real domestic demand was masked by a substantially higher rate of real inventory depletion.

Throughout the ensuing period to the middle of 1984, the increase in total real consumption expenditure remained the principal driving force of the upswing. By the second quarter of 1984 real private and government consumption expenditure, taken together, had risen by 10 per cent above its level in the first quarter of 1983. To some extent the experience of the second quarter of 1983 repeated itself in the second quarter of 1984. Total real consumption expenditure increased at a seasonally adjusted annual rate of 14 1/2 per cent in the latter quarter, but a markedly higher rate of real inventory depletion, supported by a decline in real fixed investment, caused aggregate real gross domestic expenditure to decline. After this decline, the level of real gross domestic expenditure was nevertheless still 10 1/2 per cent higher than its trough in the second quarter of 1983.

As discussed, South Africa could not afford to sustain this higher level of domestic expenditure. Not only did it result in increased inflationary pressure, but it also caused a weakening of the balance of payments and contributed to a sharp depreciation of the rand.

Business cycle indicators



Up to the third quarter of 1983, the upswing received little support from an increase in the demand for South African exports. The volume of exports actually continued to decline, partly reflecting the effect of the drought on agricultural exports. From the fourth quarter of 1983, however, real export demand began to show a distinct rise and to exert an expansionary influence on domestic economic activity.

The economic upswing was clearly reflected in a renewed increase in real gross domestic output, which had been declining from the beginning of 1982. In the initial phase of the upswing, namely in the second quarter of 1983, the recovery in the real output of the non-agricultural sectors of the economy was still obscured by a sharp decline in real agricultural output, caused by the drought in the summer rainfall areas of the country. But despite the continuing drought, total real gross domestic product started to rise from the third quarter of 1983. By the second quarter of 1984 it had increased by 6½ per cent above its recent low in the second quarter of 1983. Real non-agricultural output increased by 7½ per cent from its low in the first quarter of 1983 to the second quarter of 1984. This increase was well dispersed through the economy. Particularly large output increases were evident in industry and commerce, reflecting the sharp rise in consumption expenditure, and in non-gold mining production, as a result of the increase in export demand from the fourth quarter of 1983.

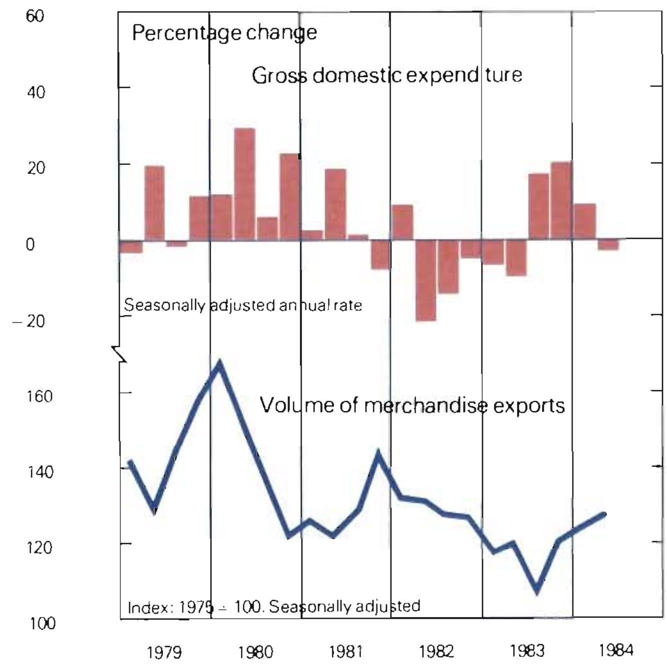
Owing to the increase in international commodity prices that accompanied the economic recovery in the industrial countries and a further slowing down of the inflation rates of trading partners, South Africa's terms of trade (excluding gold) improved moderately from the first quarter of 1983. Up to the second quarter of 1983, however, this improvement was offset by a sharp decline in the gold price. But between the second quarter of 1983 and the second quarter of 1984 even the overall terms of trade showed a marginal improvement. Together with changes in real net factor payments to the rest of the world, this improvement caused the real gross *national* product to increase at a slightly higher rate than real gross *domestic* product between the second quarter of 1983 and the corresponding quarter of 1984, namely by 7½ per cent.

Movements in main components of real domestic demand

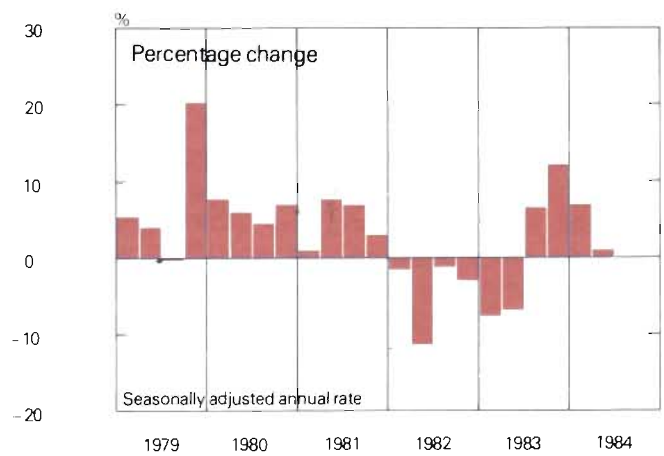
Private consumption expenditure

As mentioned earlier, private consumption expenditure was one of the main generating forces of the economic upswing. From the first quarter of 1983 quarterly increases, expressed in real terms, accelerated consistently and in the second quarter of 1984 it reached a seasonally adjusted annual rate of 12 per cent. This

Real gross domestic expenditure and volume of merchandise exports



Real gross domestic product

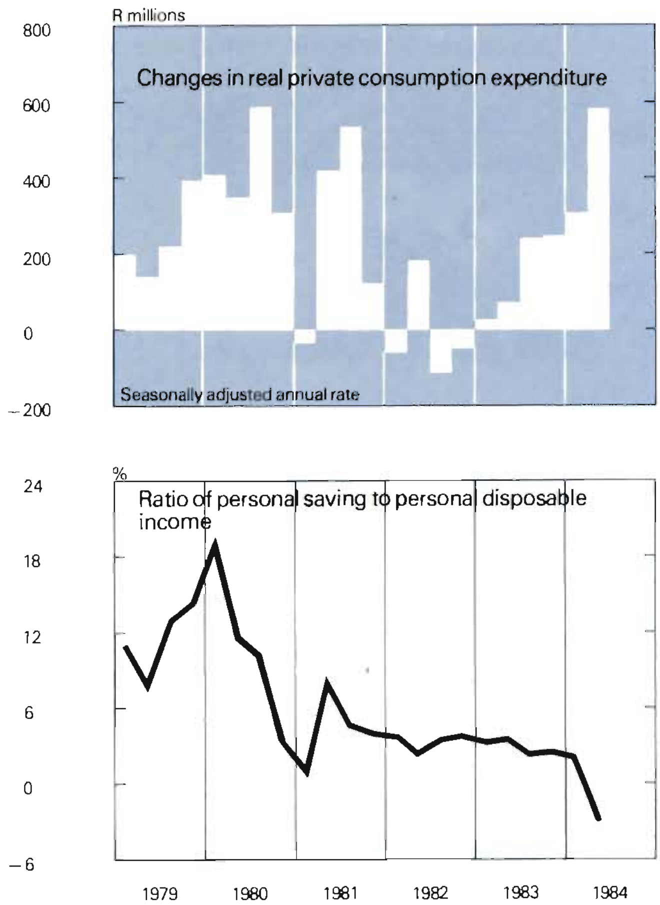


exceptionally high rate of growth partly reflected artificially inflated consumer purchases ahead of the increase, with effect from 1 July, in the general sales tax rate from 7 to 10 per cent on all goods and services, excluding certain basic foodstuffs. In the second quarter of 1984, real private consumption expenditure was 7½ per cent above its recent trough in the fourth quarter of 1982.

The strong consumer demand in South Africa is even more apparent in a somewhat longer-term perspective. Translated into *per capita* terms, real private consumption expenditure declined by only 3 per cent during the economic downswing from the third quarter of 1981 to the first quarter of 1983, while *per capita* real personal disposable income fell by about 4½ per cent. During the subsequent economic upswing, *per capita* real private consumption expenditure rose by 4½ per cent during the five quarters to the middle of 1984, while *per capita* real personal disposable income maintained a downward course and declined by more than 3 per cent. These divergent rates of change implied the large-scale use of consumer credit. In turn, this found expression in a decline in the personal savings ratio from its former longer-term level of about 9 per cent to only 2,4 per cent in the first quarter of 1984. In the second quarter, personal saving actually turned negative.

The strong rise in real private consumption expenditure, in absolute terms as well as in relation to the increase in real personal disposable income, was particularly evident in expenditure on durable and semi-durable goods. Consumer behaviour during recent years may be explained partly in terms of the rising standard of living and low savings propensity of the lower income groups, with a concomitant increased demand for durable and semi-durable goods that was partly financed by consumer credit. More generally, consumer behaviour reflected the strong influence of inflationary expectations on spending decisions after a decade of double-digit inflation, the ready availability of consumer credit facilities, the discouraging effect on saving of negative real after-tax interest rates, and the "wealth effect" on consumer expenditure of an inflationary increase in the value of financial assets and real estate.

Private consumption expenditure and personal saving

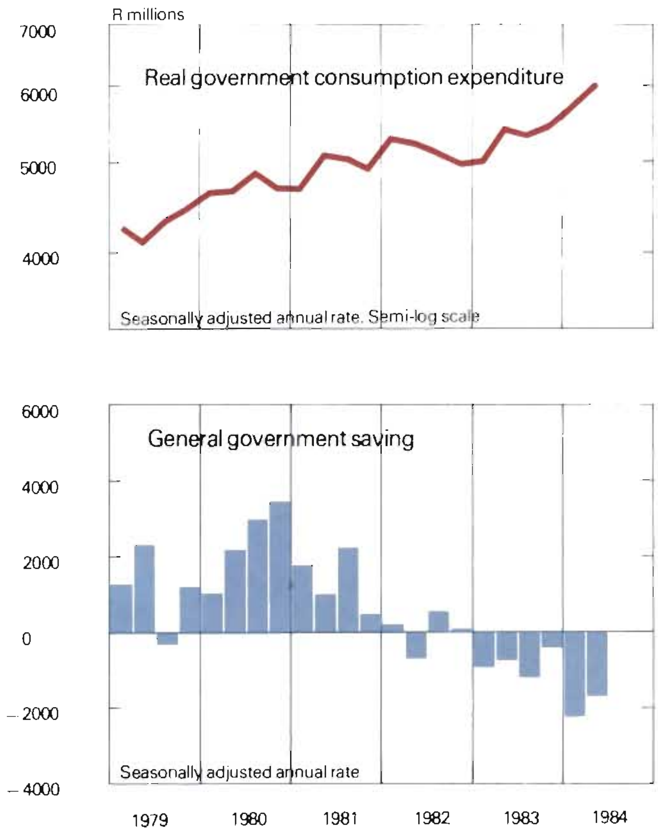


Government consumption expenditure

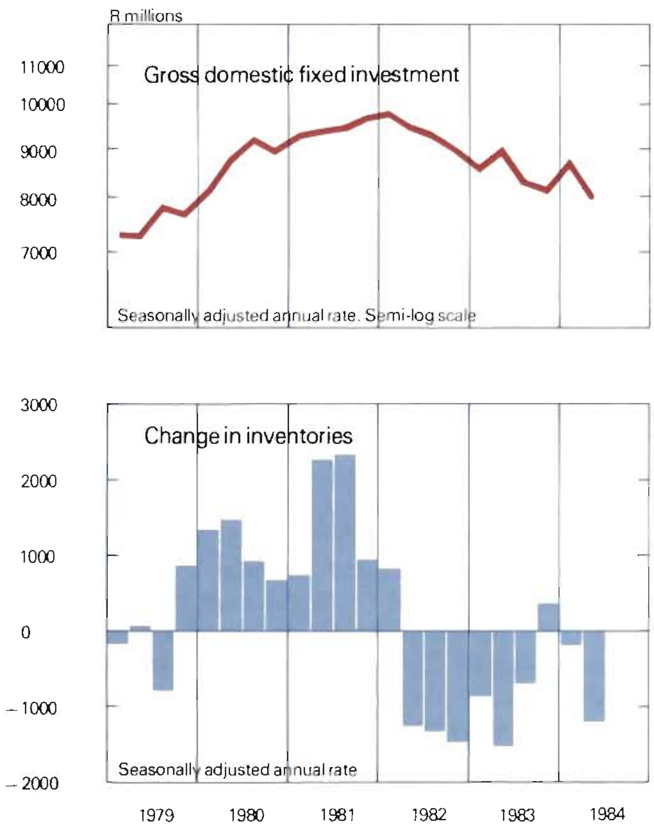
Real government consumption expenditure declined moderately during the 1982/83 fiscal year, but maintained a fairly strong upward trend from the second quarter of 1983. Apart from an increase in employment, the increase in real terms applied also to other categories of expenditure. In the first half of 1984 real government consumption expenditure was 12 per cent higher than in the first half of 1983.

A sharp rise in the salary and wage scales of general government caused government consumption expenditure to rise rapidly in nominal terms. In the first half of 1984 nominal consumption expenditure was 27 per cent

General government consumption expenditure and saving



Real gross domestic investment



above its level in the first half of 1983. The increase in salary and wage scales reflected a restructuring in accordance with a programme of occupational differentiation, as well as a general upward adjustment from 1 January 1984.

From the beginning of 1981 the rate of increase in the nominal current expenditure of general government continuously exceeded that in nominal current income. This resulted in a gradual decline in the excess of current income over expenditure, i.e. in general government saving. From the first quarter of 1983 there was an actual shortfall of income relative to expenditure, which accumulated to R850 million in 1983 and, at a seasonally adjusted annual rate, to almost R2 000 million in the first half of 1984.

Gross domestic fixed investment

Showing its typical lag in relation to the general business cycle, the real fixed investment expenditure of the private sector continued to decline during the first three months of the new economic upswing from the second quarter of 1983. The strong increase in real consumption expenditure and accompanying decline in real inventories, however, prompted some increase in real private fixed investment from the third quarter of 1983. But this increase was maintained only up to the first quarter of 1984 and was then followed by a decline in the second quarter. The latter was evident in various sectors, in particular in mining, agriculture and, for the first time in two years, residential construction. After the decline in the second quarter, the private sector's real fixed investment was only 2 per cent higher than its trough in the second quarter of 1983.

The public sector's real fixed investment followed an erratic course during the period of economic upswing but declined on balance. In total, real gross domestic fixed investment was 5½ per cent lower in the second quarter of 1984 than in the first quarter of 1983.

Net real fixed investment in manufacturing increased only moderately between the first quarter of 1983 and the second quarter of 1984, implying only a small addition to production capacity during this period. The sharp rise in real consumption expenditure and the increase in the volume of exports, apart from lowering real inventory levels, had the effect of raising the utilisation of production capacity from a low of 84 per cent in the second quarter of 1983 to almost 87 per cent in the second quarter of 1984.

Inventory investment

Real inventory investment showed wide quarterly fluctuations during the period of economic upswing, but on balance real inventories declined considerably from the first quarter of 1983 to the second quarter of 1984. This decline was particularly evident in industrial and commercial inventories. The ratio of real industrial and commercial inventories to real non-agricultural gross domestic product continued to decline from its most recent peak of 29 per cent in the first quarter of 1982 to 22½ per cent in the second quarter of 1984.

Factor income and saving

Despite the economic upswing during most of 1983, the increase in nominal factor income in the form of salaries and wages decelerated from 19 per cent in 1982 to 14 per cent in 1983. The upswing did not generate undue pressure on labour resources, but the large salary and wage scale adjustments in the public sector, referred to earlier, was mainly responsible for an acceleration of the increase in nominal salaries and wages to a seasonally adjusted annual rate of 17½ per cent in the first half of 1984. The other main component of factor income, namely total gross operating surplus, however, clearly reflected the influence of the economic upswing on company profits. Despite a decline in the first quarter of 1983, gross operating surplus increased by 12 per cent in the year as a whole and at a seasonally adjusted annual rate of 8½ per cent in the first half of 1984.

Owing to larger company profits, corporate saving increased appreciably in 1983 and the first half of 1984. As mentioned earlier, personal saving declined to a low level during this period, while the saving by general government was actually negative. Although supplemented by a rise in the provision for depreciation, the increase in corporate saving was not sufficiently strong to prevent the ratio of total gross domestic saving to gross domestic product from declining from 25½ per cent in the first quarter of 1983 to 19½ per cent in the second quarter of 1984.

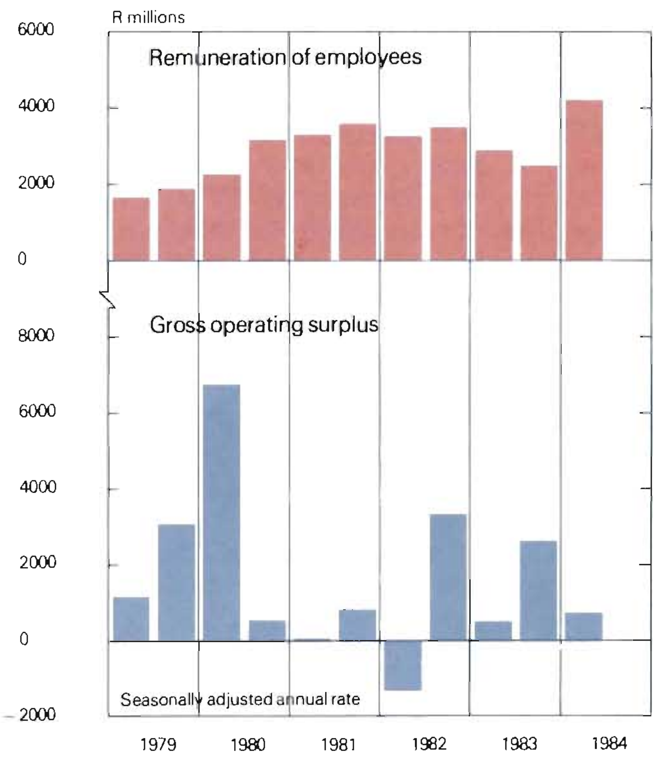
Employment*

A positive effect of the economic upswing was a reversal of the decline in employment that had been in progress since the second quarter of 1982. During the initial phase of the upswing, namely the second and third quarters of 1983, employment rose only marginally, but the increase accelerated to 1,3 per cent (seasonally adjusted annual rate) in the fourth quarter and to 2,1 per cent in the first quarter of 1984.

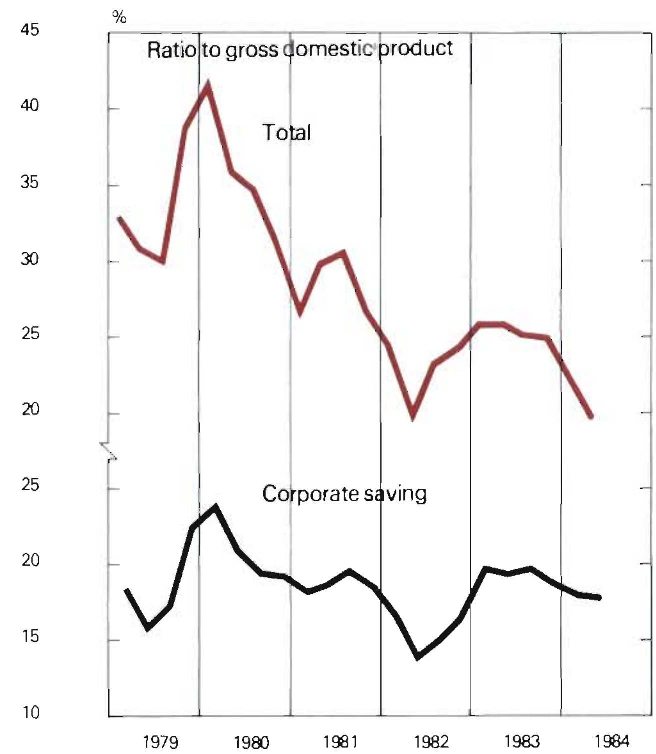
The cyclical decline in employment up to the first quarter of 1983 was confined to the private sector.

* Employment and labour remuneration statistics refer to the non-agricultural sectors of the economy and are available only up to the first quarter of 1984.

Changes in factor income



Gross domestic saving



Public authority employment rose uninterruptedly during the entire period of economic downswing and continued to grow during the subsequent period of economic recovery. It was not before private sector employment had stopped declining that overall employment began to show renewed expansion. Private sector employment, which had declined from the first quarter of 1982, stabilised at a lower level in the second and third quarters of 1983 and started to rise from the fourth quarter. This increase gained momentum in the first quarter of 1984. Higher employment levels were particularly evident in manufacturing, mining, electricity generation, financial services and private transport.

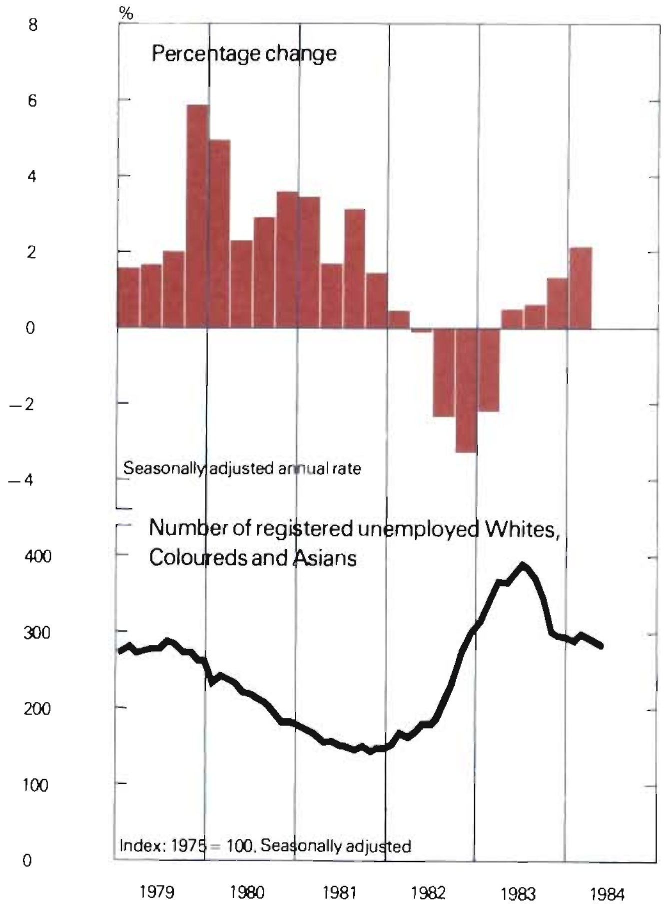
The employment increase was mirrored in a decline in unemployment. Seasonally adjusted, the number of registered unemployed Whites, Coloureds and Asians decreased from its most recent peak of 40 090 (1,8 per cent of the labour force) in June 1983 to 29 740 (1,3 per cent of the labour force) in June 1984. As a ratio of the economically active Black population, Black unemployment declined from 8,5 per cent in June 1983 to 7,8 per cent in March 1984.

Wages and productivity

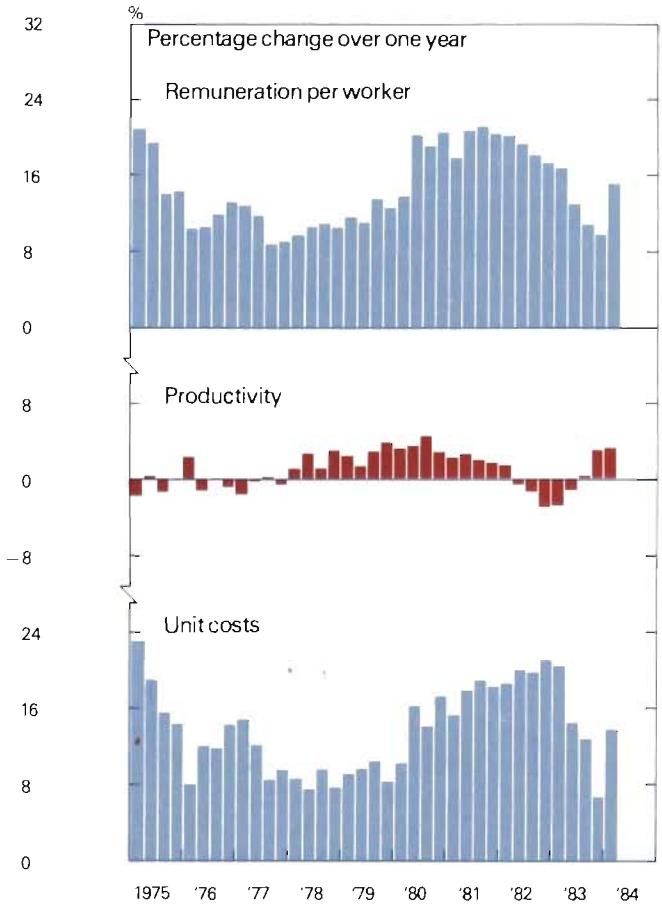
The growth in nominal wages moderated appreciably during 1983. Salaries and wages per worker in the non-agricultural sectors of the economy rose on average by 12,4 per cent in 1983, compared with an average annual increase of 19,0 per cent during the preceding three years. Moreover, the rate of growth over a four-quarter period slowed down consistently in the course of 1983 to only 9,8 per cent in the fourth quarter. Subsequently, however, the growth rate accelerated to 15,2 per cent in the first quarter of 1984. An important contribution to this acceleration came from public authorities, reflecting the increase in salary and wage scales in the public service, referred to earlier. Remuneration per public authority employee was in fact 19,5 per cent higher in the first quarter of 1984 than in the corresponding quarter of 1983.

In real terms, the increase in the remuneration per worker in the economy as a whole slowed down from 4,6 per cent in 1981 to 3,5 per cent in 1982 and to 0,2 per cent in 1983. Measured over a four-quarter period,

Non-agricultural employment



Labour productivity, remuneration and unit costs in non-agricultural sectors



the rate of growth in real labour remuneration actually turned negative during the second half of 1983, but subsequently accelerated to 4,5 per cent in the first quarter of 1984.

Labour productivity, as measured by the real gross domestic product per worker in the non-agricultural sectors, declined on average by 0,3 per cent in 1983, following upon a decrease of 0,9 per cent in 1982. However, despite this year-on-year decline, the growth rate in labour productivity turned positive in the second quarter of 1983. Measured over a four-quarter period, productivity growth reached 3,1 per cent in the first quarter of 1984. Such a productivity increase is typical of the initial phase of an economic upswing, as more intensive use is made of the existing employed labour force.

The productivity gain from the first quarter of 1983 to the first quarter of 1984 did not, however, match the corresponding growth of 4,5 per cent in real salaries and wages per worker. This discrepancy was largely due to the special salary and wage scale adjustments by public authorities. Nevertheless, these changes implied an increase of only 1,4 per cent in real unit labour costs over the four-quarter period concerned. The corresponding increase in nominal unit labour costs amounted to 11,7 per cent.

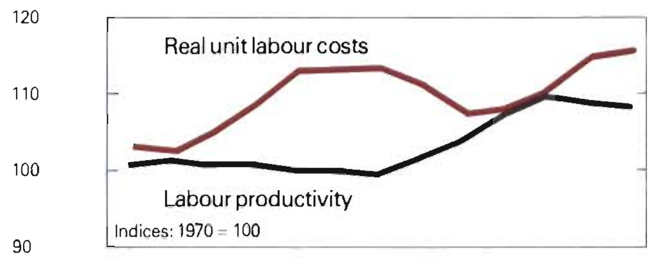
The higher rate of growth in real labour remuneration than in labour productivity is not only a short-term phenomenon, but has become a secular feature. For example, between 1970 and 1983 real salaries and wages per worker rose at an average annual rate of 1,8 per cent, while the corresponding rate of increase in productivity amounted to only 0,6 per cent.

In addition to a disappointing productivity performance, the difference in these longer-term growth rates points to an unduly high rate of growth in nominal salaries and wages per worker as well as in nominal unit labour costs. Naturally, during the period concerned the sustained rapid rise in nominal unit labour costs formed part of the inflationary process. In an accounting sense, nominal wages comprise the greater part of overall costs and prices, and any undue increase in nominal salaries and wages is likely to be reflected in price increases.

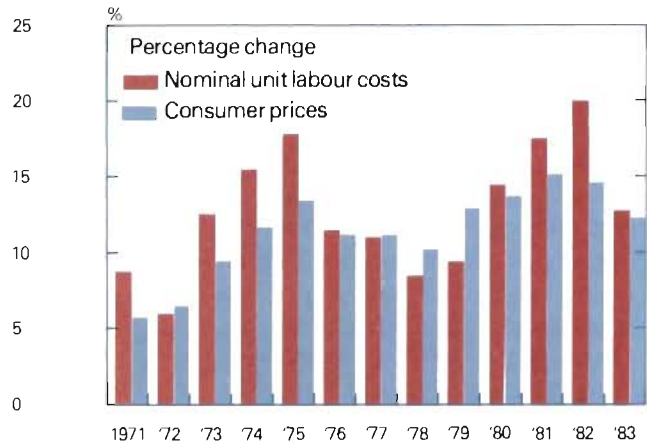
Prices

Progress in lowering the rate of inflation continued during most of 1983. Quarterly increases in consumer as well as production prices decelerated consistently up to the third quarter. This moderation of inflation was largely due to the considerably lower rate of increase in nominal aggregate domestic demand, as reflected in an actual decline in real terms, from about the second quarter of 1982. This weakening of demand served to reduce pressures on prices as well as on labour resources. In addition, it found expression in a decline in imports and contributed in this way to a strengthening of the balance of payments and an appreciation of the rand up to Sep-

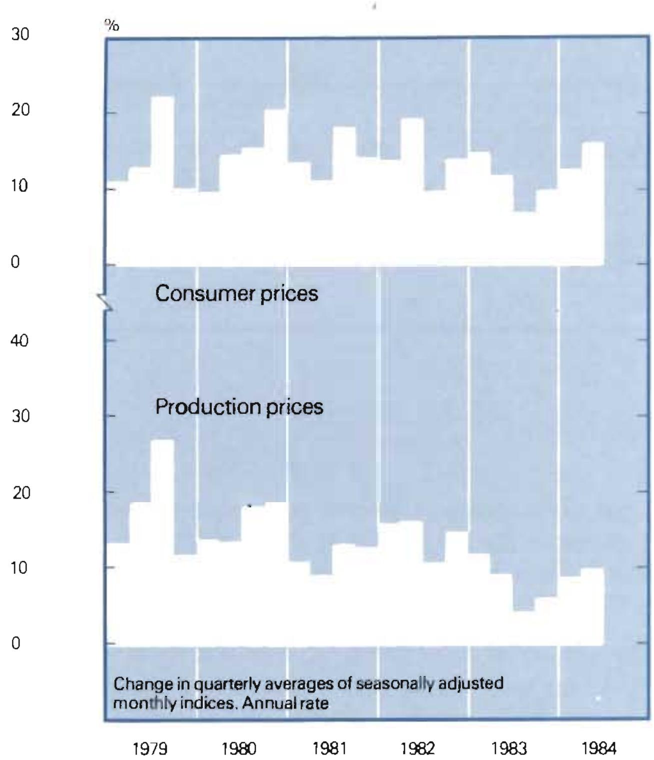
Unit labour costs and productivity



Unit labour costs and consumer prices



Percentage change in prices



tember 1983. In turn, the appreciation of the rand, through its effect on import prices, supported the general slow-down of price increases.

From the fourth quarter of 1983, however, prices started to rise at higher rates. By that time, most of the inflation-restraining influences had been reversed. Real gross domestic expenditure had shown a renewed strong rise from the preceding quarter and, coinciding with a sharp drop in the gold price, the rand had begun to depreciate. Subsequently, further upward pressure on prices was introduced by an almost continuous downward floating of the exchange rate of the rand, the severe drought, the higher rate of increase in salaries and wages per worker, and a number of administered price adjustments in the second quarter of 1984. In addition, the increase in the general sales tax rate from 6 to 7 per cent on 1 February had the statistical effect of raising the consumer price index.

These developments resulted in the further acceleration of quarterly increases in both consumer and production prices during the first half of 1984. Measured over a twelve-month period, consumer and production prices increased at rates of 11,6 per cent and 8,1 per cent, respectively, in June 1984.

In July the effective exchange rate of the rand declined further by no less than 16 per cent. If it were to remain at this lower level, the resulting rise in import prices will in due course bring about an acceleration in the rate of inflation, both directly and indirectly through its effect on other prices and costs. The prospect of such an acceleration of the rate of inflation was one of the main reasons for the authorities' adoption of a more restrictive economic policy stance in early August.

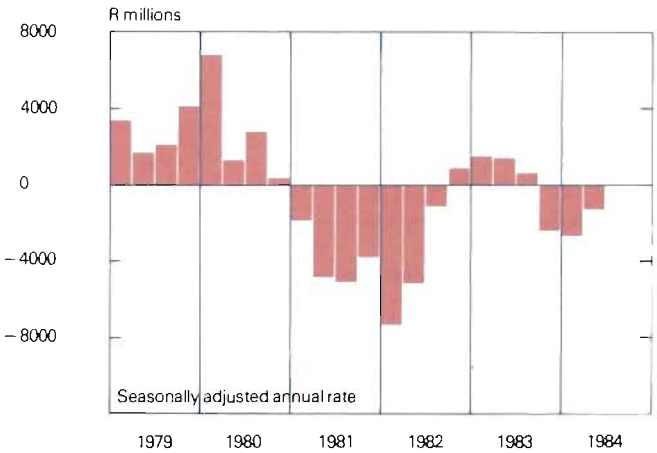
Foreign trade and payments

Balance of payments on current account

Apart from its domestic expansionary effect, the renewed strong rise in gross domestic expenditure from about the middle of 1983 was reflected in a sharp increase in imports and a weakening of the current account of the balance of payments. In the fourth quarter the current account moved into deficit after it had been in surplus from the fourth quarter of 1982. In addition to the import increase, the reappearance of a current account deficit was due to a downward movement of the gold price from February 1983, a decline in exports and a concomitant rise in imports of agricultural products because of the drought, a sluggish recovery of other non-gold exports, and a rise in net service and transfer payments to foreigners.

At a seasonally adjusted annual rate, the current account deficit amounted to R2,5 billion in the fourth quarter of 1983. A small surplus of R282 million was, however, still recorded in 1983 as a whole. Subsequently, in the first quarter of 1984, the deficit (at a seasonally adjusted annual rate) increased to R2,8 billion (3 per cent of gross domestic product), but in the second quarter it shrunk to R1,4 billion.

Balance on current account



Balance of payments on current account
(Seasonally adjusted annual rates)
R millions

	1983				1984	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Merchandise exports	9 884	10 305	9 590	11 077	11 620	12 340
Net gold output	10 802	9 879	10 020	9 015	11 020	10 210
Merchandise imports	−15 155	−14 769	−15 285	−18 443	−20 990	−19 830
Net service and transfer payments	− 4 024	− 3 966	− 3 689	− 4 113	− 4 410	− 4 070
Balance on current account	1 507	1 449	636	− 2 464	− 2 760	− 1 350

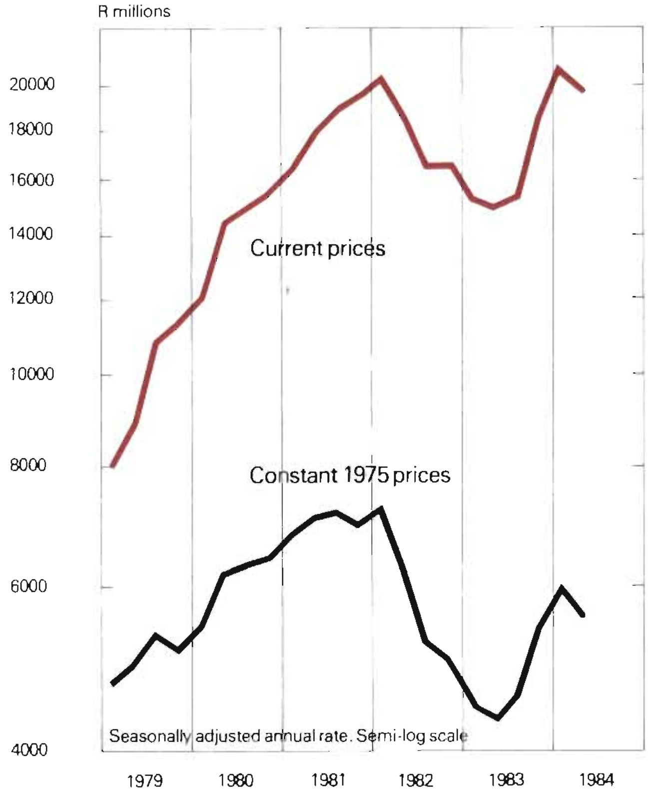
Movements in main current account items

Merchandise imports

Imports, which had declined by 28 per cent in terms of value and by 40 per cent in terms of volume from the first quarter of 1982 to the second quarter of 1983, resumed an upward course in the subsequent quarter. This renewed increase proceeded at a rapid pace in the fourth quarter and the first quarter of 1984, but was followed by a decline in the second quarter. From its cyclical low in the second quarter of 1983 to the second quarter of 1984 the value of imports rose by 34 per cent, while the corresponding volume increase amounted to 29 per cent. This swing in imports served materially to bring about the considerable turnaround in the current account balance.

Apart from the cyclical upswing in gross domestic expenditure, other factors also played their part in the recent increase in import demand. For example, additional imports were necessitated by the drought. Furthermore, prior to the marked depreciation of the rand in recent months, the substitution of imported goods for domestically produced goods was encouraged by the substantially higher rate of inflation in South Africa than in trading-partner countries. The effect of this inflation differential on import demand was strengthened by the gradual abolition during 1983 of the surcharge on imports.

Merchandise imports

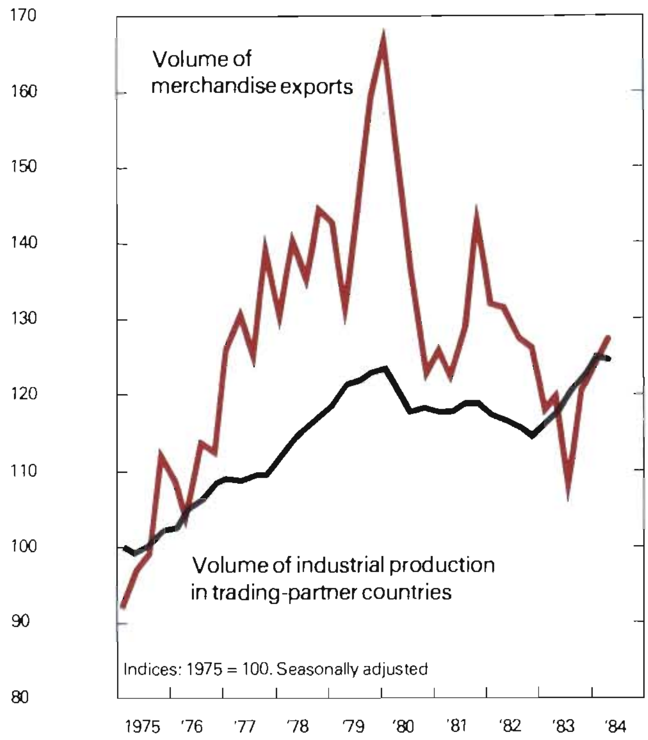


Merchandise exports

Merchandise exports (i.e. excluding gold) declined in rand value terms by 8 per cent between the first quarter of 1980 and the third quarter of 1983. In volume terms, the decline amounted to as much as 37 per cent. Although a new economic upswing in the industrial countries began from about the beginning of 1983, it initially had little effect on South African exports. The rise in international commodity prices that accompanied the upswing, merely served to offset the further decline in the volume of exports. It was not before the fourth quarter of 1983 that the export volume started to recover and the value of exports began to show a distinct increase.

The initial slow response of exports to the cyclical upswing in the industrial countries, which was in contrast with previous experience, had various causes.

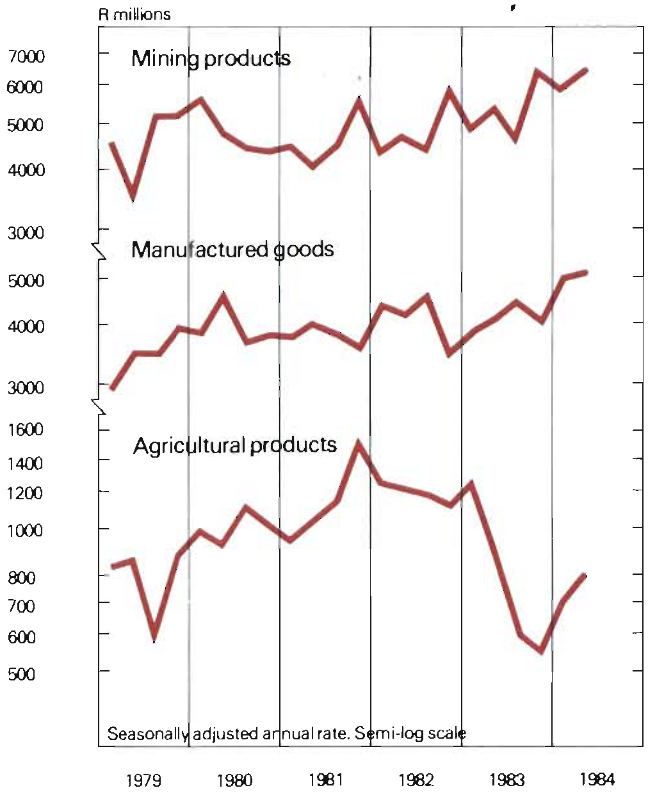
Volume of merchandise exports and industrial production in trading-partner countries



Firstly, the economic upswing was not evenly distributed among the industrial countries, but confined mainly to the United States. Even within the United States recovery was concentrated, at least for some time, in certain sectors of the economy, such as residential construction, the production of durable consumer goods and the manufacturing of high technology electronic equipment, which required little additional inputs of South African export products. Secondly, the drought caused a marked decline in agricultural exports and this tended to mask increases in the non-agricultural export categories. Finally, the severe recession, aggravated by drought conditions, and accompanying balance of payments problems in neighbouring countries restrained the growth in exports of manufactured goods to these countries.

Some of these constraining influences disappeared in the course of 1983. In the fourth quarter exports showed a considerable increase that was sustained in the first half of 1984. With a more pronounced economic upswing now in progress in the industrial countries, non-agricultural exports are likely to improve further during the second half of the year. The depreciation of the rand from October last year, apart from raising the rand prices of exports, should also serve to promote a further increase in the export volume.

Classification of merchandise exports



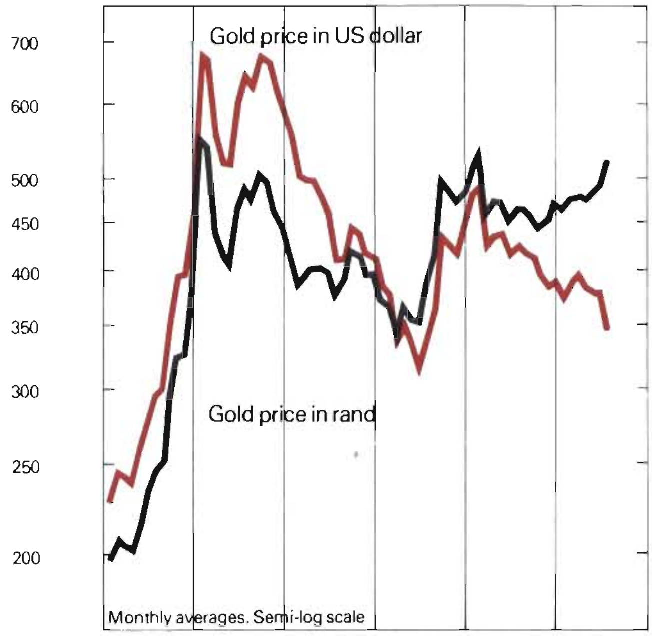
Net gold output

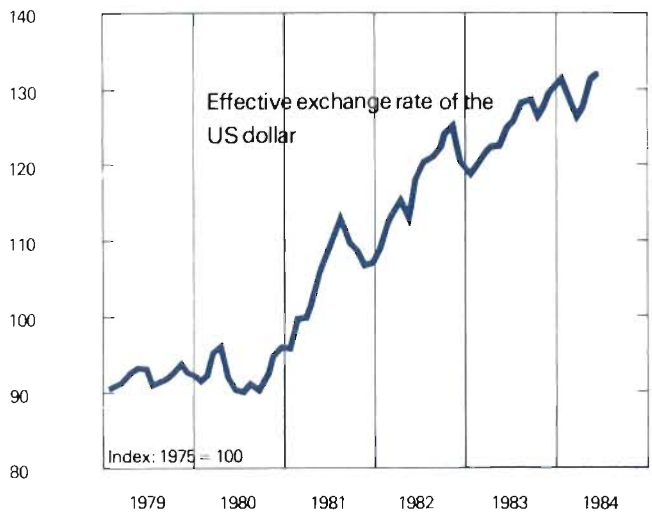
In addition to the increase in imports, a fall in the gold price during 1983 played an important part in transforming the current account surplus into a deficit. The gold price, as fixed on the London market, reached an average of US $492 per fine ounce in February 1983. After a sharp drop of more than US $100 per fine ounce towards the end of February, the price fluctuated further downwards to an average of US $388 per fine ounce in December. During the first six months of 1984 it fluctuated around a level of US $380 per fine ounce, but in July it fell markedly to an average of US $348 per fine ounce.

The downward drift of the gold price in the course of 1983 and the subsequent sharp fall in July 1984 were to a large extent related to the strengthening of the US dollar. This implied the substitution of high yielding dollar assets for gold holdings by investors, a shift that was encouraged by the present status of the US dollar as the most desired international reserve asset and by further increases in already high real short-term interest rates in the United States.

Since the rand depreciated only moderately in terms of the US dollar during the first nine months of 1983, the rand price of gold closely followed the movements in the US dollar price during this period. A more substantial decline in the rand-dollar exchange rate during the fourth quarter and the first seven months of 1984 had the effect of keeping up the rand price of gold. In fact, the rand price per fine ounce of gold increased from an average of R456 in the last quarter of 1983 to R473 in the first quarter of 1984, to R483 in the second quarter and R521 in July. Assisted by a volume increase, the value of the net gold output in the first half of 1984, therefore, rose significantly above its low in the last quarter of 1983.

Gold price and effective exchange rate of the US dollar





Net service and transfer payments

Net service and transfer payments to foreigners declined moderately during the first three quarters of 1983, but showed a renewed increase from the fourth quarter. As mentioned earlier, this increase contributed to the emergence of a deficit on the current account in the last quarter of 1983 and helped to sustain the deficit during the first half of 1984. Higher interest payments, an increase in the remuneration of foreign migrant workers, and higher freight and merchandise insurance payments in respect of larger imports were the main causes of the increased deficit on the services account of the balance of payments. The growth of the deficit was partly restrained by smaller dividend payments to foreigners and by a moderate rise in service receipts by South African residents.

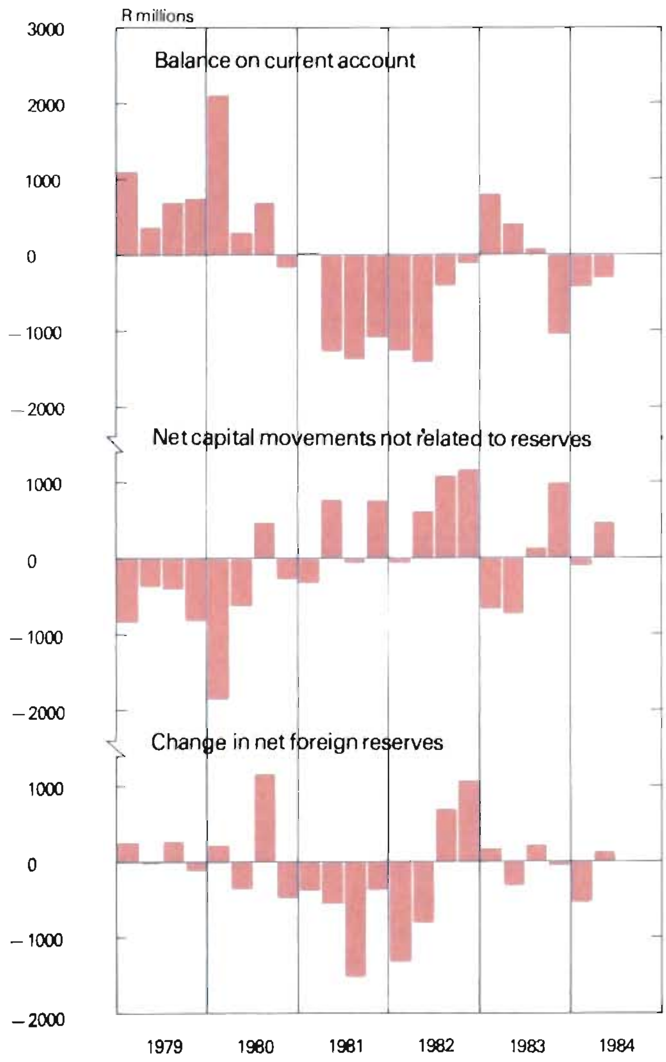
Net capital movements

The changes in the South African balance of payments on current account during 1983 and the first six months of 1984 were to a large extent accompanied by equilibrating changes on the capital account. Apart from the usual volatile short-term capital movements, long-term capital movements originating in the private sector also showed fluctuations during the period concerned. Net capital movements are summarised in the accompanying table and only the private sector's capital flows will be singled out for further comment.

The long-term capital movements of the private sector were dominated during 1983 by foreigners' net sales of South African securities. These net sales amounted to R1 275 million and were prompted, among other things, by the actual and expected further decline in the gold price and the transfer of control in South African companies from foreigners to South African residents. Such a repatriation of foreign equity capital from South Africa had been made possible by the abolition of exchange control over non-residents in early February 1983. From late 1983, however, foreigners again became net purchasers of South African securities. During the first six months of 1984 such net purchases amounted to R341 million.

Sharp fluctuations also occurred in short-term capital movements of the private sector. The fall in the gold price in February 1983 gave rise to expectations that the rand would depreciate. These expectations, together with a continuing decline in imports, were mainly responsible for a substantial outflow of short-term capital during the first half of 1983. A fairly stable exchange rate of the rand during the third quarter and the sharp rise in imports in the fourth quarter contributed to a substantial inflow of short-term capital during the second half of 1983. This was followed by a renewed net outflow during the first half of 1984, apparently mainly because of unfavourable "leads and lags" in foreign payments and receipts that were based on the actual and expected further depreciation of the rand.

Overall balance of payments



Net capital movements not related to reserves
R millions

	1983		1984
	1st half	2nd half	1st half
Long-term capital			
Central government and banking sector	258	31	315
Public corporations and local authorities	206	598	119
Private sector			
Net purchases of securities	–746	–529	341
Other	219	–502	147
Total	–63	–402	922
Short-term capital, including unrecorded transactions	–1 353	1 510	–583
Total	–1 416	1 108	339

Foreign reserves

Despite offsetting changes in the current account balance, on the one hand, and net capital flows on the other, net foreign reserves showed notable fluctuations in the course of 1983 and the first seven months of 1984. On balance, however, net foreign reserves declined by only R26 million during 1983 and by a further R429 million during the first half of 1984.

In order to supplement the cash component of foreign reserves and, at times, the cash reserves of the banking system, the Reserve Bank and other banking institutions negotiated additional short-term foreign loans. The increase in these liabilities related to reserves amounted to R1 109 million during 1983 and to R310 million during the first half of 1984. During July, the Reserve Bank at times intervened actively in the foreign exchange market to promote orderly exchange rate changes. Despite this intervention, the Bank's net foreign reserves declined by only R465 million during the month.

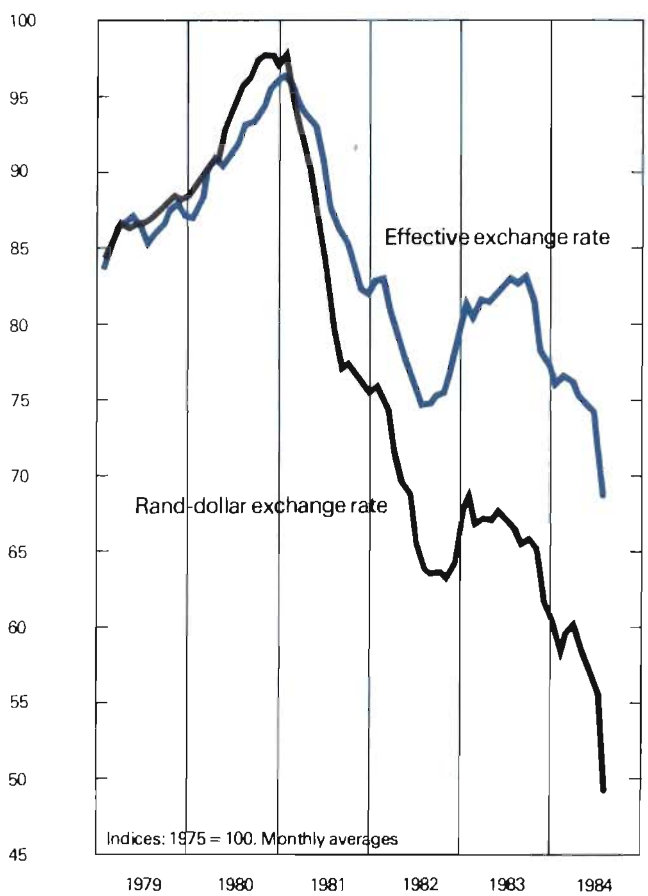
Exchange rates

Movements in the effective exchange rate of the rand during 1983 and the first half of 1984 broadly reflected overall balance of payments changes. During the first nine months of 1983, when both the current account and the overall balance of payments were in surplus, the effective exchange rate of the rand rose moderately. When the current account as well as the overall balance of payments moved into deficit from the fourth quarter of 1983, the effective exchange rate started to decline. A downward trend was maintained during the first six months of 1984, followed by a sharp fall in July and a slight increase during the first half of August.

Apart from the more fundamental interaction between the balance of payments and the exchange rate, exchange rate movements during 1983 and the first seven months of 1984 were influenced substantially by the intermittent strong appreciation of the US dollar against virtually all other currencies. In particular, during the fourth quarter of 1983 and the seven months to July 1984, the appreciating dollar became a dominating force in the domestic foreign exchange market, causing the exchange rate of the rand in terms of the dollar to fall markedly. Owing largely to the relative importance of the dollar in the trade weighted average exchange value of the rand, the depreciation of the rand against the dollar was also reflected in a decline in the effective exchange rate of the rand.

In addition to this direct influence on the exchange rate of the rand, the exceptionally strong dollar had an important indirect effect. As mentioned earlier, movements in the gold price showed a fairly consistent inverse correlation with changes in the effective exchange rate of the dollar. The strengthening of the dollar, therefore, resulted in a weakening of the gold

Exchange rates of the rand



price and of the current account of the balance of payments. In turn, this exerted further downward pressure on the exchange rate of the rand.

The influence of the strong dollar on the exchange rate of the rand extended even further. Because of its inverse relationship with the gold price, the periodic strengthening of the dollar gave rise to expectations that the rand would depreciate. Such expectations caused unfavourable "leads and lags" in foreign trade payments and receipts and encouraged also other forms of outward capital movements. The inevitable weakening of the capital account of the balance of payments served to strengthen downward pressures on the exchange rate of the rand.

Movements in the effective exchange rate of the rand as well as in the rand's exchange rates in terms of the currencies of South Africa's main trading partners are set out in the accompanying table. Following upon an increase of 11,2 per cent in the effective exchange rate of the rand from a low in July 1982 to the end of September 1983, the rand depreciated, on average, by 13,5 per cent during the subsequent nine months. During July 1984 the effective exchange rate fell sharply further by 16,0 per cent, bringing the total decline from the end of September 1983 to 27,2 per cent. In terms of the strongly appreciating US dollar, the rand depreciated by as much as 33,8 per cent during this ten-month period. The rand's depreciation against other currencies was somewhat more moderate. After the new policy measures had been introduced by the authorities in early August, the rand appreciateo slightly in terms of the US dollar and also on average against all currencies.

The marked depreciation of the rand, especially during July, was the result not only of the strengthening dollar and the declining gold price, but also of the unsustainable demand-led economic upswing, and emphasized the need to moderate the growth in domestic demand and to strengthen the balance of payments. Apart from reacting to the more fundamental influences, the sharp depreciation of the rand also served to illustrate the strong impact of expectations and market perceptions on exchange transactions and exchange rates. These probably caused the recent fall in the exchange rate to overshoot the correction required by fundamental factors, including the inflation differential between South Africa and its trading partners.

Changes in the exchange rates of the rand
%

	31 July 1982 to 30 Sept 1983	30 Sept 1983 to 31 July 1984	31 July 1984 to 15 Aug 1984
Effective exchange rates.	11,2	−27,2	6,4
US dollar	4,2	−33,8	7,6
British pound	20,9	−24,2	6,0
German mark	11,6	−27,4	6,7
Swiss franc	5,7	−23,5	5,8
Japanese yen	−4,1	−31,2	5,7
French franc	21,7	−26,6	6,8

Money and bank credit

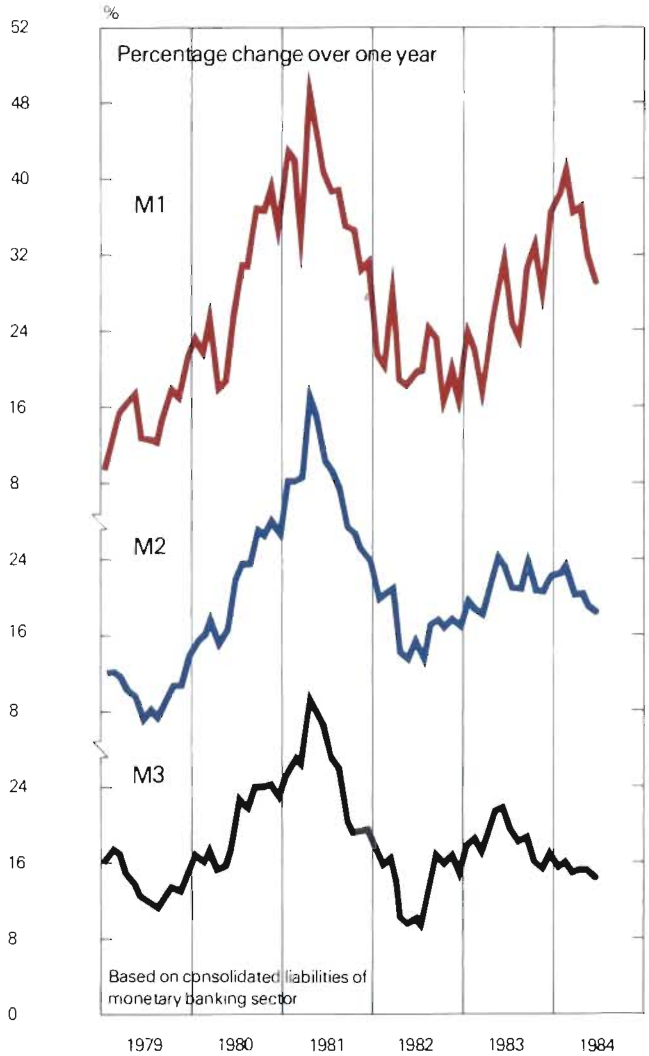
Reassessment of monetary aggregates as indicators of monetary change

Although South Africa has not yet adopted a policy of formally setting target growth rates for monetary aggregates as part of its monetary policy strategy, the importance of curbing the rate of growth in the money supply has long been recognised as an integral part of anti-inflationary policy. However, the usefulness of measured money supply changes as a reliable indication of short-term monetary expansion or contraction has seriously, although hopefully only temporarily, been impaired during recent years by a number of basic economic developments as well as various technical and conceptual difficulties. Among these have been, firstly, distortions of the measured money supply figures by the processes of "disintermediation" and "re-intermediation", including shifts by banks from on-balance-sheet to off-balance-sheet financing and vice versa. These processes were, of course, greatly influenced by the abolition in 1980 of deposit rate control and bank credit ceilings, which brought much lending back on to the balance sheets of banks and, therefore, inflated the money supply figures while, at the same time, sharply reducing the velocity of circulation of money. Secondly, money supply figures measured as at month-ends have been subject to unpredictable and erratic fluctuations which have tended to obscure the direction of short-term change. Lastly, monetary aggregates have been affected by shifts among various classes of deposits owing to changes in liquidity preferences, financial innovations and actual and expected changes in the level and structure of interest rates.

The experience in South Africa has been that the rate of change in the narrowly defined money supply (M1*) at times shows large and irregular short-term fluctuations. For example, at a seasonally adjusted annual rate, quarterly changes in M1 varied between 10 and 65 per cent during 1983. Traditionally, monetary change in South Africa has been judged in terms of movements in M2†, but even this aggregate has as times shown large short-term volatility and, like M1, has recently been influenced quite substantially by shifts among the different categories of deposits.

As in several other countries, a case can be made out that in South Africa a broad monetary aggregate (M3), which includes, apart from M2, also "long-term" deposits with monetary banking institutions, i.e. deposits with an unexpired maturity of six months or longer, will be a more reliable and stable indicator of monetary change. Such an aggregate is less influenced by changes in asset preferences associated with financial innovations and variations in expectations, and in interest rate structures. This approach does, of course, not deny that shifts among different classes of deposits are significant in their own right and provide important additional information for purposes of financial analysis. A broad monetary aggregate has the further advantage that it

Money supply



* Defined as coin and banknotes in circulation, plus demand deposits of the non-bank private sector with monetary banking institutions.

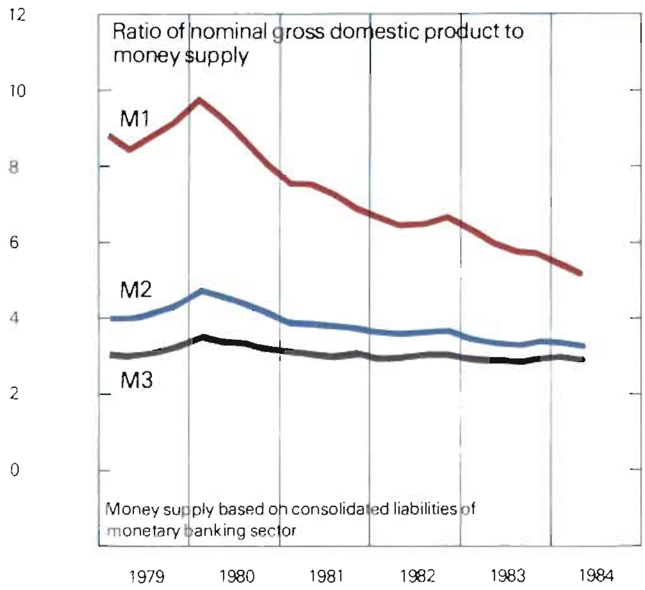
† Defined as M1, plus short-term deposits other than demand deposits and medium-term deposits (including savings deposits) of the non-bank private sector with monetary banking institutions.

normally closely reflects changes in the financing of the Government's budget deficit, in credit to the private sector and in the country's balance of payments.

Financial practices in South Africa have evolved in such a way that there are only marginal liquidity differences between short, medium and long-term deposits, which appear to have limited effects on spending decisions. Empirical evidence also suggests that, of the different indicators, M3 is under present circumstances probably the most reliable and stable aggregate to be used for assessing monetary change.

As the financial system has evolved in South Africa, savings and time deposits with building societies (including building society "shares") and savings accounts with the Post Office Savings Bank (including Savings Bank and national savings certificates) are similar in character to savings and time deposits with banking institutions. Apart from savings and time deposits, transmission accounts are maintained with building societies and the Post Office Savings Bank specifically for transaction purposes. Conceptually, these accounts should form part of the definition of M1. The feasibility of including the transmission, savings and time deposits with non-monetary banking institutions, building societies and the Post Office Savings Bank in the monetary aggregates is currently receiving the attention of the Reserve Bank. For the time being, however, the existing definitions of M1, M2 and M3 will continue to be used in official Reserve Bank statistics.

Income velocity of money



Changes in money supply and velocity of circulation

Depicting broad movements during recent years, the rate of growth (as measured over a twelve-month period) in M3 slowed down from a peak of 34 per cent in April 1981 to 9 per cent in May 1982, before accelerating again to 22 per cent in June 1983. In terms of seasonally adjusted data, the main counterpart of this acceleration initially was an increase in net foreign reserves during the second half of 1982 and January 1983 that was accompanied by a continued expansion of bank credit to the private sector. When the net foreign reserves declined subsequently, an expansionary influence on the money supply was exerted by an increase in net bank credit to the government sector, in addition to a somewhat more rapid expansion of bank credit to the private sector.

After June 1983 the rate of growth in M3 slowed down considerably to 16 per cent in January 1984 and then more moderately to 14 per cent in June. Seasonally adjusted data show that during the second half of 1983 declines in both net foreign reserves and net bank credit to the government sector served to diminish the expansionary influence of bank credit to the private sector on the money supply. During the first half of 1984 net foreign reserves increased, while at the same time bank credit to the private sector showed a substantial rise. However, part of the influence of these factors was neutralised by a decline in net bank credit to the government sector and, in combination, these changes had as their counterpart a slight deceleration of the growth in the money supply.

Throughout the entire period referred to above, the income velocity of M3 slowed down. After it had risen to a peak in the first quarter of 1980, the velocity of M3 declined, with minor fluctuations, by 20 per cent to the second quarter of 1984.

In contrast with the changes in the rate of growth in M3, the increase (measured also over a twelve-month period) in M1, while showing major fluctuations, slowed down to 16 per cent in December 1982, but accelerated afterwards to 29 per cent in June 1984. This acceleration clearly exaggerated the extent of monetary expansion during this period. The velocity of circulation of M1, in fact, declined by 23 per cent from the fourth quarter of 1982 to the second quarter of 1984.

The growth of M1 was greatly distorted by an appreciable shift from long and medium-term deposits to demand deposits. This shift was in response to actual and expected changes in interest rates as well as in the structure of interest rates, including the introduction of interest on cheque deposits from March 1983. In addition, the lowering of liquid asset requirements for banking institutions reduced the inducement for these institutions to compete for long-term deposits. The accompanying table shows the effect of these shifts on the composition of the non-bank private sector's deposit holdings with monetary banking institutions.

Composition of private sector deposits with monetary banking institutions

%

	1982 4th qtr.	1983 4th qtr.	1984 2nd qtr.
Demand deposits	41,5	50,4	53,0
Other short-term deposits	5,4	6,4	6,4
Savings and medium-term deposits	34,9	29,4	26,5
Long-term deposits	18,2	13,8	14,1
Total	100,0	100,0	100,0

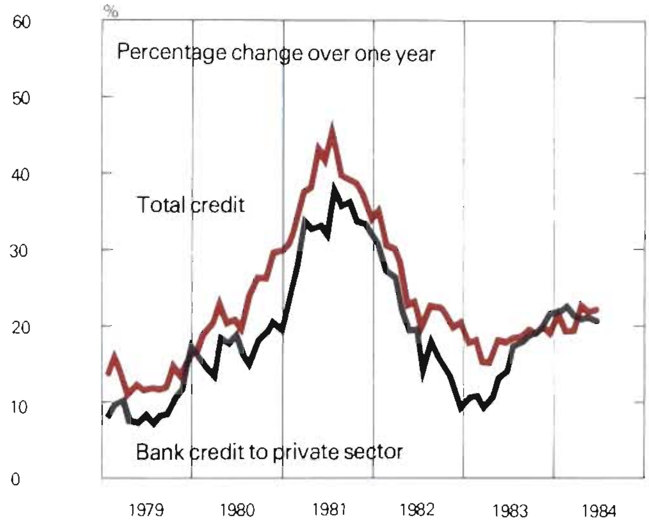
Changes in the growth rate of M3 were reflected in related interest rate movements. The higher growth rate of M3 from about the middle of 1982 to early 1983 was accompanied by a sharp decline in interest rates. Rates started to edge upwards during the three months to May 1983, but showed a more distinct increase from June onwards, when the rate of growth in M3 slowed down. The slight further deceleration in the growth rate of the money supply from early 1984 was reflected in a largely sideways movement of interest rates until the end of June.

Credit intermediated by the banking system

The expansion of bank credit to the private sector was the main counterpart of the growth in the money supply during recent years. The rate of increase in this component of total bank credit, nevertheless, clearly reflected cyclical change in the economy. Coinciding with the economic downswing, the rate of increase over a twelve-month period in the monetary banking sector's credit to the private sector slowed down from a peak of 46 per cent in July 1981 to 15 per cent in April 1983. During the ensuing period of economic upswing, this rate of increase accelerated again to 22 per cent in June 1984.

Initially during the upswing, namely in the second quarter of 1983, the higher rate of increase in credit extended to the private sector was largely due to a shift from foreign to domestic financing of foreign trade as well as increased transactions in financial assets. From the middle of the year, however, it also began to reflect the higher rate of growth in nominal gross domestic expenditure, especially private consumption expenditure. For example, measured over a twelve-month period, the increase in hire-purchase credit and leasing finance extended by the banking sector accelerated from 20 per cent in June 1983 to 37 per cent in June 1984. The persistent high rate of increase in bank credit to the private sector, more particularly in consumer credit, was a major reason for the tightening of monetary policy as part of the recent more restrictive general policy stance. The measures announced were aimed at raising the cost of credit in order to discourage its excessive use.

Bank credit



The influence of the cyclically higher rate of increase in bank credit to the private sector from the second quarter of 1983 onwards was strengthened on occasion by an absolute increase in net bank credit to the government sector. Such an increase occurred during the second quarter of 1983. During most of the fifteen months to June 1984, however, net bank credit to the government sector actually declined. This served to lower the rate of growth in total bank credit. Measured over a twelve-month period, the rate of increase in total credit intermediated by the banking system reached a low of 9 per cent in March 1983, but accelerated to 21 per cent in June 1984.

Financial markets and interest rates

Reserve Bank operations

Money market conditions during the period from January 1983 to the middle of August 1984 were, as usual, influenced by a combination of exogenous factors and Reserve Bank and Treasury operations in the financial markets. Apart from the Reserve Bank's participation in government debt management, its operations consisted, firstly, of other open-market operations aimed at controlling the money supply and moderating seasonal and other short-term fluctuations in money market conditions, and, secondly, of the accommodation of cash shortages in the market at interest rates that would contribute to firmer monetary control. Changes in market conditions were naturally reflected in the movements of short-term interest rates.

The Bank's participation in government debt administration consisted of open-market sales of new government stock obtained on tap from the Treasury and by subscriptions to public issues. These sales supplemented the Treasury's issues of new stock as a means of financing the Government's deficit before borrowing. During the eighteen months to June 1984 government stock to the amount of about R2 700 million was issued on tap to the Bank. The Bank's net sales of government stock in the market during this period amounted to R2 600 million.

The purpose of the Bank's marketing of government stock was to help finance the Government's deficit before borrowing without resort to bank credit and to contribute in this way to monetary control. At times the government sector resorted to bank credit to help finance its deficit, but on other occasions there was an "overfunding" of the deficit. Sales of government stock to the non-bank private sector affected the money supply and bank reserves directly. By reducing the ability of the banks to create additional credit, the latter exerted also an indirect contractionary influence on the money supply. Not infrequently, the Reserve Bank's funding operations contributed to temporary shortages in the money market. In order to alleviate such shortages as well as to smooth out seasonal and other short-term fluctuations in money market conditions and interest rates, the Bank, as part of its open-market operations, entered into repurchase transactions with banks and discount houses and also bought liquid bankers' acceptances outright from discount houses.

Outstanding repurchase agreements reached a peak of R1 251 million towards the end of October 1983 and amounted subsequently to R750 million at the end of 1983. At the end of February 1984, when there was a substantial flow of tax funds to the Government, the amount outstanding stood at R950 million. In accordance with the subsequent easing of the market as a result of increased government spending, all agreements were allowed to expire by the second week of May. New agreements were concluded for short periods over the May, June and July month-ends. Agreements outstanding at the end of July amounted to R600 million, but expired in early August.

The first outright purchases of liquid bankers' acceptances by the Reserve Bank were made in July 1983. On 28 October the Bank's holdings of such securities reached a peak of R147 million. However, by the end of April 1984 all of these acceptances had reached maturity.

In addition to transactions in government stock, repurchase agreements and outright purchases of acceptances, the Reserve Bank's open-market operations included sales of special tax Treasury bills, the maturities of which were scheduled to coincide with the tax payment peaks at the February, August and November month-ends. For example, sales of bills, which are due to mature at the end of August 1984 and February 1985, totalled R500 million and R350 million, respectively, during the second quarter of this year. During July and the first half of August bills of R200 million, maturing at the end of November 1984, were sold. To supplement the Bank's open-market operations, the amount of Treasury bills offered at the weekly tender was varied on several occasions in accordance with changes in market conditions. From 18 June 1984 the Reserve Bank issued Land Bank bills by way of weekly public tenders. As in the case of Treasury bills, the amounts offered for tender were adjusted to prevailing market conditions.

Accommodation of shortages in the market by the Reserve Bank took several forms. The most important of these was the refinancing through the discount window for the discount houses and, on occasion, also for banking institutions. This refinancing consisted of the rediscounting of Treasury bills, Land Bank bills and liquid bankers' acceptances at the Bank's rediscount rates and of overnight loans, covered by specified securities, at rates determined for this purpose by the Bank. During 1983 the amount of refinancing as at month-ends averaged R817 million, but it increased to R1 796 million during the first seven months of 1984.

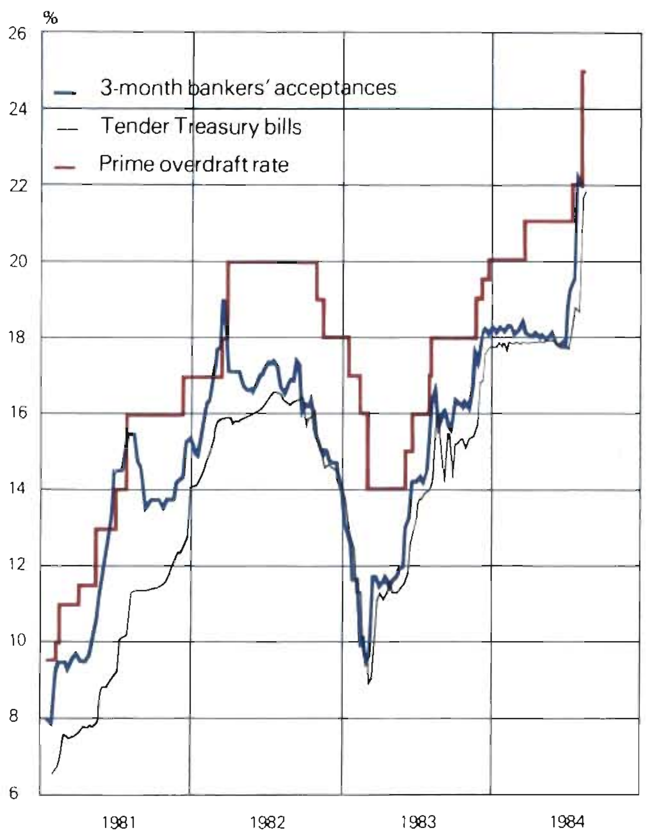
As from 12 December 1983 the Bank started to set at its discretion fixed rates for the refinancing of different classes of securities for discount houses. Before that date, the refinancing rates were determined by adding fixed margins to the prevailing market rates for different classes of securities. This change was intended to strengthen the Bank's influence on interest rates and, therefore, its monetary control. The Bank continued to quote higher refinancing rates for banking institutions. As operational variables in the process of improving monetary control, the Bank's refinancing rates for discount houses were used actively as a policy instrument during July and in early August 1984. These rates were increased in three steps by 1 per cent during July and by a further 3 per cent with effect from 3 August.

Another form of accommodation consisted of the placing of funds of the former National Finance Corporation and of the newly established Corporation for Public Deposits at call with the discount houses. At the end of March 1984 the amount reached R359 million and at the end of July it stood at R300 million.

A related step was the progressive lowering of the liquid asset requirements for banking institutions. These requirements were lowered in July, September and December 1983 and again in March 1984. The results of these adjustments were that the differentiation between "large" and "small" banks disappeared, the requirement in respect of short-term liabilities declined from 54 and 50 per cent to a uniform 25 per cent, and the requirement in respect of medium-term liabilities declined from 34 and 30 per cent to a uniform 18 per cent. In addition, the supplementary cash reserve (equal to 2 per cent of medium-term liabilities) that had to be held with the former National Finance Corporation, was abolished.

An approximate amount of R3 500 million in liquid assets and an amount of about R200 million in cash were released to banking institutions by these changes. Although the release of liquid assets did not supply cash to the banking institutions, these assets could be used to meet pressure on cash resources and this served to moderate upward pressure on interest rates. Apart from its short-term objective, the lowering of the liquid asset requirements was consistent with the planned longer-term transition from a liquid asset to a cash reserve system of credit control, as recommended by the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa.

Short-term interest rates



Short-term interest rate movements

After short-term interest rates had declined sharply from September 1982 to February 1983, they increased appreciably during March. Subsequently, they moved sideways during April and May, but continued on an upward course during the remainder of 1983. After the introduction of fixed refinancing rates for discount houses by the Reserve Bank in December 1983, money market rates moved in a narrow band around these rates during the first half of 1984. In July, the unusual strength of the US dollar and concomitant sharp decline in the gold price caused a moderate decline in the net foreign reserves of the Reserve Bank and a tightening of money market conditions. In addition, the Bank's refinancing rates were raised, as indicated earlier, as part of the announced tightening of monetary policy. These developments caused short-term interest rates to move sharply upwards from July.

The rate on three-month bankers' acceptances, for example, increased from a low of 9,30 per cent on 4 March 1983 to 18,10 per cent at the end of 1983. On 29 June 1984 the rate stood at 17,80 per cent, but rose to 22,00 per cent on 10 August. Likewise, the Treasury bill tender rate increased from a low of 8,86 per cent on 4 March 1983 to 17,62 per cent on 30 December and to 17,64 per cent on 29 June 1984. Subsequently, it rose to 21,72 per cent on 10 August. The prime overdraft rate of the clearing banks was raised in steps from 14 per cent in March 1983 to 20 per cent at the end of the year. It was increased further to 21 per cent in March 1984, to 22 per cent in July and to 25 per cent in early August.

Capital market developments

The economic upswing was evident not only in real economic activity, but also in financial activity*. Typically, however, the upturn in financial activity commenced somewhat earlier. Coinciding with an increased general availability of funds, transactions in financial assets already started to rise from the third quarter of 1982, at a time when real economic activity was still on a downward trend. The increased availability of funds was related to a temporary rise in the gross domestic savings ratio and an acceleration in the rate of growth in the money supply under the impact of a rise in the gold price, a decline in imports and a resulting increase in the net foreign reserves.

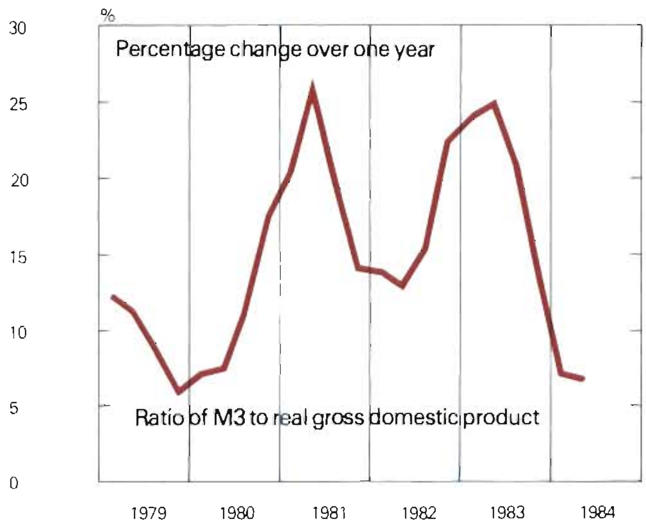
As an indicator of changes in general liquidity, the rate of increase over a twelve-month period in the broad money supply (M3*) per unit of real output accelerated from a low of 13 per cent in the second quarter of 1982 to 22 per cent in the fourth quarter and to a peak of 25 per cent in the second quarter of 1983. The more moderate rise in the money supply and the increase in real economic activity from the third quarter of 1983 had the effect of slowing down this rate of increase to 14 per cent in the fourth quarter and to 7 per cent in the second quarter of 1984. These changes were accompanied by a sharp decline in interest rates during the second half of 1982 and in early 1983, followed by an upward movement during the ensuing period.

Illustrating the increased financial activity from the middle of 1982, the value of public-sector stock traded on the stock exchange rose markedly from R6,8 billion in the twelve months to June 1982 to R25,1 billion in the subsequent twelve-month period. However, in line with the lower general availability of funds from the third quarter of 1983, the turnover in public-sector stock decreased moderately to R20,9 billion in the twelve months to June 1984. Likewise, the value of shares traded on the stock exchange increased from R2,0 billion in the twelve months to the middle of 1982 to R4,5 billion in the twelve months to June 1983, before declining to R3,5 billion in the subsequent twelve-month period. In the fixed property market, the value of real estate transactions in these successive twelve-month periods amounted to R6,5 billion, R8,5 billion and R11,8 billion, respectively. Conditions in this market, therefore, remained buoyant, even after the general availability of funds had begun to diminish.

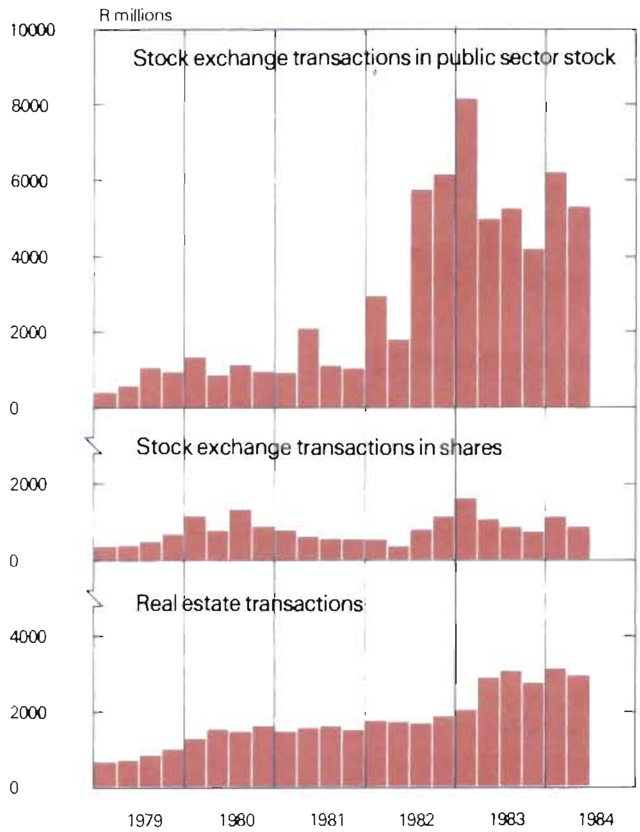
Borrowers in both the public and the private sector availed themselves of the opportunity to raise new funds in the more liquid financial markets from the middle of 1982. In the fixed-interest security market, new funds raised by the public sector through issues of marketable securities to the banking as well as the non-bank private sector amounted to R4,9 billion in the twelve months to

* See definition of M3 in the money and bank credit section of this review.

Money per unit of real output



Security and real estate transactions

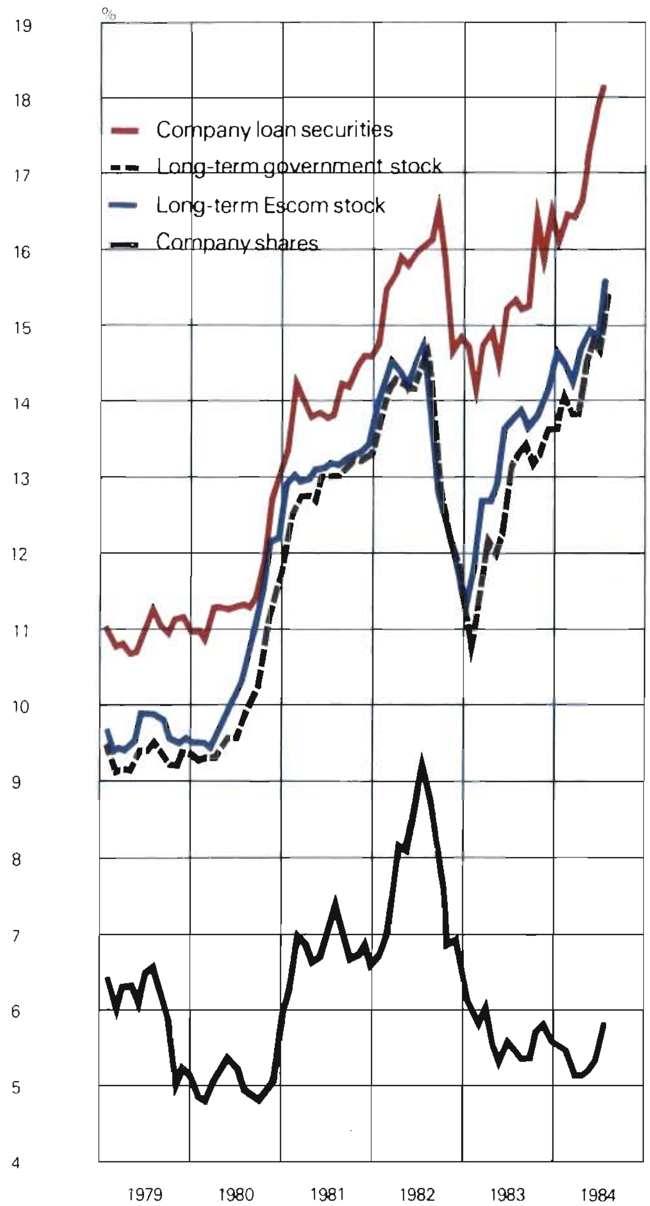


June 1983 and to R3,5 billion in the subsequent twelve-month period to June 1984. The public sector stock holdings of the major non-bank institutional investors, namely insurers, pension funds and building societies, increased by almost the full amount of new issues during 1983 and the first half of 1984. This indicates that new funds were raised by the public sector mainly in the non-bank private sector. New issues of fixed-interest securities by companies listed on the stock exchange during the two twelve-month periods to June 1983 and June 1984 amounted to R195 million and R639 million, respectively.

In the share market, new share capital raised by companies listed on the stock exchange amounted to respectively R104 million and R1 552 million in the two successive twelve-month periods to June 1983 and June 1984. The considerably larger amount in the latter period reflected more favourable conditions (at higher share prices) for raising new share capital on the stock exchange, which provided an inducement to shift from expensive short-term bank financing to permanent share capital. Despite the increase in new share capital raised, bank credit (including leasing finance) to companies increased by R1 724 million during the twelve months to June 1984, compared with R1 030 million during the preceding twelve months. Bank credit, therefore, remained an important source of corporate finance.

In the mortgage market, the increased general availability of funds from the third quarter of 1982 was reflected in a higher rate of increase in mortgage lending. New mortgage loans granted by building societies and participation mortgage bond schemes rose from R2 135 million in the twelve-month period to June 1982 to R4 666 million in the subsequent twelve months. In the ensuing twelve-month period to June 1984, however, the corresponding figure was somewhat lower at R4 484 million, owing to a smaller net inflow of funds to the building societies that reflected the decline in general liquidity from the third quarter of 1983.

Capital market yields



Long-term interest rates

The course of long-term interest rates corresponded, with only minor deviations, to the changes in the rate of growth in the broad money supply (M3) discussed earlier. One deviation was in early 1983, when long-term interest rates started to increase after the sharp drop in the gold price in the second half of February, even though the increase in M3 continued to accelerate until June. The fairly rapid slow-down of the increase in M3 from July 1983 to early 1984 was accompanied by a further upward movement of long-term interest rates. The slight further deceleration in the rate of monetary expansion from February 1984 was reflected in a more or less sideways movement of long-term yields to the middle of the year. In July, however, long-term rates reacted strongly to the marked decline in the gold price and in the exchange rate of the rand by moving sharply upwards.

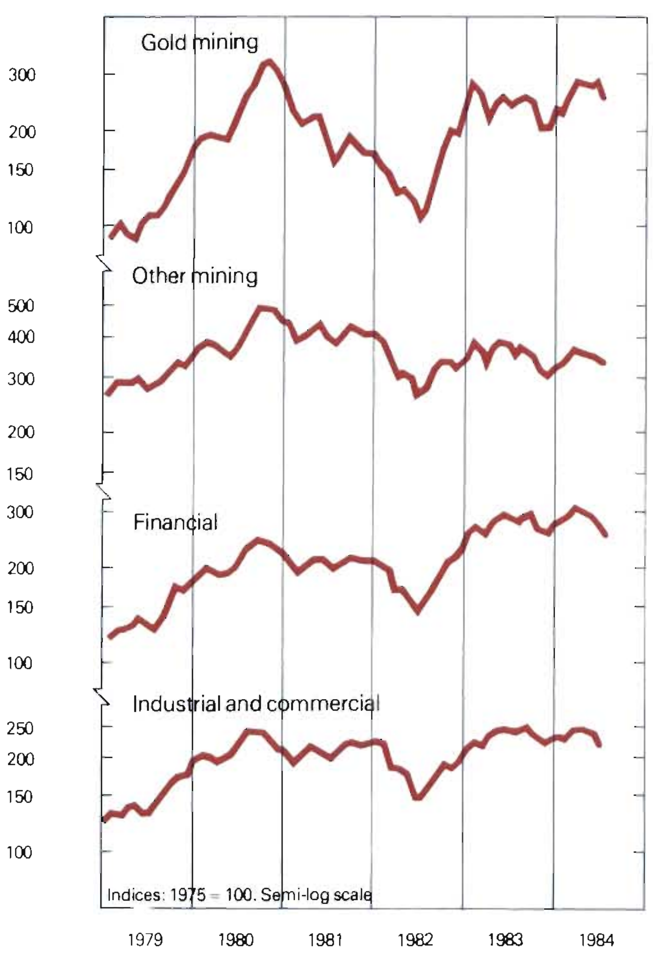
The monthly average yield on long-term government stock rose from a low of 10,6 per cent in January 1983 to 14,7 per cent in June 1984 and increased further to 15,4 per cent in July. The corresponding yield on Escom stock increased from 11,2 per cent in January 1983 to 14,8 per cent in June 1984 and to 15,6 per cent in July. In contrast to these yield movements, the average dividend yield on all classes of shares continued to fluctuate downward during 1983 and the first quarter of 1984, but showed a slight increase from April onwards. This yield reached a peak of 9,4 per cent in June 1982 and declined afterwards to 5,1 per cent in March 1984, Subsequently, it moved up significantly to 5,8 per cent in July.

The continued decline in the dividend yield during a period in which other long-term yields increased sharply, reflected the strong rise in share prices. Share prices reached a cyclical low in June 1982, but followed an upward course until March 1984. Two clear interruptions in this upward movement occurred in February and October 1983, when the US dollar price of gold showed sharp declines. Subsequent decreases in April and July 1984 were once again related to declines in the dollar price of gold, but may well prove to be part of a more fundamental downward adjustment in line with the anticipated contraction of economic activity during the second half of 1984. From June 1982 to March 1984 share prices increased on average by 103 per cent, but they declined subsequently by 13 per cent to July. During 1983 and so far during 1984 changes in share prices reflected a general scarcity of script in the face of strong institutional buying and renewed net purchases by foreigners from late in 1983.

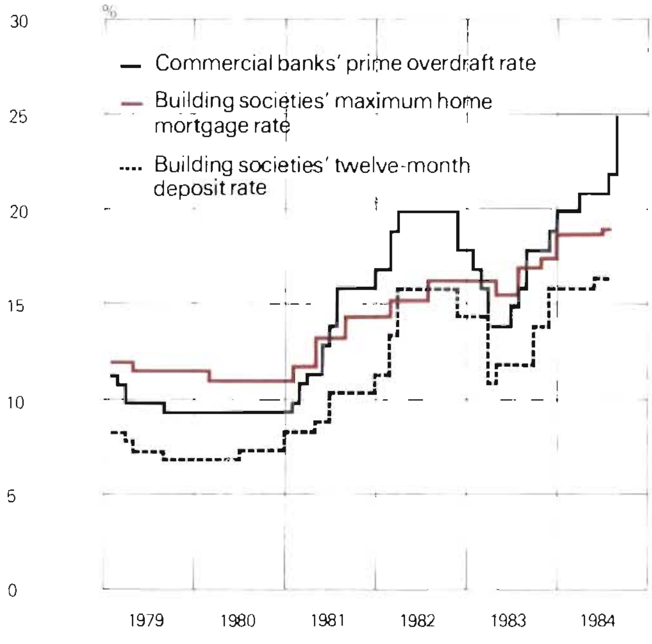
In line with the stronger upward movement of long-term interest rates from the middle of 1983, the building societies' maximum home mortgage rate was increased from 15,0 per cent to 16,5 per cent in July 1983 and to 17,0 per cent in August. Subsequently, it was raised in two steps to 18,75 per cent in December and by 0,25 per cent to 19,00 per cent in June 1984. Participation mortgage bond schemes raised their mortgage rates in several steps from 15,0 per cent in July 1983 to 20,3 per cent in July 1984.

An indication of the movement of longer-term deposit rates is provided by changes in the twelve-month deposit rate of banks and building societies. The predominant rate on twelve-month deposits, which had declined to 11,0 per cent in March 1983, was raised in several steps to 16,5 per cent in July 1984.

Share prices



Interest rates



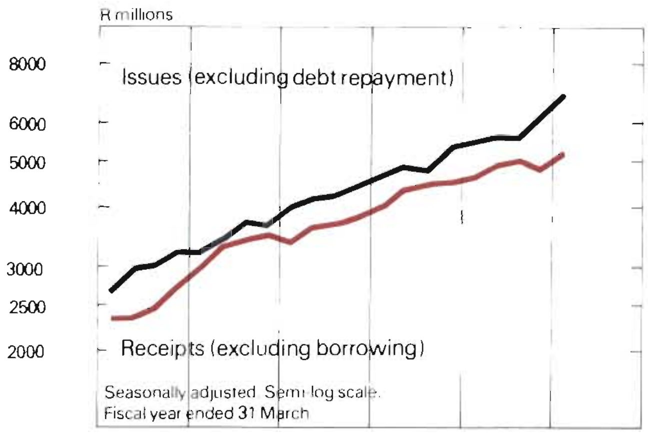
Government finance

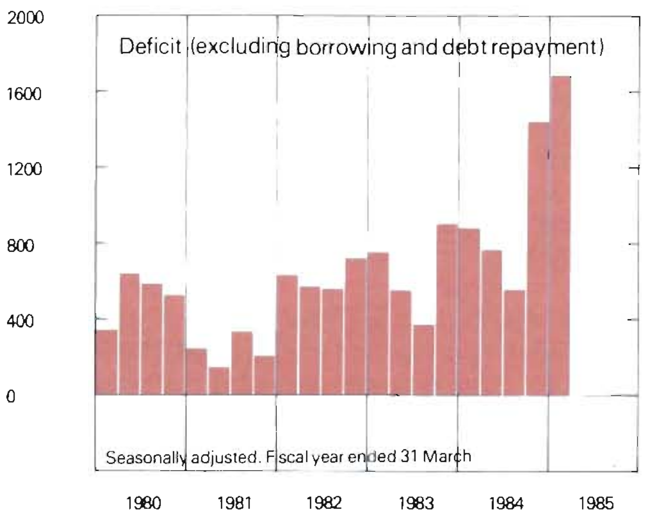
Expenditure and revenue

Nominal central government expenditure, as measured by issues from the Exchequer Account* to government departments, increased by 15 per cent in the 1983/84 fiscal year, a rate of increase that was considerably higher than had been anticipated in the original Budget. Additional expenditure amounted to a record 9 per cent of the original expenditure estimates. Among other things, the additional expenditure was in respect of improved conditions of service for government employees, drought relief, defence, increased subsidies and higher interest payments on government debt. Subsequently, in the first quarter of the 1984/85 fiscal year, i.e. the second quarter of 1984, issues to government departments showed an increase of 24 per cent in relation to those in the corresponding quarter of the preceding fiscal year.

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

Exchequer Account





Central government revenue rose by 11 per cent in 1983/84, a moderately higher rate than had been provided for in the original Budget. This rate of increase was not only low in comparison with the rate of growth in expenditure, but also notably lower than in immediately preceding fiscal years. This slower revenue growth was due to an actual decline in income tax receipts from companies other than gold mines as well as in customs and excise duty receipts. The latter reflected the abolition of the surcharge on imports and a 28 per cent rise in transfers of customs, excise and other duties to neighbouring countries. The growing divergence between revenue and expenditure was the major reason for an increase in the general sales tax from 6 to 7 per cent, with effect from 1 February 1984.

This growing divergence continued in the first quarter of the 1984/85 fiscal year, when revenue grew at a considerably lower rate than expenditure, namely by 12 per cent (compared with the first quarter of the preceding fiscal year). With a view to narrowing the difference between revenue and expenditure and to limiting the deficit before borrowing, the general sales tax was raised further to 10 per cent, with effect from 1 July. From that date, however, basic foodstuffs were completely exempted from the tax.

As shown in the accompanying table, the composition of central government revenue in some respects changed considerably during recent years. What is striking, is the

Composition of Central Government revenue
%

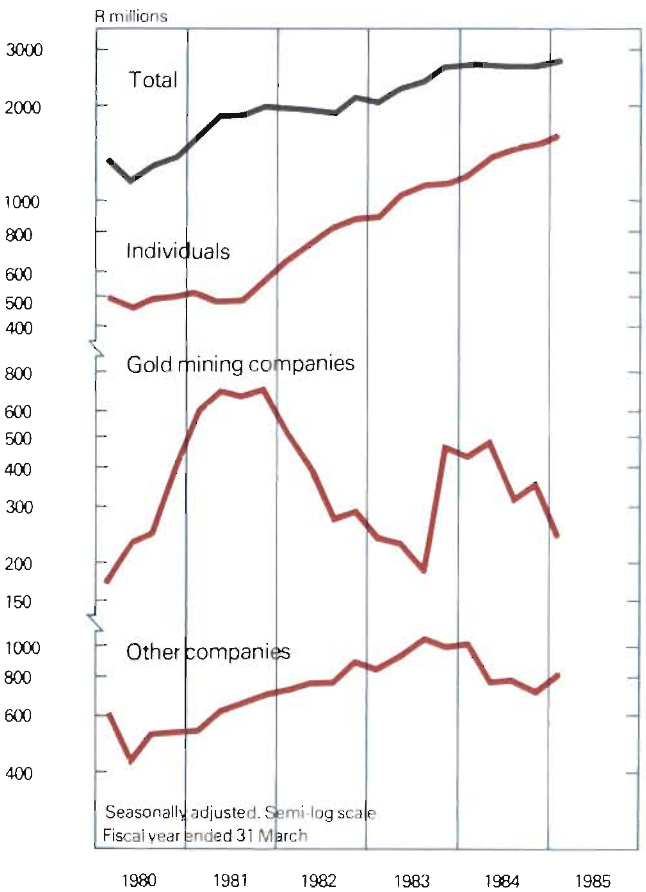
	Fiscal years ended 31 March				
	1980	1981	1982	1983	1984
Receipts from gold mines*	15	27	15	10	12
Income tax receipts from:					
Other mining companies..	3	2	1	1	1
Non-mining companies ..	19	18	22	21	17
Individuals	20	16	22	25	30
Customs and excise duties..	13	11	14	13	10
General sales tax	13	12	15	19	20
Other revenue	17	14	11	11	10
Total	100	100	100	100	100

* Income tax and lease payments by gold mining companies.

volatility of revenue receipts from gold mining companies. This was attributable to the large swings in the gold price and their effect on gold mining profits. Another remarkable change was the relative increase in personal income tax receipts, which showed an average annual rate of increase of 32 per cent between 1979/80 and 1983/84. In the latter fiscal year, personal income tax for the first time equalled total company income tax (including mining lease payments by gold mining companies). High rates of increase in nominal salaries and wages contributed to the rapid growth in personal income tax, but of equal importance was the effect of "fiscal drag". A considerable shift in relative importance occurred also in the case of general sales tax receipts, owing to tax scale increases as well as the sharp rise in nominal private consumption expenditure.

Apart from shifts in the composition of government revenue, a noteworthy feature of the composition itself is the relatively small contribution to total revenue of income tax receipts from companies other than gold mines. In 1983/84 non-gold mining companies contributed a mere 1 per cent to total revenue and all non-mining companies only 17 per cent. This matter received special attention in the 1984/85 Budget Speech of the Minister of Finance, who announced the Government's intention to raise the effective rate of company taxation by phasing out some of the tax incentives and concessions to companies.

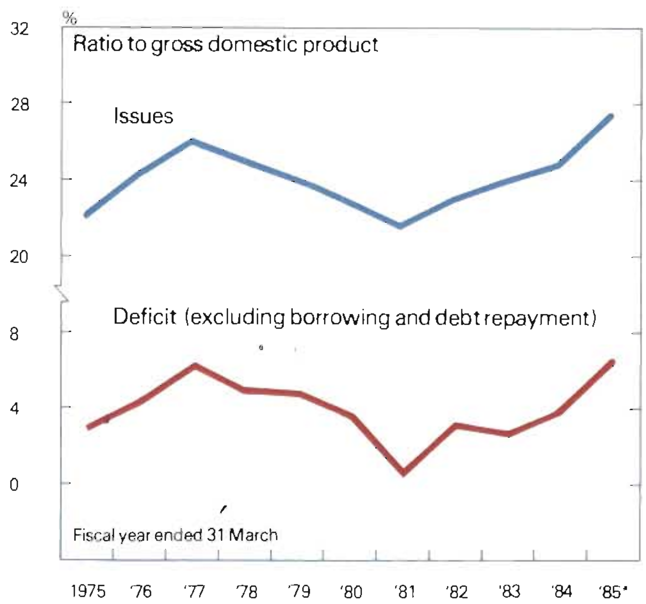
Income tax collections



Financing operations

The divergence of revenue and expenditure growth rates in 1983/84 resulted in a substantial deficit before borrowing of R3 685 million. A deficit of this order, 4,1 per cent of gross domestic product, required large-scale borrowing outside the banking sector in order to avoid undesirable monetisation. In fact, in the first quarter of the fiscal year, net bank credit of R500 million was extended to the Central Government. During the remainder of the year, however, the Government reduced its net indebtedness to the banking sector by R1 207 million. The "overfunding" of the deficit by R707 million in the fiscal year as a whole was achieved by extensive borrowing from non-banking sources. An amount of R1 673 million was borrowed from the non-bank private sector, either directly or through Reserve Bank sales of government stock obtained on tap from the Treasury. In addition, the Government sold shares in Sasol, mostly to the non-bank private sector, for an amount of approximately R900 million. The proceeds of this sale were deposited with the Public Debt Commissioners. The Public Investment Commissioners (Public Debt Commissioners prior

Relative changes in Exchequer issues and deficit



*First quarter of fiscal year. Seasonally adjusted to 31 March 1984) contributed R2 536 million to the financing of the deficit by means of net investments in government securities, including the investment of the proceeds of the Government's sale of shares in Sasol. Net foreign borrowing amounted to R183 million in 1983/84.

Owing to an exceptionally sharp rise in government expenditure, reflecting partly the usual seasonal pattern, the deficit before borrowing soared to R2 659 million in the first quarter of 1984/85. Successful borrowing from non-banking sources, including Reserve Bank sales of government stock, could not prevent an increase of R232 million in net bank credit to the Central Government.

Policy implications of government transactions

As discussed earlier, increased general government expenditure made an important contribution to the largely domestic-demand-led economic upswing from the second quarter of 1983. It was pointed out that such a recovery is not sustainable in the absence of appropriate export growth (including gold). Relative fiscal contraction is, therefore, a necessary condition for slowing down aggregate domestic demand as part of the required short-term adjustment in the economy and for achieving circumstances conducive to sustainable longer-term economic growth. The latter will include balance of payments equilibrium and a relatively strong rand, a lower and declining rate of inflation, greater international competitiveness, a contraction of the growth in government expenditure in order to provide additional scope for more productive private-sector expenditure, and a deficit before borrowing that is sufficiently small to ensure that its financing will not exert undue upward pressure on interest rates or "crowd out" other borrowers in the rest of the public sector and in the private sector.

Analysing the degree of fiscal expansion, the ratio of nominal central government expenditure (as measured by Exchequer issues to government departments) to gross domestic product increased from a low of 21,7 per cent in the 1980/81 fiscal year to 24,1 per cent in 1982/83 and 24,8 per cent in 1983/84. Subsequently, this ratio (based on seasonally adjusted data) rose further to 27,5 per cent in the first quarter of 1984/85.

This relative fiscal expansion was somewhat enhanced by a small decline in the ratio of central government revenue (interpreted in the sense of a transfer of resources from the private sector to the Government) to gross domestic product from 21,2 per cent in 1980/81 to 21,1 per cent and 21,0 per cent in 1982/83 and 1983/84, respectively. In the first quarter of 1984/85 this ratio (based on seasonally adjusted data) decreased further to 20,6 per cent. The net result was that the Central Government's deficit before borrowing, as a ratio of gross domestic product, grew from 0,9 per cent in 1980/81 to 2,9 per cent in 1982/83, to 4,1 per cent in 1983/84 and to 6,9 per cent in the first quarter of 1984/85.

These results indicate that the recent direction of relative fiscal change, in terms of expenditure as well as the deficit before borrowing, was towards greater expansion.

Policy stance adopted in the 1984/85 Central Government Budget

The need for short-term economic adjustment and relative fiscal contraction was part of the main theme of the 1984/85 Budget presented to Parliament on 28 March 1984. In assessing the implications of the existing economic situation for fiscal and monetary policy in the fiscal year ahead, the Minister of Finance stated that South Africa had to face up to certain harsh realities which required that a temporary pause in the process of economic expansion be accepted. The dollar price of gold had declined further since the third quarter of 1983 and remained relatively low, the country was still faced with a serious drought, and non-gold exports remained sluggish. As had been the case in the preceding year, the Minister opted for a middle course policy which would avoid extremes. In terms of this option, the exchange rate would be permitted to decline moderately, while at the same time a conservative "mix" of fiscal and monetary policy, including high interest rates, would be applied with a view to curbing aggregate demand and total expenditure. The immediate objectives of such a policy would be to maintain a sound balance of payments and to reduce the rate of inflation as a prerequisite for achieving optimal and stable economic growth in the longer term.

To achieve this objective, it was deemed important to improve the "mix" of fiscal and monetary policy. In 1983/84 the deficit before borrowing had risen above the desirable level and although it had been financed without new money creation, there were limits to a financing policy of this kind. It might mean that the Government was financing current expenditure by borrowing, which ought to be avoided, or that increased government stock issues on the capital market were raising interest rates and "crowding out" other deserving borrowers in both the public and private sectors. To avoid an unduly large Budget deficit, it was deemed necessary to follow a dual course of action, namely to curb the increase in government spending and to make tax adjustments.

To give effect to the latter decision, certain customs and excise duties were increased, the tax rate on companies other than gold and diamond mines was raised from the existing 46,2 per cent (including a surcharge of 10 per cent) to 50 per cent, and the surcharge on gold and diamond mines was increased from 15 to 20 per cent. In order to raise the effective rate of company taxation, certain incentive and investment allowances were reduced. The Minister also confirmed the Government's intention to introduce a fringe benefit tax. Subsequently, on 11 May, the Minister announced that, with effect from 1 July, the general sales tax on certain basic foodstuffs would be abolished and that the rate on all other articles would be increased from 7 to 10 per cent.

As part of the additional policy measures announced on 2 August, the Government reaffirmed its intention to curtail public sector spending in order to limit the deficit before borrowing.