South African Reserve Bank

Annual Economic Report

85

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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-fifth ordinary general meeting to be held on 27 August 1985

Contents

Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

The 1984 *Annual Economic Report* focused on the relatively short, but vigorous, economic upswing from the second quarter of 1983 to the middle of 1984. At the time, it was explained that, in the face of adverse extraneous developments, this essentially consumption-based upswing proved to be unsustainable because of growing imbalances in the economy, such as a deteriorating balance of payments on current account, a weakening of the rand and accelerating inflation. The *Report* also listed the additional remedial policy measures introduced early in the second half of 1984 to bring about a much needed adjustment in the economy. This year's *Report* reviews the progress that has been made towards achieving this adjustment, firstly in terms of correcting short-term imbalances, and secondly in terms of effecting structural changes aimed at promoting sustainable growth and employment creation in the longer term.

Adjustment in the economy commenced almost instantaneously and was triggered by an abrupt substantial decline in real gross domestic expenditure, and in particular in the private and government consumption components, in the third quarter of 1984. This decline in consumption partly represented a natural downward correction of spending from its exorbitant level in the preceding quarter and partly a response to the more restrictive policy stance. Real gross domestic expenditure fell further during the ensuing three quarters and by the middle of 1985 the decline from the second quarter of 1984 had accumulated to 9 per cent.

This real expenditure decline naturally exerted a contractionary influence on real output growth. At the same time, however, an accelerating increase in real exports promoted higher levels of real output in export sectors and in this way served to cushion the effect of the fall in real domestic demand. On balance, these two off-setting forces brought about a decline of 2½ per cent in real gross domestic product between the second quarter of 1984 and the corresponding quarter of 1985. The contradictory forces at work were also reflected in an uneven distribution of the decline in real output among the different sectors of the economy. Those that are mainly dependent on export demand achieved a much better output performance than the others relying more on domestic demand. As might be expected, the contraction of real output was accompanied by a considerable increase in unemployment.

The downward adjustment of real gross domestic expenditure was reflected in an appreciable decline in the volume of imports, which supplemented the strong real export growth and helped to bring about a substantial improvement in the balance of payments on current account. In the fourth quarter of 1984 the current account moved into surplus and by the second quarter of 1985 the surplus had grown to a seasonally adjusted annualised figure of R5,4 billion. It was not before the second quarter of 1985, however, that the *overall* balance of payments recorded a surplus. Previously, during both the fourth quarter of 1984 and the first quarter of 1985 a large net outflow of short-term capital had occurred. As a reflection of the overall balance of payments surplus as well as a somewhat weaker US dollar, the effective exchange rate of the rand achieved a significantly greater degree of stability in the second quarter.

Despite the success achieved in eliminating excess demand, the rate of inflation, as measured by the consumer and production price indices, continued to accelerate during the twelve months up to the middle of 1985. This was largely the delayed result of the earlier demand inflation and the accompanying depreciation of the rand up to January 1985, and was fully in accordance with official prognostications.

In terms of short-term objectives, therefore, the adjustment in the economy had by the middle of 1985 succeeded in bringing about a substantially improved balance of payments, a more stable exchange rate of the rand and prospects of an imminent peak and subsequent decline in the rate of inflation. Moreover, expectations had arisen that the sharp downward adjustment of real domestic demand would soon come to an end and that the anticipated further increase in real exports would then be reflected in positive real economic growth. In fact, the leading business cycle indicator had already predicted some economic recovery in due course.

Subsequently, however, political unrest in certain Black townships in South Africa and the proclamation of a state of emergency in a number of magisterial districts provoked an intensified disinvestment campaign, partial economic sanctions and diplomatic actions against South Africa. This resulted in nervousness in the foreign exchange market, a net outflow of funds through the stock exchange and further repayments of foreign short-term debt. In consequence, the effective exchange rate of the rand declined abruptly by 12½ per cent in the last few days of July and the declining trend in interest rates was temporarily reversed. All in all, however, the financial markets did well to absorb these shocks without any significant disruption; the exchange rate of the rand soon showed some recovery and interest rates resumed their downward movement.

The process of adjustment was underpinned during the first half of 1985 by a significantly lower rate of growth in the money stock and a more moderate rise in government expenditure. Progress in unwinding imbalances in the economy and improved monetary control, supported by the establishment of a better balance between monetary and fiscal policy in the March 1985 Budget, permitted a decline in interest rates. This decline towards the middle of 1985 was officially endorsed by the Reserve Bank, which lowered its refinancing rates in four steps of 1 per cent each from 6 May to 4 July. The clearing banks' prime overdraft rates were similarly reduced on four occasions from 25 per cent to 21 per cent.

Subsequent information confirmed that excess demand in the economy had been eliminated, that the balance of payments on current account had achieved a large and sustainable surplus, that short-term foreign liabilities had been reduced by a considerable amount, and that during the second quarter net foreign reserves had shown a large increase. These circumstances, together with the increased effectiveness of fiscal policy, led to the conclusion that a further moderate easing of monetary policy in the form of a reduction in interest rates would be justified. This conclusion was not fundamentally changed by the prevailing abnormal political conditions in South Africa, despite the resulting downward pressure on the exchange rate of the rand. If the depreciation of the rand had been associated with excessive money creation and over-spending, as was the case during the first half of 1984, the appropriate response of monetary policy would have been to allow interest rates to rise. In the prevailing recessionary conditions, however, the situation called for monetary measures to prevent the political developments from bringing about an undue rise in interest rates. Accordingly, the Reserve Bank, with effect from 20 August, lowered its rediscount and other refinancing rates by 1,75 per cent. This was followed by a reduction in the clearing banks' prime overdraft rate from 21,0 to 19,5 per cent.

The Reserve Bank used this occasion to implement, with the approval of the Government, the recommendations of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa relating to the future role of discount policy and Bank rate. This means, firstly, that the Bank will in future make increased and more clearly defined use of its discount policy as a means of influencing the money supply, interest rates and total spending – as an integral part of overall stabilisation policy. Secondly, the Bank has reintroduced the traditional Bank rate as its formal rate for rediscounting Treasury bills for the discount houses. From 20 August, the Bank set its new formal Bank rate at 16 per cent.

The progress made during the first half of 1985 towards achieving the intermediate monetary policy objective of exercising appropriate control over the rate of increase of the monetary aggregates was most encouraging. The full realisation of this intermediate objective will, of course, be an important step in pursuit of the ultimate policy objectives of a high and sustainable rate of real economic growth and the creation of adequate employment opportunities within an environment of reasonable price stability and a sound balance of payments. With a view to exercising firm monetary control, the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa recommended in its recently released *Final Report* the adoption of target rates of growth for one or more selected money supply aggregates. This did not imply, however, a rigid "money rule"; the Commission specifically recommended that monetary targeting should be applied in South Africa with a fair measure of flexibility and with a "low profile".

With a view to achieving better fiscal control, the March 1985 Budget of the Central Government was designed to meet three basic conditions in the 1985-86 fiscal year. Firstly, there was to be no increase in real terms in government expenditure. Secondly, current expenditure was not again to be financed partly, as during the preceding two fiscal years, with borrowed funds. Thirdly, the deficit before borrowing was to be kept below 3 per cent of gross domestic product to ensure that it would be financed without either significant resort to bank credit or contributing to upward pressure on interest rates. At the same time, the Government committed itself to improved monitoring of actual expenditure in order to keep expenditure overruns to a minimum.

After taking account of normal seasonal patterns, expenditure in the first quarter of the fiscal year was roughly on target. In addition, the deficit before borrowing was financed, as during 1984-85, without using bank credit. Borrowing from non-bank sources even exceeded the borrowing requirement during this period. From the middle of 1984 this deliberate "overfunding" formed an important part of the monetary authorities' operations aimed at improving monetary control.

Although the fiscal policy measures, as set out in the Budget, were aimed at supporting the necessary short-term adjustment in the economy, the Minister of Finance also outlined a fiscal strategy for achieving the long-term policy objectives mentioned earlier. This included fiscal retrenchment through the reversal of the rising trend of public-sector spending in relation to gross domestic product, as well as through privatisation and deregulation; the restriction of the government sector's deficit before borrowing to a percentage of gross domestic product that is sufficiently low to prevent the Government's financing operations from "crowding out" the private sector; and a reform of the tax system in order to enhance productive effort as well as productivity, saving and investment.

In conclusion, much progress has been made towards achieving short-term policy objectives during the period of adjustment since the middle of 1984, but these objectives have not yet been fully realised. Further pursuit of these goals, and especially the objective of reducing the rate of inflation, appears to be essential if South Africa is to get into step with those trading-partner countries which have already achieved considerable success in their economic stabilisation programmes. At the same time, however, policy will increasingly have to address longer-term structural issues, of which the recent inadequate savings performance and the downward trend in real fixed investment (to which reference will be made later in this review) may be singled out as requiring special attention, if the stated long-term policy objectives are to be achieved. An important step in this direction has already been taken by the adoption of the longer-term monetary and fiscal policy frameworks referred to above.

Domestic economic developments

Downswing in economic activity as reflected in domestic demand and output

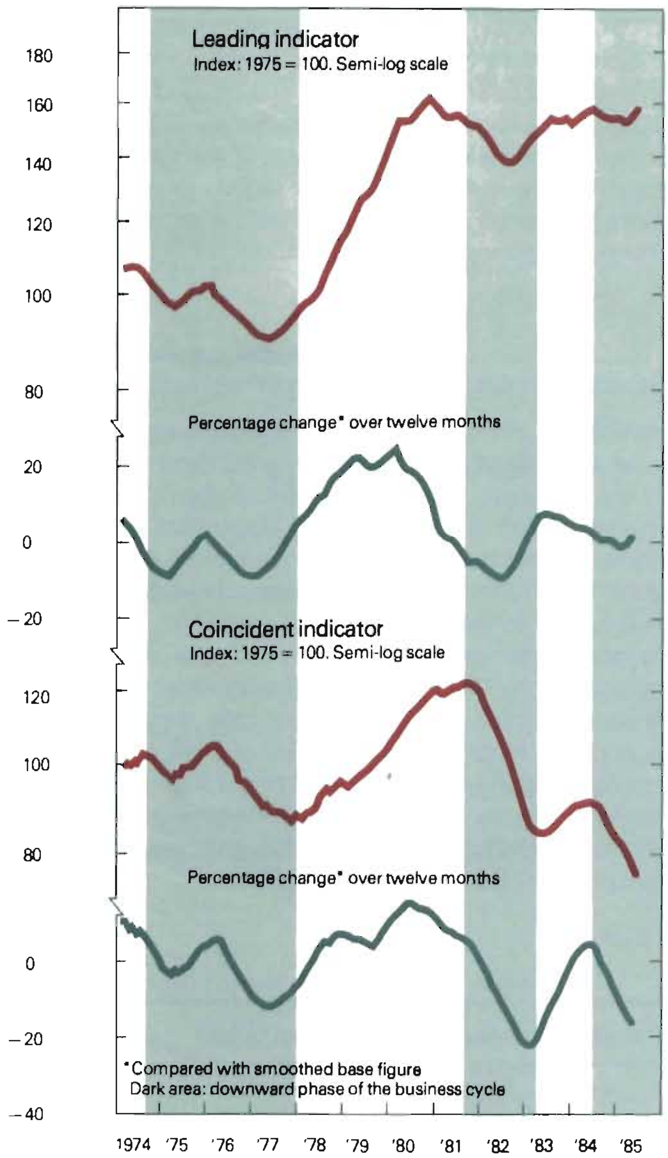
The relatively short, but nonetheless vigorous, economic upswing from about the second quarter of 1983 came to an abrupt end in the middle of 1984. Since then, the economy has been in a downswing characterised by a contraction of real economic activity that has been notably more severe than during immediately preceding downward phases of the business cycle. As shown in the accompanying graph, the leading business cycle indicator, and in particular changes in its growth rate, predicted the downswing well in advance. Subsequently, this indicator reached a lower turning point in February 1985 and appears to signal some economic recovery in due course. The coinciding business cycle indicator, however, suggests that the downswing has not yet reached its lower turning point.

The events leading to the economic downturn were discussed in detail in the 1984 *Annual Economic Report.* What is striking, was the rapid turnaround in economic activity after the middle of 1984. For example, real gross domestic expenditure and its main component, namely private consumption, fell abruptly at seasonally adjusted annual rates of 6½ per cent and 20½ per cent, respectively, in the third quarter. This expenditure decline has continued since then. By the second quarter of 1985 real gross domestic expenditure had fallen 9 per cent below its level in the second quarter of 1984. Declines were evident in all the major expenditure components.

The contraction of real gross domestic expenditure between the second quarter of 1984 and the second quarter of 1985 included a more than proportional decline of 14 per cent in real imports of goods and non-factor services. This illustrates South Africa's high marginal import propensity as well as the relatively price-elastic demand for imported goods. As will be indicated later on, import prices in terms of rand were inflated substantially by the depreciation of the rand.

The contractionary effect of the decline in real aggregate domestic demand on output was partly offset by a considerable increase of 13½ per cent in real exports of goods and non-factor services between the second quarter of 1984 and the second quarter of 1985. In volume terms, export growth had already begun in the fourth quarter of 1983, but the main upward thrust came in the first half of 1985. Exports benefited materially from the broadening of economic expansion and, in particular, investment activity in the industrial countries as well as from the substantially improved international competitiveness gained through the depreciation of the rand.

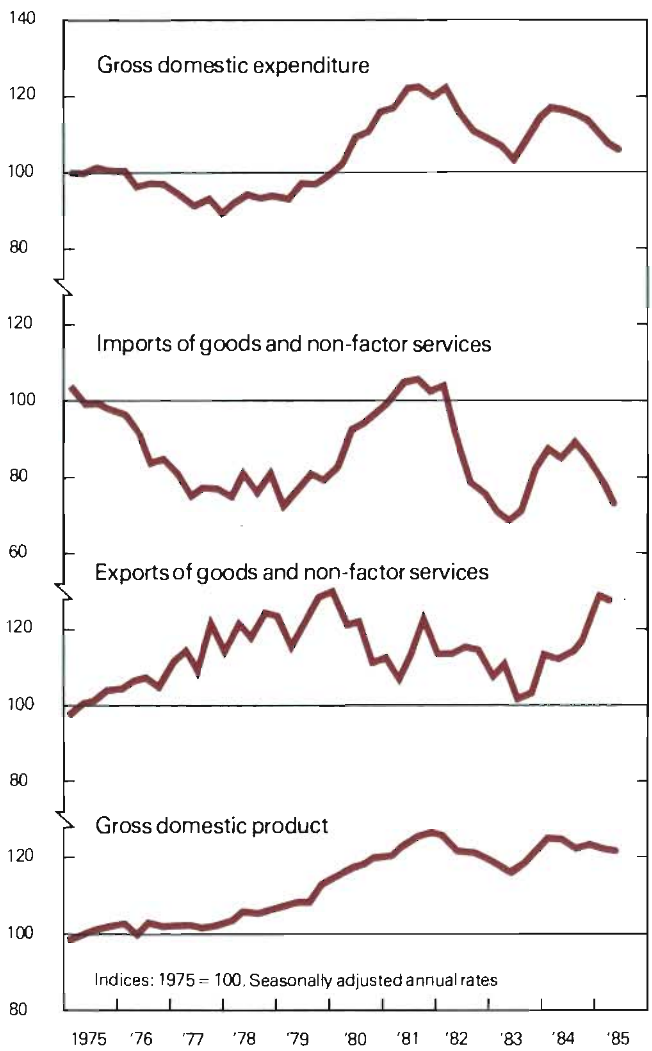
Business cycle indicators



The excellent performance of the export sector served to cushion the impact of the decline in real domestic demand on domestic output. Accordingly, the decline in real gross domestic product between the second quarter of 1984 and the second quarter of 1985 amounted to only 2½ per cent. Any prospective increase in real gross domestic product will depend heavily on a continuation of the growth in the export volume, because a significant increase in real domestic demand cannot realistically be predicted for the months immediately ahead.

South Africa's terms of trade improved moderately from the second quarter of 1984 to the second quarter of 1985. At the same time, however, there was an increase in net factor payments to the rest of the world. Taken together, the net effect was a slightly larger decline, namely 3 per cent, in real gross *national* product than in real gross *domestic* product.

Expenditure on real gross domestic product



Sectoral breakdown of change in real output

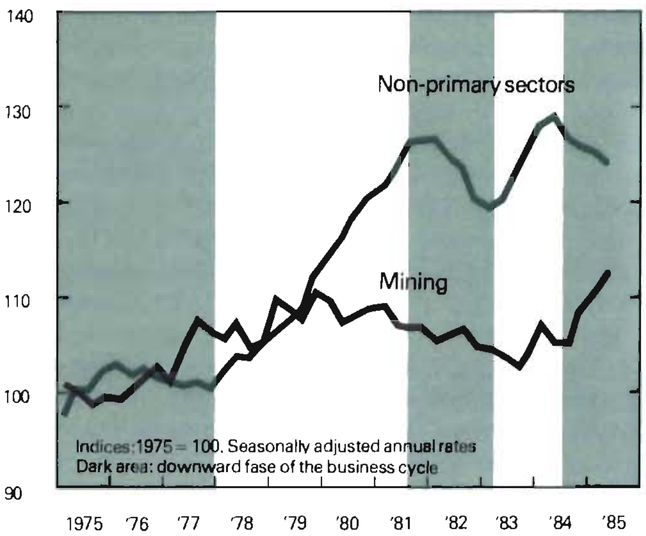
An analysis of the change in real gross domestic product in terms of the real value added by the different sectors of the economy, reveals a marked divergence between mining, which is predominantly dependent on export demand, and the other sectors relying mainly on domestic demand. In response to increased foreign demand, real output in the mining sector started to rise in the fourth quarter of 1983 and the increase accelerated notably during 1984 and 1985. The accompanying table shows that, in contrast, all the other main sectors, except agriculture, recorded either a lower rate of growth or an absolute decline in real output during the current downswing. Of these, only the sectors general government, finance, and electricity, gas and water managed to maintain positive rates of real output growth.

Percentage change in levels of real output

Sectors	Phases of the business cycle: Downswing from fourth quarter of 1981 to first quarter of 1983 (six quarters)	Unsustained upswing from second quarter of 1983 to second quarter of 1984 (five quarters)	Downswing from third quarter of 1984 until second quarter of 1985 (four quarters)
Agriculture, forestry and fishing	–10	–16½	16½
Mining and quarrying	–2	1	7
Electricity, gas and water	2	5½	5
Finance, insurance, real estate and business services	5	5	1
General government	5½	6	1
Construction (contractors)	–8	–1½	–12½
Manufacturing	–13	7½	–6
Trade, catering and accommodation	–4½	14½	–11½
Transport and communication	–12	13	–2
All sectors	–5½	6	–2½

Real agricultural output increased by 16½ per cent between the second quarter of 1984 and the second quarter of 1985, reversing a similar decline during the preceding recovery phase of the business cycle because of the then prevailing drought conditions. Despite this improvement, the real value added by the agricultural sector in the first half of 1985 was still some 10 per cent below its average levels of 1980-82.

Sectoral breakdown of real gross domestic product



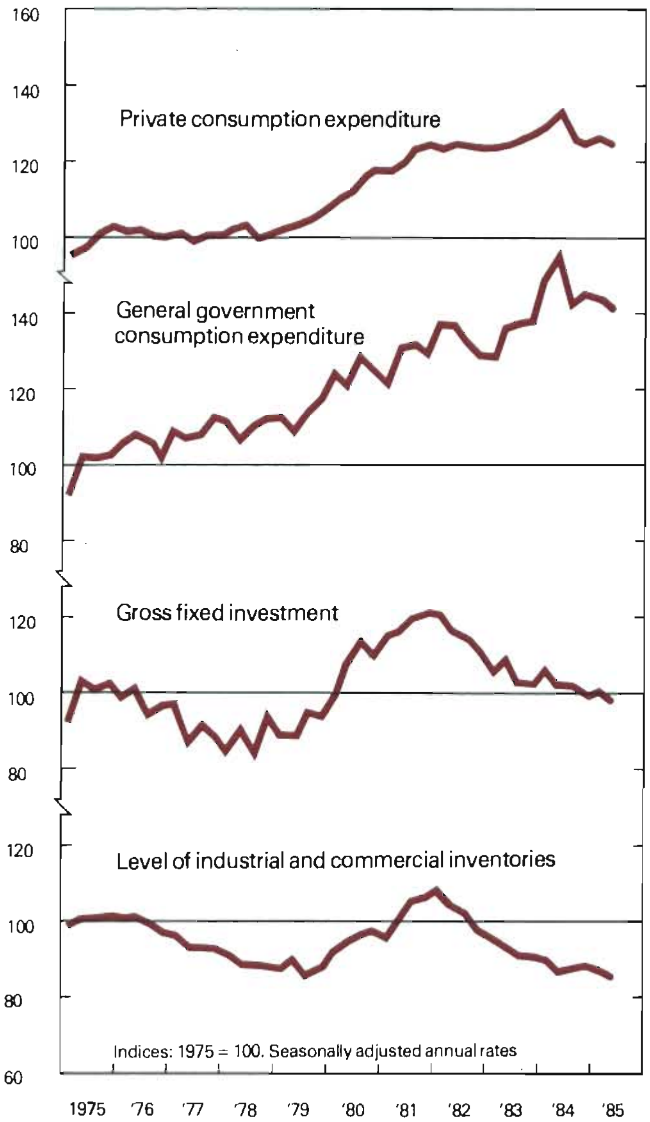
Changes in main components of real domestic demand

Private consumption expenditure

The more stringent economic policy measures that came into effect early in the third quarter of 1984 had a pronounced downward impact on real private consumption expenditure. The abrupt sharp fall in this component of total expenditure in the third quarter to a large extent represented a corrective adjustment from the exorbitant level of expenditure in the preceding quarter, following the announcement that general sales tax would be increased on 1 July. Subsequently, real private consumption continued on a downward course until the middle of 1985, except for a temporary small rise in the first quarter of 1985. Between the second quarter of 1984 and the second quarter of 1985 a decline of 7 per cent was recorded.

The extreme volatility of consumer spending on durable goods is illustrated by a trough-to-peak increase of 30 per cent in real outlays on private transport equipment during the 1983-84 upswing and a peak-to-pre-

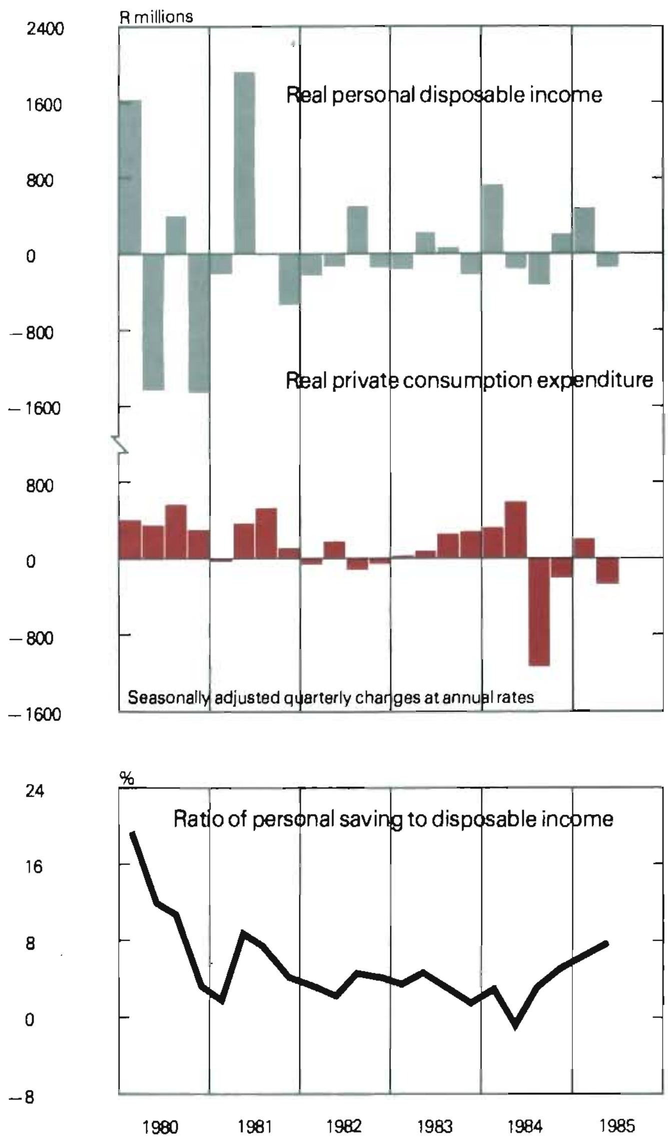
Main components of real gross domestic expenditure



sent-level decline of 52 per cent during the ensuing downswing. Real outlays on furniture and household appliances followed a similar pattern, with a rise of 7 per cent during the 1983-84 upswing and a 16½ per cent decline between the second quarter of 1984 and the corresponding quarter of 1985.

In one respect, the behaviour of real private consumption expenditure during the downswing to the middle of 1985 differed significantly from previous experience. During preceding downward phases real consumer spending on non-durable goods, at most, showed a lower rate of growth, but between the second quarter of 1984 and the second quarter of 1985 it actually declined by 4 per cent.

Disposable income, consumption and saving of households



Viewed over a somewhat longer period of time, it would appear that recent changes in private consumption expenditure represented a delayed reaction in consumer behaviour to fundamental earlier changes. Since the beginning of the nineteen-eighties the combination of inflation and the progression of personal income tax scales resulted in a considerable erosion of personal disposable income. As a ratio of the current income of private households, direct tax payments increased from 6½ per cent in 1980 to 12 per cent in 1985. On top of this higher direct tax burden, households have had to shoulder a substantial portion (estimated at well above 50 per cent) of the increasing burden of indirect tax.

Prior to the third quarter of 1984, the spending behaviour of consumers was apparently not inhibited by the increasing tax burden because the cost of consumer credit was not a sufficient deterrent in the face of prevailing and expected further high rates of inflation as well as expected inflation-related salary and wage adjustments. This is clearly demonstrated by an average annual growth rate of 33½ per cent in consumer credit outstanding between the end of 1979 and the end of 1984, and an accompanying sharp fall in the personal savings ratio from about 12 per cent in 1979 to 2½ per cent in 1984.

Over the past four quarters the growth in consumer credit slowed down markedly, following the sharp increase in finance charges applicable to hire-purchase and other forms of consumer credit. At the same time, the improvement in the after-tax rate of return on savings, occasioned by higher nominal interest rates, prompted consumers to substitute future consumption for current consumption. As a result, the personal savings ratio rose from a negative figure in the second quarter of 1984 to about 7½ per cent in the second quarter of 1985. Policy changes since the middle of 1984 have, therefore, succeeded in bringing consumer behaviour more into line with changes in the real after-tax income of households.

Government consumption expenditure

An upsurge in real government consumption expenditure of 20½ per cent between the first quarter of 1983 and the second quarter of 1984 was a major driving force of the economic upswing during this period. In the third quarter of 1984 real government consumption expenditure showed a sharp decline. Since then, it has resumed an upward trend, but the rate of increase has slowed down considerably. Over the four-quarter period to the middle of 1985 a decline of 9 per cent was recorded.

Gross domestic fixed investment

Except for small temporary increases in the second quarter of 1983 and the first quarters of 1984 and 1985, real gross domestic fixed investment has declined continuously since the beginning of 1982. Changes in investment and in the capital stock have, therefore, to be viewed over a somewhat longer time-span than the past twelve months of general economic downswing. During the period of three and a half years to the middle of 1985 total real gross domestic fixed investment declined by about 18 per cent. The corresponding declines in the real fixed investment of the private sector and public authorities amounted to 24 per cent and 19 per cent, respectively, whereas the real fixed investment of public corporations increased by 3½ per cent during this period.

A sectoral breakdown of the private sector's fixed investment shows that the real investment of the agricultural sector declined uninterruptedly from a peak in the third quarter of 1981 to a 25-year low in the second quarter of 1985. The latter figure was 62 per cent lower than in the third quarter of 1981. Recurring drought conditions obviously had a negative influence on the investment decisions of the agricultural sector. In addition, the increase in the cost of agricultural finance to more market-related levels may also have contributed to the lower rate of capital formation in agriculture.

Real fixed capital formation in private manufacturing recorded a substantial decline of 43 per cent between the first quarter of 1982 and the second quarter of 1985. This downward trend was interrupted only temporarily in the first half of 1984. From the third quarter of 1984 real gross fixed investment was only sufficient to cover real depreciation. Consequently, the real fixed capital stock of private manufacturing, which serves as an indicator of production capacity, did not increase any further from that quarter. Nevertheless, the fall in domestic demand was such that the rate of capacity utilisation still declined by 2½ per cent from 87 per cent in the second quarter of 1984 to 84½ per cent in the second quarter of 1985.

The increased export demand for metals and minerals as well as the beneficial effect of the depreciation of the rand on mining profitability, led to an acceleration of investment activity in the mining sector from the third quarter of 1983. Despite this upturn, real fixed capital formation by the mining sector in the second quarter of 1985 was still 27 per cent below its peak in the third quarter of 1981.

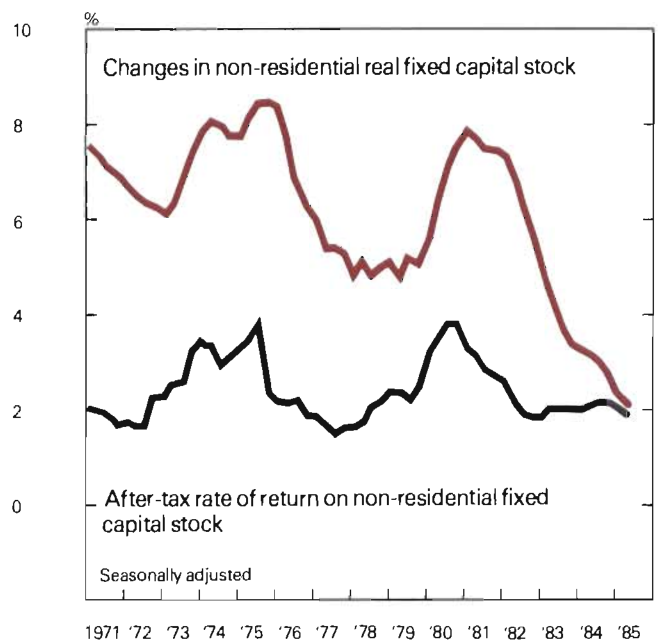
Real fixed capital outlays on private residential buildings increased, on average, at a fairly high annualised rate of 5 per cent throughout the downswing of 1981-83. The revival of economic activity in 1983 accelerated this growth rate to as high as 17½ per cent. The escalation in building activity was, however, completely reversed in the second quarter of 1984, and during the ensuing downward adjustment phase to the second quarter of 1985 private residential investment declined, on average, at an annualised rate of 10 per cent.

A breakdown of the real fixed investment of public authorities indicates a persistent decline in the real fixed capital outlays of general government. In the second quarter of 1985 the level of this expenditure was 15½ per cent lower than in the fourth quarter of 1981. Likewise, the real fixed capital outlays of public business enterprises declined by 23½ per cent between the first quarter of 1982 and the second quarter of 1985.

Reference has already been made to the recent stagnation of the real fixed capital stock of private manufacturing. The real fixed capital stock of the private sector as a whole still increased by 2 per cent between the second quarter of 1984 and the second quarter of 1985, but its growth rate has decelerated considerably since the end of 1981. The accompanying graph shows that additions to the private sector's non-residential capital stock have varied closely over time with the return on invested capital.* The upsurge in investment spending during 1980-81 was associated with a rise in the after-tax return on investment to a level sharply higher than any experienced during the preceding four years. Lower profitability since 1981 was followed by a slow-down of the growth in private capital formation. Contradicting previous experience, the improvement in corporate profitability during 1983, however, was not followed by a revival in private sector investment. In part, this could be ascribed to a fairly sharp decline in capital formation by the agricultural sector. The secular trend towards a higher burden of personal and company tax may also have exerted a negative impact in this respect.

* Ratio of after-tax operating surplus of private-sector companies (excluding inventory profits and after adjustment of depreciation to a replacement cost basis) to the non-residential capital stock of the private sector (valued at replacement cost).

Private sector's capital stock and rate of return



Inventory investment

Real inventories, which had declined from the second quarter of 1984, increased temporarily in both the third and fourth quarters of 1984, but resumed a downward trend during the first half of 1985. The increase in the second half of 1984 should be viewed as largely an involuntary accumulation of stocks owing to the abrupt fall in the other components of real gross domestic expenditure in the third quarter of 1984. The net result of inventory changes during the past four quarters was a slight rise from 29 per cent to 29½ per cent in the ratio of real non-agricultural and non-strategic inventories to real non-agricultural gross domestic product between the second quarter of 1984 and the corresponding quarter of 1985.

Real industrial and commercial inventories, which represent about 70 per cent of total inventories, showed a similar movement during the past four quarters. During the first half of 1985 manufacturers and retailers succeeded in running down their inventories. Wholesalers and motor vehicle dealers were, however, less successful in moving stocks and the level of their real inventories at the end of June 1985 was higher than at the end of 1984.

Factor income

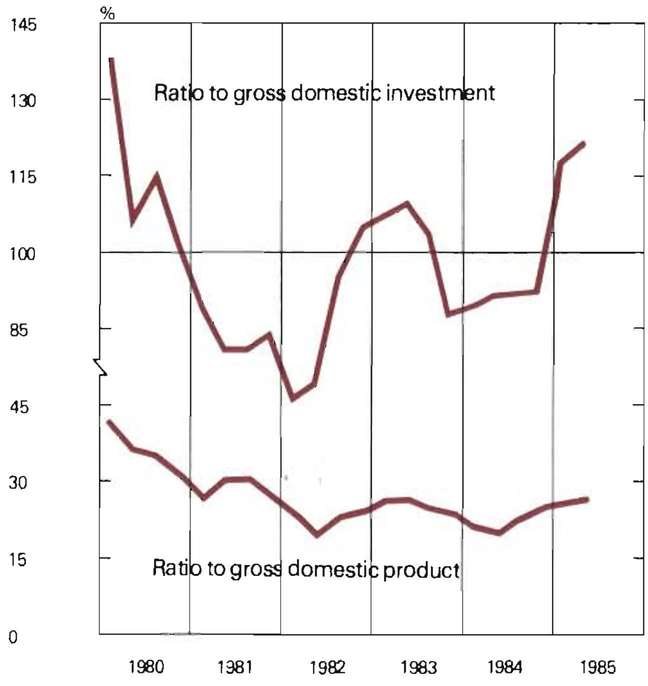
Nominal factor income in the form of remuneration of employees typically grows at lower rates than total factor income during upward phases of the business cycle, but has a higher growth rate than total factor income during periods of economic downswing. This phenomenon has repeated itself during the current downswing since the middle of 1984, implying that an increasing share of output has been allocated to labour remuneration. The increase of 13½ per cent during the four-quarter period of economic downswing to the middle of 1985 exceeded the growth rate of 12½ per cent in nominal gross domestic product at factor cost. However, it decelerated relative to the increase of 16 per cent during the preceding five-quarter period of economic upswing. This slow-down was evident in all the main sectors of economic activity, with the exception of mining and transport and communication.

The other main component of factor income, namely total gross operating surplus, clearly reflected the influence of the economic downswing on company profits. After it had shown an annualised average quarterly increase of 16½ per cent during the upswing of 1983-84, the corresponding growth rate decelerated again to 10½ per cent during the present downswing. All the major sectors, except mining (reflecting higher export volumes and prices) and the sector electricity, gas and water (resulting from tariff increases), contributed to this deceleration. The severity of the present downswing was particularly striking in the case of manufacturing and trade. The average quarterly declines in the gross operating surplus of these two sectors amounted to 14½ per cent and 21 per cent, respectively, during the four-quarter period to the middle of 1985.

Domestic saving

As mentioned earlier, saving by private households showed a remarkable recovery over the past four quarters, partly as a result of the net repayment of consumer debt. As a ratio of personal disposable income it was converted from a negative figure in the second quarter of 1984 to a positive figure of 7½ per cent in the second quarter of 1985. During the same period the savings shortfall of general government, which had been in evidence since the beginning of 1983, was reduced significantly. A moderation of the increase in current expenditure and a higher rate of growth in tax revenue, *inter alia* because of higher general sales tax rates and an increase in the effective rate of company tax, were mainly responsible for the smaller revenue shortfall of general government. Owing to the lower rate of increase in corporate profits, corporate saving declined over the four quarters to the middle of 1985. Depreciation allowances showed their normal rise during this period. As a ratio of gross domestic product, gross domestic saving increased from 20 per cent in the second quarter of 1984 to 26 per cent in the second quarter of 1985.

Gross domestic saving



A relatively high savings ratio is an essential prerequisite for a sustained high rate of real economic growth in South Africa. Traditionally, the South African economy could rely upon an inflow of foreign funds to help finance its investment requirements. Recurring pronouncements on disinvestment and other economic sanctions against the country, as well as rising taxes, have created uncertainties about the continued availability of foreign investment funds. In these circumstances, it appears that South Africa's future capital formation and, therefore, output growth will become increasingly dependent upon domestic saving.

Employment*

In line with the decline in real output from the third quarter of 1984, employment growth began to lose momentum. In the fourth quarter employment actually started to decline and in the first quarter of 1985 the decline progressed at a seasonally adjusted annual rate of 2,2 per cent. In the calendar year 1984, however, employment still grew by 1,4 per cent.

The weakening of employment towards the end of 1984 was not evenly spread among the non-agricultural sectors of the economy. To begin with, public-authority employment maintained a steady upward trend during 1984 and showed signs of weakening only in the first quarter of 1985. Private-sector employment, on the other hand, showed a distinct cyclical downturn already from the fourth quarter of 1984. Within the private sector itself, the export-orientated mining industry continued to expand its employment rather strongly throughout 1984 and also during the first quarter of 1985. In the course of these fifteen months employment also continued to rise in the wholesale trade and in most groups of financial institutions. In contrast, significant employment declines, most of them already beginning before the fourth quarter of 1984, occurred in manufacturing, construction, the motor trade and the hotel industry.

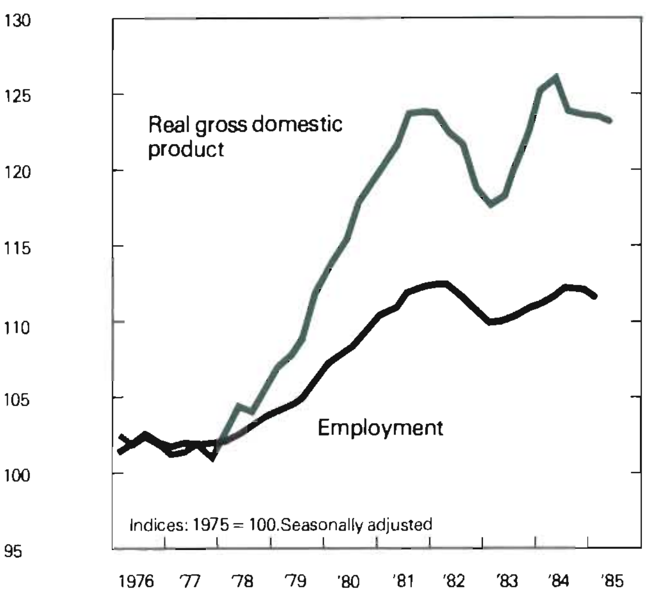
In relation to a steady increase in the economically active population, the initially lower and eventually negative employment growth inevitably resulted in considerably higher unemployment. Seasonally adjusted, the number of registered unemployed Whites, Coloureds and Asians rose from a low of 29 350 in July 1984 to 40 570 in December and to 65 080 in June 1985. Black unemployment, expressed as a ratio of the economically active Black population, increased from a low of 7,6 per cent in January 1984 to 8,2 per cent in April 1985.

* Employment and labour remuneration statistics refer to the non-agricultural sectors of the economy and are available only up to the first quarter of 1985.

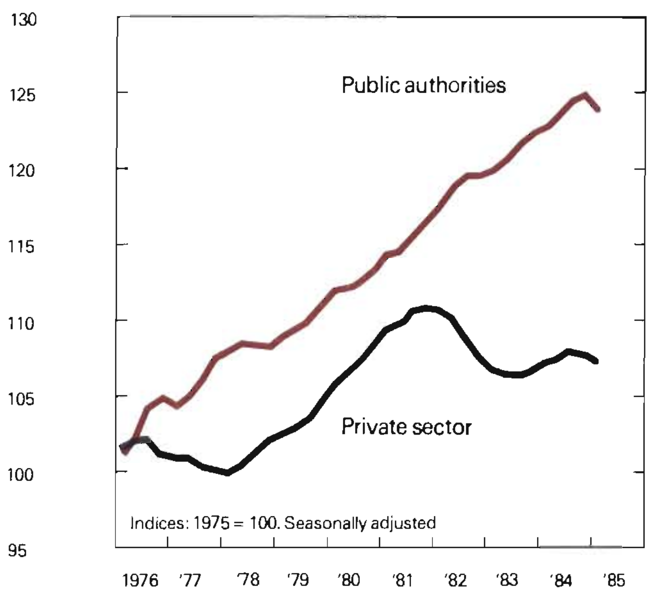
Remuneration per employee in non-agricultural sector
Percentage change

			1983	1984
Private sector	–	Nominal	14,1	13,2
		Real	1,7	1,4
Public authorities	–	Nominal	8,9	22,4
		Real	–2,9	9,6
Total	–	Nominal	12,7	15,8
		Real	0,4	3,7

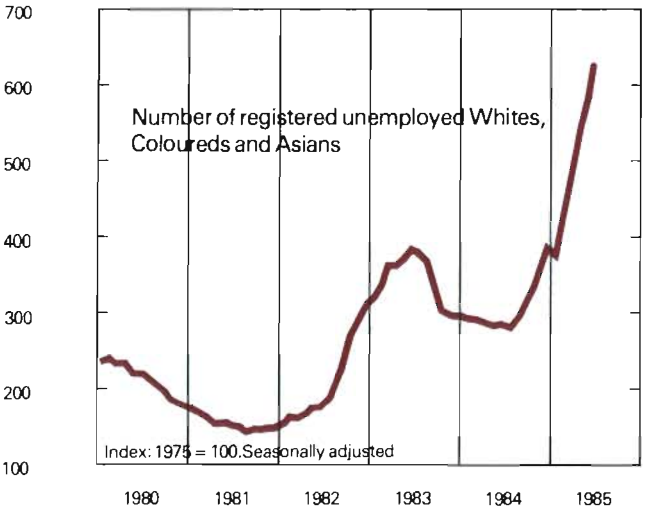
Non-agricultural real output and employment



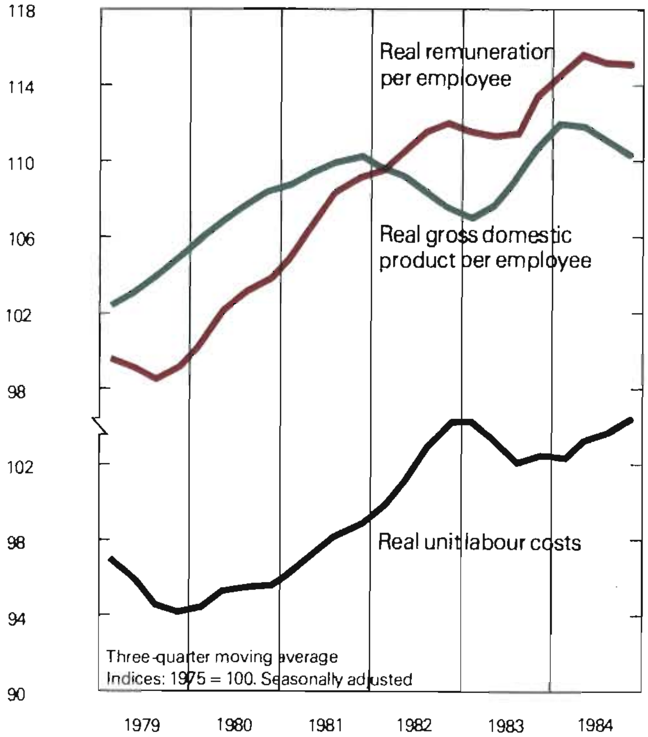
Non-agricultural employment in public and private sectors



Unemployment



Non-agricultural labour productivity, remuneration and unit costs



Labour costs and productivity

To an important extent labour costs in 1984 were inflated by a structural upward adjustment of salary and wage scales by public authorities. In nominal terms, the increase in labour remuneration per person employed in the non-agricultural sectors accelerated from 12,7 per cent in 1983 to 15,8 per cent in 1984. This acceleration was accounted for by an increase of 22,4 per cent in the average remuneration per employee of public authorities. The increase in nominal remuneration per private-sector employee actually decelerated slightly from 14,1 per cent in 1983 to 13,2 per cent in 1984.

More recently, in the first quarter of 1985, salaries and wages increased more slowly in the face of declining employment opportunities. Compared with the first quarter of 1984, nominal remuneration per employee increased by 11,9 per cent, a rate of increase that was significantly lower than the average for 1984 and also below the prevailing rate of inflation.

In real terms, remuneration per employee in the non-agricultural sectors increased by 0,4 per cent in 1983 and by 3,7 per cent in 1984. The latter figure was distorted by the public authorities' salary and wage scale adjustments. Measured over a four-quarter period, real labour remuneration declined by 2,7 per cent in the first quarter of 1985, in marked contrast with appreciable increases in each of the four quarters of 1984.

Labour productivity, as measured by the real gross domestic product per person employed in the non-agricultural sectors, increased by 2,7 per cent in 1984, compared with a decline of 0,2 per cent in 1983. Productivity growth in 1984 was concentrated in the first half of the year. During the second half it turned negative because of a cyclical decline in real gross domestic product that was not matched by a corresponding downward adjustment in employment. Measured over a four-quarter period, productivity declined at a rate of 1,8 per cent in the first quarter of 1985.

The higher rate of increase in real remuneration per employee than in labour productivity in 1984 meant that the "real wage gap", which had become a longer-term feature of the South African labour market, widened still further. The existence of such a gap is indicative of wage rigidity, and in the longer run it may have the undesirable effect of contributing to structural unemployment. This may come about directly through either labour displacement owing to the substitution of capital for labour, or labour shedding resulting from the discontinuation of unprofitable output. Indirectly, the prolonged existence of a real wage gap may contribute to structural unemployment by adversely affecting profitability and hence also new investment that might have created additional output and employment.

The increasing disparity in 1984 between the growth rates of real remuneration per employee and labour productivity was also reflected in an acceleration in the rate of increase in real unit labour costs from 0,6 per cent in 1983 to 1,1 per cent in 1984. In nominal terms, the increase in unit labour costs in 1984 remained at its 1983 level of 13 per cent. On average, therefore, unit labour costs did not exert stronger upward pressure on prices in 1984. The increase in these costs did, however, gain considerable momentum in the course of the year. In the fourth quarter the increase, measured over a four-quarter period, amounted to 17 per cent. Subsequently, it slowed down to 14 per cent in the first quarter of 1985.

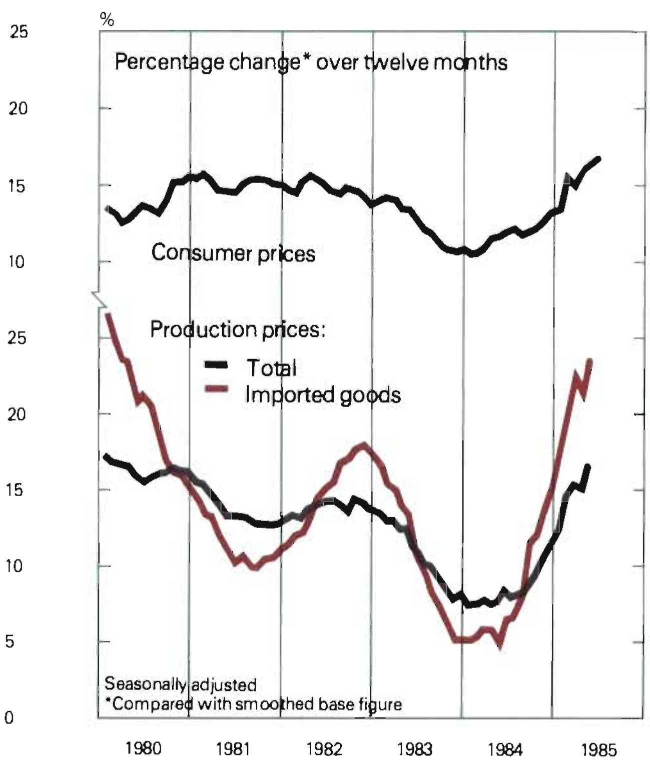
Prices

Up to the middle of 1985 the rate of inflation continued to accelerate despite a substantially slower increase from the third quarter of 1984 in nominal aggregate domestic demand. During the second quarter of 1985, however, it became evident that domestic expenditure was no longer exerting any significant upward pressure on prices, either directly or indirectly through pressure on labour resources and on the exchange rate of the rand. Instead, the sustained price acceleration basically represented a delayed adjustment to the overspending of 1983-84 in the form mainly of a marked increase in import prices, owing to the earlier depreciation of the rand, and an upward adjustment of administered prices in response to preceding price and cost rises. In addition to these influences, further increases in the general sales tax rate, which came into effect on 1 July 1984 and 25 March 1985, resulted in a rise in the consumer price index.

The reasons for the substantial depreciation of the rand will be discussed in more detail in another section of this review, but to some extent it was related to a domestic rate of inflation that had become increasingly out of line with the inflation rates in trading-partner countries. In June 1985 the increase in South African consumer prices was about 3 times as high as the weighted average increase in the consumer prices of trading partners.

Measured over a twelve-month period, the increase in consumer prices* accelerated from a recent low of 10,4 per cent in January 1984 to 13,1 per cent in December 1984 and to 16,7 per cent in June 1985. The corresponding increase in production prices accelerated from a low of 7,3 per cent in January 1984 to 11,4 per cent in December 1984 and to 16,8 per cent in June 1985. Illustrating the effect of the depreciation of the rand, the increase over a time-span of twelve months in the import price component* of the production price index accelerated from a low of 4,8 per cent in May 1984 to 23,0 per cent in June 1985.

Prices



* Compared with a smoothed base figure consisting of a centred twelve-month moving average.

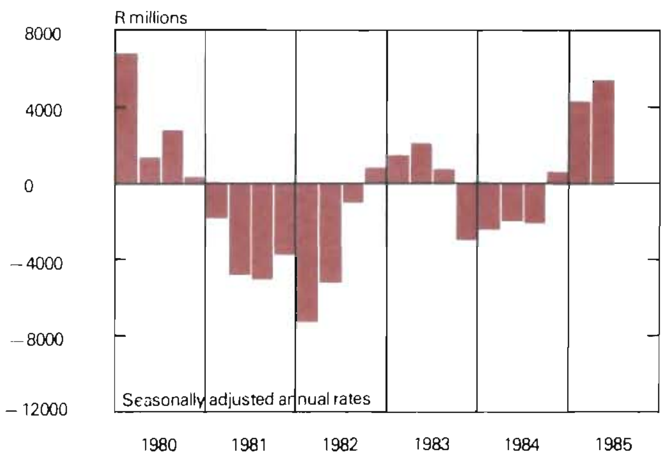
Foreign trade and payments

Balance of payments on current account

During 1984 and the first half of 1985 external and internal circumstances combined to produce a substantial improvement in the balance of payments on current account. Externally, South African exports benefited materially from the upward trend in global economic activity, including a growth of 9 per cent in the volume of world trade in 1984 and a projected further increase of 5 per cent in 1985. In addition, exports were promoted by the depreciation of the rand since the end of September 1983 and the accompanying improvement in South Africa's international competitiveness. Domestically, the slow-down in domestic demand from the second half of 1984 was reflected in an appreciable decline in the volume of imports. This decline was, of course, also related to the impact of an increase in import prices stemming from the depreciation of the rand. In addition, lower agricultural imports, owing to better agricultural crops, contributed to the decrease in the volume of imports.

At a seasonally adjusted annual rate, the current account balance changed from a deficit of R2,5 billion in the first quarter of 1984 to a small surplus of R0,6 billion in the fourth quarter. Subsequently, the surplus increased substantially to no less than R5,4 billion in the second quarter of 1985. As shown in the accompanying table, this marked swing of R7,9 billion in the current account balance during the five-quarter period concerned was predominantly due to an increase in the value of merchandise exports.

Balance on current account



Trends in main current account items

Merchandise exports

The value of merchandise exports increased consistently from its most recent low of R9,6 billion (seasonally adjusted annual rate) in the third quarter of 1983 to R19,7 billion in the second quarter of 1985. In volume terms, this represented a growth of 23 per cent to the fourth quarter of 1984 and a further 21 per cent to the second quarter of 1985.

In terms of rand, export prices rose by 38 per cent from the third quarter of 1983 to the second quarter of 1985. If the decline of 36 per cent in the effective exchange rate of the rand during this period is taken into account, it is clear that the depreciation accounted for the larger part of the rise in the rand prices of exports. This was especially the case after the middle of 1984, when international commodity prices declined in response to the strengthening of the dollar.

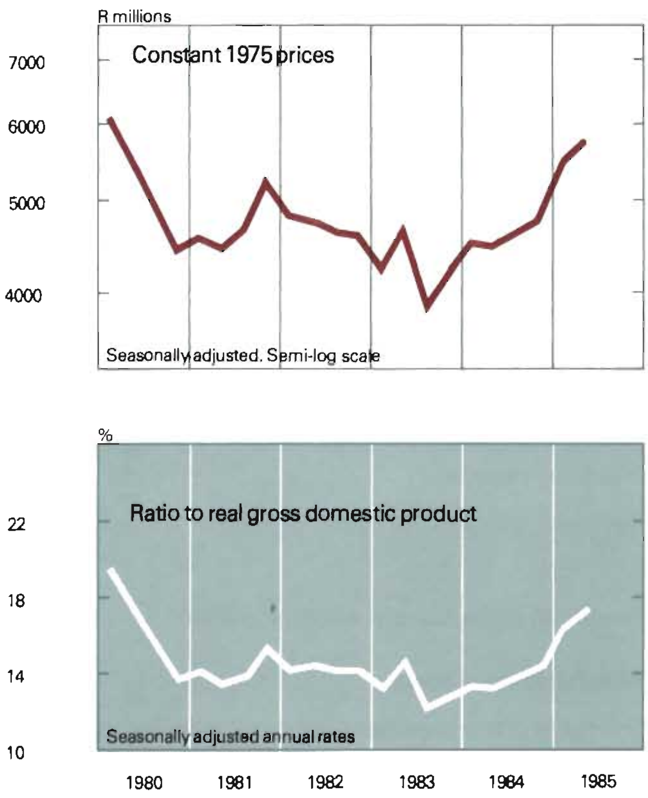
An expansion of export volumes was evident in the case of most of the major export products during the past seven quarters. Particularly large increases were

Current account of the balance of payments*
R millions

	1984				1985	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Merchandise exports	11 584	11 943	12 878	14 375	17 850	19 670
Net gold output	11 019	10 208	11 803	13 706	14 250	12 620
Merchandise imports	–20 821	–20 041	–21 811	–22 747	–22 630	–21 540
Net service and transfer payments	–4 289	–4 110	–5 000	–4 721	–5 140	–5 350
Balance on current account	–2 507	–2 000	–2 130	613	4 330	5 400

*Seasonnaly adjusted annual rates.

Real merchandise exports



recorded in exports of coal, ferro-chrome, iron ore and wool. Net agricultural exports, which had turned negative in the third quarter of 1983 because of the effect of drought conditions on both imports and exports, became positive again in the second quarter of 1985. This change was brought about by a decline in maize imports and an increase in other agricultural exports.

Net gold output

A moderate increase in the rand value of the net gold output, associated with the depreciation of the rand, supplemented the part played by other exports in transforming the deficit on the current account of the balance of payments into a surplus. In 1984 the value of the net gold output increased by 18 per cent and this was followed by a further 5 per cent rise from the second half of 1984 to the first half of 1985. On average, the rand price of gold increased by 12 per cent in 1984 and by 8 per cent from the second half of that year to the first half of 1985. The volume of the net gold output showed a moderate rise in 1984, but declined slightly during the first half of 1985.

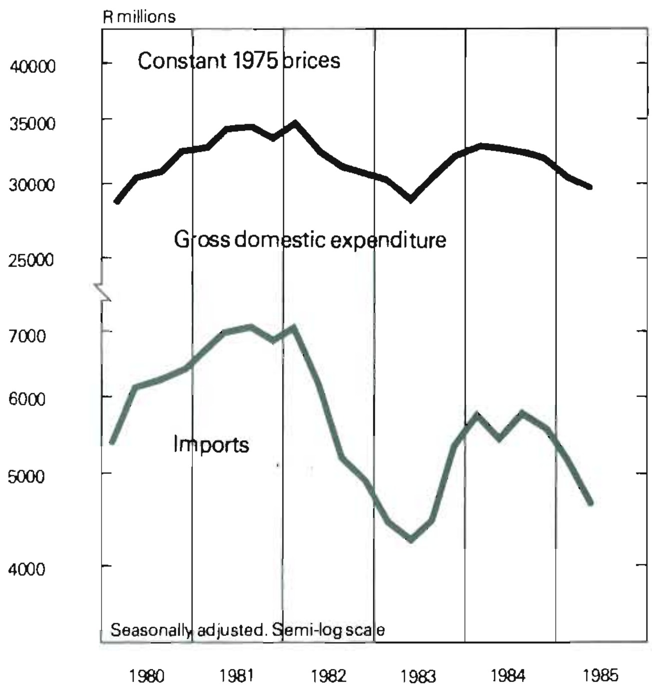
The rand price of gold followed a steady upward course during 1984 and the first half of 1985, rising from a quarterly average of R456 per fine ounce in the fourth quarter of 1983 to R606 in the fourth quarter of 1984 and R627 in the second quarter of 1985. Adjustments in the rand-dollar exchange rate served to compensate for the declining trend in the US dollar price of gold during 1984 and early 1985. The latter price fell from an average of $388 per fine ounce in the fourth quarter of 1983 to $302 in the first quarter of 1985, but recovered to $319 in the second quarter. This recovery was associated with the weakening of the dollar in foreign exchange markets.

Merchandise imports

The rand value of merchandise imports increased strongly during the fifteen-month period of economic upswing to the middle of 1984. Subsequently, however, it rose marginally during the second half of 1984 and remained approximately unchanged during the first half of 1985. Having regard to the sharp depreciation of the rand from the middle of 1984 and its effect on import prices, the stable import values implied a considerable decline in volume terms.

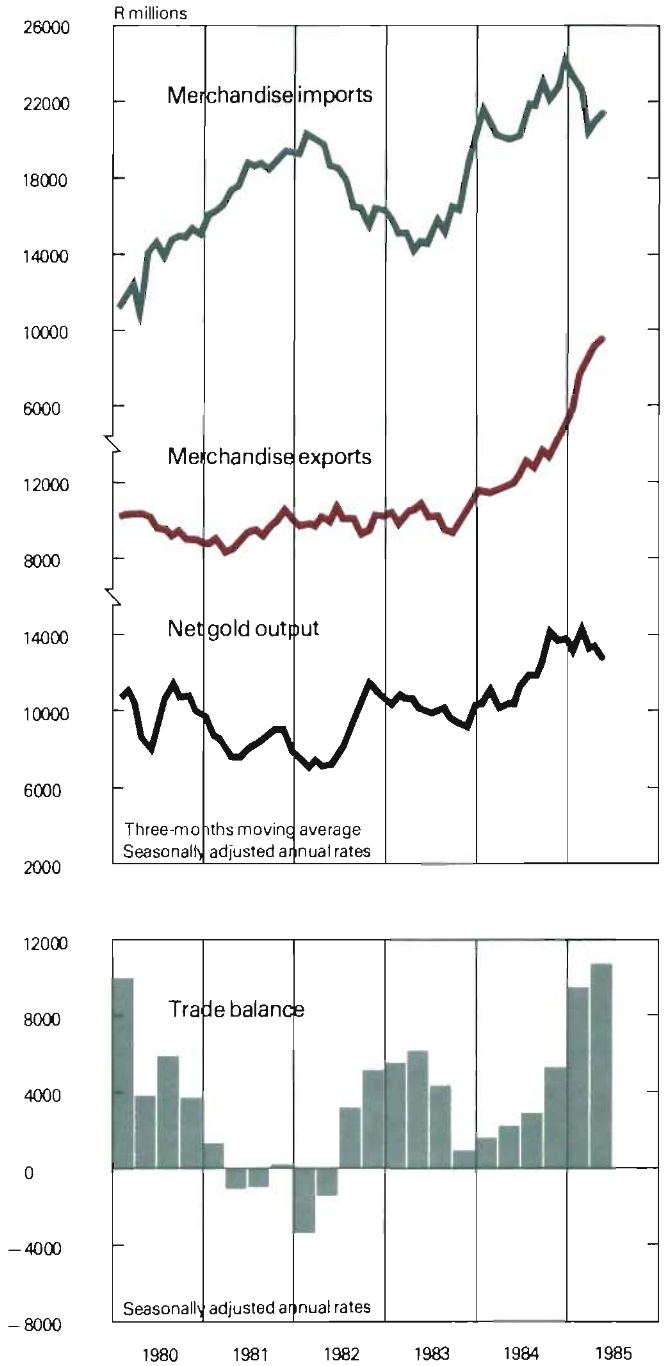
As part of the downward adjustment of real gross domestic expenditure, the volume of imports indeed started to fall from the fourth quarter of 1984. By the second quarter of 1985, the import volume had decreased by 19 per cent from its most recent peak in the

Real merchandise imports and gross domestic expenditure



third quarter of 1984. Volume declines were prominent in the import categories of processed foodstuffs, textiles and chemical products. As mentioned earlier, agricultural imports also showed a substantial decline, mainly because the latest maize crop was sufficiently large to satisfy domestic demand.

Balance of payments: Trade account

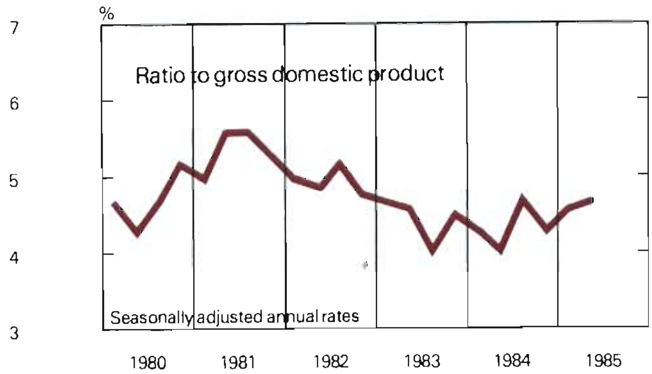


Net service and transfer payments

Since a large proportion of service payments to foreigners is denominated in rand, for example dividends on South African shares and the wages of foreign migrant workers, these payments were to a lesser extent inflated by the falling exchange value of the rand than the other main current account aggregates. Nevertheless, service payments still showed an appreciable increase during 1984 and the first half of 1985, mainly because of higher interest payments on the foreign loans of the public sector and larger dividend payments to foreigners on their increased investment in securities listed on the Johannesburg Stock Exchange.

The increase in service payments was partly offset by higher service and net transfer receipts. As a ratio of gross domestic product, net service and transfer payments declined from 5,4 per cent in 1981 to 4,3 per cent in 1984. The latter ratio was more in line with the average of 4,5 per cent during the nineteen-seventies.

Net service and transfer payments



Capital movements

The dominating feature of the capital account of the balance of payments during 1984 and the first half of 1985 was the substantial net outflow of short-term funds not related to reserves, amounting to R5,6 billion (including unrecorded transactions). This outward movement of short-term funds was partly offset by a net inflow of long-term capital, totalling R3,2 billion during the eighteen months to the middle of 1985.

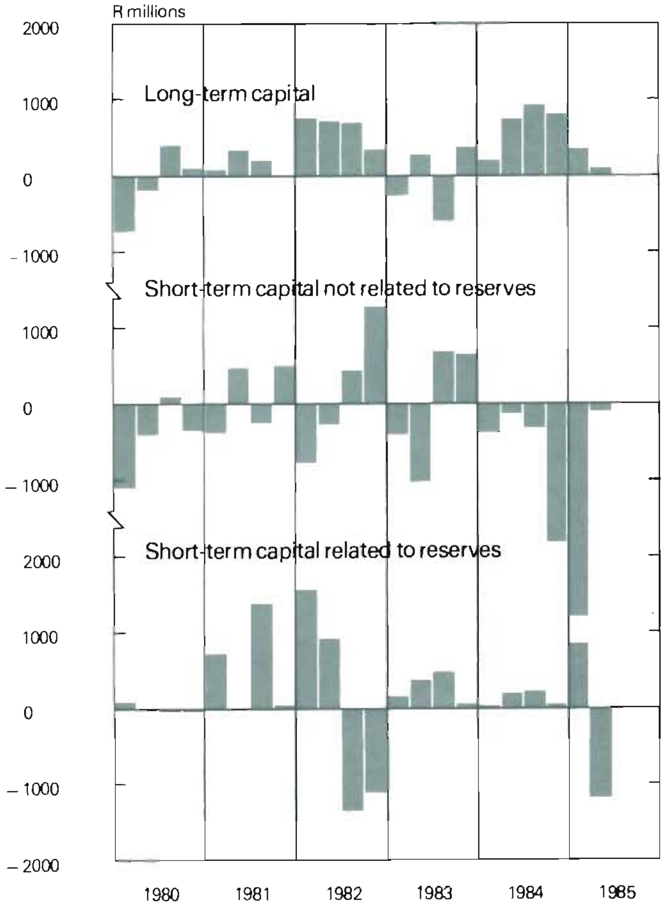
During 1984 and the first quarter of 1985 the net inflow of long-term capital was more or less evenly distributed between the public and the private sectors. The inflow to the public sector consisted mainly of net new foreign borrowing by the Treasury, the South African Transport Services, the Department of Posts and Telecommunications and public corporations. A major part of the net inflow of long-term capital to the private sector consisted of net purchases by non-residents of securities listed on the Johannesburg Stock Exchange. These net purchases amounted to R1,0 billion during the five quarters concerned.

Net security purchases by non-residents still amounted to R60 million in April 1985, but from May onwards they became net sellers of securities. This was the main cause of a net outflow of long-term capital from the private sector of R317 million during the second quarter. Although a final figure is not yet available, the indication is that net security sales gained momentum during July owing to the political developments referred to earlier. A net inflow of long-term funds to the public sector continued during the second quarter. On balance, a net inflow of long-term capital, amounting to R104 million, was recorded during this period.

The substantial outflow of short-term capital was heavily concentrated in the fourth quarter of 1984 and the first quarter of 1985. In the fourth quarter of 1984 and January 1985 the net outflow reflected unfavourable leads and lags in foreign payments and receipts, triggered by the sharp appreciation of the US dollar in terms of virtually all other currencies and the subsequent actual and expected further depreciation of the rand. After the decline in the exchange rate had been reversed towards the end of January and expectations of a further exchange rate decrease had subsided, the capital outflow during February and March became motivated by other influences. The decline in imports served to reduce foreign import financing. At the same time, the rapid expansion of exports led to an increase in short-term export credits to non-residents. In addition to these trade-related capital flows, the higher value of the rand prompted repayments of foreign short-term debt.

During the second quarter the net outflow of short-term capital assumed much smaller proportions, causing a marked improvement in the capital account of the balance of payments. Together with the surplus on the current account, the improved capital account produced a surplus on the overall balance of payments.

Net capital movements



Net capital movements not related to reserves
R millions

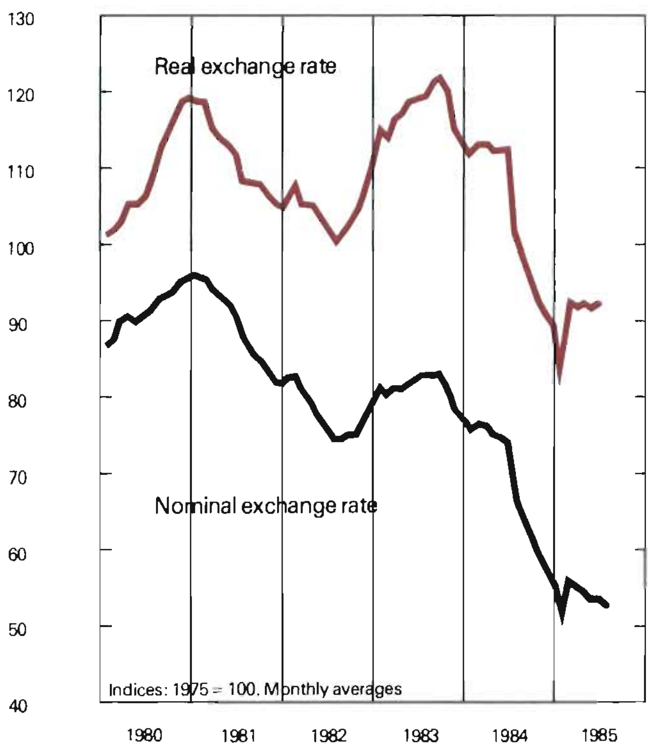
	1983		1984		1985	
	1st half	2nd half	1st half	2nd half	1st qr	2nd qr
Long-term capital						
Central government and banking sector	258	52	327	462	3	–48
Public corporations and local authorities	227	658	119	863	104	469
Private sector						
Net purchases of securities	–746	–529	341	550	352	–236
Other	261	–419	149	–97	–104	–81
Total long-term capital	—	–238	936	1 778	355	104
Short-term capital, including unrecorded transactions	–1 434	1 341	–503	–2 134	–2 808	–113
Total capital movements	**–1 434**	**1 103**	**433**	**–356**	**–2 453**	**–9**

Foreign reserves

Except for the second quarter of 1984, the overall balance of payments was in deficit throughout 1984 and the first quarter of 1985. This found expression in a decline of R2,5 billion in the net gold and other foreign reserves. Subsequently, however, the large surplus on the current account and the improved capital account resulted in an increase of R1,4 billion in net foreign reserves during the second quarter. During July the Reserve Bank's net foreign reserves declined by R162 million.

In order to supplement the cash component of foreign reserves in the face of a sustained deficit on the overall balance of payments, the Reserve Bank and other banking institutions borrowed abroad on short term during 1984 and the first quarter of 1985. During this fifteen-month period their reserve-related liabilities increased by R1,4 billion. The surplus on the overall balance of payments in the second quarter, however, enabled the banking system to reduce its reserve-related liabilities by R1,2 billion.

Effective exchange rate of the rand



Exchange rates

Exchange rate changes in South Africa during 1984 and the first half of 1985 were once again influenced by the behaviour of the US dollar in foreign exchange markets. From the end of 1983 to the end of February 1985 the effective exchange rate of the dollar increased by 22 per cent. In March, however, the appreciation, which had been in progress since 1980, appeared to come to an end. Since then the dollar exchange rate has been moving downwards.

Apart from this external influence, changes in the exchange rate of the rand also reflected structural adjustment in the form of greater convergence with its purchasing power parity, after inflation in South Africa had for some time been out of step with that in trading-partner countries and after the rand had appreciated from the middle of 1982 to the end of September 1983. In addition, the exchange rate was affected by changes in the current account of the balance of payments and by trade-related and investment-related capital flows as well as by exchange rate expectations and associated capital movements.

As a reflection of these various influences, the nominal effective exchange rate of the rand declined by 44 per cent between the end of September 1983 and the end of July 1985. After an initial sharp drop from its peak at the end of September 1983, the effective exchange rate drifted moderately downwards until the middle of 1984. By that time it had declined by 13½ per cent. A marked further appreciation of the US dollar in July and again in December, together with a persistent deficit on the over-

Changes in the exchange rates of the rand

%

	29 Sept 1983 to 21 Jan 1985	21 Jan 1985 to 13 Feb 1985	13 Feb 1985 to 31 July 1985	29 Sept 1983 to 31 July 1985
Effective exchange rate	–44,1	28,1	–21,6	–43,9
US dollar	–52,8	27,3	–16,0	–49,5
British pound	–37,4	31,5	–35,9	–47,2
German mark	–43,3	32,1	–28,5	–46,4
Swiss franc	–40,9	33,7	–31,3	–45,7
Japanese yen	–49,2	31,5	–24,2	–49,4
French franc	–42,8	31,9	–28,7	–46,2

all balance of payments, caused the depreciation of the rand to accelerate to 25½ per cent during the second half of 1984.

By the end of the year strong expectations of a further depreciation of the rand had been created and, by themselves, they caused a substantial net outflow of short-term capital in the form of unfavourable leads and lags in foreign payments and receipts. This capital outflow, in turn, served to weaken the exchange rate still further. This process continued during the first three weeks of January 1985, a period in which the effective exchange rate of the rand decreased by a further 13½ per cent.

Towards the end of January market perceptions started to change when it became known that the desired downward adjustment in domestic demand was firmly under way, and that the current account of the balance of payments had actually moved into surplus. The immediate effect was a correction of the preceding over-reaction of the market, and the effective exchange rate increased by 28 per cent during the ensuing period to 13 February. Subsequently, to the end of March, it fluctuated notably, but ended this period more or less at its level of middle February.

From the end of March to 25 July the effective exchange rate drifted downwards by 5 per cent. During the last six days of July, however, it fell abruptly by 12½ per cent, largely because of the effect of political unrest in South Africa and world-wide pronouncements of possible economic and financial sanctions against the country.

As shown in the accompanying table, bilateral exchange rates of the rand more or less followed the same pattern as the effective exchange rate. Owing to the US dollar's relative strength *vis-à-vis* other currencies, the depreciation of the rand was more pronounced against the dollar than in terms of the other major currencies.

An examination of movements in the *real* effective exchange rate of the rand provides more information on the influence of the other factors referred to earlier. For example, from the end of 1982 to the end of September 1983 the real effective exchange rate of the rand increased by almost 10 per cent, despite a deteriorating balance of payments on current account and a continuing high rate of inflation that was becoming more out of step with those of trading partners. It would appear that the rand was somewhat overvalued at that stage and that a downward correction was necessary to reduce South Africa's competitive disadvantage in international markets. From the third quarter of 1983 to the fourth quarter of 1984 the real effective exchange rate of the rand declined by 25 per cent, before increasing slightly by 1,2 per cent to the second quarter of 1985. The improvement of international competitiveness is reflected in the emergence and rapid growth of the surplus on the current account of the balance of payments, resulting mainly from an increase in the volume of exports and a simultaneous decline in the volume of imports.

Apart from affecting the balance of payments, the depreciation of the rand also had broader economic implications. Through its beneficial effect on export earnings and income, the depreciation served to cushion the impact of the policy-induced downward adjustment of domestic demand on the economy. An undesirable consequence, however, was that the depreciation contributed materially to the acceleration of inflation referred to earlier. This underscores the need to correct balance of payments disequilibria by means of conventional monetary and fiscal policy measures rather than through exchange rate adjustments alone.

Monetary and financial developments

Reliability of monetary aggregates as indicators of monetary control

In several countries monetary policy has come to be formulated within the stable framework provided by the control of money stock growth. Control has been exercised by setting target ranges for money stock growth and by maintaining the actual monetary expansion within the target ranges by means of central bank operations in the financial markets.

The selection of monetary aggregates to serve as reliable indicators of monetary control has differed among countries and has been influenced, among other things, by the reaction of aggregates to changes in financial regulation and to financial innovation. In some countries these influences have caused some monetary aggregates to show considerable short-term instability, which has occasionally rendered them unsuitable as indicators of monetary control. More fundamentally, the usefulness of monetary aggregates as targets has depended on the predictability as well as the stability of their relationships with interest rates, aggregate demand and inflation, which are important considerations in achieving the ultimate objectives of monetary policy. An additional consideration has been the amenability of the chosen aggregates to control by the monetary authorities through the use of monetary policy instruments.

Generally, broader monetary aggregates have been less susceptible to short-term instability and, therefore, better suited to monetary targeting. On the other hand, they have not always shown better correlation with aggregate demand than the narrower aggregates. Moreover, they have generally been less interest-elastic and not as amenable to policy manipulation as the narrowly defined aggregates.

In the recently released *Report* of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa, the Commission recommended that target rates of growth be adopted for one or more selected money supply aggregates. This did not imply, however, the adoption of a rigid and overriding "money rule" that would leave interest rates and exchange rates completely free to find their own levels at all times. Instead, the Commission recommended that monetary targeting should be applied in South Africa with a fair measure of flexibility and with a "low profile". More specifically it recommended that, in setting and changing money supply targets from time to time, or in intentionally permitting them to be breached, the monetary authorities should openly exercise discretion based on their assessment of the general economic situation and prospects at the time, including their "view" on the appropriate level and structure of interest and exchange rates at that stage.

If these recommendations are accepted by the Government, South Africa will follow the example of several other countries which have already achieved remarkable success in exercising firm monetary control and in lowering the rate of inflation.

As pointed out by the Commission, monetary targeting would not have been desirable in the circumstances prevailing in South Africa in the past. The measured monetary aggregates, in particular the narrowly defined M1, have at times shown great volatility. This was partly due to financial innovations and banking practices which caused continuous shifts among various categories of deposits and blurred the distinction between savings and transactions balances.

More important, growth rates of the money stock have been distorted by the use of non-market-orientated instruments of monetary policy. As discussed in more detail in the 1984 *Annual Economic Report*, the existence of a direct monetary control regime and non-market-related interest rates until the beginning of the nineteen-eighties gave rise to large-scale "disintermediation", a relatively slow monetary expansion and a concomitant rise in the velocity of circulation of money. The subsequent abolition of direct controls and the move towards a market-orientated monetary policy and market-related interest rates reversed this process. This became evident in extensive "re-intermediation", an artificial acceleration in money stock growth and a sharp decline in the velocity of circulation of money.

More recently, however, there have been signs that a more normal money-income relationship is being restored. Within such a more stable environment, the institution of the proposed procedure of monetary targeting seems to be more opportune. Nevertheless, monetary aggregates may continue to show appreciable short-term instability because of unanticipated extraneous shocks and ongoing financial innovation. A "pragmatic" approach to monetary targets, therefore, seems desirable.

Changes in money stock and velocity of circulation

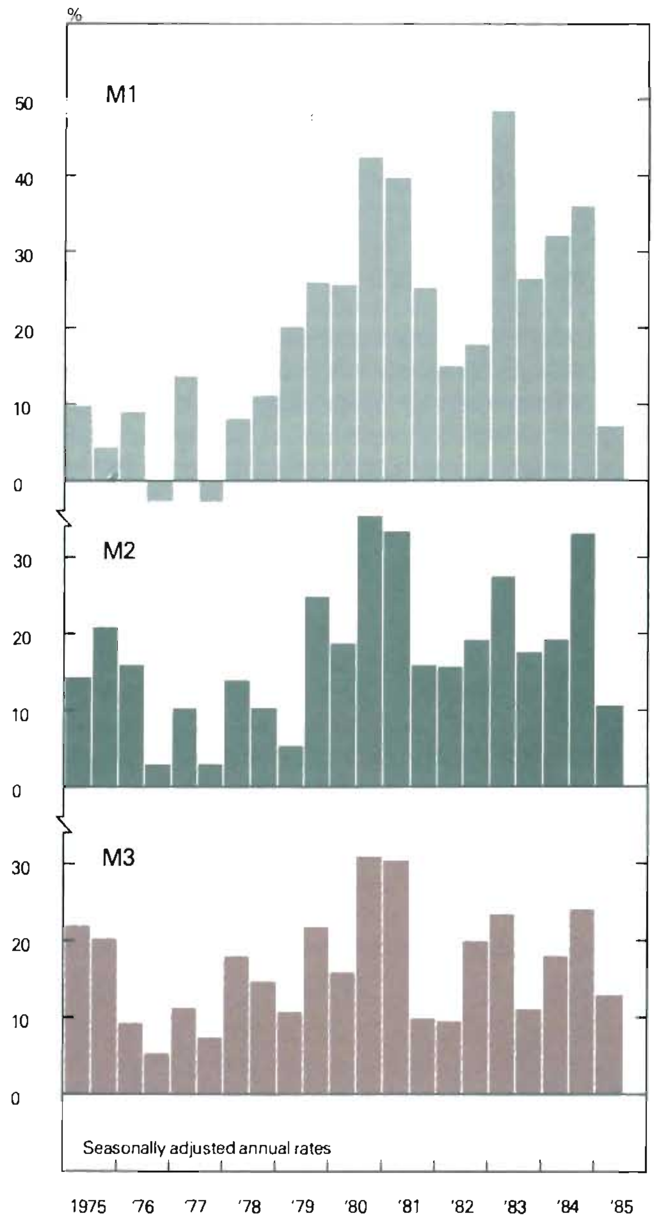
The money stock not only continued to grow at a high rate during 1984, but the expansion also accelerated notably in the course of the year. During the first half of 1985, however, the increase in the money stock slowed down significantly. For example, the increase over a twelve-month period in the broad money stock (M3) accelerated from 16,9 per cent in December 1983 to 24,7 per cent in November 1984, before slowing down to 20,5 per cent in June 1985. As shown in the accompanying table, the more narrowly defined monetary aggregates, M2 and M1, followed roughly similar growth patterns.

Because they are measured over a fairly long time-span of twelve months, the quoted growth rates for M3 tended to underestimate both the monetary expansion during 1984 and the subsequent deceleration during the first half of 1985. Measured over a shorter time-span of six months, the seasonally adjusted annual rate of growth in M3 accelerated from 18 per cent in the first half of 1984 to 29 per cent in the second half, but slowed down to 13 per cent in the first half of 1985. As shown in the accompanying table, the deceleration in the corresponding growth rates of M2 and M1 was even more pronounced.

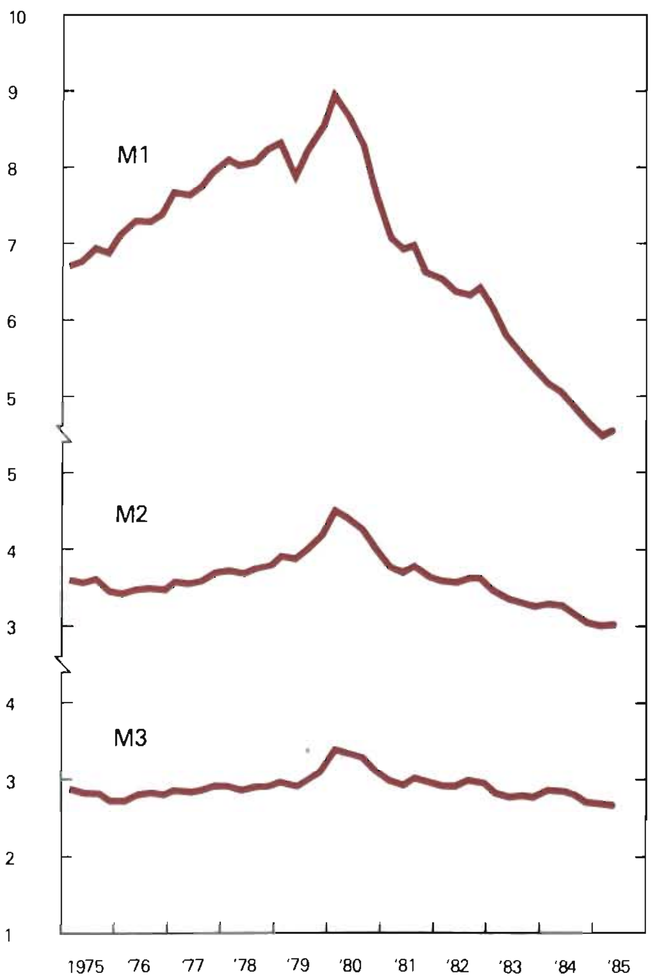
Growth rates of monetary aggregates
%

	M1	M2	M3
Measured over 12 months:			
1983 – December	36,7	22,3	16,9
1984 – June	29,1	18,4	14,2
November	39,6	28,9	24,7
December	34,0	25,8	23,2
1985 – June	20,8	21,3	20,5
Measured over 6 months (seasonally adjusted annual rates):			
1984 – 1st half	32,1	19,2	17,9
2nd half	36,1	33,1	28,8
1985 – 1st half	7,2	10,6	12,7

Changes in money stock



Income velocity of money



Composition of private-sector deposits with banking institutions
%

	1983	1984	1985	
	4th qr	2nd qr	4th qr	2nd qr
Short-term deposits	52,8	55,8	57,4	54,7
Savings and medium-term deposits	33,0	29,8	30,1	31,8
Long-term deposits	14,2	14,4	12,5	13,5
Total	100,0	100,0	100,0	100,0

The higher growth rates of M1 and, to a lesser extent, of M2 during 1984 were caused by a relative shift from long-term and medium-term deposits to demand and other short-term deposits. This shift occurred in response to the inverse maturity structure of deposit interest rates, the payment of interest on cheque deposits and the banks' cash management schemes for their clients. This shift towards shorter-term deposits was more or less discontinued in the first quarter of 1985 and actually reversed in the second quarter, reflecting actual and expected changes in interest rates as well as in the structure of interest rates. In addition, the general slow-down of economic activity resulted in greater preference for precautionary rather than transaction balances. Because of these changes, M1 and M2 started to show lower rates of increase than the broader M3.

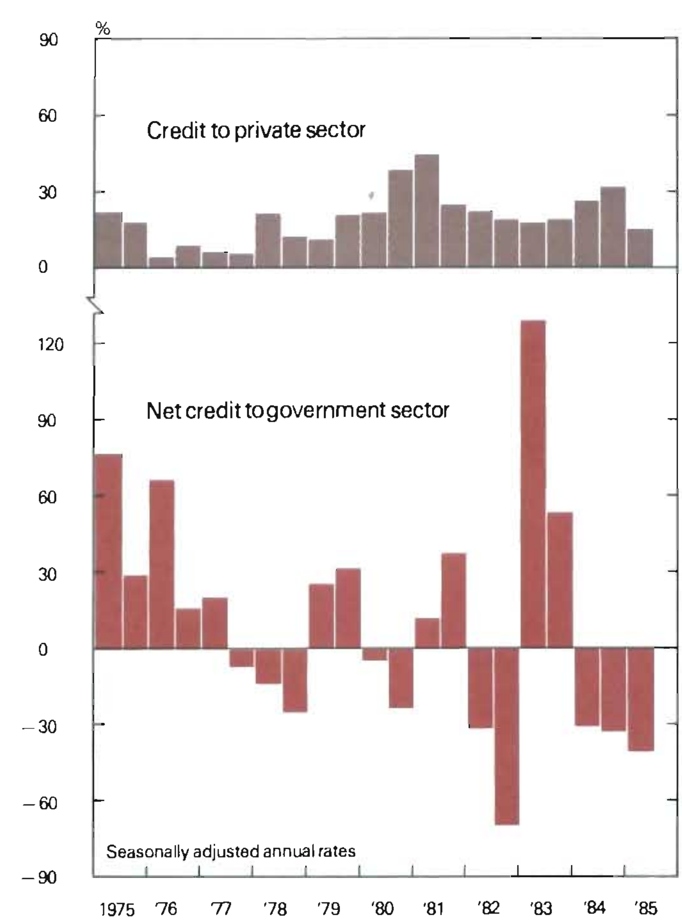
From the point of view of monetary control, the accelerated monetary expansion during the second half of 1984 was of limited significance, owing to a concomitant fall in the income velocity of money. The velocity of M3 declined by 4,2 per cent from the first to the second half of 1984, that of M2 by 5,6 per cent and that of M1 by 7,7 per cent. The extent of these declines was indicative of a notable deceleration of the increase in monetary demand during that period, as shown by the decline in real gross domestic expenditure referred to earlier. The slowdown of monetary expansion during the first half of 1985 was accompanied by a still further decline in the velocity of circulation of all three monetary aggregates, indicating a sustained deceleration of the growth in monetary demand. The declines in the velocity of circulation of M3, M2 and M1 amounted to 3,3 per cent, 3,9 per cent and 5,5 per cent, respectively, during the first half of 1985.

Credit intermediated by the banking system

Throughout 1984 and the first quarter of 1985 the main counterpart of the increase in M3 was an expansion of bank credit to the non-bank private sector. This expansionary effect on the money stock was to some extent offset by a consistent decline in net bank credit to the government sector and, from the second half of 1984, also by a decline in net foreign reserves. Credit demand weakened considerably in the second quarter of 1985 and credit to the private sector was actually overtaken by an increase in net foreign reserves as the predominant counterpart of monetary expansion.

Despite the downswing in general economic activity during the second half of 1984, the increase in bank credit to the private sector accelerated from a seasonally adjusted annual rate of 26 per cent in the first half of the year to 31 per cent in the second half. The notably lower rate of increase in nominal gross domestic expenditure and the actual decline in real expenditure suggest that much of the additional credit was not used to finance higher spending. Instead, much of the credit was used to finance a build-up of inventories and the unanticipated higher rand cost of imports resulting from the depreciation of the rand. To a large extent, the higher rate of credit growth was also related to the financing of increasing short-term credits granted by exporters to their clients, the financing of the unfavourable leads and lags in foreign payments and receipts referred to earlier, the augmenting of company cash flows and the capitalisation

Changes in bank credit



Changes in bank claims on the non-bank private sector
R millions

	1984				1985	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Deposits and investments	−110	−56	−213	−244	85	909
Bills discounted	−17	87	124	−62	1	128
Hire purchase credit	662	637	834	256	338	−122
Leasing finance	248	245	203	34	−20	−8
Other loans and advances	1 410	1 589	933	1 748	1 497	490
Total claims	2 193	2 502	1 881	1 732	1 901	1 397

of accrued interest on previously existing bank credit. In addition, there was some re-intermediation of credit transactions owing to tighter conditions in the inter-company market for funds.

During the first half of 1985 the seasonally adjusted annual rate of increase in bank credit to the private sector decelerated to 15 per cent, indicating a distinct weakening of credit demand. For the purposes of supplementing cash flows, capitalising interest, granting trade credits and paying income tax (in particular at the end of February), companies' demand for bank credit continued to grow fairly rapidly. In the accompanying breakdown of bank credit to the private sector, this is shown as a sustained increase in bank overdrafts. In contrast, the growth of hire-purchase credit and leasing finance tapered off significantly during the first half of 1985, confirming that additional bank credit was not used to any large extent for the financing of consumption and fixed investment expenditure.

The increase in bank credit to the private sector was countered to some extent by a consistent decline in net credit to the government sector during the eighteen months to the middle of 1985. From the first half of 1984 to the second half, the increase in total bank credit extension accelerated from a seasonally adjusted annual rate of 20 per cent to 26 per cent, but during the first half of 1985 it slowed down to 12 per cent.

Monetary policy and related operations of the Reserve Bank

Monetary policy was tightened considerably at the beginning of the past twelve-month period. In response to an upward spurt in the exchange value of the US dollar and an accompanying marked decline in the gold price as well as in the exchange rate of the rand in July 1984, the Reserve Bank raised its rediscount and other re-financing rates by 1 per cent and this step induced all short-term interest rates to show a similar rise. With a view to adjusting domestic expenditure to a more sustainable level, strengthening the balance of payments and the exchange rate, and ultimately lowering the rate of inflation, the authorities in early August 1984 adopted a more restrictive policy stance. 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.

Following a considerable decline in real gross domestic expenditure, a significant improvement of the balance of payments on current account and a decline in market interest rates (including a reduction of 1½-2 per cent in the clearing banks' prime overdraft rates), the Reserve Bank on 19 November 1984 lowered its refinancing rates by 1 per cent. In December 1984, however, the US dollar exchange rate showed another abrupt upward shift, which triggered the downward slide of the exchange rate of the rand and the substantial net outflow of short-term capital described earlier. These developments prompted the Reserve Bank to restore on 8 January 1985, its refinancing rates to their former levels of early November.

In recognition of the better balance between monetary and fiscal policy embodied in the March 1985 Budget of the Central Government, the fundamental change in economic conditions since the middle of 1984, and the decline in interest rates that had already occurred, the Reserve Bank lowered its refinancing rates, mostly by 1 per cent, on 6 May 1985. This was followed by three further reductions of 1 per cent at a time on 21 May, 14 June and 4 July. Following the further confirmation that excess demand in the economy had been eliminated and that the balance of payments had continued to strengthen considerably, the Bank on 20 August lowered its refinancing rates by an additional 1,75 per cent. After these adjustments, the Bank's rediscount rates for discount houses stood at 16,00 per cent for Treasury bills, 16,25 per cent for Land Bank bills and 16,50 per cent for bankers' acceptances. At the same time, the Bank reintroduced the traditional Bank rate as its formal rate for rediscounting Treasury bills for discount houses.

On 29 January 1985 the Reserve Bank announced that in order to strengthen its influence over accommodation to the banking system, it would in future provide accommodation to discount houses only against the security of assets owned by them, and that banking institutions requiring accommodation would have to approach the Bank directly. The new arrangements will enable the Bank to penalise individual banking institutions which expand their credit excessively and then require unduly large amounts of Reserve Bank credit, by applying higher refinancing rates.

As part of the longer-term process of reducing the liquid asset requirements for banking institutions, the Reserve Bank lowered these requirements in the last week of March 1985. The requirement in respect of short-term liabilities was reduced from the 25 per cent, to which it had been lowered in March 1984, to 22 per cent. At the same time, the requirement in respect of medium-term liabilities was reduced from 18 to 16 per cent. These requirements were lowered further to 20 per cent in the case of short-term liabilities and to 15 per cent in the case of medium-term liabilities by an amendment to the *Banks Act* that was promulgated on 31 July 1985. From that date the 5 per cent requirement in respect of acceptance liabilities and certain other contingent liabilities was abolished.

The Reserve Bank's policy-related operations in the financial markets from the middle of 1984 consisted, firstly, of active participation in government debt management. Net sales of government stock, including a private placement through a stockbroker, during the year to June 1985 amounted to R3 891 million, of which R2 139 million was sold during the second quarter of 1985 alone. During July further government stock sales to the amount of R245 million were made. Expectations that interest rates had peaked and would decline in the period ahead created a receptive market for government stock during the second quarter of 1985 and the early part of July. Accordingly, most of the Government's gross borrowing requirement in the 1985/86 fiscal year was satisfied during the first four months of the fiscal year.

Secondly, the Reserve Bank's operations in the government stock market consisted of open-market operations aimed at monetary control. In order to counter the effect on the money stock of either the expansion of bank credit to the private sector or an increase in net foreign reserves, the Reserve Bank at times sold more government stock to the non-bank private sector than was required to cover the Government's borrowing requirement. This deliberate "overfunding" resulted in a decline of R981 million in the banking sector's net claims on the government sector from July 1984 to June 1985.

Thirdly, the Reserve Bank's operations were aimed at the smoothing of short-term fluctuations in money market conditions and interest rates. These took the form of repurchase agreements concluded with banking institutions for short periods at a time, sales of special Treasury bills to mature at tax-payment dates and variations in the amounts of Treasury bills and Land Bank bills offered at the weekly tenders.

Fourthly, the Reserve Bank operated in the foreign exchange market, mostly to stabilise exchange rate movements but also to acquire foreign exchange for meeting outright forward exchange commitments. Money market conditions were affected appreciably by these operations.

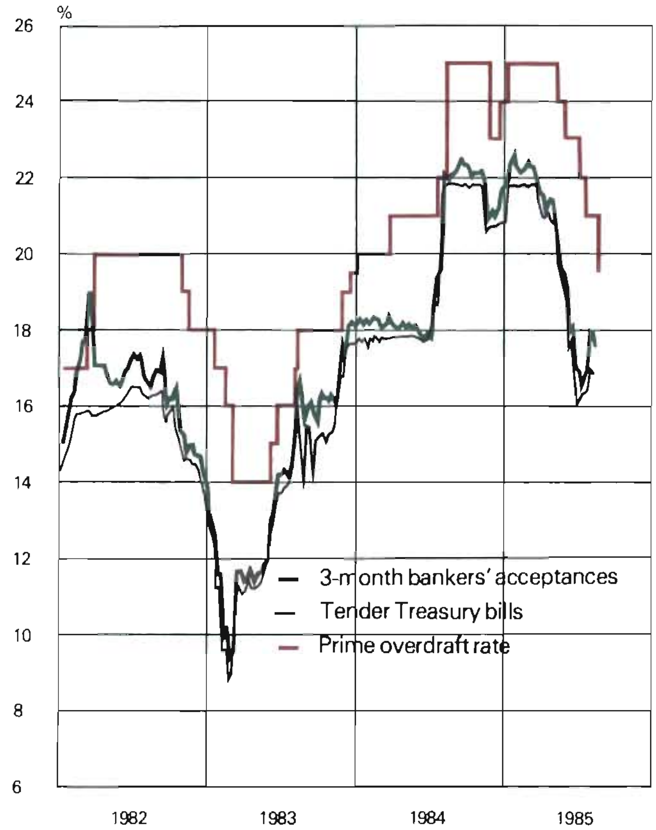
Finally, the Reserve Bank accommodated the net shortage of funds in the money market arising from its market operations and also from other factors affecting the money market. Accommodation was provided to discount houses and other banking institutions in the form of rediscounting and overnight loans. In June 1984 the average daily amount of accommodation amounted to R1 877 million. Subsequently, it grew steadily to R2 102 million in December, before it declined to R860 million in June 1985. In July the daily amounts of accommodation averaged R1 037 million. The amount of accommodation provided by the Reserve Bank was reduced by the Bank's placing of funds of the Corporation for Public Deposits with the discount houses. These funds amounted to R300 million at the end of June 1984, R500 million at the end of December and R750 million at both the end of June and the end of July 1985.

Money market conditions and short-term interest rates

After short-term interest rates had increased sharply with the imposition of higher refinancing rates by the Reserve Bank early in August 1984, they initially remained fairly stable at their higher levels. However, in accordance with the easing of money market conditions in early November referred to earlier, a general downward movement in interest rates occurred. By 16 November the three-month bankers' acceptance rate, for example, had declined to 20,95 per cent, compared with 22,25 per cent at the end of September. On the same day the clearing banks announced reductions of 1½-2 per cent in their prime overdraft rates, with effect from 19 November.

In response to the marked further decline in the dollar price of gold and the substantial net outflow of short-term funds during the second half of December 1984 and in early January 1985, money market conditions tightened and short-term interest rates firmed again. In these circumstances, the clearing banks' prime overdraft rates were raised to 24 per cent on 17 December and further to 25 per cent on 8 January. Owing partly to seasonally high income tax payments in February, market conditions became even tighter and short-term interest

Short-term interest rates



rates rose to new peaks. The three-month bankers' acceptance rate, for example, increased to 22,75 per cent during the last week of February.

From the beginning of March, market conditions eased considerably as a result of a fundamental change in economic circumstances in the form of the cooling-down of the economy, a weakening in the private sector's demand for bank credit, an improved balance of payments and a relatively stable exchange rate of the rand. A better balance between fiscal and monetary policy also promoted a greater degree of monetary ease. As a reflection of this easing in market conditions, short-term interest rates dropped considerably from their levels at the end of February. The three-month bankers' acceptance rate declined to 16,40 per cent in the first week of July, while the tender Treasury bill rate fell from 21,80 per cent on 22 February to 16,00 per cent on 28 June. The prime overdraft rates of the clearing banks were reduced in steps, by 1 per cent at a time, on four occasions between early May and the middle of July to their present level of 21 per cent. Short-term deposit rates followed a similar course, but showed even larger declines from the beginning of March to early July. After the lowering of the Reserve Bank's refinancing rates on

20 August, the clearing banks reduced their prime overdraft rates to 19,5 per cent.

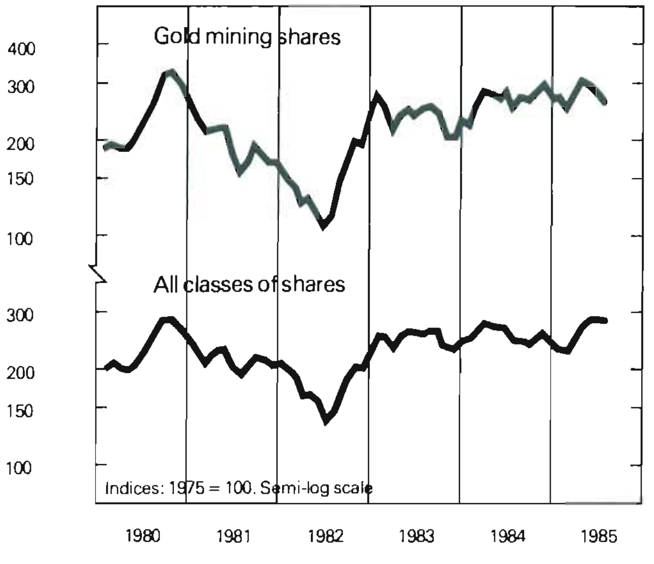
Towards the end of July political factors caused an increased demand for foreign exchange and a concomitant sharp decline in the exchange rate of the rand. Although these developments did not reflect any fundamental change in the economy, they caused money market conditions to tighten and interest rates to move to higher levels. The Reserve Bank, however, promptly took countervailing action and interest rates resumed their downward movement as market conditions became more settled. By 2 August the rates on three-month bankers' acceptances and tender Treasury bills had increased to 17,90 per cent and 17,04 per cent, respectively, but by 16 August they had again declined to 17,80 per cent and 16,88 per cent, respectively.

Capital market developments

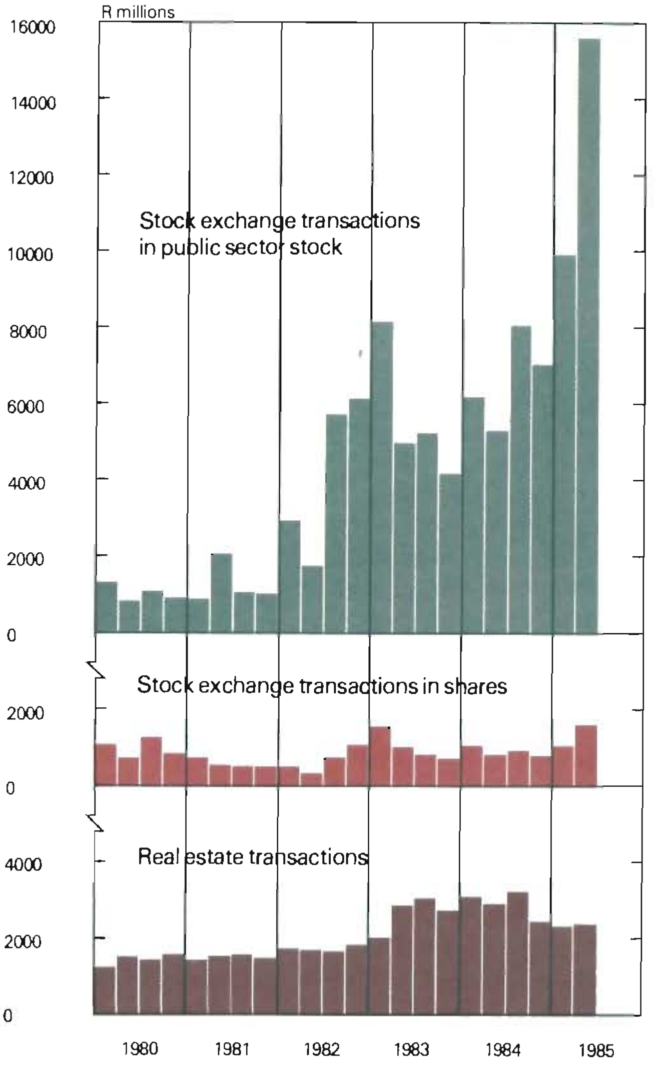
In the face of an increase in the general availability of funds, the decline in real economic activity from the second half of 1984 was accompanied by a considerable increase in financial activity. The further increase in the flow of funds to the financial sector was reflected, firstly, in the acceleration of the increase (over a twelve-month period) in the deposit liabilities of the banking sector from 14,8 per cent in June 1984 to 18,6 per cent in June 1985. Secondly, the corresponding increase in liabilities to the public of building societies, the Post Office Savings Bank, participation mortgage bond schemes and unit trusts amounted to 10,6 per cent in June 1985, a rate of increase that was roughly equal to that recorded over the twelve-month period to June 1984. Thirdly, the liabilities of insurers and private pension funds increased by an additional 21,8 per cent between the first quarter of 1984 and the first quarter of 1985, after they had already risen by as much as 23,2 per cent over the preceding four-quarter period.

Illustrating the increased financial activity from the second half of 1984, the value of public-sector stock traded on the stock exchange increased from R20,9 billion during the twelve months to June 1984 to R40,5 billion, during the subsequent twelve-month period. Likewise, the value of shares traded on the stock exchange rose from R3,5 billion during the twelve-month period to June 1984 to R4,4 billion during the twelve months to the middle of 1985. In the fixed property market, the value of real estate transactions in the two

Share prices



Security and real estate transactions



successive twelve-month periods amounted to R11,7 billion and R10,4 billion, respectively. The somewhat lower real estate transactions reflected the slackening of activity in the fixed property market from the fourth quarter of 1984.

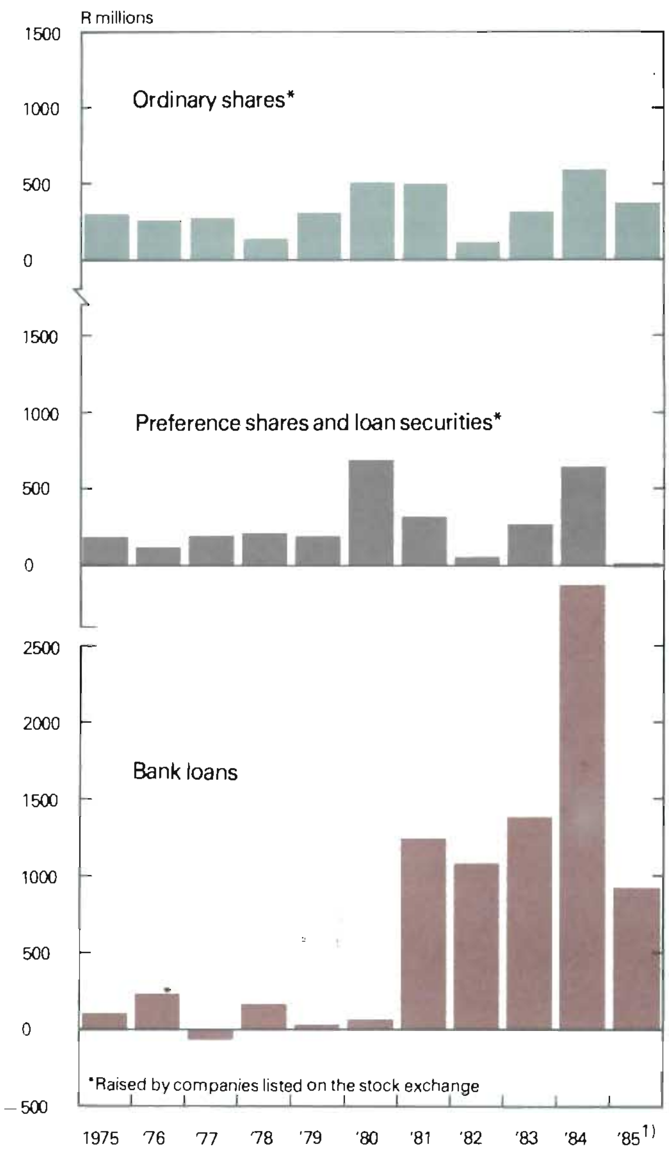
Part of the increased share turnover during the twelve months to June 1985 was related to transactions by non-residents in securities listed on the Johannesburg Stock Exchange. During the first ten months of this period net security purchases by foreigners amounted to R1 044 million. Subsequently, during May and June, net security sales totalled R261 million. Total net purchases of R783 million during the twelve-month period as a whole compared with net sales of R50 million during the twelve months to June 1984. During July net security sales by non-residents increased largely because of changes in the political situation. The selling was concentrated in gold shares and was exacerbated by the disappointing performance of the US dollar price of gold in response to the weakening of the dollar exchange rate. During May and June gold share prices declined, on average, by 8,9 per cent, followed by an identical further decline during July.

In the primary markets the public sector raised new funds amounting to R4,4 billion, through new issues of fixed-interest securities to the banking sector as well as the non-bank private sector. A corresponding amount of R3,7 billion was raised during the preceding twelve-month period. New issues of fixed-interest securities by companies listed on the stock exchange during the two successive twelve-month periods to June 1984 and June 1985 amounted to R628 million and R95 million, repectively.

New capital raised in the share market by companies listed on the stock exchange amounted to R1 549 million and R476 million during the twelve months to June 1984 and the subsequent twelve months to June 1985, respectively. The decline in the amount of new capital raised, despite relatively favourable conditions on the stock exchange, was probably related to the decline in real fixed investment. Instead of increasing permanent share capital, companies preferred to increase their use of bank credit. Debt financing is, of course, encouraged by the tax system because firms are allowed to deduct nominal interest payments from taxable profits, thus effectively halving the cost of borrowed funds. Bank credit, including leasing finance, to companies increased by R2,6 billion during the twelve months to June 1985, compared with R1,7 billion during the preceding twelve months. Apart from employing bank credit as working capital, including the financing of higher inventory levels, credit was apparently also used during the currently prevailing recessionary conditions to supplement cash flows and to capitalise interest on previously existing credit.

In the mortgage market, an improved net inflow of funds to building societies and participation mortgage bond schemes allowed these institutions to step up their mortgage lending during the first half of 1985. Nevertheless, new mortgage loans granted by them declined from a total of R4,4 billion during the twelve months to June 1984 to R3,7 billion during the subsequent twelve months. Despite the recently improved availability of mortgage finance, the demand for mortgage loans remained subdued owing to an insufficient increase in personal disposable incomes to accommodate mortgage loan commitments inflated by the prevailing high mortgage rates.

Share capital and loans raised by companies



1) First half of year

Long-term interest rates

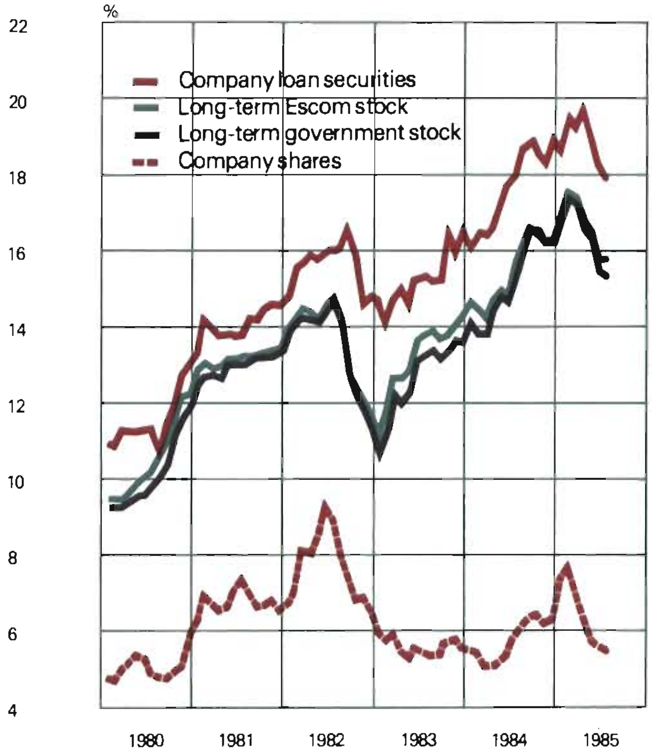
Long-term interest rates followed a course similar to that of short-term rates. After the further tightening of monetary policy in July and again in August 1984, long-term rates also started to increase faster. Like short-term rates, long-term interest rates eased temporarily towards the end of November and the first half of December, but resumed their upward movement from the second half of December to the end of February 1985. Subsequently, they moved downwards until early July, before showing a renewed rise during the remainder of the month. On balance, however, a decline was still recorded during the month as a whole.

In terms of monthly averages, the yield on long-term government stock increased from 14,7 per cent in June 1984 to a peak of 17,4 per cent in February 1985. Thereafter, it declined to 15,5 per cent in June and to 15,3 per cent in July. The average dividend yield on all classes of shares increased from 5,3 per cent in June 1984 to 7,7 per cent in February 1985, but declined to 5,6 per cent in June and to 5,4 per cent in July. These dividend yield changes mirrored broad movements in share prices. From June 1984 to February 1985 share prices declined, on average, by 11,7 per cent. Subsequently, they rose by 19,4 per cent to June, before declining again by 0,6 per cent in July.

The building societies' maximum home mortgage rate increased from 19,0 per cent in June 1984 to 21,5 per cent in April 1985. This rate did not follow the decline in other long-term yields and interest rates, except that two building societies which had quoted higher rates on new mortgage loans of more than R60 000, brought their rates in line with those of the other societies by reducing them to 22,0 per cent in May and 21,5 per cent in June. Participation mortgage bond schemes revised their mortgage rates from 19,3 per cent in June 1984 to 23,6 per cent in January 1985. In line with the general decline in interest rates, this rate was reduced to 20,0 per cent in June.

The movement of long-term deposit rates is illustrated by the changes in the twelve-month deposit rate of banks and building societies. The predominant rate on these deposits, which had been raised in steps from 16,5 per cent in July 1984 to 20,5 per cent in March 1985, was reduced in stages to 16,0 per cent in June and 15,0 per cent in July.

Capital market yields



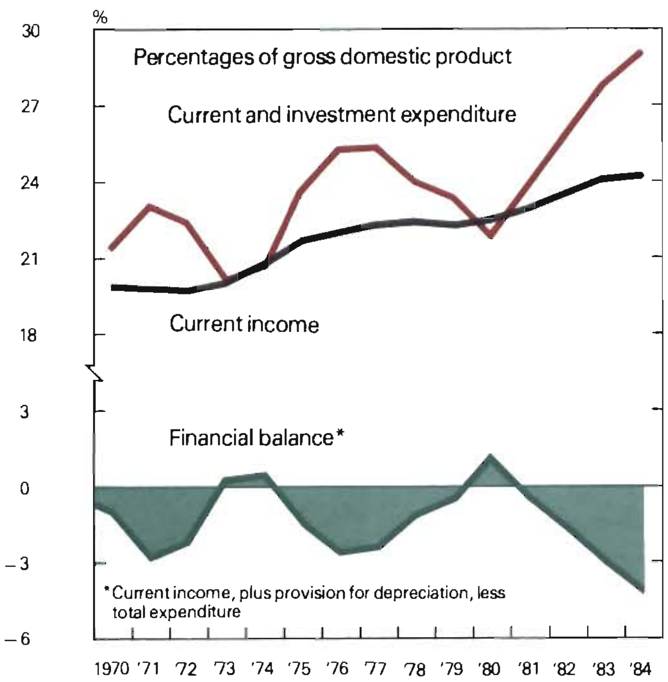
Government finance

Longer-term trends in general government expenditure and income

General government consumption expenditure was one of the major driving forces behind the short-lived economic upswing from about the second quarter of 1983 to the middle of 1984. As discussed earlier, the unsustainability of this essentially consumption-based upswing necessitated not only short-term adjustments so that imbalances in the economy could be unwound, but also emphasised the need for structural adjustments, aimed at creating an environment conducive to sustainable economic growth in the longer term. Key elements in the short-term adjustment, as well as in the longer-term structural adjustment, are government expenditure restraint and the avoidance of borrowing for the purpose of financing current spending. Structural adjustment requires the retrenchment of the overall role of government in the economy, which implies, in addition, the reduction of taxes in relative terms and a borrowing requirement that is sufficiently small to prevent the "crowding out" of private-sector borrowers.

Against this background the longer-term evolution of general government expenditure, income and financial balance may be examined. The accompanying table shows that from 1983 to the middle of 1985 the ratio of *total* general government expenditure to nominal gross domestic product reached levels significantly higher than in the preceding seven years. The corresponding ratio of *current* expenditure by general government in-

General government expenditure, income and financial balance



General government expenditure and income
Ratios to nominal gross domestic product at market prices
%

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985[1]
Consumption expenditure	14,8	15,1	14,3	13,8	13,4	14,6	15,7	15,9	17,2	18,2
Current transfers	4,1	4,1	4,1	3,8	3,4	3,4	4,1	5,1	5,2	5,7
Interest on public debt	1,6	1,8	2,0	2,2	1,9	2,4	2,9	3,7	3,8	4,3
Total current expenditure	20,5	21,0	20,4	19,8	18,6	20,5	22,7	24,7	26,2	28,2
Gross investment	4,6	4,2	3,6	3,5	3,1	3,2	2,9	2,9	2,7	2,7
Total expenditure	25,1	25,2	23,9	23,3	21,7	23,7	25,7	27,6	28,9	30,9
Direct taxes	12,6	12,3	11,7	11,6	12,2	11,9	11,9	12,7	12,2	13,6
Indirect taxes	7,6	8,2	8,7	8,6	7,8	8,6	9,9	9,6	10,2	10,5
Income from property	1,0	1,2	1,3	1,4	1,7	1,6	1,1	1,2	1,2	0,9
Total current income	21,8	22,3	22,3	22,2	22,4	22,8	23,4	24,1	24,1	25,4
Saving	1,3	1,3	1,9	2,4	3,8	2,3	0,7	−0,6	−2,1	−2,8
Financial balance[2]	−2,8	−2,3	−1,1	−0,6	1,2	−0,3	−1,6	−2,9	−4,2	−4,9

[1] First half.
[2] Surplus +, deficit −. Total current income, plus provision for depreciation, less total expenditure.

creased even more pronouncedly, implying a diminishing relative share of gross investment in overall expenditure.

A breakdown of current expenditure into broad categories shows appreciable increases, relative to gross domestic product, in consumption expenditure by general government as well as in current transfers and interest on public debt during the past three years. The steady increase in the relative importance of general government expenditure during recent years underscores the desirability of fiscal retrenchment.

Retrenchment on the expenditure side is a prerequisite for a reduction in general government's demands on productive resources, through either taxes or borrowing. As shown in the accompanying table, the ratio of the current income of general government to nominal gross domestic product moved to distinctly higher levels from 1983 onwards. The increase was, however, noticeably slower than the relative rise in both current and total expenditure, implying a deteriorating financial balance and greater reliance on borrowing as a means of supplementing current income. An increased tax ratio, i.e. the ratio of total taxes to nominal gross domestic product, largely accounted for the above-mentioned relative rise in current income. This was accompanied by an increase in the relative importance of indirect taxes. The direct tax ratio rose only moderately, but as will be discussed later on, significant shifts occurred during recent years in the structure of the income tax component of direct taxes.

As was pointed out in an earlier section of this review, the savings performance of general government deteriorated noticeably during recent years. From 1983 to the middle of 1985 current expenditure actually exceeded current revenue. This negative saving was reflected in a growing negative financial balance, which amounted to more than 4 per cent of gross domestic product in both 1984 and the first half of 1985.

Central government expenditure, revenue and debt creation

Trends in general government expenditure and income are largely determined by developments in the expenditure and revenue of the Central Government. In the latest full fiscal year, i.e. 1984/85, central government expenditure, as measured by adjusted Exchequer* issues to government departments, increased by 22,9 per cent, a rate of increase that was considerably higher than the original budget estimate. The additional expenditure was mainly in respect of interest payments on government debt, improved salary and wage scales for government employees, and further aid to the drought-stricken agricultural sector. The increase in 1984/85 raised the ratio of central government expenditure to nominal gross domestic product to 25,5 per cent, the highest figure

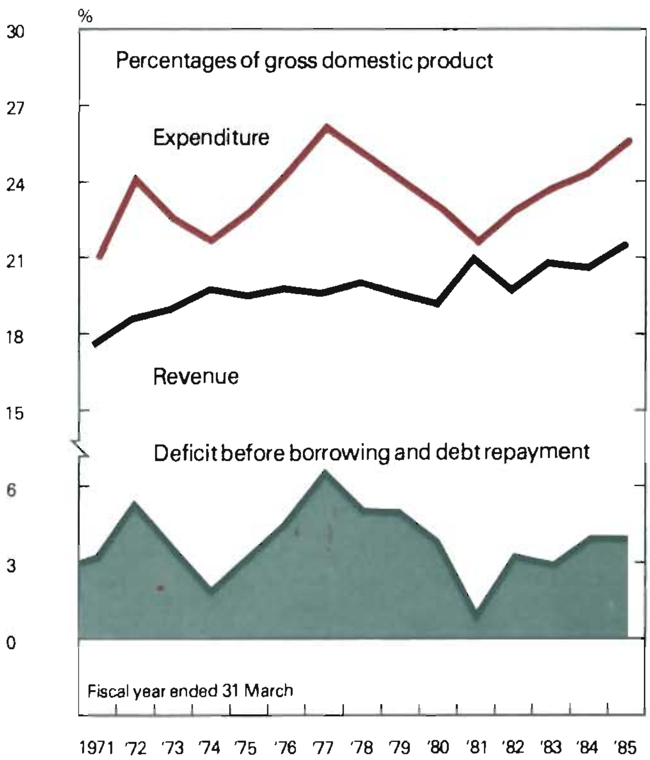
*The Exchequer Account is adjusted for changes in the balance on the Paymaster-General Account.

Composition of central government revenue
%

	Fiscal year ending 31 March 1980	1981	1982	1983	1984	1985
Receipts from gold-mines*	15	27	15	10	12	8
Income tax receipts from:						
Other mining companies	3	2	1	1	1	1
Non-mining companies	19	18	22	21	17	16
Individuals	20	16	22	25	30	31
Customs and excise duties	13	11	14	13	10	8
General sales tax	13	12	15	19	20	25
Other revenue	17	14	11	11	10	11
Total	100	100	100	100	100	100

*Income tax and lease payments by gold mines.

Central government expenditure, revenue and deficit



recorded since 1976/77. As in the case of total general government expenditure, the Central Government's expenditure ratios became conspicuously higher as from the 1982/83 fiscal year.

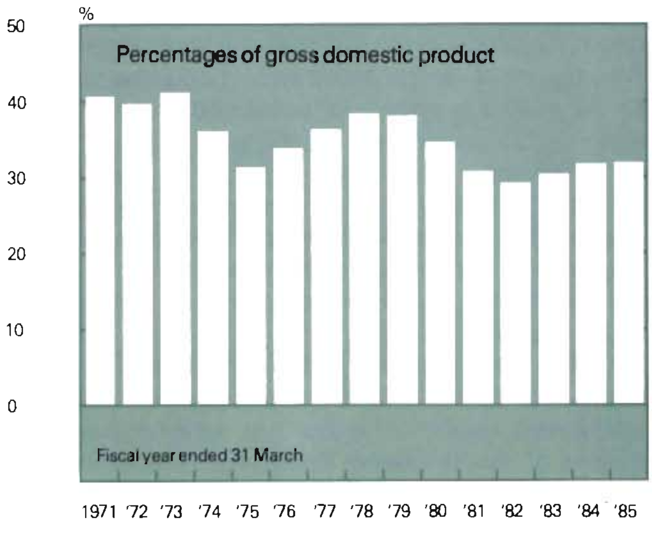
Central government revenue increased by 23,2 per cent in 1984/85, also a substantially higher rate of increase than the original budget estimate. The latter, however, did not provide for the post-budget increase in general sales tax that came into effect on 1 July 1984. As a ratio of nominal gross domestic product, revenue in 1984/85 amounted to 21,6 per cent. This ratio also moved to a slightly higher level during the past three fiscal years.

The difference between expenditure and revenue, representing the deficit before borrowing and debt repayment, amounted to R4 351 million (4,0 per cent of gross domestic product) in 1984/85. This ratio confirmed a continuation of the upward shift during the past four fiscal years. Borrowing from non-bank sources during 1984/85 exceeded the borrowing requirement by R1 126 million. This deliberate "overfunding" formed part of the operations of the monetary authorities aimed at better monetary control.

The borrowing operations of the Central Government raised the average level of government debt in 1984/85 to 31,9 per cent of gross domestic product. As shown in the accompanying graph, the decline in this ratio from its high levels during the latter part of the nineteen-seventies was reversed during the past three fiscal years.

By itself, an increase in the debt ratio has to be interpreted with caution, because debt ratios are affected by differing rates of growth in gross domestic product. However, to the extent that savings of the private sector are channelled into government debt rather than productive investment, the growth of capital stock and hence the growth potential of the economy may be lowered. This will be the case whenever the increase in government debt is the counterpart of government consumption instead of government investment, or when government investment proves to be less productive than private investment. In addition to these potential disadvantages of a rising government debt ratio, interest payments on government debt compound very rapidly, so that the debt service burden imposes considerable upward pressure on government spending.

Central government debt



Structural shift in composition of tax burden

Reference has already been made to the increase in the overall tax burden and in the relative importance of indirect taxes. Compositional changes in the tax burden may be examined further with reference to the revenue of the Central Government. Within the income tax category, the relative importance of personal income tax increased notably during the past three fiscal years. On average, this form of income tax amounted to 23 per cent of total central government revenue during the seven fiscal years to 1981/82, but it increased subsequently to a peak of 31 per cent in 1984/85. On the other hand, the ratio of company income tax to total revenue declined from an average of 37 per cent during the seven-year period 1975/76-1981/82 to 25 per cent in 1984/85. The latter decline was mainly attributable to relatively smaller income tax receipts from gold mining as well as non-mining companies.

The main reasons for the increased burden of income tax on individuals were, firstly, the rapid inflation-related growth in nominal salaries and wages and, secondly, the effect of "fiscal drag" stemming from the movement of taxpayers into higher income tax brackets that were not adjusted to inflation. For example, a weighted average marginal tax rate of 19 per cent applied to individual taxpayers in the 1980/81 tax year, but by the 1984/85 tax year this rate had risen to approximately 29 per cent. Income tax receipts from gold mining companies were lower, despite a higher average rand price of gold, because of larger capital expenditure deductions from taxable incomes and the restructuring, in the form of mergers and joint ventures, of company operations. The dwindling contribution of income tax receipts from non-mining companies to total revenue, in turn, reflected the effect of tax concessions and incentives to companies. From the 1984/85 fiscal year, however, the Government started with the phasing out of some of these concessions in order to raise the effective rate of company tax.

The shift, in relative terms, of the direct tax burden towards individual taxpayers during recent years was accentuated by a growing indirect tax burden. These taxpayers are liable for about 60 per cent of general sales tax payments, but their relative liability in respect of other indirect tax cannot readily be quantified. Nevertheless, considering only income tax and general sales tax, individual taxpayers' contribution to total government revenue increased from about 31 per cent to 46 per cent over the last three fiscal years.

The 1985/86 Budget of the Central Government

As is customary, the 1985 Budget Speech of the Minister of Finance contained major policy pronouncements. These were addressed to the achievement of, firstly, short-term adjustments in the economy and secondly, longer-term adjustments of a more structural nature.

In outlining short-term policy priorities, the Minister stated that priority still had to be accorded to counteracting inflation and strengthening the balance of payments, the exchange rate and net foreign reserves. The Government continued to attach great importance to the objectives of growth and employment, but the best way to achieve these aims in the longer term would be first to curb inflation and strengthen the balance of payments.

In terms of these priorities, the intended short-term economic strategy would operate in the following way: Firstly, the process of reducing total public and private sector spending in real terms, which had begun after the middle of 1984, would be continued. Secondly, the surplus which had already been achieved on the balance of payments on current account would have to be maintained long enough to bring about an appreciation of the rand and a meaningful rise in the net foreign reserves. Thirdly, the rate of inflation would have to decline as the pressures of excess demand diminish and the influence of the lower exchange rate of the rand is dissipated.

Only when these objectives had been achieved, would the stage be set for a new economic upswing and a period of high and sustainable economic growth, which remained the fundamental policy objective. This approach ruled out any artificial stimulation of the economy. Instead, in the opinion of the Minister, the economic situation called for an effective and not a notional continuation of the economic strategy of curbing the expansion of total spending in the economy by means of monetary and fiscal policies. In this regard, there was an essential need to add more fiscal policy to the overall policy "mix". Notwithstanding the intended restrictive policy stance, the unduly expansionary effect of fiscal policy in the preceding two fiscal years had caused monetary policy to bear too great a share of the burden of stabilisation. More effective monetary policies would have been attainable if fiscal policy had been less expansionary.

For fiscal policy to play its full and fair part in overall strategy in the year ahead, the Budget had to meet three basic conditions. Firstly, there had to be no increase in real terms in total government expenditure in 1985/86, compared with 1984/85. Secondly, current expenditure could not again be financed, as had happened during the preceding two years, with borrowed funds. Thirdly, the budgetary deficit before borrowing had to be kept below 3 per cent of gross domestic product to ensure that it would be financed without either significant resort to bank credit or contributing to any upward pressure on interest rates.

In accordance with these objectives and conditions, government expenditure was designed to increase by 11,4 per cent in 1985/86, compared with the estimated comparable expenditure in 1984/85. Expenditure estimates for 1985/86 incorporated a cut in staff-related costs of about R500 million. Assisted by a fairly wide range of direct as well as indirect tax increases, revenue was estimated to rise by 18,8 per cent in 1985/86. The deficit before borrowing for 1985/86 was estimated at R2 970 million, amounting to 2,5 per cent of the expected gross domestic product.

The Minister addressed himself also to longer-term policy goals, namely a high and sustainable rate of real economic growth and the creation of adequate employment opportunities – on the basis of reasonable price stability and a sound balance of payments. The strategy for achieving these goals would include a reversal of the rising trend of total public-sector spending in relation to gross domestic product; the maintenance, barring highly unusual circumstances, of the government sector's deficit before borrowing to not more than 3 per cent of gross domestic product; a reform of the tax system in order to strengthen fiscal incentives and enhance productive effort as well as productivity, saving, investment, risk-taking and innovation; and further fiscal retrenchment through privatisation and deregulation.

Developments in the first quarter of the 1985/86 fiscal year

In view of the substantial expenditure overruns during the 1983/84 and 1984/85 fiscal years, the Government committed itself to an improved monitoring of expenditure in the course of the 1985/86 and future fiscal years. The purpose of the monitoring system would be to create an early-warning system for possible overspending, so as to enable government departments to take timeous corrective and compensatory steps, or for the Government to consider the priority and other implications of unavoidable, but justified, additional expenditure. Such a monitoring system would, however, take into account the normal seasonal pattern of expenditure in the course of the fiscal year.

During the first quarter of the current fiscal year, i.e. the second quarter of 1985, Exchequer issues (as adjusted) were 18 per cent higher than in the corresponding quarter of the preceding fiscal year. The amount of these issues represented 26 per cent of the estimated total expenditure in 1985/86. In terms of seasonal patterns, this percentage was roughly in line with the average proportion of expenditure in the first quarters of the preceding three fiscal years. Expenditure so far in 1985/86 has, therefore, been on target, despite higher payments of interest on government debt and the distorting effect of the transfer of the increases in teachers' salaries from the preceding fiscal year.

Exchequer receipts increased by 33,0 per cent in the first quarter of 1985/86, compared with the corresponding quarter of 1984/85. Budget estimates provided for an increase of 18,8 per cent in the fiscal year as a whole. The sharp rise in receipts was partly due to the overflow of income tax payments by non-mining companies that were due in the preceding fiscal year and substantially higher general sales tax receipts associated with the increased tax rate of 12 per cent and a temporary upsurge in consumer expenditure before the new tax rate came into effect. Despite the considerable increase in receipts, the deficit before borrowing and debt repayment amounted to R2 558 million in the first quarter of 1985/86. The financing of this deficit meant that a substantial part of the Government's borrowing requirement in 1985/86 had already been satisfied by the end of June. Borrowing operations were facilitated by investors' expectations of a decline in interest rates, which created a receptive market for government stock.