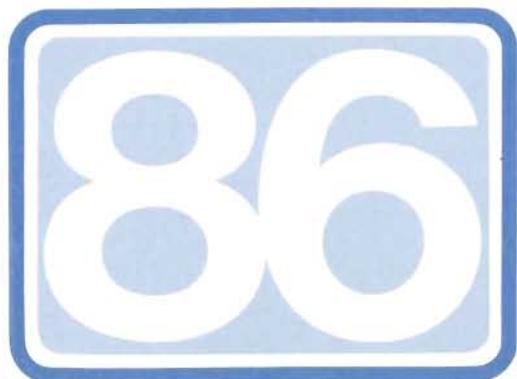


South African Reserve Bank

Annual Economic Report

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-sixth ordinary general meeting to be held on 26 August 1986



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Introduction

The 1985 *Annual Economic Report* mainly concerned itself with the major adjustments that had been made by the South African economy during the year to June 1985 in eliminating the excess demand that had been allowed to arise in the course of the mini-boom of 1983-1984. The *Report* noted, in effect, that by the second quarter of 1985 this adjustment process had substantially been completed: domestic demand no longer exerted undue pressure on available resources, considerable surpluses had been restored to the balance of payments on current account, and the exchange rate of the rand had shown a marked degree of stability during the first six months of the year. The *Report* also observed that, in the light of the appreciable cooling-down of the economy that had already been experienced, some room had been created for the restimulation of consumption and investment expenditure, and noted the initial monetary policy steps that had been taken in that direction. Although referring to the early consequences of the socio-political unrest, the *Report* was published before imposition of the "standstill" on certain foreign debt repayments and subsequent events.

This year's *Report* records that the marked downward movement of the economy that accompanied the adjustment process, did indeed come to an end in the second quarter of 1985. The encouraging recovery that commenced in the third quarter of 1985 and was confirmed in the fourth quarter, did not, however, build up sufficient self-sustaining momentum to continue smoothly through the first half of 1986. The recovery, in fact, faltered in the first quarter of 1986 before regaining some lost ground in the second quarter. Present indications nevertheless are that the South African economy has consolidated its earlier advances and is now in the process of moving on to somewhat higher levels of expenditure and output. Because of its earlier vacillations, however, the recovery is unlikely to result in growth of the real gross domestic product during the calendar year 1986 of more than 1½ to 2 per cent.

After four successive quarters of declines, real gross domestic *expenditure* revived significantly in the third quarter of 1985. It fell back in the fourth quarter, however, despite a continued moderate rise in real private consumer spending. The subsequent acceleration of the rate of increase in total real domestic expenditure in the first three months of calendar year 1986 was based essentially on a sharp rise in real government consumption expenditure in the final quarter of fiscal 1985/86, and on a marked decline in the rate at which real inventories were being drawn down in most sectors of the economy. Neither of these two forces, however, continued to exert a comparable stimulative effect in the second quarter of 1986. As a result of these various developments, the real

gross domestic *product* rose encouragingly in both the third and fourth quarters of 1985 but fell back in the first quarter of 1986 before recovering marginally in the second quarter.

A disturbing feature of expenditure trends in the year to mid-1986 was the behaviour of real gross fixed capital formation, which continued on the downward course on which it had found itself since the first quarter of 1982. Largely as a result of this generally poor investment performance and of continued paring of inventories, the volume of imports uncharacteristically was approximately 13½ per cent lower in the four quarters of the current recovery to mid-1986 than in the four quarters of the preceding recessionary period to mid-1985.

This tendency towards lower real import levels was reinforced by the effect of the declining exchange value of the rand on relative import prices. Aided by relatively stable prices of import goods in foreign currencies, and accompanied by a sustained strong South African export performance, this decline in import volumes resulted in continuing large surpluses on the balance of payments on current account. Barring any strongly adverse future developments, the current account surplus for the calendar year 1986 may plausibly be expected to be of the order of R5 billion to 6 billion.

On the capital account of the balance of payments, the near-equilibrium between long and short-term capital movements that had arisen in the second quarter of 1985 was upset by unexpected new developments after the middle of the year. The declaration of a state of emergency on 20 July 1985, in a general environment of increased social tensions and civil unrest, contributed to a marked deterioration of foreign perceptions of South Africa's socio-political stability and of the outlook for its economy. The resultant large net outflow of foreign capital and intensified downward pressure on the exchange rate began to assume critical proportions when, towards the end of July 1985, certain foreign banking institutions made known their intention of not renewing credit facilities they had previously made available to South African banks.

The "standstill" on certain foreign debt repayments and associated measures of exchange control that were put into effect from 2 September 1985, and the minor adjustments to operating procedures in the foreign exchange market that were introduced on 6 December 1985, did not succeed in stemming the net outflow of foreign capital. In a general climate of strongly negative overseas sentiment towards South Africa and of unfavourable exchange rate expectations, downward pressure on the exchange rate was experienced during most of the second half of 1985, and intermittently in the first half of 1986. This pressure bore little relationship to the strength of South Africa's international trading position and the realities of its economy.

In the general absence of continuing domestic demand-inflationary pressures, the behaviour of the exchange rate, in turn, assumed a pivotal position in determining the inflation rate. Slack conditions in the South African labour market played a part in preventing the prevailing inflation rate from being passed on fully in wage settlements. The resultant decline in average real wages and salaries, and in total real labour remuneration, was an important element in accounting for the lack of sustained buoyancy in real private consumer expenditure. This and other developments, including an increased reluctance on the part of private households and business enterprises to enter into long-term spending commitments, contributed to a situation by mid-1986 in which the South African economy had not yet begun to exploit the usual, mutually reinforcing, effects of a cyclical revival of real consumer demand on investment, and of investment on output, employment and real consumer demand.

Declines in the net gold and other foreign reserves of the banking system, and relatively slow growth in domestic bank credit, provided explanations, in accounting terms, for a continuation of the decline in the rate of growth in the money supply that had commenced at the beginning of 1985. In the second quarter of 1986, the rate of increase in the newly defined "broad" money supply, M3, was well below the lower limit of the target range for the rate of growth in this monetary aggregate that had been adopted by the monetary authorities on the introduction of monetary targeting in March 1986.

Viewed in conjunction with the general absence of domestic excess monetary demand, the prevailing lack of vigour in the economy, and the strong position of the balance of payments on current account, these developments justified further adjustments in the stance of both monetary and fiscal policy. As noted earlier, some preliminary steps in relaxing the stance of monetary policy had already been taken in May 1985. Further such steps were applied during the remainder of 1985 and the first eight months of 1986. In the process of easing its discount and related policies, the Reserve Bank reduced its Bank rate (i.e. its rate for rediscounting Treasury bills for the discount houses) on no fewer than eleven occasions from 6 May 1985 to 5 August 1986, thereby lowering this rate from 21,75 to 10,50 per cent. Other short-term interest rates were adjusted, or declined, commensurately. The commercial banks, for example, reduced their prime overdraft rate from its historically high level of 25 per cent in early May 1985 to 14 per cent from late-August 1986.

In the realm of fiscal policy, the Central Government's Budget of March 1985 still accorded priority to counteracting inflation and to strengthening the balance of payments, the exchange rate and the net foreign reserves. Subsequent adjustments in the Government's spending policies, however, sought to establish a shift towards encouragement of consumption and investment expenditure. In accordance with this approach, the Minister of Finance in September 1985 announced a package of "moderately, but responsibly" stimulating measures. The

Central Government's Budget for fiscal 1986/87 similarly was intended to be "moderately expansionary", while an additional stimulatory package was announced by the Minister of Finance on 17 June 1986.

The capital markets, under the influence of the general easing of the financial environment as brought about and represented by the decline in interest rates, witnessed considerably increased turnovers in gilt and semi-gilt-edged securities, a continuation of the accelerated rise in share prices, further substantial increases in the availability of funds to financial institutions, and a rise in the amount of new funds raised in the primary market by the private sector.

By August 1986, the "real" as distinct from the financial side of the South African economy still remained subdued by a lack of confidence and a pervasive sense of uncertainty about the future. This situation was exacerbated as the economy came to face a distinct possibility of an intensification of economic sanctions by some of its more important international trading partners. Few signs were as yet discernible of a more spirited revival in consumer demand.

A variety of conditions nevertheless had been created that eventually should prove conducive to a more vigorous upturn in aggregate private expenditure; in addition, the economy was well-positioned for meeting any such recovery in aggregate demand. Conditions favourable for an eventual return to more buoyant rates of growth in spending included the relaxed stance of monetary policy, relatively low interest rates (notably in real terms), and the authorities' manifest willingness to accept an acceleration of the rates of increase in bank credit and the money supply; the stimulative effect still to be exerted by the Government's somewhat more expansionary approach to its own spending policies, as incorporated *inter alia* in the March 1986 Budget and the package of supplementary measures as announced in June 1986; the rise in the market values of various consumer-owned assets, as brought about, among other things, by the lower level of interest rates; some reduction in the real burden of household debt; and the effect of the relatively low exchange rate of the rand in discouraging imports, encouraging exports, and raising the value in domestic currency of export proceeds. The supply capabilities of the economy were increased by the relatively low current levels of capacity utilisation and the enhanced employability of labour on account of the earlier downward drift of average real wages and labour remuneration generally. Historically low levels of commercial and industrial inventories, moreover, would ensure that a more vigorous resurgence in aggregate demand would be translated speedily into increased production activity, employment, output and economic growth.

Domestic economic developments

Slow and erratic recovery

The South African economy experienced a cyclical downswing from the middle of 1984 to the middle of 1985. The encouraging recovery that commenced in the third quarter of 1985 was interrupted in the first quarter of 1986. Preliminary estimates of the national accounts aggregates for the second quarter of 1986 nevertheless suggest that the balance of forces acting on the economy remained in favour of modestly positive growth for 1986 as a whole. Current indications are that the South African economy is still in the process of recovering, albeit slowly and erratically, from the 1984/85 recession.

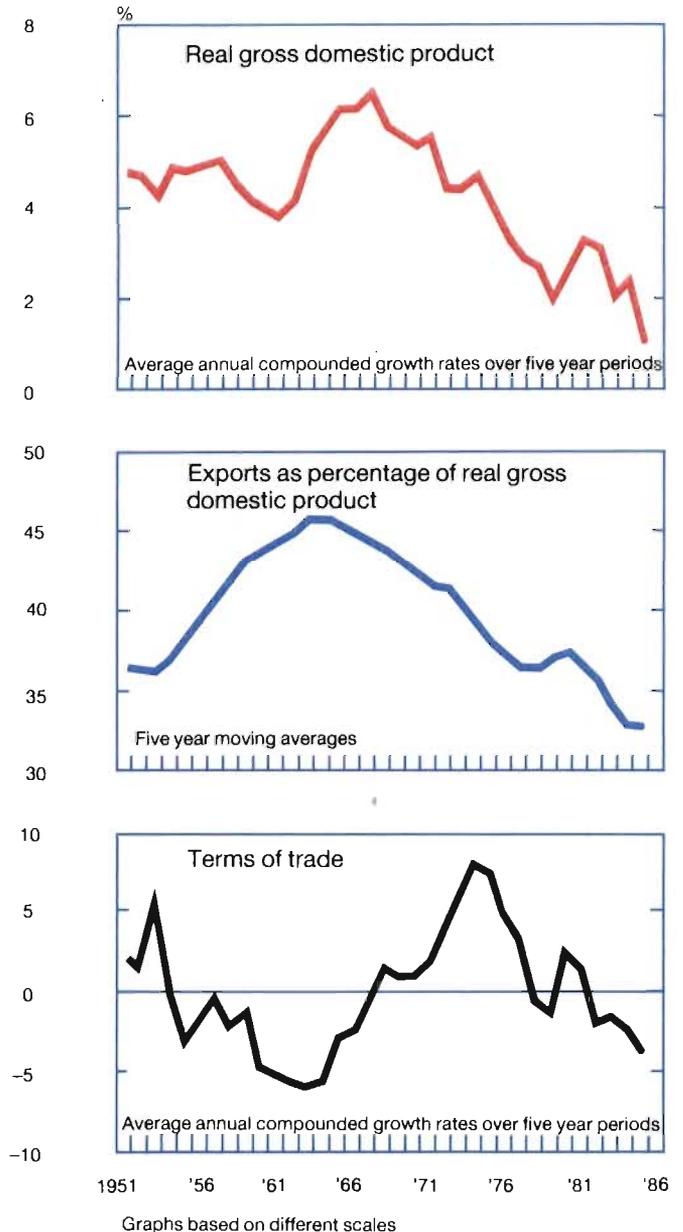
Background to the 1984/85 downswing and current recovery

The relative severity of the 1984/85 recession could be attributed to a concurrence of several long-run and short-run growth-depressing developments. Since the mid-1970s, cyclical forces of expansion and contraction in the South African economy have been superimposed on a fundamentally weaker longer-term growth trend. Evidence of a long-run decline in the real rate of expansion of the South African economy is provided by the averages of the annual rates of growth in the real gross domestic product over successive (or overlapping) multi-year periods. Such averages amounted, for example, to 4,9 per cent for the years from 1946 to 1974 and to 4,1 per cent for the entire post-war era, but to only 2,0 per cent for the years from 1974 to 1985.

As suggested by the accompanying graph, major causes of this long-run decline in the real rate of growth almost certainly are to be found in the decline in relative export volumes (i.e. in a weakening of the "pull" of rising exports as an incentive to the expansion of productive capacity), and in the deterioration of the terms of trade (as a prime determinant of real spending power and of the total availability of goods and services out of which further real investments are to be made). From approximately 1975, both of these developments have generally tended to affect the South African real economic growth rate adversely. Both can, in turn, be traced to a relative decline in the world demand for primary commodities (including gold, diamonds and platinum) that traditionally have made up the bulk of South African exports but, since the 1960s and 1970s, have decreased in relative importance as production inputs and inflation hedges in the international economy.

From the point of view of the business cycle, the effect of the downward drift of the long-run growth trend has been to decrease the strength and duration of cyclical upswings and to increase the depth and duration of cyclical downswings. The downswing of 1984/85 also was exposed to this effect.

Change in exports and the terms of trade and gross domestic product growth



In addition to these structural forces, the 1984/85 downswing bore the imprint of the pattern of earlier monetary and fiscal demand management. The domestic overspending that had built up in the course of the 1983/84 mini-boom was slow to respond, at first, to the tightening of the monetary authorities' policies from the second quarter of 1983. This was partly a matter of the usual lags in the effect of monetary policy measures. Partly, it was also a matter of an initial lack of co-ordination and unity of purpose of monetary and fiscal policy. By the third quarter of 1984, the attendant effects of sustained domestic over-expenditure (such as the high and rising inflation rate, current account deficits, severe downward pressure on the exchange rate, and substantial declines in the net gold and other foreign reserves) left little option but to adopt notably more stringent policies. Monetary policy therefore was tightened decisively in July and August 1984, while the Central Government's Budget of March 1985 accorded priority to curbing inflation and to strengthening the exchange rate and the net foreign reserves. The commendable result of these measures was to cause the economy to adjust rapidly to spending levels more in keeping with its limited resources.

The 1984/85 downswing, finally, took place in a period of important socio-political reform initiatives that were accompanied by an increase in social tensions, political unrest and an enhanced sense of uncertainty about the future. The present, rather hesitant, economic recovery has had to establish a foothold in this generally inpropitious socio-political and psychological environment. In doing so, it has had the support of export volumes that have generally been rising since the end of 1983, of an increasingly favourable balance of payments on current account since late-1984, and of a rapid easing of monetary policy from the second quarter of 1985. Both the domestic lack of confidence and foreigners' strongly negative percep-

tions of South Africa's political stability and economic prospects have, however, had pervasive effects on developments as described in virtually every section of this *Report*.

Trends in output

Real gross domestic product, which declined at a seasonally adjusted average annual rate of approximately 3½ per cent in the first half of 1985 but at a rate of as much as 7 per cent during the final stages of the 1984/85 downswing in the second quarter of 1985, advanced encouragingly at an average annual rate of approximately 2½ per cent in the third and fourth quarters of 1985. After falling back in the first quarter of 1986, the volume of gross domestic output is provisionally estimated to have shown modest positive growth (at an annual rate of approximately 1½ per cent) in the second quarter of 1986.

During the four most recent quarters to the middle of 1986 the rate of increase in real gross domestic product amounted to approximately 1 per cent. This limited positive growth rate was insufficient, however, to make up for the decline in the level of real output that had been sustained during the preceding business contraction. As a result, real gross domestic product in the second quarter of 1986 was still significantly below its level in the second quarter of 1984.

Increases in output as measured by real value added were experienced by virtually all major sectors of the economy during the four quarters to the second quarter of 1986. This development stood in marked contrast to conditions during the preceding contractionary stages of the business cycle, when only agriculture and the financial services sectors still succeeded in recording production gains. A notable exception to the general pattern of improved output performances during the current recovery

Changes in levels of real output (Annualised percentage changes in seasonally adjusted quarterly data)

Sectors	Phases of the business cycle		
	Upswing from second quarter of 1983 to second quar- ter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quar- ter of 1985 (four quarters)	Upswing from third quarter of 1985 to second quar- ter of 1986 (four quarters)
Agriculture, forestry and fishing	-1	18½	6
Mining and quarrying	2	-2½	2
Secondary industry	5½	-6	-
Trade, catering and accommodation	14½	-8½	-5½
Transport and communication	10	-2	½
Financial services	4	1½	2
General government	5	-1½	3½
Gross domestic product at market prices	5½	-3	1
Gross national product	5	-2½	1

was the decline in real value added by commerce, which dropped by 5½ per cent between the second quarter of 1985 and the second quarter of 1986, largely because of marked weakness in private consumer demand.

A traditional feature of the South African economy has been the slow response of gross domestic product to historically observed changes in the terms of trade. To the extent that such changes are occasioned by a rise in the dollar price of gold, the reaction of the domestic economy in changing its level of physical output may actually be perverse; this arises from the gold mining industry's well-known propensity to shift to the mining of lower-grade ore in response to a higher gold price. In contrast, an improvement in the terms of trade will, other things remaining equal, raise real gross national product simultaneously.

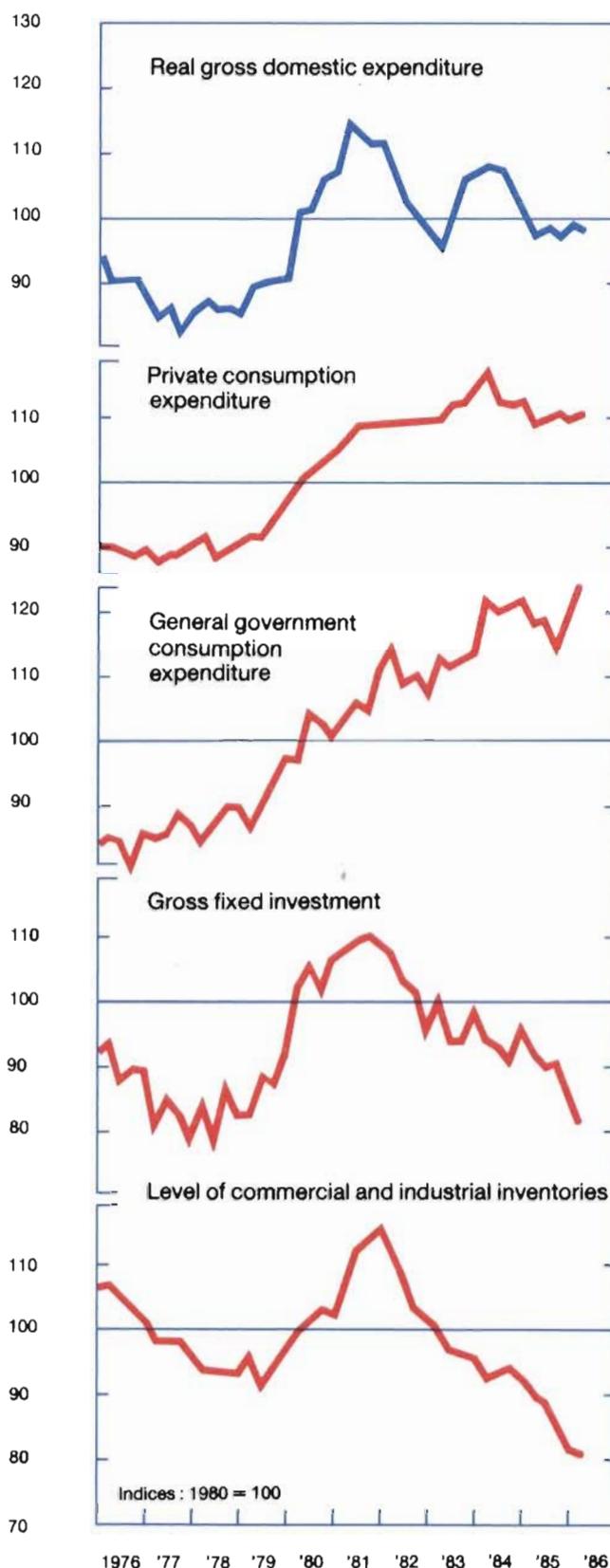
Primarily because of changes in the terms of trade (as based on a general improvement in international commodity prices), real gross national product rose at a seasonally adjusted annual rate of as much as 6½ per cent during the second half of 1985. It fell back, however, at a rate of 5 per cent during the first half of 1986, leaving an increase of approximately one per cent during the current recovery to the second quarter of 1986 as compared with a decline of 2½ per cent during the preceding contraction. By the middle of 1986 the real gross national product was, therefore, also still significantly below the level that had been attained in the second quarter of 1984.

Trends in domestic demand

The effect of the monetary authorities' policy of curtailing excessive domestic monetary demand during 1983-84 was strongly evident in a decline of as much as 10½ per cent in real gross domestic expenditure from the second quarter of 1984 to the second quarter of 1985. During the ensuing four-quarter period, the marked easing of the authorities' policies from the second quarter of 1985, achieved some initial success by reversing this decline and bringing about a slight increase in real domestic aggregate demand of approximately 1 per cent. In assessing this result, the extent of the "swing" from a strongly negative rate of change in the preceding recessionary period to the slightly positive rate of change in the current recovery, is to be noted. Also to be kept in mind are the usual lags in the effect of policy changes and the generally poor climate of business and consumer sentiment in which the restimulation of domestic spending had to be effected.

The marginal increase in domestic expenditure over the four-quarter period concerned was accompanied by a further decline in the volume of imports of as much as 4 per cent. This development was related to the continuing decline in gross domestic fixed investment, a further running-down of inventories, and shifts in favour of the domestic *vis-à-vis* the foreign prices of goods (when expressed in domestic currency), on account of the lower exchange value of the rand.

Real gross domestic expenditure and its components



Changes in levels of real aggregate demand

(Annualised percentage changes in seasonally adjusted quarterly data)

	Phases of the business cycle		
	Upswing from second quarter of 1983 to second quar- ter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quar- ter of 1985 (four quarters)	Upswing from third quarter of 1985 to second quar- ter of 1986 (four quarters)
Private consumption expenditure	5½	-7	1½
Consumption expenditure by general government	11	-3½	5
Gross fixed investment	-1	-2½	-11½
Gross domestic expenditure	9	-10½	1
Exports of goods and non-factor services	2½	13	-2
Imports of goods and non-factor services	16½	-12	-4
Gross domestic product	5½	-3	1

Private consumption expenditure

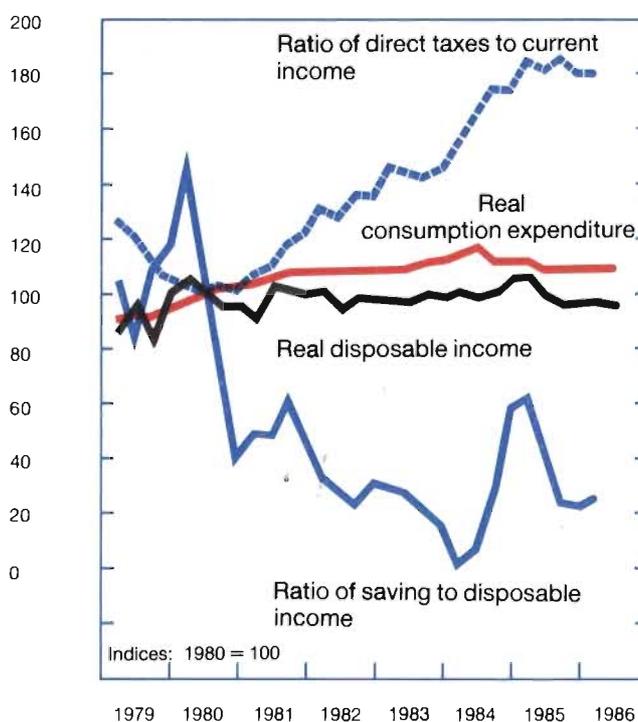
Real private consumption expenditure increased at an average annual rate of 4 per cent during the years from 1973 to 1981 but at an annual rate of only 1 per cent during the 4½ years to the second quarter of 1986. Much of this longer-term slowdown in the growth of consumer spending can be explained from the effect of inflation-induced increases in taxation on real disposable personal incomes ("fiscal drag"). Initial attempts at maintaining earlier consumption standards and spending patterns by a reduction of saving out of current income, borrowing, or drawing down asset holdings, eventually were abandoned in the light of the rising interest costs of consumer credit in 1983 and 1984, less favourable employment opportunities as the 1984/85 downswing began to take hold, and diminishing prospects for rapid real income improvements. Real consumer expenditure was reduced by 7 per cent from the second quarter of 1984 to the second quarter of 1985, while personal saving in relation to personal disposable income rose from -3 to 5 per cent.

From the beginning of the current economic recovery to the second quarter of 1986, private consumption expenditure increased by approximately 1½ per cent. This renewed modest rise in consumer spending was not supported by an increase in real disposable income and was, therefore, again accompanied by a decline in the personal savings ratio. In the conditions of the second half of 1985 and the first half of 1986, the decline in real personal disposable income did not represent "fiscal drag" but arose (understandably) from the failure of household incomes, more particularly labour remuneration, to keep pace with the prevailing inflation rate.

Lower interest rates, some reduction of the real burden of consumer debt entered into previously, and "wealth effects" arising from the perceived rise in stock market prices and in prices of other consumer-owned assets, may be advanced as reasons for explaining the increase in real consumption expenditure from the third quarter of 1985.

During the four quarters to the middle of 1986, real private consumption expenditure on durable goods recovered significantly, rising by 8 per cent. Real expenditure on non-durables increased marginally by ½ per cent, whereas real spending on semi-durables and consumer services remained essentially unchanged. The mild recovery in total real private consumer spending was not, however, spread evenly over the four quarters concerned. A fairly marked revival in real consumer spending

Tax burden, disposable income, consumption expenditure and saving of private households



in the second half of 1985 was followed by an abrupt downward adjustment in the first quarter of 1986, which, in turn, was somewhat more than fully reversed in the second quarter of the year. Outlays on durable goods, notably on new motor cars, accounted for much of this seemingly erratic consumer behaviour. The decline in real consumer spending in the first quarter of 1986 also was explained partly by the fact that early Easter holidays significantly reduced the number of trading days in March. In addition, a "bunching" of consumer goods purchases, notably of durables, had occurred in the fourth quarter of 1985, in anticipation of price increases that were expected to be announced in the new year on account of the depreciation of the rand.

Real consumption expenditure by general government

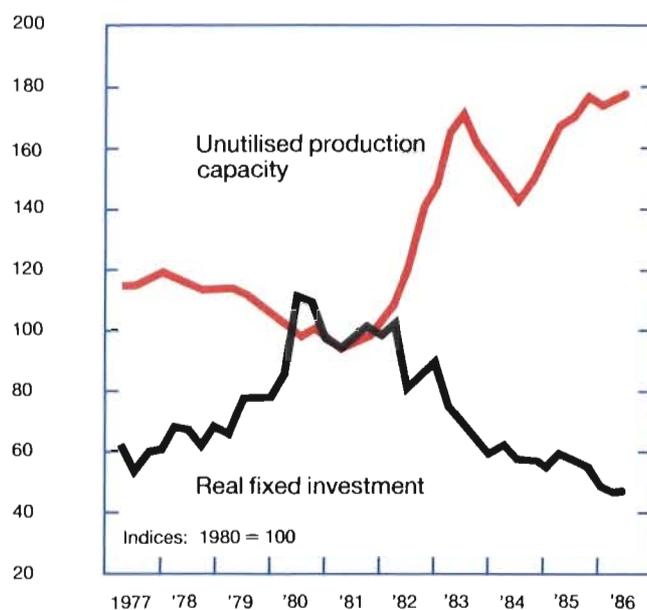
Increases in real consumption expenditure by general government have generally exceeded the growth in real gross domestic product since 1980, as is reflected in a rise in the ratio of real government expenditure to real gross domestic product from about 13½ per cent in 1980 to more than 15 per cent in 1985. Since early 1983, however, the volume of real government consumption expenditure also has tended to behave in a broadly contra-cyclical fashion. Having amounted to an average of 14½ per cent of real gross domestic product during the five quarters to mid-1984 that also covered the 1983-84 mini-boom, real government consumption spending rose to 15½ per cent of gross domestic product in the recession phase covering the second half of 1984 and the first half of 1985. This ratio then declined again to 14½ per cent in the early stages of the current recovery in the fourth quarter of 1985, but returned to 15½ per cent as the recovery lost momentum in the first half of 1986. This mildly stabilising effect broadly arose from changes in the rate of change in real government consumption expenditure tending to be in the opposite direction from changes in the rate of change in total real private sector expenditure during the period concerned.

At seasonally adjusted annual rates, the quarter-to-quarter changes in real government consumption expenditure during the four quarters of the present economic recovery amounted to 2 per cent, -14 per cent, 21 per cent and 15½ per cent, respectively. The relatively rapid rate of increase in the first quarter of 1986 reflected a bunching of expenditures, including additional appropriations, in the final quarter of fiscal 1985/86.

Real fixed investment

Real fixed capital formation in the South African economy, which had been declining since the first quarter of 1982, actually continued to do so at an accelerating pace during the current slow economic recovery from the middle of 1985 to the middle of 1986. The most disturbing aspect of this development has been the uninterrupted decline in capital formation in the manufacturing industry, which,

Real fixed investment and unutilised production capacity in manufacturing



among other things, was accounted for by generally low utilisation rates and low rates of return on invested capital funds. The accompanying graph shows the inverse relationship between real fixed investment in manufacturing and the degree of unused production capacity. Recent declines in the exchange value of the rand may, however, reasonably be expected to lead to a broader demand for locally manufactured goods, enhanced degrees of capacity utilisation, and eventually to higher rates of capital formation.

With the exception of general government, real fixed capital formation declined in all major sectors of the economy during the four-quarter period to the middle of 1986. Poor farming conditions and declining net farm incomes over the past several years, the rising local prices of farming equipment with a high import content, increasing farm debt, and the increasing cost of servicing this debt, caused the volume of gross fixed investment expenditure in agriculture to decline by a further 21½ per cent in the four quarters to mid-1986, after a decrease of 9 per cent in the four quarters to mid-1985.

In the private manufacturing sector, a decline in real fixed investment of 6½ per cent during the 1984/1985 recession was followed by a further decline of 7 per cent in the four quarters to the second quarter of 1986. This was accounted for partly by an earlier decrease in the degree of capacity utilisation from 87 per cent in the second quarter of 1984 to 84,4 per cent in the second quarter of 1985. As a result of these declines in new investment, the stock of productive assets in manufacturing actually shrank by 2 per cent during the four quarters to the middle of 1986, after having increased by a mar-

ginal 1/2 per cent during the four quarters of the preceding recession period.

Mining companies, capitalising on rising overseas demand for South African minerals and the decline in the exchange value of the rand, increased their capital spending by 13 per cent during the four quarters to the middle of 1985, but decreased such spending slightly by 1/2 per cent in the course of the current economic recovery. Households' real fixed investment in residential buildings declined further by 10 per cent during the current recovery, after having decreased by 17 per cent in the period from mid-1984 to mid-1985.

Public sector investment, which, until recently, had held up well in comparison with private sector investment, fell back sharply in the first half of 1986. Fully on account of cut-backs in capital spending by the South African Transport Services, fixed investment by government business enterprises in the transportation and communication sectors dropped by more than 17 per cent in the four quarters to the middle of 1986, after having shown an increase of 15 per cent in the four quarters to mid-1985. Real capital expenditure by general government departments increased, however, by 14 1/2 per cent during the current recovery, after having declined by 1 1/2 per cent during the preceding recession. A drastic revision of previous expansion programmes, notably by Escom, caused a slight increase in real fixed investment by public corporations of 1/2 per cent in 1984/85 to be converted into a sharp decline of no less than 28 per cent in the four quarters to the middle of 1986.

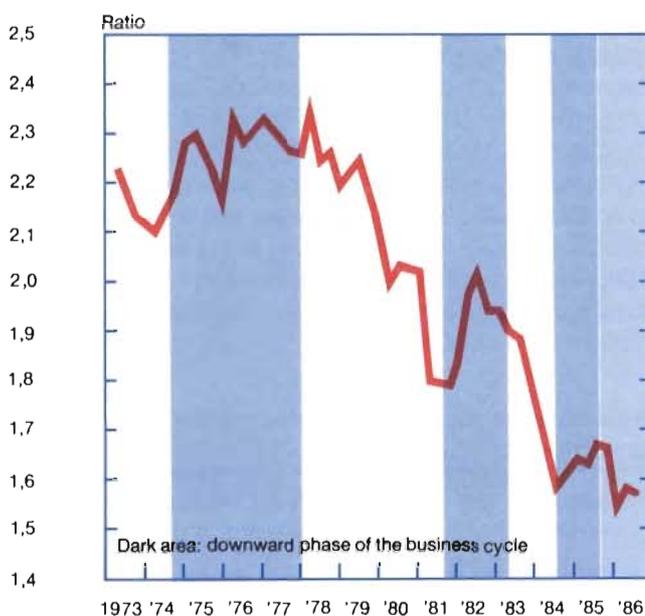
Change in real inventories

Inventories, in addition to being sensitive to high interest rates, tend to be depleted "intentionally" during the advanced stages of cyclical downswings and "unintentionally" (or "involuntarily") during the earlier stages of cyclical upswings. By the same token, they tend to be built up intentionally during the advanced stages of upswings and unintentionally during the earlier stages of downswings.

In apparent disregard of this principle, real commercial and industrial inventories declined in every quarter from the end of 1981, with the sole exceptions of the third and fourth quarters of 1984. After the end of 1984 inventories were again being drawn down until the fourth quarter of 1985. In the fourth quarter of 1985, the inventories-to-sales ratio of commercial and industrial stocks reached a historical low of 1,5.

Total real inventories still declined sharply in the third and fourth quarters of 1985, comprising the first two quarters of the current recovery. A considerably lower rate of depletion of real inventories was apparent, however, in the first half of 1986. This deceleration of the de-stocking rate accounted for an important part of the rise in real gross domestic expenditure during this period. Lower rates of inventory depletion were apparent in particular among commercial and industrial inventories, and among diamond and agricultural stocks in trade.

Ratio of commercial and industrial inventories to sales



Factor incomes

Changes in labour remuneration, measured over four-quarter periods, tended to exceed increases in the consumer price index during most of the years since 1976. The rate of increase in labour remuneration, however, fell well short of the inflation rate in the first quarter of 1985, and has continued to do so since then. In the second quarter of 1986 labour remuneration was about 11 per cent higher than in the second quarter of 1985, while consumer prices had increased by some 17 1/2 per cent during this period. The implied decline in *real* labour remuneration may be regarded as a direct consequence of slack conditions in the labour market since the beginning of 1985.

The gross operating surplus, constituting the other main component of aggregate factor income, displayed increases at rates well in excess of the rate of increase in labour remuneration from the beginning of 1985. Increases in business profits faster than those in wages are not unusual in times of improving business conditions, such as have been in evidence, to the observed limited degree, since the middle of 1985. The more recent developments were, however, unusual in that the increase in the share of the operating surplus in total factor income arose, in part, from the actual *decline* in total real wages. In a more "typical" cyclical upswing, the increase in the relative share of the operating surplus tends to be accompanied by a *rise* in total real wage remuneration, and therefore occurs in spite of it.

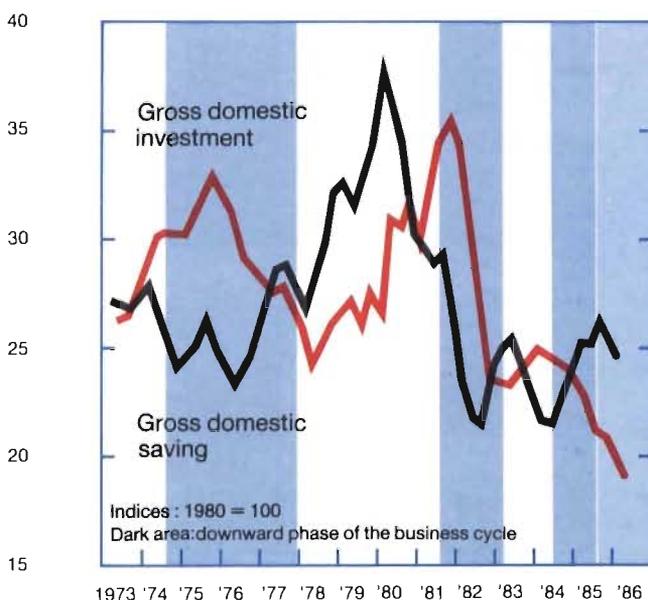
Measured over a four-quarter period, the rate of increase in the gross operating surplus accelerated significantly from 12 per cent in the second quarter of 1985 to 29 per cent in the fourth quarter, but fell back to 17 per cent in the second quarter of 1986. The subdued nature and lack of sustained vigour of the current economic recovery therefore also were clearly evident in the behaviour of the gross operating surplus.

The sluggishness of the present recovery was particularly noticeable in the trade sectors. Nominal gross operating surpluses in these sectors actually declined by about 1½ per cent between the second quarter of 1985 and the second quarter of 1986. Together with a slowing-down of the rate of increase in the operating surpluses of the mining industry, these declines were, however, somewhat more than fully offset by improved profit performances in manufacturing and transportation. The decline in the operating surplus of the trade sector, and moderation of the rate of increase in the operating surpluses of mining companies (showing the effect of the higher average exchange value of the rand in the first four months of 1986), also were important elements in explaining the renewed slowdown in the rate of increase in the total operating surplus from the fourth quarter of 1985 to the second quarter of 1986.

Domestic investment and savings ratios

The ratio of gross domestic investment to gross domestic product, both in nominal terms, declined from an average of 30 per cent in 1980-1982 to 24 per cent in 1983-1984.

Gross domestic investment and saving as ratios of gross domestic product



In the course of the current slow economic recovery, this ratio declined further from 23 per cent in the first half of 1985 to 19 per cent in the second half, and to less than 18 per cent in the first half of 1986. At this level, the ratio was well below its long-term trend. Its uncharacteristic decline during a cyclical upswing was an obvious reflection of the combination of declines in real gross domestic fixed investment and of the running-down of inventories that occurred during this period.

The gross domestic savings ratio had increased to 27½ per cent in the course of the 1984/85 business contraction but, true to its "normal" behaviour in cyclical upswings, began to decline with the onset of the current recovery. The value of this ratio in the second quarter of 1986 amounted to 22½ per cent, against 19½ per cent in the second quarter of 1984. The decline in the ratio over the last four quarters was due to decreases in the corporate and household savings ratios and a widening in the revenue shortfall of general government, which more than outweighed the increases in depreciation allowances. From the second quarter of 1985 to the second quarter of 1986 corporate and household savings as percentages of nominal gross domestic product declined from 9 per cent and 3 per cent to 5 per cent and 1½ per cent, respectively.

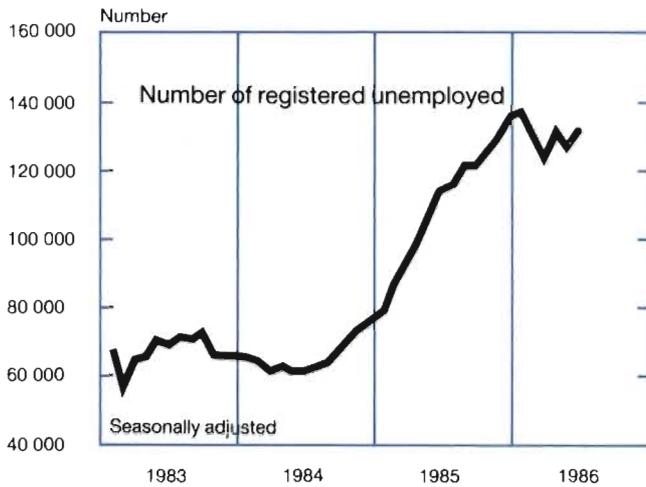
Employment*

The slight improvement in economic activity during the second half of 1985, followed by a fairly general decline in the volume of production in the economy during the first quarter of 1986, was also reflected in the demand for labour. Employment in the non-agricultural sectors of the economy increased moderately at seasonally adjusted annual rates of 0,8 per cent and 1,7 per cent in the third and fourth quarters of 1985, respectively, but then remained essentially unchanged in the first quarter of 1986. The modest quarterly increases during the second half of 1985 no more than made up for the decline in non-agricultural employment that had occurred during the second quarter of 1985; as a result, employment in the non-agricultural sectors in the first quarter of 1986 was at approximately the same level as in the first quarter of 1985.

Increases in employment in the second half of 1985 were recorded in the private sector as well as among public authorities. In the first quarter of 1986, however, modest further increases in employment by public authorities were accompanied by a decline in the employment level in the private sector. Within the private sector, increases in employment by the gold mining industry and private transport, in particular, were neutralised by decreases in employment in manufacturing, construction, non-gold mining, trade, and other industries. Further declines in employment in manufacturing, construction,

*Comprehensive employment and labour remuneration statistics are available only up to the first quarter of 1986.

Unemployment



electricity generation and the South African Transport Services were reported in respect of the second quarter.

Falling well short (at an annual rate of about 1 per cent) of the steady longer-term increase in the economically active population (amounting to an annual rate of some 2½ per cent), the relatively slow growth in employment during the three quarters to the end of March 1986 resulted in increased unemployment among all population groups. This was also evident from the rise in the seasonally adjusted number of registered unemployed from 79 700 in January 1985 to 137 700 in January 1986; this number subsequently declined, however, to 131 200 in June.

Since the middle of 1985, registration of unemployed workers may to some extent have been affected in certain parts of the country by social unrest. Special training and job creation programmes, as implemented by Government since 1985, also contributed materially, however, to the observed levelling-off in registered unemployment during the first half of 1986. By the end of March 1986, a total of approximately 253 000 people had already completed their training in terms of these programmes. In addition, some 300 000 people were employed at that time in various special projects, while a further 27 000 employment opportunities were estimated to have been created in the informal small business sector. The Central Government's Budget for 1986/87 provided for an amount of R235 million for the continuation of these programmes, and a further 86 000 people were reported to have completed their training in the course of the second quarter of 1986.

Labour remuneration

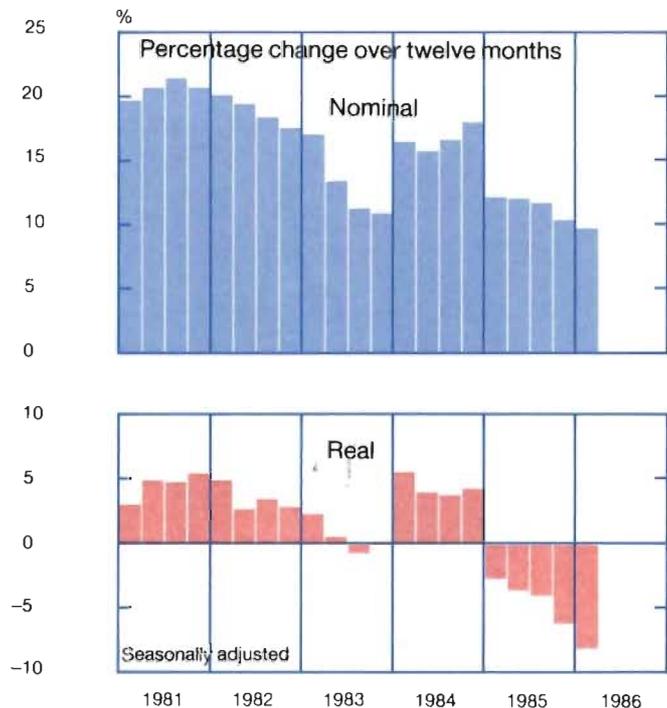
The easier labour market conditions that prevailed during 1985 and the first half of 1986 were characterised not only by an underutilisation of labour resources but also by relatively moderate wage settlements in various sections of the economy.

A marked moderation of wage settlements was apparent notwithstanding a sharp decline in the purchasing power of wage income. The rate of increase in salaries and wages per worker in nominal terms in the non-agricultural sectors of the economy slowed down from 16,6 per cent in 1984 to 11,3 per cent in 1985. Measured over a four-quarter period, this rate declined from 17,9 per cent in the fourth quarter of 1984 to as relatively little as 10,0 per cent in the first quarter of 1986.

In real terms, remuneration per employee rose by 4,4 per cent in 1984 but declined by 4,2 per cent in 1985. More strikingly, real remuneration per worker in the first quarter of 1986 was no less than 7,7 per cent below its level in the first quarter of 1985.

These developments clearly demonstrate that effective monetary and fiscal demand management policies can prevent wages and salaries from rising excessively and thereby prevent wage and salary increases from being an inflationary element in their own right. Indeed, the facts show the extent to which labour, even when increasingly well-organised or unionised, may be exposed to the ill-

Remuneration per employee in non-agricultural sectors



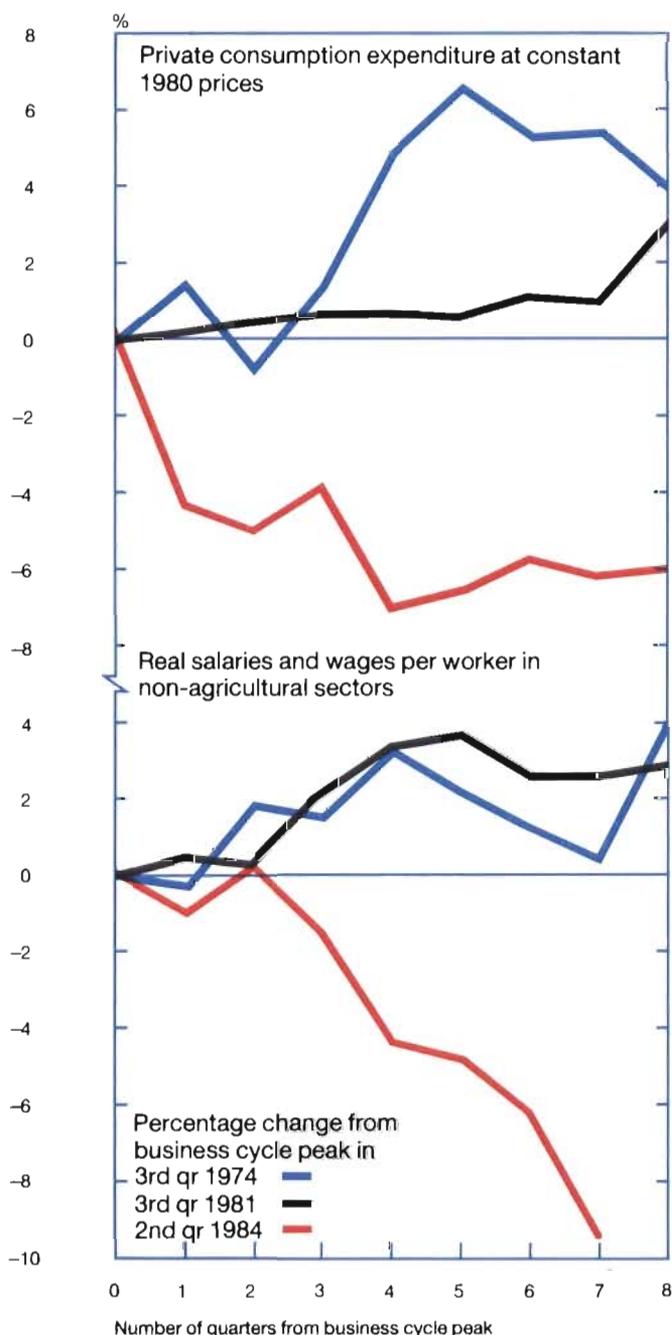
effects of price level increases caused by factors other than excessive aggregate monetary demand. (When inflation does result from excessive monetary demand, nominal wages may, of course, be expected to be "pulled up" by such demand along with, and broadly in line with, the effect of the demand-pull inflation on the prices of goods and non-labour services, and will, therefore, not necessarily result in any significant decline in average *real* wages.)

The 1985-1986 drop in average real wages also served to bring home both the extent and the wide-spread

nature of the decline in real living standards that accompanied the adjustment process which was forced upon the South African economy by adverse external developments during the past several years.

The decline in real wages, plus the effects of less favourable employment prospects, clearly was a factor of major significance in accounting for the decline in real private consumption expenditure from approximately the third quarter of 1984. As shown in the accompanying graph, the decrease in real wages per worker since the second quarter of 1984 was unusually severe in comparison with the movements in average real wages that occurred during the corresponding stages of earlier recessionary periods.

Recession phase comparisons

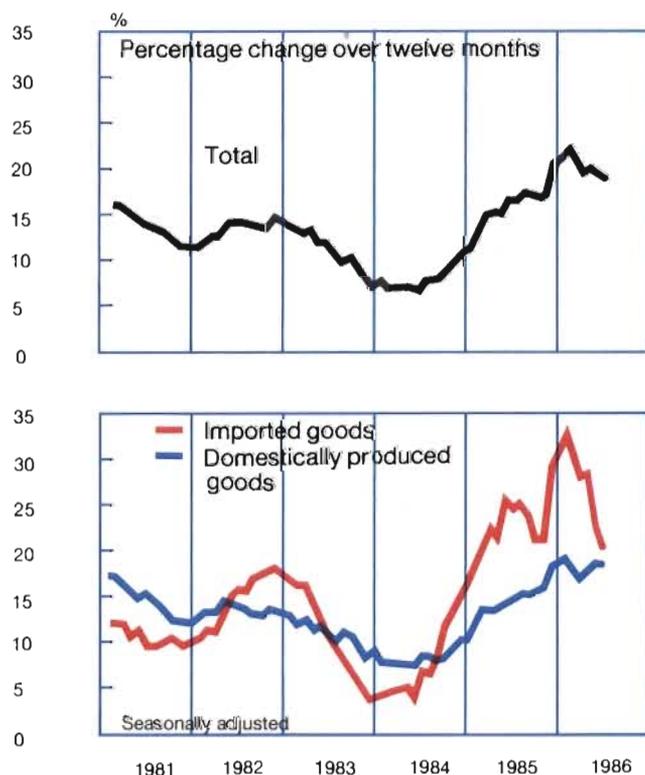


Prices

The inflation rate, as measured by changes in consumer and production price indices, accelerated in 1985 and into the first quarter of 1986, but slowed down in the second quarter of 1986.

Momentum in the rate of increase in the general price level built up in the course of 1984 mainly as a delayed effect of excessive domestic monetary demand in 1983/84 and as a result of the depreciation of the rand since late-1983. Depreciation of the rand from late-1983 to the

Production prices



first quarter of 1985 was influenced, among other things, by strong appreciation of the US dollar in terms of most other currencies during much of this period. It also followed, however, upon a ten-year period in which the South African inflation rate was well in excess of that of its principal international trading partners. For part of the period concerned, therefore, the decline in the exchange rate of the rand up to early 1985 also represented a downward adjustment in the exchange value of the currency towards levels more closely reflecting the decline in its relative purchasing power over a more extended number of years.

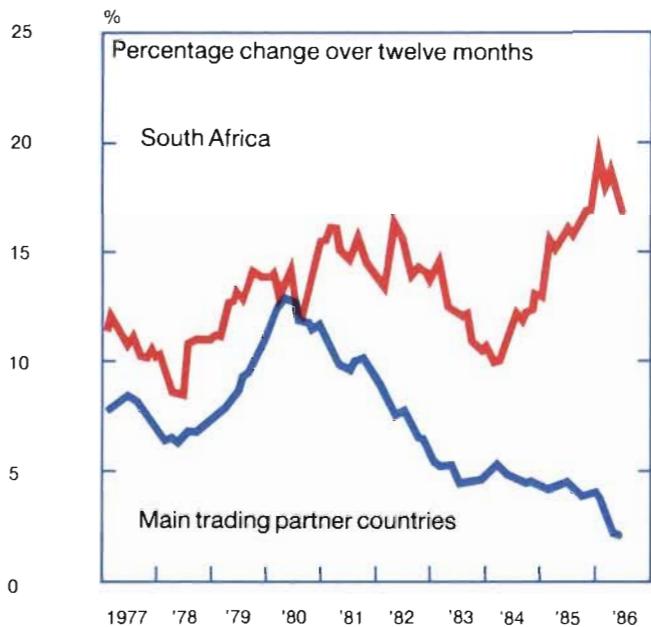
Both of these elements in the process of domestic price increases, however, appeared to have worked themselves out by the middle of 1985. Excess demand in the South African economy had substantially been removed by the second quarter of 1985 and the exchange rate displayed remarkable stability (at a level of some two rand to the US dollar) during most of the first six months of that year.

The abrupt re-acceleration of inflation in the second half of 1985 and into the early months of 1986 was, therefore, essentially based on a new set of extraneous developments. To a major extent, this resurgence in the rate of price increases reflected a renewed drop in the exchange rate that followed upon the declaration of a state of emergency on 20 July 1985, a deterioration in overseas perceptions of South Africa's political stability and of the outlook for its economy, and the resultant outflow of capital. Upward pressures on the domestic price level from this source were exacerbated by the imposition, on 23 September 1985, of a 10 per cent surcharge on imports.

In accordance with these developments, the quarter-to-quarter rate of increase in the import price component of the production price index slowed down rapidly from a seasonally adjusted annual level of 33 per cent in the first quarter of 1985 to 21 per cent in the second quarter and to 15 per cent in the third quarter. It then accelerated again to no less than 40 per cent in the fourth quarter of 1985 and to as much as 48 per cent in the first quarter of 1986. The rate of increase in the overall production price index similarly accelerated from approximately 14 per cent in the third quarter of 1985 to a peak of 27 per cent in the first quarter of 1986. It then fell back to 12 per cent in the second quarter of the year.

In the area of consumer prices, a number of administered prices, such as those of electricity, transport, water, petrol and bread, were raised during the second half of 1985 and in January 1986. In addition, a sharp rise in food prices during the fourth quarter of 1985 and in January 1986 contributed to a continuing high rate of price increases. Measured over a twelve-month period, the rate of increase in consumer prices accelerated from 13,9 per cent in January 1985 to a peak of 20,7 per cent in January 1986. It then declined fairly sharply to 16,9 per cent in June 1986.

Consumer prices



The decline in the rate of price increases from February 1986 mainly reflected a recovery in the exchange rate of the rand from late-December 1985, as well as a decline in crude oil prices on the international markets. These factors led to a lowering of the local prices of petroleum products in March and April. Prices of imported goods increased, on average, at lower rates in February and March 1986, and actually declined in April, May and June.

Identifying more explicitly the *shorter-term* changes in the rate of inflation, and broadly mirroring the quarter-to-quarter behaviour of the overall production price index set out above, the quarter-to-quarter increase in the consumer price index (at a seasonally adjusted annual rate) accelerated from 13,6 per cent in the third quarter of 1985 to no less than 27,2 per cent in the first quarter of 1986. It then declined sharply to a relatively modest 12,8 per cent in the second quarter.

Although a number of further administered price increases stand to be effected in the near future, certain more favourable developments may plausibly exercise a restraining effect on the inflation rate during the remainder of 1986. These developments include a marked reduction in the rates of increase in the monetary aggregates, the current lower rates of increase in labour and other business costs, and the abolition of the surcharge on imports of certain raw materials and intermediate goods.

Foreign trade and payments *

Balance of payments on current account

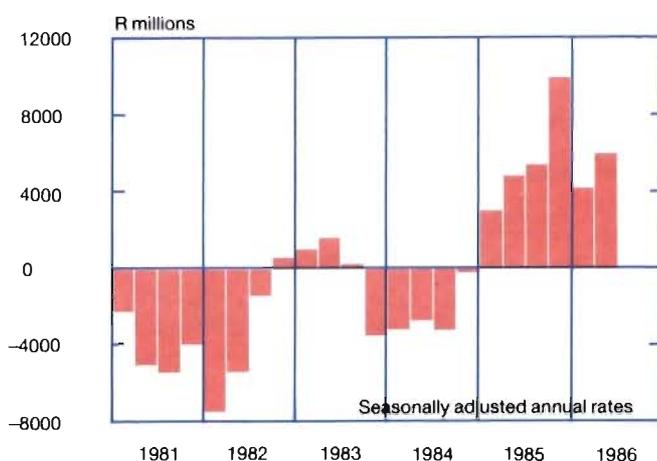
After moving out of deficit in the first quarter of 1985, the current account of the South African balance of payments showed increasingly large surpluses during the remainder of the year. At seasonally adjusted annual rates, these surpluses amounted to R3,1 billion, R5,0 billion, R5,5 billion and R10,1 billion in the four quarters of 1985, respectively. Special circumstances leading to a lower volume of gold exports and a high value of mineral imports caused the surplus to contract to an annual rate of R4,3 billion in the first quarter of 1986; it subsequently recovered, however, to an annual rate of R6,0 billion in the second quarter. As matters stand, a surplus of the order of approximately R5 billion to R6 billion may reasonably be expected for 1986 as a whole.

The current account surpluses of 1985 and 1986 to date were aided by the depreciation of the rand and an upward trend in world economic activity. On a more fundamental level, however, they also provided evidence of the remarkable adjustment effort that had been made by the South African economy from approximately the third quarter of 1984 – both for rectifying the acute domestic over-spending that had been allowed to develop in the course of the preceding twelve months and, in a much broader context, also as a preliminary step in a more protracted process of coming to terms with longer-term trends in the world economic environment, which in the past number of years have not generally favoured the primary-producing economies. At the same time, the considerable and increasing strength of the current account in the course of 1985 served to cushion the impact of acute new problems caused by adverse socio-political developments and culminating in large outflows of foreign capital and the repayment of foreign debt, particularly during the second half of the year.

The substantial improvement in the current account of the balance of payments in 1985 and the first half of 1986 largely represented an impressive further increase in the value of merchandise exports. Except for temporary declines in the third quarter of 1985 and the first quarter of 1986, the value of such exports displayed a more prolonged cyclical upward movement from R9,6 billion (at a seasonally adjusted annual rate) in the third quarter of 1983 to R24,0 billion in the second quarter of 1986.

A substantial part of the increase in the rand value of merchandise exports in the course of 1985 and the first two quarters of 1986 obviously was due to the declining

Balance of payments: Current account balance



*Balance of payments statistics used in this *Report* differ in certain respects from those used in the Bank's June 1986 *Quarterly Bulletin* as a result of some revisions. In particular, substantial revisions were made to the items "service payments", based on a survey of interest payments to foreigners, and "merchandise imports", because of timing adjustments between the fourth quarter of 1985 and the first quarter of 1986. The revised statistics will be published in full in the September 1986 *Quarterly Bulletin*.

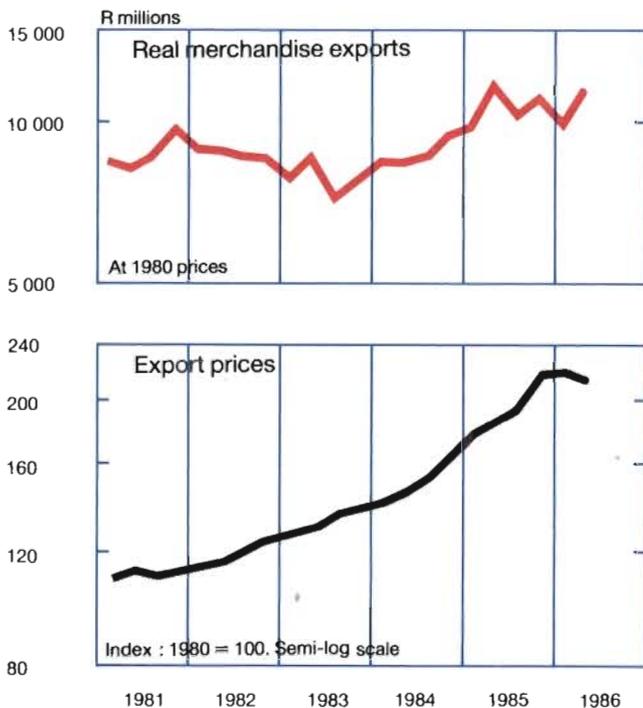
Current account of balance of payments

Annualised seasonally adjusted figures

R millions

	1985				1986	
	1st qr	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Merchandise exports	17 156	21 297	19 720	23 687	21 360	24 020
Net gold exports	14 253	12 623	16 320	18 644	14 850	15 770
Merchandise imports	-22 150	-22 120	-22 978	-24 932	-23 710	-24 580
Trade balance	9 259	11 800	13 062	17 399	12 500	15 210
Net service and transfer payments	-6 171	-6 837	-7 534	-7 278	-8 220	-9 190
Current account balance	3 088	4 963	5 528	10 121	4 280	6 020

Merchandise exports



exchange value of the rand. The rising value of exports also was based, however, on increased competitiveness of South African export goods in overseas markets because of this decline in the exchange rate, and was supported by continuing economic expansion in major trading partner countries. The *volume* of exports, accordingly, although tending to level off from the third quarter of 1985, nevertheless was some 20,8 per cent higher in the second quarter of 1986 than in the fourth quarter of 1984.

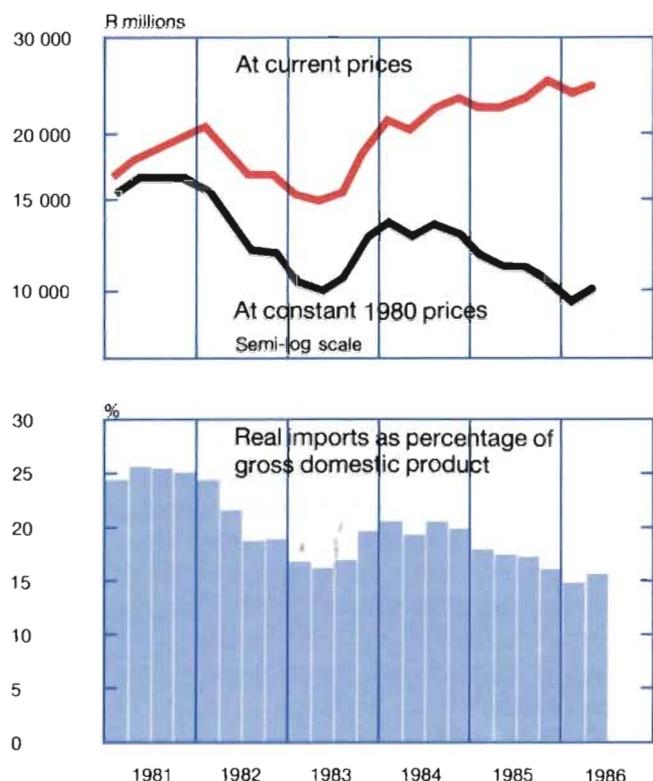
Major contributions to the increase in export volumes from the beginning of 1985 were made by sugar, diamonds and coal. Sugar exports benefited from a better sugar crop. Exports of diamonds increased under the influence of the strengthening of economic conditions in industrialised countries. Exports of coal were furthered by extensions to the Richards Bay harbour, an upgrading of railway transport facilities from the coal-mining areas, and the increased availability of handling capacity (as a result of a sharp decline in import traffic) at harbours other than Richards Bay. Coal exports started to decline, however, from the beginning of 1986.

The value of net gold exports, at a seasonally adjusted annual rate, increased from R13,7 billion in the fourth quarter of 1984 to R18,6 billion in the fourth quarter of 1985. Mainly because of labour problems and the mining of lower-grade ore, it subsequently declined to R14,9 billion in the first quarter of 1986, but recovered to R15,8

billion in the second quarter. The further increase in net gold exports during 1985 was somewhat more than fully accounted for by a rise of 35 per cent in the rand price of gold, which itself reflected the decline in the exchange value of the rand. The dollar price of gold declined during 1985 but remained fairly stable in the first half of 1986; having shown more substantial fluctuations in January, it moved between relatively narrow limits of US \$335 and US \$350 per fine ounce during the remainder of this period. International factors that normally would have influenced the gold price unfavourably (such as the decline in world oil prices, relatively high real interest rates, and low inflation rates in industrialised countries), were offset by the weakening of the dollar on the foreign exchange markets. The decline in the exchange value of the dollar also was a major factor accounting for the sharp rise in the gold price in August 1986.

The volume of merchandise *imports* declined sharply in the course of 1985 in response to the initial marked slowdown in domestic economic activity, the subsequent continuing lack of vigour in domestic aggregate demand, and the decline in the exchange rate, also demonstrating the relatively high degree of sensitivity of the volumes of South African imports to import prices. With few exceptions, all major categories of imports contributed to the

Merchandise imports



decline in total import volumes, which amounted to 15½ per cent during the year as a whole. Particularly large decreases were recorded in machinery and electrical equipment and in transport equipment, reflecting low levels of domestic fixed investment and a slump in the motor industry. The volume of merchandise imports continued to decline in the first quarter of 1986 but rose again in the second quarter. Its level in the second quarter, however, was still below the quarterly average of 1985.

Lower import volumes were more than offset by sharp increases in import prices, which (in view of relatively stable price levels in major trading partner countries) were due almost entirely to the depreciation of the rand. As a result, the total value of merchandise imports in 1985 as a whole still increased fairly significantly to R23 billion, or by 7 per cent. In the first quarter of 1986, further price rises, which more than fully offset further volume declines, caused the value of imports to reach a seasonally adjusted annual rate of R23,7 billion. This figure subsequently rose to R24,6 billion in the second quarter of the year.

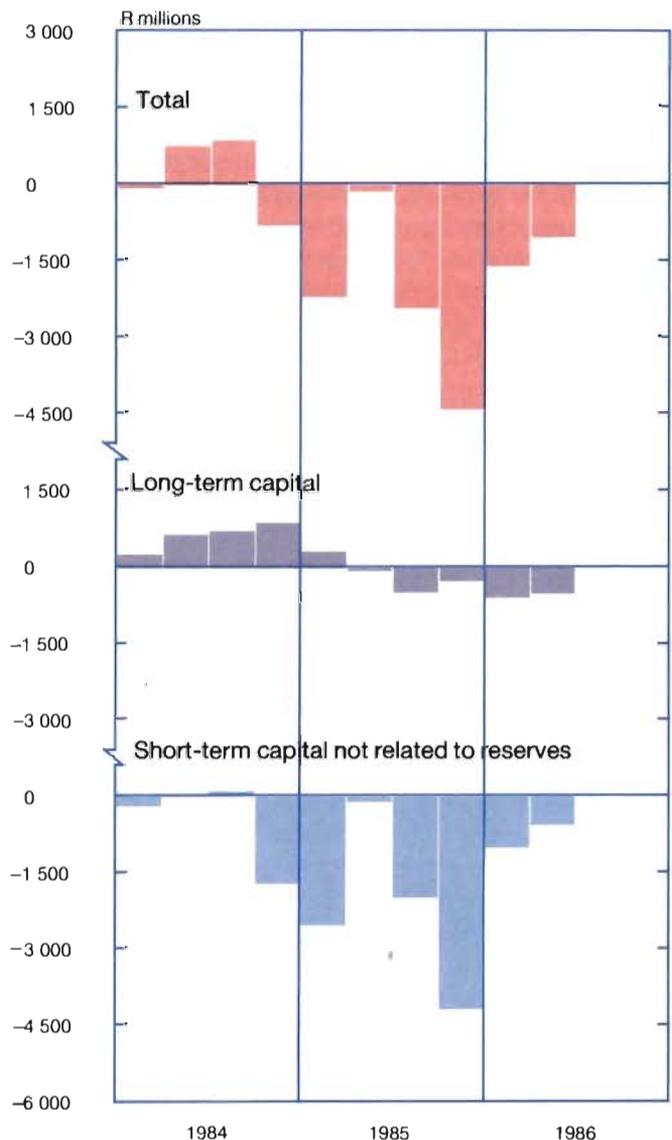
Net service and transfer payments to foreigners increased substantially from R5,7 billion (at a seasonally adjusted annual rate) in the fourth quarter of 1984 to R7,3 billion in the fourth quarter of 1985 and to as much as R9,2 billion in the second quarter of 1986. This rise occurred mainly in interest payments on foreign loans and in dividend payments to foreigners, reflecting increased profits in export-oriented industries. Freight and merchandise insurance payments rose in accordance with the increased value of imports. The increase in service payments was offset only partly by an increase in service and transfer receipts.

Capital movements prior to imposition of the debt "standstill"

In the first quarter of 1985, short-term capital movements (mostly consisting of "leads and lags" in international payments and receipts, which, in turn, were based on expectations of a further depreciation of the rand) more than fully accounted for a total net capital outflow (not related to reserves) of close to R2,2 billion. In the second quarter of 1985, a reversal of the unfavourable leads and lags situation caused the non-reserve-related outflow of short-term capital to contract to a negligible level of only about R0,1 billion. Also in the second quarter, however, a resumption of net sales of South African securities by non-residents on the Johannesburg Stock Exchange, in conjunction with certain other factors, caused the earlier net inflow of long-term capital to be wiped out.

This resultant approximate equilibrium on the capital account of the balance of payments was, however, upset by unexpected new developments after the middle of the year. The declaration of a state of emergency in certain magisterial districts on 20 July in a general climate of political unrest, contributed to a worsening of overseas

Capital movements



perceptions of South Africa's socio-political stability and of the prospects for its economy. The resultant renewed net outflow of foreign capital and intensified downward pressure on the exchange rate began to assume critical proportions when, towards the end of July, certain foreign banking institutions made known their intention of not renewing credit facilities they had previously made available to South African banks. In these highly abnormal and disturbed conditions, the South African monetary authorities eventually found themselves forced to close the foreign exchange market and the stock exchange for a four-day period to 1 September 1985, in order to decide on an appropriate policy strategy for coping with this situation.

The debt standstill and related arrangements

A "standstill" on most foreign debt repayments, initially meant to expire on 31 December 1985, became effective from 2 September 1985. The standstill arrangements did not apply to payments for normal current transactions and specifically excluded repayments on several categories of foreign debt (namely, outstanding amounts due by local importers to foreign suppliers; bonds issued on foreign stock exchanges, and public-sector notes privately placed; debts to the International Monetary Fund; debts guaranteed by foreign governments or their export credit agencies; debt commitments of the South African Reserve Bank; and new loans granted after 2 September 1985 which did not replace existing loans). When these various exemptions were taken into account, the temporary postponement of repayments applied to 57,5 per cent of all foreign debt outstanding at the end of August 1985.

Arrangements were made for amounts of maturing "affected debt" repaid by a South African debtor and not re-advanced to another borrower by an intermediating South African bank, to be deposited, in foreign currency, with the Reserve Bank by the foreign exchange dealer involved. From 1 January 1986, such deposits had to be made with the Public Investment Commissioners. Simultaneously with the imposition of the standstill, exchange control on capital transfers by non-residents was re-introduced in the form of the financial rand.

On 6 December 1985, additional measures were introduced to ensure the more effective application of exchange rate and exchange control procedures. These new measures *inter alia* laid down that the gold mining industry was henceforth again to be paid exclusively in rand for all gold bullion sold to the Reserve Bank, instead of half in US dollars and half in rand as before. A second measure

required that forward cover be taken out by exporters within seven days of shipment of the export goods concerned. On 10 December 1985, the standstill was extended for a further three months to 31 March 1986.

A "broad consensus of agreement" between South Africa and its principal foreign creditor banks was announced on 20 February 1986. In terms of this agreement, South Africa, on its part, stated its preparedness to lift the repayment restrictions on 5 per cent of the "affected debt" that had already matured or would mature up to 30 June 1987. Five per cent of all such debt that had already matured or would mature on or before 15 April 1986 would, moreover, be repaid in a single amount on that day; the repayment of 5 per cent of debt maturing between 15 April 1986 and 30 June 1987 then was to be effected on the original maturity dates of the debts concerned. A meeting to review the progress made in implementing these arrangements was scheduled for September 1986, while a major review of the overall situation was to take place in April 1987.

Capital movements after imposition of the standstill

Implementation of the standstill arrangements and stricter application of the exchange control regulations, although necessary at the time the standstill was imposed, did not succeed in stemming the outflow of capital from South Africa. As shown in the accompanying table, the net outflow of short-term capital in the third and fourth quarters of 1985 was, in fact, substantially larger than before.

The very large increase in short-term capital outflows in the second half of 1985 was accounted for, firstly, by large repayments on loans that were exempted from the standstill restrictions and that might well have been rolled over if South Africa's credit rating had not been reduced

Net capital movements*

R millions

	1985					1986	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Long-term capital							
Public authorities	22	30	-349	-118	-415	-195	-70
Public corporations	104	469	243	1	817	30	-110
Banking sector	-36	-206	-63	7	-298	-43	-33
Non-bank private sector							
Net purchases of listed securities by non-residents	352	-236	-306	-184	-374	-404	-117
Other	-104	-81	-37	47	-175	-2	-146
Total	338	-24	-512	-247	-445	-614	-476
Short-term capital, including unrecorded transactions	-2 529	-115	-1 967	-4 175	-8 786	-1 000	-556
Total capital movements	-2 191	-139	-2 479	-4 422	-9 231	-1 614	-1 032

* Excluding changes in foreign liabilities related to reserves.

by the imposition of the standstill. Secondly, adverse leads and lags came into operation. For example, switches were effected in the financing of imports from a credit to a cash basis, while some exporters delayed the repatriation of export proceeds by granting credit to their overseas customers for extended periods: Thirdly, certain private enterprises arranged for their maturing foreign debt obligations to be repaid through the intermediation of South African banks. Since these loans were subject to the standstill restrictions, the foreign liabilities concerned were effectively taken over by the South African banking system. The resultant somewhat artificial decrease in the "net foreign reserves" then appeared in the balance of payments statistics as being explained by an outflow of non-reserve-related short-term capital.

The introduction of the standstill and related measures also led to an outflow of long-term capital in the second half of 1985. This outflow consisted largely of repayments of foreign debt by the Central Government. At the same time, the steady inflow of long-term capital in the form of net new borrowing by public corporations for all practical purposes dried up completely after the standstill had come into effect.

The adverse leads and lags situation in the period immediately after imposition of the standstill gradually wore itself out in the first two months of 1986, but was revived by uncertainties surrounding the advance repayment of matured "affected debt" on 15 April. Outflows of short-term capital remained high in the second quarter of 1986, *inter alia* in the light of perceived threats of intensified economic sanctions against South Africa and of news of continued social unrest.

Outflows of long-term capital continued to be recorded in the first half of 1986 as foreign loans falling due perforce had to be repaid without new loans commonly being made available. Certain public corporations, however, continued to be able to raise long-term overseas credits in the form of project financing.

Foreign reserves

Banks' assumption, after imposition of the standstill, of clients' foreign repayment obligations, contributed materially to the increase in the banking system's total foreign liabilities of R2,1 billion that was recorded in the course of 1985. The decline in the net gold and other foreign reserves, which amounted to R3,3 billion, was similarly affected by the shift of short-term foreign liabilities of non-bank private-sector entities to banking institutions. In the light of these developments, the comparability of recent and more historical foreign reserve data clearly is limited, and actual comparisons are likely to be misleading.

Exchange rates

After having declined by 35½ per cent from the end of June 1984 to late-January 1985, the effective exchange rate of the rand stabilised significantly during the remainder of the first six months and most of July 1985, deriving support from the rising surplus on the balance of payments on current account.

A preponderance of political rather than economic considerations, referred to above – such as socio-political unrest, the declaration of a state of emergency, diplomatic initiatives against South Africa, and the withdrawal of credit lines by certain overseas banks – subsequently caused the exchange rate to decline heavily during the last ten days of July and most of August 1985. A new low level of the exchange rate, at 36,05 US cents, was reached on 27 August 1985, i.e. immediately prior to the authorities' suspension of foreign exchange and stock exchange operations from 28 August 1985. When the foreign exchange markets re-opened after imposition of the standstill on 2 September, the commercial rand recovered momentarily to 45,55 US cents, but then depreciated further, mainly under the impact of adverse leads and lags, by some 4½ per cent on a trade-weighted basis up to 18 December 1985.

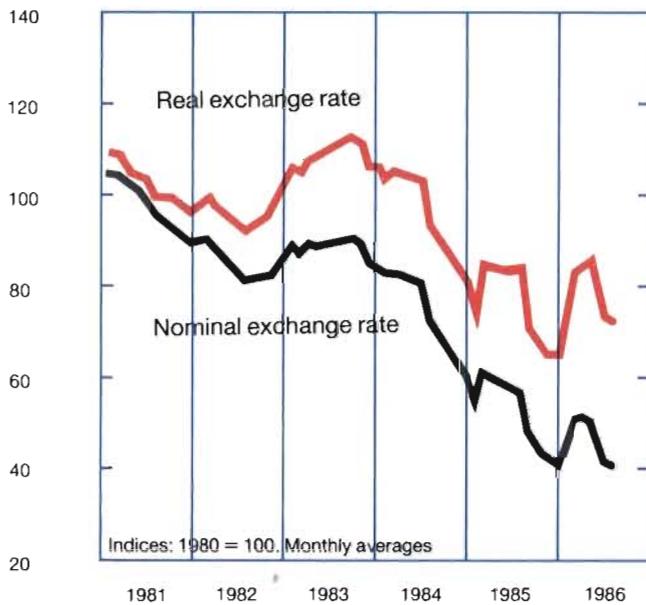
Changes in the exchange rates of the rand and the financial rand

%

	29 Jun 1985 to 27 Aug 1985	27 Aug 1985 to 18 Dec 1985	18 Dec 1985 to 13 Mar 1986	13 Mar 1986 to 12 Jun 1986	12 Jun 1986 to 11 Aug 1986	31 Dec 1984 to 11 Aug 1986	31 Dec 1985 to 11 Aug 1986
Rand							
Weighted average	-27,2	-4,4	30,1	-28,7	7,9	-31,0	-4,8
US dollar	-25,9	-1,7	36,4	-29,1	9,7	-22,2	0,4
British pound	-31,1	-4,5	33,3	-32,0	13,9	-38,6	-1,9
German mark	-32,6	-11,2	24,6	-31,8	2,7	-48,9	-15,5
Swiss franc	-34,1	-9,0	25,2	-33,2	0,3	-50,0	-19,4
Japanese yen	-29,5	-16,3	21,9	-34,9	1,9	-52,3	-22,9
French franc	-32,7	-10,8	25,2	-29,3	4,6	-45,8	-10,8
Financial rand	-	-23,6*	26,5	-43,4	-3,7	-	-28,4

* From 2 September 1985

Effective exchange rate of the rand



Exhaustion of the adverse leads and lags and generally improved market sentiment, particularly after the reform-oriented speech by the State President at the opening of Parliament on 31 January 1986 and the successful debt negotiations concluded in London in February, caused the rand to appreciate by 30 per cent up to 13 March 1986. Subsequent fluctuations of the rand exchange rate were influenced, *inter alia*, by the foreign debt repayment that, in terms of the "broad consensus agreement", was effected on 15 April 1986; by a marked depreciation of the US dollar in the international foreign exchange markets; and by changes in overseas perceptions of political disturbances in South Africa and of the possible effects of extended economic sanctions.

On 11 August 1986, the effective exchange rate of the rand was 31,0 per cent below its level at the end of 1984. Its depreciation since the beginning of 1986, however, amounted to only 4,8 per cent.

The financial rand reached a lower turning point of 24,00 US cents on 5 November 1985 but recovered to 37,50 cents on 5 March 1986. It subsequently weakened to 19,50 US cents on 11 August. The financial rand discount *vis-à-vis* the commercial rand accordingly widened from 26,7 per cent on 5 March 1986 to as much as 50,2 per cent on 11 August 1986.

Monetary and financial developments

Introduction of monetary targeting

In October 1983, the Governor of the Reserve Bank stated the Bank's intention, dependent on the Government's reaction to the *Final Report of the De Kock Commission**, to introduce "steps to pave the way" for setting precise target rates of growth for one or more monetary aggregates. The Commission itself subsequently recommended that target rates for money growth be adopted but that the target or targets concerned should not be made to amount to a strict "money rule", and should generally be applied in a "low-profile" and flexible manner. This discretionary approach to monetary targeting implied, among other things, that the targets should be capable of being attained without requiring for their realisation an undesirably or unacceptably high (or low) level of domestic interest rates, an undesirably or unsustainably high (or low) level of the exchange rate, an unduly rapid rise (or decline) in the exchange rate, and/or an unsustainably rapid rate of increase (or decrease) in the net foreign reserves.

Introduction of formal monetary targeting was eventually announced by the Minister of Finance in his Budget Speech for 1986/87. The target as then formulated by the Reserve Bank set a lower limit of 16 per cent and an upper limit of 20 per cent to the rate of increase in the quarterly average of the newly redefined "broad" money supply (M3) from the fourth quarter of 1985 to the fourth quarter of 1986. Fixed at these levels, the target was meant to be high enough to accommodate a somewhat higher real economic growth rate in 1986 than in 1985, but low enough to prevent a re-emergence of demand-inflationary pressures.

Since, *ideally*, the money growth rate in terms of this target should not exceed 20 per cent per annum or fall short of 16 per cent per annum at any time during the targeting period, a "cone" could be drawn linking the value of M3 at the beginning of the targeting period (taken as mid-November 1985) to the permissible maximum and minimum values of M3 at the end of the targeting period (taken as mid-November 1986); the two sides of the cone then trace out the upper and lower limits to M3 that preferably should not be breached at any point in time (i.e. at any month-end) in the course of the targeting "year". Alternatively, a "tunnel" could be drawn that allowed for a two-percentage point deviation of the observed value of M3 from its "central" or 18 per cent target-growth path in the course of the year. In accordance with the Reserve Bank's flexible and pragmatic approach to monetary targeting, however, the Bank made clear that it would not necessarily feel called upon to react immediately, if at all, if the money

supply as at any particular month-end were to fall outside the "tunnel" or "cone". More long-lasting movements of M3 outside the tunnel or cone, on the other hand, would require corrective action if the disciplinary effect of the target and the credibility of the monetary authorities were to be maintained.

In introducing monetary targeting, the South African monetary authorities followed the example of monetary authorities in a variety of other countries, several of whom had already been notably successful in subduing inflation in their economies. The essential reason for monetary targeting is to be found in the well-established long-run relationship between inflation and preceding or accompanying excessive rates of increase in the money supply. The De Kock Commission, moreover, also observed a marked relationship between cyclical variations in the rate of change in the money supply and subsequent changes in the rate of change in gross domestic expenditure and the gross domestic product. The Commission noted, however, that changes in the South African monetary control system since approximately 1980 were likely to have influenced significantly the timing and other aspects of this relationship.

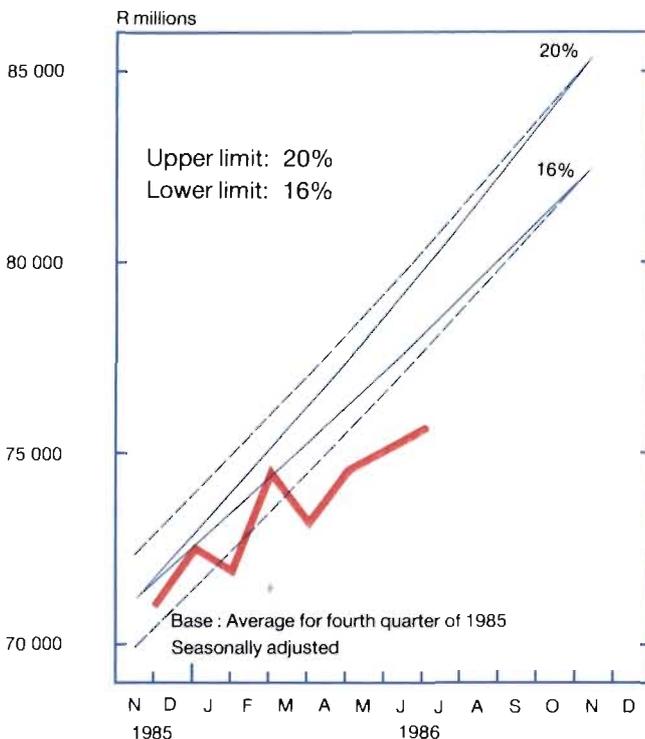
The newly defined "broad" money supply M3, as selected for targeting purposes, comprises all banknotes and coin in circulation outside the "monetary" financial institutions, plus all deposits (including building society shares) of the domestic private sector with these monetary institutions. Excluded from these deposits are deposits of monetary institutions with one another; "monetary institutions" includes all banks and building societies and the Post Office Savings Bank.

M3 was selected for targeting purposes in the prevailing conditions primarily because of its relatively stable relationship over time to macro-economic quantities such as the gross domestic product at current prices, i.e. because of its relatively stable "velocity of circulation". Being defined comprehensively, M3 tends to be influenced relatively little by shifts in depositors' preferences for various kinds of deposits; to the extent that all varieties of deposits with the major depository institutions are included in M3, such shifts will influence M3's composition without affecting its size. In addition, M3 contains various components that are unlikely to be influenced materially by factors provoking "disintermediation" and "reintermediation" (i.e. shifts by holders of funds between deposit-holding with a "monetary" institution and direct lending to some "ultimate borrower"). As a result, M3 itself is less sensitive to disintermediation and reintermediation phenomena than are the more narrowly defined monetary aggregates.

Allowing themselves to be guided by M3 as one element in the data they will consider in formulating their policies, the monetary authorities have the benefit of the relative

**The Monetary System and Monetary Policy in South Africa: Final Report of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa*; Government Printer, Pretoria, RP 70/1984.

Target ranges for growth in M3 during 1986



immediacy with which monetary statistics normally become available. Targeting the money supply also is superior to targeting, for example, the gross domestic product at current prices, in that the latter could logically force the monetary authorities deliberately to foster inflation. Such action might be held to be required if a low rate of growth of the real economy – for unavoidable, non-monetary, reasons, such as a drought – would make it seem likely that the targeted rate of growth of the gross domestic product at current prices would not otherwise be attained.

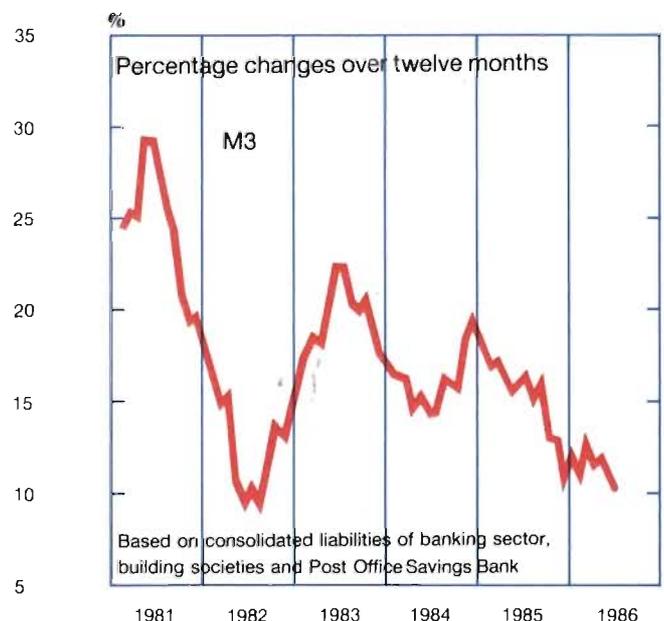
The South African monetary authorities elected to announce publicly their monetary target. Reasons for publicly announcing such targets may include that targets which are widely known to the general public may have a beneficial effect on inflationary expectations and may strengthen the public's confidence in the authorities' anti-inflationary resolve. In addition, such targets may provide a measure of guidance to the business community, consumers and labour interests concerning the authorities' probable monetary policy actions and future policy stance. Advance notification of the likely stance of monetary policy facilitates an orderly and timely adjustment of spending plans and provides some of the parameters within which wage negotiations, for example, may be conducted.

Growth of the money supply

Measured over a twelve-month period, the growth rate of the newly defined broad money supply, M3, declined from a peak of 19,5 per cent in November 1984 to 10,2 per cent in November 1985; it then fluctuated between a high point of 13,1 per cent and a low point of 9,9 per cent during the seven months up to June 1986. The February 1986 "outlier" of 13,1 per cent, however, attained its comparatively high level partly because of the effect of large-scale temporary borrowing by investors from the banking system for the purpose of subscribing to a large public share issue. The seasonally adjusted annual rate of increase in M3 from the beginning of the targeting "year" (mid-November 1985) up to the end of June 1986 amounted to 10,0 per cent. Being well below the lower limit of the Reserve Bank's targeting range of 16 per cent, these various growth rates lent support to the authorities' arguments in favour of an orderly but relatively rapid relaxation of their monetary policies, such as had already been put into effect from the second quarter of 1985. By the end of June 1986, M3 fell short of the lower limit of the targeting range by some R2,6 billion, or by 3,3 per cent.

Broadly similar growth tendencies were displayed by M2. In comparison with both M3 and M2, however, the twelve-month growth rate of M1 slowed down considerably faster, from as much as 41,7 per cent in November 1984 to only 5,0 per cent in September 1985 and to negative rates in the subsequent nine months to June 1986. The growth rate of M1A, which comprises pure "means of payment" only, decreased from 15,7 per cent in Novem-

Money supply



ber 1984 to 3,4 per cent in June 1985, but subsequently accelerated again to 30,4 per cent in June 1986. The behaviour of both M1 and M1A was, however, influenced greatly by certain non-recurrent developments of a non-economic nature, as set out in more detail below.

Growth in all monetary aggregates since early 1985 incorporated the various effects and side-effects of the rapidly easing stance of monetary policy and the unusually large and rapid drop in short-term interest rates, as well as the effects of continuing structural changes in the banking and financial system and of adjustments in the regulatory environment. Some of these developments also help to account for the marked divergences in the growth rates of the various monetary aggregates.

Of prime importance among the bank-regulatory adjustments was the abolition, with effect from September 1985, of banks' monthly "averaging" of their daily demand liabilities to the public in calculating their short-term liabilities to the public for the purpose of their cash reserve and liquid asset requirements. Up to August 1985, the banks, when calculating their *short-term* liabilities to the public for the purpose of their cash reserve and liquid asset requirements, had been allowed to include in these liabilities the *average* during the month (rather than the *month-end* amount) of their *demand* liabilities. The banks, however, were able to increase the benefits to be derived from this concession by promoting depositors' holdings of so-called "one-day notice/month-end call" deposits. Since this kind of deposit did not rank as a demand deposit during the month, its introduction and promotion had the effect of greatly reducing the monthly average of the banks' daily *demand* deposit liabilities (and therefore also of their total short-term liabilities as calculated for the statutory reserve asset requirements). At the same time, however, the existence of these deposits also resulted in artificially raised levels of *call* deposits (as included in M1) on the *month-end*, when the banks' various deposit liabilities are recorded for inclusion in the monetary aggregates.

Abolition of this variety of "averaging", which represented one of several amendments to the Banks Act as laid down by the Financial Institutions Amendment Act, 1985, therefore was to reduce sharply the month-end amounts of call money included in M1 (and accordingly of M1 itself), in favour of increased month-end holdings by depositors of alternative money deposits as included in M1A, of "near-money" or long-term deposits as included in M2 and/or M3, and probably also of other, non-monetary, financial or non-financial assets. In addition to the abolition of banks' averaging of their demand liabilities, however, amendments were made in the course of 1985 to the liquid asset and cash reserves requirements themselves, as discussed below, among the various bank-regulatory changes that were effected in the course of the year to June 1986.

Banks sharpened their competition for cheque deposits, while both banks and building societies sought to enhance the attractiveness of their transmission deposit facilities. Finally, the large number and extent of the reductions in Bank rate and the commercial banks' prime rate from

May 1985 to August 1986, exerted pressure, at times, on the commercial banks' margins between their average lending rates and the average cost of their funds (including the cost of long-term funds taken in earlier at the then prevailing higher interest rates). In the banks' endeavours to maintain or restore this margin, the *average* of their overdraft and other lending rates is likely to have declined less than their prime overdraft rates; some additional downward pressure from this source may, moreover, also have existed at times on the rates on new deposits taken in. This situation is likely to have been conducive to some further encouragement of direct lending by corporate entities in the market for inter-company funds (the "grey market"), as well as other forms of disintermediation.

"Disintermediation" of a certain kind also occurred to the extent that financial investors, yielding to the lure of the rising stock market, occasionally came to prefer investments in shares (or in the units issued by unit trusts) at the apparent expense of their aggregate deposit holdings. As noted in the capital market section of this *Report*, increased new issues of company shares *inter alia* allowed certain corporate bank clients to redeem a part of their loan indebtedness to the banking system in the course of 1985/86; the counterpart of this was a diminished rate of increase in the money supply. In a related development, institutional investors' holdings of cash deposits, as included in the monetary aggregates, which had risen by more than R2 billion during 1984, increased by only about R500 million during the subsequent fifteen months to the end of March 1986.

When these various developments are taken into consideration, the subdued and unexpectedly slow growth of M3 during the twelve-month period to June 1986 and during the first 7½ months of the 1985/86 monetary-targeting "year", would still appear primarily to have been accounted for by the relative weakness of the South African economy and the accompanying low need for money and lack of credit demand. M3 growth, however, would also seem to have been held down (while its velocity of circulation would tend to have been raised), *inter alia* by the effect of the abolition of the banks' previous "averaging" procedures on depositors' holdings of call money and of bank deposits generally. In addition, various factors are likely to have fostered "disintermediation" in a comprehensive sense of the term.

Changes in composition of M3

Largely because of the abolition of the banks' previous "averaging" procedures already referred to, the total of deposits and similar investments constituting M1, in relation to all deposits of the private non-monetary sector with "monetary" institutions, declined from 34 per cent in December 1984 to 28 per cent in June 1986. M2 deposits not also included in M1 (i.e. deposits and similar investments with other short and medium-term unexpired maturities) increased their share in the total from 38 to 43 per cent. M3 deposits not also included in M2 (i.e. deposits,

etc., with long-term unexpired maturities) increased their relative importance only slightly from 27 to 29 per cent. A shift towards the longer end of the maturity spectrum of deposits customarily tends to occur during periods of declining interest rates and declining interest rate expectations. The rather muted strength of this development during the eighteen months to June 1986 is likely to have been one aspect of a much more general increase in "liquidity preference" during this period.

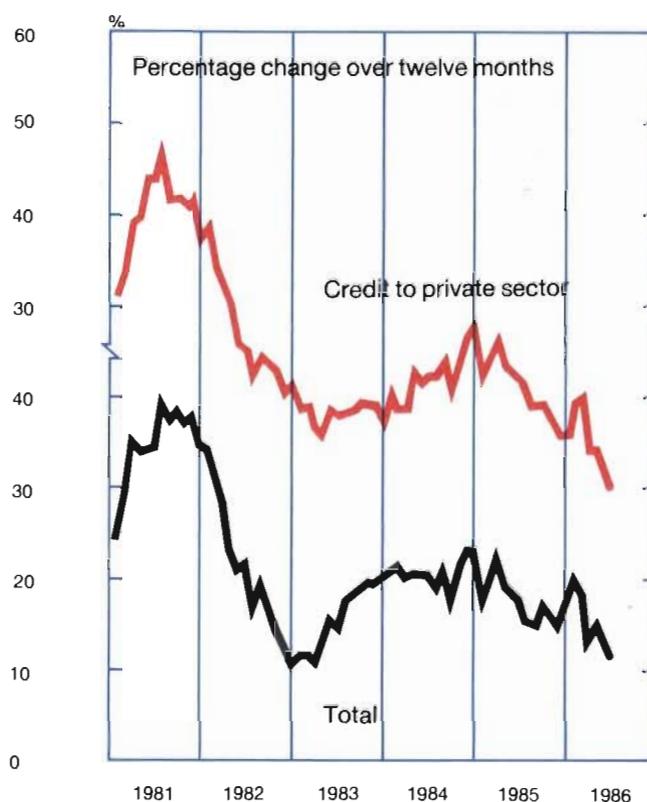
Banking institutions' share in the total of private sector deposits with "monetary" institutions decreased slightly from 66 per cent at the end of December 1984 to 63 per cent at the end of June 1986, lending support to banks' statements and views concerning the strength of the competition offered by building societies and the Post Office Savings Bank during this period.

Bank credit

A decline in the net gold and other foreign reserves of the consolidated "monetary" sector provided the main explanation, in accounting terms, of the deceleration of the growth rate of M3 during 1985 and the first half of 1986. The rate of increase in bank credit to the private sector, however, also declined substantially during this period. Measured over twelve months, this rate fluctuated downwards from its most recent peak of 28 per cent in December 1984 to 10 per cent in June 1986. Pronounced slackness in the demand for bank credit obviously was a reflection of the downward trend in and the subsequent flaccid condition of the economy. Specifically, it reflected the existence of substantial surplus production capacity and poor investment demand; the running-down of business inventories; heavy indebtedness of much of the agricultural sector; consumers' reduced borrowing powers on the basis of markedly less buoyant or declining real-income levels and less promising employment prospects; households' reduced willingness to borrow under the impact of the overhang of debt incurred previously and of a sense of uncertainty about the future; and banks' increased cautiousness in lending in the light of diminishing "debtor quality" and an increase in bad debts.

These various factors, in conjunction with a widening of certain interest rate margins, also expressed themselves in shifts in the composition of banks' new lending portfolios. Whereas the prime overdraft rate decreased from 25,0 per cent in early May 1985 to 15,5 per cent in January 1986, maximum rates as determined under the Limitation and Disclosure of Finance Charges Act initially remained unchanged at their exceptionally high August 1984 levels up to February 1986; the rates then laid down (i.e. 29 per cent for the smaller and 24 per cent for the larger money lending and credit transactions) continued to be markedly positive in real terms. In a different area, companies continued to have recourse to bank credit for augmenting cash flows, for the capitalisation of interest on credit facilities utilised, for effecting a transition from off-shore to domes-

Bank credit



Percentage changes over twelve months in bank claims on the non-bank private sector

	1984		1985		1986
	Jun	Dec	Jun	Dec	Jun
Deposits and investments	-23,2	-26,8	6,8	16,5	2,2
Bills discounted	-38,0	43,7	25,7	49,3	84,8
Hire-purchase credit ...	39,4	36,1	16,4	1,2	-2,7
Leasing finance	32,5	21,8	7,4	-6,5	-12,3
Other loans and advances	35,4	39,9	31,1	25,3	16,0
Total	22,5	28,1	22,0	15,7	9,5

tic sources of finance, and (at times) for the financing of unfavourable leads and lags in international payments and receipts. In this situation, the banks' leasing finance actually decreased materially; hire-purchase credit declined more marginally; and the rate of increase in banks' "other" loans and advances slowed down to comparatively low levels. The banks' bill portfolios, on the other hand, increased sharply in percentage terms.

The slowdown in the extension of bank credit to the private sector was, however, to some extent offset by an increase (of R455 million, or 19,5 per cent) in net bank credit to the government sector in the eighteen months to June 1986. Given the general absence of domestic excess demand and the below-target rate of increase in the money supply, this recourse by the government sector to bank credit clearly was not to be condemned for its potentially inflationary consequences.

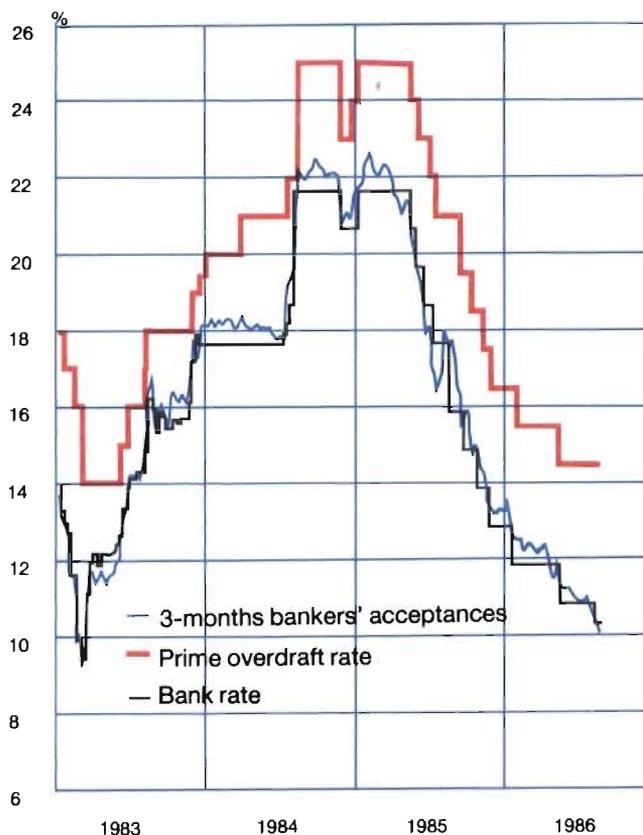
Bank rate policy and interest rates

Money market interest rates eased from the beginning of March 1985 in response to the waning of seasonal money market pressures in conjunction with the increasingly noticeable cooling-down of the economy, an improved balance of payments position, a relatively stable exchange rate, and generally enhanced prospects for an eventual relaxation of the Reserve Bank's discount policy. The Banks' rediscount rates were, in fact, lowered by 1 per cent (the rediscount rate for Treasury bills for discount houses being reduced to 20,75 per cent) with effect from 6 May 1985. In motivating this step, the Bank made reference to the improved monetary-fiscal policy "mix" that had been established by the Central Government's Budget for 1985/86 and to the "virtual elimination" of domestic excess demand that had already been brought about, as well as to the transformation of earlier deficits into a surplus on the current account of the balance of payments and to a recent strengthening of the gross and net foreign reserves.

During the remainder of 1985, the Bank's rediscount and overnight lending rates were reduced on an unprecedented seven further occasions, the Bank's rediscount rate for Treasury bills for the discount houses (i.e. "Bank rate") thereby being brought down to 13 per cent as from 20 November 1985. After a further reduction of 1 per cent in May, but with the exception of December, cuts in the Bank's rediscount rates were effected in every calendar month during the remainder of 1985. The Bank also made use of the occasion of its August 1985 discount rate reduction to announce its intention of giving effect to the De Kock Commission's recommendations regarding discount policy, namely that (1) more active and more clearly defined use be made of discount policy for influencing the money supply, interest rates and total expenditure, and (2) "Bank rate" be restored as the formal and traditional designation of the rate at which the Bank is prepared to rediscount Treasury Bills for the discount houses.

Further reductions in Bank rate (eventually to 10,50 per cent) and in the associated rates for refinancing at the discount window were effected in January, May and August 1986. In its motivations of the Bank rate cuts of January and May, the Bank, while referring to early signs of a cyclical recovery in the economy in the second half of 1985, also noted the persistent slowdown in credit extension and money growth and the need for active further restimulation of consumer and investment spending. The Bank, accordingly, took the view that the September 1985 imposition of the standstill on certain foreign debt repayments and the accompanying problems relating to South Africa's foreign debt situation, the outflow of foreign capital and the exchange rate, should not be allowed to stand in the monetary authorities' way in their endeavours to revitalise the domestic economy. Conversely, in the Bank's view, a further lowering of domestic interest rates was unlikely significantly to exacerbate the foreign debt, foreign reserves or foreign payments positions, while a re-invi-goration of the domestic economy and its rate of growth might actually turn out to be beneficial to the balance of payments on capital account. At the same time, the Bank made clear that, in contrast to the position during most of

Short-term interest rates



the preceding twenty-five years, South Africa's inflation problem in 1985/86 obviously could not be attributed to excessive levels of domestic aggregate demand.

In accordance with the Reserve Bank's downward adjustments of its refinancing rates, and often in anticipation of such adjustments, money market interest rates started to decline from about the end of February 1985. With the exception of a period towards the end of July and in early August 1985 (when expectations regarding a possible increase in the Reserve Bank's rediscount rates in the then prevailing conditions of uncertainty caused a slight upward movement), short-term rates declined sharply during the remainder of 1985. The three-month bankers' acceptance rate, for example, declined from 22,50 per cent at the end of February 1985 to 16,90 per cent at the end of June before increasing slightly to 17,80 per cent at the end of July. It then declined further to 13,60 per cent at the end of 1985. The prime overdraft rate of the commercial banks was reduced from its historically high level of 25,0 per cent at the beginning of May 1985 to 16,5 per cent at the end of November, and remained at this level up to the end of the year.

During the first eight months of 1986, the Reserve Bank's further Bank rate reductions by 1 per cent to 12 per cent in January, by 1 per cent to 11 per cent in May, and by 1/2 per cent to 10,50 per cent in August, were duly followed by reductions in the commercial banks' prime rate to 15,5 per cent, 14,5 per cent and 14,0 per cent, respectively. The rate on three-month bankers' acceptances declined from 13,6 per cent at the end of December 1985 to 10,75 per cent at the end of June 1986. It amounted to 10,10 per cent on 15 August.

Other policy and bank-regulatory measures

In accordance with the De Kock Commission's recommendations, and in terms of the Financial Institutions Amendment Act, 1985, the liquid asset requirements against banks' short-term and medium-term liabilities to the public were lowered, with effect from approximately 21 September 1985, from 22 and 16 per cent to 20 and 15 per cent, respectively. At the same time, the 5 per cent liquid asset requirement against the banks' liabilities under acceptances and certain other contingent liabilities was removed. The banks' right to "average" their demand liabilities in calculating their short-term liabilities, discussed earlier, was replaced by a new form of "averaging" relating to the banks' liabilities with an original maturity of not more than 31 days.

Abolition of the earlier variety of "averaging" caused the banks to experience substantial shortfalls in both their cash reserve and liquid asset positions. Subject to certain conditions, they were granted a one-year period of grace for rectifying these deficiencies.

The Financial Institutions Amendment Act, 1985, also permitted the banks to include the monthly average of

their daily holdings of "vault cash" (i.e. their holdings of notes, coin and gold coin in vaults, tills and automated teller machines), as during the month to be reported on, in their holdings of cash reserves for meeting the cash reserve requirements. The cash reserve requirement against the banks' short-term liabilities to the public was reduced from 8 to 5 per cent with effect from 1 April 1986. In view of this concession, banks were, however, not allowed to continue to show a cash reserve deficiency after the date of certification of their monthly returns for March 1986.

Although the effect of these various measures was slight in the context of the present monetary control system (which does not in essence rely on banks' limited holdings of either liquid assets or cash reserves to restrain their lending powers or their capacity for money creation), they fitted in well with the general easing of the monetary authorities' policy stance. The reduction in the banks' minimum required holdings of non-interest-earning cash reserves also served to mitigate one of the various forces making for disintermediation.

Government debt management operations during the fiscal year to the end of March 1986 and the first quarter of fiscal 1986/87 were mainly concerned with funding of the Government's borrowing requirements. Net sales of government stock amounted to nearly R4,3 billion during this fifteen-month period. The great majority of these sales, amounting to over 80 per cent of the total, were effected in the second quarter of 1985 and the second quarter of 1986, i.e. in the first three months of fiscal 1985/86 and fiscal 1986/87.

Refinancing and related actions

Seasonal pressures, mainly relating to movements in government funds, caused the money market to experience unusually large shortages at the end of August 1985 and February and March 1986 in particular. To relieve the strain on the Reserve Bank's refinancing facilities at the discount window, the Bank, where it felt justified in doing so, made frequent and active use of variations in the amount of funds of the Corporation for Public Deposits placed at call with the discount houses, up to an informal limit to the amount of such funds of R800 million. (Amounts up to R900 million were, however, made available in this way in late-July 1986.) Repurchase agreements were offered for essentially similar reasons and for occasionally extensive periods, notably in the course of the second half of 1985. The highest amount of repurchase agreements outstanding at any time during the twelve months to August 1986 ran to R1 000 million over the September 1985 month-end. Considerable amounts of refinancing accommodation nevertheless remained to be provided at the discount window at various stages in the course of this period. The peak amounts so provided ran to more than R2,2 billion on 19 December 1985 and to close to R2,4 billion on 29 March 1986.

Capital market developments

The capital market, in the one-and-a-half years to the middle of 1986 and beyond, showed tendencies that, in various respects, had already become apparent early in 1985. These developments included, *inter alia*, considerably increased turnovers in gilt and semi-gilt-edged securities and company shares on the stock exchange; a continuation of the accelerated rise in share prices that had commenced with the start of the decline in interest rates from the end of the first quarter of 1985; further, relatively large, increases in the availability of funds to financial institutions; and an increase in new funds raised in the primary capital market by both the public and private sectors. In addition, increases occurred in new mortgage lending by building societies, while real estate transactions rose to a higher level towards the end of 1985.

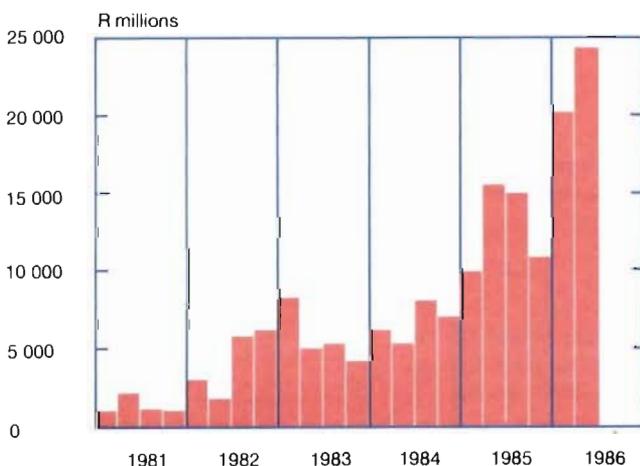
To some extent, the further increase in activity in the capital markets in the face of the relatively weak performance of the real economy and poor investment demand, reflected a shift in the provision of finance from foreign to domestic sources. It also incorporated the effect of the expanding options markets. To a more important degree, it would, however, appear to have reflected a general easing of the domestic financial situation as brought about and represented by the decline in short-term and, to a lesser extent, also in longer-term interest rates.

Funds available to financial institutions increased substantially from the beginning of 1985. The total of longer-term deposits with banks, building societies, the Post Office Savings Bank and participation mortgage bond schemes rose by 14,6 per cent during 1985 (compared with 7,1 per cent in 1984), and by a further 8,6 per cent during the six months to June 1986. Offering relatively favourable

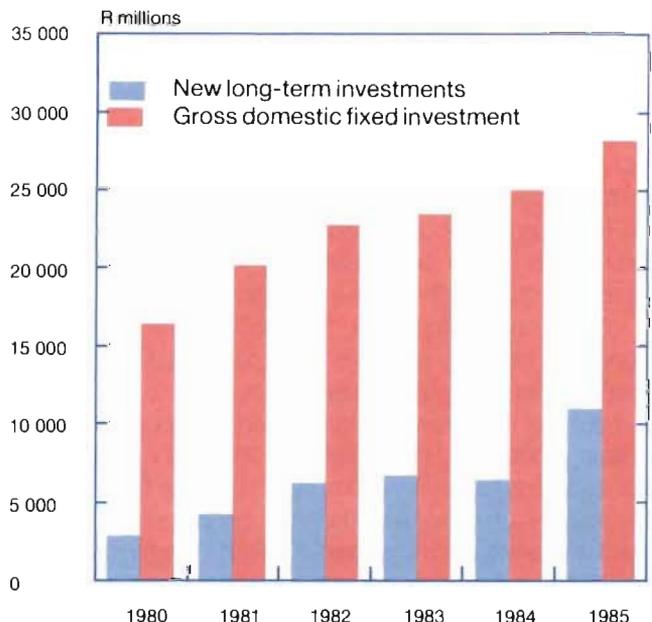
deposit interest rates, the building societies in particular succeeded in attracting substantial amounts of new funds. Total liabilities of insurers and private pension funds rose by R12 billion or by 25,2 per cent during 1985 against 22,4 per cent during the preceding year. As a result, the relative importance of the flow of contractual savings to insurers and pension funds increased further during this period. Expressed as a ratio of gross domestic fixed investment, for example, the net new long-term investments of insurers and private pension funds in the form of loan stock, company shares, long-term loans and real estate, rose to 38,9 per cent in 1985 from 25,6 per cent in 1984.

New funds raised by the public sector through issues of marketable securities to the bank and non-bank private sector increased from R2,8 billion in 1984 to R3,6 billion in 1985. A further R1,7 billion was raised during the six months to June 1986. New funds raised during the twelve months to June 1986, however, actually were R1,5 billion less than the amount of R4,0 billion raised in 1984/85, largely on account of the curtailment of public sector capital expenditure. Because of very large issues at "deep-discount" prices, notably by public enterprises, and substantial subscriptions by internal funds, the total marketable stock debt of the public sector outstanding nevertheless rose by R13,4 billion in 1985, compared with an increase of only R8,2 billion in 1984, and by a further R6,2 billion in the first half of 1986. New issues of fixed-interest securities by companies listed on the stock exchange de-

Stock exchange transactions in public sector stock



Insurers and private pension funds



clined from R642 million in 1984 to R410 million in 1985, followed by only R65 million during the subsequent six months.

Doubts about the future behaviour of long-term interest rates, and disenchantment with the longer-run price performance of long-term fixed-interest securities over the past several years, caused financial investors to continue to give preference to security purchases in the short and short-to-medium-term categories of the securities markets during most of 1985 and the first half of 1986. The redemption structure of public-sector stock debt, moreover, allowed scope for shorter-term loan stock issues by the Central Government. In these conditions, a new three-year government stock issue to the amount of R1 000 million, made available to the Reserve Bank on tap, was, for example, successfully marketed by the Bank in the course of the second quarter of 1986.

New capital raised in the share market by companies listed on the stock exchange rose from R0,6 billion in 1984 to R1,4 billion in 1985, followed by a further R0,5 billion in the subsequent six months. Encouraged by favourable conditions on the stock exchange, this recourse to new share issues allowed companies to consolidate some of their loan indebtedness to the banking system. It accordingly helped to explain why bank credit to companies (including leasing finance), despite lower interest rates, rose only moderately by 7 per cent in the eighteen months to June 1986, after having increased by as much as 41 per cent in 1984 alone.

The value of public-sector stock traded on the stock exchange rose further during 1985 and the first half of 1986 and amounted to R51,2 billion and R44,5 billion in these two periods, respectively, compared with only R26,6 billion in 1984. Similarly, the corresponding values of shares traded on the stock exchange amounted to R6,4 billion, R4,7 billion and R3,7 billion, respectively. Transactions by foreigners in securities listed on the stock exchange contributed materially to this increase in trading activity. As noted in an earlier section of this *Report*, non-residents from May 1985 turned into large net sellers of South African securities, mainly because of socio-political developments in South Africa and overseas perceptions of these developments. Non-residents' net sales of South African securities were concentrated in sales of gold shares and were exacerbated by foreign views concerning the depreciation of the financial rand.

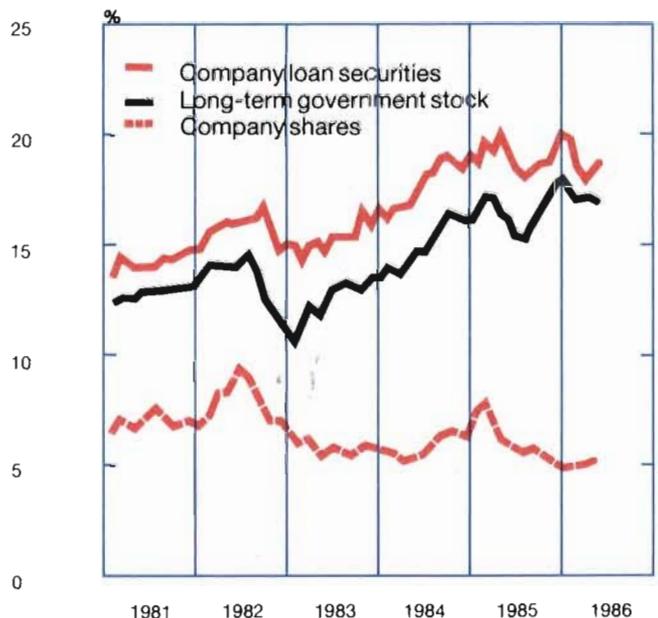
In the mortgage market, the substantially larger flow of funds to building societies and participation mortgage bond schemes enabled these institutions to increase the amount of their new mortgage loans paid out from R4,8 billion in 1984 to R4,9 billion in 1985 and a further R3,4 billion in the following six months. Despite the improved availability of mortgage finance, conditions in the real estate market, and more particularly in the private housing market, remained subdued. Lack of buoyancy in the housing market, and in the fixed property markets generally, *inter alia*, would appear to have reflected the general decline in real personal disposable incomes and

limited prospects for income improvements, as well as potential buyers' reluctance to enter into long-term commitments involving the purchase of not readily realisable fixed assets in a changeable and unpredictable socio-political environment.

Long-term interest rates

The behaviour of long-term interest rates departed significantly from the trend in money-market interest rates during an important part of the eighteen months to June 1986. Having eased, along with short-term rates, from March 1985 up to early July 1985, long-term rates sharply reversed this downward trend from late July up to the end of 1985. This turnabout in the course of long-term rates was induced by uncertainties arising from the South African foreign debt situation and its possible implications for, among other things, the public-sector borrowing requirement that might have to be satisfied in the domestic securities markets; it also reflected concern about the future inflation rate. Barring temporary increases in March and April, long-term rates did, however, resume a mildly downward trend in the first two quarters of 1986. Various factors and considerations (including a firm gold price, some improvement in inflation expectations, continuing downward pressure on short-term interest rates, and covering by writers of call options in the options market) then caused these rates to decline heavily in July and August, to levels comparable to those of late-July 1985.

Capital market yields



The average monthly yield on long-term government stock decreased from 17,4 per cent in February 1985 to 15,3 per cent in July 1985. It then increased to a historically high level (in nominal terms) of 18,1 per cent in December 1985 before declining again to 16,4 per cent in July 1986 and 15,3 per cent in early August. In contrast, "spillover" effects from the continuing decline in money-market interest rates, and investors' response to the "opportunity costs" attached to maintaining very short portfolios, had already caused the yields on shorter-term loan stock to decline on balance well before the marked drop in virtually all rates in July-August 1986. The yield on three-year government stock, for example, declined markedly from 18,6 per cent in February 1985 to 15,5 per cent in June 1985. It then fluctuated around this level for the remainder of the year before declining gradually until May 1986 and more substantially thereafter to 12,5 per cent in July 1986 and 11,7 per cent in the first week of August.

The rapid downward adjustment of short-term interest rates during the eighteen months to mid-1986, *vis-à-vis* the small net *increase*, on balance, in long-term interest rates over this period, caused the yield curve embracing the full spectrum of short and long rates dramatically to change its general appearance between March 1985 and June 1986. The markedly "inverse" or downward-sloping shape of this curve at the earlier date had been replaced by a pronounced degree of "normality" - i.e. by a strongly upward slope - by the middle of 1986.

The average dividend yield on all classes of shares declined on balance from 7,7 per cent in February 1985 to 5,1 per cent in July 1986. During this seventeen-month period, share prices increased, on average, by 51 per cent. The generally upward trend in share prices was evident in the prices of all classes of shares, but was well below average in the case of coal mining and real estate share prices. The largest increases in share prices during this period were recorded by companies related to the

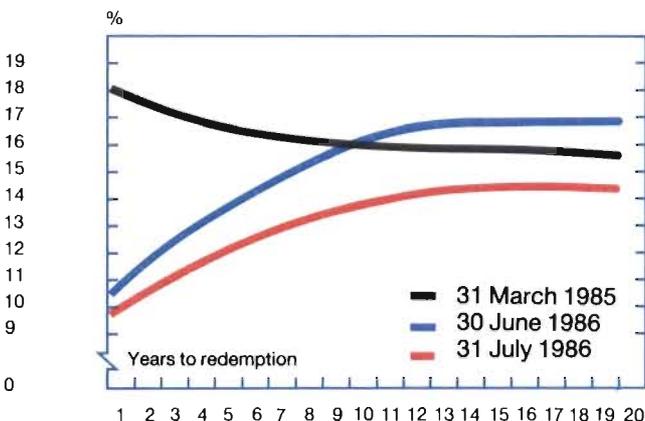
exporting sector, which benefited from the lower external value of the rand.

The protracted longer-term downward trend in the average yield on company shares (as it had been in evidence from the middle of 1982), in combination with the general longer-term rise in the yield on long-term government stock (from early 1983 to the end of 1985), eventually caused the gap between these two yields - traditionally known as the "inverse" yield gap - to amount to an unprecedented 13,3 per cent by the end of 1985.

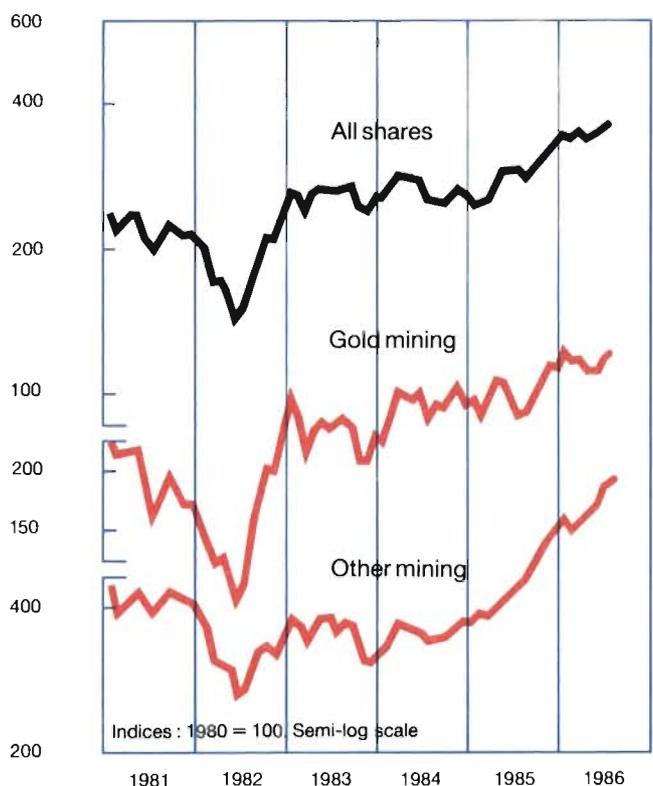
In line with the general downward tendency in shorter-term capital market yields, the building societies' predominant maximum home mortgage rate was reduced from 21,5 per cent in April 1985 to 18,25 per cent in October. It was lowered further to 17,0 per cent in May 1986 (when the set of differentiated rates quoted earlier also was replaced by a uniform rate for all borrowers), and again to 16,0 per cent in June 1986. Participation mortgage bond schemes similarly revised their mortgage rates downward in several steps from 23,6 per cent in December 1984 to 15,9 per cent as from January 1986, in line with the general decline in short and medium-term interest rates.

An indication of the general movement of long-term deposit rates was provided by changes in the twelve-

Government security yield curves



Share prices



month deposit rate of banks and building societies. The predominant rate on these deposits, which had been reduced in steps from 20,5 per cent in March 1985 to 14,0 per cent in August 1985, was raised to 14,5 per cent in November 1985. This rate was, however, reduced again from January 1986 onwards and stood at 12,0 per cent at the end of June.

Government finance

Adjustment in stance of fiscal policy

The March 1985 Budget of the Central Government still accorded priority to counteracting inflation and to strengthening the balance of payments, the exchange rate and the net foreign reserves. As the year progressed, however, it became increasingly clear that the objective of eliminating excess monetary demand had been achieved and that substantial surpluses were being attained on the balance of payments on current account. These conditions not only justified a fairly rapid relaxation of monetary policy, as discussed in earlier sections of this *Report*, but also made desirable a shift in the stance of fiscal policy. This was true in particular inasmuch as several of the remaining problems troubling the economy (such as those relating to inflation, the net foreign reserves position, and the depreciation of the rand) increasingly were attributable to "their own special causes," and therefore would have to be dealt with by remedial action outside the sphere of normal monetary and fiscal demand management.

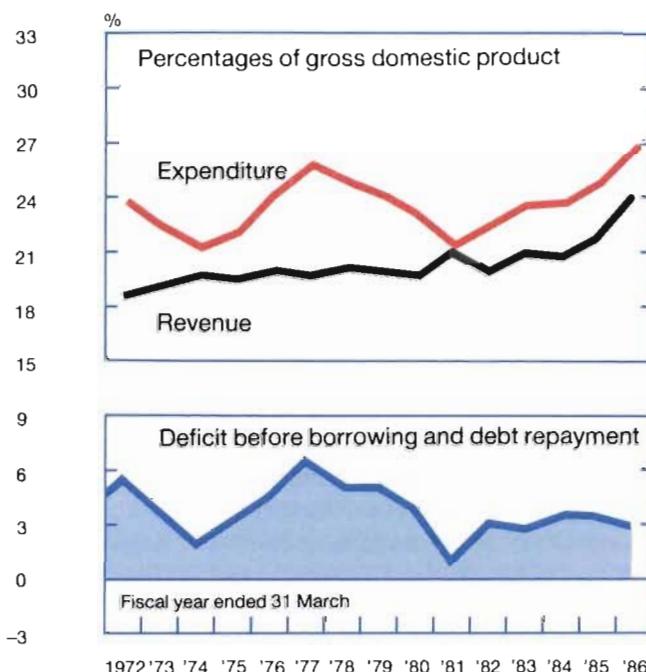
Adjustments in the Government's spending policy after the March 1985 Budget therefore primarily sought to establish a shift towards encouragement of consumption and investment expenditure, with a view to fostering employment and bringing about a higher degree of capacity utilisation. In accordance with this approach, the Minister of Finance in September 1985 announced a set of "moderately, but responsibly" stimulating measures that were aimed specifically at further employment creation, labour training, the promotion of small business enterprises, and alleviation of social distress. The Additional Appropriation Bill of February 1986, moreover, also provided for increased expenditure mainly in respect of security services, government debt servicing, provincial subsidies, local authority development and low-cost housing.

Central government expenditure, revenue and deficit before borrowing

Adoption of a moderately more expansionary approach to government spending meant a deliberate departure from strict adherence to the "basic condition" (the first of three such conditions enunciated in the Budget Speech for 1985/86) that an increase in total government expenditure in *real* terms during the year should be avoided. In the event, issues from the Exchequer Account* in fiscal 1985/86 rose by 21,3 per cent in *nominal* terms, against an originally budgeted increase in government expenditure of 13,6 per cent.

This large increase in government spending, in conjunction with the relatively poor performance of the real

Central Government expenditure, revenue and deficit



economy, caused the ratio of Exchequer issues to the gross domestic product to rise from 24,9 per cent in fiscal 1984/85 to 27,0 per cent in fiscal 1985/86. This meant a continuation of the upward trend in this ratio that had been in evidence since fiscal 1981/82.

The stimulatory effect of the increase in government expenditure was, however, neutralised, wholly or partly, by an even larger rise in revenue receipts. In order to limit the impact of increased government spending on the budgetary deficit, the imposition of an import surcharge of 10 per cent accompanied the set of supplementary spending measures of September 1985. Substantial increases in revenue also resulted from the increase in the general sales tax, as announced in the 1985/86 Budget, from 10 to 12 per cent from the end of March 1985. In addition to

*The Exchequer Account is adjusted for changes in the Paymaster General Account. This adjustment is made to obtain a more accurate measure of actual government expenditure. Exchequer Account issues are channelled to the Paymaster General Account for their eventual disbursement. Actual payments out of the Paymaster General Account may, however, differ significantly at times from the amount of Exchequer issues. The discount on new issues of government stock and transfers to the Gold and Foreign Exchange Contingency Reserve Account are excluded from Exchequer issues and deficits in this review.

these tax increases, the efficiency of tax collection was improved considerably by various measures to close existing tax loopholes, and by implementation of a third provisional tax payment by corporate provisional taxpayers. Finally, a substantial increase was recorded in tax payments by mining companies, reflecting higher export earnings in rand terms because of the depreciation of the rand, in combination with a strong foreign demand for mining exports.

On the basis of these various developments total revenue receipts rose by 24,9 per cent, against an originally budgeted increase of only 18,8 per cent. The ratio of Exchequer receipts to the gross domestic product accordingly rose to 24,2 per cent, a substantially higher value of this ratio than at any other time during the past sixteen years. Tax receipts from non-mining companies rose by no less than 27½ per cent, largely because of the elimination of tax arrears and certain tax concessions; this rate of increase could be compared with an average annual growth rate of only 6½ per cent in the preceding three years. A decrease, on the other hand, was recorded in receipts from customs and excise duties, because of the sluggish performance of the domestic economy and the concomitant decline in import volumes. Tax concessions and a lower rate of growth in nominal personal income also caused a decline in the rate of increase in income tax payments by individuals, which shrank from an average of 32 per cent in the three years from fiscal 1982/83 to fiscal 1984/85 to slightly less than 14 per cent in fiscal 1985/86.

The strong rise in total revenue nevertheless allowed the amount of general government dissaving (i.e. the extent to which current general government expenditure is financed with borrowed funds) to be reduced from its relatively high level of nearly R2,6 billion in fiscal 1984/85 to less than R0,7 billion in 1985/86. Only a relatively minor part of current government spending accordingly still had to be met out of the proceeds of government borrowing.

Higher revenues also helped to narrow the deficit before borrowing and debt repayment from 3,4 per cent of the gross domestic product in both 1983/84 and 1984/85 to 2,8 per cent in fiscal 1985/86. By having this effect, these revenue increases allowed the deficit to comply with another "basic condition" laid down in the 1985/86 Budget speech, namely, that a ratio of 3 per cent of the gross domestic product should not be exceeded. In absolute terms, the deficit amounted to R3 415 million. Most of this amount was provided by the Public Investment Commissioners. Sluggish demand for bank credit, below-target rates of increase in the money supply, and the general absence of domestic demand-inflationary pressures, however, also allowed the deficit to be financed with less stress than usual being laid on the need for borrowing from suitable, appropriately non-inflationary, non-banking sources. Net new government borrowing from the banking sector accordingly amounted to somewhat over R1,2 billion in 1985/86, against an actual decrease in the total of such borrowing by a roughly similar amount during the preceding year. Net new bor-

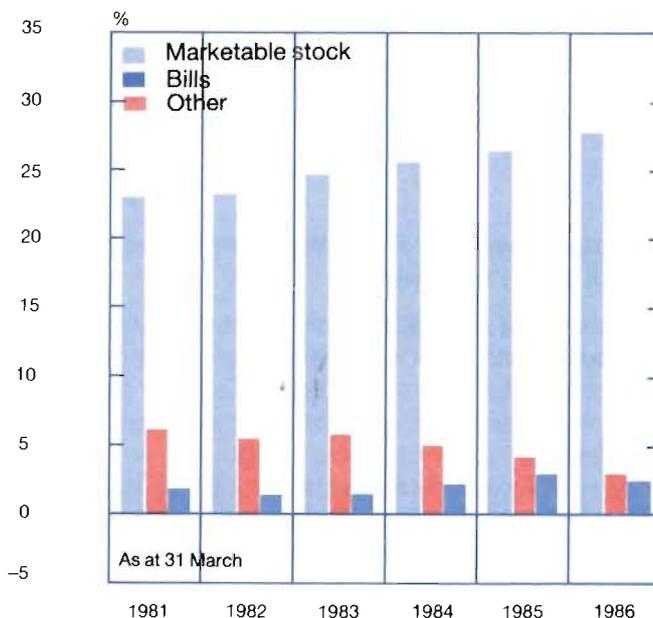
rowing from the domestic non-bank private sector, on the other hand, was reduced from nearly R3,2 billion in fiscal 1984/85 to less than R0,5 billion in fiscal 1985/86.

Most of the Government's borrowing operations again were carried out in the first quarter of the fiscal year. Investors' preferences for shorter-dated securities, in conjunction with favourable market conditions created by the general decline in short and medium-term interest rates (which, as noted earlier in this *Report*, was not matched by commensurate declines in long rates during most of the year), caused the amount of the Government's total net new borrowing operations to be more than fully accounted for by its net new borrowing in the short and medium-term maturity categories.

The smaller deficit before borrowing also resulted in a lower rate of increase in the total government debt outstanding, causing a reversal of the rising trend in the ratio of government debt to the gross domestic product that had been in evidence during the preceding four fiscal years. Despite the repayments made by the Government on its foreign loan obligations, the ratio of the Government's foreign debt to its total debt declined only slightly, reflecting the decline in the exchange value of the rand. Expressed in foreign currencies, however, the Government's foreign debt decreased considerably.

Marketable domestic debt increased further in relative importance during the year. Repayment of the 1978/79 loan levy in December 1985 accounted for a continuation of the decline in the relative importance of non-marketable debt. Finally, the preponderance of new security

Central Government debt



sales in the short and medium-term categories already referred to, also caused the average residual maturity of the domestic marketable government debt outstanding to contract substantially from 155 months at the end of March 1985 to 133 months at the end of March 1986. The average maturity of foreign marketable debt, on the other hand, increased slightly during the same twelve-month period. This was due to the forced redemption of maturing debt in non-resident hands, including debt that would normally have been renewed.

The 1986/87 Central Government Budget

In his presentation to Parliament of the Central Government's Budget for 1986/87 on 17 March 1986, the Minister of Finance indicated that the more stimulatory approach to fiscal policy already adopted in September 1985, would be continued in the new fiscal year. The general character of the authorities' short-term monetary and fiscal strategy was described as being "moderately expansionary." Recovery of the South African economy was to be promoted by the encouragement of investment and consumer spending so as to generate increases in income, output and employment. The strategy to be adopted nevertheless also was designed to prevent a re-emergence of excess demand. The prevention of renewed conditions of excess demand was stated to be important, not only to avoid the re-appearance of demand inflation, but also to ensure a sufficiently large surplus on the current account of the balance of payments so as to allow a part of the country's foreign debt commitments to be redeemed.

The Minister accordingly made clear that the extent of the stimulus that could be imparted to the domestic economy was limited by external circumstances. The "scope" for restimulation that had been created by the preceding year's successful adjustment effort, was constrained by the repayments that would have to be made on the country's foreign debt; these repayments, moreover, would have to be made without prospects for significant new borrowing abroad. Some latitude nevertheless remained for increased government expenditure in the four areas already identified as "key areas" in the Budget for 1984/85, namely the maintenance of order and stability, and constitutional, economic and social development. Any remaining leeway would be available for helping to promote renewed economic expansion.

High priority would be accorded to expenditure aimed at job creation and at the upgrading of the skills, the capabilities and the quality of life of individuals and their communities. Comprehensive action in this field would embrace the improvement of basic services in less-developed areas over the next three years. The Budget also made other provisions for programmes that, directly or indirectly, would contribute to the upliftment of Black people. The amounts set aside for these various initiatives were stated to be the maximum that present economic circumstances allowed. As economic growth and the

privatisation programme gathered momentum, however, the Government would be better placed to extend these initiatives.

For providing a broad and lasting basis for sustained economic growth in South Africa, and for creating permanent job opportunities for the growing population, large-scale investment in new undertakings and expansion of existing undertakings were stated to be a necessity. The Government had decided to pursue a two-fold approach in this regard. Firstly, all capital expenditure by the public sector was to be continually evaluated with a view to giving effect, on a priority basis, to economically justified savings. In this way, the public sector's claims on the capital market could be reduced so as to leave more room for investment by the private sector. Secondly, current spending by the public sector was to be reduced.

On the basis of these various principles, government expenditure according to the Budget estimates was expected to increase by 13,9 per cent. After allowing for a number of tax concessions, government revenue was foreseen to rise by 13,1 per cent. The more important tax concessions consisted of a rebate of 5 per cent on personal income tax in addition to the abolition of the 7 per cent income tax surcharge; an increase in the rebate on the taxable income of married women; and an increase in the amount of interest income that is exempted from taxation. These various concessions would be partly neutralised, however, by a further phasing-in of the taxation of fringe benefits. The deficit before borrowing was projected to amount to R3 944 million, or to about 2,7 per cent of the gross domestic product as estimated for fiscal 1986/87. Since the Public Investment Commissioners were expected to be able to provide most of these funds, net new government stock issues to be sold in the open securities markets would have to provide only R893 million of this amount.

The additional stimulatory package

By the middle of June 1986 it had become apparent that the performance of the real economy during the calendar year 1986 was likely to fall short of expectations as they had been held at the time of presentation of the 1986/87 Budget. During the third reading of the Appropriation Bill on 17 June 1986, the Minister of Finance accordingly announced a package of additional stimulatory measures that was designed to strengthen the impact of the set of monetary and fiscal policies already in place. The package meant that, in their endeavours to generate a moderate upturn in consumption and investment expenditure, the authorities were now coming to place increased emphasis on the fiscal element in their monetary-fiscal policy "mix".

The stimulatory package, to an aggregate amount of R1,5 billion, consisted mainly of the immediate repayment of the 1979/80 loan levy, exemption of certain imported goods from the 10 per cent surcharge on imports, a reduction in the excise duties on motor vehicles, a more lenient approach to fringe benefit taxation on motor cars,

further increases in aid to drought-stricken farmers, additional low-cost housing and job-creation programmes, and additional help for the Small Business Development Corporation. It was estimated that the Government in terms of these measures would concede R250 million in revenue, while spending an extra R450 million, during the remainder of fiscal 1986/87. Financing of the resultant increase in the budgetary deficit was to be provided in the form of a transfer to the Exchequer of certain revenues, and of the sales proceeds of certain assets, of the Central Energy Fund and the Industrial Development Corporation. The various elements in the package therefore were not meant to be neutralised by an increase in taxation, while the Government also sought to limit its need for increased recourse to the capital market.

The first quarter of the 1986/87 fiscal year

During the first quarter of fiscal 1986/87 (i.e. the period April to June 1986), Exchequer issues rose substantially. The increase in these issues over those of the corresponding quarter in 1985/86 amounted to 22,9 per cent. This percentage increase was well above the Budget estimates of a rise in government expenditure of 13,9 per cent for 1986/87 as a whole.

Government revenues in the first quarter of 1986/87 were 20,8 per cent higher than in the first quarter of 1985/86, notwithstanding a further decline in receipts from excise duties. Income tax payments by the gold mining industry during the quarter, however, exceeded their year-earlier levels by as much as 44,0 per cent. Large increases also were recorded in receipts from income tax on other companies and on individuals, and from general sales tax and customs duties.

The deficit before borrowing, which typically tends to be large during the first quarter of each fiscal year, amounted to R3 115 million, or to some 79 per cent of the budgeted deficit for fiscal 1986/87 as a whole. When the discount on new stock issues is included, the Public Investment Commissioners, the banking sector and the private non-banking sector contributed R1 091 million, R1 408 million and R932 million, respectively, to the financing of this deficit.