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-seventh ordinary general meeting to be held on 25 August 1987

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Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

From the third quarter of 1984 to the second quarter of 1985, the South African economy passed through a period of balance of payments adjustment and cyclical contraction. This was followed, firstly, by a period of slow and vacillating recovery from the third quarter of 1985 to the second quarter of 1986, and then by a more decisive although still moderate upswing from approximately the middle of 1986.

By the third quarter of 1987, the more important features and achievements of the economic upturn during the immediately preceding four-quarter period could be identified as follows:

- Real gross domestic product, having grown at a fairly brisk pace in the second half of 1986 but at more modest rates in the first half of 1987, was some 2¾ per cent higher in the second quarter of 1987 than in the second quarter of 1986. Aggregate real output in the four-quarter period to mid-1987 exceeded real output during the preceding four quarters by approximately 2 per cent. Moreover, an increased number of sectors of the economy shared in this real output growth. The associated increase in the demand for labour succeeded in reversing fairly significantly the sharp rise in unemployment that had been observed from the middle of 1984 to the end of 1985.
- Real gross domestic expenditure, having shown major fluctuations in the three preceding six-month periods from the third quarter of 1985, advanced both more steadily and more strongly in the first half of 1987. Aggregate real domestic expenditure in the second quarter of 1987 was provisionally estimated to have exceeded its one-year-earlier level by an approximate 6½ per cent.
- Unusual strength continued to be displayed by the balance of payments on current account. Supported by a marked improvement of the capital account in the second half of 1986 and the first half of 1987, the sustained very large surpluses on current account in 1986 and 1987 allowed a major rebuilding of the foreign reserves from the low point that had been reached at the end of April 1986. The continued current account surpluses also provided support for a marked strengthening of the exchange rate of the rand from its lower turning point in mid-June 1986. Sustained strength of the overall balance of payments position, South Africa's meticulous compliance with its debt-servicing obligations, and its strict adherence to the first set of "interim arrangements" for the repayment of debts that had been agreed upon with foreign creditor banks in March 1986, contributed to more favourable foreign perceptions of South Africa's stability and creditworthiness. This also facilitated the satisfactory conclusion of a second set of interim arrangements with the banks concerned in March 1987.
- Judged by all normal economic criteria, South Africa's foreign debt position remained sound. Indeed, net repayments of foreign debt inside and outside the "standstill net" to an amount of about R8 billion were made by South African banks, other private enterprises and public entities from the beginning of 1985 up to June 1987. The ratio of foreign debt outstanding to total exports of goods and services, was reduced from 171 per cent in 1984 to 108 per cent in 1986 – a relatively low figure by international standards.
- The rate of inflation in consumer prices, although still unacceptably high, declined from high points at annualised rates of 26,0 per cent and 20,7 per cent in the first and third quarter of 1986, respectively, to 15,0 per cent in the second quarter of 1987.

Rewards for the major adjustment effort that had been made by the South African economy from the second half of 1984 therefore were earned in 1986 and early 1987 in the form of simultaneous achievement of an unusually strong balance of payments position, a higher if still moderate rate of real economic expansion, and some moderation of the inflation rate.

By the third quarter of 1987, however, it was becoming apparent that the upswing was not gaining as much momentum as had been projected. The progressive decline in the real rate of growth from the fourth quarter of 1986 to the second quarter of 1987 pointed to the fact that the upswing, unlike upswings in the 1960s and 1970s, had not yet succeeded in developing a cumulative, self-sustaining and self-reinforcing character. Specifically, real gross domestic fixed investment, despite its encouraging recovery in the third and fourth quarters of 1986, had as yet failed to respond in a significantly positive manner to earlier increases in export volumes and to increases in domestic demand in the course of 1986 and the first half of 1987. Against this background, earlier projections of a real growth rate of 3 per cent for the calendar 1987 year as a whole now appear unlikely to be realised.

In the area of monetary developments, relatively low rates of growth in the broadly defined money supply, M3, continued to be recorded in the course of 1986 and the first half of 1987. At 10,3 per cent, the seasonally adjusted annual rate of increase in M3 from the beginning of the 1987 targeting year (taken as mid-November 1986) to the end of June 1987 still fell significantly short of the 14 per cent lower limit of the 1987 target range. Private sector holdings of money and close money substitutes continued to be held down, in 1987 as in 1986, by well-established as well as by more recent disintermediation phenomena. Although supported by the rising levels of the net gold and other foreign reserves, growth in the money supply was restrained, in the accounting sense, by slow growth in the demand for credit extended by monetary institutions. To a major extent, this represented the counterpart of the effect of disintermediation on the demand for money and close money substitutes. The demand for credit also continued to be restricted, however, by low levels of fixed investment spending, declining levels of inventories, fairly limited increases in the value of merchandise imports, and households' continuing reluctance to add to their financial indebtedness.

The moderately expansionary stance of monetary policy that had been arrived at by the progressive easing of policy in the course of 1985 and 1986, was maintained throughout the first eight months of 1987. Bank rate was reduced further in 1986 in five steps from 13 per cent at the beginning of the year to 9½ per cent from 10 December. It then was kept at this level up to the end of August 1987. The clearing banks' prime rate was lowered from 15½ per cent in January 1986 to 12 per cent in December 1986 but reverted to 12½ per cent in January 1987. No further changes in this rate were effected during the remainder of 1987 to date.

As in the case of monetary policy, the stance of fiscal policy remained moderately expansionary throughout 1986 and the first eight months of 1987. Fiscally stimulatory actions in 1986 were contained in the Central Government's Budget for fiscal 1986/87 and in a package of additional stimulatory measures that was adopted in June 1986. Further such measures were contained in the Part Appropriation Bill presented in February 1987 and in the Central Government's Budget for fiscal 1987/88 as presented in June 1987.

The capital market in 1986 and the first eight months of 1987 saw further large increases in trading activity that bore little relation to the pace of activity in the real economy. Exceptionally high turnovers in the securities markets were accompanied by further sharp rises in share prices and by further declines in long-term yields and interest rates. Signs of a significant revival were also apparent in the fixed property market. In the primary securities market, the increased availability of funds was not matched by a commensurate rise in borrowing needs, which remained subdued in line with low levels of fixed investment demand.

By the third quarter of 1987 the prospects were that the South African economy in the quarters ahead would continue to show real growth at modest to moderate rates. Conditions still existed, however, that were "friendly" to a renewed and more vigorous acceleration in consumer expenditure, to its translation into increased fixed investment spending, and to the eventual mutual reinforcement of consumption and investment through the "multiplier" and "accelerator" mechanisms. These conditions included the obvious scope still being offered by the current account of the balance of payments for a more spirited revival of aggregate domestic demand. They also included the low level of short-term and long-term interest rates in inflation-adjusted terms, the ample availability of money and credit, the accommodative stance of monetary policy, and moderate fiscal restimulation.

Domestic economic developments

Outline of main stages in economic developments since 1983

From about the middle of 1983 the South African economy, in rapid succession and approximately on a split-year basis, experienced:

• The so-called "mini-boom" of 1983-84. Being based essentially on an excessive rise in government and private sector consumption expenditure, relying heavily on a rapid expansion of consumer credit and occurring in an unpropitious international environment of weakening gold and commodity prices, the mini-boom was made unsustainable by overspending and a deterioration of the balance of payments on current account, accompanied by a decline in the exchange value of the rand. It accordingly called for firm corrective action for the removal of excess domestic monetary demand. Such action was taken in the form of a relatively severe further tightening of monetary policy in the third quarter of 1984 and a generally restrictive Central Government Budget in March 1985. The mini-boom, the need for its early termination, and the authorities' corrective actions, served to stress the importance of close co-ordination between monetary policy and the Government's budgetary and related policies.

• A period of balance of payments adjustment and cyclical recession from the third quarter of 1984 to the second quarter of 1985. The decisive policy actions of the second half of 1984 and early 1985 contributed in large measure to the desired cooling-down of the economy and were markedly successful in transforming the deficit on the balance of payments on current account into large surpluses during 1985, 1986 and the first half of 1987. This provided a vital element of strength in enabling the country to cope with the crisis on capital account that was set off by foreign banks' termination of credit facilities to South African banks from July 1985. The unusually strong current account position then also facilitated orderly arrangements for the repayment of foreign debt from March 1986 and enabled South Africa to meet its obligations in terms of these arrangements both comfortably and conscientiously. In the prevailing circumstances, however, this process of balance of payments adjustment inevitably entailed temporary declines in real personal disposable income and in private sector consumption expenditure, accelerated declines in real investment expenditure, and therefore a marked reduction in the real growth rate and a sharp rise in unemployment.

• A period of slight, hesitant and vacillating recovery from the third quarter of 1985 to the second quarter of 1986. A relatively strong export performance and substantial surpluses on current account as in 1985 and 1986, in conjunction with the authorities' change-over to moderately expansionary monetary and fiscal policies from the second quarter of 1985, normally would have provided impetus for a major upswing in the South African economy. In the event, however, a more substantial revival in the second half of 1985 and the first half of 1986 was held back by a series of adverse, extraneously imposed developments and conditions. These included inter alia an enhanced sense of uncertainty and a lack of business and consumer confidence induced by socio-political events in 1985 and by foreigners' negative perceptions of and responses to these events.

• A more decisive upswing from the third quarter of 1986. From approximately the middle of 1986, the slight earlier recovery in the South African economy assumed the strength of a moderately vigorous upswing. Substantially positive real rates of growth in the second half of 1986 were succeeded, however, by more modest rates of expansion in the first half of 1987. Positive real growth rates in this period were accompanied by further improvements in the South African export performance during most of 1986, a rising dollar price of gold from September 1986, a strengthening of the exchange rate and strongly rising foreign reserves, more positive foreign views of South Africa's stability and creditworthiness, and continued considerable strength of the balance of payments on current account. Rewards for the major adjustment effort of late 1984, 1985 and early 1986 therefore were earned in 1986 and early 1987 in the form of simultaneous achievement of fairly sturdy rates of real economic growth and an unusually strong external position.

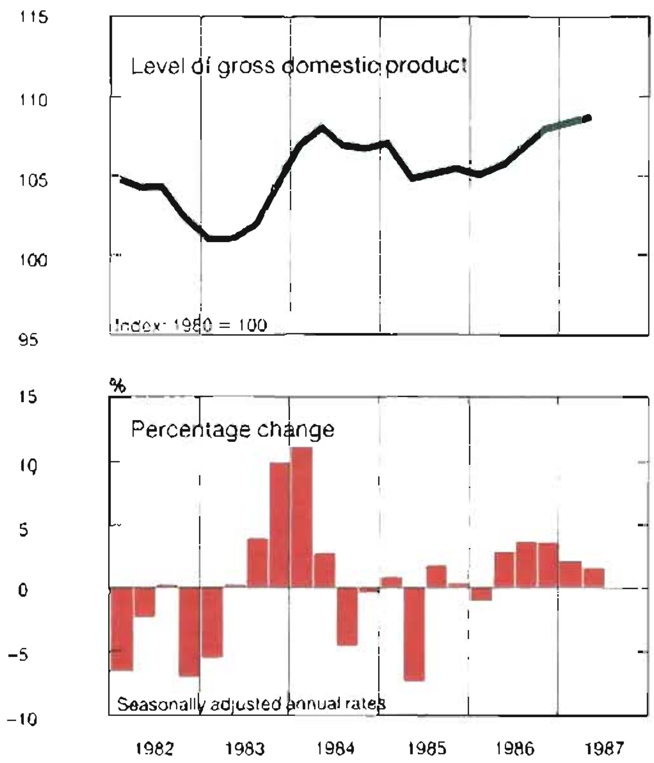
By the middle of 1987 the South African economy appeared set for continued if only modest expansion. However, the downward drift of the real growth rate in the first and second quarters of 1987 pointed to the fact that the upswing, unlike upswings in the 1960s and 1970s, had not yet, at that stage, taken on a cumulative and self-invigorating character. Obvious limits existed to real private consumption expenditure in the absence of more powerful employment and income-generating forces beyond the sphere of private consumption itself. In the presence of political uncertainties and other inhibiting factors, a notable feature of the upswing to date has been the failure of earlier rises in export volumes, of the moderate rise in real private consumption expenditure, and of government spending programmes, to stimulate fixed investment expenditure in the manner of the cyclical upswings of the 1960s and 1970s.

Trends in output in 1986-1987

The recession in the South African economy that was induced by the decline in real domestic spending during the initial adjustment period in the second half of 1984 and the first half of 1985, was accompanied by a contraction in real gross domestic product between the second quarter of 1984 and the second quarter of 1985 of approximately 3 per cent. During the subsequent period of hesitant and vacillating recovery from the third quarter of 1985 to the second quarter of 1986, which included the abrupt fall-back in real domestic output in the first quarter of 1986, real gross domestic product increased on balance by a modest 3/4 per cent. The fairly impressive upswing in the economy during the second half of 1986 and its continuation at more modest rates in the first half of 1987 is provisionally estimated to have resulted in real output growth during the past four quarters at an average annualised rate of 2 3/4 per cent.

Higher rates of aggregate real expansion in the past four quarters to mid-1987 also resulted in a larger number of sectors of the economy being able to show real

Real gross domestic product



Change in levels of real aggregate demand
Annualised percentage changes in seasonally adjusted quarterly data

Sectors	Upswing from second quarter of 1983 to second quarter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quarter of 1985 (four quarters)	Recovery from third quarter of 1985 to second quarter of 1986 (four quarters)	More decisive upswing from third quarter of 1986 to second quarter of 1987 (four quarters)
	Phases of the business cycle			
Private consumption expenditure	6 1/2	-8	1	3 1/2
Consumption expenditure by general government	9	-6	12	5
Gross fixed investment	-1 1/2	-6	-19 1/2	2
Gross domestic expenditure	9	-10 1/2	1/2	6 1/2
Exports of goods and non-factor services	2 1/2	12 1/2	-1 1/2	-6
Imports of goods and non-factor services	16 1/2	-12	-4 1/2	4
Gross domestic product	5 1/2	-3	3/4	2 3/4

Higher rates of aggregate real expansion in the past four quarters to mid-1987 also resulted in a larger number of sectors of the economy being able to show real output growth. During the slight upward movement of the real economy in its early recovery stages from the third quarter of 1985 to the second quarter of 1986, increases in real value added of more than marginal significance were experienced only by the sectors agriculture, financial services and general government. In contrast, virtually all major sectors of the economy were able to raise their real output levels during the period of more decisive expansion of the real economy from the middle of 1986.

Above-average increases in real output were displayed by agriculture, manufacturing, trade and financial services. Agricultural production responded markedly to relatively more favourable weather conditions in the summer rainfall areas during the 1986/87 rainy season. Manufacturing production was aided by earlier declines in the exchange value of the rand, which served to sustain the competitiveness of South African industry domestically and abroad and promoted some further penetration of export markets. Sustained high levels of activity in the financial markets, notably the stock market, contributed to a relatively sharp rise in value added in the financial services sector.

Below-average rates of real growth, or mild output declines, were shown by the mining, construction and transportation sectors. Mining output was affected adversely by declines in the volumes of certain mineral exports. The mild decline in real value added by transport and communication was an indication of a decline in the volume of goods handled that was similarly related to lower volumes of exports of metals and minerals. The continuing poor performance of the construction sector could be related to earlier declines in, and to persistently low levels of, domestic fixed capital formation.

The annualised rates of increase in real gross domestic product from the start of the more decisive upswing in aggregate economic activity declined progressively from approximately 3½ per cent in the third and fourth quarters of 1986 to 2 per cent in the first quarter of 1987 and to a provisionally estimated 1½ per cent in the second quarter of 1987. Confirmation of this low early estimate of the real growth rate in the second quarter of 1987 would suggest a disappointing fading of the various forces that have supported the upswing to date. It would also point to the failure of the upswing to develop a more cumulative and self-reinforcing character. In evaluating the growth rate of the second quarter of 1987 cognisance should, however, be taken of the probably not-insignificant adverse impact on aggregate output of various work stoppages in April, May and June, and of the unusually large number of official and semi-official public holidays (or non-working days) that fell in this period.

Despite the slowdown in output growth in the second quarter of 1987, aggregate real output in the first half of 1987 still was some 3 per cent above the level of real output in the first half of 1986. In the light of the comparatively high rates of real growth that were recorded in the second half of 1986, an exceptional acceleration of real output growth in the remainder of 1987 would, however, be needed for real output in the second half of 1987 also to exceed output in the second half of 1986 by 3 per cent. Earlier projections of a 3 per cent rate of growth in real gross domestic product for the calendar year 1987 as a whole therefore now seem unlikely to be realised. Output growth in calendar 1987 nevertheless is expected to be significantly stronger than the revised estimate of real growth of ½ per cent in calendar 1986.

Aggregate demand

From the beginning of the current economic recovery in the third quarter of 1985, the quarter-to-quarter change in aggregate real domestic expenditure changed direction in every quarter except the second quarter of 1987: increases in real gross domestic expenditure in the third quarter of 1985 and in the first and third quarters of 1986 were succeeded by decreases in the fourth quarter of 1985 and in the second and fourth quarters of 1986. In three of the past eight quarters to the second quarter of 1987, moreover, the annualised rate of change in total real gross domestic expenditure, whether an increase or a decrease, would appear to have been of the order of more than 20 per cent.

This very high degree of instability in the behaviour of real gross domestic expenditure in the two years to the middle of 1987 was essentially due to irregular changes in inventory investment and in consumption expenditure by general government. More stable and predictable behaviour was displayed by the moderate rise in private consumption expenditure from its mid-1985 low and – apart from its sharp decline in the first half of 1986 – also by real gross domestic fixed investment.

Aggregate real gross domestic expenditure responded sharply to the adoption of restrictive monetary and fiscal policies in the second half of 1984 and in early 1985. It declined by 10½ per cent from the second quarter of 1984 to the second quarter of 1985. Only a marginal increase, on balance, then was recorded during the early stages of the economic recovery up to the middle of 1986. The more pronounced upswing in

Change in levels of real output

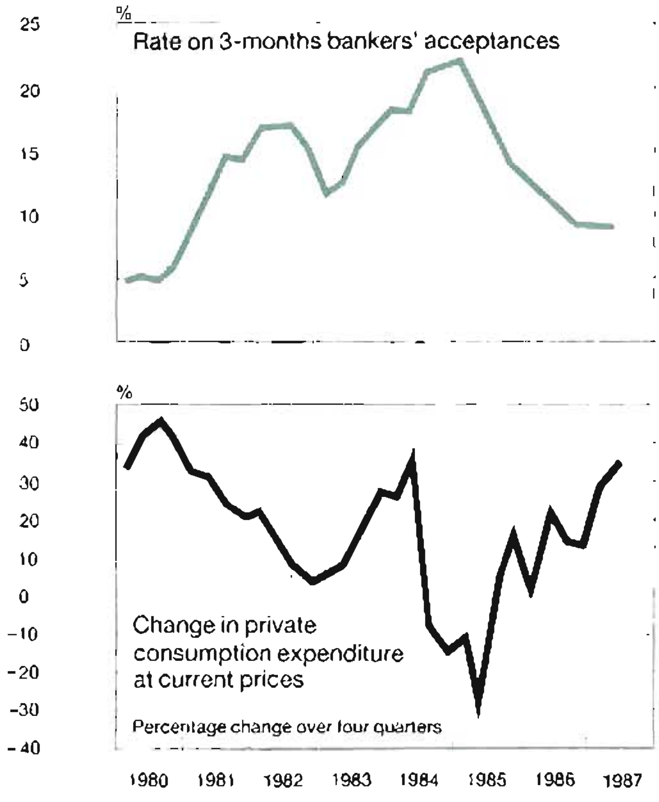
Annualised percentage changes in seasonally adjusted quarterly data

Sectors	Phases of the business cycle: Upswing from second quarter of 1983 to second quarter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quarter of 1985 (four quarters)	Recovery from third quarter of 1985 to second quarter of 1986 (four quarters)	More decisive upswing from third quarter of 1986 to second quarter of 1987 (four quarters)
Agriculture, forestry and fishing	–3	10	15	9
Mining and quarrying	2½	–1½	–1	–1½
Secondary industry	5½	–5½	–1	4½
Trade, catering and accommodation	14½	–8½	–3½	5
Transport and communication	9	–2½	1	–3½
Financial services	4	1½	2½	2½
General government	4½	–	3	2½
Gross domestic product at market prices	5½	–3	¾	2¾

the economy from the third quarter of 1986 subsequently caused aggregate real gross domestic expenditure to rise at an annualised rate of approximately 7 per cent from the second half of 1986 to the first half of 1987. In the second quarter of 1987, however, real gross domestic expenditure still fell short of the peak that had been attained three years earlier by as much as 4½ per cent.

Aided by the mild ½ per cent increase in real gross domestic product over this three-year period, the decline in and the subsequent relatively subdued level of real gross domestic expenditure almost inevitably also found expression in higher levels of the so-called net foreign balance, i.e. the excess of exports of goods and non-factor services over imports of such goods and services. Relative to real gross domestic product, the net foreign balance rose from 7½ per cent in the second quarter of 1984 to some 14½ and 15 per cent in the second quarter of 1985 and 1986, respectively, before declining to 12 per cent in the second quarter of 1987.

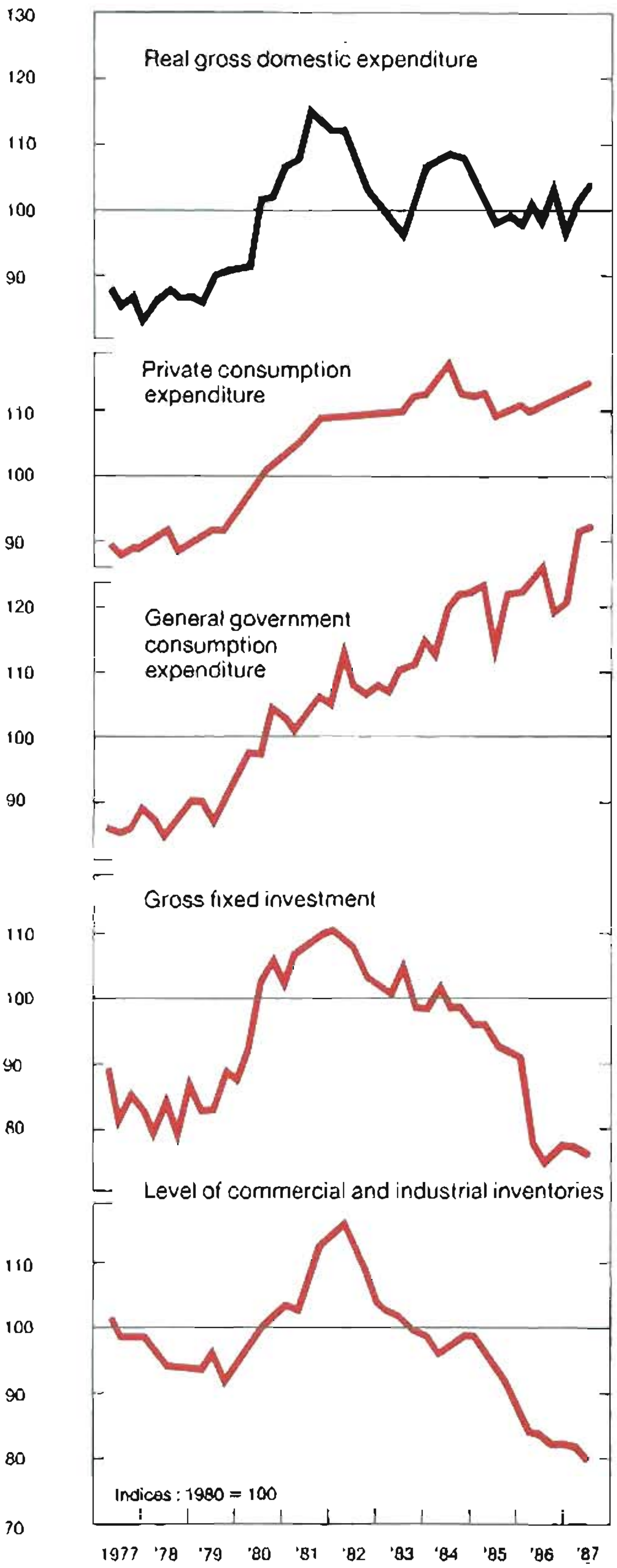
Change in private consumption expenditure on durable goods and interest rates



Private consumption expenditure

Real private consumption expenditure declined markedly (i.e. by some 7 per cent) during the two-year period from the third quarter of 1984 to the second quarter of 1986, but recovered fairly significantly (i.e. by a pro-

Real gross domestic expenditure and its components



visionally estimated 4 per cent) when real consumer outlays in the first half of 1987 are compared with real consumer outlays in the first half of 1986. This recovery in real private consumption expenditure was based partly on some improvement in aggregate real personal disposable income. It was aided, however, by various other factors, including factors that were inherent in the relatively easy monetary and financial environment.

Modest increases in employment in the non-agricultural sectors of the economy, in conjunction with nominal wage increases that were broadly if incompletely attuned to the inflation rate, caused aggregate real remuneration of employees to increase modestly during 1986 and the first half of 1987. In addition, household property income (inter alia comprising dividend and interest receipts as well as the profits of non-incorporated business enterprises) increased at rates in excess of the prevailing inflation rate. Direct tax payments, on the other hand, rose at rates below the inflation rate. Both of the latter developments therefore added to the improvement in aggregate real personal disposable income during this period.

Aggregate real private consumption expenditure actually increased more than proportionately to the rise in aggregate real personal disposable income. This was reflected in a further decline in the personal savings ratio to about 1½ per cent in the first half of 1987 from somewhat more than 2½ per cent in the calendar year 1986. Unlike similar declines in the 1983-84 upswing, however, this decline in the personal savings ratio was not based on an increase in consumer credit outstanding. The ratio of consumer credit outstanding to personal disposable income actually declined from an average value of more than 32½ per cent in the first half of 1985 to an average value of approximately 25 per cent in the first half of 1987. Households therefore had to draw on other resources, such as their investments with depository institutions, to support the relatively high level of their consumer spending.

Various factors may have played a part in accounting for the high and increasing ratio of real private consumption expenditure to aggregate real personal disposable income, and for the high propensity to consume out of disposable income increments. Firstly, as noted in a subsequent section, increases in the average nominal wage *per worker* in the non-agricultural sectors of the economy generally did not keep pace with the rate of inflation in consumer prices during the period from the first quarter of 1984 to the fourth quarter of 1986 as a whole. The resultant decline, on balance, in the *real* wage *per worker* during this period, and the difficulties of effecting a downward adjustment of living standards, are likely to have put upward pressure on the ratio of real consumption expenditure to real disposable income among a substantial proportion of households. Secondly, continued low and declining levels of interest rates in 1986, and "wealth effects" arising from the rise in stock market prices and in prices of other consumer-owned assets, may have encouraged the monetisation of assets for consumption purposes and a high inclination to spend out of current income.

A broad but fairly consistent inverse relationship between the levels of money market interest rates (as a proxy for the full set of interest rates that may have some bearing on households' spending and saving decisions) and the rate of change in real spending on consumer durables, is shown by the accompanying graph. Low interest rates may act as an inducement for increased recourse to consumer credit and may act as a deterrent to increased financial investment with depository institutions. In addition, they may, however, also exert a variety of direct and indirect influences on consumer expenditure through their manifold direct and roundabout effects on household incomes and wealth. It is to be noted, therefore, that the graph is *not* to be read as showing the *ceteris paribus* effect of high or low interest rates on the rate of change in real purchases of consumer durables, i.e. as a guide to the interest sensitivity of such purchases in an otherwise unchanged situation. The sharp decline in real durable consumption expenditure in the second quarter of 1985, for example, represented households' response to increased uncertainty and to an actual or perceived deterioration in their economic situations generally. It did *not* merely reflect a slightly lagged response to the peak level of interest rates that was reached in the first quarter of 1985.

The general acceleration in average consumer spending during the four quarters of the more vigorous economic upswing from the third quarter of 1986 was fairly evenly distributed among the principal categories of consumer goods and services. The rise in real spending on consumer durables, which bore the brunt of the adjustment process in consumer spending from the second half of 1984 to the first half of 1986, slightly outpaced the rise in spending on the other goods and services categories.

The seasonally adjusted annual rates of increase in aggregate real private consumption expenditure during the four quarters to mid-1987 are estimated to have amounted to 4, 5, 3½, and 2½ per cent. The tapering-off in these rates in the first half of 1987 may be difficult to reverse in the immediate future in the absence of a material improvement in aggregate real disposable personal income.

Real consumption expenditure by general government

Considerable volatility was shown by the quarter-to-quarter changes in real consumption expenditure by general government through 1985, 1986 and the first half of 1987. Real government consumption expenditure declined sharply in the third quarter of 1986 and increased only moderately in the fourth quarter, but then rose strongly in the first half of 1987. Total real government consumption expenditure during this four-quarter period as a whole exceeded by 1½ per cent the volume of such expenditure in the four quarters to mid-1986. This comprised, however, an annualised increase of 22 per cent in the first half of 1987, after a decrease of 8 per cent in the second half of 1986.

Real fixed investment

Real gross domestic fixed investment in 1985 and the first half of 1986 continued on the downward trend that had been in evidence since the first quarter of 1982, but then essentially moved sideways, or recovered marginally, from the middle of 1986. After a sharp decrease in total real gross domestic fixed investment during the first half of 1986, encouraging increases were recorded in the third and fourth quarters of 1986. Disappointing declines occurred again, however, in the first and second quarters of 1987, mainly because of large cutbacks in capital outlays by the business enterprises of general government. A rise in real private sector fixed investment resulted in a resumption of the recent upward trend in total real fixed capital formation during the second quarter of 1987. Despite this modest improvement, aggregate real gross fixed investment in the first half of 1987 was estimated to have shown no increase when compared with the first half of 1986. By mid-1987, therefore, fixed investment had as yet failed to respond in any significantly positive manner to the more pronounced upswing in the South African economy from the middle of 1986.

The average ratio of gross domestic fixed investment to gross domestic product during the first half of 1987 amounted to only 18½ per cent, compared with a ratio of 19 per cent in 1986 and more than 27 per cent during the period of rapid economic expansion from 1980 to 1982. To some extent, the severe weakness of the South African economy's investment performance in the past several years has represented the result of an accidental concurrence of a variety of extraneous factors and developments. These have included the effect of successive years of drought on the fixed capital expenditure of the farming community, the completion of large expansion projects by Sasol, and decisions by certain public corporations and government business enterprises to raise the cost-effectiveness of their operations. Civil unrest, strongly negative foreign perceptions of the South African situation, disinvestment by foreign business concerns and South Africa's exclusion from the international capital markets, as well as a diffused lack of "confidence" and a generally enhanced sense of uncertainty about the future, exerted strongly inhibiting effects on fixed capital formation in 1985 and 1986. The influence of some of these factors clearly continued to be felt in the first half of 1987.

Particularly large declines were recorded in gross fixed capital formation in the manufacturing sector. Gross fixed capital expenditure in manufacturing industry fell short of depreciation allowances throughout the four quarters from the third quarter of 1986 to the second quarter of 1987. As a result, total production capacity in manufacturing in early 1987 had shrunk to a level equivalent to production capacity as at the beginning of 1983.

Extraneous developments that result in diminished business confidence, increased uncertainty and higher perceived risk of capital investments, will adversely affect investment demand at any given level of the so-called relative "user cost" of capital goods. In addition, however, developments such as befell the South African economy in 1985 in particular may *raise* the user cost of capital in various ways. Fixed investment will then be affected adversely both by the higher relative user cost of capital and by the lower inducement to invest at any relative level of these user costs.

The user cost of capital (which also indicates the implicit rental value of capital goods) comprises elements of costs (or benefits) such as the price of new capital goods, depreciation allowances, long-term interest rates, and various taxes (or tax concessions) pertaining to the purchase, leasing or operation of the capital goods concerned. The *relative* user cost of capital is the ratio of the user cost of capital to the general level of manufacturing output prices.

The relative user cost of capital rose strongly from approximately the middle of 1983 up to early 1986, not least because of the effect of successive declines during this period in the effective exchange rate of the rand on the domestic prices of capital goods relative to the domestic prices of goods and services generally. The reasons for this exchange rate behaviour and the important part it played in restoring balance of payments strength and cushioning the impact on the economy of capital outflows and other adverse extraneous developments, are noted elsewhere in this *Report*. The relative user cost of capital was also raised in 1984 and 1985 by the higher level of domestic interest rates that resulted from the adverse balance of payments developments in these years and from the authorities' countervailing monetary policies.

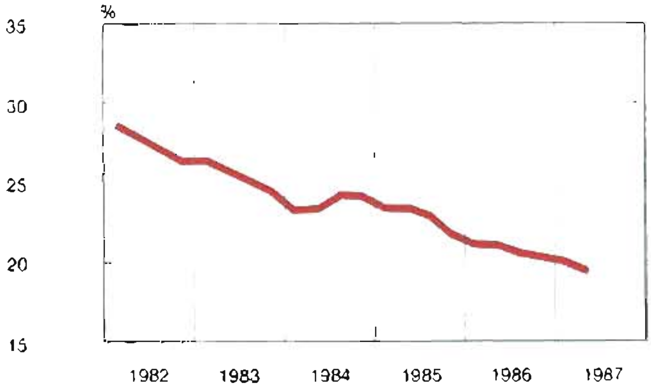
Attention was drawn in the *Annual Economic Report* for 1986 to the inverse relationship between real fixed investment in the manufacturing sector and the degree of unused production capacity. Inasmuch as the various adverse developments that unfavourably affected real fixed investment in 1984, 1985 and early 1986 also found expression in a rising level of the relative user cost of capital, an inverse relationship can also be shown to have existed between these two series. A levelling-off of the relative user cost of capital in the course of 1986 was accompanied by a bottoming-out and some recovery in aggregate real fixed investment in the third and fourth quarters of that year.

Inventory investment

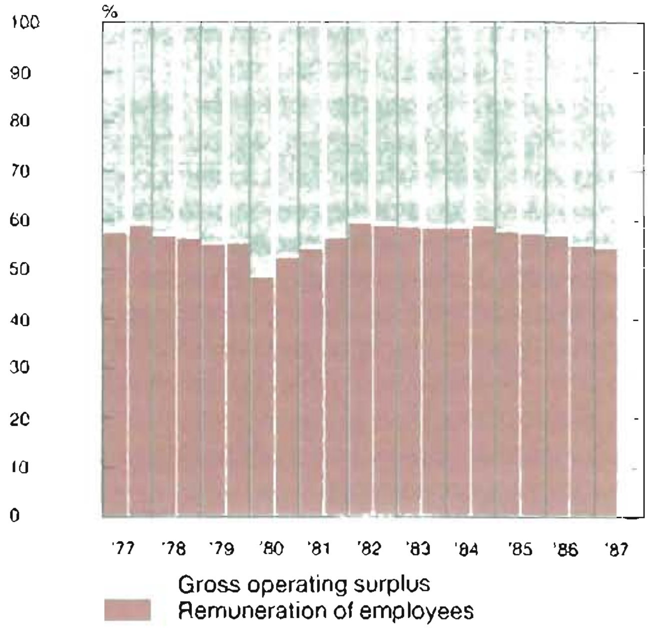
The level of real industrial and commercial inventories continued to decline further during the four quarters of the more pronounced upswing from mid-1986, but did so at a reduced rate. Relative to real gross domestic product in the non-agricultural sectors of the economy, these inventories in the second quarter of 1987 reached a new low of less than 20 per cent. This may be compared with a ratio of 28 per cent as recently as 1982.

The inventory cycle conventionally tends to lag the general business cycle. Inventories will normally be reduced deliberately or voluntarily during the more advanced stages of downswings. Their lagged relationship to the business cycle means, however, that they will continue to decline – perhaps involuntarily, because of less-than-fully anticipated increases in sales – during the earlier stages of the ensuing upswings. Conversely, inventories will normally continue to rise during the earlier stages of cyclical downswings. This fairly well-established pattern of inventory behaviour of the 1960s and 1970s was conspicuously absent, however, during the cyclical movements of the 1980s. The only

Ratio of real industrial and commercial inventories to gross domestic product excluding agriculture



Composition of gross domestic product at factor cost



interruption of the persistent decline in the volume of commercial and industrial inventories during this period occurred in the second half of 1984, when the sharp and sudden impact of the authorities' restrictive policies caused inventories to be accumulated involuntarily. Apart from factors such as the relative assuredness of supplies, techniques for more efficient inventory management and attempts at cost-cutting and rationalisation in a difficult business environment, inventory ratios among industrial and commercial enterprises in the past few years may also have been influenced downwards by considerations of uncertainty and risk, such as also affected real fixed capital formation.

Reductions were also effected in 1986 and in the first two quarters of 1987 in the volumes of non-industrial and non-commercial inventories. Diamond stocks-in-trade were reduced by more lively conditions in the international diamond market and increased diamond exports. Together with a drawing-down of mining stocks, this more than neutralised a relatively sharp increase in the inventory holdings of agricultural marketing organisations.

Factor income

Total nominal factor rewards rose briskly, by 23 per cent, from the second quarter of 1986 to the second quarter of 1987 under the impact of rising prices and wages and moderate increases in real production. The financial services sector, manufacturing and agriculture made significant advances in nominal value added and contributed substantially to the increase in aggregate factor incomes.

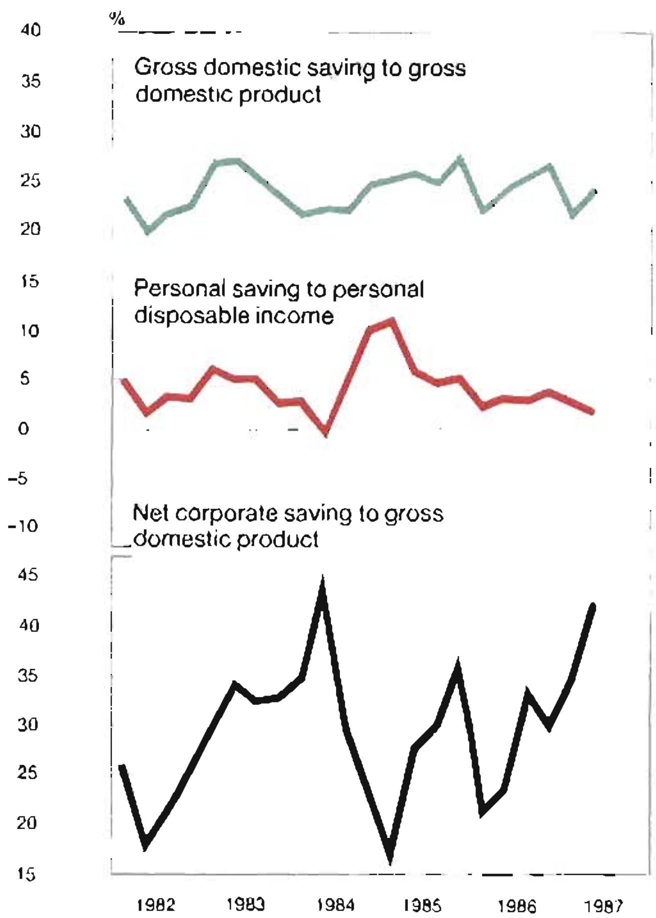
The share of labour in the total value of output behaved in a manner that is typical of the early stages of a normal cyclical upswing. Nominal wage increases, measured over one-year periods, usually still decline in the early stages of the upward phase of the business cycle. In combination with an increase in profit margins, this results in a decrease in labour's share in the total value of output. From the second quarter of 1985 to the second quarter of 1987, this share declined from 57 to approximately 54 per cent.

Increases in operating surpluses were dispersed widely through the economy in the four most recently completed quarters. Increases of more than 30 per cent were recorded in the agricultural and manufacturing sectors and in the trade and transport services sectors from the third quarter of 1986 to the second quarter of 1987.

Domestic investment and saving

The poor performance of gross domestic fixed investment and inventory investment again produced a substantial savings surplus (i.e. a surplus of domestic saving over domestic investment) during 1986 and the first half of 1987. The ratio of gross domestic investment to gross domestic product amounted to approximately 19 per cent during this period. This compared

Savings ratios



poorly with the average investment ratio of approximately 27 per cent during the years from 1980 to 1982 referred to earlier.

Domestic saving increased during the more pronounced upswing from mid-1986 to mid-1987 solely because of increased saving by the corporate sector. Relative to gross domestic product, gross domestic saving nevertheless declined significantly from approximately 26½ per cent in 1986 to about 23 per cent in the first two quarters of 1987. A decline in the gross domestic savings ratio is, however, a common feature of the earlier stages of an upswing in economic activity.

The general government sector once again experienced a shortfall of current income vis-à-vis current expenditure and therefore turned in a negative savings contribution. Household savings relative to personal disposable income shrank somewhat further to exceptionally low levels that amounted to an estimated average of only about 1½ per cent in the first half of 1987. The bulk of domestic savings therefore was contributed by the corporate sector; some 64 per cent of gross corporate savings currently is needed, however, for the replacement of worn-out or obsolete capital goods.

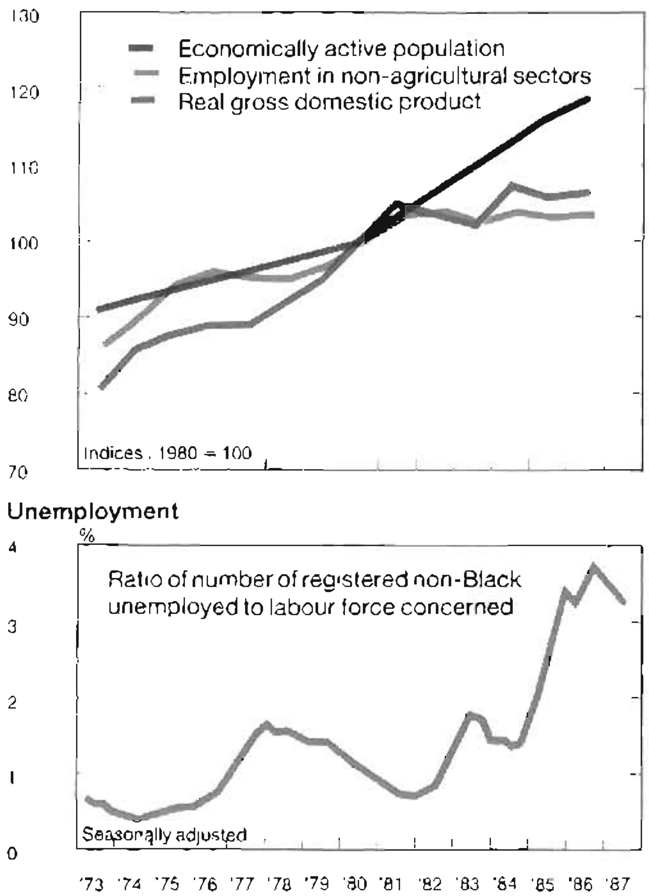
Employment

The moderate acceleration of the economic recovery from the middle of 1986 also resulted in a more pronounced increase in the demand for labour. Total employment in the non-agricultural sectors of the economy rose at seasonally adjusted annual rates of 0,6 and 1,2 per cent in the third and fourth quarters of 1986, respectively. These increases were modest by the standards of employment growth in the 1970s and early 1980s, which – for the years from 1970 to 1982 – amounted to an annual average of 2,5 per cent. They nevertheless compared favourably with the actual *decline* in employment from 1982 to 1985 and with the virtual absence of any increases in employment in the first half of 1986. Higher total employment levels in the second half of 1986 reflected further increases in employment by public authorities in the third and fourth quarters, and in private sector employment in the fourth quarter of the year.

Further strengthening of the demand for labour also succeeded in reversing fairly significantly the sharp rise in unemployment that had occurred from the middle of 1984 up to the end of 1985. The seasonally adjusted number of all registered unemployed varied around 130 000 in the course of 1986 but declined to approximately 125 000 in March 1987 and to approximately 121 000 in May. Viewed in relation to the labour force concerned, the decline in the number of registered *non-Black* unemployed from the second half of 1986 compared favourably with the declines in registered unemployment during the corresponding early stages of the economic upswings of 1972-1974, 1978-1981 and 1983-1984. In similar fashion, the revised Current Population Survey for Blacks showed the number of unemployed Black workers to have decreased fairly dramatically from 1 181 000, or approximately 20 per cent of the Black labour force, in July 1986, to 1 040 000, or 16,7 per cent of the Black labour force, in March 1987.

Despite these cyclical improvements, unemployment by the standards of South Africa's experience of the 1960s, 1970s and early 1980s remained at high levels during 1986 and the first half of 1987. In the

Real gross domestic product, economically active population and employment in non-agricultural sectors



second quarter of 1987, the ratio of non-Black unemployment to the non-Black labour force, for example, still amounted to 3,3 per cent. This may be compared with ratios of 1,5 and 1,3 per cent at corresponding points in time from the relevant lower cyclical turning points in the course of the economic upswings of 1978-1981 and 1983-1984, and of only 0,5 per cent at the corresponding point in time in the course of the economic upswing of 1972-1974. Like several industrial countries, South Africa may, therefore, have experienced a change to durably or "structurally" higher unemployment levels that do not readily lend themselves to treatment by conventional policies of aggregate demand management.

Special training and job creation programmes have been implemented since 1985 as temporary measures for the short-term alleviation of the unemployment problem. During the two years ended March 1987, 560 000 persons completed training in terms of these programmes. An average of 232 000 persons per day were employed in various job creation programmes during 1986. In March 1987 the number of people so employed amounted to 289 000. In 1986 it was decided that the special employment programme would be continued for the next five years.

Longer-term policies, aimed at combating the non-cyclical element in the unemployment situation, are contained in the Government's long-term economic strategy for fostering economic growth and promoting job creation. These include, inter alia, the Government's declared policies of deregulation and privatisation as well as measures for further enhancing the mobility of labour and the efficient functioning of labour markets.

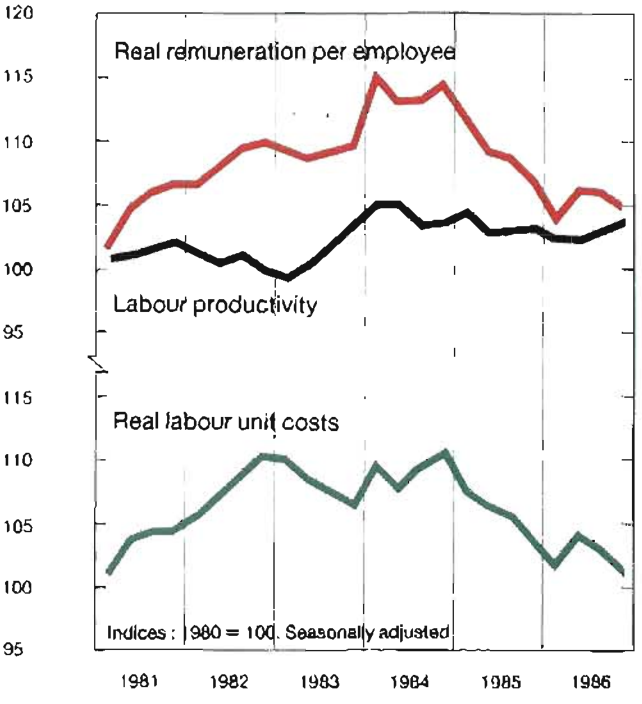
As noted in a subsequent section, a marked decline has been in evidence since the first quarter of 1984 in the ratio of the real remuneration per worker to real labour productivity. The decline in average real labour remuneration obviously made a major contribution to the decline in average real personal disposable income in recent years, which has been an important element among the various recent constraints on aggregate real private consumption expenditure and aggregate real domestic demand.

Labour costs and productivity

The rate of increase in the average nominal amount of salaries and wages per worker in the non-agricultural sectors of the economy accelerated from 11,2 per cent in 1985 to 14.4 per cent in 1986. Higher rates of increase were observed in both the public and the private sector. Reflecting the relative moderateness of wage settlements, however, the rate of increase in average nominal labour remuneration in 1986 as well as in 1985 still fell significantly short of the rate of increase in the consumer price index. Remuneration per employee *in real terms* accordingly declined by 4,3 per cent and 3.6 per cent in 1985 and 1986, respectively. The average real wage per worker in the fourth quarter of 1986 was 2,0 per cent lower than in the fourth quarter of 1985, and no less than 9,1 per cent lower than the high point in this average in the first quarter of 1984

Moderation in wage settlements was maintained despite a sharp increase in the membership of registered trade unions and a sharp rise in the incidence of strikes and industrial disputes in recent years. Membership of registered trade unions rose from 781 000 in 1980 to 1,7 million in 1986. The number of man-days lost on account of industrial disputes and work stoppages

Non-agricultural labour productivity, remuneration and unit costs



rose from 380 000 in 1984 to 1,3 million in 1986. Wages and wage-related problems, however, accounted for only 31 per cent of strikes in 1986, against 55 per cent in 1980 and 42 per cent in 1985.

Labour productivity, as measured by the real gross domestic product per worker in the non-agricultural sectors of the economy, declined by 1,0 per cent in 1985 and by 0,6 per cent in 1986. In addition to long-term and "structural" factors that have adversely affected the productivity of South African labour since the 1970s, labour productivity also declined cyclically during the economic downswing from the second half of 1984 through the first half of 1985 and during the earlier stages of the subsequent economic recovery from the second half of 1985 through the first half of 1986. Productivity in 1986, moreover, was influenced unfavourably by the increased number of industrial disputes and work stoppages. Improvements in productivity were recorded, however, during the second half of the year. Increases in real output per worker at seasonally adjusted annual rates of 2,9 and 3,4 per cent in the third and fourth quarters of 1986, respectively, mainly reflected the more pronounced rise in the volume of non-agricultural production, which significantly exceeded the rise in non-agricultural labour inputs during this period.

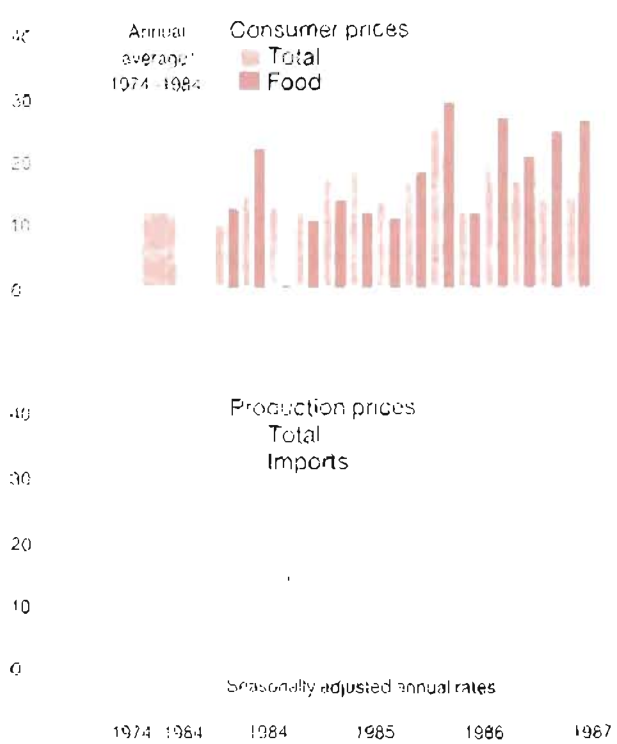
Larger relative increases in *nominal* wages, in conjunction with the lower average level of labour productivity, caused the rise in unit labour costs, in nominal terms, to accelerate from 12,3 per cent in 1985 to 15,0 per cent in 1986. On a quarter-to-quarter basis this rate slowed down sharply, however, from an annualised level of 25,3 per cent in the second quarter of 1986 to only 8,8 per cent in the fourth quarter. In contrast, the decline in the average *real* wage per worker from the first quarter of 1984 also caused the *real* cost of labour per unit of physical production to decline throughout 1985 and 1986. By the end of 1986 real labour costs per unit of physical output barely exceeded their level as in the first quarter of 1981.

Prices

The inflation rate, as measured by quarter-to-quarter changes in the consumer price index at seasonally adjusted annual rates, slowed down from as much as 26,0 per cent in the first quarter of 1986 and 20,7 per cent in the third quarter of 1986, to 15,1 per cent and 15,0 per cent in the first and the second quarter of 1987, respectively. Measured in the same way, the rate of inflation in production prices subsided from 26,3 per cent and 18,3 per cent in the first and the third quarter of 1986 to 13,7 per cent and 12,7 per cent in the first and the second quarter of 1987, respectively. These more recent improvements, however, were not yet reflected in the annual averages of the inflation rate. From the calendar year 1985 to the calendar year 1986 the rate of inflation in consumer prices and in production prices still advanced from 16,2 per cent to 18,6 per cent and from 16,9 per cent to 19,6 per cent.

Contrary to the South African experience during most of the post-war period, the rise in the inflation rate up to the first quarter of 1986 and its temporary rise in the third quarter of 1986 clearly could not be attributed to excessive further increases in aggregate domestic monetary demand. A relative *lack* of aggregate monetary demand, in fact, continued to be evident from the relatively high degree of underutilisation of capital and labour resources from 1985 onwards. The adoption of a moderately expansionary stance of monetary and fiscal policy in the course of 1985 and 1986 accordingly was justified by the need to reinvigorate domestic demand and restimulate growth in the presence of substantial idle production capacity.

Percentage change in prices



Unduly rapid increases in nominal *wages* – i.e. wage "push" – similarly could not account for the acceleration of the inflation rate in 1986. Increases in money wages are, of course, a vital ingredient of inflation as a process of sustained increases in the general price level. "Autonomous" wage increases, moreover – i.e. increases in money wages that cannot be explained from increases in the *demand* for labour – are also likely to have played some part in the South African inflation experience of the past several years. It was noted in an earlier section, however, that increases in the average nominal wage per worker fell short of the rise in the average level of consumer prices in both 1985 and 1986. From the labour point of view, therefore, wage settlements in these two years generally were of a "defensive" rather than "aggressive" nature. As such, these settlements failed fully to maintain the average worker's real wage position. During 1985, 1986 and the first half of 1987 they also did not succeed in increasing, or even in fully maintaining, the share of aggregate real labour remuneration in real gross domestic product at its average level as in 1984.

The main reason for the acceleration of the inflation rate from 1985 to 1986 clearly was the decline in the effective exchange value of the rand in the course of 1984, the second half of 1985 and parts of 1986. The various shorter-term *variations* in the inflation rate in 1985 and 1986 primarily reflected the lagged effects on the prices of imported goods of depreciations or appreciations of the rand exchange rate in preceding quarters. Most recently, the marked strengthening of the exchange rate from September 1986 contributed materially to lower levels of the inflation rate in the first two quarters of 1987. Against this, the slowly declining general *level* of the inflation rate around which these variations have taken place, clearly also incorporated the effect of inflationary *expectations*. In the light of the inflation experience of the past several years, a broad "consensus" concerning the minimum rate of inflation that is to be expected within the foreseeable future is likely to exist among both the buyers and sellers of labour services, and of goods and services generally.

In the wake of the steep decline in the exchange value of the rand during the second half of 1985, prices of imported goods that are included in the production price index rose at a seasonally adjusted annual rate of as much as 41,0 per cent in the first quarter of 1986 and at an average annual rate of 28,4 per cent in the first half of the year Following the recovery of the rand in the first quarter of 1986 (and its renewed decline in the second quarter), these prices then advanced at an average annual rate of only 9,9 per cent in the second half of 1986 The marked improvement in the effective exchange rate of the rand from September 1986 subsequently helped the tempo of increases in imported goods prices to retreat slightly further to an average annualised rate of 9,6 per cent in the first half of 1987

Variations in the rate of increase in the general price level during 1986 and the first half of 1987 not only reflected the effects of earlier short-term changes in the exchange rate, but also incorporated the impact of sharp and variable increases in the consumer prices of food. The rate of increase in the average consumer price level of foodstuffs rose sharply in the first quarter of 1986, slowed down in the second quarter, but accelerated sharply again from the third quarter of 1986 up to the second quarter of 1987. To a certain extent, these price movements reflected the effect of a relative undersupply of items such as vegetables and meat.

Notwithstanding the accelerated rise in food prices the rate of increase in the consumer price index over twelve-month periods slowed down from 20,0 per cent in September 1986 to 16,1 per cent in January 1987 before reverting to 16,8 per cent in March and to 17,2 per cent in June. Decelerations in the rates of increase in the cost of housing and services, and in the prices of motor cars, contributed to these moderately lower rates of increase in the consumer price index.

Even at its moderately lower levels of recent quarters, the inflation rate in the South African economy continued to be significantly higher than in earlier years and far in excess of the inflation rates in the country's principal international trading partners. Further filtering-through of the effects of the higher average level of the exchange rate from September 1986 will, however, continue to affect the inflation rate beneficially during the remainder of 1987 and is likely to result in a lower average level of the inflation rate in 1987 than in 1986. Against this, various recent developments by the third quarter of 1987 appeared likely to set limits to further declines in the inflation rate in the short term. Such developments included the still relatively high rate of increase in food prices; higher rates of increase in the prices of basic metals, machinery, chemicals, furniture and other wood products, and clothing, in the second quarter of 1987; and upward adjustments to certain administered prices, such as postal and transport tariffs, that became effective in July.

Foreign trade and payments

Successful balance of payments adjustment

The deficits that were recorded on the balance of payments on current account from the fourth quarter of 1983 to the third quarter of 1984 amounted in total to R3,3 billion, or to 3 per cent of gross domestic product. The total net inflow of reserve-related and non-reserve-related short and long-term capital during this period amounted to a broadly commensurate R3,2 billion. In 1985 and 1986 the total net *outflow* of capital (including reserve-related capital) amounted to R7,2 billion and R8,4 billion, respectively. The *surpluses* that were recorded on the current account of the balance of payments during these two years amounted to R5,9 billion and R7,2 billion, or to 5 per cent of gross domestic product in both these years.

The very large internal and external adjustments implied by these data, which indicate the extent to which South Africa was compelled to achieve current account surpluses so as to be able to become a medium-sized capital-exporting country, were the more remarkable for having been made in an international environment of relatively slow growth in world trade and production, sagging world commodity prices in both absolute and relative terms, a diminished international demand for gold, diamonds and other "hedge assets" against inflation, and a rising tide of protectionism that was damaging in particular to the more labour-intensive exports of developing countries.

As was noted in earlier sections, these adjustments were forced upon the South African economy by the unsustainability of the mini-boom of 1983-84 and, to a much more important extent, by the externally imposed crisis on the capital account that arose in 1985. It was also noted that these adjustments were made only at the price of substantially higher levels of unemployment, reduced rates of growth in real output, income and expenditure in the domestic economy, and downward pressure on living standards. They were accompanied in 1985 and the first half of 1986 by considerably lower levels of the effective exchange rate and the foreign reserves, and by considerably higher rates of inflation, than would otherwise have been experienced.

The adjustments were also remarkable, however, for having been made in a world in which a number of developing countries failed to rise to the challenges that were posed by their large international indebtedness and their debt-servicing obligations. Strength of the balance of payments on current account enabled South Africa to comply punctiliously at all times with the requirements of interest-servicing its foreign debt, to meet fully and meticulously its debt repayment obligations as set out in its first and second debt repayment agreements with foreign creditor banks, and to repay substantial amounts of foreign debt outside the so-called standstill net. South Africa therefore successfully warded off the symptoms of "debt fatigue" as displayed by certain debtor countries that were forced, or elected, to limit or to suspend interest payments on their foreign debt. In making its adjustments, moreover, South Africa did not have access to the open international capital markets, nor did it enjoy the benefits of

Current account of balance of payments
Annualised seasonally adjusted figures
R millions

	1985	1986					1987	
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Merchandise exports	20 465	20 211	24 270	28 635	27 076	25 048	23 850	24 430
Net gold exports	15 460	15 780	16 069	18 038	16 989	16 719	18 370	17 030
Merchandise imports	–23 045	–24 575	–24 364	–30 340	–22 777	–25 514	–26 410	–27 370
Trade balance	12 880	11 416	15 975	16 333	21 288	16 253	15 810	14 090
Net service and transfer payments	–6 955	–8 797	–9 646	–9 376	–8 409	–9 057	–8 650	–8 320
Current account balance	5 925	2 619	6 329	6 957	12 879	7 196	7 160	5 770

being able to borrow from the International Monetary Fund. South Africa, in fact, was required to make repayments on its debt to the IMF.

Further large current account surpluses were recorded in the first half of 1987. In addition, South Africa, as set out in more detail in subsequent sections, from mid-1986 to mid-1987 experienced a substantial strengthening of its exchange rate, an approximate doubling of its gross foreign reserves, and substantial improvements in the various measures that are used for assessing the relative extent of countries' foreign indebtedness, their debt-servicing capabilities and their international creditworthiness.

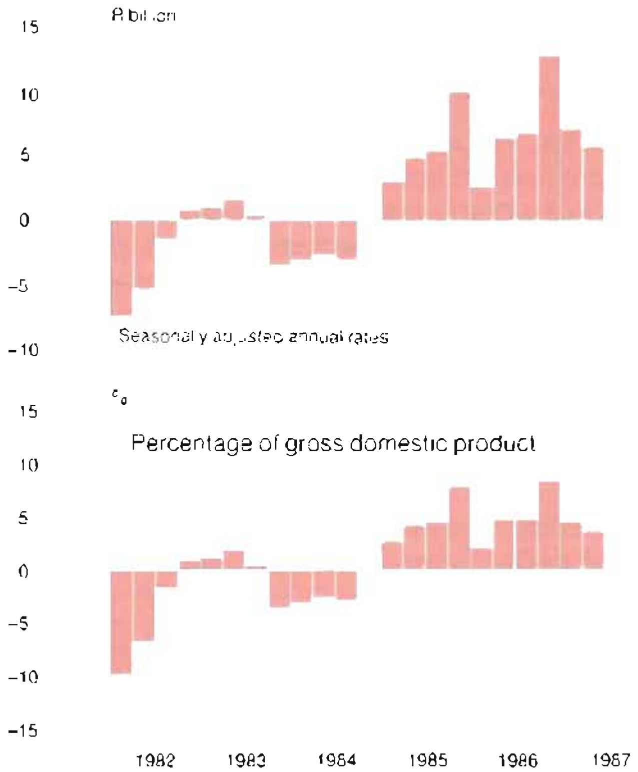
Balance of payments on current account

Having moved into surplus in the first quarter of 1985, the current account of the balance of payments improved further during the remainder of 1985 and in calendar 1986 (compared with calendar 1985) but declined somewhat in the first half of 1987. At seasonally adjusted annual rates, the balance on current account changed from a deficit of R3,4 billion in the fourth quarter of 1983 to a surplus of no less than R12,9 billion, or 9 per cent of gross domestic product, in the fourth quarter of 1986. The surplus then shrank to a quarterly average, at an annualised level, of R6,5 billion in the first half of 1987. This was somewhat below the quarterly average in 1986 but still amounted to 4 per cent of gross domestic product.

The sustained surplus on the current account of the balance of payments during the past ten quarters resulted mainly from an impressive performance of merchandise (non-gold) exports, which nearly tripled from a seasonally adjusted annualised level of R9,6 billion in the third quarter of 1983 to R27,1 billion in the fourth quarter of 1986. This increase partly reflected the lower value of the rand in terms of other currencies. It was also brought about, however, by a substantial rise in the volume of exports. South Africa accordingly succeeded in maintaining its share in world exports at a level of slightly more than 1 per cent.

The rise in the volume of South African merchandise exports in 1986 amounted to 7 per cent. This reflected a more rapid expansion of world trade, which grew by 5 per cent in 1986 against an increase of 3 per cent in 1985, as well as increased competitiveness of South African exports resulting from a lower average real effective exchange rate of the rand. Better rainfall and other weather conditions also resulted in higher volumes of agricultural exports. The somewhat lower volume of merchandise exports in the first half of 1987 reflected, inter alia, a slowdown in world economic growth and,

Balance of payments: Balance on current account

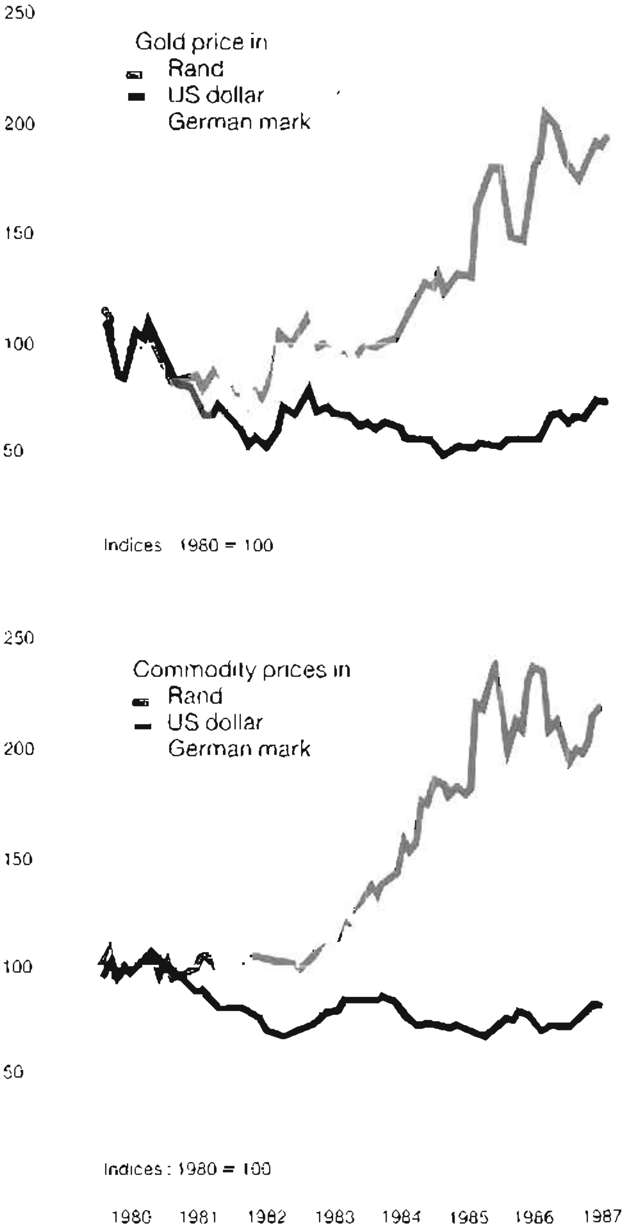


to some extent, also the application of international sanctions against certain South African export goods. Relative to real gross domestic product, the volume of merchandise exports increased from 12 per cent in the fourth quarter of 1983 to 18½ per cent in the fourth quarter of 1986. It then subsided to 17 per cent in the second quarter of 1987.

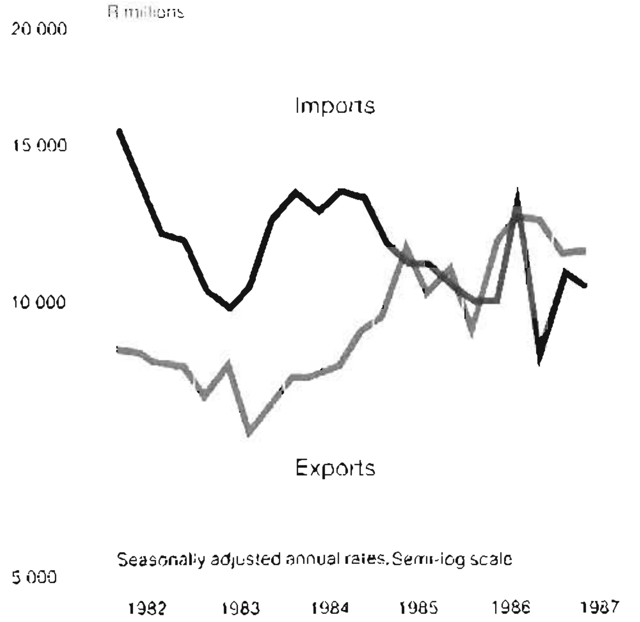
Export *prices*, on average, rose by 14½ per cent in 1986. This was accounted for by a depreciation of 12,3 per cent in the effective exchange rate of the rand and by a moderate increase in international commodity prices. International commodity prices in 1986 rose by 5 per cent in terms of the US dollar, but were still some 25 per cent below their average level in 1980. They continued to decline substantially, however, in terms of the German mark. International prices of precious metals, on the other hand, advanced considerably, even in terms of the strong currencies.

The value of net gold exports, which had also increased substantially from 1983 to 1985, rose by a further 8 per cent during 1986 as a result of a higher average level of the gold price. In accordance with the mines' policy of mining lower-grade ore, the *volume* of gold production was reduced further in 1986. This part-

Gold and commodity prices



Merchandise imports and exports at constant 1980 prices



ly neutralised the higher gold price, with the result that the value of net gold exports increased by only about 1 per cent from the second half of 1986 to the first half of 1987.

The price of gold per fine ounce fluctuated sharply upwards from US $343 in the first quarter of 1986 to US $450 in the second quarter of 1987. Exchange rate changes, however, occasionally caused the quarterly average of the gold price to fall back in terms of rand. The rand price of gold rose from R740 per fine ounce in the first quarter of 1986 to R945 in the third quarter, but retreated to R844 in the first quarter of 1987 owing to the rand's appreciation against the dollar. It then rose to R907 in the second quarter of 1987, when a marked further rise in the price of gold in the international markets more than offset the effect of a further rise in the dollar/rand exchange rate.

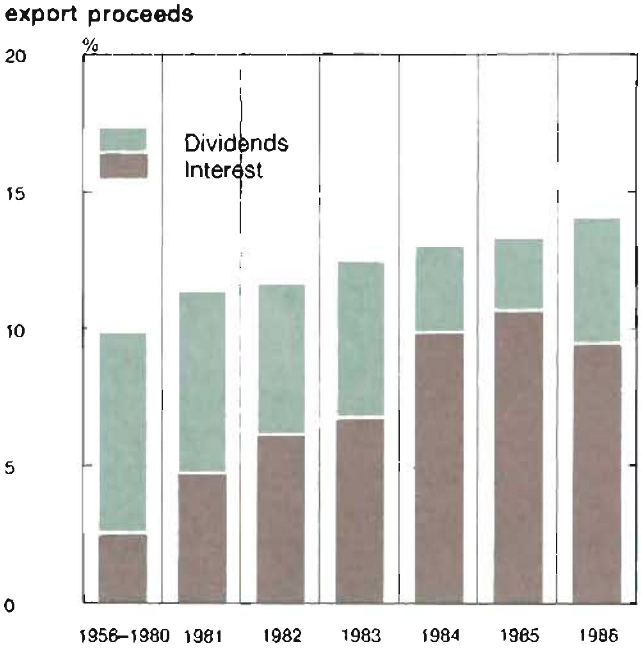
Transformation of the current account deficits that were recorded during the 1983-84 mini-boom into continuous surpluses from the first quarter of 1985 onward, also reflected a fairly low rate of increase in the value of merchandise *imports* during the past several years. The fairly modest 11 per cent increase in the value of merchandise imports from 1985 to 1986 was more than fully accounted for by a 17 per cent rise in the average level of import prices. The *volume* of merchandise imports actually declined by 5 per cent in 1986, despite the more pronounced rise in economic activity in the second half of the year. By the second quarter of 1987, the seasonally adjusted volume of merchandise imports still fell short quite substantially (i.e. by as much as 21½ per cent) of its mini-boom high point in the first quarter of 1984.

Relatively sluggish growth in import volumes during the recession of 1984-85 and the reluctant recovery of 1985-86 also was apparent from a decline in the import "penetration ratio" (i.e. the ratio of real merchandise imports to real gross domestic product or real gross domestic expenditure). The ratio of the volume of merchandise imports to real gross domestic expenditure declined from 21½ per cent in calendar 1984 to 18½ per cent in calendar 1986. This was primarily an indication of lower levels of economic activity in much of 1986 than in most of 1984. To some extent the further decline in the penetration ratio also was a reflection, however, of continuing import substitution, and more particularly of an increased measure of South African self-sufficiency in the production of liquid fuels after the completion of Sasol II and Sasol III.

From the second half of 1986 to the first half of 1987 the value of merchandise imports rose marginally by 1 per cent. This was once again more than fully explained by a rise in import prices (of 2 per cent), which mainly reflected a hardening of prices in the international oil market. Despite further increases in real output and expenditure in the first half of 1987, import volumes again declined slightly (by 1 per cent).

Net service and transfer payments to foreigners rose from R7,0 billion in 1985 to R9,1 billion in 1986 but then declined to a seasonally adjusted annualised level of R8,5 billion in the first half of 1987. The increase in the net amount of such payments from 1985 to 1986 was the result of a rise in service and transfer payments to foreigners and a less than proportionate increase in service and transfer receipts from foreigners. The rise in such payments to foreigners was mainly due to rising costs of freight and insurance and to increased payments of dividends. Payments of dividends to foreigners actually rose to as much as 20½ per cent of total dividend payments, compared with an average of 17 per cent during the quarter-century from 1960 to 1985.

Interest and dividend payments as percentage of total export proceeds



Capital account

Developments which forced the imposition of the standstill on most foreign debt repayments from 2 September 1985 continued to affect movements on the capital account of the balance of payments during 1986 and, to a diminishing extent, also during the first half of 1987. As observed in the Reserve Bank's *Annual Economic Report* for 1986, the imposition of the standstill and the simultaneous reimposition of exchange control over non-resident equity capital movements did not succeed in preventing a large net outflow of capital, which derived mainly from strongly adverse leads and lags in international payments and receipts.

The outflow of capital not related to reserves amounted to R6,9 billion in the second half of 1985 but subsided sharply to R2,7 billion in the first half of 1986. A further large outflow of non-reserve-related capital, amounting to R3,4 billion, was, however, recorded in the second half of 1986. This outflow was accounted for mainly by continuing repayments on foreign loans and by a substantial build-up of foreign assets that was related to the higher value of South African merchandise exports.

From the beginning of 1987 the capital account of the balance of payments improved substantially. To a major extent, this improvement reflected more favourable foreign perceptions of the South African economic and socio-political situation. The total net outflow of capital (excluding changes in reserve-related liabilities) during the first half of 1987 accordingly contracted further to R0,5 billion.

In addition to these various capital movements, the banking sector and the Government reduced their reserve-related short-term foreign liabilities by R2,3 billion in 1986 and by a further R1,0 billion in the first half of 1987.

As is apparent from the accompanying table, the initial sharp deterioration and subsequent improvement of the capital account of the balance of payments from the first half of 1985 to the first half of 1987 comprised major changes in flows of both long-term and short-term capital. A significant inflow of *long-term* foreign capital during most of the first half of 1985 was transformed into a major outflow immediately after imposition of the standstill and the reimposition of exchange

Net capital movements (not related to reserves)
R millions

	1985		1986		1987
	1st half	2nd half	1st half	2nd half	1st half
Long-term capital					
Public authorities	52	–467	–265	–40	–226
Public corporations	573	244	–80	5	695
Banking sector	–242	–56	–76	–27	–22
Private sector					
Net purchases of listed securities	155	–491	–550	–844	–755
Other capital	–224	11	–119	–193	–260
Total long-term capital	314	–759	–1 090	–1 099	–568
Short-term capital, including unrecorded transactions	–2 644	–6 142	–1 621	–2 287	64
Total capital movements	–2 330	–6 901	–2 711	–3 386	–504
Change in liabilities related to reserves	–323	2 394	–2 258	–25	–1 004

control on non-resident equity capital from 2 September 1985. In its earlier stages, this outflow arose mostly from repayments on foreign loans by public authorities, and from a change-over from net purchases to net sales by non-residents of securities listed on the Johannesburg Stock Exchange. Although recorded as long-term capital outflows, such sales, under the financial rand system, do not, of course, occasion an actual loss of foreign reserves.

Even more substantial outflows of long-term capital were recorded in the first and second halves of 1986. A worsening of these outflows occurred as net sales of listed securities by non-residents quickened and as repayments on foreign loan commitments also began to be made by public corporations. Conversely, subsidence of the net outflow of long-term capital in the first half of 1987 was attributable mainly to renewed net foreign borrowing by public corporations. New foreign loans raised by public corporations in the six months to mid-1987 amounted to R695 million.

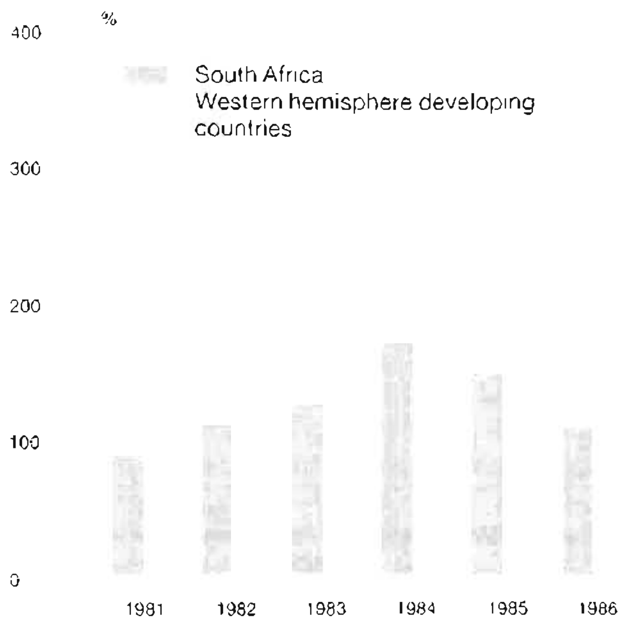
The large net outflow of non-reserve-related *short-term* foreign capital in the first half of 1985 accelerated sharply in the second half of 1985 and, although it subsequently declined significantly, remained large throughout 1986. The outflow during 1986 as a whole amounted to R3,9 billion, compared with an outflow of R8,8 billion during 1985. The continuing relatively high level of short-term capital outflows during 1986 was related not only to intermittent unfavourable leads and lags (notably in the second quarter of the year), but also to the granting of additional export credits to foreign buyers of South African goods (notably in the fourth quarter). The increase in such credits amounted to R2,7 billion for 1986 as a whole. A small net *in*flow of non-reserve-related short-term foreign capital, amounting to R64 million, was, however, recorded during the first half of 1987.

The decline in *reserve-related* liabilities of R3,3 billion during the eighteen months to the end of June 1987 included a repayment of R1,3 billion on South Africa's 1982 loan from the International Monetary Fund. In addition, large repayments were made on the Reserve Bank's foreign loan commitments.

Major improvement of foreign debt position

Substantial repayments on foreign debt during the period after imposition of the standstill caused South Africa's foreign loan commitments to contract from US $23,7 billion at the end of August 1985 to US $20,4 billion at the end of December 1986, when valued at the dollar exchange rates that prevailed at the end of August 1985. When valued at the dollar exchange rates as at the end of December 1986, South Africa's foreign debt as on that date amounted to US $22,6 billion; the smaller decline in this case arises from the effect of the depreciation of the US dollar vis-à-vis other major currencies on the dollar equivalents of foreign loan obligations that are denominated in non-dollar currencies.

Ratio of external debt to exports of goods and services



When expressed in terms of its ratio to total exports of goods and services, South Africa's foreign debt contracted substantially from 171 per cent in 1984 to 108 per cent in 1986. This may be compared with a significant further deterioration of this ratio among Western hemisphere developing countries from 277 per cent in 1984 to 355 per cent in 1986. A broadly similar improvement in South Africa's foreign debt situation was indicated by the ratio of interest payments to total exports of goods and services as a standard measure of debt-servicing capability. This ratio declined from 10,7 per cent in 1985 to 9,5 per cent in 1986.

Further arrangements for the repayment of debt to foreign creditors were negotiated with foreign creditor banks in February 1987 against the background of South Africa's strongly favourable balance of payments on current account and its improving foreign debt position. The so-called Second Interim Arrangements that became effective in July 1987 closely resembled the "consensus of agreement" of February 1986 but were different from these "first" arrangements in four major respects:

Firstly, a longer debt standstill period, which was to extend from 1 July 1987 to 30 June 1990, was agreed upon.

Secondly, a new formula for further debt repayments was determined. An up-front payment was to be made on 15 July 1987 of 3 per cent of the as yet unrepaid amounts of all "affected debts" that had matured on or before 30 June 1987; the amount of this repayment came to approximately US $300 million. Further repayments then were to be made on an on-going basis of 3 per cent of all newly maturing "affected debts" on their respective maturity dates up to 30 June 1990. Finally, repayments were to be made on 15 December 1987 and 15 June 1988 (or on the original maturity dates, where applicable), of 2 per cent of the as yet unrepaid amounts of all "affected debts" maturing or having matured on or before 31 December 1987 and 30 June 1988, respectively; and on 15 December 1988, 15 June and 15 December 1989, and 15 June 1990 (or on the original maturity dates, where applicable), of 1½ per cent of the as yet unrepaid amounts of all "affected debts" maturing or having matured on or before 31 December 1988, 30 June and 31 December 1989, and 30 June 1990, respectively. When the up-front repayment of 15 July 1987 is included, the total amount of debt to be repaid in these various ways came to about US $1,5 billion, or to an effective 11,8 per cent of all "affected debts" outstanding to foreign creditors on 1 July 1987.

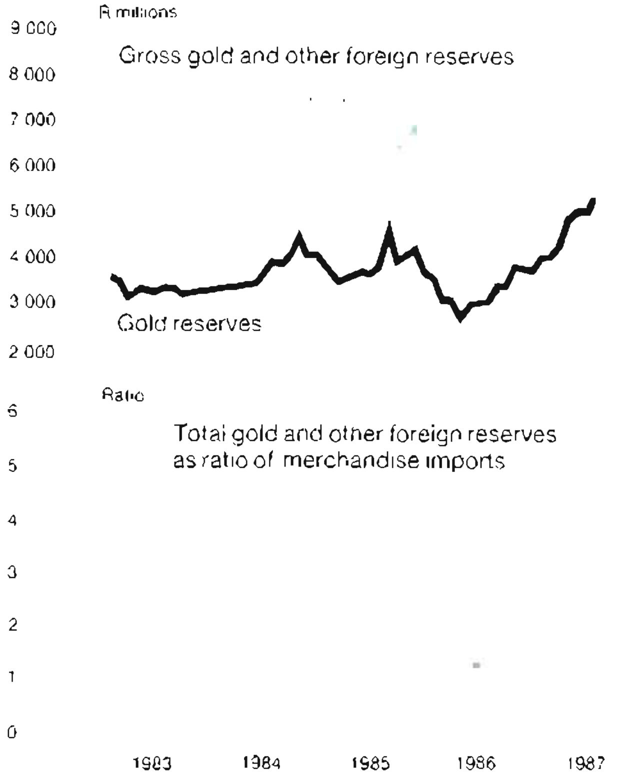
Thirdly, a revised "exit clause" was accepted which would allow creditors to convert debt inside the net to long-term debt outside the net. Debt so converted would be repayable over a ten-year period. A proportion in accordance with the above formula would be repayable up to the end of June 1990; the remainder then would be repayable in ten equal semi-annual instalments beginning five years after the conversion date.

Fourthly, a possibility was held open that debt inside the net would be made convertible into equity outside the net. As of August 1987, this possibility was still being investigated.

Foreign reserves

Under the impact of the sustained large surpluses on the current account of the balance of payments and the more recently improving position of the capital account, the total gross gold and other foreign reserves rose from a low turning point of R3,9 billion at the end of April 1986 to R7,8 billion at the end of June 1987. At this level, the reserves were equivalent to approximately 3½ months' imports. In July 1987 the gold and other foreign reserves of the Reserve Bank rose further by R596 million to R7,1 billion at the end of the month. Apart from improvements in the country's foreign exchange holdings, the Reserve Bank's gold holdings also increased substantially. These holdings rose from 3,7 million fine ounces at the end of July 1986 to 6,2 million fine ounces at the end of July 1987

Total gold and other foreign reserves



Exchange rates

Considerable fluctuations occurred in the effective exchange rate of the rand over the 20-month period from the end of December 1985 to the end of August 1987. A sharp drop in the average exchange value of the rand was recorded from late-August to mid-December 1985. Some improvement in foreign perceptions of the South African situation, a consequent fading-away of adverse leads and lags from mid-December 1985 into the first quarter of 1986, and the successful negotiation of the first set of debt repayment arrangements in February 1986 then caused the average value of the rand to appreciate by 30 per cent from 18 December 1985 to 13 March 1986.

From 13 March 1986, the effective exchange rate of the rand fell back sharply to a new record low on 12 June 1986. This renewed decline was occasioned by foreigners' response to continued socio-political disturbances in South Africa and by threats of extended economic sanctions, as well as by a marked depreciation of the US dollar vis-à-vis European currencies and the yen and by the rand's inability to maintain its value vis-à-vis the US dollar.

In the ensuing weeks, the exchange value of the rand recovered only slightly up to the end of August 1986. A sharp rise in the dollar price of gold, however, then caused the effective exchange rate of the rand to rise abruptly up to 22 September to a level that was some 23 per cent above the low point of 12 June 1986. From 22 September the rand continued to strengthen against the dollar; the effective exchange rate, however, showed only a modest further appreciation up to the end of the year. The average effective exchange rate of the rand in calendar 1986 was some 12 per cent lower than in calendar 1985.

Changes in the exchange rates of the rand
%

	18 Dec 1985 to 13 Mar 1986	13 Mar 1986 to 12 June 1986	12 June 1986 to 22 Sept 1986	22 Sept 1986 to 31 Dec 1986	31 Dec 1986 to 31 July 1987
Weighted average	30,1	–28,7	23,1	0,6	3,2
US dollar	36,4	–29,1	26,7	0.8	6,0
British pound	33,3	–32,0	32,3	–0,6	–2,3
German mark	24,6	–31,8	17,6	–4,0	0,9
Swiss franc	25,2	–33,2	14,5	–0,3	–
Japanese yen	21,9	–34,9	17,9	4,6	–1,0
French franc	25,2	–29,3	19,1	–1,5	1,3
Financial rand	26,5	–43,4	14,2	–7,1	43,0

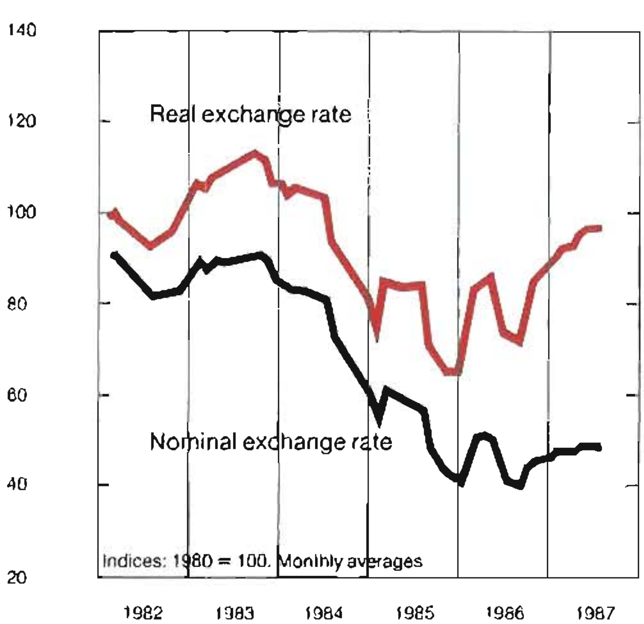
During the first six months of 1987 the rand appreciated further against the dollar but remained broadly unchanged against other major currencies. The rise in the average effective exchange value of the rand from the fourth quarter of 1986 to the second quarter of 1987 accordingly amounted to an undramatic 5,3 per cent.

In July 1987 the general strengthening of the US dollar in the international foreign exchange markets had little effect on the rand's exchange rates vis-à-vis other major currencies. The effective exchange rate of the rand therefore was influenced only slightly by this development.

The financial rand, like the commercial rand, depreciated sharply from early March 1986. At its record low level of 18,25 US cents, reached on 7 August 1986, its discount vis-à-vis the commercial rand amounted to as much as 52,3 per cent. During the remainder of 1986 the financial rand fluctuated around 21 US cents.

In line with the rising dollar price of gold and more favourable foreign perceptions of the South African economic and socio-political situation, which were also aided by South Africa's successful negotiation of the new debt repayment arrangements with foreign creditor banks in February 1987, the value of the financial rand strengthened markedly from the beginning of 1987. On 31 July 1987 its value amounted to 30,75 US cents. This represented a discount vis-à-vis the commercial rand of 36,5 per cent, compared with a discount of approximately 50 per cent during the four months to the end of February. From the end of March 1987 the financial rand fluctuated between 28 and 33 US cents. The financial rand discount varied between 30 and 42 per cent during this period.

Effective exchange rate of the rand



Monetary and financial developments

Easing of monetary policy and maintenance of expansionary policy stance

Monetary policy was eased further in the course of 1986 and a moderately expansionary stance of policy was maintained during the first eight months of 1987.

A first step in easing monetary policy from the restrictive stance that had been adopted in the second half of 1984, was taken by the Reserve Bank on 5 May 1985 when Bank rate was reduced from 21,75 to 20,75 per cent. In motivating this step, the Bank referred to the elimination of domestic excess monetary demand that had already been effected in preceding months, the reappearance of surpluses on the balance of payments on current account and the improved "mix" of monetary and fiscal policy that had been brought about by the Budget for the fiscal year 1985/86. During the remainder of 1985, Bank rate and the Reserve Bank's set of associated refinancing rates were reduced further on an unprecedented seven occasions. By the end of 1985, Bank rate amounted to 13 per cent.

Further one per cent reductions in Bank rate became effective from 17 January and 5 May 1986. After May 1986 Bank rate was lowered further, by half a percentage point on each occasion, with effect from 5 August, 5 September and 10 December 1986. In its statement accompanying the December Bank rate reduction, the Reserve Bank noted that this step represented "a further easing of monetary policy in order to promote sound economic growth and to impart additional momentum to the present moderate upswing in the economy". The "scope" for a further relaxation of the Bank's policy was noted to have been enlarged by developments such as the anticipated large surplus for 1986 on the balance of payments on current account, recent improvements in the balance of payments on capital account, a rising level of the total gold and other foreign reserves, recent strengthening of the exchange rate, and continued below-target growth in the M3 money supply.

The reduction of Bank rate by ½ per cent (to 9½ per cent) from 10 December 1986 was followed, unusually, by a lowering of the clearing banks' prime overdraft rate by as much as 1½ per cent (to 12 per cent). However, in the fourth week of January 1987 the clearing banks, in a move viewed by the Reserve Bank as a technical correction, raised prime rate again by ½ per cent (to 12½ per cent). This prompted the Bank to issue a statement to the effect that Bank rate would be kept unchanged at its then-existing level of 9½ per cent; that no rise was foreseen in the general level of interest rates in the months more immediately ahead; and that no change was envisaged, for the time being, in the Bank's own broad monetary policy stance.

Through 1986 and 1987 to date, the monetary authorities remained strongly aware of the need for curbing inflation. It was noted, however, that, to an important degree, inflation as in 1986 and 1987 was being maintained at its unacceptably high levels by the cost-push effects of earlier declines in the exchange rate. Inflation could not, therefore, as had often been the case in the past, be attributed straightforwardly to excess money creation or to unduly large increases in aggregate domestic monetary demand. In these circumstances, attempts at curbing inflation by raising interest rates or tightening monetary policy in any other way would not be appropriate.

The moderately expansionary stance of monetary policy that had been arrived at by the progressive easing of policy in the course of 1985 and 1986, was maintained throughout the first eight months of 1987. Given the historically low and already substantially negative level of many interest rates, in "real" or inflation-adjusted terms, in 1986 and 1987, little positive result on balance was to be expected, in the Bank's opinion, from even further reductions in Bank rate and from further declines in nominal interest rates generally. A renewed *upward* trend in interest rates, on the other hand, was likely to manifest itself only (and Reserve Bank action to influence interest rates upwards would become appropriate only) if the prevailing economic upswing were to gain considerably more and potentially excessive momentum and if the money supply and the demand for credit were to rise accordingly.

Slow growth in M3 money supply

Despite the moderately easy stance of monetary policy, the broad money supply, M3, in 1986 and the first half of 1987 grew only relatively slowly and at less than the relevant 1986 and 1987 target rates. The growth in the M3 money supply from its quarterly average in the fourth quarter of 1985 to its quarterly average in the fourth quarter of 1986 amounted to only 10,1 per cent. This rate of increase therefore fell well below the growth rate of 16 per cent that had been set as the lower limit of the target range for 1986. The shortfall of M3 vis-à-vis the lower limit of the monetary target eventually amounted to as much as R4,2 billion, or 5,2 per cent.

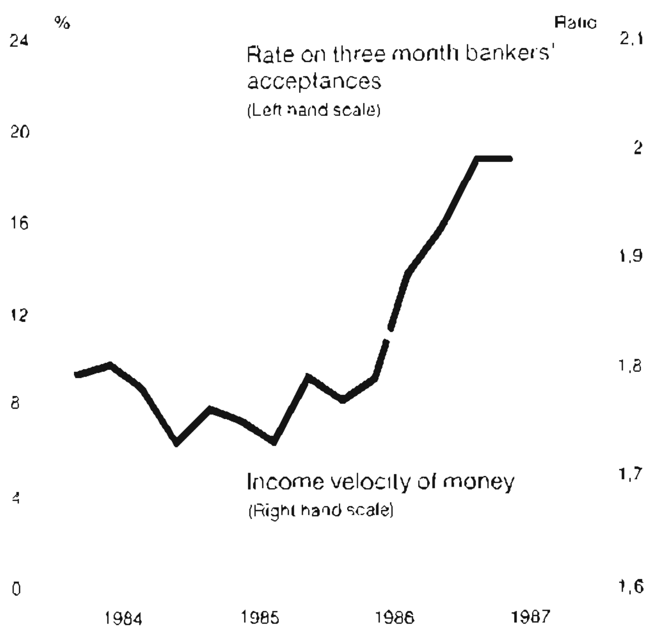
Increases in the velocity of circulation of M3, however, more than fully made up for the extent to which growth in M3 fell short of the target range. From the fourth quarter of 1985 to the fourth quarter of 1986 the income velocity of circulation of M3 (i.e. the ratio of the nominal value of gross domestic product in any particular quarter to the average value of M3 during that quarter) rose by 7,6 per cent. The increase in the "effective" money supply (i.e. in M3 multiplied by its velocity of circulation) in the first year of targeting accordingly amounted to 18,4 per cent. This fell well between the lower and upper limits of the target range of 16 and 20 per cent.

The marked rise in velocity also provided incidental support for the Reserve Bank's arguments in favour its existing policy of setting a *flexible* and "low-profile" target and against the adoption of any strict money growth "rule". By pursuing a policy of truly aggressive monetary ease, the monetary authorities in 1986 in all probability would have been able to force up the growth rate of M3 to its minimum target value of 16 per cent. However, the policy actions that would have been needed for such an outcome would most probably not have resulted in a smaller increase in M3's velocity of circulation and, in the conditions prevailing in the South African economy in 1986, actually might well have caused velocity to rise even more than it did. The resultant increase in MV or in the "effective" money supply then might have turned out to be excessively large.

The increase in the M3 velocity of circulation in 1986 occurred in an environment of marked further declines in interest rates. This stands in contrast to the more general monetary experience (including the experience of various industrialised countries in recent years) in which a decline in interest rates more normally tends to result in, or be accompanied by, an increased demand for money at given levels of nominal gross domestic product, and therefore tends to result in a decline in the velocity of circulation. As discussed more fully in a subsequent section, the South African experience has to be explained in the light of factors that reduced the attractions of holding money or close money substitutes when compared with the benefits to be derived from alternative uses of the funds concerned.

An increase in velocity, amounting to 2,9 per cent, was recorded in the first *quarter* of 1987. No further change in velocity, however, was recorded in the second quarter of the year.

Income velocity of money and short-term interest rates

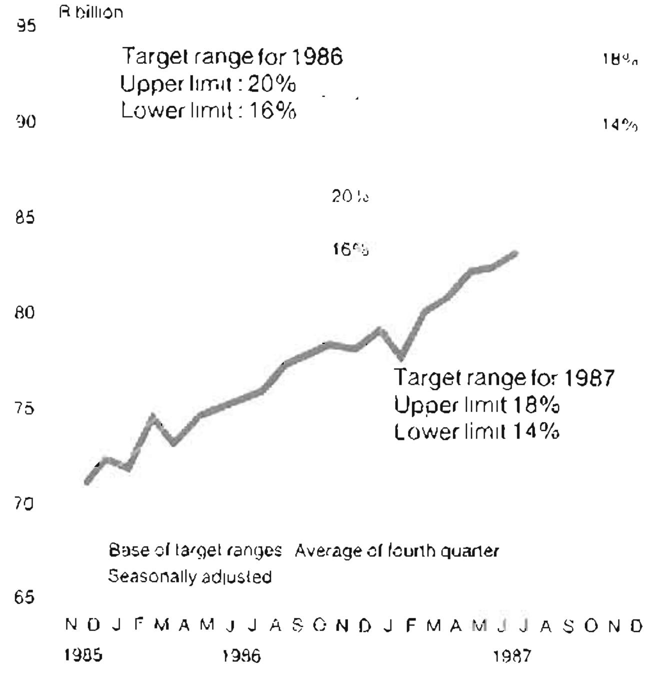


Monetary target for 1987

A new target range for the rate of increase in M3 was announced by the Reserve Bank in March 1987. In terms of this target, the rate of growth in the quarterly average of M3 from the fourth quarter of 1986 to the fourth quarter of 1987 was not to be less than 14 per cent or more than 18 per cent. In explaining the lowering of the target by two percentage points from its 1986 levels, the Bank stated that this would serve to "reaffirm the determination of the monetary authorities to prevent excessive money creation and any re-emergence of demand inflation". In the views of the authorities, realisation of the new target would be consistent with simultaneous achievement of a projected acceleration of the growth rate of the real gross domestic product to some 4 per cent from the fourth quarter of 1986 to the fourth quarter of 1987, and of a further gradual decline in the inflation rate. A more pronounced reduction of the upper and lower limits of the target range, on the other hand, might have been perceived as being at odds with the authorities' declared intention of lending more momentum to the upswing in the economy.

The seasonally adjusted annual rate of increase in M3 from the beginning of the new targeting year (taken as mid-November 1986) up to the end of June 1987 amounted to 10,3 per cent. M3 as at the end of June 1987 accordingly fell short of its minimum target value by approximately R1,7 billion, or by 2,0 per cent. When the increase in the velocity of circulation is taken into

Target ranges for growth in M3



account, the increase in the "effective" money supply, at a seasonally adjusted annual rate, amounted to 16,7 per cent. At this level, the rate of increase in the effective – as distinct from the actual – M3 money supply therefore was somewhat above the centre of the 1987 target range.

Divergent behaviour of various monetary aggregates

Marked differences could be observed in the behaviour of the various monetary aggregates during the past twenty-four months. The highest degree of stability, relatively speaking, was displayed by M3 as the most comprehensive of the monetary aggregates. Growth in M3 was held down, however, by various new as well as established "disintermediation" phenomena. Measured over twelve months, the rate of increase in M3 slowed down steadily throughout 1986 to a low point of 7,7 per cent in February 1987. It then rose moderately to 10,4 per cent in June 1987.

The twelve-month rate of increase in M2 also fluctuated downwards from 14,1 per cent in December 1985 to only 4,0 per cent in February 1987 before recovering to 8,5 per cent in June 1987. In contrast to these developments, the rate of increase in M1, which had actually declined to –12,8 per cent in January 1986, rose very rapidly to 17,6 per cent in June 1987. The rate of increase in M1A fluctuated around an average level of 24 per cent in 1986 but then declined sharply from 26,3 per cent in February 1987 to only 9,9 per cent in June.

In explaining the recent growth rates of the various monetary aggregates, and the differences between them, two sets of factors may be distinguished:

- *The first set of factors* causes holders of money or of close money substitutes to give up such holdings in favour of a reduction of liabilities (repayment of debts), or in favour of increased holdings of assets that are not included in the monetary aggregates. Such factors will necessarily cause a reduction in the rate of increase in M3 over any given period and in most cases will also affect the growth rates of one or more of the narrower monetary aggregates.

Included in such factors are all causes of "disintermediation", i.e. of processes involving a substitution of "direct" financing, by so-called primary lenders of so-called ultimate borrowers, for lending that previously was or normally would have been extended by a bank or some other monetary institution. Disintermediation was fostered, in 1986 and 1987, by increased margins between the banks' deposit rates and their average lending rates. It was also fostered by poor after-tax real rates of return on deposits with the banks or the building societies, which caused depositors with these institutions to look around for alternative investment opportunities, as presented, for example, by insurance companies, the strongly rising share market and unit trusts.

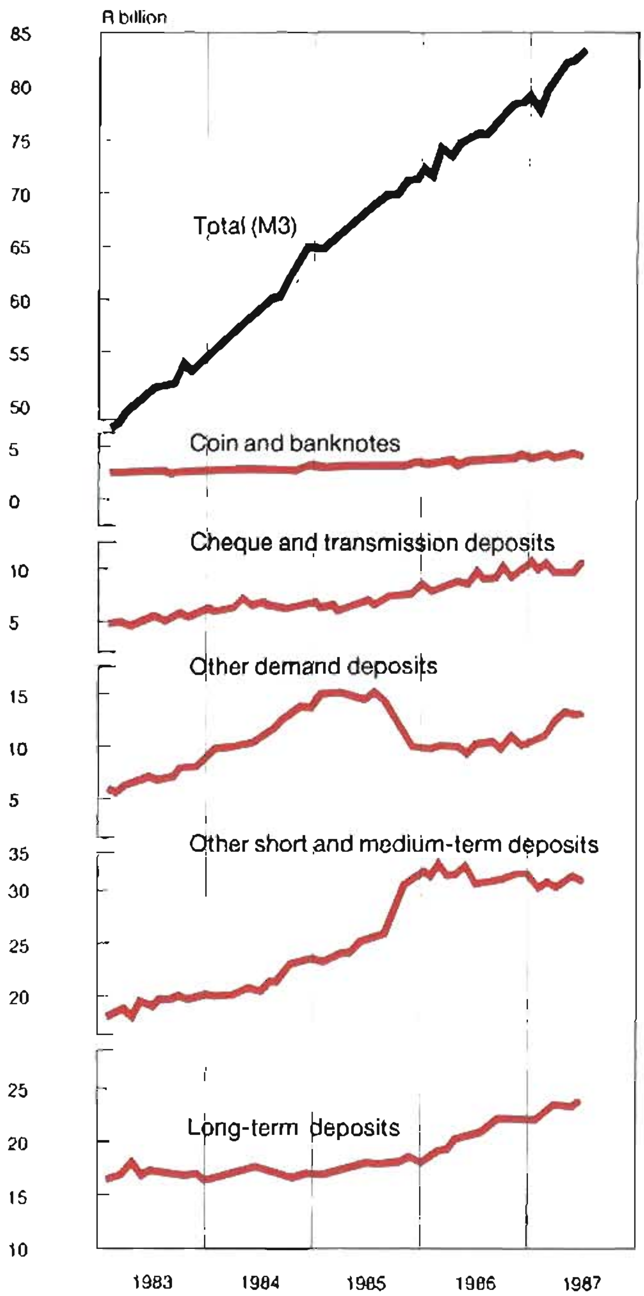
Also included in this first set of factors are recent developments in so-called "cash management", including those that involve a setting-off against one another of credit and debit balances in the books of banking institutions by or on behalf of a corporate entity or groups of corporate entities. Minimum requirements that have to be met for such set-offs to be acceptable in terms of the Banks Act, were laid down by the Reserve Bank in July 1987.

Examples of factors in the first category that were operative in 1986 and 1987 were the low level of deposit interest rates relative to the inflation rate; the attractions of the strongly rising share market, the new asset-based capital requirements for banking institutions, which contributed to a widening of the gap between the banks' deposit rates and their average lending rates as the banks sought to raise their profitability and to strengthen their reserve positions; and the rapid spread of more intensive use of cash management techniques.

- *The second set of factors* causes holders of money or close money substitutes to shift from one component of M3 to another. Such factors may affect the growth rate over any given period of M1A, M1 and/or M2. They do not, however, affect the growth rate of M3.

An example of factors in this category are interest rate expectations, which may cause investors to shift to longer-term deposits in periods of prolonged declines in interest rates and expected further declines in interest

Composition of M3



Coin, banknotes, cheque and transmission deposits = M1A
M1A and other demand deposits = M1
M1 and other short and medium-term deposits = M2
M2 and long-term deposits = M3

rates. Also included in this category with regard to 1986 was the abolition, with effect from September 1985, of the banks' procedure for "averaging" their daily demand liabilities in calculating their short-term liabilities for the purpose of their cash reserve and liquid asset requirements. As was explained in some detail in the Bank's *Annual Economic Report* for 1986, the abolition of this variety of averaging caused major shifts by depositors out of month-end holdings of "other" demand deposits (as included in M1) into month-end holdings of "other" short-term and medium-term deposits (as included in M2 but not in M1); to a minor extent, there may also have been a shift into cheque and transmission accounts (as included in M1A). Finally, the rapid spread of cash management techniques in recent quarters has favoured holdings of overnight and call deposits (as included in M1) at the expense of cheque deposits (as included in M1A).

The twelve-month growth rate of M1A in the course of most of 1986 therefore was affected positively by the after-effects of the abolition of "averaging" in September 1985. It then was affected negatively in 1987 by the spread of cash management techniques. The twelve-month growth rate in M1 was affected downwards during most of 1986 by the sharp drop in "other" demand deposits immediately after the abolition of averaging. It was boosted, however, by the recent spread of more intensive cash management.

The twelve-month growth rate in M2 was affected positively by the abolition of "averaging". Very slow quarter-to-quarter growth in M2 in more recent quarters reflected a relative shift to long-term deposits (not included in M2), as is customary in periods of declining interest rates. Long-term deposits actually increased by 34,8 per cent from the end of December 1985 to the end of June 1987. Medium-term deposits, on the other hand, decreased by 3,7 per cent during this period.

Instability in the growth rates of M1A, M1 and M2 in 1986 and 1987 on account of institutional and "structural" changes, provided *ex post facto* support for the authorities' selection of M3 for targeting purposes. Relatively slow growth in M3 during 1986 and the first half of 1987 was explained, in accounting terms, by the low rate of increase in credit extended by institutions in the "monetary" sector. Measured over twelve-month periods, the rate of increase in total credit extended by the monetary sector declined from 16,8 per cent in December 1985 to as little as 5,4 per cent in February 1987 before rising again to 8,8 per cent in June 1987. A major contribution to the increase in M3 was, however, made by the substantial rise in the net gold and other foreign reserves from the second half of 1986.

Bank credit

A remarkable feature of the current economic upswing to date was the slow increase in the private sector's demand for bank credit despite major reductions in credit costs. Turning points in the rate of increase in such credit traditionally have adhered relatively closely to turning points in the general business cycle. In 1985, 1986 and most of 1987, however, the amount of bank credit outstanding broadly failed to respond to the recovery in economic activity. The twelve-month rate of increase in credit extended by banking institutions to the private sector declined from 15,7 per cent in December 1985 to only 1,7 per cent in February 1987 before rising mildly to 5,1 per cent in June 1987. At a seasonally adjusted annual rate, the rise in bank credit to the private sector during the first half of 1987 amounted to only 2,5 per cent. From the second quarter of 1985 to the second quarter of 1987, the contraction in the *real* volume of bank credit outstanding (after adjustment by the consumer price index) actually amounted to as much as 14,9 per cent.

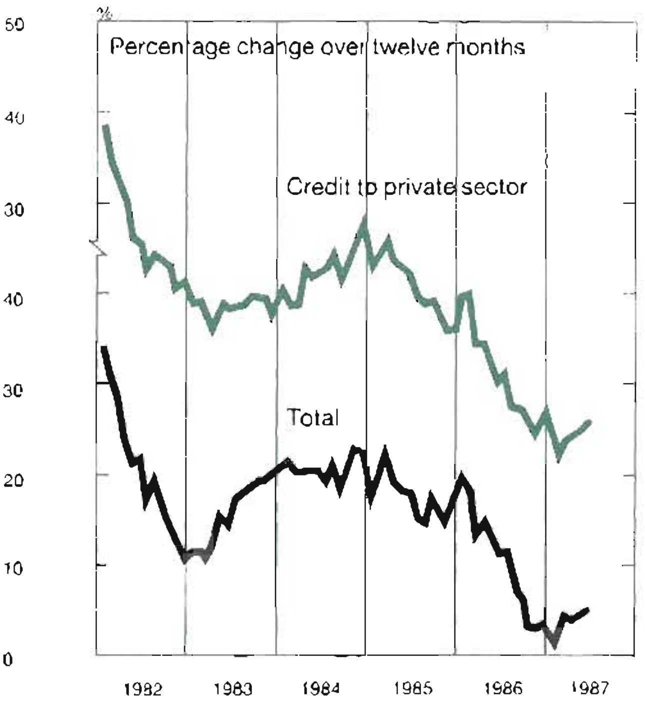
To a major degree the slackness of private sector credit demand in 1986 and the first half of 1987 reflected the effect of the various "disintermediation" phenomena referred to earlier. The increased use that was being made of "set-offs" of corporate clients' debit and credit balances in the books of banking institutions, such as are permitted under certain conditions under the present banking regulations, played an important part in this regard.

The demand for credit was also held back by the existence of surplus production capacity, low levels of fixed investment, relatively slow growth in imports, and declining levels of inventories. Increased recourse to new share issues on the stock exchange allowed firms (or subsequent recipients of the funds concerned) to repay loans from banking institutions. Household demand for credit was held back by the relatively slow growth in personal disposable income, a perceived lack of buoyancy in future income prospects, and an unwillingness to add new financial obligations to existing household indebtedness.

Interest rates on important varieties of credit, moreover, did not decline in proportion to the banks' reduction of their prime lending rates. Maximum rates under the Usury Act in respect of loans from R4 001 to R70 000, for example, were reduced from 30 per cent at the end of 1985 to 21 per cent at the end of 1986 and 19 per cent in January 1987. Unlike deposit interest rates, therefore, these borrowing rates remained positive in real terms and are likely to have had a significant inhibiting effect on credit demand.

The banking sector's net claims on the government sector decreased from R3 606 million at the end of December 1985 to R2 036 million at the end of December 1986, but increased to R2 843 million at the end of June 1987. The government sector's reduction of its net indebtedness to the banking system caused the increase in *total* bank credit in 1986 to be even smaller than the increase in bank credit to the private sector; however, it was somewhat larger than the increase in private sector credit in the first half of 1987. The increase in total bank credit amounted to only 3,4 per cent from December 1985 to December 1986 but to a seasonally adjusted annual rate of 5,9 per cent in the first six months of 1987.

Bank credit



Reserve Bank's operations in the money market

Mainly because of the easing effect on money market conditions of increases in the net gold and other foreign reserves, the aggregate month-end amount of assistance provided by the Reserve Bank to the money market in the form of rediscounts and overnight loans at the discount window, funds from the Corporation for Public Deposits (CPD) with the discount houses, and occasional repurchase agreements (or "buy-backs"), subsided from a high point of more than R4 billion at the end of March 1986 to only R520 million at the end of February 1987 and R1,1 billion at the end of March 1987. CPD funds placed with the discount houses reached a peak of R1 400 million at the end of December 1986.

A modified procedure for making CPD funds available to the market was adopted by the Reserve Bank from the month-end of March 1987. In terms of these new arrangements, funds made available by the CPD are to be tendered for from time to time – as determined by the Reserve Bank – by the banks and the discount houses, instead of being placed out on call with the discount houses by the Bank.

A major reason for the introduction of this new procedure was to distinguish this method of influencing money market conditions from the Reserve Bank's basic discount policy. The Bank's discount policy, which is at the heart of its monetary policy, relates to its policy regarding the extension of financial assistance in the form of "refinancing", i.e. the rediscounting of money market paper or the extension of overnight loans to the discount houses and the banks. The initiative in obtaining such refinancing assistance rests with the discount houses and the banks, and requests for such assistance are related directly to the cash reserve deficiency that is being experienced by the institution making the request.

The granting of refinancing at the Bank's "discount window", therefore, is essentially different from the Bank's operations relating to public debt management, the Bank's own open-market transactions (including "buy-backs" and "reverse buy-backs"), currency swaps, and other ways of supplying cash reserves to or withdrawing cash reserves from the money market. The latter kinds of operations are undertaken at the Reserve Bank's initiative. Being undertaken at the Bank's initiative, they can be used for the very purpose of influencing the size of the so-called "money market shortage" (i.e. the residual overall shortage of cash reserves that is experienced by the money market as a whole and that has to be made good through the Bank's refinancing operations at its discount window).

Since the putting-out of CPD funds on tender also is undertaken at the Bank's initiative, it is a part of the Bank's open-market and similar operations rather than being related to the Bank's refinancing activities. Being able to regulate, within fairly accurate limits, the size of the money market shortage, the Bank may bring about or tolerate variations in the shortage as a signal to the market concerning its wishes whether or not there should be a significant rise or decline in interest rates.

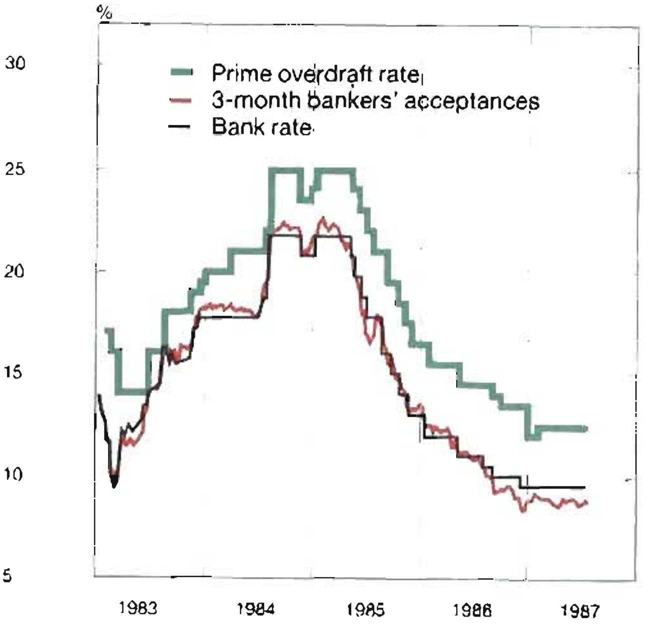
From its introduction, extensive use was made of the new CPD funds tender system in accordance with its clearly defined function of helping to influence the money market shortage. An amount of R963 million was, for example, made available to the market in this way at the end of March 1987. The Bank, however, also entered into buy-backs, "reverse buy-backs", currency swaps, and outright purchases or sales of government stock or money-market paper in open-market operations. In conjunction with the CPD tender system, these actions served to keep the amount of discount window refinancing within certain limits and to "provide assets to the market" when surpluses of cash reserves arose. Partly as a result of these operations, the monthly average of the Bank's refinancing at the discount window declined from R380 million in January 1987 to R100 million in June. Refinancing amounted to R415 million at the end of July 1987 and to R40 million on 10 August.

In a different adjustment concerning its refinancing procedures, the Reserve Bank, with effect from 18 May 1987, reduced the margins between its refinancing rates on the various rediscountable instruments from 25 to 15 points. This meant, for example, that at an unchanged rediscount rate of 9,5 per cent for Treasury bills for discount houses, the rediscount rates for discount houses for Land Bank bills and for three-month liquid bankers' acceptances were lowered from 9,75 per cent to 9,65 per cent and from 10,0 per cent to 9,80 per cent, respectively.

Short-term interest rates

After their very rapid decline during the preceding one-and-a-half years, money market rates became more stable from the third quarter of 1986. The rate on three-month bankers' acceptances, for example, varied only between relatively narrow limits of 9,90 per cent at the end of August 1986 and 8,30 per cent in the second week of December 1986. On 10 August 1987 this rate amounted to 8,75 per cent. Money market rates had softened to below the relevant Reserve Bank rediscount rates in August 1986; they remained at levels of up to 1½ percentage points or more below these rediscount rates during the ensuing twelve months. The clearing banks' prime rate was reduced from 14,0 to 13,5 per cent in September 1986 and to 12 per cent in December 1986. As noted earlier, however, this rate, in a "technical correction" aimed at restoring a more appropriate alignment between the prime rate and relevant money market rates, subsequently was raised again to 12,5 per cent in January 1987.

Short-term interest rates



The introduction, by the Minister of Finance in his Budget speech of June 1987, of so-called Senior Citizen Savings Bonds (popularly known as Granny Bonds, and carrying an annual interest of 15 per cent), resulted in a firming of deposit rates with banks and building societies, as these institutions acted to protect their customer base. Rates on twelve-month deposits increased by about one-half percentage point. Upward adjustments of deposit rates resulted in an increase in the building societies' mortgage lending rate. No change was made to the clearing banks' prime rate, however, in the light of the different structure of the banks' sources of funds.

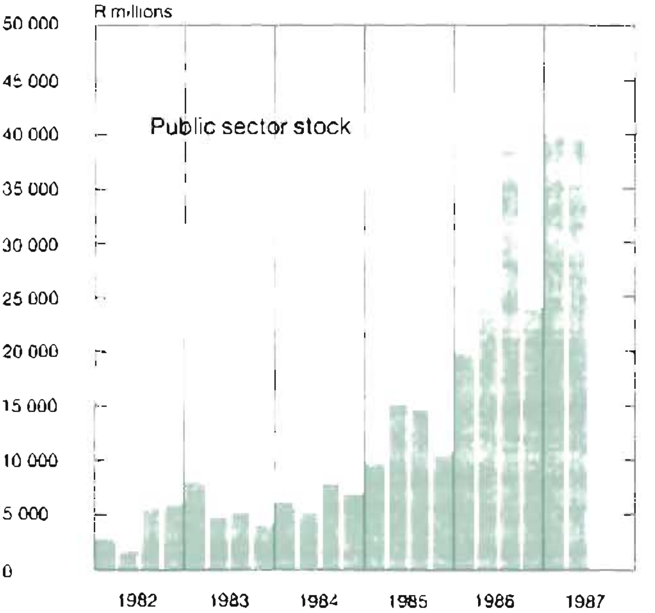
Following an unprecedented response to the Senior Citizen Savings Bonds issue and in view of the possible distortions this could cause in the flow of funds in the market, the Minister of Finance on 8 August 1987 announced the termination of this issue. At the same time a new issue with a much lower maximum investment limit of R20 000 was announced. Applications for this new issue will, however, be limited to qualifying persons who have already given notice of withdrawal of other investments, with a view to investing in the Senior Citizen Savings Bonds.

Capital market developments

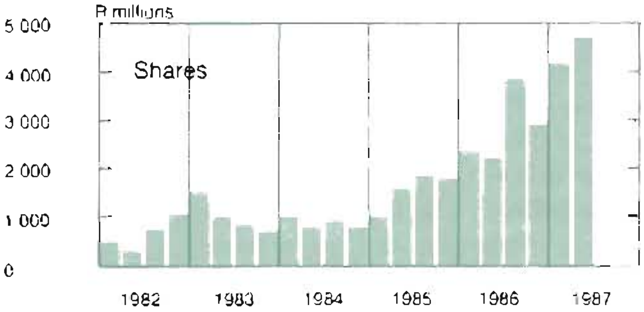
The capital market in 1986 and the first half of 1987, in continuation of trends that had been building up in the increasingly "easy" financial environment from early 1985, saw further large increases in trading activity that bore little relation to the pace of activity in the real economy. Very high turnovers of stocks and shares in the secondary market were accompanied by a further acceleration in share prices, declines in long-term yields and interest rates, and moderate to significant increases in the value of transactions in the fixed property market. In the primary market, in contrast, the increased availability of funds was not matched by a commensurate rise in the demand for new funds, which remained sluggish in line with low levels of gross fixed investment in the economy, even in nominal terms.

New records were set in secondary-market trading activity in 1986 and the first half of 1987. The value of public-sector stock traded on the stock exchange more than doubled from R51,2 billion in 1985 to R108,1 billion in 1986. It subsequently rose much further, to R80,4 billion, in the first *half* of 1987 followed by a further R17,0 billion in July. In a similar manner, the value of shares traded on the stock exchange rose from R6,4 billion in 1985 to R11,5 billion in 1986 and to R9,0 billion in the first *half* of 1987 and amounted to R1,9 billion in July. In the fixed property market, which has been slow in the present upswing to experience the custom-

Stock exchange transactions



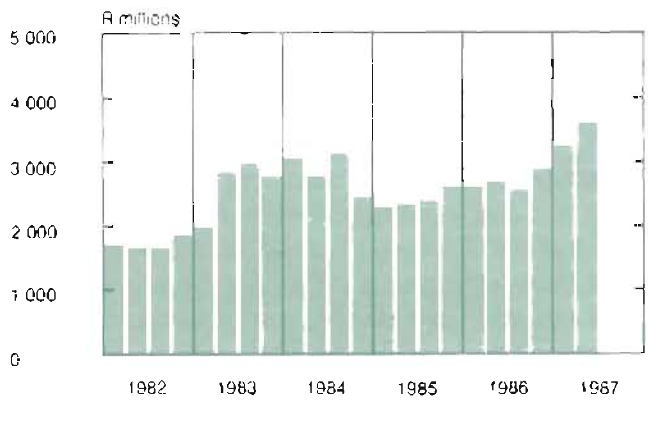
Stock exchange transactions



ary cyclical spill-over of investible funds from the securities markets, the value of real estate transactions rose more gradually by 11 per cent, to R10,8 billion, from 1985 to 1986, and increased by 20 per cent in the first half of 1987 compared with the first half of 1986.

The unprecedented rise in trading activity in fixed-interest securities in 1986 and the first half of 1987 could be attributed, firstly, to the generally downward movement of long-term interest rates from the end of 1985. It was, however, also related to an increase in jobbing, i.e. in the buying and selling of securities at a margin for traders' own account. Traditional jobbers in the capital market in the course of 1986 and 1987 increasingly were joined in their jobbing activities by traditional long-term investors, such as long-term insurers and pension funds. Long-term savings institutions, such as the insurers and pension funds, found themselves forced to take part in jobbing activities in

Real estate transactions



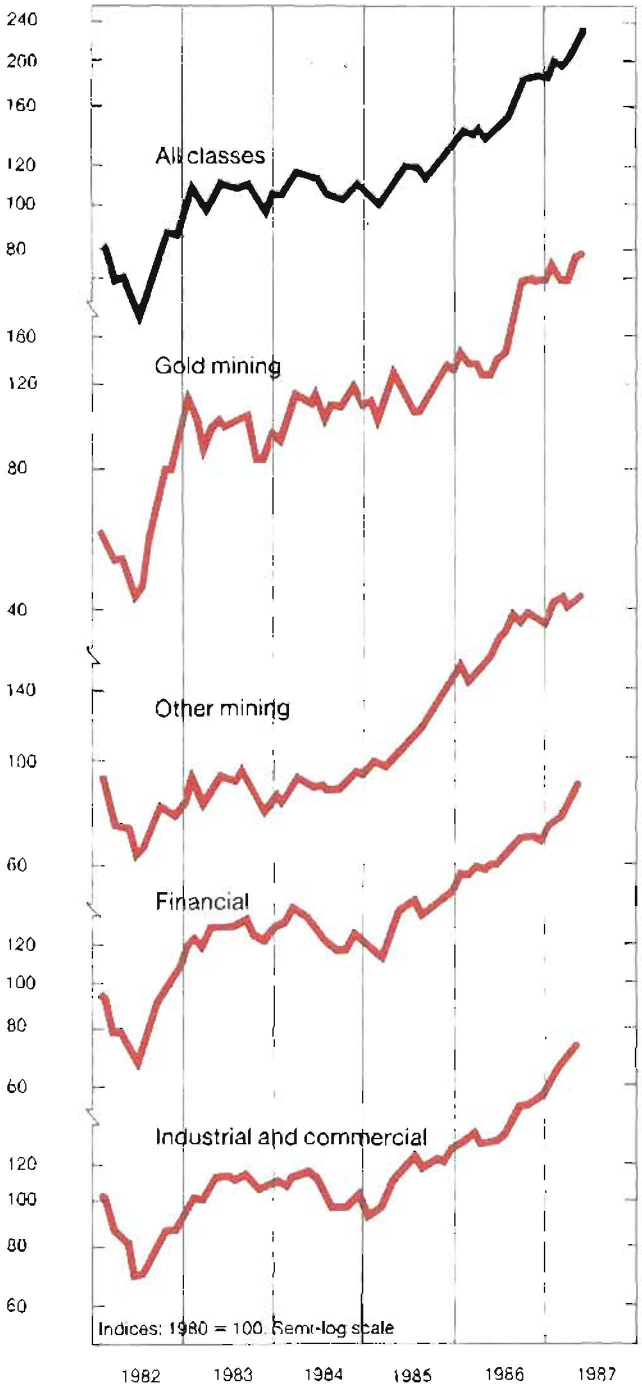
order to improve their investment performance in a climate of increasingly acute competition for the management of private savers' and asset holders' funds. In 1986 long-term insurers and pension funds accounted for 35 per cent of the purchases of government stock in the secondary market that were recorded in the Treasury's stock registers. This may be compared with shares in such purchases of 32 and 10 per cent in the case of banking institutions and the Public Investment Commissioners, respectively, and with the long-term institutional investors' own share in such purchases of only 17 per cent as recently as 1980.

Rising turnovers of company shares in 1986 and the first half of 1987 were also related to endeavours by the institutional investors to improve their investment performance through the regular restructuring of their share portfolios in accordance with changing views, perceptions and conditions. During 1986 the institutional investors built up their holdings of gold mining shares and other metal and mining-related shares on the basis of their expectations concerning future movements in the rand price of gold and other commodities. In the first half of 1987, these institutions increasingly moved into industrial shares on the basis of their expectations concerning the upswing in the South African economy.

A part of the rise in turnovers of company shares was also accounted for by the trading activities of non-residents. Total share purchases by non-residents in 1986 amounted to R1,9 billion, compared with R1,4 billion in 1985. Total share sales by non-residents amounted to R3,3 billion in 1986, against R1,8 billion in 1985.

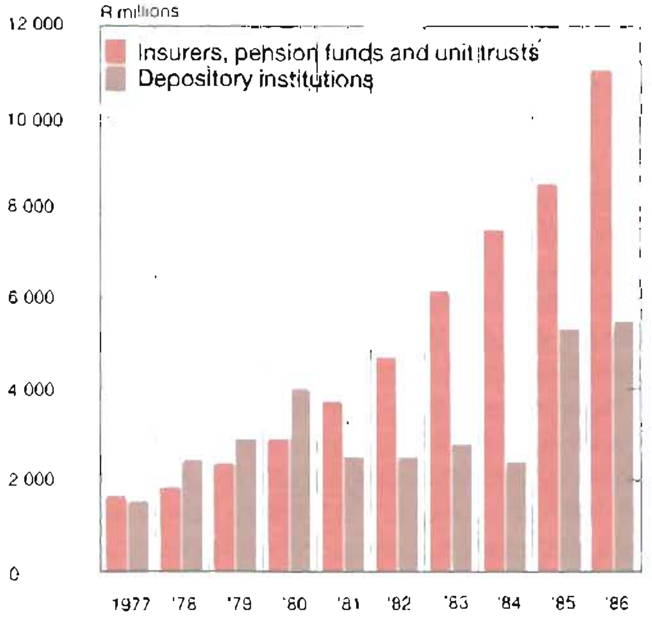
Share prices responded strongly to the increase in investor demand. The average price level of all classes of shares rose by 38 per cent in 1986 and by a further 21 per cent in the first half of 1987 followed by a further 7 per cent in July. In 1986, the general rise in share prices was led by the rise in mining share prices, which advanced by 53 per cent against increases of 28 per cent in industrial and commercial share prices and 25 per cent in financial share prices. In the first half of 1987, the lead in the general price advance was taken over by industrial and commercial share prices, which rose by 34 per cent against price increases of 26 per cent in financial shares and 8 per cent in mining shares. The sharp rise in share prices during the eighteen months to the end of June 1987 was not matched by commensurate increases in corporate earnings. It was therefore based in large measure on favourable expectations concerning corporate businesses' future profitability.

Share prices



In the *primary* capital market further shifts were apparent in 1986 in the composition by kind of recipient institution of the supply of longer-term funds. Specifically, the flow of gross premium income of long-term insurers and private pension funds (i.e. of the long-term contractual savings institutions) and net sales of units by unit trusts. increased in 1986 by as much as 29,4 per cent. This may be compared with an increase of only 2,8 per cent in the flow of longer-term funds to banks and building societies, participation mortgage bond schemes and the Post Office Savings Bank (i.e. to deposit-receiving institutions in a comprehensive sense of the term).

Flow of saving funds to capital market institutions



The increased relative importance of insurers, pension funds and unit trusts in the intermediation of long-term savings funds could be attributed primarily to an increased public awareness of the erosive effects of inflation and taxation on the purchasing power of long-term savings and on the consequently increased demand for financial investments that are likely to show some form of capital appreciation in an inflationary environment. Further factors in raising the share of insurers, pension funds and unit trusts in the long-term savings flow included the tax-free or tax-saving investment facilities that were offered by some of these institutions and new instruments created by them to encourage contributions on a regular basis; the excellent investment performance of most of these institutions during the past several years; the persistently negative level of real interest rates on rival depository investments with deposit-receiving institutions; and the continued sluggish performance of the fixed property market.

In the mortgage market, the net inflow of funds to building societies and participation mortgage bond schemes increased by 18,3 per cent in 1986. The amount of these institutions' net new mortgage lending, however, greatly exceeded their net inflow of funds in 1986. This was possible because of increased capital repayments on mortgage loans during 1986 and because of a drawing-down of funds that had previously been accumulated and earmarked for mortgage lending purposes. The amount of mortgage loans paid out by building societies and participation mortgage bond schemes consequently rose by as much as 47 per cent from R4,9 billion in 1985 to R7,2 billion in 1986. A further R4,3 billion was paid out in the first half of 1987.

The demand for funds in the primary capital market in 1986 was maintained at the same high level as in 1985 when an amount of R3,7 billion was raised by way of net new issues of fixed-interest securities of the public sector. The relatively smaller amount of R1,5 billion raised in the first half of 1987 was a reflection of the net effect of the repayment of a very large loan by the Central Government.

New issues of fixed-interest securities by companies listed on the stock exchange decreased from R0,4 billion in 1985 to R0,3 billion in 1986. Issues in the first half of 1987 amounted to R0,2 billion. New *share* capital raised by listed companies, on the other hand, advanced from R1,4 billion in 1985 to R2,0 billion in 1986. A further R1,0 billion was raised in this way in the first half of 1987. The rise in new share issues may be held to have reflected companies' endeavours further to reduce their financial gearing in the prevailing climate of high and rising share prices on the stock exchange.

Long-term interest rates and yields

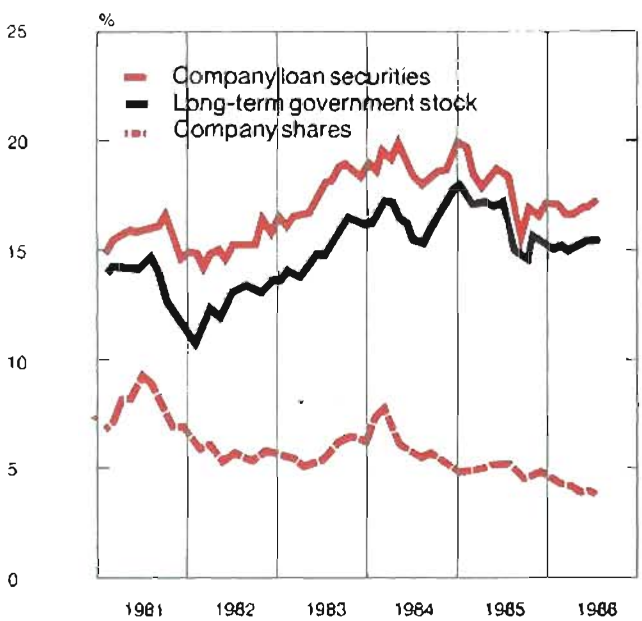
Long-term interest rates moved downwards in 1986 in a delayed and initially reluctant response to the general easing of financial conditions and the decline in short-term interest rates from early 1985. Changes in inflationary expectations and other factors caused the decline in long-term rates to be interrupted and reversed temporarily in September and October 1986. The downward trend in rates was resumed from late October 1986 and was continued, although at a diminishing pace, up to the end of March 1987. Renewed inflationary expectations, and concern about an increase in the public sector borrowing requirement that would be disclosed belatedly by the 1987/88 Budget in June 1987, then caused long-term rates to rise mildly again from April 1987.

In terms of monthly averages, the yield on long-term government stock decreased from a high point of 18,1 per cent in December 1985 to 14,5 per cent in September 1986, but reverted sharply to 15,8 per cent in October 1986. It then declined gradually to 15,0 per cent in March 1987 before hardening to 15,6 per cent in June and easing slightly to 15,5 per cent in July.

The yield on three-year government stock began its downward movement from early 1985 and declined from 18,6 per cent in February 1985 to a low of 10,4 per cent in September 1986. Like the yield on long-term stock, this yield then hardened temporarily in October and November 1986 before fluctuating downwards again to 10,7 per cent in June 1987. In July this yield rose to 11,0 per cent.

Investors' continued preference for a shorter average maturity of their portfolios caused a widening of the gap between the yields on long-term and short-term stock. The margin between the average yields on long-term and three-year government stock increased from only 0,21 per cent in 1985 to 3,57 per cent in 1986 and

Capital market yields



to 4,28 per cent during the first half of 1987. The "normal", upward-sloping, appearance of the yield curve therefore was maintained.

Real interest rates on government debt instruments (i.e. nominal rates on such instruments adjusted for the prevailing inflation rate) remained negative in 1986 and the first half of 1987. The average real rate on long-term government stock declined from 0,50 per cent in 1985 to −1,92 per cent in 1986. In the first six months of 1987 this rate advanced slightly to −1,34 per cent.

Mirroring the sharp rise in share prices during the eighteen months to June 1987, the average dividend yield on all classes of shares declined on balance from 4,8 per cent in December 1985 to 3,9 per cent in June 1987 and 3,7 per cent in July. Because of the considerably larger decline in yields on fixed-interest securities, the so-called "inverse yield gap" (i.e. the gap between the yield on long-term government stock and the average dividend yield on all classes of shares) narrowed from an unprecedented 13,3 per cent at the end of 1985 to 10,0 per cent in August and September 1986. The yield gap then widened again to 11,7 per cent in June 1987.

The building societies' maximum home mortgage rate was lowered broadly in accordance with the general downward trend in shorter-term capital market yields. This rate was reduced from 18,25 per cent in October 1985 to 17,0 per cent in May 1986, at the time when the set of differentiated rates that used to be quoted by the building societies was replaced by a uniform rate for all borrowers. The mortgage rate then was lowered further, in four steps, to 13,5 per cent in January 1987. The predominating mortgage rate was increased again, however, to 14,0 per cent in May 1987, and was raised further to 14,5 per cent in July 1987. In August a major building society reduced its home mortgage rate for new loans to 12,95 per cent.

The predominant rate on twelve-month deposits with banks and building societies, serving as an example of deposit interest rates generally, was reduced gradually from 14,5 per cent in November 1985 to 9,5 per cent in December 1986. This rate was, however, raised again to 10,0 per cent in February 1987 and has since been maintained at that level among banking institutions. The building societies' twelve-month deposit rate was increased further to 10,5 per cent in June 1987. In broad terms, therefore, yields and interest rates generally could be considered to have bottomed out in the course of the first or second quarter of 1987.

Government finance

Continuation of stimulatory fiscal policy stance

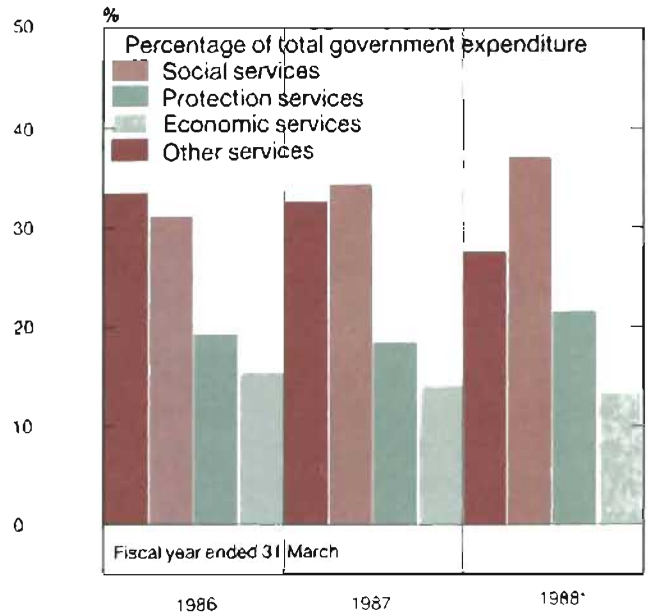
Success in removing excess monetary demand from the economy had caused the Government to adopt a more expansionary approach to fiscal policy in the course of 1985. This was given effect, in September 1985, by the announcement of a package of "moderately but responsibly" stimulatory measures that were aimed, inter alia, at creating employment and alleviating social distress.

A moderately expansionary stance of fiscal policy was maintained throughout 1986 and the first half of 1987. Fiscally stimulatory actions were contained in the Central Government's Budget for the fiscal year 1986/87, a further package of stimulatory measures that was adopted in June 1986, the Part Appropriation Bill presented in February 1987 and the Central Government's Budget for fiscal 1987/88 as presented in June 1987. These policy measures were primarily aimed at strengthening the initially weak and erratic economic recovery by encouraging higher levels of investment and consumption expenditure and, in respect of fiscal 1987/88, to exploit more fully the room still remaining for further expansion in the South African economy.

Steps included in the Government's short-term fiscal strategy comprised various tax concessions as well as increases in government expenditure. In particular, reductions were effected in personal income tax in various ways, so as to counter, to some extent, the restrictive effects of fiscal drag on personal disposable income and consumer expenditure. Adjustments to government expenditure similarly sought to encourage private sector consumption and investment with a view to raising employment and to bringing about enhanced degrees of capacity utilisation generally. Greater emphasis was also laid, however, on social development. For this purpose, provision was made inter alia for increased government outlays on education, housing, relief for the unemployed and the improvement of pensions.

Fiscal policy statements since the third quarter of 1985 have accorded priority to the part to be played by budgetary policy in fostering income, output and employment. As explained by the Minister of Finance in his 1987/88 Budget speech, however, current emphasis on the growth-promoting role of fiscal actions in the short to medium-term was not meant to signify a departure from the authorities' longer-term objective of gradually reducing the role of government in the national economy. Specifically, it was stated to be the authorities' intention to bring about a lower level of public sector expenditure relative to gross domestic product, and to increase the private sector's involvement in economic activity. In this endeavour the authorities' declared policy intentions with regard to privatisation and deregulation obviously could play a part. In a somewhat similar vein, arguments bearing on the economy's more immediate needs for restimulation could be advanced for justifying temporary departures from the "basic conditions" of budgetary policy that were enunciated by the Minister of Finance in his Budget speech of March 1985, namely that borrowed funds should not normally be used for financing current expenditure and that the ratio of the deficit before borrowing to gross domestic product should not normally exceed a figure of the order of 3 per cent.

Functional classification of government expenditure



*Budget estimate

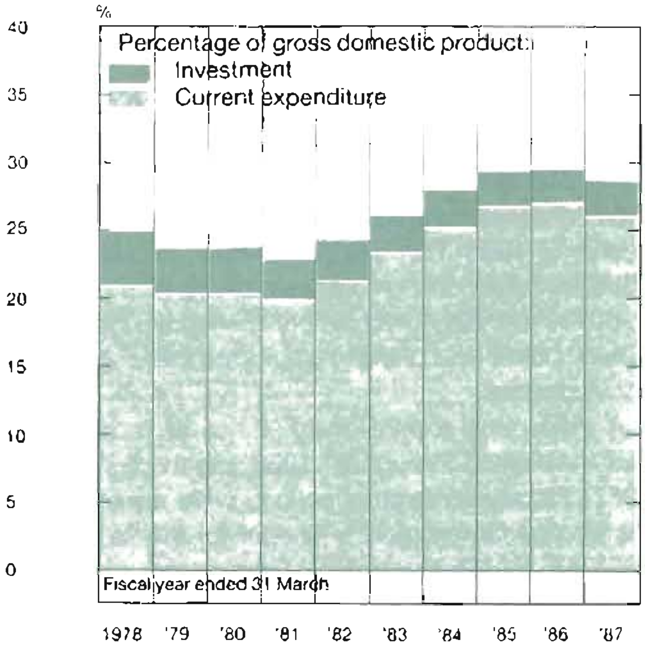
Income, expenditure and saving of general government

In the event, increased emphasis on the growth-promoting role of fiscal policy from 1985 did not result in an increase in the relative importance of spending by *general* government. Relative to nominal gross domestic product, total expenditure by general government (i.e. by the central governments of South Africa and of the independent and self-governing national states, by provincial administrations, and by local authorities) showed little change during the three-year period from the fiscal year 1984/85 to the fiscal year 1986/87. After having risen from 17,2 per cent in fiscal 1979/80 to 20,2 per cent in 1984/85, the ratio of general government spending on final goods and services to gross domestic product actually declined slightly, to 19,8 per cent, in fiscal 1986/87.

This mild decline in the general government spending ratio was attributable essentially to a decline in the relative size of *current* government expenditure. The ratio of gross *investment* expenditure by general government to the gross domestic product remained virtually unchanged during the three-year period concerned.

The decrease in the relative significance of current government expenditure, in turn, was a result of opposing tendencies in consumption expenditure by the

Expenditure by general government



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

	Fiscal years			
	1979/80	1984/85	1985/86	1986/87
Direct taxes	11,6	12,9	14,2	13,4
Indirect taxes	8,3	10,2	10,9	10,3
Other current income	2,0	2,0	1,5	1,8
Current income	21,9	25,1	26,6	25,5
Consumption expenditure	13,7	17,5	17,3	17,1
Interest on public debt	2,8	4,1	4,3	3,9
Current transfers	3,8	5,1	5,3	5,0
Current expenditure	20,3	26,7	26,9	26,0
Gross investment	3,5	2,7	2,6	2,7
Total expenditure	23,7	29,4	29,5	28,7
Saving	1,6	–1,7	–0,3	–0,5
Borrowing requirement*	–1,7	–4,2	–2,8	–3,0

*Total current income plus provision for depreciation less total expenditure.

various tiers, or levels, of general government. Specifically, consumption expenditure by provincial administrations and local authorities relative to gross domestic product decreased sharply in fiscal 1986/87. Consumption expenditure by the Central Government, on the other hand, showed an increase, mainly on account of the transfer of certain functions previously performed by the provincial administrations to the Central Government. At the same time, lower levels of interest rates in the domestic economy in fiscal 1986/87 caused the ratio of interest payments on the public debt to gross domestic product to decline significantly. The relative level of transfer payments also retreated slightly in 1986/87 after having increased sharply during the fiscal years from 1979/80 to 1985/86.

Curtailment of the upward trend in general government expenditure during the past two fiscal years allowed certain concessions to be made with regard to personal income tax. The resultant decline in the relative contribution of income tax payments by individuals, in conjunction with a sharp decrease in direct tax payments by non-mining companies because of earlier poor profit performances by businesses in the non-mining sectors of the economy, caused the ratio of direct taxes to nominal gross domestic product to fall back significantly in fiscal 1986/87. However, the ratio of indirect taxes to gross domestic product also declined, largely because of lower growth in general sales tax receipts.

During the past ten fiscal years the average annual rate of increase in general government revenue, at 18,5 per cent, has fallen well short of the average annual rise in current government expenditure, at 19,3 per cent. This necessarily meant a deterioration in the savings performance of general government and also necessitated increased reliance on government borrowing for supplementing current government income. General government has, in fact, had to borrow for financing current expenditure since fiscal 1982/83. The relative extent of such "dissaving" by general government was, however, reduced markedly in fiscal 1985/86 before rising slightly again in fiscal 1986/87.

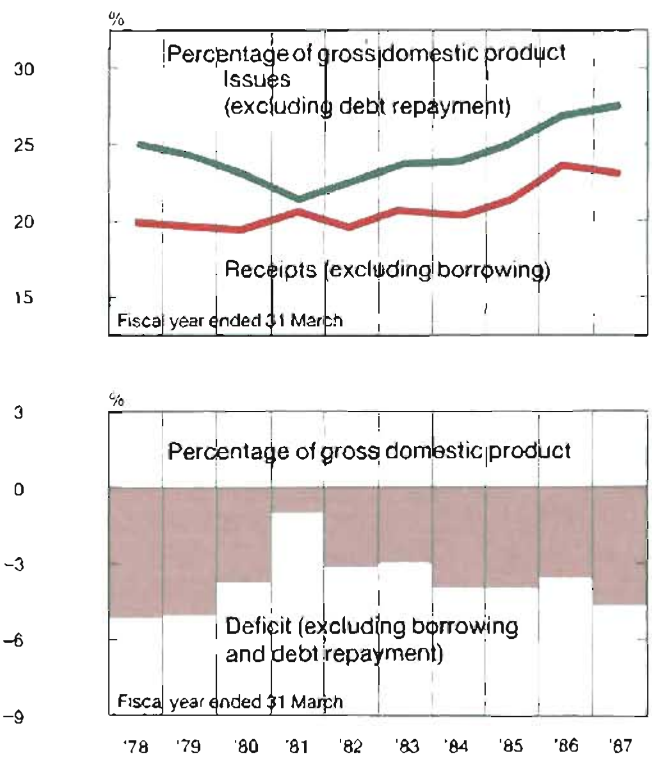
Negative saving (or dissaving) by general government over the past several years was reflected in an increased general government borrowing requirement. Relative to gross domestic product, the borrowing requirement (i.e. the excess of total general government expenditure over current general government income and provision for depreciation) rose from 1,7 per cent in fiscal 1979/80 to as much as 4,2 per cent in fiscal 1984/85. However, a sharp reduction in the rate of increase in current government expenditure caused the borrowing requirement and its ratio to gross domestic product to decline markedly in fiscal 1985/86. The reduced rate of increase in current government income then caused the borrowing requirement and its ratio to gross domestic product to revert to somewhat higher levels again in fiscal 1986/87.

Expenditure, revenue, deficit, and borrowing of Central Government in fiscal 1986/87

In fiscal 1986/87 Exchequer issues (by the *Central* Government) amounted to nearly 85 per cent of expenditure by *general* government; Central Government revenue amounted to more than 90 per cent of general government revenue. Trends in general government expenditure and income therefore are largely determined by developments in expenditure and revenue of the Central Government.

Expenditure, revenue and the resultant deficit before borrowing of the Central Government in fiscal 1986/87 departed significantly from the Budget proposals as presented originally in March 1986. In accordance with Government thinking referred to earlier, this

Exchequer Account



Budgeted and actual government expenditure and revenue; fiscal year 1986/87

	Budget[1]		Actual[3]	
	R millions	Percentage change[2]	R millions	Percentage change[2]
Expenditure	37 571	13,9	40 321	22,5
Revenue	33 627	13,3	34 130	16,4
Deficit before borrowing	3 944	13,4	6 191	53,3
Deficit as percentage of GDP	3,1	...	4,1	...

1 Original Budget estimates.
2 Compared with actual results in fiscal year 1985/86.
3 As reported by the Minister of Finance in the 1987/88 Budget speech.

divergence of the eventual Budget outcome from the Budget proposals to a major degree was a matter of deliberate policy which was meant to lend support to the hesitant economic recovery. The eventual stimulatory impact of fiscal policy in 1986/87 therefore was substantially larger than the impact that had been aimed at in preparing the Budget of March 1986.

The rate of increase in nominal Central Government expenditure in fiscal 1986/87, as reported by the Minister of Finance in his Budget speech of 3 June 1987, amounted to 22,5 per cent. This considerably exceeded the original Budget estimate of 13,9 per cent. Expenditure additional to the original Budget estimates partly arose from the further package of stimulatory measures of June 1986. In terms of these measures, R762 million was spent mainly on matters such as housing, labour training and employment creation, and various forms of assistance to the farming community. The increase in Central Government expenditure in fiscal 1986/87 caused the ratio of such expenditure to gross domestic product to rise to a record 27,4 per cent. This may be compared with a lower turning point in this ratio of 21,3 per cent in fiscal 1980/81.

The increase in Central Government *revenue* in fiscal 1986/87, at 16,4 per cent, only moderately exceeded the original Budget estimates. This increase included, however, an amount of R1 012 million that had been transferred from the Central Energy Fund for financing the package of additional stimulatory measures of June 1986. When these receipts are excluded, Central Government revenue in fiscal 1986/87 actually fell somewhat short of the Budget estimates. Failure of total revenue from conventional sources to meet the Budget estimates mainly derived from lower-than-budgeted increases in general sales tax receipts and in income tax collections from non-mining companies. Lower-than-estimated increases in these two revenue items, in turn, mainly were a reflection of limited growth in the domestic demand for goods and services in preceding quarters. Receipts from gold mining companies, on the other hand, exceeded the Budget estimates, because of a higher-than-anticipated average rand price of gold and the resultant increased profitability of the gold mining industry. Income tax collections from individuals and income from customs and excise duties were close to the Budget estimates.

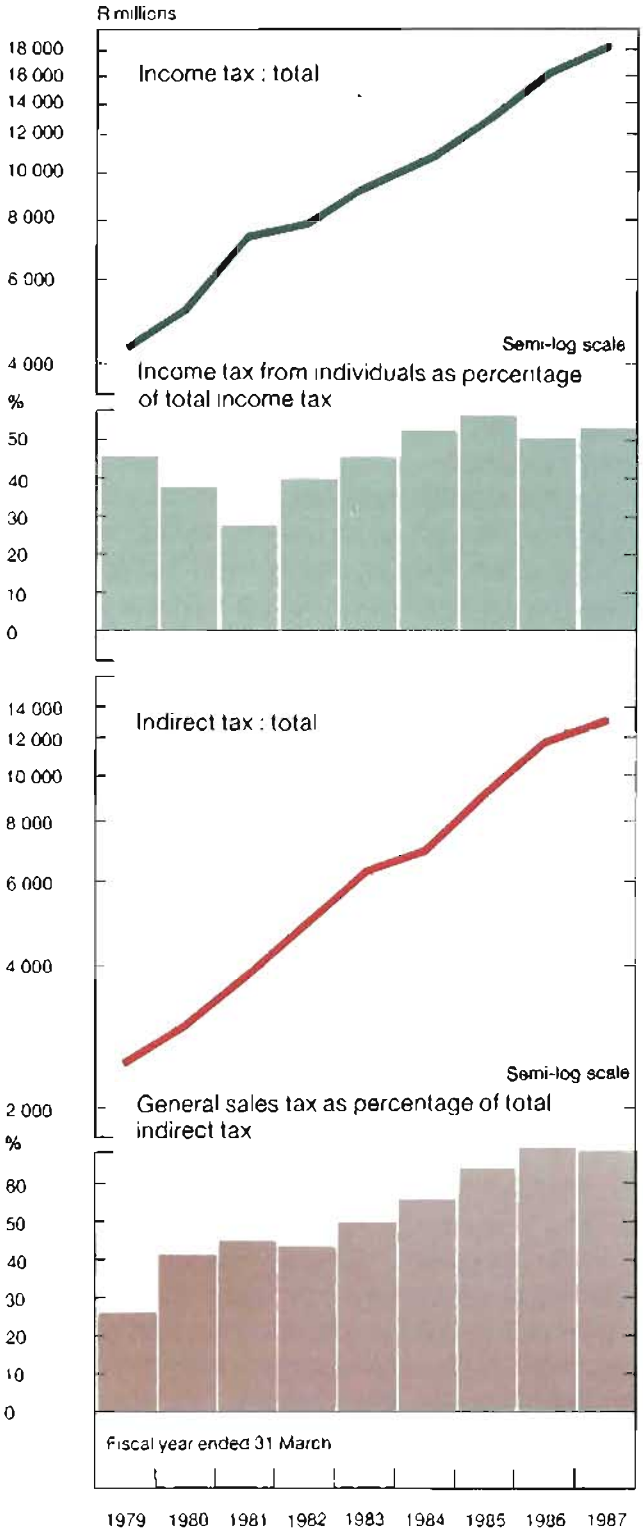
The 1986/87 deficit before borrowing and debt repayment, at R6 191 million, amounted to 4,1 per cent of the gross domestic product, against the Budget estimate of 3,1 per cent. At this level, the 1986/87 deficit also markedly exceeded the deficit of fiscal 1985/86, which had amounted to R3 247 million or to 2,6 per cent of the gross domestic product. The 1986/87 deficit was financed from the following sources:

	R millions
Public Investment Commissioners[1]	3 689
Non-bank private sector	902
Banking sector	663
Foreign sector[2]	1 015
	6 269
Less: discount on government stock[3]	78
Total financing	6 191

1 Net cash purchases of new government stock.
2 Net debt repayments of R17 million and the utilisation of R1 032 million of foreign creditors' funds held with the Public Investment Commissioners.
3 Excluding the discount on new issues to the Public Investment Commissioners.

The increase in the deficit did not prevent a decline in the ratio of total outstanding Central Government debt

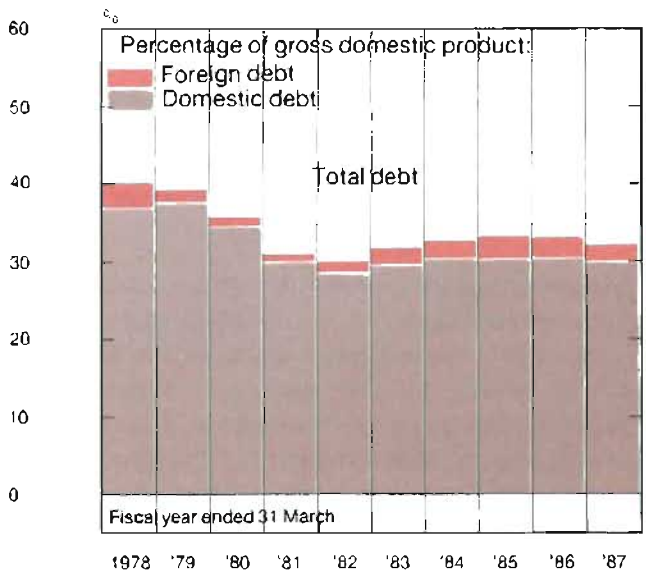
Revenue collections – State Revenue Fund



to nominal gross domestic product from 33,3 per cent in fiscal 1985/86 to 32,3 per cent in fiscal 1986/87. At this reduced level, the value of the Central Government debt ratio actually fell below its average level for the past five as well as for the past ten years. Foreign debt of the Central Government was reduced substantially in fiscal 1986/87 by the repayment of foreign loans, notably to the International Monetary Fund. This reduction in the Central Government's foreign debt obligations occurred despite exchange rate movements that resulted in unfavourable valuation adjustments. The ratio of the Central Government's foreign debt to its total debt accordingly shrank from 9,5 per cent in fiscal 1985/86 to only 6,8 per cent in 1986/87.

Domestic marketable debt continued to account for an increasing proportion of total debt. Early repayment of the 1980 and 1983 loan levies contributed to the decline in the relative importance of domestic non-marketable debt.

Central Government debt



The 1987 "Mini-budget" and the Central Government Budget for 1987/88

Postponement of the main Budget for fiscal 1987/88 from March to June 1987 greatly increased the importance of the 1987 Part Appropriation Bill, which was presented to Parliament on 9 February 1987. The 1987 "Mini-budget" was presented by the Minister of Finance against a background of data suggesting a fairly impressive recent strengthening of the economic recovery from low levels of economic activity in the first half of 1986. Economic conditions in early 1987 also included continuing relatively high levels of unemployment and of unused production capacity generally; a continued sluggish demand for bank credit and slow growth in the money supply; some recent improvements in business sentiment and in overseas perceptions of the South African economic and socio-political situation; and continued exceptional strength of the balance of payments on current account.

In these circumstances, further stimulatory action was again decided upon. Expansionary measures included, firstly, repayment of the 1983 loan levy before the end of March 1987 so as to exert an almost instantaneous invigorating effect on personal disposable income. Secondly, tax concessions were announced for married women so as to encourage them to continue to make their skills available to the economy, and rate adjustments were to be made in respect of individual income tax tables so as to provide some alleviation of the burden of fiscal drag, counteract the impact of the phasing-in of the taxation of fringe benefits and reduce further some of the disincentive effects of high marginal income tax rates. Thirdly, the tax-free amount of interest earnings was to be raised from R500 to R1 000 per taxpayer to encourage personal savings. Fourthly, an amount of R117 million was to be made available as a first instalment in a five-year programme for the reconstruction of agriculture in drought-stricken areas, while a further R120 million was to be provided for various other assistance programmes for the agricultural sector. Finally, an amount of R200 million was set aside for improving pensions and allowances.

At the time of the Minister of Finance's presentation of the main Budget for fiscal 1987/88 to Parliament on 3 June 1987, the authorities still faced an economic upswing of only moderate vigour and uncertain staying power. Partly in the light of the continuing slack in the economy, the Minister stated that the highest priority in determining economic goals in South Africa should be given to a growth process that would generate work and ensure participation in the ensuing benefits by the greatest number of people.

Considerations of long-term economic strategy would, however, also have to be taken into account. In this context, the Minister noted that new ground was being broken in the 1987/88 Budget in that government expenditure and financing were being based for the first time on approaches and priorities laid down by the State President's Committee on National Priorities, which formed part of a five-year plan for such expenditure. This plan, which was to be revised annually, envisaged a relative reduction in total public sector expenditure from nearly 38 per cent of gross domestic product in fiscal 1985/86 to approximately 34,5 per cent in fiscal 1991/92, thereby to leave more room for private sector economic activity and initiatives.

With regard to the Government's fiscal and monetary policy for the fiscal year 1987/88, it was explicitly noted that room for further expansion still existed in the economy. This "room for growth" should be fully exploited in the short to middle term. Caution would, however, be required in dealing with the prevailing situation. On the one hand the potentially large stimulatory impact of ambitious new ventures, such as the Mossel Bay gas conversion project and the Lesotho Highlands Water Scheme, would have to be kept in mind. On the other hand, a fear still existed that the upswing might fail to gather the necessary momentum and might have to be supported once again.

In the light of these various arguments the Budget, read in conjunction with the various fiscal measures already announced in the Part Appropriation Bill of February 1987, was meant to maintain the authorities' moderately expansionary fiscal policy stance. High priority would, however, continue to be accorded to the need for combating inflation.

It was envisaged that the Budget would succeed in stimulating the economy along the following interrelated paths:

Firstly, the potential impact of the tax concessions, that had already been announced in the Part Appropriation speech and which amounted to some R1 billion, was to be strengthened slightly further by exempting certain raw materials and intermediate products subject to customs duty from the 10 per cent import surcharge. Total government revenue in fiscal 1987/88 was estimated to rise to R38,4 billion, or by 12,6 per cent.

Secondly, total Government expenditure was estimated to rise to R46,9 billion, or by 16,2 per cent. This would include assistance to agriculture amounting to approximately R1 billion.

Thirdly, provision was made for an increase in the deficit before borrowing from R6,2 billion in 1986/87 to

R8,4 billion in 1987/88, or from 4,1 per cent of gross domestic product to 4,7 per cent.

Fourthly, it was proposed that this deficit be financed partly by a more effective utilisation of foreign funds invested with the Public Investment Commissioners by virtue of South Africa's arrangements for the repayment of foreign debt. This highly unusual method of financing - which was not meant to create a precedent for the Government's financing procedures in any more normal situation – would allow the budget deficit to be covered in the following way:

	R millions
Public Investment Commissioners (PIC)	4 100
New government stock issues	2 500
Non-marketable securities	340
Foreign loans including funds from deposits held with PIC	1 119
Use of available balances	366
Total financing, net of debt repayment	8 425

The first quarter of fiscal 1987/88

During the first quarter of fiscal 1987/88, i.e. during the second quarter of calendar 1987, Exchequer issues (after the usual adjustment for changes in the balance on the Paymaster-General Account) were 18,2 per cent higher than in the corresponding quarter of fiscal 1986/87. This percentage increase notably exceeded the Budget estimate of an increase in expenditure of 16,2 per cent during the fiscal year as a whole. Issues in the first quarter of fiscal 1987/88 amounted to 25,6 per cent of estimated total expenditure for the fiscal year. In terms of seasonal patterns, the ratio of first-quarter issues to total budgeted expenditure for the fiscal year 1987/88 as a whole nevertheless was somewhat lower than the average ratio of first-quarter expenditure in the preceding three fiscal years.

Exchequer receipts in the first quarter of fiscal 1987/88 increased by 5,6 per cent, compared with the corresponding quarter of fiscal 1986/87. This increase therefore fell well short of the Budget estimate of an increase in revenue of 12,6 per cent for the fiscal year as a whole. Receipts in the first quarter represented 18,7 per cent of total budgeted revenues for the full fiscal year. As in the case of Exchequer issues, this percentage was somewhat lower than the average ratio of first-quarter receipts to total receipts during the preceding three fiscal years.

The deficit before borrowing in the first quarter of fiscal 1987/88 amounted to R4 467 million, or to approximately 53 per cent of the budgeted deficit for the fiscal year as a whole. During the preceding three fiscal years the first-quarter deficit amounted on average to 58,4 per cent of the *actual* – as against the budgeted – deficit eventually recorded in the course of the year. Including the discount on new government stock issues, the deficit of R4 800 million in the first quarter of fiscal 1987/88 was mainly financed by the banking sector and the non-bank private sector to the amounts of R3 064 million and R2 141 million, respectively. The Exchequer's indebtedness to the Public Investment Commissioners and the foreign sector, on the other hand, was reduced by R351 million and R54 million, respectively.