South African Reserve Bank

Annual Economic Report

89

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-ninth ordinary. general meeting to be held on 29 August 1989

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Hierdie verslag is ook in Afrikaans beskikbaar

Introduction

Looking at spending trends, balance of payments developments and the accelerating rate of monetary expansion, the Reserve Bank's *Annual Economic Report* for 1988, as released in August of that year, concluded that the South African economy had by then moved into the "advanced" stages of a fairly typical, if only moderately vigorous, upswing. It also considered that the fairly marked slowdown of growth in the second quarter of 1988 might well signify the start of a levelling-out of the real growth rate in the more final stages of the then current economic expansion. The *Report* accordingly held prospects for the real growth rate in the year 1988 to be of the order of 2½ per cent.

In the event, the second half of 1988 saw a continuation of growth at a rather stronger-than-expected average rate that broadly matched the average growth rate of the first half of the year. Real output growth during the calendar year 1988 was thereby brought to somewhat more than 3 per cent; the increase in aggregate real gross domestic expenditure amounted to a major 7 per cent. Because of a downward shift in real gross domestic expenditure in the final two quarters of 1988, and because of a major strengthening of the South African merchandise export performance, the second half of 1988 also saw a reinvigoration of the surpluses on the balance of payments on current account, which had seemed in danger of being wiped out earlier in the year.

In contrast to these developments, the first six months of 1989 witnessed an approximate halving of the real growth rate from its 1988 levels and a first-quarter rebound of domestic expenditure, mainly because of a surge in real government consumption outlays. Conflicting signals regarding the direction in which the economy is headed are likely to be emitted by cyclically sensitive time series on either side of a cyclical turning-point. Recent behaviour of the broad national accounts aggregates does not, however, contradict the view – as derived from recent movements in the comprehensive business cycle indicators as well as from more sector-specific evidence – that the upper turning-point of the 1986-1988 upswing is likely to have been reached, at least in a technical sense, towards the very end of 1988 or in the first few months of 1989.

Output and spending trends in the first half of 1989 were still compatible, in general terms, with the "broad economic projection" for 1989 that underlay the monetary authorities' adoption of a target rate of growth for the M3 money supply in 1989 of 14 to 18 per cent. A key element in that projection was an envisaged current account surplus of the order of R3½-4 billion. This was believed to be consistent with, among other things, an envisaged further increase in real gross domestic product of some 2 per cent and an increase in the average level of real gross domestic expenditure that should not exceed 1 per cent.

Realisation of the authorities' "broad economic projection" for 1989 would be tantamount to achieving a "soft landing" for the South African economy. By mid-August 1989 little uncertainty remained that domestic spending and production activity were cooling down. However, in the light of the uncompromising nature of the need for a substantial current account surplus (and in the light of certain untoward balance of payments developments – notably the sharp further drop in the dollar price of gold in the first half of 1989), doubts could still be entertained as to whether spending and output were, in fact, slowing down at an appropriate speed and to the requisite extent.

Quite remarkable strength of the South African merchandise export performance in both the second half of 1988 and the first half of 1989 allowed the surplus on current account to be restored to an average annualised level of some R5,0 billion in the third and the fourth quarter of 1988, but to an annualised level of only R2,3 billion in the first two quarters of 1989. Both these sets of current account surpluses were, however, exceeded by unexpectedly heavy outflows of capital (not related to reserves) in all four quarters to mid-1989. In conjunction with a strengthening of the US dollar during most of the year to mid-1989 and the associated decline in the dollar price of gold, these outflows of capital remained the prime source of downward pressure on both the foreign reserves and the exchange rate of the rand. Depreciation of the effective exchange rate of the rand amounted to close to 12 per cent from the end of June 1988 to the end of June 1989.

In the area of monetary developments, significant decelerations were observed in the rate of expansion of the money supply and in monetary institutions' credit to the private sector from the third quarter of 1988 onward. Incorporated in these slowdowns were the effects of the authorities' tightening of their policy stance which had started some three quarters earlier. In the process of the adoption of stricter policies, Bank rate and the clearing banks' prime rate were raised in a number of steps by 7½ and 8 percentage points, to eventual levels of 17 and 20 per cent. As of August 1989, however, the most recently recorded rates of credit expansion and monetary growth still remained at levels of up to and over twenty per cent and therefore unacceptably high.

A notable feature of banking in the 1986-1988 upswing was the initial rapid rise in the percentage share of bank credit to individuals at the expense of the share of bank lending to companies and "other" borrowers. This was a reflection of, among other things, private households' recourse to credit in defence of established and habitual consumption patterns and in attempts to improve their standards of living, and of firms' healthier financial positions and the enhanced strength of corporate balance sheets. From the second quarter of 1988, however, lending to companies accelerated more approximately in line with rising investment and turnovers.

Inflation, as measured by the quarter-to-quarter and twelve-month rates of change in the principal price indices, reaccelerated from late 1987 or early 1988 through 1988 and the first half of 1989. As in preceding years, this could again be traced in substantial measure to earlier bouts of weakness of the exchange rate of the rand. Concerns were justified, however, about the apparently high and possibly rising level of the South African "core" inflation rate, the acceleration of inflation in a period in which the "real" economy was already beginning to slow down, and the apparently ever deeper entrenchment of double-digit inflation in inflation expectations.

The capital markets in the year to mid-1989 witnessed a marked recovery of turnover and prices of company shares; a further waning of new-issue activity; further shifts in the distribution of the flow of longer-term funds to recipient institutions; and a hardening of most long-term yields and interest rates to levels last seen in 1985 or early 1986.

In its *Annual Economic Report* for 1988 the Reserve Bank noted that, "in a set of conditions that was probably insufficiently appreciated at the time", the South African economy in 1987 up to September of that year "saw a rare combination of rising monetary demand and quickening economic activity, real economic growth ..., large current account surpluses, rising foreign reserves and a strengthening exchange rate, and declining inflation rates". The Bank implied that this happy but improbable set of conditions could not be expected to persist for any great length of time.

A balance sheet of pluses and minuses for the advanced upswing year 1988 would show monetary demand to have risen faster, economic activity to have quickened further, and the rate of real economic growth to have shown another mild increase from 1987. Against this, the current account surpluses narrowed, the foreign reserves showed a decline, the exchange rate weakened, and the inflation rates accelerated – as is, of course, not unusual in the advanced stages of a cyclical expansion. Fewer pluses and more minuses would have to be recorded for the first half of 1989, which may now be viewed as making up the early stages of a consolidation period.

However, as the economy moved from expansion in 1988 into cooling-down and consolidation in the first half of 1989, it could look at some important achievements and points of strength:

Firstly, as an unusual event in South African business cycle history, current account surpluses were maintained at significant levels virtually uninterruptedly throughout the 1986-1988 upswing and continued to be recorded in the early stages of the consolidation phase.

Secondly, the volume of merchandise exports strengthened at near-record rates in the second half of 1988 and the first half of 1989, notably in the second quarter of 1989. This rise in export volumes was the more remarkable for being recorded well past the apparent cyclical high point in exports in the third quarter of 1986 and in close proximity to the presumed upper turning-point of the general business cycle. In addition, an encouraging part of these increases in real exports consisted of increased export volumes of manufactured goods.

Thirdly, as discussed more fully in the main text of this *Report*, the burden of South Africa's total foreign debt in relative terms was reduced by some two-fifths or more in the three-year period from 1985 to 1988. South Africa continued to meet its foreign debt repayment obligations meticulously with regard to debt both inside and outside the standstill net and could point to some gains in foreign confidence and respect for doing so.

Fourthly, stepped-up economic activity and improvements in labour productivity in the advanced stages of the upswing left a legacy in the form of a slightly higher level of real personal disposable income per head of the population in 1987 and 1988 than in 1986 – the first such increase since the mini-boom year 1984.

Fifthly, low interest rates and stepped-up new-issue activity in 1986 and 1987, and impressive financial results in 1988 in particular, left many companies in a relatively healthy financial position and therefore better able to withstand a period of consolidation, comprising, among other things, a higher level of interest rates. The business confidence inspired in this way itself provided some assurance against an unduly hard landing of the economy.

Finally, a "landing" that would be "soft" in still allowing scope for some moderate further increase in domestic spending and real output growth, while nevertheless amounting to a "landing" in affording relief to the balance of payments and foreign reserve situation, still appeared capable of realisation as of mid-August 1989.

There remain, however, a number of problem areas which caution against any premature relaxation of the current restrictive policy stance.

- The rising trend in inflation gives reason for concern.
- Although the rates of increase in the monetary aggregates such as the money supply and bank lending to the private sector have recently peaked and are now subsiding, they still remain at an unacceptably high level.
- South Africa's official foreign reserves are at a very low level and the surplus on the current account of the balance of payments, although improving, is still not sufficient to meet the large capital outflows *and* replenish the foreign reserves.
- Government expenditure is still relatively high and the deficit before borrowing is still well in excess of the Government's capital expenditure programme. Dissaving by the Government therefore continues to absorb a large part of the net domestic saving.

In addition, various unresolved or inadequately resolved problems containing a "structural" element need further attention. These include the high "core" inflation rate, unsound capital-labour ratios and the long-term upward drift of the unemployment rate, issues concerning the adequacy and appropriate use of real saving and investment, and problems concerning the restoration of incentives to work, save and invest. The ways in which these problems are going to be addressed should reasonably be expected also to impinge on the future manner of conduct of short-term monetary and fiscal stabilisation policies.

Domestic economic developments

Trends in output

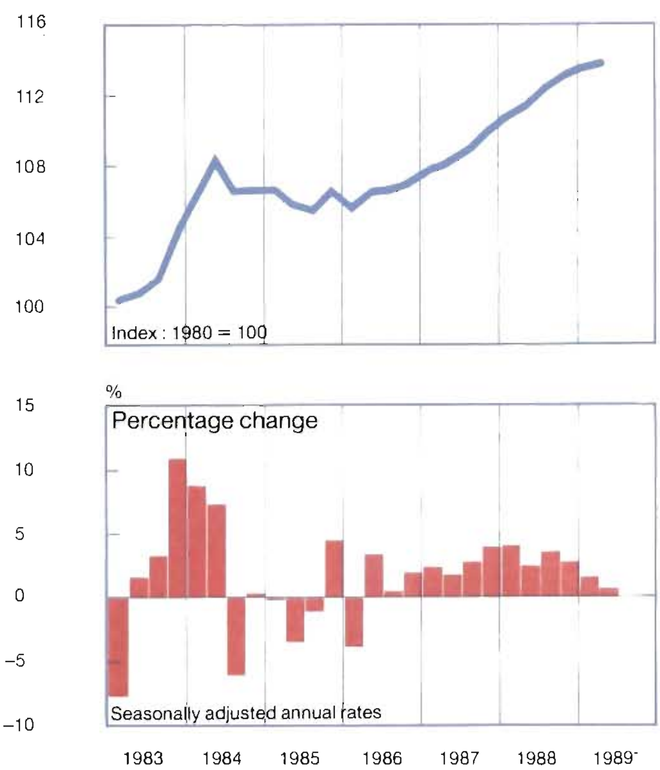
Growth of the real gross domestic product of the South African economy amounted to a *negative* 1 per cent in the recession year 1985, but to steadily strengthening if fairly modest positive rates of ½ per cent, more than 2 per cent and more than 3 per cent in the three upswing years from 1986 to 1988. The real growth rate then slowed down to a provisionally estimated average level, in seasonally adjusted and annualised terms, of some 1½ per cent from the second half of 1988 to the first half of 1989.

Conflicting signals as to the direction in which the economy was moving were emitted by changes in cyclically sensitive time series on either side of the year-end of 1988, as is to be expected in the presumed vicinity of a cyclical turning-point. However, read in conjunction with the low or decelerating average rates of growth in real gross domestic expenditure and product in the first half of 1989, the behaviour of the comprehensive leading and coincident business cycle indicators suggested that an upper turning-point of the business cycle – in a technical sense – was likely to have been reached towards the end of 1988 or in the first few months of 1989. The annual average rate of real growth of the South African economy over the eleven-quarter 1986-1988 upswing (which is now considered to have started in the second quarter of 1986) to the end of 1988 and during the extended period from the second quarter of 1986 to the second quarter of 1989 both amounted to approximately 2½ per cent. The economic growth rate during these two periods, therefore, was only slightly higher than the rate of population growth and decidedly lower than the average annual economic growth rate of 5 per cent in the cyclical expansion of 1978-1981 and of 6 per cent in the mini-boom of 1983-1984.

Despite slackening of their rates of increase in the first half of 1989, the actual behaviour of aggregate real output and expenditure in these two quarters was still consistent with the realisation of a real growth rate of some 2 per cent, as projected by the authorities, for 1989 as a whole, and therefore with the "soft landing" of the economy that currently ranks among the objectives of official policy. By the early third quarter of 1989, in fact, doubts could still be entertained as to whether the "landing" in prospect might not turn out to be too soft or too long drawn-out from the point of view of a comfortable handling of the South African balance of payments and foreign reserve situation.

On a shorter-term basis, the flagging quarter-to-quarter rates of real growth in the middle quarters of 1987 – which, at the time, caused some concern about the staying power of the then fledgling cyclical expansion – were succeeded by more robust rates of growth at an annualised level of nearly 4 per cent in the fourth quarter of 1987 and the first quarter of 1988. In the five most recently completed calendar quarters to the second quarter of 1989, the annualised quarter-to-quarter rates of growth in real gross domestic product generally displayed a mildly weakening trend from a low-level starting-point of little more than 2 per cent in the second quarter of 1988, through 3½ and nearly 3 per cent in the third and the fourth quarter of 1988, to 1½

Real gross domestic product



and a provisionally estimated ½ per cent in the first and the second quarter of 1989.

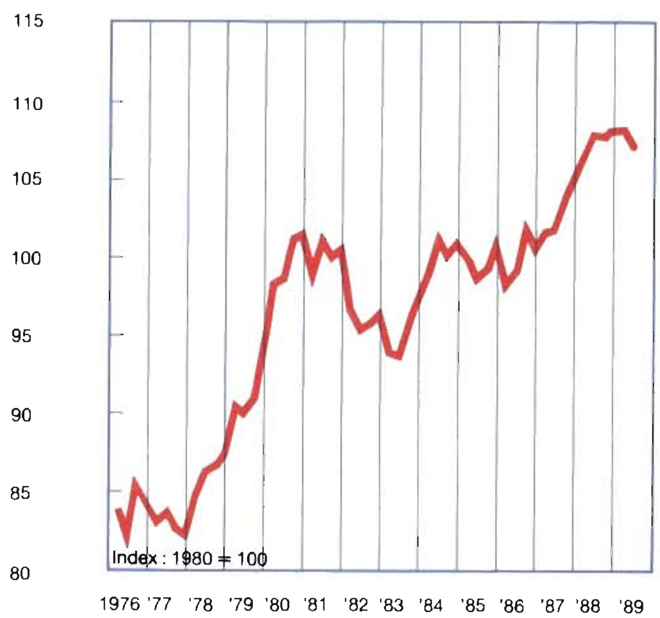
Having started in conditions of domestic socio-political tensions and of acute foreign hostility to South Africa, the 1986-1988 upswing was nevertheless able to benefit from a sustained cyclical strengthening of the world economy and especially of the economies of South Africa's main international trading partners. The volume of South African merchandise exports actually increased more rapidly (at an average annual rate of more than 15 per cent) during the eleven quarters of the 1986-1988 upswing than during the preceding ten quarters that followed the low point in exports in the third quarter of 1983 (during which the average annual rate of merchandise export growth amounted to less than 11 per cent). In the more recent past, considerably higher annualised rates of growth of the volume of merchandise exports than were recorded in the preceding seven years since early 1980, were registered from the first to the second half of 1988, and again from the second half of 1988 to the first half of 1989.

Domestically, various factors served to support demand and production in the course of 1988. Such factors included, among other things, the effects of reduced levels of households' stocks of consumer durables, of the continued ready availability of consumer credit, and of various reasons for the "pre-emptive" buying of such durables, on the household sector's purchases of durable consumer goods; the increase in new investment in real private residential buildings from the middle of 1987 as a stimulus to the demand for consumer durables and semi-durables; a further strengthening of private-sector fixed investment demand for the replacement, renewal and some augmentation of fixed capital stocks; and the rising level of real consumption expenditure by general government. A reversal of several of these factors, together with a weakened dollar price of gold and more modest growth in the world economy, may contribute to further moderation of the South African growth rate in the remainder of 1989 and in the ensuing year.

Real gross *national* product, as a more suitable aggregate measure of changes in national wealth and in the nation's material well-being, rose at a significantly more impressive average annual rate than real gross domestic product during the upswing period as a whole. From the second quarter of 1986 to the fourth quarter of 1988 the average annual rate of increase in total real gross national product amounted to 3½ per cent. Real gross national product per head of the population accordingly advanced at an average annual rate of more than 1 per cent during this period.

Higher growth in real gross national product than in real gross domestic product could be attributed mainly to a sustained decline in South Africa's real net factor payments to the rest of the world. As discussed somewhat more fully in the section on foreign trade and payments in this *Report*, this decline primarily reflected the impact of foreign firms' disinvestment actions, and of the repayment of foreign debt, on payments of dividends and interest to non-residents. The effect of these reduced factor payments was, however, reinforced by an improvement in the terms of trade in 1987 and the first half of 1988 in particular.

Real gross national product

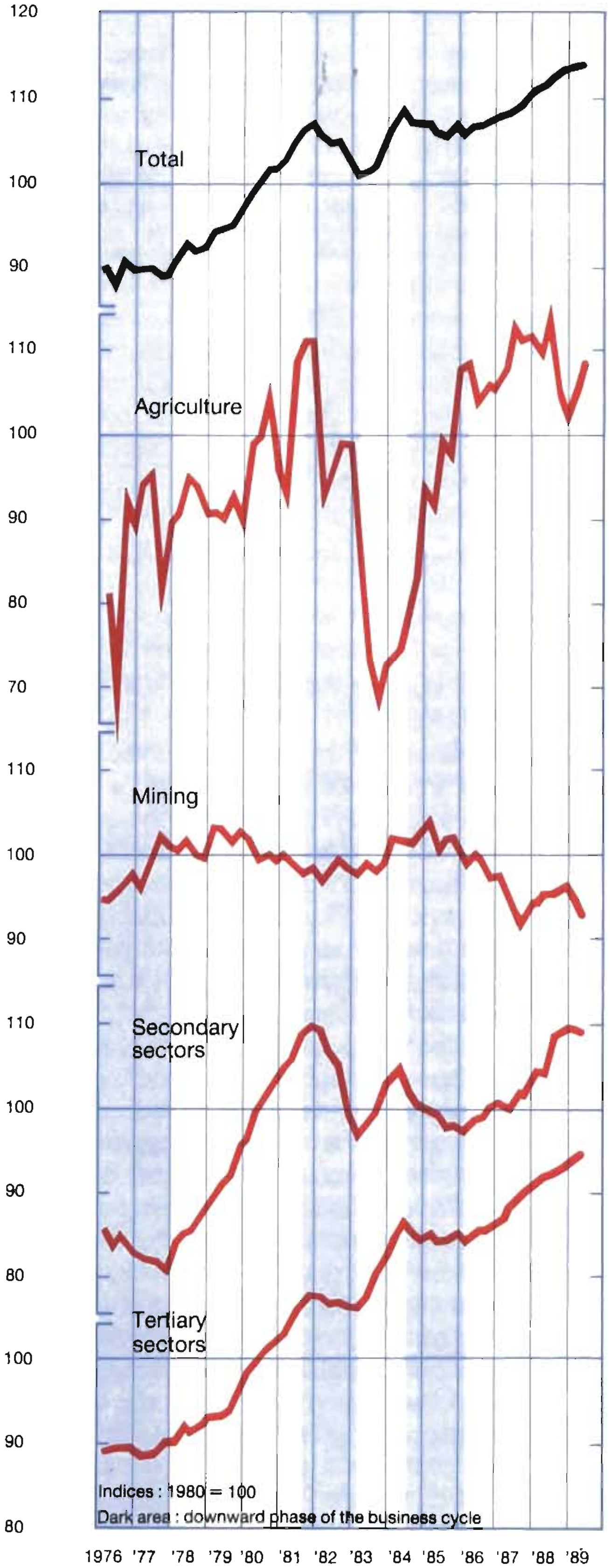


Real gross national product rose at an even more favourable annualised rate of 5½ per cent in both the second half of 1987 and the first half of 1988. However, a deterioration of the terms of trade, on account of a sustained decline in the dollar price of gold and a weakening of world commodity prices from the middle of 1988, then caused it to move essentially sideways through the second half of 1988 and the first half of 1989.

Sectoral output performances

With the exceptions of agriculture and mining (which declined) the average annual rates of production increases in all sectors of the economy during the upswing from the second quarter of 1986 to the end of

Components of real gross domestic product



1988 were significantly lower than their counterparts in the cyclical expansion from 1978 to 1981 and in the mini-boom of 1983-1984. Real value added by the *primary sectors* shrank at an average annual rate of some 1½ per cent. This was the result of declines at a rate of about 2½ per cent in agriculture and of some 1 per cent in the mining industry.

Real value added in *agriculture* recovered substantially from very low levels in the drought years 1983 and 1984 to a high point in the second quarter of 1988. However, it fell back thereafter on account of a disappointing maize crop in the 1987/88 season and because of late harvesting of the (very good) wheat crop of 1988.

Real output of the *mining sector* in the first half of 1989 was still 7 per cent lower than at the high point that had been reached in 1985. The *gold mining industry* faced increasing depths of mining operations, diminishing grades of ore, rapidly rising production costs and relatively small increases in the rand price of gold in both 1987 and 1988; by 1987, South Africa had become the highest-cost gold producer among the world's five most important gold-producing nations. *Coal* production was relatively stable from 1986 to 1988, but retreated slightly in the first half of 1989. After having weathered the effect of international trading sanctions, however, the coal mining industry experienced markedly higher export volumes and an improvement in world prices in 1988.

A firm average annual rate of output growth of 4½ per cent in the *secondary sectors*, mainly reflecting growth at a rate of 5 per cent in manufacturing, nevertheless still fell short substantially of the growth rates of earlier upswing periods. This could be attributed in large part to factors (such as the prevailing sense of uncertainty and lack of confidence, sanctions or the threat of sanctions, the rising cost of imported machinery and equipment, and over-capacity and rationalisation in the South African Transport Services, Eskom and other public-sector enterprises) which over the past several years have held back fixed investment in manufacturing industry. In 1988, however, markedly higher levels of domestic demand and a strengthening export performance combined to produce real output growth in the secondary sectors at a rate of 5½ per cent. This compared relatively favourably with the annualised growth rate of 7 per cent that had been recorded in the mini-boom of 1983-1984.

In the *tertiary sectors*, the slightly above-average annual growth rate of 3 per cent in the 1986-1988 upswing to the end of 1988 similarly was still well below the growth rates of the preceding two cyclical expansions. Failure to match the growth rates of earlier expansion phases was shown by all sub-sectors of tertiary activities. The growth rate of real value added by

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

Sectors	Phases of the business cycle			
	Upswing from first quarter of 1978 to third quarter of 1981 (15 quarters)	Upswing from second quarter of 1983 to second quarter of 1984 (5 quarters)	Downswing from third quarter of 1984 to first quarter of 1986 (7 quarters)	Upswing from second quarter of 1986 to fourth quarter of 1988 (11 quarters)
Primary sectors	1	1	4	–1½
Agriculture	6	–6	20	–2½
Mining	–1	3	–1½	–1
Secondary sectors	8½	7	–4½	4½
Manufacturing	9	8	–5½	5
Tertiary sectors	5	7½	–1	3
Gross domestic product	**5**	**6**	**–1½**	**2½**
Gross national product	**5½**	**6**	**–1½**	**3½**

general government, however, apart from being relatively stable, came close to the long-term trend value of this growth rate of some 3½ to 4 per cent per year. Over the past four to six quarters to mid-1989 the annual growth rates in various tertiary activities varied from 3 per cent in commerce to 1 per cent in transport, storage and communication. Both commerce and transport were favoured by higher levels of domestic demand as well as by rising imports and exports and an increase in tourism.

The sub-sector *financial services* reflected, among other things, continued buoyancy of the property market and a return to higher turnovers on the Johannesburg Stock Exchange in the second half of 1988 and the first half of 1989. The annual growth rate of *government services* receded to 2½ per cent in the past six quarters to mid-1989 despite significant increases in the number of government workers in the independent and self-governing national states.

In the past few years it has been suggested with increasing frequency that a misleading picture of the extent of economic activity in South Africa and of both quantitative and qualitative aspects of the country's economic growth and development is presented by the official national accounts statistics. The reason for this view is the omission of the so-called *"informal sector"* from the national accounts data. However, despite the informal sector's undoubted importance from various points of view, a conclusion to the effect that this sector's absence from the official statistics means invalidation of the national accounts, does not yet stand up to analysis.

The informal sector, by definition, comprises all activities in all areas of economic endeavour that are not recorded statistically. It affects the formal sector through the utilisation of income, the absorption of workers that would otherwise be unemployed, and the extraction of inputs from recorded production. The South African informal sector is pulled towards the formal sector (through gradual "formalisation" of its activities), rather than pushed away from it (for avoiding taxation or regulatory interference, as tends to be true in more advanced economies).

Survey-based indications as at present are that real value added in the informal sector may amount to some 3 to 5 per cent of measured real gross domestic product. Even an annual real growth rate of this sector of as much as 15 per cent would not, therefore, add more than some ½ to ¾ percentage points to the growth rate, as officially measured, of the South African economy. This does not provide sufficient justification for discarding the national accounts estimates as presenting an incorrect or unreliable description of South African real economic growth and related developments.

Trends in domestic expenditure

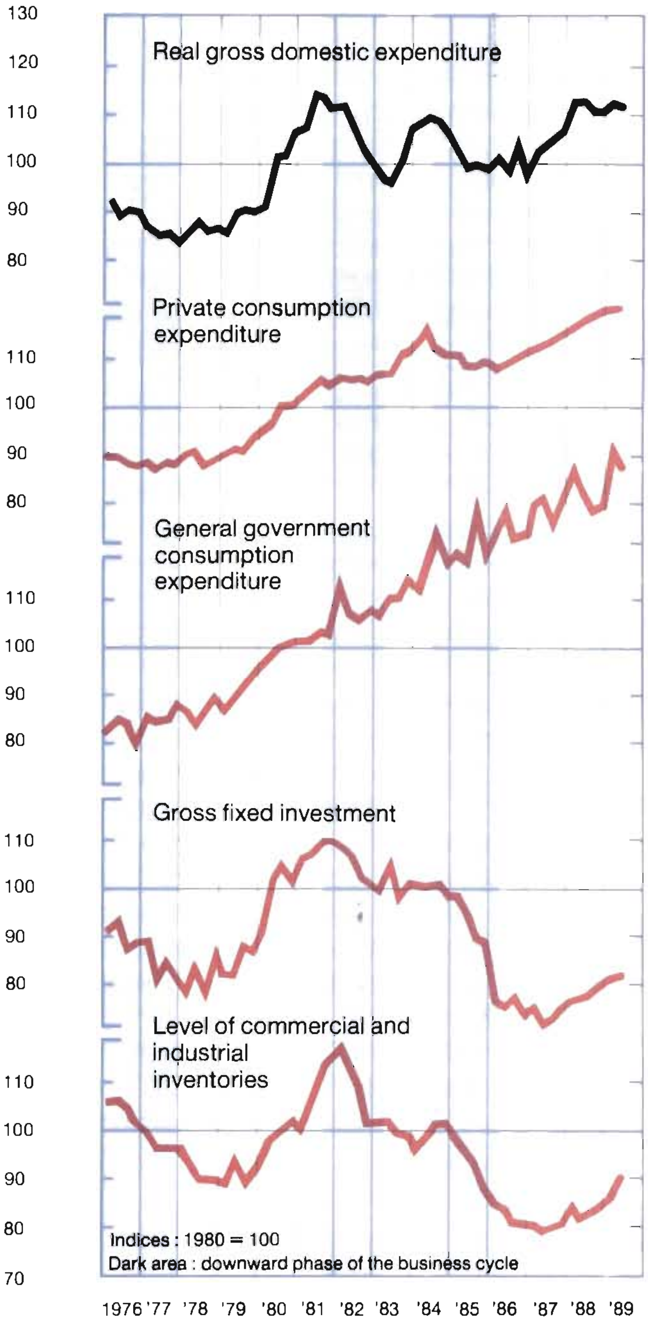
Six changes of direction of the quarter-to-quarter change in aggregate real gross domestic expenditure were observed in as many consecutive quarters from the third quarter of 1985 to the fourth quarter of 1986. From the first quarter of 1987, however, real gross domestic spending set out on a decidedly upward course which lasted up to the second quarter of 1988. It then declined fairly significantly during the remainder of that year.

Aggregate real gross domestic expenditure in the calendar year 1988 was 7 per cent higher than in 1987. In the first two quarters of 1989 the seasonally adjusted and annualised quarter-to-quarter rates of growth in real gross domestic spending amounted to some 6 per cent and to a provisionally estimated –2 per cent, respectively. While rising fairly markedly again from the second *half* of 1988 to the first *half* of 1989, the level of total real domestic spending in the second *quarter* of 1989 nevertheless was slightly lower, on balance, than in the second *quarter* of the preceding year.

The average annual rate of increase in total real gross domestic expenditure during the 1986-1988 upswing from the second quarter of 1986 to the fourth quarter of 1988 amounted to 3½ per cent. This compared poorly with average annual rates of increase of 8½ per cent in the prolonged expansion phase from 1978 to 1981 and of 10 per cent in the mini-boom of 1983-1984. More closely comparable rates of increase were recorded, however, in the accelerating growth phases of these upswing periods.

Average annual rates of increase in the various components of real gross domestic expenditure during the eleven quarters to the fourth quarter of 1988 ranged from 1½ to 4 per cent and were also markedly lower than their counterparts in earlier expansion phases. As a result of these divergent growth rates, major shifts became apparent in the course of the 1986-1988 upswing in the relative shares of the various main components of spending in total domestic expenditure. Specifically, the share of private consumption expenditure rose from 55½ per cent in the beginning of the 1980s to an average of 60½ per cent during the three years from 1986 to 1988. Conversely, the share of gross domestic fixed investment shrank from an average of 28 per cent to an average of 21 per cent between these two periods. Government consumption expenditure, like private consumption expenditure, increased its proportion, namely from 14½ to 20 per cent. *Total* real consumption expenditure of both the private and the public sector, therefore, raised its share in aggregate gross domestic spending from about 70 to as much as 80 per cent.

Real gross domestic expenditure and its components



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

Sectors	Phases of the business cycle			
	Upswing from first quarter of 1978 to third quarter of 1981 (15 quarters)	Upswing from second quarter of 1983 to second quarter of 1984 (5 quarters)	Downswing from third quarter of 1984 to first quarter of 1986 (7 quarters)	Upswing from second quarter of 1986 to fourth quarter of 1988 (11 quarters)
Private consumption expenditure	5½	8½	−4½	4
Consumption expenditure by general government	4½	9	3	1½
Gross fixed investment	8	−½	−14	1½
Gross domestic expenditure	8½	10	−4½	3½
Exports of goods and non-factor services..	−2	3	1½	7
Imports of goods and non-factor services..	9	16½	−11	11
Gross domestic product	**5**	**6**	**−1½**	**2½**

Despite slackness of real fixed capital spending and inventory accumulation, the annualised rate of increase in real imports of goods and non-factor services during the years from 1986 to 1988 substantially exceeded the rates of increase in real exports of such goods and services and in aggregate real domestic expenditure, as is normal in the expansion phases of the South African business cycle. An 11 per cent annual rate of increase in these imports, flanked by a 7 per cent rate of increase in such exports, caused the ratio of the so-called "real foreign balance" to real gross domestic product to contract from a high point of 14 per cent in the fourth quarter of 1986 to 6½ per cent in the fourth quarter of 1988.

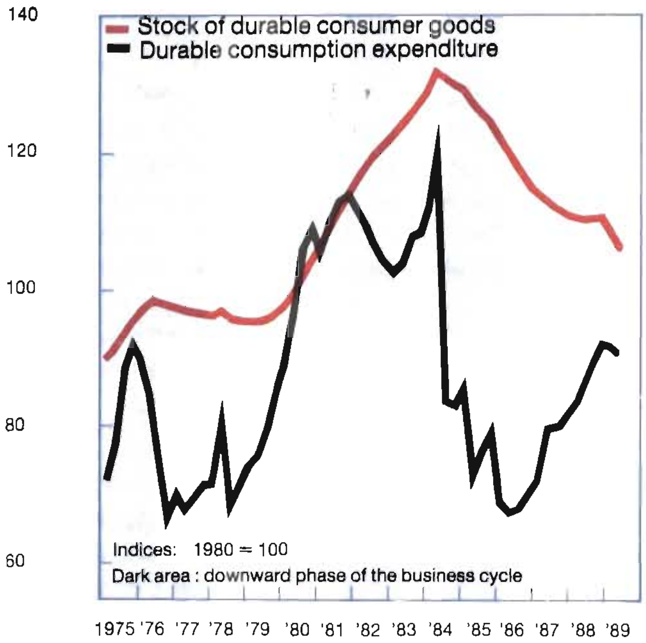
Private consumption expenditure

Following its severe downward adjustment in the second half of 1984, 1985 and early 1986, aggregate real private consumption expenditure grew remarkably steadily, at an average annual rate of some 4 per cent, from the second quarter of 1986 to the final quarter of 1988. A high point in the annualised quarter-to-quarter rate of increase in consumer spending – incorporating *inter alia* substantial pre-emptive buying in anticipation of exchange rate declines and price increases, and also because of fears of a possibly limited future availability of certain imported goods – was recorded in the third quarter of 1988. The average level of total real private consumption expenditure was nearly 5 per cent higher in 1988 than in 1987. Its rate of increase then slowed down markedly, however, in the first two quarters of 1989.

Despite the fairly brisk and steady expansion in real consumer outlays during the upswing years, the level of total real private consumption expenditure in the first half of 1989 was still only 3½ per cent higher than at its peak in the second quarter of the mini-boom year 1984. Similarly but more dramatically, the level of real expenditures on consumer *durables* was still 26 per cent *lower* in the first half of 1989 than at its most recent high point in the second quarter of 1984. As is shown in the accompanying graph, the quite firm recovery of households' durable goods purchases in the course of the upswing did not, in fact, succeed in maintaining households' accumulated real stock of such durables or in restoring it to its 1984 level. Instead, this stock, although levelling out in 1988, declined almost uninterruptedly from its high point in the second quarter of 1984 to the middle of 1989, and did so at an average annual rate of some 4½ per cent.

In explaining this deterioration in households' real consumable asset wealth, the very slim rise in *total* consumption levels, and the long-lasting drop in purchases of consumer durables since 1984, account has to be taken of the downward drift of real personal disposable income per head of the population, which shrank at an average annual rate of ½ per cent from 1980 to 1984 and at an accelerated pace of 2½ per

Real expenditure on durable consumer goods



cent from 1984 to 1988. Despite a mild improvement from the fourth quarter of 1988, real personal disposable income per capita in the first half of 1989 was only 1½ per cent higher than its average level during the year 1986.

Against this very limited rise in real per capita incomes, real private *consumption* expenditure per capita was 4½ per cent higher in the first half of 1989 than its average level in 1986. Facing relatively high inflation and low or negative interest rates in real terms, and seeking to maintain or improve their standards of living, households increased their indebtedness and reduced the personal savings ratio. A mild reversal of these tendencies has, however, been in evidence since the fourth quarter of 1988 in response to the strengthening of aggregate real personal disposable income during that year.

Consumption expenditure by general government

In the course of the past six quarters to mid-1989, real consumption expenditure by general government rose strongly in the first quarter of 1988 and very strongly in the first quarter of 1989. It declined significantly, however, in the second and third quarter of 1988 and in the second quarter of 1989, and moved essentially sideways in the fourth quarter of 1988. Because of its being measured up to a quarter of relatively low government spending, the average annual rate of increase in real goverment consumption expenditure during the recent upswing up to the final quarter of 1988 (amounting to only 1½ per cent) fell well short of the growth rate of real gross domestic product (of 2½ per cent) during this period. When the first half of 1989 is added, however, the average annual rate of increase in real government consumption outlays from the second quarter of 1986 is raised to 3 per cent. The uncommonly rapid rise in this kind of spending in the first quarter of 1989 was a major factor in keeping the annualised growth rate of aggregate real domestic expenditure during that quarter at broadly the same level as that which prevailed in 1988 vis-à-vis the preceding calendar year.

From the start of the 1986-1988 upswing to the beginning of 1989, the rate of increase in real government expenditure on intermediate goods and services, at an average annual level of 2½ per cent, broadly matched the growth rate in real gross domestic product. The real wage bill of government, on the other hand, rose at an average annual rate of some 3½ per cent.

When a long-term view of developments is taken, the claim of the government's consumption expenditure on gross domestic product expanded substantially over time from an average of 10½ per cent in the 1960s to nearly 13 per cent in the 1970s, and to more than 16½ per cent in the 1980s to date. It reached a new high point at an average of 18½ per cent in 1987 and 1988. The counterpart of this development has been a declining trend in the ratio of gross domestic saving to gross domestic product.

Gross domestic fixed investment

Total real gross domestic fixed investment reached a lower turning-point in the second quarter of 1987 and rose during the ensuing eight quarters. Its average annual rate of increase during the entire upswing period to the end of 1988 amounted to a slender 1½ per cent – against 8 per cent in the cyclical expansion from 1978 to 1981. Total real fixed investment nevertheless was some 6½ per cent higher in 1988 than in 1987, but advanced at a somewhat lower and declining tempo in the first half of 1989. Although real private-sector fixed investment slowed down mildly in the second half of 1988 and the first half of 1989, this decline was neutralised partly by stepped-up investment outlays by public corporations from the second quarter of 1988 onwards. A significant contribution to such spending was made by public corporations that are involved in pre-production expenditure on projects such as Mossgas and Mossref.

The increase in total real gross fixed investment expenditure in 1988 was the first such an increase in a full calendar year in the past seven calendar years. The most recently recorded levels of total real gross fixed investment were, however, still some 25 per cent lower than the high point in fixed investment that had been attained in the fourth quarter of 1981.

The recovery in aggregate real gross domestic fixed investment from the third quarter of 1987 to the end of 1988 was fully accounted for by increased real fixed capital formation by the private sector. Real fixed capital expenditure by both public authorities and public corporations actually declined, on balance, during the upswing period. This also caused the share of private-sector investment in total real gross domestic fixed investment to expand to a record high point (in the period since 1960) of nearly 67 per cent. As the reverse side of this development, the shares of public corporations and public authorities in aggregate fixed investment shrank to 12 per cent and to a record post-1960 low of 21 per cent, respectively. Shrinkage of the investment volumes of public-sector enterprises, however, contributed greatly to the creation of "exportable surpluses" out of concurrent gross domestic product. Low public-sector investment, in other words, helped to create and maintain the current account surpluses of the 1985-1989 period and appeared as an important counterpart of recent outflows of capital.

The rising preponderance of private-sector investment also helped to account for the relatively late – or heavily lagged – appearance of the recovery of real fixed investment spending in the context of the 1986-1988 cyclical upswing. By the second quarter of 1986 private-sector business interests were still influenced greatly by the uncertainties and lack of confidence that had been engendered by the socio-political disturbances and foreign hostility of the preceding two years.

Sectoral increases in real fixed capital formation in the private sector of the economy in 1988 and the first half of 1989 were especially important in manufacturing industry, commerce, transport and finance. The general strengthening of investment activity from the third quarter of 1987 did not, however, prevent physical capital stocks from shrinking in sectors such as manufacturing, agriculture and transport during the 1986-1988 upswing period.

An analysis of public-sector fixed capital expenditure in terms of a functional classification of such expenditure shows investment in facilities for the provision of basic infrastructural services (electricity generation, water provision, transport and communication, etc.) to have exhibited a long-term downward trend. Investment in social infrastructure (health services, education, etc.), on the other hand, by the late 1980s had regained a proportion of total real gross domestic fixed investment that was comparable with its share in the 1960s. In all, public-sector fixed investment relative to total fixed investment declined from an average of 48½ per cent in the 1970s to a historical low point of approximately one-third in 1988.

Changes in inventories

Inventory investment – which averages less than 3 per cent of gross domestic product, but because of its volatility may be important in short-term developments – contributed very little to gross domestic product in the 1986-1988 upswing. The long-term downward sweep of total real inventories since 1982, and its shorter-term downward movement from a recent high point in the fourth quarter of 1984, were interrupted, however, from the third quarter of 1987. Build-ups of real inventories made significant contributions to aggregate domestic demand in the second half of 1987, the first half of 1988 and the first half of 1989.

The longer-term downward trend in real inventory levels appears to have been associated with the introduction of superior and technologically more advanced techniques of inventory management (such as computerisation), as well as with the increased general assuredness of supplies. Among shorter-term considerations that have exerted a depressing effect on firms' inventory holdings, businesses' needs for improved cash flows and reductions of operating costs in the "distress period" from late 1984 to early 1986 were followed by rising and eventually positive real interest rates from late 1987. The renewed drawing-down of inventories in the second half of 1988 would appear to have been partly of an "involuntary" or unintended nature. It was affected by unexpectedly heavy sales on account of "pre-emptive" buying by households and business enterprises; at the same time the marked rise in merchandise export volumes in the second half of 1988 and the first half of 1989 is likely to have been met partly out of stocks.

Prolonged disinvestment in inventories from late 1984 through the first half of 1987 resulted in a historically low level of non-agricultural and non-strategic inventories to non-agricultural gross domestic product. This ratio declined from an average of 35½ per cent in the 1970s to an average of 28 per cent in the period from 1986 to the first half of 1989. In the second half of 1988, the strength of final demand also resulted in low levels of inventories to turnover, notably in the retail and motor trades. Slackening of demand growth in the first half of 1989, on the other hand, would appear to have contributed to an "involuntary" rise in the ratio of commercial and industrial inventories to sales from approximately 1½ months' sales in the second half of 1988 to 1¾ months' sales by mid-1989.

A sectoral analysis shows that inventory levels in 1988 were still unusually low particularly in commerce and the mining industry. Buoyant conditions in the world diamond market also brought about unusually low diamond stocks-in-trade in the course of 1988.

Factor incomes

The rate of increase in aggregate nominal factor income accelerated, in accordance with the increasing buoyancy of domestic economic conditions, to 16 per cent in 1987 and to 16½ per cent in 1988, but moved sideways in the first half of 1989 as the rapid rise in the gross operating surpluses of business enterprises tapered off.

The *gross operating surplus* component of factor income rose significantly, by 17 per cent, in 1986, but slowed down to a rise of 14 per cent in 1987 not least because of the adverse effect of strikes and labour unrest on operating surpluses in the gold mining industry and therefore on profitability in the mining sector in general. In 1988, substantial improvements in the gross operating surpluses of manufacturing, commerce, transport and finance were neutralised partly by lower than expected operating surpluses in the primary sectors. The total gross operating surplus in 1988 was 16½ per cent higher than in the preceding year.

In the first half of 1989 the growth rate in the aggregate operating surplus decelerated markedly to an annualised level of some 11½ per cent. This was a reflection of, among other things, the weaker gold price, a deceleration of the decline in company liquidations, and the mild cooling-down of economic activity in general.

Aggregate nominal labour remuneration rose by 14 per cent in 1986 and by 17 per cent in 1987, but at a marginally lower rate in 1988. The 1988 slowdown could be attributed partly to the absence of general salary adjustments by public authorities and to a contraction of the labour force in the mining industry. In the first half of 1989 indications were that the tempo of strengthening of nominal remuneration packages was again accelerating. This was a reflection of, among other things, improved conditions of service in employment by public authorities and stepped-up wage demands by labour unions in accordance with the rising inflation rate.

An analysis of labour remuneration relative to sectoral gross domestic product in the various sectors of the economy shows that this ratio rose substantially over the past two and a half years in the mining industry and in the financial sector in particular. In addition, the ratio of general government's share of remuneration of employees to the gross domestic product of *all* sectors advanced from 8½ and 9½ per cent in the 1960s and 1970s to 12½ per cent in 1987 and 1988, and to 13½ per cent in the first half of 1989. These and related developments caused the ratio of aggregate remuneration of employees to aggregate gross domestic product to increase from its recent low point of 57 per cent in 1986 to approximately 59 per cent in the first half of 1989.

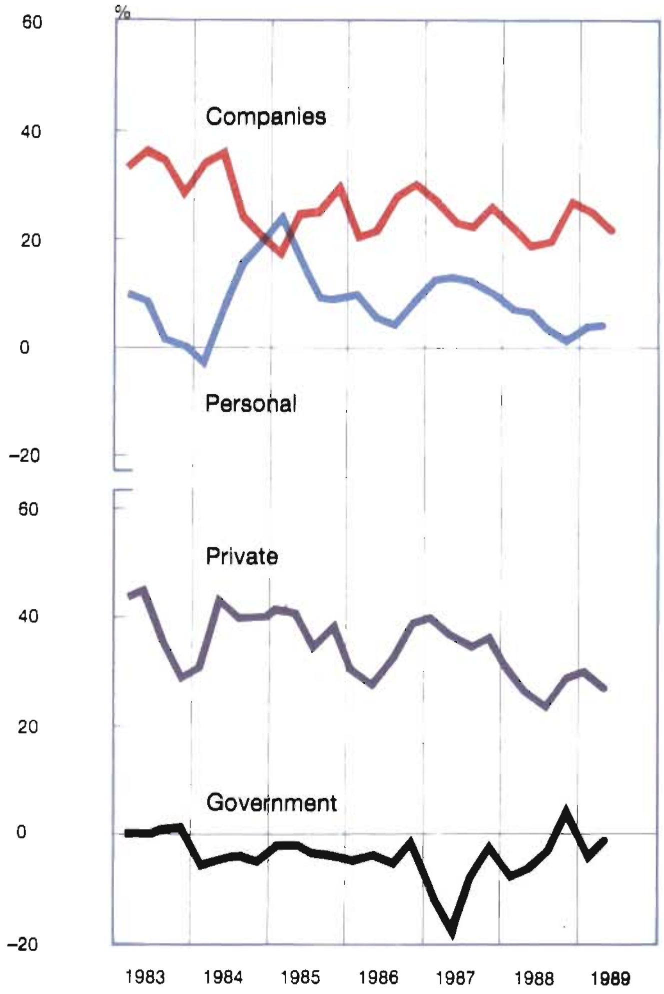
Domestic saving and investment

The ratio of gross domestic saving to gross domestic *investment* declined from a peak of 125½ per cent in the early upswing year 1986 to 107½ per cent in the advanced upswing year 1988 and to 105 per cent in the first half of 1989, as was also reflected in the shrinking of the relative surplus on the current account of the balance of payments over this period. Relative to *gross domestic product*, gross domestic saving declined from a recent high point of 27 per cent in the fourth quarter of 1986 to an average of 22 per cent in the year 1988 and to 22½ per cent in the second quarter of 1989. This ratio therefore continued to fluctuate fairly faithfully around its long-term average value of some 25 per cent, which compares favourably with the savings ratios of broadly similarly-placed economies elsewhere in the world.

The *personal* savings ratio in the South African economy (i.e. the ratio of personal saving to personal disposable income) has been pulled down in recent years, partly by the downward drift of real personal disposable income per capita in the face of habit persistence and the difficulties of adjusting living standards downwards, and partly by other factors, as referred to earlier, that have tended to raise the propensity to consume at given levels of real personal disposable income per capita.

In addition, however, a number of factors have been operating in the South African tax and inflationary environment that have encouraged profit retention and saving by private companies at the corporate level,

Components of savings as percentage of gross domestic saving



rather than saving by households and individuals at the personal level. Factors of this nature have, for example, included considerations such as low or negative real after-tax rates of return on depository investments, and the non-taxability of capital gains. A useful distinction may therefore be made between saving by the public sector, on the one hand, and by the private sector (comprising *both* saving by households and by private companies), on the other hand. Relative to "private disposable income" which is the relevant concept in this context, this "private savings" aggregate has displayed a fair measure of constancy in the long run. In proportion to gross domestic product, it has actually increased since the fourth quarter of 1988.

In contrast to the relative constancy of the savings performance of the private sector, gross saving by *public authorities* has exhibited a long-run downward trend and has also decreased sharply relative to gross domestic product. This has also found expression in relatively high values of the ratio of public authorities' borrowing requirement to gross domestic product in recent years.

The weakening of the economy's overall savings performance since 1986 could be attributed primarily to virtually uninterrupted dissaving by general government and to the historically low personal savings ratio of 1988. Gross *private-sector* saving, however, showed little change in the course of the 1986-1988 upswing, since increases in corporate saving and decreases in household saving have tended to neutralise one another. Increases in corporate saving since mid-1988 have originated mainly in the manufacturing, commercial and financial sectors of the economy as a reflection of the relatively buoyant economic conditions of 1988 and, to a lesser extent, in the first half of 1989.

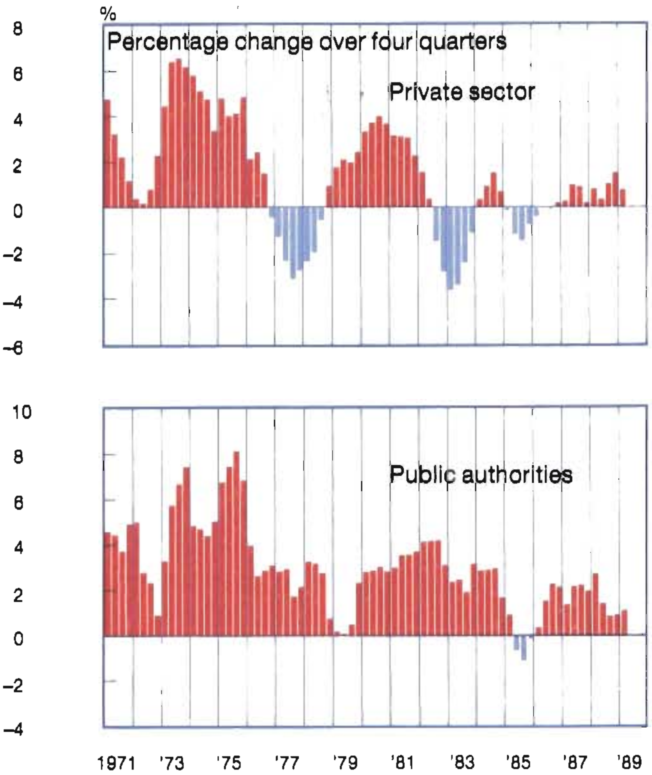
Employment

Total recorded employment in the non-agricultural sectors of the economy, which had contracted by 0,8 per cent in the recession year 1985, rose at accelerating but relatively unimpressive rates of 0,5, 1,0 and 1,1 per cent in the three upswing years from 1986 to 1988. Employment growth then slowed down, however, to a seasonally adjusted and annualised rate of only 0,4 per cent in the first quarter of 1989.

These relatively slender employment increases during three and a quarter years of generally strengthening economic activity compared unfavourably with those of earlier business cycle upswing periods. They clearly also fell short significantly of the tempo of increase of the total labour force. In the first quarter of 1989, total recorded non-agricultural employment was only 1,9 per cent higher than at its cyclical high point in the first quarter of 1982; recorded employment in the *private* sector actually displayed a net *de*crease of 2 per cent over this seven-year period.

Private-sector employment rose at a rate of slightly less than 1 per cent in 1988 and at an average annual rate of only 0,5 per cent in the three upswing years 1986 to 1988. It then declined marginally in the first quarter of 1989, partly because of accelerated lay-offs in the mining industry. Information available for the second quarter (April and May) showed a slight further rise in employment in manufacturing, but a decrease in the construction industry. Employment by public auth-

Employment in non-agricultural sectors



orities, by comparison, rose by some 1,5 per cent in 1988 and at an average annual rate of some 1,7 per cent in the three upswing years to the end of 1988. It then rose significantly faster, at an annualised rate of some 2,1 per cent, in the first quarter of 1989. Continued relatively rapid employment increases by public authorities in 1988 were experienced despite rationalisation programmes in certain business enterprises of these authorities. Such programmes resulted in staff complements being reduced by some 6 per cent (to approximately 182 000) in the South African Transport Services and more marginally (by 1 per cent, to about 95 600) in the Department of Posts and Telecommunications.

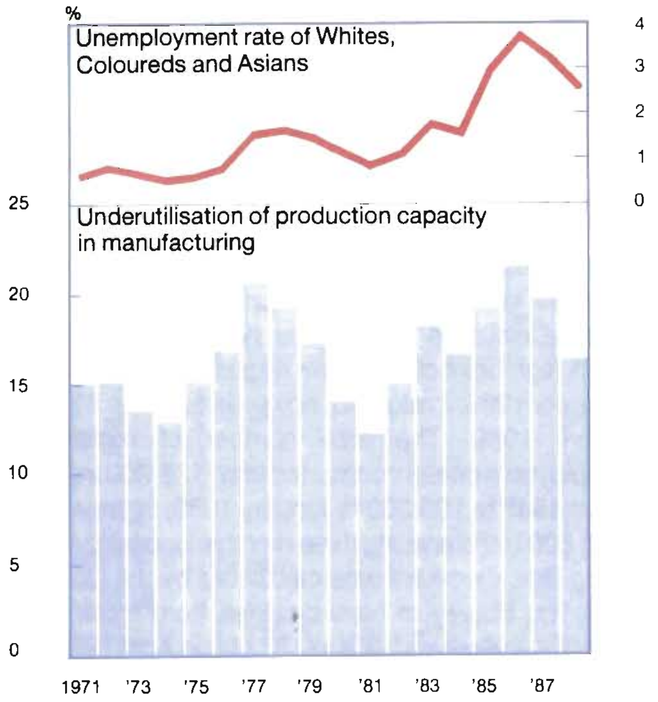
Relatively strong employment growth of some 5,0 per cent was recorded by the services industries (consisting mainly of wholesale, retail and motor trade and the financial services industries) in the private sector of the South African economy in 1988. In conjunction with relatively rapid rates of increase in employment by public authorities (which, in turn, must be weighted by the important role of public authorities in the overall provision of services), this development caused employment growth in the services sector of the economy to be notably faster than in its goods-producing industries. Inclusion of the so-called informal sector in the employment data would most probably have tended (marginally) to strengthen this tendency.

Registered *unemployment* among White, Coloured and Asian workers declined significantly more slowly during the upswing period 1986 to 1988 than during earlier expansion phases and failed to re-attain its low points of 1974 and 1981 both absolutely and in relative terms. The seasonally adjusted number of unemployed Whites, Coloureds and Asians nevertheless shrank from its high point of 82 300 in August 1986 to 45 100 in January 1989; it returned, however, to some 51 600 in April 1989. The *total* number of registered unemployed workers contracted from 136 900 in September 1987 to 108 300 in January 1989, but reverted to 115 800 in the ensuing three months. Unemployment among Black workers was calculated by the Current Population Survey to have declined from more than one million in August 1987 to 732 000 in April 1989.

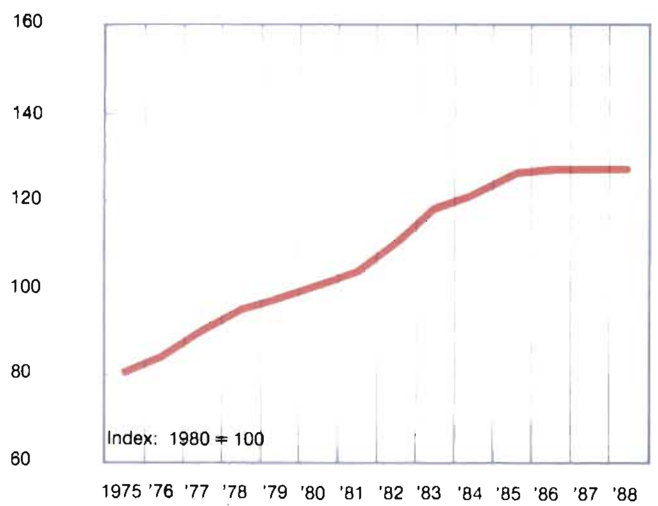
The relatively modest increases in recorded employment of the 1986-1988 upswing should be attributed, on the one hand, to the fairly limited economic growth rates of that period and to relatively very low levels of real *net* fixed domestic investment, which resulted in a low rate of increase in the economy's physical production apparatus or real fixed capital stock. On the other hand, relatively slow employment growth of the past several years can be traced to the relatively low employment-providing capability of the real fixed capital stock and of increases in that capital stock, as reflected in the relatively high capital-labour ratios that have come to apply in the South African economy. The relative recalcitrance of registered *un*employment in the face of the cyclical expansion of the 1986-1988 period, and the accompanying relatively high values of the various unemployment ratios, should be attributed to sluggish growth of the economy's fixed capital stock and the economy's relatively high capital-labour ratios *in conjunction with* relatively rapid growth of the country's employable labour force.

An accompanying graph shows broadly comparable low and high points in the degree of under-utilisation (or spare capacity) of the physical capital stock in the manufacturing sector of the South African economy as in the 1970s and in the 1980s to date, to have been associated with progressively higher unemployment rates. A second graph shows the capital-labour ratio (referring to the capital stock of the business sector outside of agriculture, and to the labour force *employed in the utilisation* of that capital stock) to have risen markedly in the years to 1984, but to have levelled out

Production capacity and unemployment



Capital-labour ratio



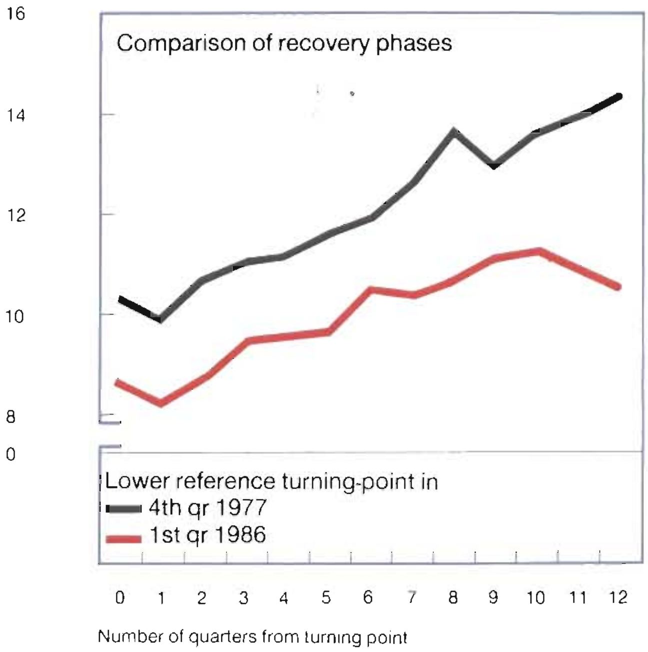
conspicuously from approximately 1986. It may be noted that a *rise* in the capital-labour ratio necessarily implies a higher value of the *marginal* capital-labour ratio than of the *average* capital-labour ratio at the point in time concerned; the employment-providing capability of *net additions* to the fixed capital stock in the 1970s and early 1980s will have been correspondingly limited. It may also be observed that a "worsening" of (i.e. a rise in) the capital-labour ratio may take place, in principle, in the absence of any real net fixed investment, i.e. in the absence of any *net* increase in the measured real fixed capital stock. This will occur, for example, when a replacement of worn-out capital equipment is used as an opportunity for the introduction of more capital-intensive or labour-saving production techniques.

Considerable attention has been paid recently to the *reasons for* the relatively high capital-labour ratios in the South African economy, their steady rise in the 1970s and early 1980s, and their more recent levelling-off. Subordinate roles in the explanation of these phenomena may have been played by diverse conditions and developments such as increases in the non-wage costs of labour and change-overs to more advanced technologies (including computerisation, automation and robotisation) that are obviously highly capital-intensive while not allowing of significant variation of the ratios in which capital and labour may be combined. Most important, however, are likely to have been businesses' long drawn-out responses to shifts in the relative "cheapness" of capital and relative "expensiveness" of labour, such as have presented themselves in the 1970s and in the 1980s to date.

Increases in capital intensity (i.e. in the use of capital *relative to* the use of labour) in various industries from the 1970s to the early or mid-1980s have also shown themselves in the ratios of overtime hours worked to normal hours worked in these industries in successive business cycles during the years concerned. In manufacturing industry, for example, the value of the overtime ratio in the twelve quarters to the first quarter of 1989 was consistently *lower* (denoting a relatively more parsimonious use of labour and a less intensive use of capital) than in the first twelve quarters of the upswing that started in the first quarter of 1978. The average values of this ratio during these two twelve-quarter periods amounted to 10,2 per cent and 12,4 per cent, respectively.

Levelling-out of the capital-labour ratios since 1986 would suggest that, among various other things, both the relative "cheapening" of capital and businesses' responses to earlier "cheapenings" of capital, had by then come to an end; it has already been noted, however, that for a variety of reasons *net additions* to the

Ratio of overtime to normal hours worked in manufacturing



total fixed capital stock in the years from 1986 have been very limited. No significant *decline* in the overall capital-labour ratio would appear to have materialised to date. Declines did occur, however, on a more narrowly sectoral basis, as in manufacturing industry.

In a very different area of "structural" policy actions that will serve to raise the employability of labour, the demand for labour and the employment-providing capacity of investment, the special training and job creation programmes as implemented by the Department of Manpower since 1985 have undoubtedly been important in alleviating the unemployment problem. By the end of 1988, close to a million persons had received training in terms of these programmes. Of these, at least 30 per cent had found wage or salary-paying positions; a large part of the remainder of these persons have become self-employed.

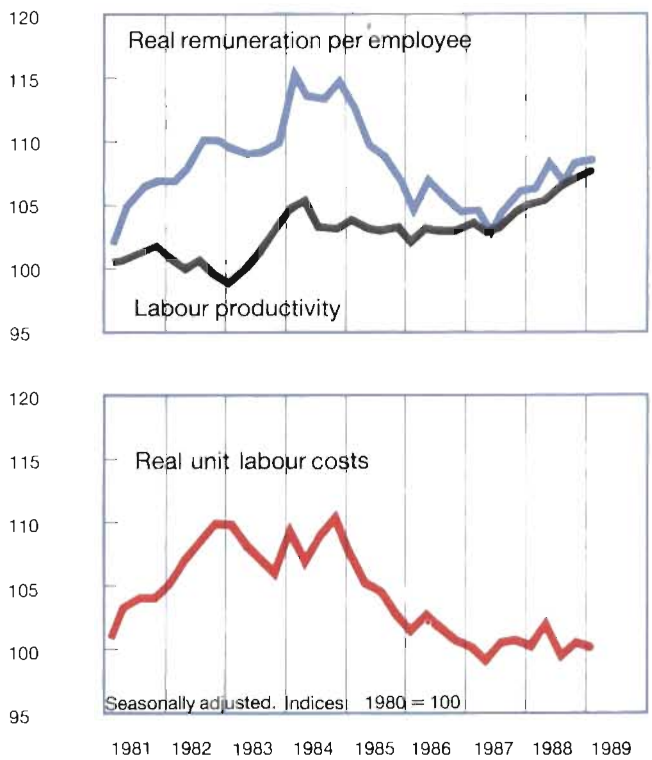
Labour costs and productivity

The year-to-year increase in the average nominal amount of salaries and wages per worker in the non-agricultural sectors of the economy accelerated fairly significantly from 14,4 per cent in 1986 to 15,4 per cent in 1987 and to 16,0 per cent in 1988. In the first quarter of 1989 the average nominal wage per worker was 16,2 per cent higher than in the first quarter of 1988. This more recent wage acceleration was mainly a reflection of salary increases in the public sector.

The average *real* wage per non-agricultural worker reached a peak in 1984. It fell back in the recession year 1985 and, in fairly typical fashion, also in the early-upswing year 1986. It then continued to do so, however, in 1987. The real wage per worker subsequently rose fairly impressively (by 2,9 per cent) in 1988; its *level* in 1988 was, however, still below that of 1982. The net percentage change in the average real wage during the 1986-1988 upswing period broadly matched the course of real wages during the expansion years from 1978 to 1980 in both mining and manufacturing. A significant *decline* in the real wage per worker, on the other hand, was recorded in the construction industry in the more recent upswing period.

Labour *productivity* (i.e. real gross domestic product per worker in the non-agricultural sectors of the economy) advanced, essentially cyclically, by 0,8

Productivity, remuneration and unit costs in non-agricultural sectors



per cent in 1987 and by 2,3 per cent in 1988. Year-on-year increases of 2,4, 2,9, 2,6 and 2,0 per cent in the second, third and fourth quarter of 1988 and the first quarter of 1989 were the largest such increases to have been recorded since the second half of 1984.

Improvements in labour productivity from 1987 to 1988 were aided by the relatively mild cyclical increases in overtime ratios referred to earlier and by a marked drop in the incidence of strikes and stay-aways. Increased recourse to conciliation boards and the Industrial Court for the settlement of labour disputes contributed to a sharp decline in the number of man-days lost on account of industrial action from 5,8 million in 1987 to only 0,9 million in 1988.

Accelerated productivity advances caused the tempo of increase in nominal labour costs per unit of physical production to decline from 14,9 per cent in 1986 to 13,4 per cent in 1988 and to increase only slightly to a year-on-year rate of 13,9 per cent in the first quarter of 1989, despite the more rapid increases in nominal labour remuneration. Broadly similar rates of increase in the *real* wage per worker and in physical labour productivity caused the *real* labour costs per unit of physical output to move essentially sideways through the year 1988 and in the first quarter of 1989.

Mild strengthening of the effective exchange rate of the rand in the course of 1987 caused the rate of increase in the prices of *imported goods* to fall back sharply from well over 20 per cent in both 1985 and 1986 to only 9,7 per cent in 1987. Renewed weakness of the rand in the foreign exchange markets through most of 1988, and the increase in surcharges on imports from mid-August 1988, subsequently caused the tempo of these price increases to reaccelerate, however, to 11,0 per cent in 1988. It then rose more pronouncedly to an average year-on-year level of 16,7 per cent in the first half of 1989.

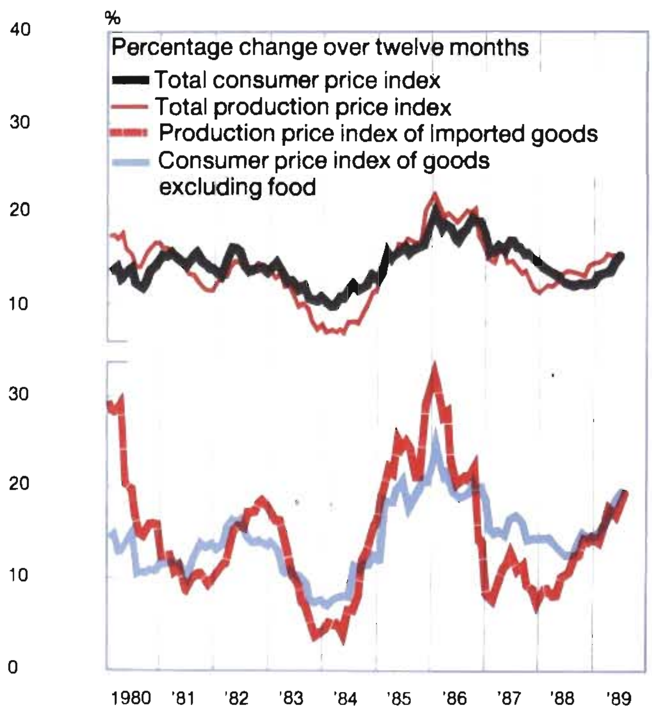
The rate of increase in the prices of *domestically produced goods* retreated from 18,7 per cent in 1986 to 13,8 per cent in 1988, but advanced to an average year-on-year level of 14,9 per cent in the first six months of 1989. Prices of domestically *manufactured* goods showed somewhat above-average increases on a year-on-year basis of 16,4 per cent during this more recent period.

Reflecting the weighted movements of its components, the rate of increase in the overall *production*

Prices

Reserve Bank econometric analyses suggest (no "proof" is possible in these matters) that pressures on the domestic means of production, as measured by the actual output/ potential output ratio, became an independent source of inflationary price increases again only as from the second half of 1988. A considerable part of the reacceleration of inflation in 1988 and the first half of 1989 must accordingly be traced to other factors than the pressures of excessive monetary demand. Such factors clearly included the more recent movements of the exchange rate; also to be included, however, are certain "autonomous" cost and price increases (including tax and administered price increases, mainly in 1989) not related in any *direct* fashion to demand conditions, and a possible worsening of inflation expectations. A two-way relationship exists, of course, between exchange rate movements and differences in inflation rates in South Africa and its principal international trading partners. In 1988 the inflation rate in South Africa, as measured by changes in the consumer price index, was still nearly four times as high as the weighted average inflation rate (of 3,3 per cent) in South Africa's seven most important trading partner countries, after having been more than nine times as high in 1986.

Prices



price index slowed down from 19,6 per cent in 1986 to 13,9 per cent in 1987 and to 13,2 per cent in 1988. It then reaccelerated, however, to 15,3 per cent in the first six months in 1989 vis-à-vis the first six months of 1988.

Inflation as measured by increases in the *consumer price* index slowed down encouragingly from 18,6 per cent in 1986 to 16,1 per cent in 1987 and to 12,9 per cent in 1988, but reaccelerated to an average level of 14,3 per cent in the first half of 1989 vis-à-vis the first half of 1988. This more recent rate of consumer price inflation closely approximated the average annual rate of 14,4 per cent that had prevailed during the preceding ten years. On a shorter-term basis, the tempo of inflation in consumer prices from quarter to quarter quickened relatively sharply during the past one and a half years from a low point at a seasonally adjusted and annualised rate of 9,2 per cent in the first quarter of 1988 to 13,9 per cent in the third quarter of 1988, and to as much as 18,4 per cent in the second quarter of 1989.

An accompanying graph shows movements in the twelve-month rate of increase in consumer prices since 1980 to have consisted, mostly, of moderately muted and slightly lagged reverberations of movements in the twelve-month rate of increase in production prices. It also shows the twelve-month rate of increase in consumer prices of goods other than foodstuffs to have been associated remarkably closely with the twelve-month rate of increase in the rand prices of imported goods. Because of the recently accelerated increases in the prices of domestically produced goods, however, the reacceleration of consumer price rises (over twelve-month periods) since mid-1988 has failed to show its usual damped-down relationship with changes in the rate of increase of import prices.

Above-average rates of increase were displayed by the goods component of the consumer price index in 1988; below-average rates of increase were shown, correspondingly, by the services component. This was largely a reflection of the impact of the accelerating rise of the rand prices of imported goods on the goods component of the consumer price index. The reverse of this situation applied in the first half of 1989, when the rate of increase in the prices of services significantly exceeded the rate of increase in the prices of consumer goods. To an important extent this represented the effect of higher domestic interest rate levels on the cost of housing as a major service item in the average household's consumption pattern. More favourable weather conditions, on the other hand, simultaneously caused the rise in food prices in the first half of 1989 to fall short of the inflation rate in consumer prices in general.

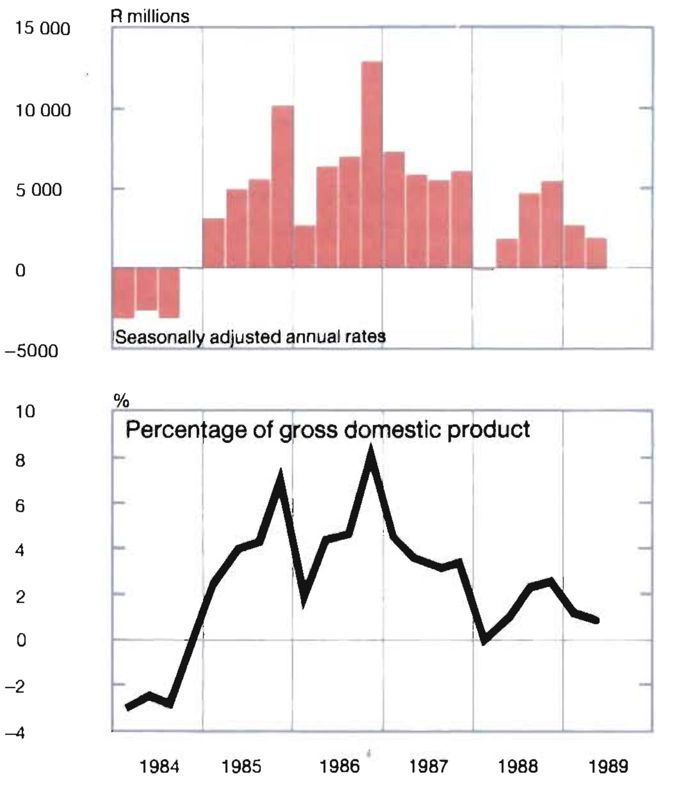
Foreign trade and payments

Sustained surpluses on current account through 1988/89

Having dipped fleetingly into a marginal deficit in the first quarter of 1988, the current account of the South African balance of payments showed significant surpluses again during the remainder of 1988 and the first half of 1989. If, as seems likely, the 1986-1988 upswing technically came to an end in late 1988 or early 1989, this upswing will, therefore, have been unusual in having produced virtually uninterrupted current account surpluses throughout its duration. The cumulative current account surplus from the beginning of the upswing in the second quarter of 1986 to the end of 1988 amounted to 3,0 per cent of the concurrent gross domestic product. This may be compared with a relative current account surplus of 2,0 per cent in the cyclical expansion from the beginning of 1978 to the third quarter of 1981 and with a relative *deficit* of 1,6 per cent in the mini-boom period from the second quarter of 1983 to the middle of 1984.

Not surprisingly, however, the current account surplus did shrink significantly during the eighteen months to mid-1989 from both its absolute and relative levels in preceding years. Having amounted to R5,9 billion in the recession year 1985 and to R7,2 billion (4,9 per cent of gross domestic product) and R6,2 billion in the early upswing years 1986 and 1987, the surplus contracted to R2,9 billion (1,5 per cent of gross domestic product) in 1988, and to a quarterly average, at a seasonally adjusted annual rate, of R2,3 billion (1,1 per cent of gross domestic product) in the first half of 1989.

Balance of payments on current account



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

	1988					1989	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Merchandise exports	26 300	29 282	33 830	36 476	31 472	34 560	44 320
Net gold exports	18 530	19 948	20 230	19 780	19 622	18 970	18 150
Merchandise imports	−36 780	−38 310	−40 070	−41 520	−39 170	−42 150	−49 580
Net service and transfer payments...	−8 108	−9 172	−9 370	−9 290	−8 985	−8 670	−10 920
Balance on current account	**−58**	**1 748**	**4 620**	**5 446**	**2 939**	**2 710**	**1 970**

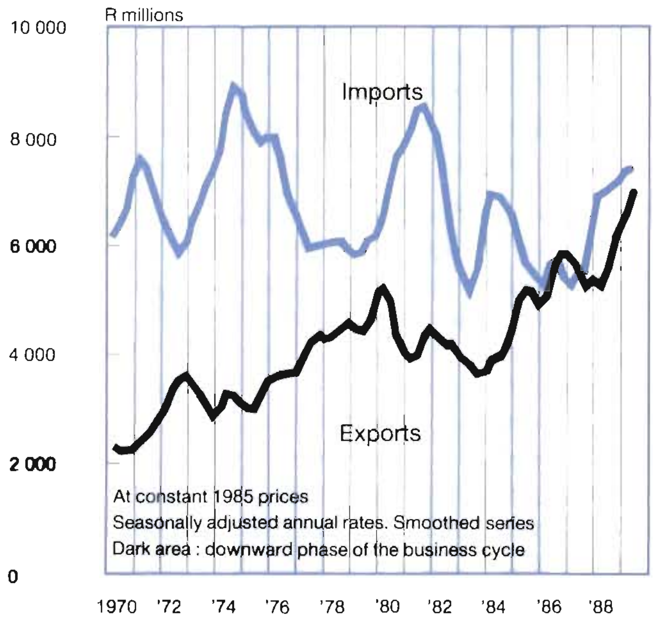
Further shrinkage of the current account surplus in the six quarters to mid-1989 was mainly a matter of strong cyclical expansion of merchandise imports. The *value* of merchandise imports rose by 38 per cent in 1988 vis-à-vis 1987, and advanced further at a seasonally adjusted and annualised rate of 17 per cent from its quarterly average level in 1988 to its quarterly average in the first two quarters of 1989. The average level of import *prices* in domestic currency was 10½ per cent higher in 1988 than in 1987, and rose further at an annualised rate of as much as 22 per cent in the ensuing six months.

Accompanying the sharp rise in real gross domestic expenditure in the first quarter of 1988, the *volume* of merchandise imports bounded upwards (by a seasonally adjusted but un-annualised 19 per cent) from the fourth quarter of 1987 to the first quarter of 1988, and was 25 per cent higher in the year 1988 than in the year 1987. Again broadly in sympathy with domestic spending trends, however, the volume of imports subsequently levelled out during the ensuing four quarters from the second quarter of 1988. As a result, it was actually ½ per cent lower in the first quarter of 1989 than in the first quarter of 1988.

An unexpected sharp increase in the volume of merchandise imports (amounting to a seasonally adjusted but un-annualised 10 per cent from the preceding quarter) was recorded in the second quarter of 1989. Against its background of slackening growth in economic activity and a mild decrease in real domestic demand, this abrupt new spurt in import volumes would appear to have been accounted for partly by South African businesses' pre-emptive buying in anticipation of possible further exchange rate depreciation, higher oil prices or the introduction of further measures for the curbing of imports, and by firms' rebuilding of inventories of imported goods.

A major counterweight to the effect of rising imports on the current account surplus was offered by the strength of *merchandise exports*. The *volume* of these exports appeared to have peaked cyclically in the third quarter of 1986 and receded mildly during the ensuing six quarters to a low point in the first quarter of 1988. Export volumes, however, were 7½ per cent higher in the *year* 1988 than in the year 1987 and in the first half of 1989 strengthened further at a seasonally adjusted but un-annualised rate of 16 per cent from their average level in 1988. The rand *value* of merchandise exports – incorporating the effect of exchange rate depreciation on export volumes as well as on the rand equivalent of foreign export proceeds – rose by 25 per cent in 1988 and at a seasonally adjusted and annualised rate of 25½ per cent in the first half of 1989 from its average level in 1988.

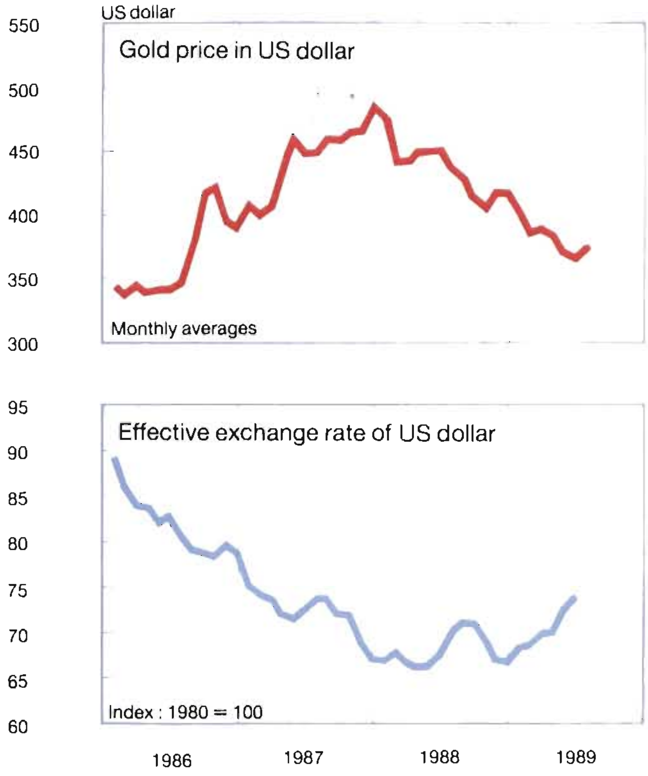
Merchandise imports and exports



A remarkably strong performance of merchandise exports was recorded in the second quarter of 1989 in particular. Substantial increases were registered in the export earnings of mineral products. This was supported, however, by highly encouraging increases in exports of manufactured goods, including machinery and electrical equipment, transport equipment, chemical products and textiles.

Net gold export earnings advanced by 6½ per cent in 1987 despite a marked decline in physical gold production. They rose by 10½ per cent in 1988 on account of a 3 per cent rise in physical gold output and a 7 per cent rise in the average rand price of gold. The 1988 increase in physical gold production represented the net outcome of a 4,7 per cent increase in the throughput of ore and a seemingly relentless continuation of the decline (amounting to some 3 per cent from 1987 to 1988) of the average gold content of ore milled. The average grade of ore milled slipped down further (to less than 5 grammes per ton) in the first half of 1989; the 5½ per cent decline in the total value of net gold exports during that period vis-à-vis its average level in 1988 was, however, due mainly to a continued major weakening of the dollar price of gold.

Gold price and effective exchange rate of US dollar



In a longer-term perspective, the price of gold in US dollars reached a historically high annual average of $613 per fine ounce in 1980. Having declined to an annual average of $360 in 1984, it reached a high point of $447 in 1987, at the end of an upward movement that had accompanied the weakening of the US dollar in the international foreign exchange markets from March 1985 to the end of 1987. The dollar price of gold then softened mildly to an annual average of $437 per fine ounce in 1988, and more markedly to a six-month average of $384 per fine ounce in the first half of 1989.

Underlying reasons for the broadly downward course of the dollar price of gold in the 1980s to date included a diminished investment demand for gold in view of a substantially less inflationary First World economic environment; strong economic performances of the major industrial countries in general and of the United States in particular, and the accompanying demand for dollars for investment purposes; relatively high real interest rates in the world's major economies, and relatively low world crude oil prices; a decline in the number, scope and seriousness of international conflict situations, and use of the dollar instead of gold as a "safe haven" investment; and the recent emergence of so-called "gold loans" for financing new or expansions of existing gold mining operations, resulting in an increase in current world gold production and in the annual incremental world gold supply.

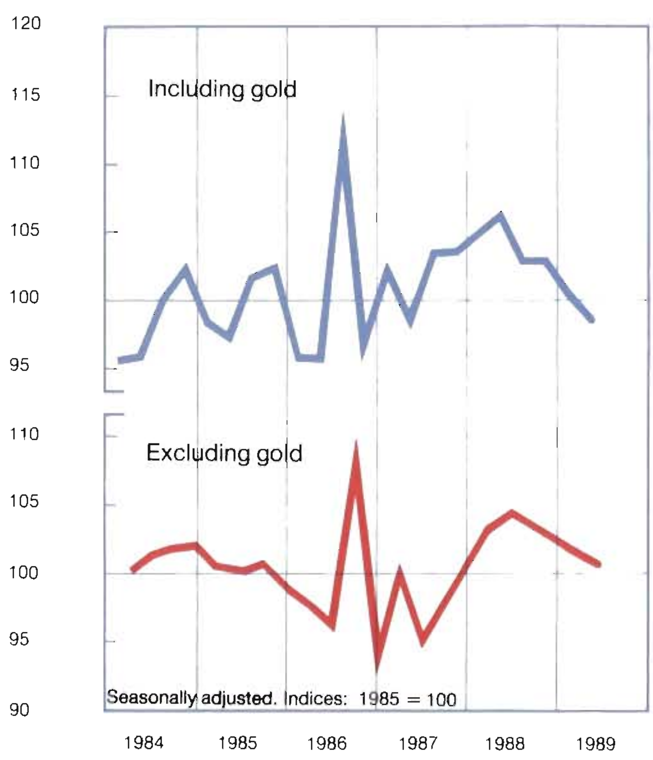
Strengthening of the rand against the US dollar in 1987 caused the 21 per cent rise in the average dollar price of gold during that year to be watered down to an increase of only 8 per cent of the gold price in terms of rand. By the same token, however, weakening of the rand against the US dollar in 1988 caused the 2 per cent decline in the average dollar price of gold during that year to be translated into a 9 per cent increase of the gold price in rand. The rand price of gold per fine ounce exceeded the R1 000 mark from mid-May to mid-November 1988. Its annual average advanced from R909 per fine ounce in 1987 to R992 per fine ounce in 1988. In the first half of 1989, however, weakening of the exchange value of the rand in terms of the dollar did not keep pace fully with the renewed strongly downward slide of the dollar price of gold. The rand price of gold accordingly retreated slightly to an average of R984 during that period.

The 1980s to date have seen a steady decline in South frica's dependence on its gold export earnings as a source of foreign exchange. From a high point of 44½ per cent in 1980 the share of the country's net gold export proceeds in its total export earnings from goods and services contracted, on balance, to 33½ per cent in 1988 and – mainly because of the very strong merchandise export performance of that period – at an accelerated pace to only 28 per cent in the first half of 1989. Physical South African gold production fell back from 675 tons in 1980 to a low point of 604 tons in 1987 before recovering to 620 tons in 1988. However, mainly because of sharply higher gold production in the United States, Canada, Australia and Brazil, total Western World gold output expanded from 959 tons in 1980 to 1 538 tons in 1988. South Africa's share in total Western World gold production accordingly shrank from 70 per cent to 40 per cent between these two years.

Like the higher level of merchandise imports, increases in *service and transfer payments to non-residents* contributed to shrinkages of the current account surplus of the past one and a half years. Net service and transfer payments to non-residents declined – for the first time in 19 years – to R8,5 billion in 1987, but reverted to R9,0 billion in 1988 and reached an annualised level of R9,8 billion in the first half of 1989. This was mainly a reflection of higher freight and merchandise insurance payments on the higher level of imports, as well as of the effect of weakening of the rand on the cost of foreign-sourced services. In addition, interest payments to foreigners showed a substantial increase in both 1988 and the first half of 1989, because of the general hardening of interest rates internationally since the middle-quarters of 1988.

The South African current account surpluses of the past 4½ years – which included close to three years of moderate cyclical expansion - were needed to enable South Africa to become a capital-exporting nation through no desire of its own while being denied access to bridging finance from the International Monetary Fund and the rest of the international financial community. In its efforts to bring about these current account surpluses, South Africa received little help from gold as its principal export: the average dollar price of gold, at $391 per fine ounce, was some 9½ per cent lower during the years concerned than during the preceding 4½ years. Neither was South Africa assisted greatly by movements in the relative world prices of its non-gold merchandise exports: the South African terms of trade, excluding gold were slightly *lower*, on average, during the 4½ years to mid-1989 than during the preceding 4½ years, namely by 0,9 per cent.

Terms of trade



Factors contributing to the current account surpluses in the 4½ years to mid-1989

In its *Annual Economic Report* for 1988 the Reserve Bank noted the rise in the volume of South African merchandise imports in the course of two years of upswing from mid-1986 to mid-1988 to have been "not unusual" (relative to real gross domestic expenditure) in the context of post-war cyclical developments. The current account surpluses of 1985, 1986 and 1987 accordingly were attributed by the Bank to (1) a relatively strong merchandise export performance, as measured by comparatively high ratios of export volumes to real gross domestic product, and (2) general restraint over real gross domestic expenditure, relative to real gross domestic product, during the three years concerned.

In any given domestic environment of propensities to consume and to invest, the monetary, fiscal and exchange rate policies of the authorities may be used to restrain real gross domestic expenditure relative to real gross domestic product, i.e. to hold down domestic "absorption" of the available (domestically produced and imported) supply of real goods and services. This allows exportable surpluses to be created as the foundation for potentially more favourable export ratios.

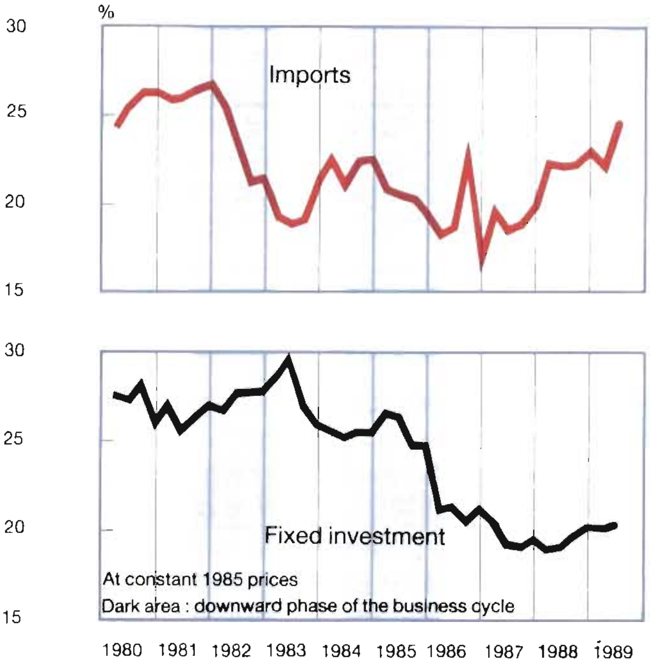
A variety of positive as well as less welcome developments and conditions contributed to the relatively strong South African export performance and current account surpluses from 1985 to mid-1989. Firstly, the annual average of the effective exchange rate of the rand was allowed to decline substantially, under South Africa's system of managed exchange rate floating, in 1984 and 1985 and, to a much smaller extent, also in 1986; after a slight strengthening in 1987, the exchange rate depreciated markedly again in 1988 and the first half of 1989. As a result of these nominal exchange rate movements, the average level of the *real* effective exchange rate (in which inflation differentials have been taken into account) was some 17½ per cent lower in the first half of 1989 than in the year 1984. Although the rand may well have been "over-valued" in 1983, its significant depreciation in real terms in subsequent years undoubtedly served to foster the competitiveness of South African exporting and import-competing industries.

Secondly, relatively high and generally rising levels of real economic activity were maintained in the economies of South Africa's principal trading partners from 1983. Aided by the exchange rate movements already referred to, the quite sturdy levels of First World economic prosperity from 1983 resulted in a firm and generally strengthening demand for South African exports. Total weighted import volumes of South Africa's main trading partners rose at an average annual rate of some 6½ per cent from 1983 to 1988. In comparison, the compound average annual rate of increase in the total volume of South African exports – although determined to a disproportionate extent by developments in a single year, 1985 – amounted to 9½ per cent during this period. An even more rapid rate of expansion of these export volumes was recorded in the first half of 1989.

Comparatively rapid growth in merchandise export volumes enabled South Africa to maintain its relative position in total world exports in nominal (US dollar) terms. South Africa actually improved its world ranking as an exporting nation from 26th position in 1985 to 24th position in 1988, despite international sanctions and the low dollar price of gold.

Thirdly, natural disasters such as floods and droughts, as well as strikes and work stoppages, caused occasional problems of production and delivery in some of South Africa's competitor countries in world markets and contributed to low world stocks of certain commodities. This served to support South African export volumes of (among other items) copper, coal, sugar, nickel and lead. Supply constraints also played a part in the sharp strengthening of international commodity prices from the end of 1986 to the middle of 1988, and in more selective price increases thereafter.

Merchandise imports and fixed investment as percentage of gross domestic expenditure



Fourthly, drought conditions in South Africa in 1982 and 1983 brought about a virtual cessation of a large part of South African *agricultural* exports and even occasioned temporary imports of maize. A gradual improvement of weather conditions since the mid-1980s permitted a resumption of substantial agricultural exports, which stand to be raised further in 1989.

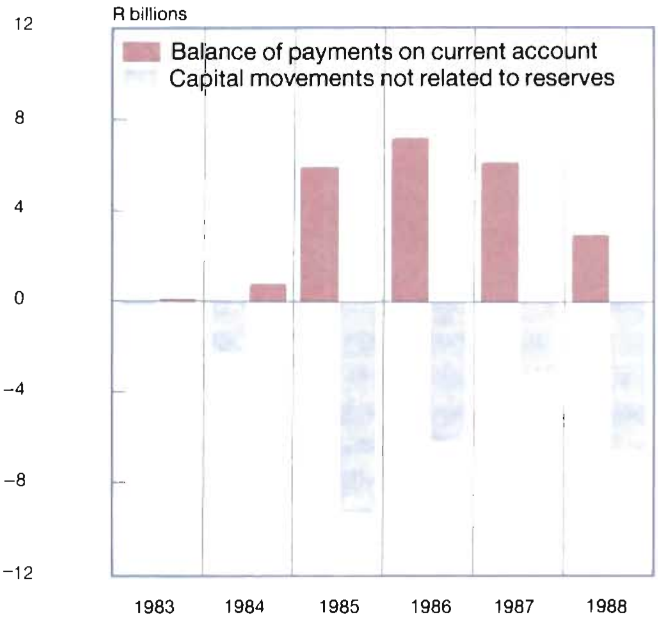
Fifth, a variety of factors as referred to elsewhere in this *Report*, reduced and held down both real gross domestic fixed investment and real inventory accumulation to unusually low levels during most of the years from 1985, including the 1986-1988 upswing period, in the South African economy. Because of the traditionally high import content of domestic fixed capital formation and of inventories in the South African economy (i.e. because of import-content ratios of these spending categories well in excess of the import-content ratio of real gross domestic expenditure in general), this relative slackness in capital spending undoubtedly held down South African merchandise import volumes over the past 4½ years to significantly lower-than-otherwise levels.

In the Bank's *Annual Economic Report* for 1988 the long-term downward trend of the ratio of the volume of merchandise imports to total real gross domestic expenditure (the "import penetration ratio") was noted to have been flattening out since the early 1980s. The most recent movements of this ratio suggest a bottoming-out and slight reversal of its earlier downward trend rather than a prolonged sideways movement. A more vigorous investment performance of the South African economy in the 1986-1988 upswing period would have strengthened this reversal and might have resulted in significantly higher apparent trend values of the penetration ratio than applied in the mid-1980s.

Finally, strength of the current account of the South African balance of payments in recent years was aided by relatively low net service and transfer payments to non-residents. Relative to concurrent gross domestic product, the amount of these net payments contracted materially from a high point of 6,2 per cent in 1986 to 4,5 per cent in 1988; the average of this ratio from 1980 to 1988 amounted to 5,1 per cent.

The significant decline in relative net service and transfer payments to non-residents since 1986 arose primarily from lower net *factor* service payments to foreigners, and more particularly from lower payments of interest and dividends. The lower level of these payments of rewards for the use of foreign capital, in turn, reflected a number of foreign companies' disinvestment actions from South Africa as well as South Africa's repayment of foreign debt and the resultant decline in its foreign debt-servicing obligations. Net *non-factor* service payments to non-residents, on the other hand, rose appreciably from 1986 because of higher freight and merchandise insurance payments on higher import values and because of increased South African travel expenditures abroad; the rise in South Africa's travel expenditures abroad more than offset a marked contemporaneous rise in South Africa's foreign travel receipts. South Africans' foreign travel expenditures have displayed a significant price inelasticity, i.e. a relatively high degree of insensitivity to the effect of exchange rate depreciation on the cost in rand of overseas tours.

Balance on current account and capital movements



Continued outflow of capital

South Africa's anomalous position as a capital-exporting country was maintained during the six quarters to mid-1989. Capital outflows during this period again arose mainly from repayments on debt that fell due in terms of the Second Interim Arrangements with foreign creditor banks, and from further repayments on debt outside the so-called standstill net in the form of trade credits and of bearer bonds and notes. Only relatively small amounts of new foreign credit were made available; the amounts made available consisted overwhelmingly of new foreign trade credits and of project financing, largely for public corporations.

The capital account of the balance of payments improved considerably during 1987 and the first quarter of 1988. It deteriorated again, however, from the second quarter of 1988 onwards. The total net outflow of capital not related to reserves in the year 1988 amounted to R6,5 billion. 1988 thereby became the first year since 1985 in which the outflow of non-reserve-related capital exceeded the surplus on current account. The total outflow of capital not related to reserves subsequently reached an amount of R2,9 billion in the first half of 1989.

Net capital movements (not related to reserves)
R millions

	1987	1988			1989
	Year	1st half	2nd half	Year	1st half
Long-term capital					
Public authorities	−529	−162	−271	−433	−449
Public corporations	817	−319	−87	−406	440
Private sector:					
Net purchases of listed securities by non-residents	−1 213	−26	93	67	−650
Other capital	−773	−395	115	−280	−464
Total long-term capital	−1 698	−902	−150	−1 052	−1 123
Short-term capital including unrecorded transactions, but excluding reserve-related liabilities	−1 371	−2 069	−3 425	−5 494	−1 821
Total capital movements excluding liabilities related to reserves	**−3 069**	**−2 971**	**−3 575**	**−6 546**	**−2 944**

The outflow of *long-term* capital – consisting mainly of repayments on debt inside the standstill net, and of further repayments on bearer bonds and notes outside the net, already referred to – contracted further from R3,1 billion in 1986 and R1,7 billion in 1987 to R1,1 billion in both 1988 and the first half of 1989. Transactions by foreigners in securities listed on the Johannesburg Stock Exchange, as included in these amounts, turned around from a net sales figure of R1,2 billion in 1987 to net purchases of R67 million in 1988, but were re-converted into net sales to an amount of R650 million in the first six months of 1989.

Outflows of *short-term* capital not related to reserves (but including unrecorded transactions) rose sharply from R1,4 billion in 1987 to R5,5 billion in 1988, and to R1,8 billion in the first *half* of 1989. A substantial proportion of these outflows in 1988 would appear to have represented switchings from foreign to domestic sources of trade financing, on the basis of anticipated declines in the effective exchange value of the rand. In addition, however, the significant strengthening of South Africa's merchandise export performance in the course of 1988 was accompanied by a rise in South Africans' foreign asset holdings to an amount of some R450 million.

From the beginning of 1985 to the end of June 1989 the total outflow of all forms of capital from the South African economy came to R24,9 billion, equalling 3½ per cent of nominal gross domestic product during that period. As much as R14,7 billion of this total was related to net repayments on foreign loans; the remainder of R10,2 billion was accounted for by increases in South African trade-related claims on non-residents, or represented unrecorded transactions. An amount of R3,6 billion of the total of debt repayments of R14,7 billion was made in accordance with the agreements with foreign creditor banks. The remaining R11,1 billion consisted of repayments on "unaffected" debt outside the standstill net.

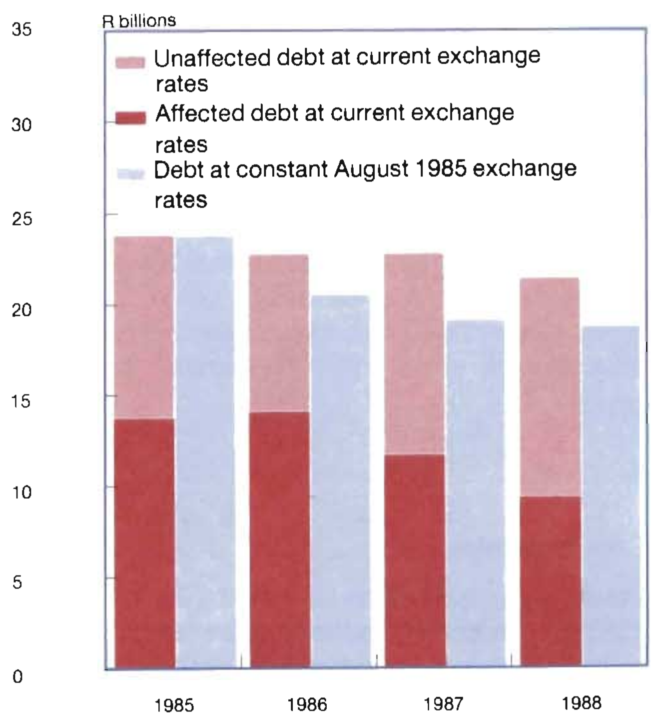
Further improvement in foreign debt position

Continued repayments on foreign debt both inside and outside the standstill net caused the total of South Africa's foreign debt to contract further from US$22,6 billion at the end of 1987 to US$21,2 billion at the end of 1988. Valued in constant US dollars at the dollar's exchange rates vis-à-vis other currencies as on 31 August 1985, the total of the foreign debt outstanding shrank impressively and encouragingly from $23,7 billion at the end of August 1985 to US$18,6 billion at the end of 1988. In terms of rand, the debt fell back from its high point of R60,1 billion as reported at the end of 1985 to a low point of R43,6 billion at the end of 1987. Depreciation of the rand in the foreign exchange markets, however, subsequently caused this amount to revert to R50,4 billion at the end of 1988.

Shrinkage of the "real" significance of this debt to the South African economy was apparent from sustained improvements in the various foreign debt ratios from 1985 to 1988; these ratios generally show the burden of the debt in relative terms to have shrunk by some two-fifths or more over this three-year period. The ratio of the foreign debt to gross domestic product retreated from 41 to 24 per cent, and the ratio of the foreign debt to export proceeds from 149 to 82 per cent. The ratio of interest payments on the foreign debt to total export proceeds declined from 10,7 per cent in 1985 to 6,5 per cent in 1988.

South Africa's ratio of foreign debt to export proceeds of 82 per cent as at the end of 1988 compared more than just favourably with the average value of this ratio, as on the same date, of 305 per cent among Western Hemisphere developing countries, a significant number of which are having to deal with serious debt problems. The average value of this ratio for

Foreign debt of South Africa



South Africa of 108 per cent during the years from 1985 to 1988 also compared very favourably, however, with the average value of foreign debt to export proceeds of 162 per cent among certain developed countries (Australia, New Zealand, Portugal and Iceland) during that period. These various figures suggest strongly, of course, that South Africa did not, during the decade of the 1980s, ever lapse into "over-borrowedness". They also confirm South Africa's *under*-borrowed status as a developing country today.

A significant shift in the maturity structure of South Africa's foreign debt came about from July 1987. From July 1987 up to 31 May 1989 an amount of US$3,9 billion was converted, in terms of provisions of the Second Interim Arrangements with foreign creditors, into 9½-year loans that are outside the standstill net. These loans are to be repaid in ten equal half-yearly instalments; the first such instalment is to be paid five years after the conversion date of the loan concerned.

Conversions into this "9½-year option" contributed materially to shrinkage of South Africa's "affected" debt from US$13,6 billion on 31 August 1985 to $9,1 billion on 31 December 1988. The "unaffected" debt rose from US$10,1 billion to $12,1 billion during this period.

Foreign reserves

Reflecting a narrowing of the current account surplus in conjunction with large outflows of capital, South Africa's total gross gold and other foreign reserves declined from their high point of R8,7 billion (US$4,2 billion) at the end of August 1987 to an interim high point of R8,2 billion (US$3,9 billion) at the end of March 1988. They then slid down more rapidly to R6,7 billion (US$2,8 billion) at the end of 1988. In more recent months, the gross reserves recovered to R7,4 billion at the end of June 1989; in dollar terms, however, they shrank somewhat further to $2,7 billion. The more recent levels of the gross foreign reserves have been equivalent to some 1½-1¾ months' imports of goods.

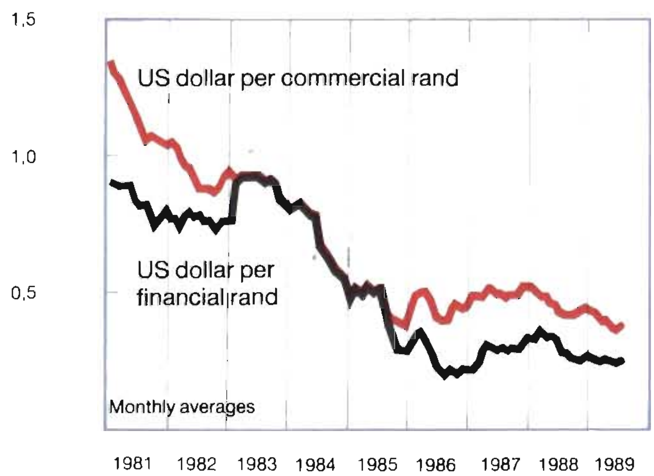
Exchange rates

Having strengthened, on balance, by 3,1 per cent in 1987, the trade-weighted value of the rand in the international foreign exchange markets weakened by 16,6 per cent in the ten months to the end of October 1988. Downward pressures on the exchange rate were exerted during this period by the strengthening of the US dollar in the world foreign exchange markets and by the downward trend of the dollar price of gold, as well as by general weakening of the South African merchandise trade account, the sustained outflow of foreign capital and the accelerating decline in the foreign reserves.

Following a bout of weakness of the American dollar, the effective exchange rate of the rand regained some lost ground from the beginning of November 1988. This process was aided by the Bank rate increase of 3 November and associated upward adjustments to the general level of South African interest rates. Mild appreciations of the rand against all major currencies were recorded up to 12 January 1989.

Renewed, remarkable and unexpected vigour of the American dollar from 12 January 1989, and accompanying slides in the dollar price of gold in January-February 1989 and in May 1989 in particular, resulted in a decline of 10,9 per cent of the effective exchange rate of the rand up to 15 June; the larger part of this decline was accounted for by the rand's loss of strength vis-à-vis the dollar. On 15 June 1989 the dollar reached its highest value against the German mark in thirty months. The rand on that date reached its lowest value in terms of the dollar ever to be recorded, at a level of US$0,3479 per rand or R2,8743 per dollar. Mild reversals of these various rate changes were registered in subsequent weeks. From 31 October 1988 to 31 July 1989 the effective exchange rate of the rand eventually weakened, on balance, by a modest 3,0 per cent.

Exchange rates



Percentage changes in exchange rates of the rand

	31 Dec 1987 to 31 Oct 1988	31 Oct 1988 to 12 Jan 1989	12 Jan 1989 to 15 Jun 1989	15 Jun 1989 to 31 Jul 1989
Weighted average	−16,6	5,1	−10,9	3,6
US dollar	−22,1	4,3	−17,6	8,5
British pound	−17,9	3,8	−2,4	−1,3
German mark	−13,1	7,8	−7,9	−0,4
Swiss franc	−9,4	8,8	−6,3	−0,8
Japanese yen	−20,3	5,2	−1,3	−0,7
French franc	−12,3	7,4	−8,6	−0,2
Financial rand	−23,3	1,5	−5,1	1,2

The *financial* rand strengthened against the dollar by nearly 50 per cent in 1987 and by a further 15½ per cent, to R2,6950 per dollar, up to 18 March 1988. Its discount vis-à-vis the commercial rand on that date, at 20,2 per cent, was at its lowest level since January 1986.

Weakening of the financial rand during the second and the third quarter of 1988 could be attributed mainly to disinvestment actions by foreign companies. The financial rand subsequently remained fairly stable in the fourth quarter of 1988 and in January and February 1989. Its fluctuations vis-à-vis the US dollar ranged from R3,49 to R4,10 per dollar and were accompanied by fluctuations in its discount vis-à-vis the commercial rand that varied from 33 to 41 per cent.

A low point of the financial rand of R4,26 to the dollar was reached on 10 May 1989 as a result of acute pressure on the commercial rand and because of the announced disinvestment from South Africa of a major multinational oil company. In subsequent weeks the financial rand fluctuated between R4,00 and R4,16 to the dollar. Its discount vis-à-vis the commercial rand during these weeks varied between narrow limits from 32 to 35 per cent.

Monetary and financial developments

Further tightening of monetary policy stance

The Reserve Bank's shift towards a less accommodative and progressively more restrictive policy stance, which had started in December 1987, was continued in 1988 and in the first several months of 1989. Bank rate, which had been raised from 9,5 to 10,5 per cent from 9 March 1988 and to 11,5 per cent from 5 May 1988, was increased on a further four occasions in the twelve months to mid-1989, to an eventual level of 17 per cent. The Bank rate changes were part of a general upward movement of money market and related short-term interest rates. The clearing banks' prime overdraft rate was raised, mostly in the wake of the Bank rate changes, from its level of 12,5 per cent as in early January 1988 to an eventual level of 20 per cent.

Concerns were expressed in the course of 1988 – not least in the light of the strength of spending in the first quarter, and of the short-lived dip into current account deficit – that the authorities in the first half of the year might have been acting too slowly and indecisively for effecting an adequate slowdown of domestic expenditure and for safeguarding the current account surplus and the foreign reserves. By mid-1989, however, the Reserve Bank, in noting prime rate to have been raised by as much as 7½ percentage points since the beginning of 1988, publicly stated its belief that the then prevailing level of interest rates would prove "adequate for the job at hand".

Among the reasons which guided the authorities in tightening their policies in the one and a half years to mid-1989 were the relatively strong growth and subsequent high level of real domestic spending; the sharp rise in imports, the weakening dollar price of gold, and accompanying pressure on the exchange rate and on the foreign reserves; South Africa's very limited access to foreign sources of credit, and the country's foreign debt repayment obligations; and considerable overshooting of the monetary target for 1988, followed by more limited overshooting of the new target for 1989 in the first few months of 1989. In addition, more stringent monetary policies could be considered to have been indicated by the rising trend in interest rates in major industrial countries since mid-1988; by strengthening perceptions of the domestic economy's longer-term needs for interest rates that would be durably positive in real or inflation-adjusted terms; and by the stimulatory effect of steeply higher real government expenditure in the first quarter of 1989, which added to doubts about the extent to which the economy would, in fact, be "cooling down".

Bank rate, i.e. the Reserve Bank's minimum rate for rediscounting Treasury bills for the discount houses, was raised from 11,5 to 12,5 per cent with effect from 29 July 1988, and to 14,5 per cent with effect from 3 November. From 23 February 1989 it was raised to 16,0 per cent for *both* the banks and the discount houses, signifying abolition of the preferential margin of 0,5 per cent that had previously been extended to the discount houses when taking up refinancing accommodation at the Reserve Bank's discount window. A fourth increase in Bank rate, to its present level of 17 per cent, came into force on 8 May 1989.

In its statements accompanying the Bank rate increases from March 1988 onward, the Reserve Bank repeatedly stressed that the "key" to effecting a slowdown in the growth of domestic expenditure and the money supply was to be found in a curbing of the Bank's own domestic credit creation. The Bank's domestic credit creation, as the main source of cash reserves for the banking system (including the "involuntary" creation of cash reserves that accompanies the Bank's incurrence of losses in providing forward foreign exchange cover), had allowed the banks greatly to increase their extension of credit to the private sector. Curbing the Reserve Bank's creation of cash reserves for the banks and the building societies would, however, generally be followed by at least a temporary rise in short-term interest rates. Increases in Bank rate and the associated set of the Reserve Bank's refinancing rates should then be viewed as an integral part of such an upward interest rate movement, and should be regarded both as a consequence of and as a part of a more stringent monetary policy.

With a view to limiting the creation of cash reserves, the Bank in its statement accompanying the Bank rate increase of 5 May 1988 laid down *inter alia* that it would provide considerably less accommodation than before through repurchase agreements, the placement of funds from the Corporation for Public Deposits in the money market, or other forms of open-market operations. In addition, accommodation through the discount window would henceforth be limited to the rediscounting of, or the provision of overnight loans against, *liquid assets* such as Treasury bills, Land Bank bills, liquid bankers' acceptances and short-term government stock.

In a similar vein, the Bank, in its policy statement of July 1988, reserved the right to penalise institutions or banking groups which, in the Bank's opinion, had expanded their credit excessively. Such penalisation was meant to take the form, mainly, of higher rediscount and interest rates on that portion of the accommodation extended which exceeded the refinancing limits that were to be determined for individual banking institutions. Finally, the Bank, in May 1989, *inter alia* stated that accommodation by means of open-market operations would, until further notice, be provided only to iron out excessively large month-end or other seasonal variations in money market conditions; that accommodation by means of rediscounting would henceforth be limited strictly to the rediscounting of Treasury bills, Land Bank bills and *genuinely liquid* bankers' acceptances; and that overnight loans would henceforth be extended in exceptional circumstances, for short periods and at penal rates only.

In addition to these various steps that were aimed at raising the cost and/or limiting the quantity of cash reserves that would enter the cash "base" of the banking system, banks and building societies were urged on various occasions (as in the policy statements of May and July 1988) to practise restraint in their extension of credit to the private sector, specifically as regards consumer credit and mortgage lending for the financing of luxurious private homes. With a view to a more accurate assessment of the strength of credit demand from various quarters and for various purposes, the banks were requested in early March 1989 to report on the types of new credit extended whenever a month-to-month increase in their lending to the private sector exceeded 1 per cent.

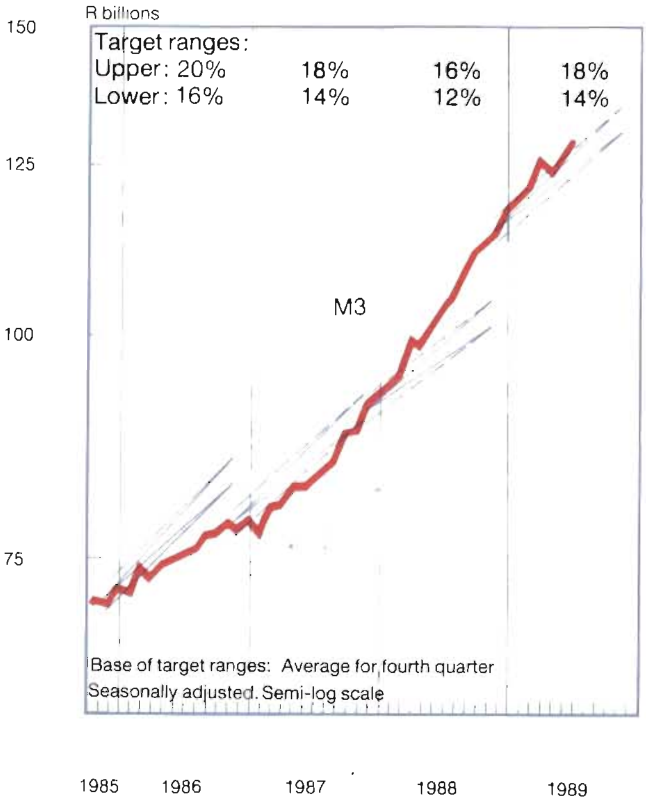
Steps were announced at the time of the Bank rate increase of 8 May 1989 (which itself, like the Bank rate increases of 5 May and 29 July 1988, was part of a comprehensive "package" of fiscal monetary and credit measures) for mitigating the burden of higher interest charges on more highly interest-sensitive borrowers, such as farmers, small business enterprises and home mortgagors in lower income groups who did not enjoy the benefits of subsidised bond finance. The Reserve Bank would, for example, extend special credit facilities to the Land Bank at low interest rates, while increased financial assistance would also be provided by the Department of Finance to development finance institutions such as the Small Business Development Corporation. The measures concerning home-owners are discussed in the paragraphs on long-term interest rates below.

Sustained rapid but decelerating growth of the money supply

Rates of increase in the broadly defined money supply, M3, which had accelerated sharply from the second quarter of 1987, peaked at high levels in the third quarter of 1988 but receded fairly significantly thereafter. The twelve-month rate of increase in M3 touched a high point of 27,9 per cent in August 1988 before sinking back mildly to 24,4 per cent in June 1989. The quarter-to-quarter increase in the quarterly average of M3, in seasonally adjusted and annualised terms, reached a peak of 29,5 per cent in the third quarter of 1988, but slid down encouragingly to 17,0 per cent in the second quarter of 1989.

Growth in the quarterly average of M3 from the fourth quarter of 1987 to the fourth quarter of 1988 – i.e. growth in M3 in the 1988 targeting year, and as measured for targeting purposes – amounted to 26,5 per cent. It therefore exceeded substantially the upper boundary of the target range for 1988 of 12 to 16 per cent.

Target ranges for growth in M3



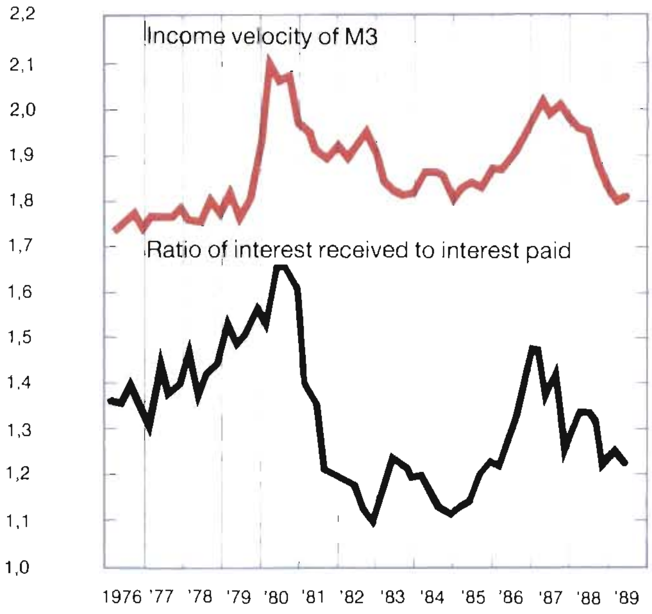
One reason for the high and (for some time) accelerating growth rate of M3 in the course of the calendar year 1988 was to be found in accelerating growth in nominal gross domestic product and expenditure. Growth in nominal gross domestic product amounted to 15,1 per cent from the fourth quarter of 1986 to the fourth quarter of 1987, but to 17,3 per cent from the fourth quarter of 1987 to the fourth quarter of 1988. Since growth in the quarterly average of M3 from the fourth quarter of 1987 to the fourth quarter of 1988 amounted to 26,5 per cent, accelerated growth in nominal gross domestic product in the course of the 1988 targeting year was nevertheless still accompanied by a decline in the ratio of gross domestic product to M3, i.e. by a decline in the income velocity of the M3 money supply. The extent of this drop in velocity in the course of the 1988 targeting year amounted to 7,3 per cent.

Growth in M3 more than proportional to the growth in gross domestic product in the course of 1988 was accounted for by an improvement of the "absolute" attractiveness of money holdings as well as by reintermediation phenomena and enhanced "liquidity preference proper" in a rising interest rate environment. The absolute attractiveness of money and near-money holdings was raised by increases in nominal interest rates on depository investments that, for some time into 1988, were not matched by increases in the concurrent or recent historical inflation rates. The nominal interest rate on three-month notice deposits, for example, was raised from less than 10 per cent in late 1987 to more than 17 per cent in late 1988. Against this, the rate of inflation in consumer prices over twelve-month periods actually *fell* (from about 15 per cent to less than 13 per cent) and on a quarter-to-quarter basis in seasonally adjusted and annualised terms increased only marginally (from 13,5 per cent to 13,6 per cent) between these two dates.

Reintermediation phenomena were noted in the Bank's *Annual Economic Report* for 1988 to be fostered by, among other things, a diminution of the relative size of the disparity between monetary institutions' average lending and average deposit interest rates. Reintermediation, as the opposite of disintermediation, takes place when "direct" financing between so-called primary lenders and ultimate borrowers, which previously was or normally would have been provided by a bank or some other monetary institution, comes onto or returns to the books and the balance sheet of such an intermediary institution.

For regulatory, institutional and practical reasons, the lending rate/deposit rate "gap" of banks and building societies in the South African economy tends to narrow in periods of rising interest rates (which normally also involve intensified competition between these institutions for appropriate funding of their lending books). Periods of rising interest rates in the South African economy therefore tend to show reintermediation phenomena and a *declining* velocity of circulation of the money supply. In 1988 and the first half of 1989 the lending rate/deposit rate ratio was, in fact, reduced considerably.

Velocity of M3 and ratio of banks' interest received to interest paid



Expectations of rising interest rates, as in 1988 and early 1989, also foster investor demand for fixed-interest-bearing depository and related investments in the short and very short maturity categories. The demand for money and near-money deposits on account of such expectations was supported during a large part of the six quarters to mid-1989 by the lacklustre performance of the share market in most of 1988.

The new monetary target for 1989

A new target range for the growth rate in M3 – the fourth of its kind since the adoption of monetary targeting in 1986 – was announced by the Reserve Bank on 7 March 1989. The new target provided for an increase in the quarterly average of M3 from the fourth quarter of 1988 to the fourth quarter of 1989 between lower and upper limits of 14 and 18 per cent.

In explaining the monetary authorities' decision to raise the lower and upper bounds of the target range from 12 and 16 per cent in 1988 to 14 and 18 per cent in 1989, the Reserve Bank stated that this was based on the acceptance by the authorities of a broad economic projection for 1989 that provided for a further increase in real gross domestic product of around 2 per cent, a surplus on the current account of the balance of payments of roughly R4 billion, a gradual rise in the official gold and foreign exchange reserves, and an average rate of increase of the consumer price index of about 15 per cent. Acceptance of a temporary quickening of inflation, however, did not imply a weakening of the authorities' resolve to control the growth of the "effective" (or "velocity-adjusted") money supply for bringing down the inflation rate. Instead, it was believed that attainment of the new monetary target, in conjunction with realisation of the projected economic growth rate of 2 per cent, would minimise the expected acceleration of inflation before reversing it.

From the mid-November 1988 starting point of the 1989 targeting year to the end of June 1989, the seasonally adjusted annual rate of increase in M3 amounted to 21,4 per cent. M3 as at month-ends broke through the ceiling of the new target tunnel in February 1989. It showed another large increase in the quarter-end month of March, but fell back significantly in April. M3's most recent movements in May and June 1989 along the upper boundary of the target tunnel were reminiscent of M3's behaviour in the first eight months of 1987, when its trajectory adhered closely to the target floor.

Changes in composition of the M3 money supply

Investors' enhanced liquidity preference in the rising interest rate environment of 1988 and early 1989, and relatively attractive interest rates on shorter-term depository investments, caused growth in M3 from mid-1988 to mid-1989 to be concentrated heavily in deposits in the shorter-term segments of the maturity spectrum. The comparative rates of increase in M1A, M1, M2 and M3 during the twelve months to mid-1989 amounted to 23,1 per cent, 12,1 per cent, 29,4 per cent and 24,4 per cent. "Other" short and medium-term deposits – comprising all deposits with unexpired maturities of more than one day but not more than six months – rose by as much as 45,9 per cent. In contrast, long-term deposits rose by a modest 8,5 per cent.

Increases in components of M3, July 1988 – June 1989
%

Banknotes and coin in circulation	27,0
Cheque and transmission deposits	21,6
M1A	23,1
Other demand deposits	1,5
M1	12,1
Other short and medium-term deposits	45,9
M2	29,4
Long-term deposits	8,5
M3	24,4

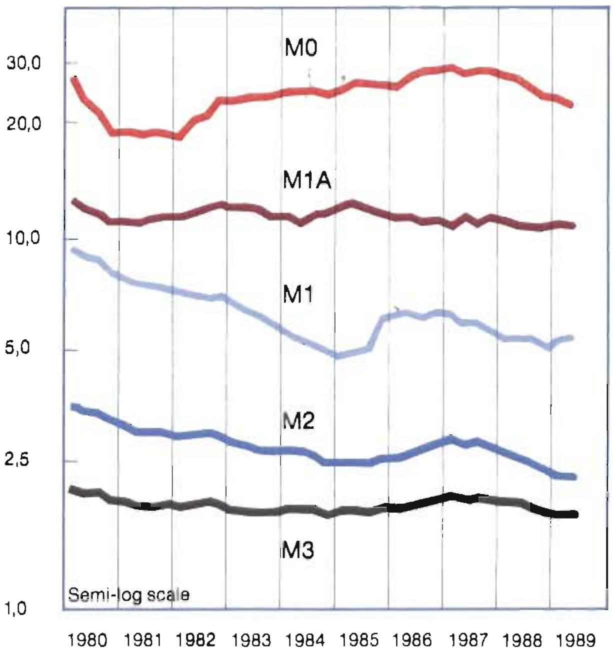
"Other" short and medium-term deposits significantly increased their share in total M3 from 38,8 per cent in mid-1988 to 45,5 per cent in mid-1989. As a symptom of the inflationary character of the 1980s to date, the share of long-term deposits in M3 has displayed a long-term downward trend which has reduced this share from 38,5 per cent at the end of 1979 to 21,0 per cent in mid-1989.

Income velocity of circulation of various monetary aggregates

Monetary aggregates other than M3 may be considered for targeting purposes and might conceivably be able to claim superiority in this regard on account of a more stable velocity of circulation, i.e. because of a more stable relationship to contemporaneous values of nominal gross domestic product. An accompanying graph makes clear that this is by no means a foregone conclusion.

In South Africa as elsewhere, innovations in banking, and institutional and regulatory changes affecting banks' operations, may have a major effect on the velocities of circulation of one or more monetary aggregates. As an example, abolition of the then prevailing "averaging" procedure (which allowed banks to average the daily amounts of their demand liabilities to the public in calculating the monthly amount of their short-term liabilities for purposes of the cash reserve requirements) powerfully influenced the non-bank private sector's month-end holdings of M1 (and therefore the measured velocity of circulation of M1) in the second half of 1985. Similarly, when holdings of gold coins ceased to rank as liquid assets for the banks from August 1988, the compensatory increase in the banks' holdings of non-gold coins, banknotes and deposits with the Reserve Bank brought about a marked reduction in the measured velocity of circulation of M0.

Income velocity of various monetary aggregates



As shown in the accompanying graph, the more stable velocities in the 1980s to date have been displayed by M1A and M3. In a fairly non-technical fashion, this lends support to the authorities' selection of M3 for targeting purposes. M3's comprehensiveness affords protection against velocity changes on account of shifts in the public's preferences for deposits of various kinds and maturities.

M3's velocity was affected at the beginning of the 1980s by the abolition of credit ceilings and deposit interest rate controls. "Within" the total of M3, relatively slow growth in long-term deposits during the 1980s (as referred to earlier) obviously has meant above-average rates of growth in the narrower aggregates (M1 and M2). Growth in these narrower aggregates, in fact, has exceeded that of nominal gross domestic product as a long-term phenomenon in the 1980s. As a result, the velocities of circulation of these aggregates have displayed a long-term downward trend.

Domestic credit extension

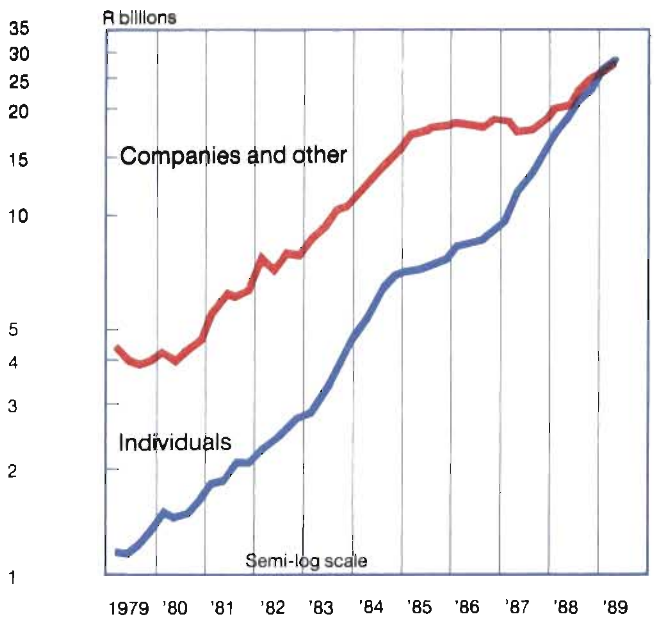
Increases in monetary institutions' credit to the private sector more than fully accounted (in the statistical sense) for the increase in M3 in 1988 and the first half of 1989. The quarter-to-quarter rate of increase in all monetary institutions' claims on the private sector, seasonally adjusted and annualised, accelerated from more than 25 per cent in the first two quarters of 1988 to cyclical high points of well over 30 per cent in the third and fourth quarter of 1988. In apparent sympathy with lower rates of growth in domestic output and expenditure, however, these rates of increase then subsided significantly in the first half of 1989.

Percentage changes in claims of monetary institutions on the private sector

Seasonally adjusted annual rates

	Banking system	All monetary institutions
1988: 1st quarter	32,8	27,0
2nd quarter	31,0	25,3
3rd quarter	43,3	33,2
4th quarter	48,0	32,6
1989: 1st quarter	29,5	24,8
2nd quarter	51,0	13,0

General and mortgage advances* by private banks



*Excluding the increase in advances in the first half of 1989 which can be attributed to the take-over of building societies by banks

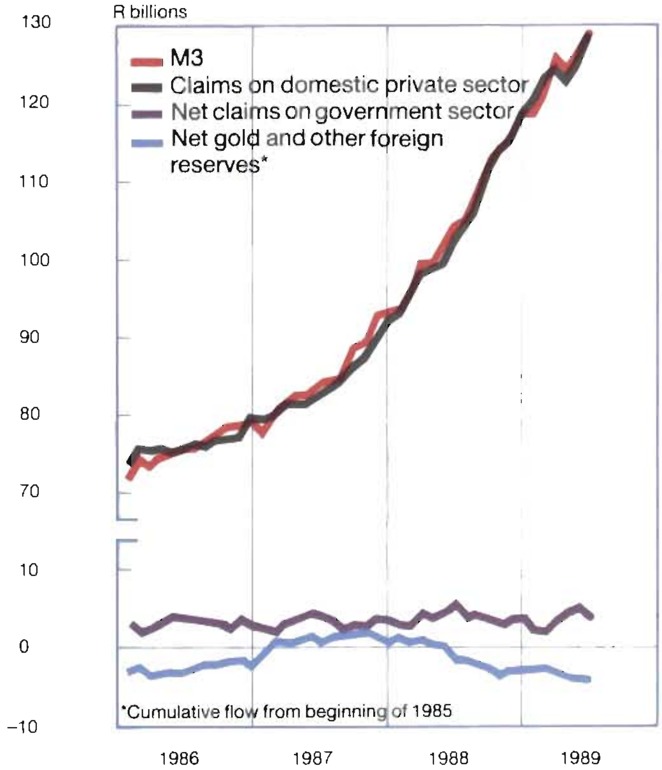
The rates of increase of *banks'* extension of credit to the private sector substantially exceeded those of the monetary system during the six quarters concerned, reaching a near-record level of 48 per cent (in annualised terms) in the third quarter of 1988. The more recent bank credit data have, however, been affected by mergers of certain building societies with banking institutions.

The twelve-month rate of increase in monetary institutions' claims on the private sector rose from single-digit figures as recently as July 1987 to a high of 30,5 per cent in October 1988. It then receded mildly to 26,0 per cent in June 1989.

Monetary institutions' total claims on the private sector rose by R26,6 billion to R128,9 billion during the twelve months to the end of June, against an increase of R25,4 billion to R129,6 billion in the M3 money supply during this period. The increase in the seasonally adjusted level of monetary institutions' total claims on the private sector in the first quarter of 1989, amounting to R5,7 billion, was significantly smaller than the average quarterly increase in these claims of R6,7 billion in 1988. A further relatively slow increase (of R6,5 billion) in the second quarter of 1989 testified to the mild slowdown of the economy and to the cumulative impact of tighter monetary policies since late 1987 or early 1988.

Rates of increase in excess of the increase of 26,0 per cent in total claims of monetary institutions on the private sector during the year to mid-1989 were recorded in these institutions' leasing finance and hire-purchase credit, and bills discounted. The large *absolute* increase in monetary institutions' mortgage lending was, however, partly due to a change-over in recent quarters from mortgage finance as provided to employees of certain public enterprises by the pension funds of those enterprises to conventional mortgage loans.

M3 and statistical counterparts



The increase in bills discounted largely reflected banks' creation of liquid bankers' acceptances for the purpose of strengthening their portfolios of statutory liquid and rediscountable assets, as well as increased Reserve Bank holdings of acceptances that had been offered to it at the discount window. Some two-thirds of the increase in hire-purchase credit consisted of

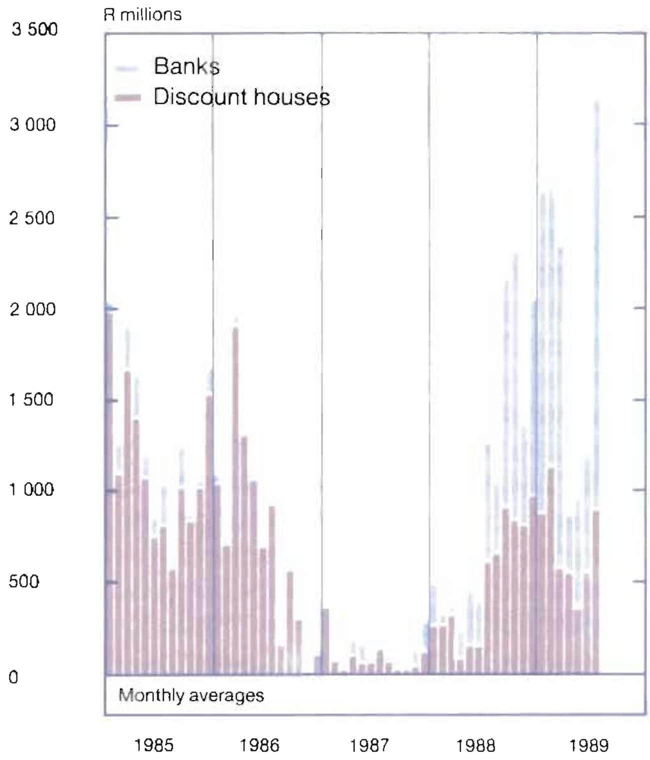
Monetary institutions' claims on the domestic private sector

	June 1988 (Rm)	June 1989 (Rm)	Percentage change
Investments	2 786	2 336	−16,1
Bills discounted	4 963	6 392	28,8
Hire-purchase credit	10 805	14 290	32,3
Leasing finance	5 733	7 822	36,4
Mortgage advances	40; 333	50 673	25,6
Other loans and advances	37 662	47 342	25,7
Total claims	102 282	128 855	26,0

vehicle finance. In marked contrast to developments in the year to mid-1988, hire-purchase credit extended to companies and other borrowers in the year to mid-1989 rose appreciably faster than hire-purchase credit to individuals. Individuals nevertheless increased their relative share in both leasing finance and hire-purchase credit over the last three and five years, respectively.

Unusually large flows of revenue to the Exchequer in the fiscal year 1988/89 and the first quarter of fiscal 1989/90 occasionally led to large build-ups of government deposits with the Reserve Bank. This was reflected in correspondingly large declines in the monetary system's net claims on the government sector. Changes in the monetary system's net gold and other foreign reserves, as a "cause" of changes in the M3 money supply, made a *negative* contribution to M3 of R3,6 billion in 1988 and declined further by some R1,2 billion in the first half of 1989. Changes in the system's "net other assets and liabilities", on the other hand, contributed positively to M3 to amounts of R2,8 billion in 1988 and of R0,2 billion in the first six months of 1989. This was more than fully accounted for by the losses incurred by the Reserve Bank in its provision of forward foreign exchange cover, which are cumulatively capitalised on the Bank's balance sheet.

Accommodation at the discount window



Reserve Bank operations in the money market

The amounts of accommodation that were provided by the Reserve Bank to the money market at the Bank's discount window, were influenced greatly during the year under review by the Bank's new policy approach of using open-market operations only for smoothing out unduly severe month-end or other seasonal fluctuations in money market conditions. Aided by more "spontaneous" market-tightening developments (including high rates of increase of bank credit and the money supply, the near-stagnant or shrinking level of the Reserve Bank's net foreign reserves, seasonal variations in the banknote circulation, and sustained high levels of government balances), the Bank's new policy posture in this matter caused the average daily amount of refinancing assistance at the discount window to rise from less than R0,4 billion in the first half of 1988 to R1,7 billion in the second half, and to R1,8 billion in the first half of 1989. A high point in window accommodation of R4,4 billion was reached on 31 July. Assistance in the form of repurchase agreements was, however, provided, for peak amounts reaching R800 million to R1 000 million, during brief periods on either side of the month-ends of August and December 1988 and of January and February 1989.

High levels of government disbursements, and substantial forward cover losses incurred by the Reserve Bank, resulted in relatively easy market conditions in April and May 1989. For counteracting this easing, the weekly Treasury bill tender (which had been suspended since 31 March) was resumed from 21 April, and the amount of Treasury bills on offer was raised from R50 million on 21 April to R80 million from 28 April and to R100 million from 12 May. Specially-dated tax Treasury bills, maturing at the end of August 1989, were sold to an amount of R0,8 billion during the period from 5 to 12 May. In addition, ultra-short-dated Treasury bills, of one and five days' original currency, were marketed on 17 and 22 May to an aggregate amount of R0,5 billion.

In a statement dated 3 August 1989 the Reserve Bank, noting the absence of the two "traditional" reasons for issuing Treasury bills (namely, to provide bridging finance for the Treasury, or to prevent interest rates from falling) once more announced a temporary cessation of offers of Treasury bills at the weekly tender. The Bank would, however, in the customary fashion, continue to market short, medium and long-term government stock.

An important development during the review period, already referred to in passing, was the termination as from 23 February 1989 of discount houses' privileged position in the use of the Reserve Bank's refinancing facilities. The main reason for this change, which meant that identical refinancing rates would henceforth be quoted to the banks and the discount houses, was that the houses had ceased to serve as the principal conduit for the provision of Reserve Bank accommodation to the banking system.

Net open-market sales of government stock by the Reserve Bank roughly doubled from R5,2 billion in the fiscal year 1987/88 to R10,1 billion in fiscal 1988/89. However, net sales of stock of R4,2 billion in the first four months of fiscal 1989/90 (i.e. in the period from April to July 1989) fell short of the amount of such sales of R5,7 billion in the corresponding period of 1988.

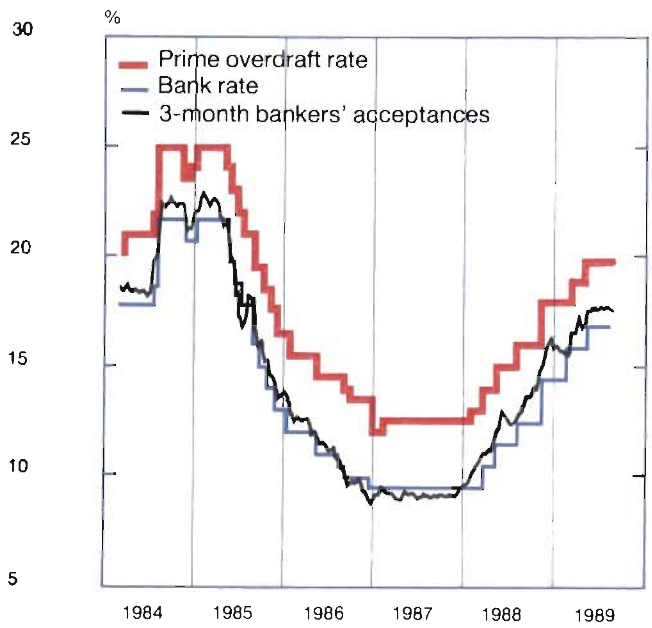
Money market interest rates

The cyclical bottoming-out of interest rates in 1987 produced an unusually high degree of interest rate stability which persisted into 1988. In contrast, and as noted earlier, Bank rate was increased six times during the fourteen months from 9 March 1988 to 8 May 1989. Accompanying the various increases in Bank rate from 9,5 to 17,0 per cent between these two dates, the market rate on three-month liquid bankers' acceptances rose from 10,75 per cent on 8 March 1988 to 17,35 per cent on 8 May 1989. It amounted also to 17,35 per cent on 11 August 1989.

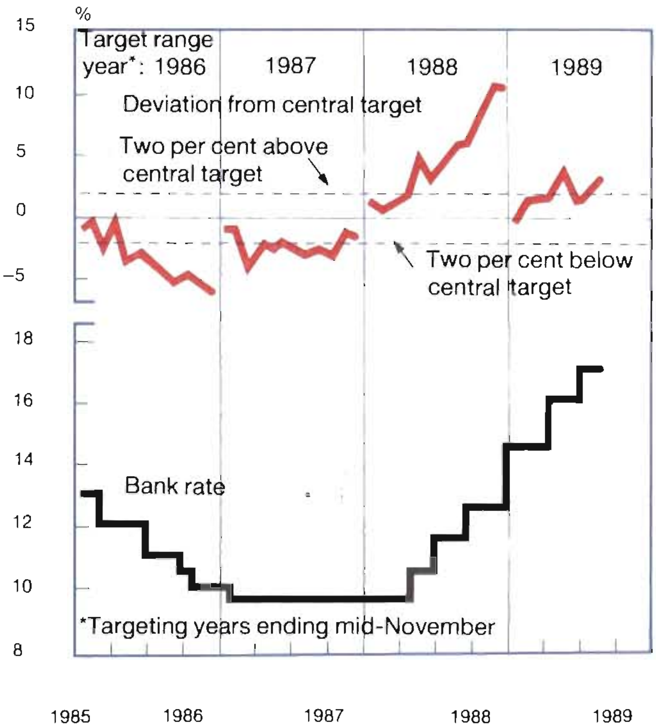
The market rate on three-month liquid bankers' acceptances generally fell below the Reserve Bank's minimum rate for such acceptances throughout most of the declining-rate years 1985 and 1986, and continued to do so throughout the stagnating-rate year 1987. In 1988, however, market rates well in excess of the prevailing rediscount rates regularly preceded the successive upward adjustments of the rediscount rates, reflecting market conditions as well as the market's expectations and anticipations of rediscount rate adjustments.

The clearing banks raised their prime overdraft rates from 12,5 to 13,0 per cent from 25 January 1988, and to 14, 15, 16, 18, 19 and 20 per cent in the wake of the Bank rate increases of 9 March, 5 May, 29 July and 3 November 1988 and of 23 February and 8 May 1989, respectively. The Bank rate changes of 29 July 1988 and 8 May 1989 formed part of "packages" of restrictive fiscal, monetary and credit measures which were introduced on 12 August 1988 and 5 May 1989.

Short-term interest rates



Percentage deviation of M3 from its central target values and Bank rate



Decisions regarding Bank rate changes are made in the light of comprehensive macro-economic information and policy objectives, rather than *solely* on the basis of changes in the M3 money supply. In addition, the South African monetary targets are deliberately applied in a flexible and low-profile manner, while extra-economic conditions and considerations may occasionally influence the date on which a Bank rate change is announced. The accompanying graph nevertheless shows that Bank rate changes since the introduction of monetary targeting have exhibited a fairly broad but generally positive relationship with movements in M3 relative to its target path. This means that, even if or when the target rate of growth of M3 is not being achieved, the targeting exercise can serve as a useful additional source of information to market participants. In addition, the targeting exercise clearly is, and has shown itself to be, useful in creating understanding of and support for appropriate interest rate policies.

Capital market developments

The slump in share prices on the Johannesburg Stock Exchange in October 1987, and its after-effects, occurred prematurely within the context of interest rate and other cyclical developments in the South African economy. At the same time the renewed strong 1988-1989 recovery of share prices, which meant a second share market bull phase within the time frame of a single cyclical expansion, was an unusual event in South African stock market history. However, when, by the third quarter of 1988, the share market had regained its footing and confidence and was ready to resume a decidedly upward course, it had to do so in a general environment of monetary policies that had already been made notably more restrictive; of strongly rising and already markedly higher money market and related interest rates; and of an economy that had moved into the mature stages, if not into the closing stages, of its cyclical upswing.

Apart from changes in their cyclical setting, various aspects of the capital markets' behaviour towards the end of the review period from mid-1988 to mid-1989 were also influenced significantly by the announcement and subsequent implementation of the abolition of the prescribed investment requirements for institutional investors. Features of developments in the markets during the year under review included a marked recovery of turnover and prices of company shares on the stock exchange; a further waning of new-issue activity by both private-sector and public-sector market participants; further shifts in the distribution of the flow of longer-term funds to recipient institutions; a decided hardening of most long-term yields and interest rates to levels last seen in 1985 or early 1986; and a topping-out, mild retreat, and renewed upward movement of trading activity in fixed property at a sustained high level of buoyancy of the fixed property market.

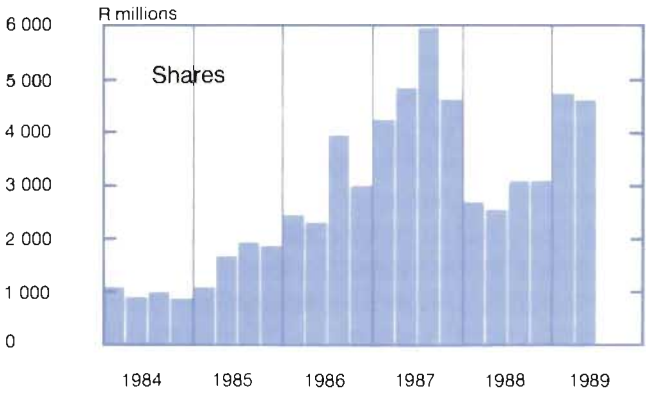
The Government's intention to abolish the prescribed investment requirements for institutional investors was announced by the Minister of Finance in his Budget Speech on 15 March 1989. New limitations on these institutions' holdings of investment assets in various categories, which were to take the place of the former prescribed asset requirements, subsequently were laid down in legislation that became effective on 5 May 1989. In broad outline, these new restrictions stipulated that pension funds and friendly societies, long-term insurers and short-term insurers would henceforth be free to invest in fixed property, company shares, mortgage bonds and certain other asset categories of more limited significance, aggregate amounts up to specified proportions (90 per cent for pension funds, friendly societies and long-term insurers, 70 per cent for short-term insurers) of the market value of their total assets (in the case of pension funds and friendly societies) or of their total liabilities (in the case of insurers), respectively. Sub-maxima, also expressed in terms of percentages of these institutions' total assets or liabilities, were, however, laid down for their holdings of fixed property, company shares, mortgage bonds and other minor asset categories. The general impact of these measures nevertheless was to grant most of the institutions concerned opportunities to reduce their portfolios of public-sector securities and to strengthen their holdings of fixed property and company shares.

Uncertainty as to what the new restrictions on the institutional investors' asset holdings would involve, contributed to increased public-sector stock trading activity in March and to a hardening of long-term stock yields in March and April 1989. Some restructuring of portfolios by these institutions, and transactions called forth by the market's expectations of price movements that would follow the institutions' portfolio adjustments, added substantially to share market activity in May and June 1989. They also lent support to the level of share prices during this period.

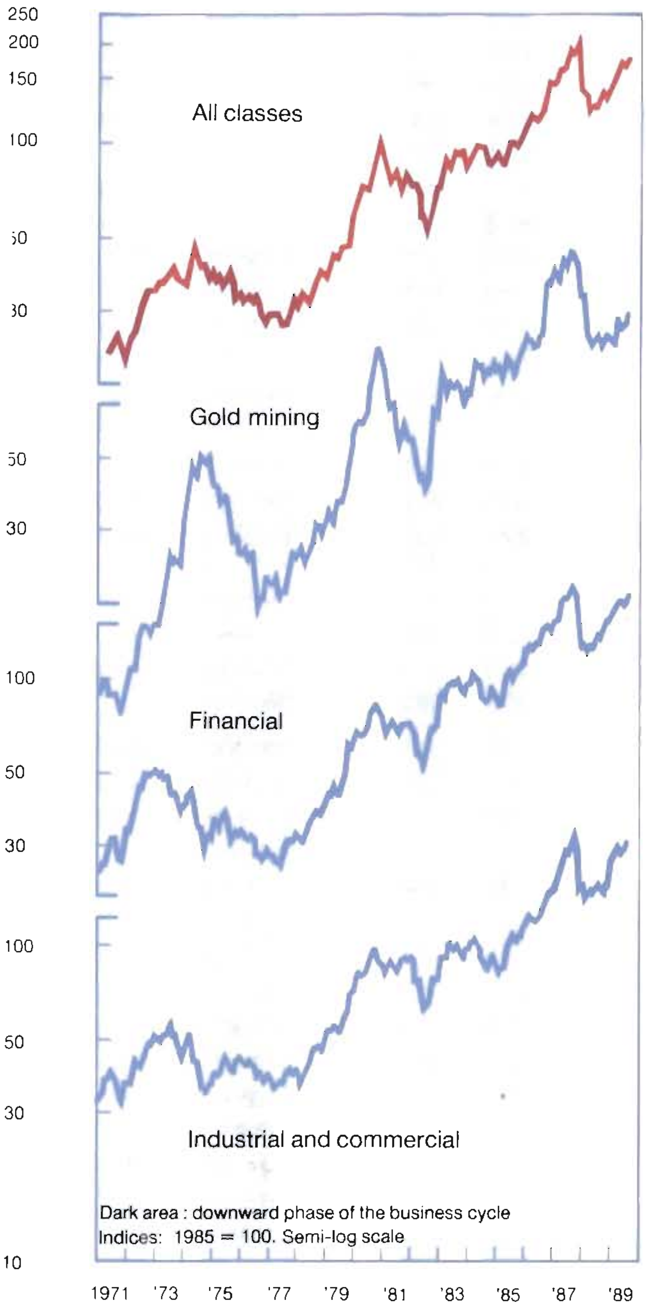
The secondary markets

The total value of shares traded on the Johannesburg Stock Exchange, which had reached a peak of R5,9 billion in the third quarter of 1987, fell back in the wake

Stock exchange transactions



Share prices



of the market's "crash" of October 1987 to a low point of R2,5 billion in the second quarter of 1988. It then recovered modestly to R3,0 billion in both the third and the fourth quarter of 1988 before rising strongly to a new plateau of R4,7 billion in the first quarter of 1989 and R4,6 billion in the second quarter. The speed of the revival in turnover from the second half of 1988 to the first half of 1989 actually significantly exceeded all earlier rates of increase in trading volumes over six-month periods in the course of the share market's upward movement from early 1985 to October 1987.

South African investors' new bullishness as a source of stepped-up trading activity in the company share market in the first half of 1989 was supported by the buying and selling operations of non-residents. In the share market boom-year 1987 non-residents bought and sold South African securities to amounts of R2,8 billion and R4,0 billion, respectively. In 1988, both these amounts were reduced to R2,0 billion. In the recovering market of the first *half* of 1989, however, non-residents purchased and sold South African securities to amounts of R1,3 billion and R2,0 billion, respectively.

The quarterly average *price* level of all classes of shares dropped by some 37 per cent from its high point in the third quarter of 1987 to its low point in the second quarter of 1988. An above-average price decline (of 44 per cent) was recorded by mining shares; a more moderate decline (of 34 per cent) was registered by financial shares as well as by industrial and commercial shares.

Contrary to developments on most overseas stock exchanges, South African share prices were slow to recover in the first two calendar quarters after their decline in the period from October 1987 to February 1988. They did, however, strengthen intermittently from the second quarter of 1988 and rose impressively from the fourth quarter of that year. The rise in the average price level of all classes of shares amounted to some 35 per cent from the second quarter of 1988 to the second quarter of 1989; the level of these prices as in the second quarter of 1989, however, still fell short by some 15 per cent of its high point in the third quarter of 1987.

Price increases from the second quarter of 1988 to the second quarter of 1989 amounted to 39 per cent in the case of financial shares and to 43 per cent in the case of industrial and commercial shares. However, the disappointing downward trend of the dollar price of gold throughout 1988 and the first half of 1989, and rapidly rising production costs, held back the advance in gold mining share prices to 14 per cent during this period. The average price of these shares in the second quarter of 1989 accordingly was still 40 per cent lower than at its peak in August 1987.

Various factors contributed to the sturdy recovery of share values that was observed from the fourth quarter of 1988 in particular. Firstly, good-quality shares at their post-slump prices clearly ranked as attractive "hedge" assets in the 1988-89 environment of sustained double-digit and newly reaccelerating inflation, relatively low and shrinking real after-tax rates of returns on most interest-bearing investments, and deteriorating inflationary expectations. Secondly, considerably improved financial results were reported by most private-sector industrial enterprises in the course of 1988 and the first half of 1989; at their relatively low price-earnings ratios in the post-slump period, many industrial shares might well be considered to be undervalued. Finally, the limited amounts of newly issued and existing quality shares on offer, in conjunction with institutional investors' high liquidity, strong cash flows and the additional freedom of portfolio selection they had been afforded towards the end of the 1988-89 review period, created conditions that were conducive to a major share price recovery. Because of the underlying strength of investor demand, share prices, although clearly sensitive to the vagaries of the gold price over shorter periods, were able to move upwards over somewhat longer periods in relative independence of the concurrent longer-term downward trend in the dollar price of gold.

In contrast to the markedly higher levels of share trading activity from the middle of 1988, the value of *public-sector* stock traded on the stock exchange increased only fairly marginally (by 6 per cent) from R165,2 billion in 1987 to R175,8 billion in 1988. This mild further rise in transaction volumes occurred, however, against the 1988 background of markedly higher and rising short-term interest rate levels and a hardening tendency in long-term interest rates.

Sustained and relatively high levels of trading activity in public-sector stock in 1988 would appear to have been attributable at least to some extent to a change in the tax rate that applies to long-term insurers, which was raised from 40 per cent to 70 per cent of the long-term insurers' net investment income by fiscal changes announced in the central government's Budget of March 1988. This increase in tax liability would appear to have occasioned a shift in long-term insurers' portfolio preferences in favour of long-term government stocks (which tend to be traded at high discounts in the market) and at the expense of their holdings of short-term government securities. In contrast, pension funds, which are not taxable, increased their relative holdings of short-term securities, and did so specifically in the middle quarters of 1988.

Having declined to only R35,0 billion in the fourth quarter of 1988, turnover of public sector stock reverted to substantially higher levels of R42,0 billion and R43,8 billion in the first and the second quarter of 1989. As observed earlier, trading activity in these two quarters was influenced by uncertainty surrounding the proposed abolition of the prescribed investment requirements for institutional investors, and by questions concerning the portfolio restrictions that were to take their place.

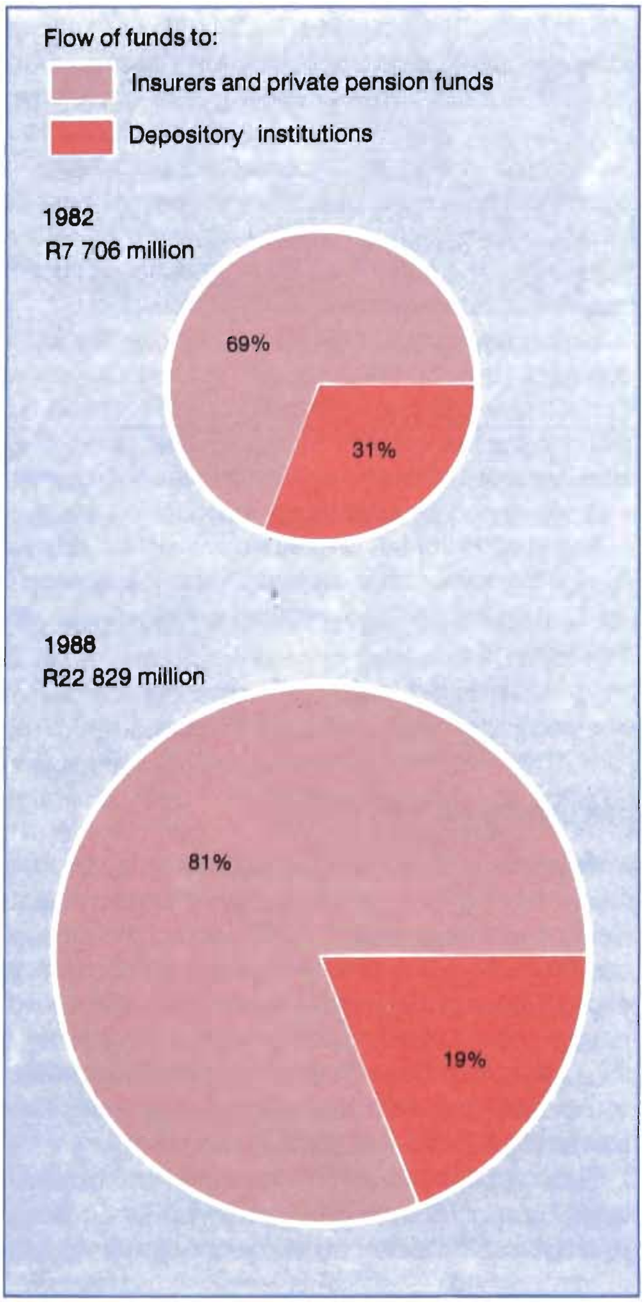
The primary markets

In the *primary capital markets*, large net redemptions of loan debt by the various public sector borrowing entities in the first half of 1988, and less receptive market conditions on account of participants' less sanguine expectations of future interest rate movements, caused net new issues of public-sector stock to contract from R4,6 billion in 1987 to R3,2 billion in 1988. An amount of net new public-sector issues of R2,3 billion was placed in the first half of 1989.

Stock market conditions, substantial corporate savings, continued relatively high levels of corporate liquidity, and the availability of internally generated corporate funds, caused the net amount of new issues of fixed-interest-bearing securities by companies listed on the stock exchange to shrink from R537 million in 1987 to only R222 million in 1988 before recovering to R534 million in the first six months of 1989. Funds raised by listed companies through new issues of share capital likewise declined from R1 974 million in 1987 to only R876 million in 1988.

An amount of R386 million was raised by means of new issues of corporate share capital in the first half of 1989. The higher level of this amount vis-à-vis the amounts of new share issues in the first half of 1988 could be attributed to the renewed buoyancy of the share market and to higher levels of private companies'

Flow of funds to depository and private contractual savings institutions



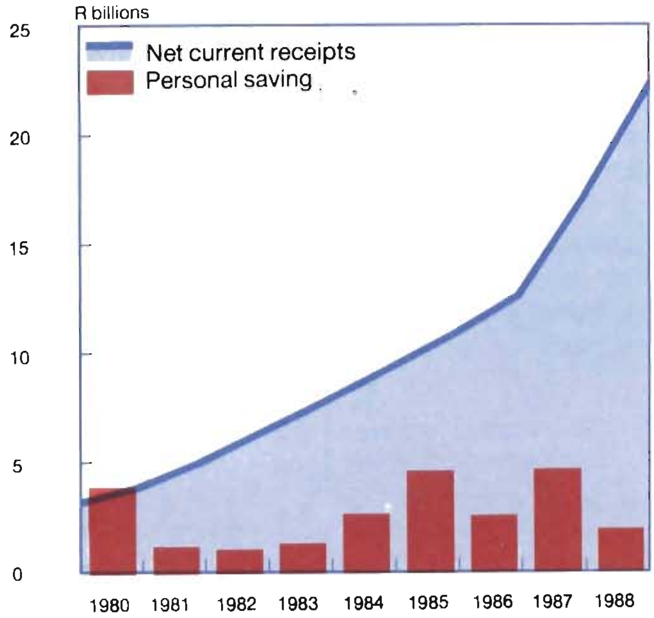
real fixed capital formation. South African private sector companies have, however, traditionally financed the greater part of their fixed investment activities from internally generated funds. Since 1970 an average proportion of only 12 per cent of such companies' fixed investment expenditure has, in fact, been financed by means of new issues of share capital.

The 1988 climate of rising interest rate expectations and quickening inflation proved unfavourable to certain financial intermediaries as collectors of longer-term depository and related fixed-interest investments. Included in the total *flow of longer-term funds to intermediaries* in the primary capital market are the net premium and net (i.e. after-tax) investment incomes of long-term insurers, the net contributions to and net investment incomes of private pension funds, net sales of units by unit trusts, and the flow of longer-term deposits to banks, building societies, participation mortgage bond schemes, the Post Office Savings Bank and other government savings facilities. The year-to-year increase in the *total* of these flows shrank fairly substantially from 28 per cent in 1987 to 13 per cent in 1988. Only a marginally higher intake of longer-term deposit funds in 1988 than in 1987 was recorded, however, by the building societies. Smaller inflows than in 1987 were registered by banks and unit trusts. Actual *out*flows were experienced by the Post Office Savings Bank and other government savings facilities.

Shifts in the pattern of investor preferences, which since the beginning of the 1980s have tended to favour the so-called long-term contractual savings intermediaries (insurers and pension funds) at the expense of the deposit-receiving institutions, were apparent even more strongly in 1988 than in 1987. Flows of longer-term funds to these various intermediaries rose by 31 per cent from 1987 to 1988 in the case of insurers and pension funds, but *declined* by 24 per cent in the case of deposit-receiving institutions. Factors favouring insurers and pension funds as savings intermediaries include, among other things, the tax advantages and inflation resistance of savings facilities offered and the continued high performance of most of these institutions' investment strategies. As shown in the accompanying graph, the aggregate of net premium income, net contribution receipts and net investment incomes of insurers and pension funds has come to exceed greatly and increasingly the total of net personal saving in South Africa as calculated for purposes of the national accounts.

Predominant features of *the mortgage market* in 1988 and the first half of 1989 were banking institutions' generally successful attempts at capturing a major part of this market; the banks' diminishing

Net current receipts* of insurers and pension funds versus personal savings



*Net premium income, net contribution receipts and net investment income of insurers and private and state pension funds

interest in mortgage lending in the course of the review period from the third quarter of 1988; and high aggregate amounts of new mortgage lending, despite significantly lower rates of increase in the flows of longer-term funds to deposit-receiving financial intermediaries. The state of flux by which the mortgage market is currently characterised was also evident from the merging of three building societies with banks in the first half of 1989.

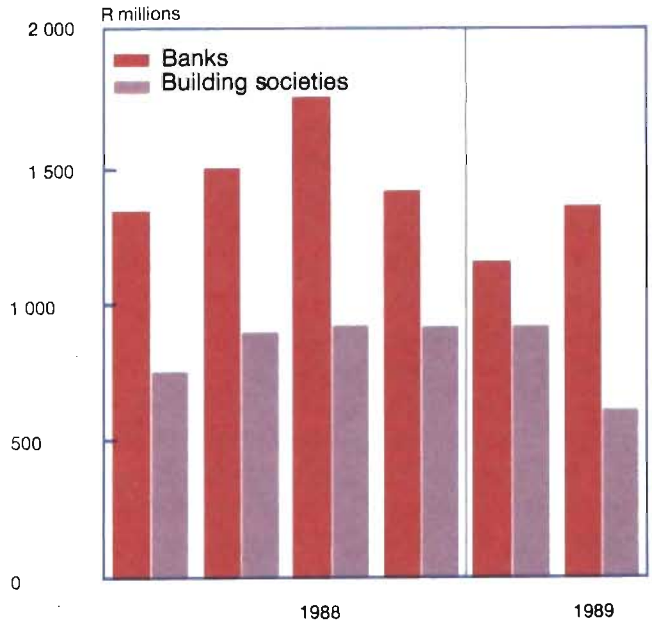
The percentage increase in the total deposit and related liabilities of the building societies was somewhat lower in 1988 than in 1987. In addition, the total net inflow of longer-term funds to the building societies and participation mortgage bond schemes, which had increased by 10 per cent in 1987, rose further by only 4 per cent in the rising interest rate environment of 1988. The aggregate amount of new mortgage loans paid out by these two groups of institutions nevertheless rose further by 11 per cent (to R10,3 billion) in 1988, after having increased by 29 per cent (to R9,3 billion) in 1987. Outpayments of new mortgage loans by the building societies well in excess of their net inflow of depositors' funds, were made possible by mortgagors' substantially increased capital repayments on existing mortgage loans. A further amount of new mortgage loans of R3,8 billion was paid out by building societies and participation mortgage bond schemes in the first half of 1989.

Despite an increase in new mortgage loans paid out, the increase in the building societies' *holdings* of mortgage loans of R3,5 billion in 1988 represented a fairly marked retreat from the increase in these holdings of R3,9 billion in 1987. This was a result of large capital redemptions by home-owners who saw reason for switching from mortgage financing by the building societies to mortgage loans provided by banks.

In contrast to the reduced increase in the mortgage holdings of building societies, the R5,9 billion increase in nine major banks' holdings of mortgage loans during 1988 was a remarkable 136 per cent higher than in 1987; at the end of 1988 the banks' total mortgage loan book stood at R10,4 billion, against R29,6 billion in the case of the building societies. The increase in the combined holdings of mortgage loans of the banks and the building societies in 1988, amounting to R9,4 billion, was an impressive 47 per cent larger than in the preceding year.

Successive bond rate increases from March 1988 contributed to a fall-off in the demand for mortgage advances towards the end of 1988 and in the first half of 1989. This found a supporting element in banks' reduced willingness to grant such advances in the face of tighter bank liquidity, the sustained demand for bank credit in banks' more conventional short-term lending categories, and shrinking interest rate differentials.

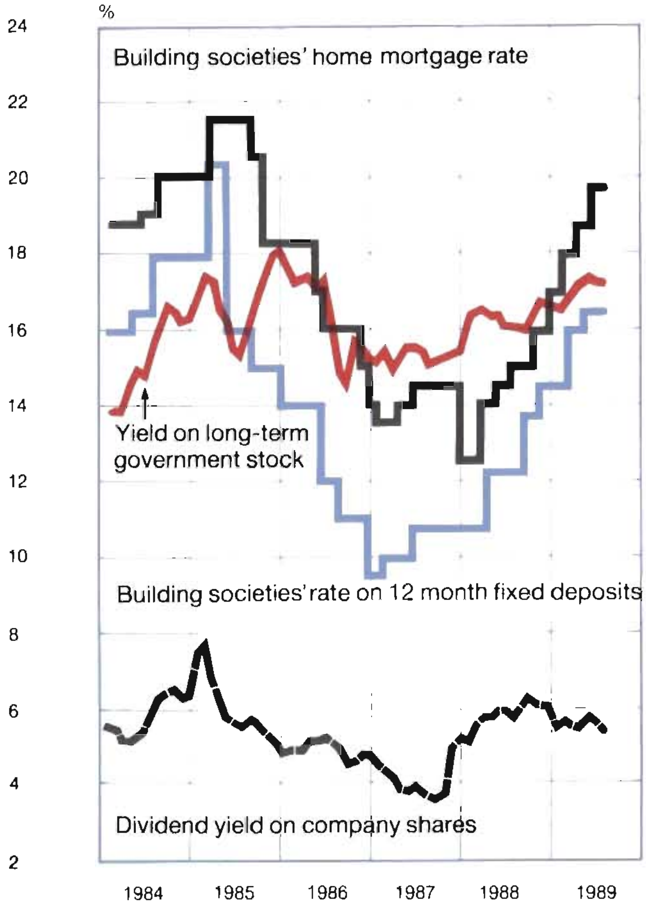
Increase in mortgage holdings



Quarterly increases in the banks' mortgage holdings accordingly tapered off fairly rapidly from R1,8 billion in the third quarter of 1988 to R1,4 billion in the second quarter of 1989 (after adjustment for the effect of three building societies' mergers with banks in February, April and June). Increases in the banks' and the building societies' holdings of mortgage loans in the first half of 1989 (after similar adjustment) amounted to R2,5 billion and R1,5 billion, respectively.

Smaller increases in the building societies' mortgage holdings in 1988 did not prevent continued buoyant conditions in the *fixed property market*. This could be attributed to major banks' aggressive marketing of mortgage finance in the earlier parts of 1988 and to increases in the property portfolios of insurers and pension funds. The *number* of fixed property transactions rose by 29 per cent in 1987 and by a further 19 per cent in 1988; the number of such transactions was, however, 9 per cent lower in the first half of 1989 than in the first half of 1988. The average *value* per transaction rose by 18 per cent (to R91 200) in 1988, and by a further 10 per cent (to R100 650) in the first six months of 1989.

Long-term interest rates and yields



Long-term yields and interest rates

Long-term yields and interest rates found themselves on a generally upward trend through 1988 and the first half of 1989. The monthly average yield on long-term government stock, which had touched a low point of 15,0 per cent in March 1987, rose to 16,6 per cent in March 1988. A temporary downward movement from March 1988 onward came to an end (at a level of 16,0 per cent) in September of that year.

The monthly average long-term stock yield eventually advanced to 17,4 per cent in May 1989 before easing slightly to 17,2 per cent in June. An unusual degree of stability was, however, displayed by this rate for an uncommonly long time: from the beginning of 1988 through the first quarter of 1989, it fluctuated in a narrow band from 16,1 to 16,9 per cent. During this fifteen-month period it did not, therefore, stray beyond the limits of a single percentage point.

Factors contributing to the long-term stock yield's upward trend in the course of the past six quarters inter alia included the various increases in Bank rate from March 1988 and the major rise in short-term interest rates in general; the disappointing performance of the dollar price of gold; the markets' intermittent doubts as to the realisability of the central government's Budget proposals for fiscal 1988/89 and 1989/90; less favourable prospects for the inflation rate; and the markets' concern about policy measures that might still have to be applied for effecting a speedier cooling-down of the economy. The *real* interest rate on long-term government stock (i.e. the nominal rate after adjustment for the prevailing inflation rate) turned positive from November 1987, as nominal rates hardened in 1988 and as the inflation rate (over twelve-month periods) for some time into 1988 still found itself on a downward course. This rate reached a high point of 3,9 per cent in November 1988 before subsiding to 1,3 per cent in June 1989.

The maximum permissible finance charges rate, as determined in terms of the Usury Act, on money lending, credit and leasing transactions for amounts of more than R6 000 but not exceeding R500 000, was raised from its low point of 19 per cent in November 1987 to 28 per cent from November 1988. The maximum rate for small transactions of up to R6 000 was raised from 23 to 31 per cent between these two months. Both these rates, however, still fell short of their historically highest levels of 30 and 32 per cent which had been in force from the end of 1984 up to January 1986.

The building societies' predominant home mortgage lending rate, which had been brought down in the process of building societies' competition with banks to 12,5 per cent as late as December 1987, was raised in eight steps from 12,5 per cent in February 1988 to 19,75 per cent in June 1989. Banks similarly started to raise their bond rates (which had generally been held at lower levels than those of the building societies) as from March 1988. The banks' bond rate was eventually raised to 20 per cent from June 1989.

Steps were announced to mitigate the impact of higher bond rate charges on certain categories of home-owners. In terms of this assistance scheme, as made known on 8 and 9 June 1989, home-owners with outstanding bonds not exceeding R90 000 on properties not exceeding R120 000 in value would be permitted to pay interest at a fixed rate of 17 per cent. The difference between 17 per cent and the prevailing standard mortgage bond rate would be capitalised; repayment of this deferred portion of the interest rate charges was to be guaranteed by the Government.

In the share market the generally weak performance of share prices in the more immediate post-slump period, in conjunction with the improving financial results of companies, caused the average dividend yield on all classes of shares to strengthen from 5,0 per cent in January 1988 to 6,3 per cent in September 1988. The renewed surge of share prices from September 1988, however, subsequently caused this yield to decline to 5,6 per cent in June 1989. The average *earnings* yield of the shares of all non-gold mining companies listed on the stock exchange advanced markedly from 10,8 per cent in December 1987 to 13,4 per cent in December 1988, but slid back marginally to 13,0 per cent in June 1989.

The predominant rate on twelve-month deposits with banks and building societies, which is regarded as indicative of deposit rates in general, shared in the general upward trend of longer-term interest rates. This rate was raised in a number of steps (with the building societies usually leading the way) from its low point of 9,5 per cent up to February 1987 to 10,8 per cent (as quoted by banks) in February 1988, and to 16,5 per cent (as quoted by both the banks and the building societies) in May 1989. The rates on tax-free investments with building societies, the Post Office Savings Bank and the Treasury were raised by 0,5 per cent from 15 April 1989. The rate on Post Office Savings Certificates and on subscription shares and deposits with building societies was thereby brought to 9,5 per cent, against its low point of 7,5 per cent in June 1988.

Government finance

Continuation of restrictive policy stance

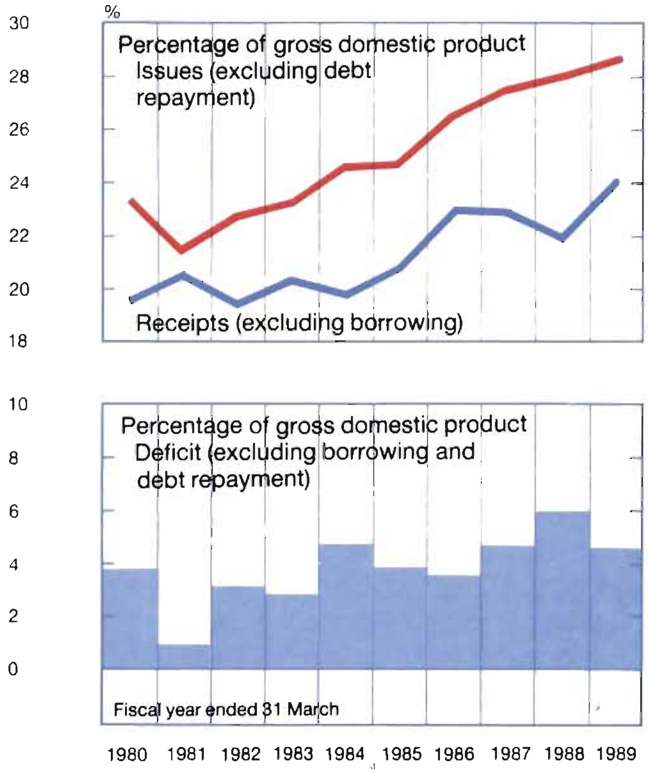
A more expansionary posture of fiscal policy was adopted in the recession year 1985 (in the form of a package of "moderately but responsibly" stimulatory measures in September of that year), and was maintained through 1986 and 1987. The main Budget for 1987/88, as presented in June 1987, was meant to exploit more completely the "room for growth" which, at that stage, was considered still to be present in the South African economy.

A return to a more cautious and less expansionary approach to the authorities' general economic policies was contained in the Central Government's Budget for 1988/89. This shift in policy was made in awareness of, and with a view to, the various "constraints" – such as those represented by the balance of payments, the limited availability of investment funds, and the prevailing inflation rate – that were seen as setting limits to the future growth capability of the South African economy. The less stimulatory tenor of the 1988/89 Budget was intended to fit in with the less accommodative stance of monetary policy that had already been adopted by the Reserve Bank towards the end of 1987.

The more restrictive policy approach of the March 1988 Budget was subsequently reinforced by the introduction of a package of demand-restraining fiscal and other policy measures in May 1988, and by a number of tax changes that were gazetted in July of that year. In addition, third-quarter increases in government expenditure at rates well in excess of the budgeted increase of 12,6 per cent, and early signs of emerging excess demand in the economy, led to the announcement of further restrictive measures in August 1988. These measures included an increase in the fuel levy, an increase in the import duties on assembled motor cars, and replacement of the 10 per cent surcharge on certain imported goods with a graded system of surcharges which ranged from nil to as much as 60 per cent. The express purpose of these measures was to curb domestic demand, to slow down the growth in imports and to protect the balance of payments.

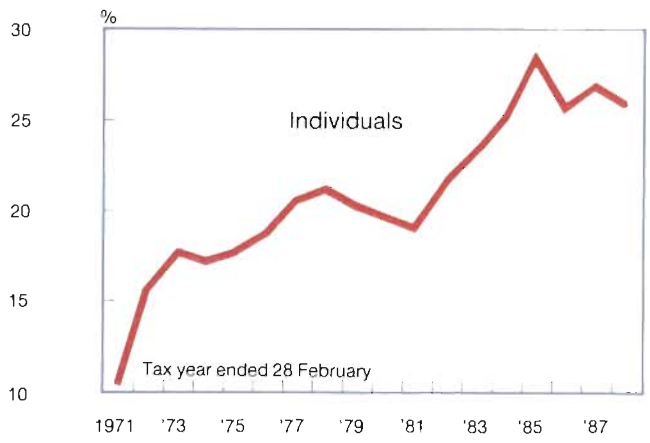
The Central Government's Budget for 1989/90, as presented on 15 March 1989, was also meant to be a continuation of the Government's more restrictive policy stance. As stated by the Minister of Finance, economic policy in the year ahead would, among other things, have to temper the strong expansion of domestic spending that had already occurred in 1988.

Exchequer Account



The Budget as presented was aimed at both the short-term and the long-term objectives of the Government while also seeking to lend support to certain desirable structural adjustments that were already taking place in the economy. These adjustment processes were to be aided by a strengthening of adjustment programmes in agriculture, mining, manufacturing and the financial sectors, with a view to creating a sounder base for accelerated economic growth. Long-term objectives of the Government that were reaffirmed in the Budget included restricting the growth rate of government expenditure to a lower level than the growth rate of expenditure in the rest of the economy; gradual reduction of the deficit before borrowing to a figure of not more than 3 per cent of gross domestic product; adherence to the five-year guide plan for state expenditure; and gradual reduction of the tax burden – more parti-

Average marginal tax rate



cularly of the average marginal tax rate on individuals, which had increased from 10,2 per cent in 1970/71 to 25,9 per cent in 1987/88.

In the area of short-term objectives the Budget, as stated by the Minister, was to steer clear of being stimulatory, so as not to add to the balance of payments difficulties. It should also not be allowed to aggravate the inflation problem by permitting undue increases in government expenditure or through unsound ways of financing the deficit. An unduly large deficit before borrowing was to be avoided so as to prevent unnecessary further pressure on the money and capital markets that would result in higher interest rates. The strong upswing in the private sector, on the other hand, should not be constrained or cooled down needlessly, but should be allowed as much scope as possible.

As in 1988, the fiscal authorities in 1989 subsequently saw reason to strengthen the more restrictive policy stance that had been adopted in their main Budget. In April 1989 supplementary fiscal measures were announced which included, among other things, an increase in the fringe benefit taxation on company cars and on employers' loans to employees at below-market interest rates.

Fiscal actions also made up an important part of the package of fiscal, monetary and credit measures that was announced on 5 May 1989. Fiscal measures in this package consisted of, among other things, the imposition of a 10 per cent loan levy of income tax paid by companies for the tax year 1989 and the abolition, with very few remaining exceptions, of the exemptions that had been granted previously from the surcharge on imports in the case of the importation of capital goods. The *rate* of the surcharge on capital goods was, however, reduced simultaneously from 20 to 15 per cent. In the area of credit measures, a further tightening was announced of certain hire-purchase conditions.

The fiscal adjustments of both 1988 and 1989, which sought to establish an enhanced degree of fiscal restrictiveness, consisted mainly of measures that would result in additional government revenue. As such, they did not contribute towards the longer-term need for a reduction in tax burdens by curtailing government expenditure. The fact that recourse was had to measures of this nature may be viewed as a reflection of the downward rigidity of government spending and of the problems that are inherent in using variations in unyielding government expenditures – which, in addition, are subject to strong upward pressures – as a tool of short-term demand management.

Outcome of Central Government Budget for fiscal 1988/89

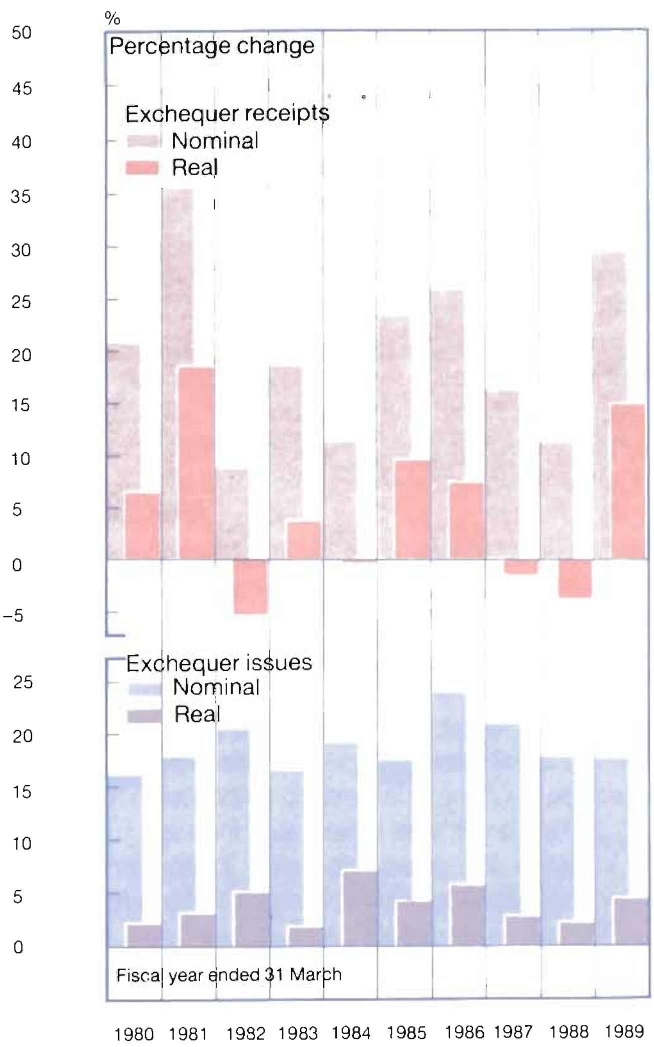
The outcome of the Central Government's Budget for fiscal 1988/89 departed considerably from the original March 1988 Budget proposals. Expenditure as well as revenue markedly exceeded the Budget estimates.

Actual nominal Central Government *expenditure* in 1988/89 reached a level of R56,6 billion. This represented an increase of 18,0 per cent from actual expenditure in 1987/88, against the increase of 12,6 per cent that had been budgeted for.

At its level of R56,6 billion, actual government expenditure in 1988/89 exceeded the original Budget estimates by R2,7 billion or by approximately 5,0 per cent. In comparison, overspending of the General and Own Affairs budgets for the preceding fiscal year (1987/88) had amounted to only 2,2 per cent; the average degree of overspending in the preceding *four* fiscal years had, however, amounted to approximately 6,6 per cent. In *real* terms Central Government expenditure rose by 4,6 per cent from fiscal 1987/88 to fiscal 1988/89. This figure is reduced to 4,2 per cent when adjustment is made for changes in the balance on the Paymaster General Account.

Well-above-average rates of increase among the principal *functional* components of government expenditure in fiscal 1988/89 were recorded by, among other spending votes, state domestic administration (25 per cent) and protection services (24 per cent). In addition, costs of the government debt (consisting of interest and management charges) rose by 27 per cent in 1988/89 and amounted to 14 per cent of total government expenditure during the year. The discount

Change in Exchequer receipts and issues

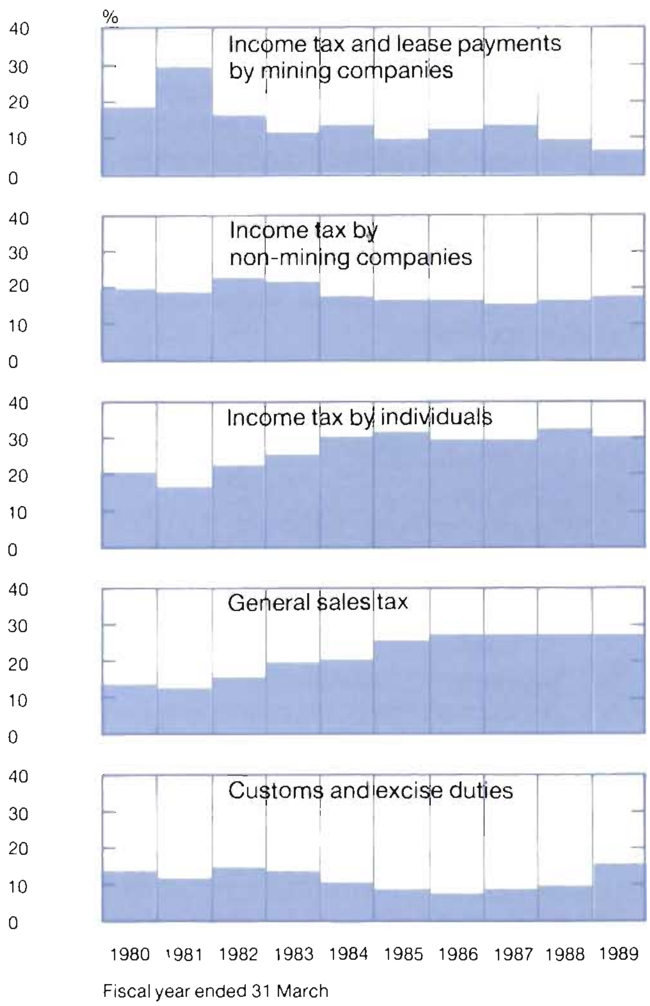


on new issues of government stock, although not normally regarded as a part of government expenditure, rose from R0,9 billion in 1987/88 to as much as R2,4 billion in 1988/89.

The potential short-term stimulatory impact of the substantial increase in real government expenditure in fiscal 1988/89 was, however, offset partly by a similarly substantial increase in government *revenue*. Total revenue in 1988/89 amounted to R48,2 billion (not including R0,6 billion received by the Exchequer from the Government's sale of ISCOR shares). At this level, recorded government revenue in 1988/89 exceeded the original March 1988 Budget estimates by R4,2 billion or by 9,6 per cent. The increase in actual nominal revenue from the preceding fiscal year amounted to 27,0 per cent; in real terms, this increase came to approximately 12,6 per cent. Revenue receipts in excess of the March 1988 Budget estimates were recorded under all principal headings with the exception of revenue from gold mining companies and "other" (miscellaneous) revenue. The remarkable increase in revenue partly reflected additional fiscal measures introduced in the course of the year to restrain the rising demand in the private sector.

As is also brought out by the accompanying graph, major shifts in the *composition* of central government revenue in 1988/89 from preceding years included a dramatic reversal of the declining trend in revenues from customs and excise duties; a continuation of the well-established downward trend in the relative contribution to total revenue from the mining industry; a con-

Composition of Central Government revenue



tinuation of the upward movement of the past few years in the relative contribution of revenues from non-mining companies; and a small decline in the percentage share of income tax receipts from individuals from the very high level these receipts had attained in fiscal 1987/88. The relative contribution of general sales tax collections remained unchanged for another year at its level of 27 per cent which it had reached in 1985/86.

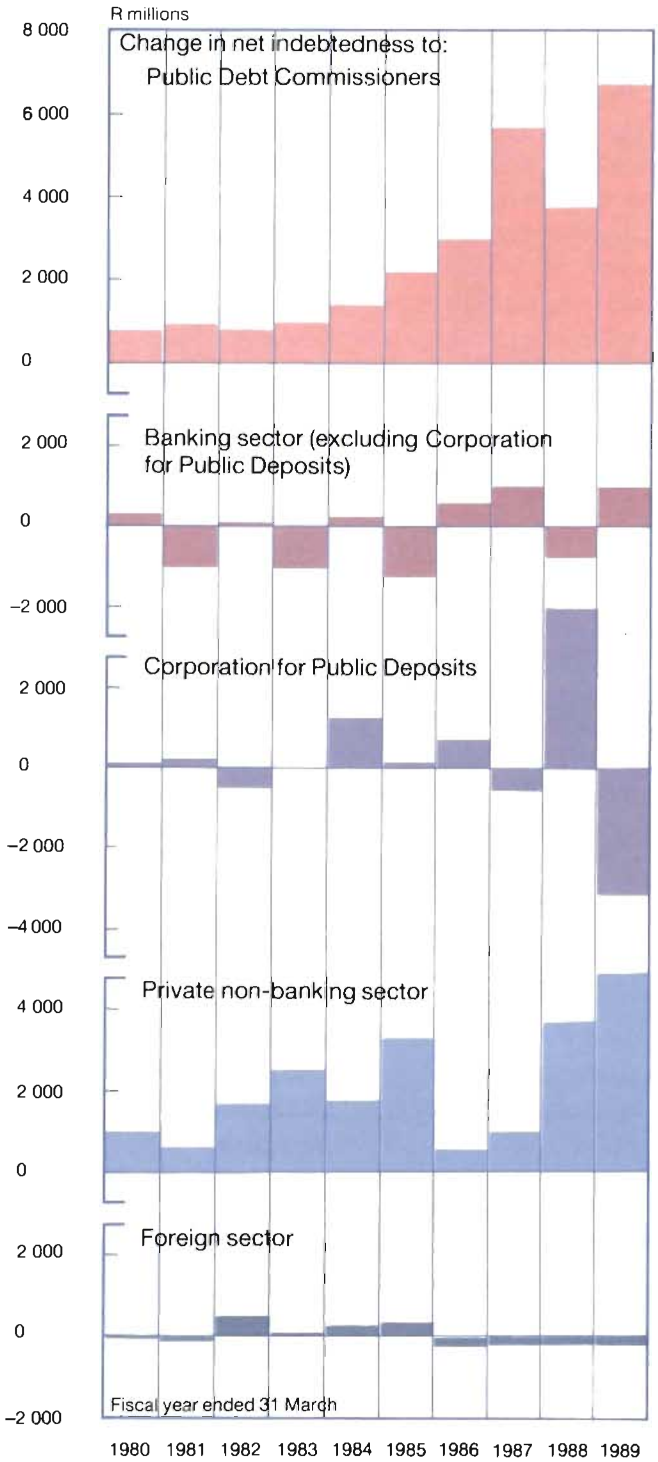
Revenue collections from customs and excise duties rose in fiscal 1988/89 by an exceptionally large 103 per cent. This was mainly a result of large increases in customs duties in general (reflecting high imports), the surcharge on imports (reflecting the higher rate of the surcharge) and the additional fuel levy. The fuel levy, dating from August 1987, was raised on three occasions during the fiscal year 1988/89 and accounted for 35 per cent of total customs and excise receipts. Revenue collections from non-mining companies rose by nearly 40 per cent from 1987/88 to 1988/89, reflecting the effect of the introduction of the minimum tax on companies in addition to those of high economic activity and high company profits.

The *deficit before borrowing and debt repayment* in fiscal 1988/89 (excluding the discount on newly issued government stock of R2 367 million) amounted to R8 394 million, or to approximately 4,1 per cent of gross domestic product. This outcome compared favourably with the deficit ratio of 4,9 per cent of the then projected gross domestic product that had been envisaged in the Budget estimates of March 1988. At R8 394 million, the actual 1988/89 deficit was also smaller, by R1 620 million, than the actual deficit of the preceding year. The financing of this deficit was provided from the following sources:

	R millions
Public Investment Commissioners	6 629
Non-bank private sector	4 794
Banking sector:	
Corporation for Public Deposits	–3 087
Other banks	1 923
Foreign sector	–98
	10 161
Plus: proceeds from privatisation	600
Less: discount on new government stock	2 367
Total financing	8 394

Features of this financing pattern included a reduction in the net borrowing from the banking sector, mainly as a result of a large redemption of short-term loans previously raised from the Corporation for Public Deposits; a sharply higher relative contribution from the non-bank private sector (to which should be added the proceeds

Financing of Exchequer Account deficit



from privatisation sales); and the growing importance of the Public Investment Commissioners.

The shrinking of the deficit from 1987/88 to 1988/89 did not prevent an increase in the ratio of the total outstanding debt of the Central Government to nominal gross domestic product from 32,7 per cent at the end of March 1988 to 33,2 per cent at the end of March 1989. The rise in this ratio was a reflection of extensive over-borrowing and of the markedly higher total discount on new issues of government stock. *Not* included in the Government's outstanding debt are its commitments with regard to the Reserve Bank's losses on the provision of forward foreign exchange cover and in respect of negotiable promissory notes issued by the Department of Trade and Industry in lieu of cash export incentives. Inclusion of these items would raise the ratio of the debt to the gross domestic product to 39,1 per cent.

As in the preceding three fiscal years, the rise in the debt in 1988/89 was a result, exclusively, of borrowing in the domestic markets. The total *foreign* debt of the Central Government declined further from R2,4 billion or 4,2 per cent of the total at the end of March 1988, to R2,2 billion or 3,2 per cent of the total at the end of March 1989. The share of *non-marketable* debt in the total debt outstanding contracted from 13,9 per cent to only 8,5 per cent – its lowest level since 1960/61 – during this period. This was mainly the result of a smaller amount of non-marketable one-day (or "call") Treasury bills held by the Corporation for Public Deposits, reflecting reduced "standstill" deposits with the Public Investment Commissioners and commensurately reduced deposit holdings of the Public Investment Commissioners with the CPD.

The average maturity of the domestic *marketable* government debt outstanding shrank further from 128 months in 1987/88 to 114 months in 1988/89. This was in accordance with investors' preferences for a shortening of the maturity structure of their portfolios in a general climate of rising interest rates.

Expenditure, revenue and the deficit before borrowing in the Budget for 1989/90

Much as in fiscal 1988/89, the Government's objective of not adding to the pressures of domestic demand implied fairly severe constraints on its intentions for fiscal 1989/90. In his Budget for 1989/90, as presented to Parliament on 15 March 1989, the Minister of Finance planned for an increase in government expenditure of 15,0 per cent. Allowing for an inflation rate of a similar order, this meant an absence of growth in government expenditure in real terms. The 15 per cent increase in budgeted expenditure included an amount of R1 000 million as a provision for unforeseen spending needs. Capital expenditure, as included in total expenditure, was estimated to amount to R5 076 million. This would be about 4 per cent less than the actual amount of such spending in 1988/89.

Government revenue was budgeted to rise by 16,0 per cent. Incorporated in this estimate were, on the one hand, the revenue-*raising* effects of an increase of one percentage point (to 13 per cent) of the rate of general sales tax with effect from 20 March 1989 and of an increase in excise duties on a range of dutiable items, and, on the other hand, the revenue-*reducing* effects of increases in the primary rebates for individual taxpayers and of a small reduction in mining taxation. The proposed separate taxation of married couples, in terms of which all salaried married women are to be taxed under the Standard Income Tax on Employees or "SITE" system, and increases in the SITE ceilings for men and unmarried women, were not expected to result in a loss of revenue in fiscal 1989/90.

The deficit before borrowing and debt repayment was estimated to amount to R9 949 million or to approximately 4,1 per cent of the projected gross domestic product. At this level, close to half of the envisaged deficit would be attributable to current expenditure, implying a further increase in the absolute amount of "dissaving" by the Central Government. It was proposed that this deficit be financed in the following way:

	R millions
Revenue	55 068
Expenditure	65 017
Deficit (before borrowing)	9 949
Financing (net of debt repayment):	
Public Investment Commissioners	5 200
New government stock issues	4 370
Non-marketable securities (net)	–280
Foreign funds (net)	367
Available balances[1]	292
Total	9 949

1 Increase –; decrease +

The first quarter of fiscal 1989/90

In the first quarter of fiscal 1989/90 (i.e. in the June quarter of 1989), Exchequer *issues* (after the usual adjustment for changes in the balance on the Paymaster General Account) were 33,8 per cent higher than in the first quarter of fiscal 1988/89. This year-on-year percentage increase obviously exceeded by far the budgeted increment of 15,0 per cent in government expenditure for the fiscal year as a whole. The ratio of first-quarter issues to budgeted expenditure for the year as a whole, at 25,6 per cent, was, in fact, markedly higher than in fiscal 1988/89. It was, however, still well below the average ratio of 26,4 per cent in the preceding five fiscal years.

Exchequer *receipts* in the first quarter of fiscal 1989/90 were a major 37,2 per cent higher than their counterpart in the first quarter of fiscal 1988/89. This sharp year-on-year rise in revenue similarly exceeded by far the budgeted increase in revenue of 16,0 per cent for the fiscal year as a whole. In this case, however, the ratio of first-quarter receipts to total budgeted revenue for the fiscal year, at 21,8 per cent, was substantially higher than the average value of this ratio of 19,7 per cent in the preceding five fiscal years. The uncommonly rapid rise in first-quarter receipts implied by these data could be attributed to the cumulative effect of the increases in fuel levies and in the surcharge on imports that had been introduced after the June quarter of 1988. In addition, revenue collections from the general sales tax were significantly higher in the June quarter of 1989 than in the June quarter of the preceding year.

The deficit before borrowing in the first quarter of fiscal 1989/90, at R4 650 million, was 25 per cent larger than in the first quarter of fiscal 1988/89. Relative to the envisaged deficit for the year as a whole, the deficit nevertheless was significantly smaller than in preceding fiscal years with the exception of 1988/89. Including the discount of R851 million on new issues of government stock, the deficit of R5 501 million was financed by the Public Investment Commissioners and the non-bank private sector to amounts of R1 947 million and R3 649 million, respectively. Exchequer indebtedness to the foreign sector and the banking sector was reduced by R24 million and R71 million.

Among the financial instruments used for financing the first-quarter deficit, net new issues of government stock during this quarter amounted to 40 per cent of total anticipated stock issues during the fiscal year as a whole, against 43 per cent during the corresponding period in fiscal 1988/89. Temporary financing of the deficit in the first quarter of 1989/90 by means of Treasury bills amounted to nearly R4,0 billion.

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