QUARTERLY ECONOMIC REVIEW

SUMMARY AND CONCLUSIONS

(1) The South African economy at present enjoys great prosperity and would still appear to be in an expansion phase of the business cycle. Although the current economic upswing has now lasted well over three years, which is longer than the average duration of past cyclical upswings, present indications suggest that it has by no means yet run its course and is still endowed with considerable vigour.

(2) In both the private and public sectors the rate of increase of fixed capital outlays on plant, equipment and construction tended to be even higher during the third quarter of 1964 than during the second quarter. The marked expansionary effect of these increases was further reinforced by another substantial rise in private consumption. On the other hand, merchandise exports declined noticeably, while inventory investment and current Government expenditure also decreased somewhat. Gold production again increased moderately.

(3) With merchandise exports declining and imports rising strongly as a result mainly of the further expansion of both capital and consumer outlays, the current account of the balance of payments showed a substantial deficit during the third quarter. This, however, coincided with a considerable net inflow of private foreign capital, so that the total gold and foreign exchange reserves of the country declined only moderately.

(4) Partly as a result of a further rise in commercial and other bank credit, the liquidity of the private sector, as measured by the seasonally adjusted ratio of money and near-money to gross national product, remained at a high level during the third quarter of 1964. The further increase in bank credit, however, helped to reduce the liquidity ratios of most banking institutions to a relatively low level. This, in turn, not only limited their ability to create more money, but also brought upward pressure to bear on short-term interest rates.

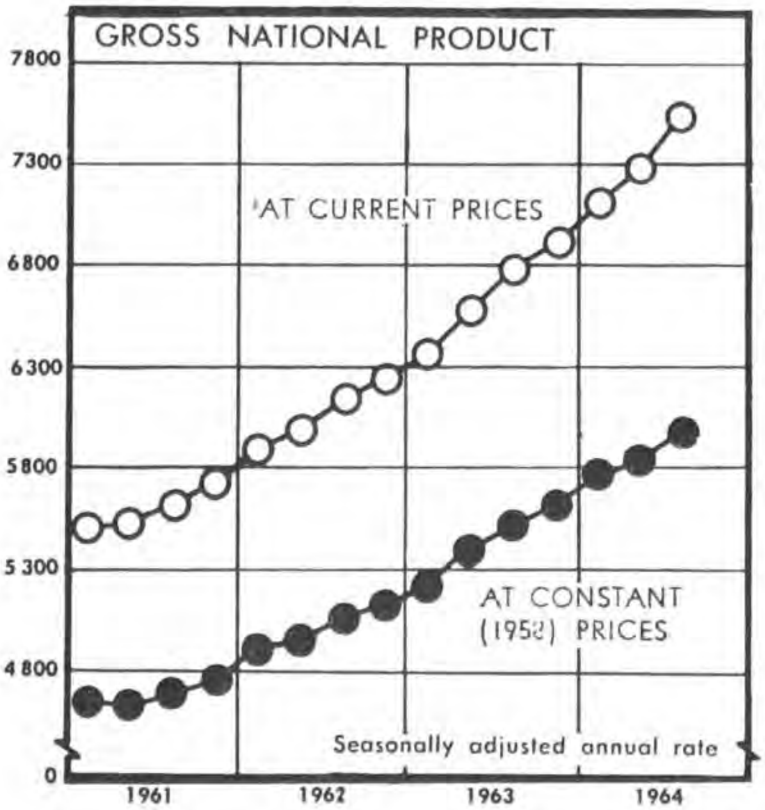
(5) In the securities markets various factors combined during the period August to November to reverse the downward tendency in stock exchange turnover and share prices which had followed the attainment of peak levels in the second quarter. These included a decline in new issues, a reduction in allocations under the "arbitrage scheme" of exchange control relaxation and the continued prosperity of the economy in general. Some upward pressure was, however, exerted on gilt-edged rates towards the end of this period and early in December the Reserve Bank increased its pattern of interest rates for Government stock by $\frac{1}{4}$ per cent.

(6) While the balance of payments position of the country remains sound and the gold and foreign exchange reserves are at a relatively high level, the economy has recently tended to move into the early stages of general demand inflation. For this reason, the Reserve Bank has not only welcomed the natural tightening of the banking situation and the tendency for interest rates to rise but has also applied certain measures with a view to strengthening the country's defences against inflationary pressures. These steps included the exercise of further moral suasion over banking institutions, a more restrictive attitude towards rediscounting by the Bank, the withdrawal of Treasury funds from the money market and an increase in Bank Rate from 4 to $4\frac{1}{2}$ per cent on the 8th December, 1964.

NATIONAL ACCOUNTS[1]

Further Rise in Gross National Product

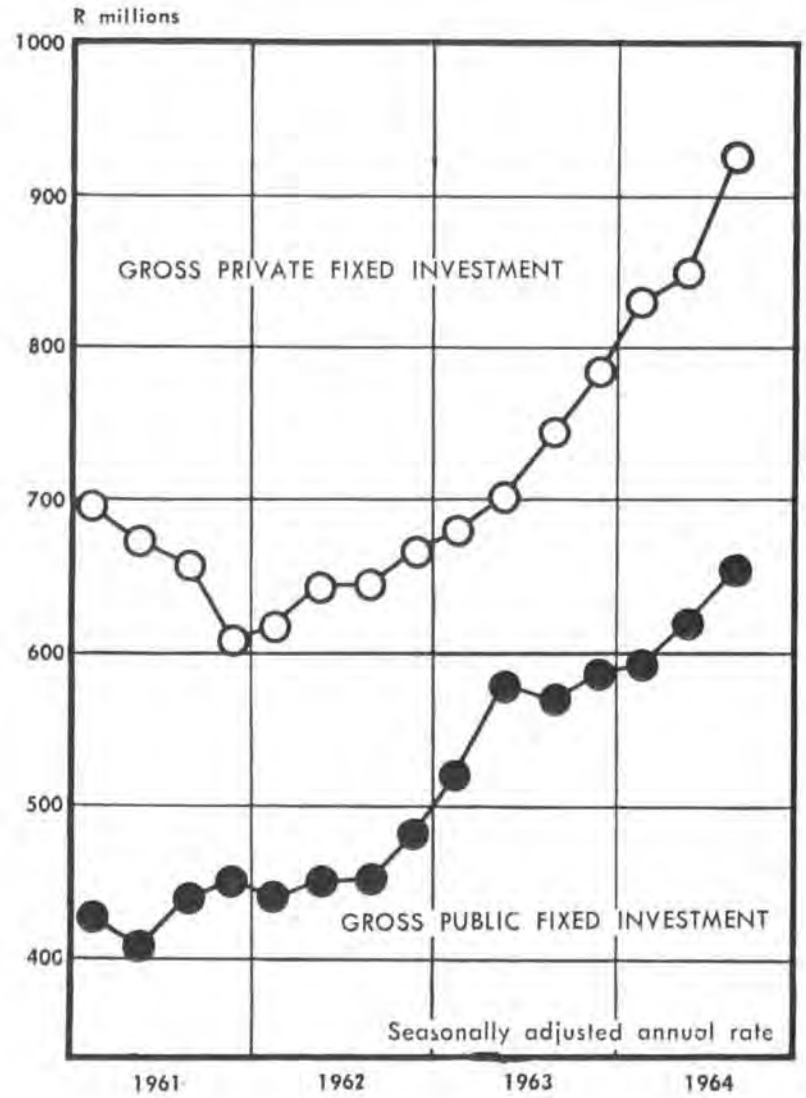
During the third quarter of 1964 the *real* gross national product increased at more or less the same annual rate as during the first and second quarters, namely 6 to 7 per cent. In monetary terms, i.e. at current prices, the rate of increase tended to accelerate somewhat, but this was attributable to a more rapid rise in the price level.



Pronounced Further Increase in Fixed Capital Outlays

The main reason for the further increase in gross national product was a continuation of the upsurge in capital outlays on plant, equipment and construction. Indeed, in both the private and public sectors the rate of increase of fixed investment tended to be even higher during the third quarter of 1964 than during the second quarter. The most important contributions to the accelerated increase in private fixed investment were made by manufacturing, commerce and residential building, while in the public sector a noticeable decline in the fixed capital outlays of public *corporations* was more than offset by a particularly sharp increase in fixed investment by public *authorities.*

1) The analysis in this section of the review is largely based on the Reserve Bank's quarterly estimates of the national accounts, *after adjustment for seasonal tendencies.* Since these quarterly figures are not yet judged reliable enough for publication, the analysis is confined to pointing out broad tendencies.



Inventory Investment

Although inventory investment, i.e. the net addition to stocks, declined noticeably during the third quarter, it was still fairly substantial, mainly as a result of a further accumulation of commercial and manufacturing inventories.

Private Consumption and Current Government Expenditure

Consumer spending continued to rise strongly during the third quarter. While this was, no doubt, party the result of the additional income generated by the increased fixed investment, it would also appear to have been facilitated by a further increase in consumer credit.

Although fluctuating sharply from month to month, the seasonally adjusted retail sales index continued to show a steady upward tendency during the third quarter, while the seasonally adjusted index of sales of new motor vehicles increased at a relatively fast rate during July and August, but then declined somewhat during September and October.

Current expenditure by the Government and other public authorities declined slightly during the third quarter.

Decline in Merchandise Exports but Increase in Gold Output

Merchandise exports declined noticeably during the third quarter, particularly exports of manufactured articles. One important reason for this would appear to have been the substantial further increase in internal demand, which tended to divert goods from the export to the home market. The gold output, however, continued to rise.

Decline in Total Saving

Gross domestic saving would appear to have declined during the third quarter. This was mainly attributable to a renewed decrease in personal saving which, in turn, was largely the counterpart of the substantial further rise in private consumption.

PRODUCTION AND EMPLOYMENT

Slight Slowing Down in Rate of Increase of Manufacturing Output

Although, as indicated above, the total monetary demand for goods and services increased during the third quarter of 1964 at a somewhat higher rate than during the first half of the year, the seasonally adjusted index of the physical volume of manufacturing output did not show a similar acceleration but, if anything, tended to increase at a somewhat slower tempo during the period May to August than during the four preceding months. This suggested that, with the economy up against the full employment ceiling, the rate of growth of output was gradually declining to a more normal figure.

Nevertheless, during the first eight months of 1964 as a whole, the index was no less than 16.5 per cent higher than during the corresponding period of 1963. The branches of secondary industry responsible for the largest contributions to this increase were those producing metal products, chemicals and chemical products, products of petroleum and coal, non-metallic mineral products, basic metals and electrical machinery.

Increase in Manufacturing Employment

A major feature of the current economic upswing has been the substantial increase in the amount of workers employed in secondary industry. Thus, whereas manufacturing employment moved upwards by a yearly average of only 1.6 per cent during the three years 1960 to 1962, it increased by as much as 7.5 per cent during 1963 and a further 6.0 per cent during the period January to August, 1964.

Over-full Employment in Construction Industry

Although the value of building plans passed showed a tendency to level off during the course of the second and third quarters of 1964, it remained at an exceptionally high level and the construction industry continued to operate under considerable pressure. In view of the shortage of artisans, employment in this sector of the economy increased at a considerably slower rate during the course of the first seven months of 1964 than during the corresponding period of the previous year. In the circumstances, the average earnings of artisans remained substantially in excess of the minimum wage rates.

Further Decline in Registered Unemployed

Further evidence of the strain in the labour market was provided by the continued decline in the number of registered unemployed Whites, Coloureds and Asiatics, which in September reached the very low figure of 11,954, the lowest recorded in the past 81 months.

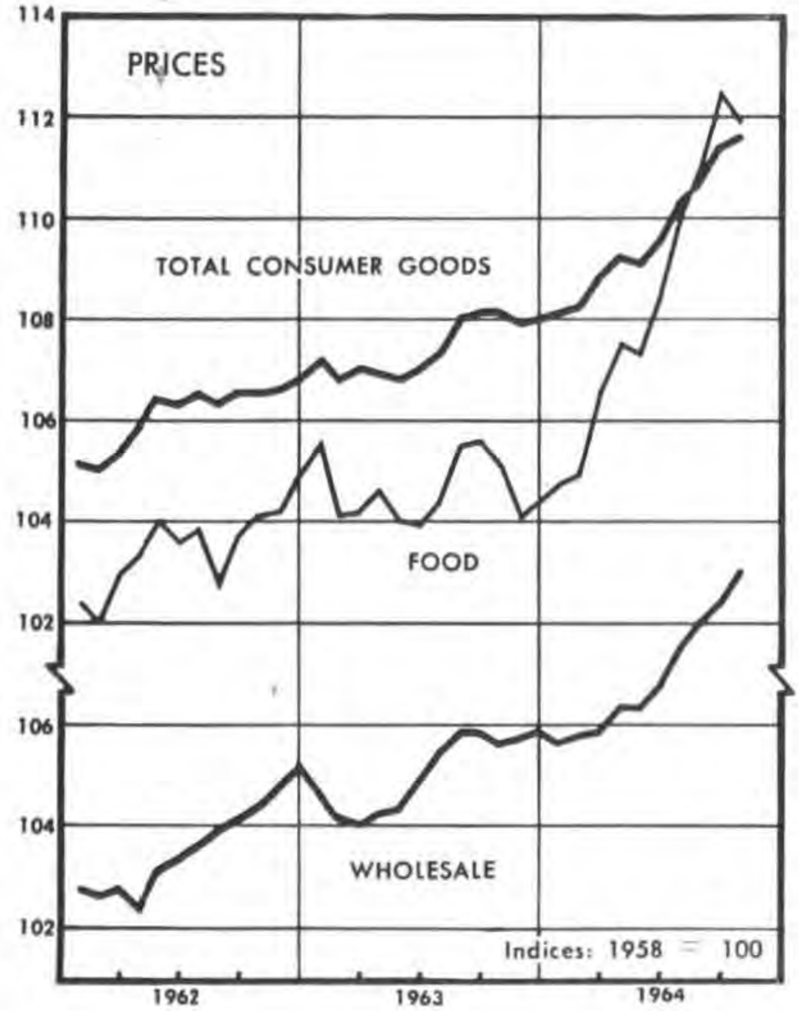
Further Rise in Real Estate Transactions

The high level of activity in the construction industry was accompanied by a further upward tendency in the index of the value of real estate transactions, which although fluctuating sharply from month to month, has not yet given any clear indication of either a turning point or a levelling off.

PRICES

Early Stages of General Demand Inflation

After more than three years of rapid expansion coupled with a remarkable degree of price stability, the economy has during recent months shown signs of moving into the early stages of general demand inflation. Until about the middle of 1964, the large increases in capital outlays, private consumption and Government expenditure were, in general, well met by increases in production and imports. At the same time there was some diversion of locally produced goods from the export to the domestic market. The result was that, although important "bottlenecks" developed in the economy and brought about certain price increases, there was no significant diffusion of inflationary tendencies and no general demand inflation in the sense of "too much money chasing too few goods". But the sharp further increase in both capital and consumer outlays during the third quarter of 1964, coming as it did at a time when the economy had for at least six months already



been in a state of virtually full employment, would appear to have tipped the scales in the direction of more widespread inflation.

This conclusion is not in the first instance based on the recent movements of the official price indices. It is true that between June and September of 1964 the consumer and wholesale price indices increased at annual rates of 6.2 and 4.5 per cent, respectively, compared with increases of only 2.3 and 1.6 during the preceding twelve months. But in the case of the consumer price index, this acceleration of the rate of increase was largely the result of a rise in food prices which, in turn, can, at least partly, be attributed to unfavourable weather conditions experienced by large agricultural regions of the country. Similarly, the more rapid increase in the wholesale price index was largely a reflection of increases in the prices of agricultural and forestry products. If these increases are excluded from the calculations, both the consumer and wholesale price indices show little more than a continuation of the moderate upward drift which was a feature of the preceding years.

Furthermore, the mere fact that profits, salaries and wages have increased substantially over the past year or two does not by itself prove the existence of demand inflation. Such increases are not only to be expected but, provided they do not exceed the increase in productivity, can be justified in a period of rapidly rising real gross national product.

The latest estimates of the various components of the total expenditure on the gross domestic product do, however, suggest that aggregate investment and consumer demand is rising somewhat too rapidly in relation to the ability of the economy to supply more goods and services in the short-run, even after taking into account the high level of imports; and it is on this assessment that the diagnosis of moderate demand inflation is based. Fortunately, the indications are that the "over-heating" of the economy is still very mild and, as will be pointed out later on, important stabilising forces of a self-regulating nature already appear to be at work.

BALANCE OF PAYMENTS

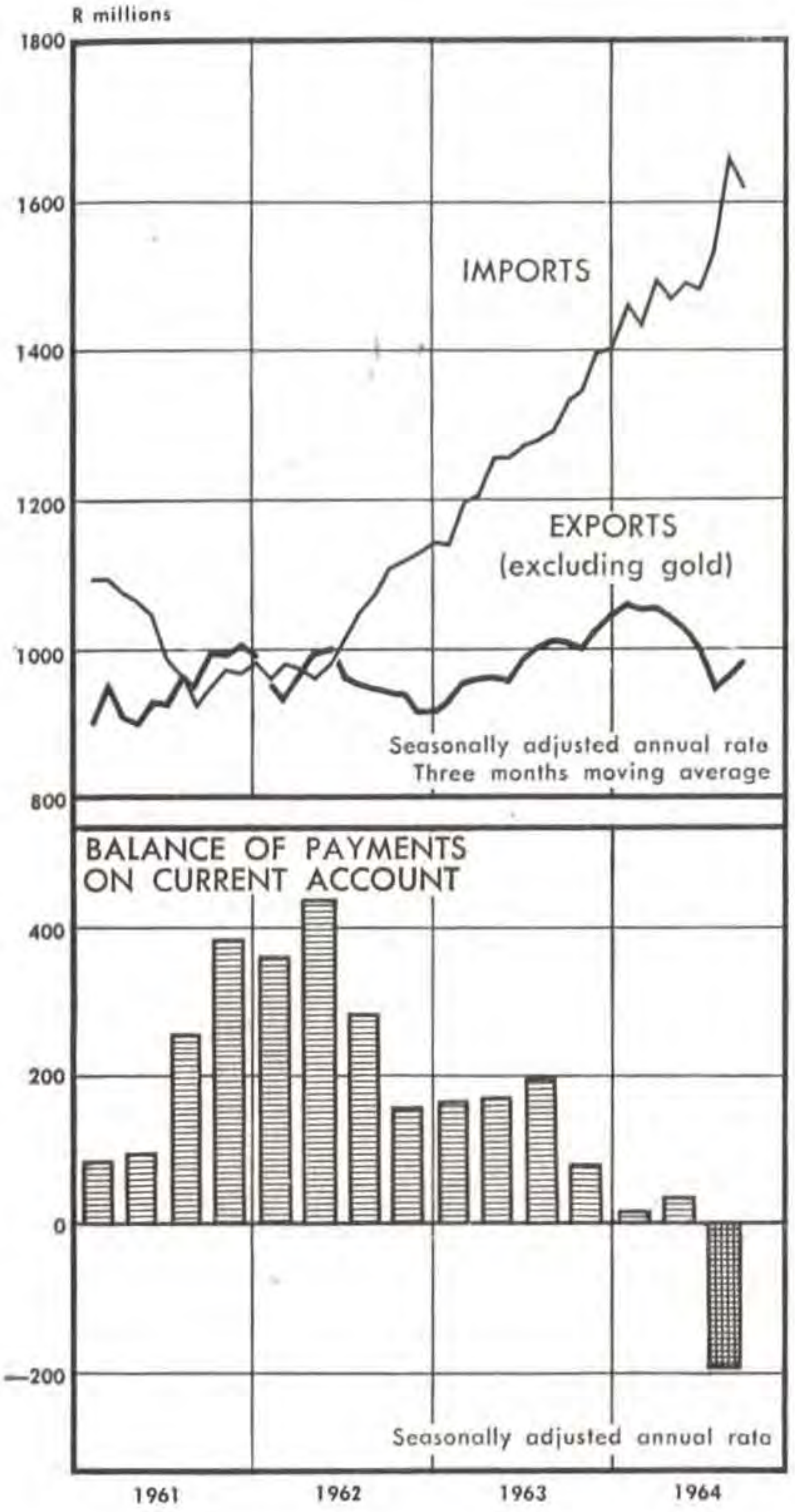
Substantial Deficit on Current Account

The behaviour of the current account of the balance of payments during the third quarter of 1964 reflected the moderate inflationary pressure in the internal economy. Thus, after showing a still negligible shortfall of R6 million during the first half of 1964, the current account moved into a clear deficit of no less than R52 million during the third quarter of the year. Even if allowance is made for seasonal changes, this deficit still amounted to as much as R49 million, which means that it was running at an annual rate of R196 million. This was the first seasonally adjusted deficit during any quarter since the last quarter of 1960 and the largest adjusted quarterly deficit since the first quarter of 1958.

The main reasons for this marked change in the current account were a further increase of R31 million in merchandise imports and a decrease of R44 million in merchandise exports, both associated, in part at least, with the tendency in the economy towards overspending. Seasonally adjusted imports, taken at an annual rate, reached the record level of R1,766 million in September.

Substantial Inflow of Private Capital

The deterioration in the current account during the third quarter did not affect the country's gold and foreign exchange reserves by as much as it might have done, since it coincided with an important improvement on private capital account. Compared with net private capital



outflows (including errors and omissions in the balance of payments estimates) of R38 million and R23 million during the first and second quarters of 1964, respectively, a net inflow of R45 million of such funds was registered during the third quarter.

One reason for this remarkable change was a decline in the net outflow of foreign funds through Stock Exchange transactions from a quarterly average of R21 million during 1963 and the first half of 1964 to only R2 million during the third quarter of 1964. This, in turn, was largely attributable to the reduction in and, after the first week in August, the complete cessation of allocations under the arbitrage scheme of exchange control relaxation. In addition, however, a fairly substantial inflow of both short and long-term funds occurred, partly in the form of funds raised abroad by new mining companies.

It is probably not entirely by chance that the first important quarterly deficit in the current account of the balance of payments for some time should have coincided with the first *net* quarterly private capital inflow registered for a number of years. Both these accounts appear to have been influenced by the continuing upswing in the internal economy. The less liquid position of the domestic money and capital markets, the higher turnovers and inventory levels of traders and the financial requirements of expanding mining and manufacturing industries are all factors which may have contributed to the reversal of the private capital outflow.

Small Net Outflow of Official and Banking Capital

Official and banking capital showed a small net outflow during the third quarter, namely of about R15 million, mainly in the form of short-term funds.

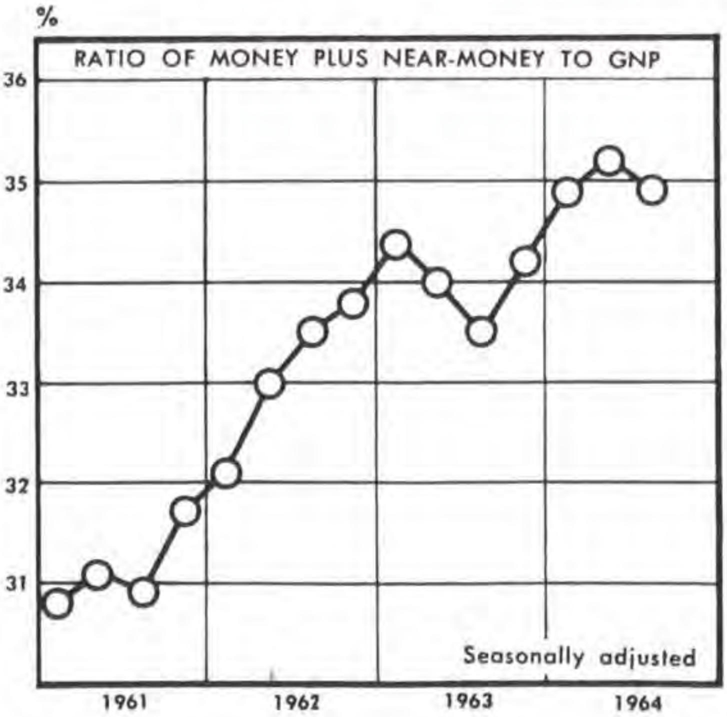
Decline in Gold and Foreign Exchange Reserves

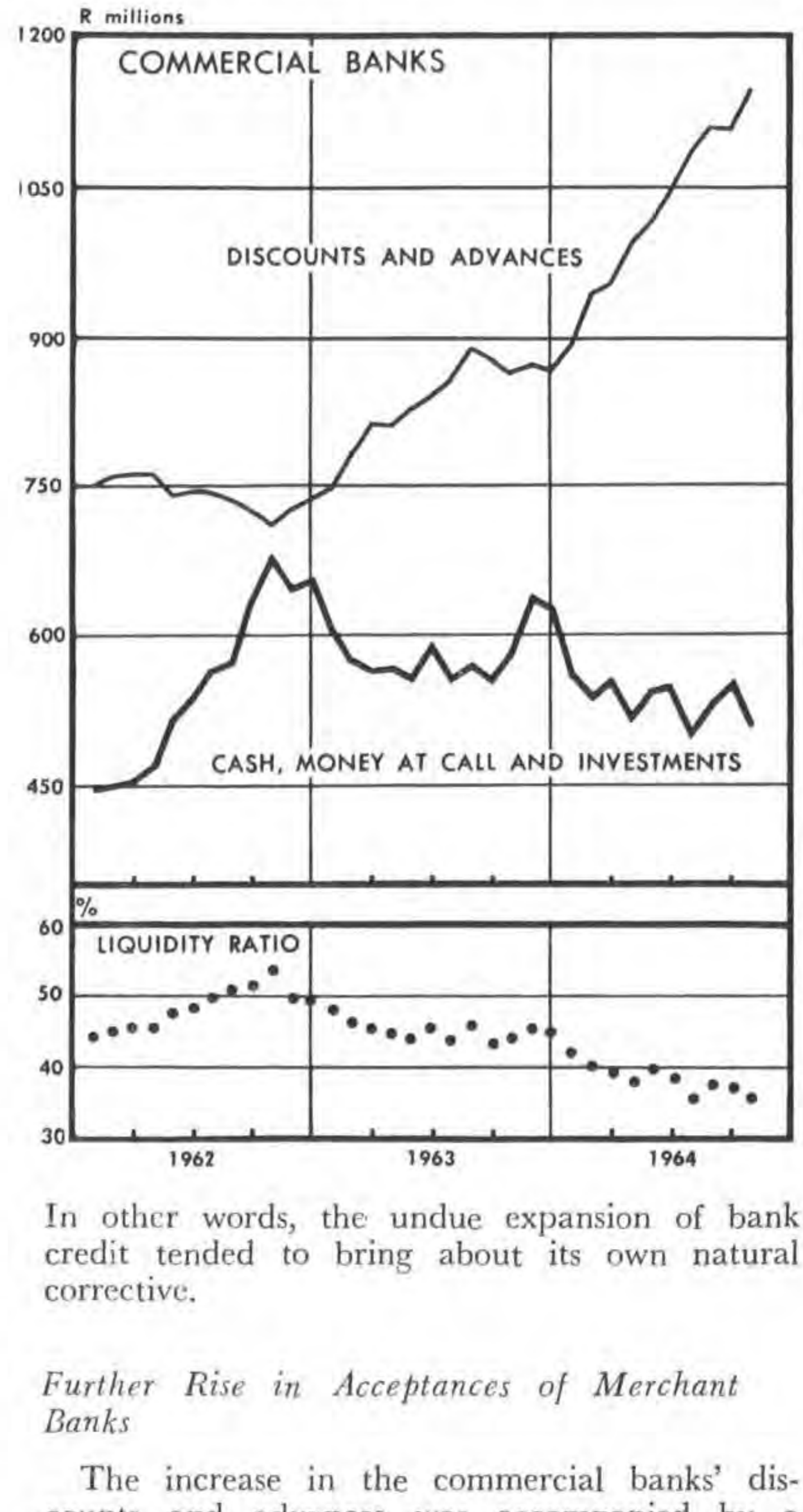
As a result of the various balance of payments changes referred to above, the total gold and foreign exchange reserves held by the Reserve Bank, the commercial banks and the Government declined further from R540 million at the end of June, 1964, to R503 million at the end of August, before rising again to R518 million at the end of September and R537 million at the end of October. This means that, despite the basic change in the current account position, the decline in the total reserves between the end of January, 1964, when a peak of R583 million was registered, and the end of October was only R46 million.

MONETARY AND BANKING SITUATION

Liquidity of Private Sector

The ratio of money and near-money to gross national product showed little change during the third quarter of 1964 and remained at approximately 35 per cent. This is an exceptionally high figure and indicates that the private sector as a whole was still in a highly liquid state during this period. The main reason for this was a further rise in credit extended to the private sector by the banking sector.





Decline in Rate of Increase of Commercial Banks' Discounts and Advances

The commercial banks' discounts and advances, which had already risen by as much as R209 million or nearly 25 per cent during the year ended June, 1964, increased by a further R95 million during the period July to October. There was, however, some slowing down of the rate of increase during this period, compared with the two preceding quarters. In contrast to the earlier expansion of commercial bank credit, which was mainly a natural corollary to the continuing upswing in general economic activity and played an important part in the raising of the real income of the country, this further increase would appear to have been excessive in the sense that it tended to facilitate the moderate "overheating" of the economy.

The slowing down of the rate of increase of commercial bank credit during recent months would appear to have been attributable, not to a reduction in the *demand* for such credit, but rather to the increasing difficulty experienced by the banks in meeting this demand owing to pressure on their own liquidity ratio. Thus, after having already declined from 44.4 per cent at the end of December, 1963, to 38.4 per cent by the middle of 1964, this ratio decreased further to 35.2 per cent at the end of October. This decline over the first three quarters of the year was mainly the joint result of the large increase in the banks' discounts and advances and a distinct downward tendency in their cash, money at call and investments, which, in turn, was largely attributable to the deficit in the overall balance of payments during this period. In other words, the undue expansion of bank credit tended to bring about its own natural corrective.

Further Rise in Acceptances of Merchant Banks

The increase in the commercial banks' discounts and advances was accompanied by a further rise in acceptance facilities extended to the private sector by merchant banks, namely from R108 million at the end of June, 1964, to R119 million at the end of October.

Decline in Call Money

Total call money held with the National Finance Corporation and the discount houses, which had fluctuated between R260 million and R290 million during the first half of the year, declined to R246 million in October. Of this total, R16 million represented funds of the Government and the Public Debt Commissioners, compared with R65 million at the end of March and R51 million at the end of August.

Although the discount houses' holdings of bankers' acceptances declined from a peak of R85 million in August to R75 million in October, their Treasury bills also decreased during this period, namely from R30 million to R21 million, so that the ratio between their holdings of bankers' acceptances and Treasury bills increased further to the relatively high figure of about 3½ to 1.

Reserve Bank

Despite the change in the underlying balance of payments position and the continued expansion of commercial and other bank credit, the Reserve Bank's total discounts, advances and investments showed no sharp or sustained upward movement during the period July to November and remained relatively low. In the circumstances, the Bank's legal gold reserve ratio declined only moderately, namely from 84.8 per cent at the end of June to 79.0 per cent at the end of November. Unlike that of the commercial and other banking institutions, the Reserve Bank's ability to create additional credit therefore remained considerable.

Further Upward Tendency in Short-term Interest Rates

Since the middle of the year, the Treasury bill tender rate and such related money market rates as the discount rate on bankers' acceptances and the call money rates of the National Finance Corporation and the discount houses, have shown a distinct further upward tendency. By the 11th December the Treasury bill rate had reached a level of 3.59 per cent, compared with the low point of 1.68 per cent reached early in November, 1963, i.e. about 13 months ago.

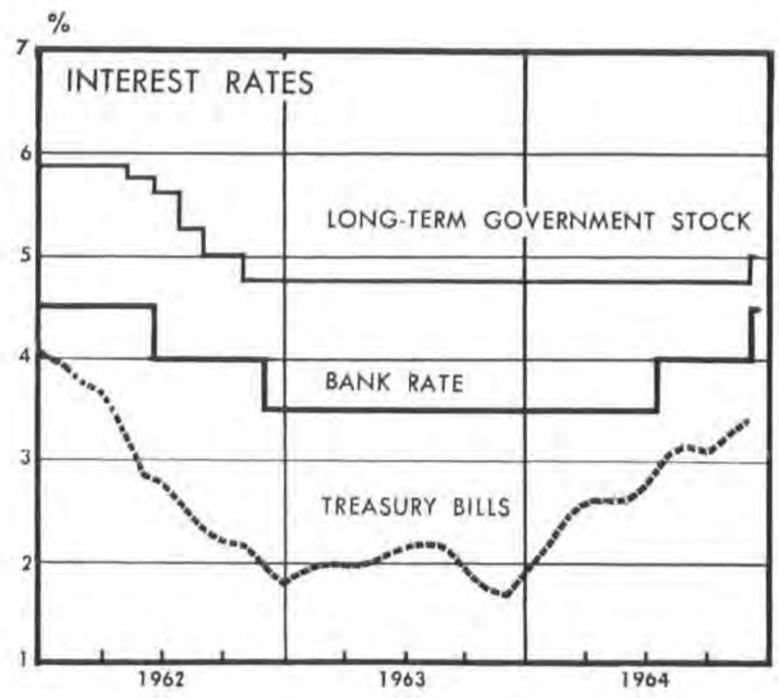
The increase in short-term rates since June may be attributed to the following factors, some of which operated only at certain stages during this period:

(1) A decline of some R30 million in the Reserve Bank's gold and foreign exchange reserves between the end of July and the first week in September, which was, however, followed by a moderate increase during the rest of September and October;

(2) a reduction in the amount of Government funds held with discount houses and commercial banks from R51 million at the end of August to R16 million at the end of November;

(3) the general expectation that money market conditions would tighten as a result of the changing balance of payments and general monetary and financial position; and

(4) two increases in Bank rate, namely from 3½ to 4 per cent on the 15th July, and from 4 to 4½ per cent on the 8th December.



Following the increase in Bank rate in December, the commercial banks increased their lending rates by ½ per cent. Several classes of banking institutions also made upward adjustments to their deposit rates during November and the first two weeks of December.

CAPITAL MARKET

New Increase in Share Prices

Important changes occurred in the security markets during the third quarter of 1964. Firstly, new issues of securities by local authorities, public corporations and the private sector amounted to only R66 million, compared with the peak of R112 million attained during the second quarter. Secondly, mainly as a result of the reduction in "arbitrage allocations", additions to the supply of scrip through purchases of South African securities by South African residents from foreigners, dwindled to a mere R2 million during the third quarter.

These developments, together with the actual and expected further economic upswing, helped to reverse the downward tendency in stock exchange turnover and share prices which had followed the attainment of peak levels in the second quarter of the year. The index (1953 = 100) of industrial and commercial share prices, for example, rose from 244 in July to 261 in October, which was not far below the peak figure of 268 registered in April of this year. The index of gold mining share prices, on the other hand, reacted more slowly and after declining from 123 in March to 112 in September, only increased to 117 in November.

In these circumstances, the average yield on industrial and commercial shares, which had risen from just less than 4 per cent in March to nearly 5 per cent in June, declined again to about 4½ per cent in September, while the average yield on gold mining shares, which had risen to well over 7 per cent during the third quarter, declined to 6.9 per cent in November.

Gilt-edged Market

In the gilt-edged market, conditions remained fairly stable during the period July to October. The Reserve Bank was not called upon to buy or sell Government stock to any notable extent and maintained its pattern of rates for such stock at the levels in operation since November, 1962. The margin between the yields on Government stock and those on newly issued municipal and public utility stock, which had risen to as much as 0.87 per cent in August, remained at this level during September and October, as was indicated by issues of municipal and public utility stock during these two months.

During November, however, upward pressure was again exerted on the rates for Government stock and on the 8th December, simultaneously with the raising of Bank Rate to 4½ per cent, the Reserve Bank increased its pattern of rates for such stock by ¼ per cent.

Substantial Inflow of New Funds to Building Societies

Following the increase in their deposit and lending rates in June, 1964, the building societies experienced a record inflow of new funds of as much as R89 million during the period July to October, of which R58 million took the form of fixed deposits and R16 million and R15 million represented share capital and savings deposits, respectively. This provided the societies with more than ample scope to meet the rising demand for buildings loans, as indicated by the fact that their mortgage advances and other loans increased by R48 million during this period, while their investments, cash and deposits increased by as much as R34 million.

Insurance Organisations

Insurance organisations invested only a net amount of R4 million in ordinary shares (excluding shares of subsidiary companies) during the third quarter, compared with R9 million during the preceding quarter. On the other hand, their investments in shares of subsidiary companies together with their loans (extended mainly to these subsidiaries) increased by as much as R15 million.

MONETARY POLICY

On the basis of its diagnosis that the total monetary demand for goods and services was rising somewhat rapidly in relation to the available supply and therefore exerting inflationary pressure on the economy, the Reserve Bank not only welcomed the natural tightening of the monetary and banking situation referred to earlier, but also applied certain measures to reinforce the operation of these and other self-regulating stabilising influences.

Round about the middle of 1964 it had seemed not unlikely that the rate of increase of monetary demand would slow down of its own accord. At that stage it was expected that the current account would show a substantial deficit during the second half of the year and that this would lead to a significant tightening of credit conditions and a sharp upward movement in interest rates. But while the current account deficit materialised as anticipated, its tightening effect on the monetary and banking situation was in large part offset by the substantial net inflow of private capital during the third quarter, as a result of which the liquidity of both the private sector and the banking system remained higher and interest rates lower than might otherwise have been the case. Since this tended to facilitate the inflationary tendency in the economy, the Reserve Bank deemed it desirable to take steps to curb the rate of increase of money and near-money and to raise the cost of credit.

These anti-inflationary measures included the exercise of further moral suasion over banking institutions, a more restrictive attitude towards rediscounting by the Bank, the withdrawal of Treasury funds from the money market and, finally, the increase in Bank Rate from 4 to 4½ per cent on the 8th December.[1]

1) The statement by the Governor of the Reserve Bank on the Bank Rate increase is reprinted on page xxiii of this issue.