Quarterly economic review

Main developments

The main short-term developments in the South African economy during the fourth quarter of 1965 and the first two months of 1966 were (1) a substantial decline in the deficit on the current account of the balance of payments, which appeared to be at least partly associated with a sharp decrease in inventory investment and a moderate decline in bank credit to the private sector, and (2) a considerable net inflow of both short and long-term foreign capital. In consequence, the total gold and foreign exchange reserves showed a marked recovery from the low point reached in September, 1965. At the same time, the real gross domestic product continued to rise and general economic activity and employment remained at a very high level. Indeed, from the point of view of economic stability, the aggregate monetary demand for goods and services still appeared to be too large rather than too small.

National accounts[1]

Real growth rates

According to the latest revised national accounts the annual growth rates for the real gross domestic product and the real gross national product during the period 1960 to 1965 were as follows:

Years	Percentage rate of increase	
	Real gross domestic product	Real gross national product
1960 to 1961	3·9	3·8
1961 to 1962	6·0	7·1
1962 to 1963	7·8	7·8
1963 to 1964	5·8	6·4
1964 to 1965	5·0	4·7

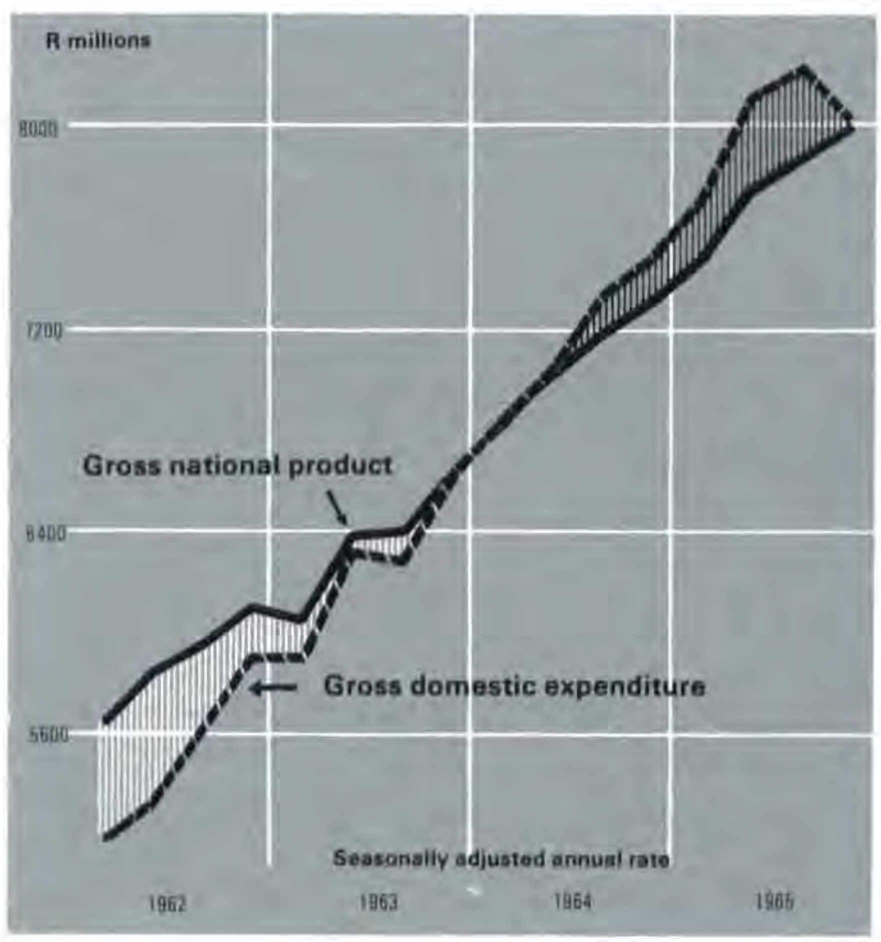
The rate of increase in the real gross domestic product of 5 per cent in 1965 is considerably higher than was expected and must be considered most satisfactory, particularly in view of the adverse effects on agriculture of the drought conditions which prevailed in large areas of the country during part of this period.

[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 figures are not yet judged reliable enough for publication, the analysis of quarterly developments is confined to pointing out broad tendencies.

Excessive rise in gross domestic expenditure followed by decline

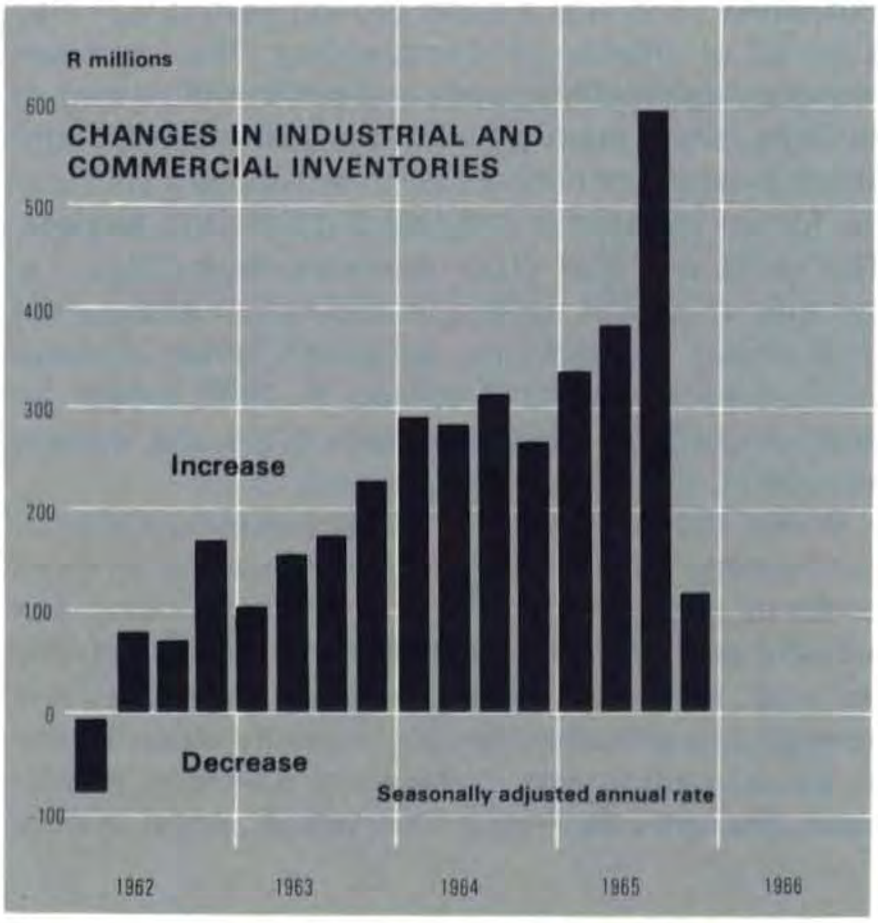
But while 1965 was a good growth year, it was also a period of inflationary overspending. The aggregate monetary demand for goods and services increased so strongly during the first half of the year that it brought about a degree of price inflation as well as a substantial further increase in imports of goods and services. The result was that gross domestic expenditure, i.e. the total of capital outlays, consumption and current government expenditure, exceeded gross national product by about R312 million in 1965, which by itself implied a substantial deficit on the current account of the balance of payments.

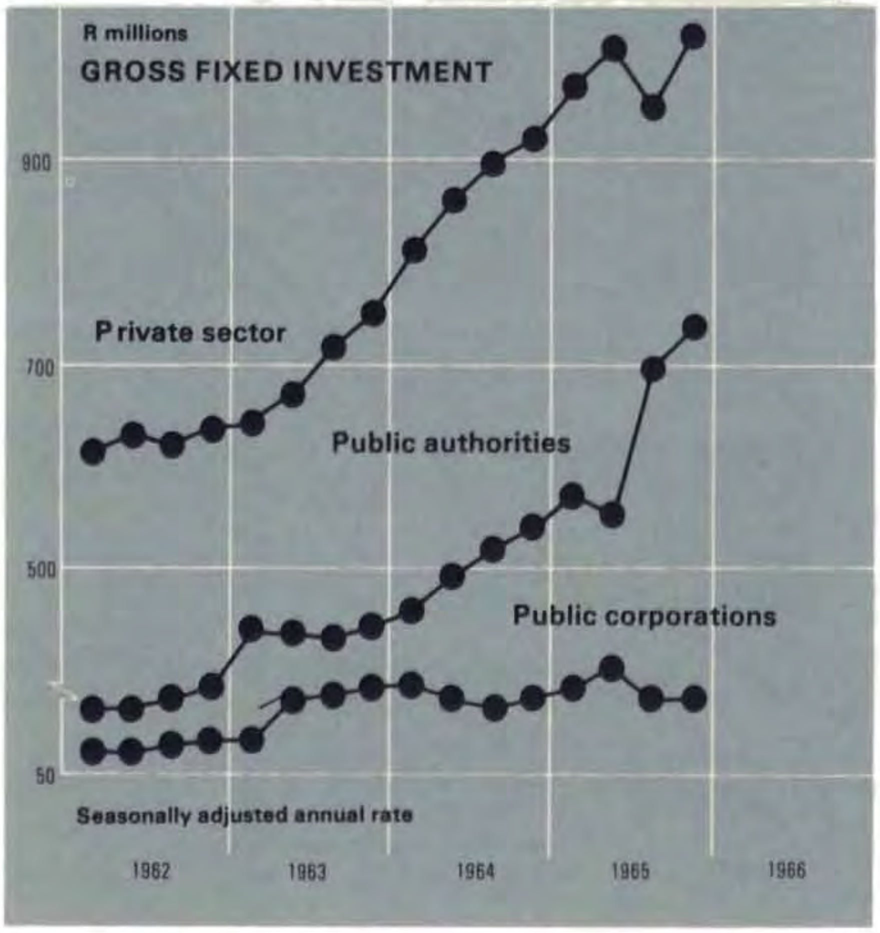
During the last quarter of 1965, however, a significant change for the better occurred in so far as gross domestic expenditure not only stopped rising but actually declined. This development, which naturally reduced the inflationary pressure on prices and imports, was almost entirely the result of a sharp decline in manufacturing and commercial inventory investment. The latter decline, in turn, would appear to have

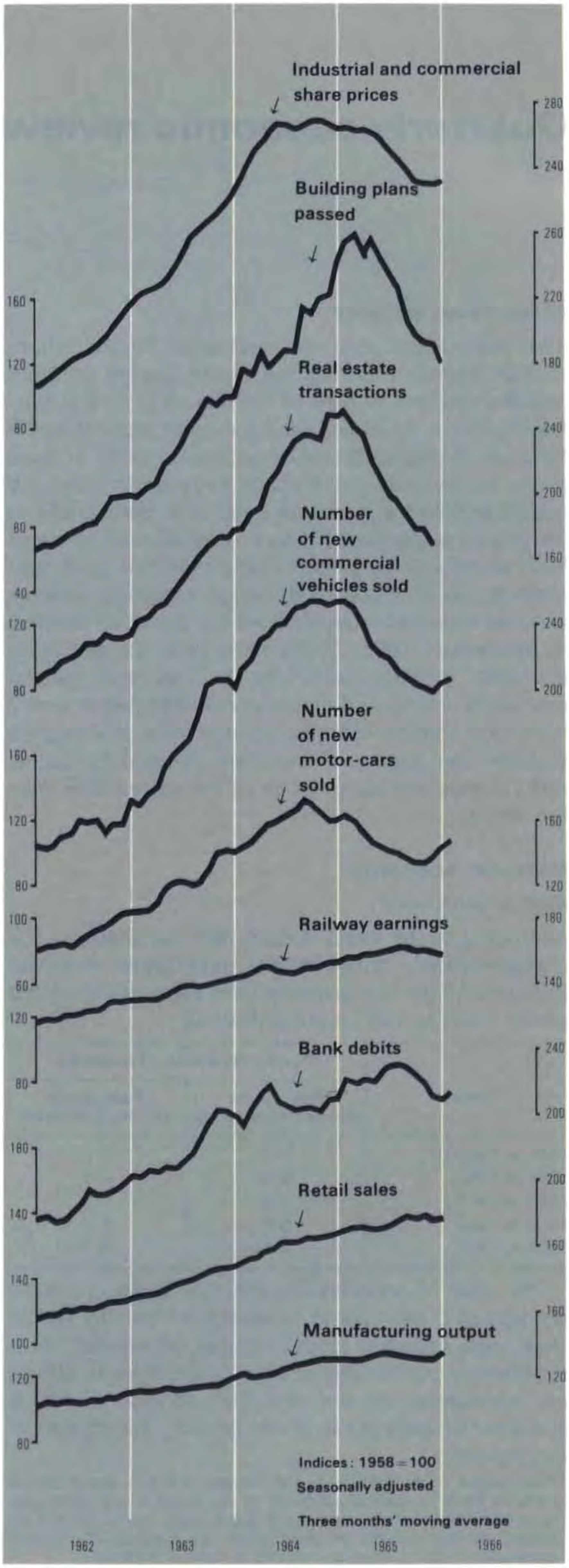


been attributable partly to the application of restrictive monetary measures and tighter import control, and partly to a natural reaction to the overstocking of the preceding quarters, when many business enterprises had still anticipated a further inflationary rise in monetary demand and a tightening of import control.

Apart from this decline in inventory investment, the underlying strength of aggregate monetary demand remained considerable during the fourth quarter, as indicated by the fact that fixed capital outlays by private enterprises continued at a very high level, while public fixed investment, private consumption and current government expenditure all increased further.







General economic indicators

The behaviour of various seasonally adjusted production and employment indices, as well as that of such other economic indicators as real estate transactions, building plans passed, retail sales, sales of motor vehicles, etc., likewise confirmed the impression that, although the cyclical economic upswing had clearly levelled off from about the middle of 1965, general economic activity still remained at a very high level. Sales of new motor cars, which had shown a downward tendency for about a year, even began to increase again from October onwards.

Prices

The seasonally adjusted index of consumer prices (1958=100) continued to rise during the period under review to a figure of 116·8 in February, 1966, compared with 112·8 a year earlier and 115·3 at the end of December, 1965. The sharper rise during January and February largely reflected an increase in food prices.

The seasonally adjusted wholesale price index (1958=100) behaved in a similar fashion, rising to 114·0 in February, compared with 110·2 a year earlier and 111·8 in December, 1965. This increase was again mainly the result of rising prices of agricultural, forestry and fishing products.

Balance of payments

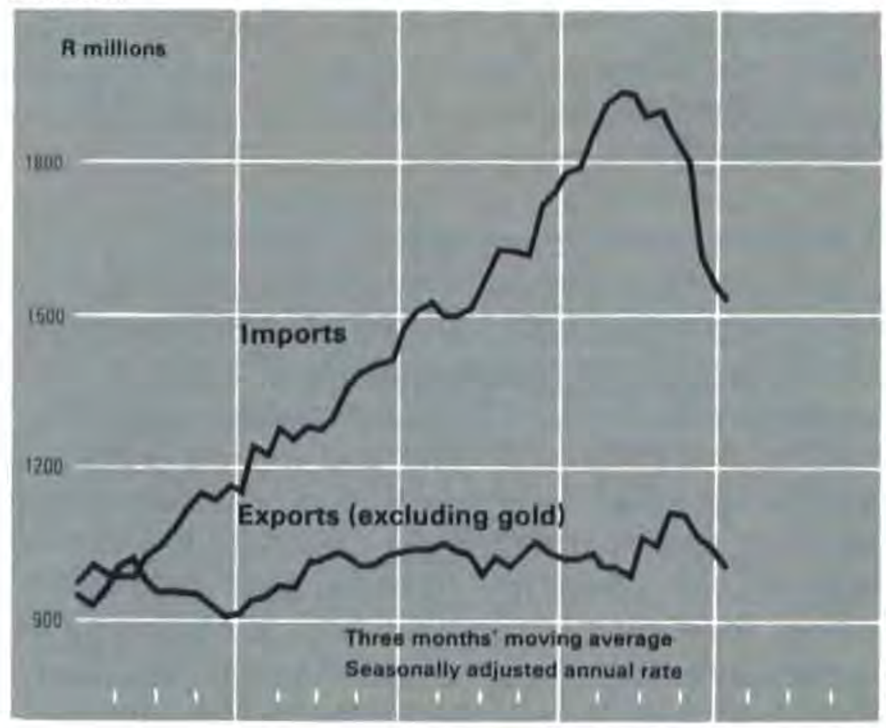
Declining tendency in imports

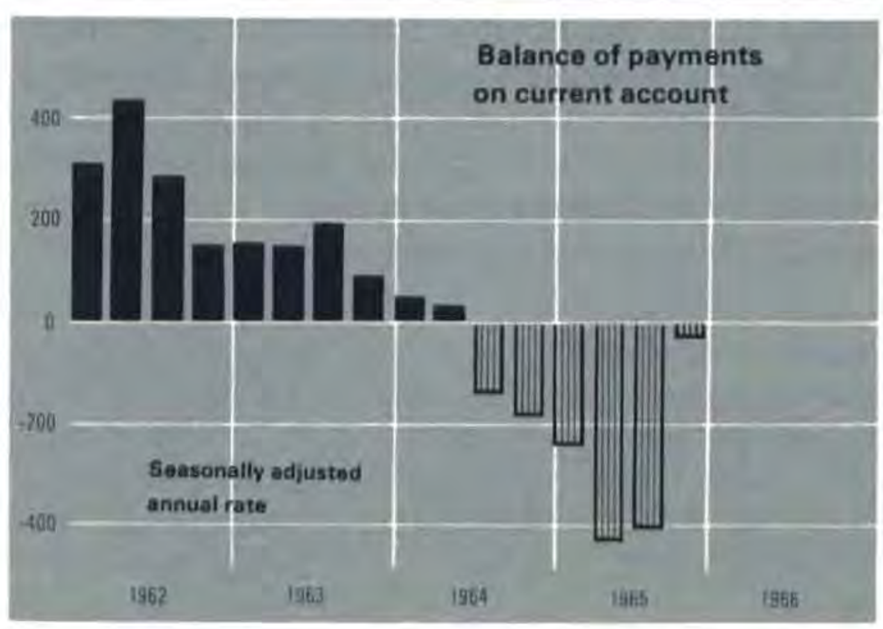
In accordance with the cyclical change referred to above, monthly figures for merchandise imports, after adjustment for seasonal influences, began to show a downward tendency from about the middle of 1965 and declined fairly sharply during the fourth quarter. If seasonal influences are eliminated, imports amounted to an annual rate of only R1,644 million during the final quarter, compared with R1,924 million in the third quarter. Although this downward tendency was particularly noticeable in the classes "manufactured goods" and "machinery and transport equipment", it occurred fairly generally.

The decline in imports was brought about partly by the tightening of import control announced in August, but was probably to a large extent attributable to the change in internal economic conditions which occurred from about the middle of the year, partly as a result of the restrictive monetary and fiscal measures, and which *inter alia* found expression in the decline in gross domestic expenditure referred to earlier. Experience has shown that imports in South Africa are highly sensitive to changes in aggregate monetary demand—a mere levelling-off or moderate decrease in total expenditure, after an excessive increase, is generally accompanied by a fairly sharp decline in imports.

Substantial decline in current deficit

Owing mainly to the downward movement in imports, the deficit on the balance of payments on current account, after adjustment for seasonal influences and taken at an annual rate, decreased from R424 million in the second quarter to R400 million in the third quarter and to only about R24 million in the fourth quarter. For the year as a whole it amounted to R271 million.





Substantial inflow of foreign capital

This improvement in the current account was accompanied, during the fourth quarter, by a net inflow of foreign capital of as much as R95 million, which brought the total net capital inflow for the year to the high figure of R235 million.

Private capital accounted for about R141 million of the latter amount. Although a considerable part of this inflow would appear to have consisted of short-term capital movements, including trade credits, there was also a substantial net inflow of long-term capital, probably of more than R60 million. In addition, due mainly to net drawings of R65 million on foreign loans by the Government and the Reserve Bank, the net inflow of central government and banking capital during 1965 amounted to R94 million.

Recovery of gold and foreign exchange reserves

The net result of the large current deficit and the substantial net inflow of capital was that the total gold and foreign exchange reserves held by the Reserve Bank, the rest of the monetary banking sector and the Government decreased by only R36 million during the year as a whole. The reserves actually decreased from R489 million at the end of 1964 to a month-end low point of R340 million at the end of September, 1965, before recovering to R453 million at the end of the year. Of the latter amount, R383 million was held by the Reserve Bank.

Developments during January and February

Despite a further decline in imports during January and February to a seasonally adjusted annual rate of below R1,600 million, the current account of the balance of payments still showed a small deficit during these two months. Since the total gold and foreign exchange reserves increased by about R16 million during this period to approximately R469 million at the end of February, of which the Reserve Bank held R435 million, there must again have been a net inflow of foreign capital, although the rate of inflow was clearly much less than during the fourth quarter of 1965. During March the Reserve Bank's gold and foreign exchange holdings increased by a further R15 million to R450 million.

Monetary and banking situation

Increase in money and near-money during fourth quarter

Despite a marked decline in the outstanding amount of credit extended by the monetary banking sector to the private sector, the total amount of money and near-money held by the private sector increased by as much as R202 million between September and December, 1965. This increase reflected mainly (1) the large rise in the gold and foreign exchange reserves during this quarter, (2) a considerable increase in the *net*[2] claims of the monetary banking sector on the Government, mainly in the form of increased holdings of Treasury bills and government stock, and (3) a further shift from long to short and medium-term deposits with monetary banking institutions. The result was that, notwithstanding the credit squeeze, the private sector as a whole remained in a relatively liquid state and potentially capable of substantially increasing its consumption and investment expenditures.

Decline in bank credit to private sector

Virtually all the banks included in the monetary banking sector showed a decline in their credit to the private sector during the period October, 1965, to February, 1966. The commercial banks' discounts and advances, for example, changed as follows during the four quarters of 1965 and the first two months of 1966:

Changes in discounts and advances of commercial banks

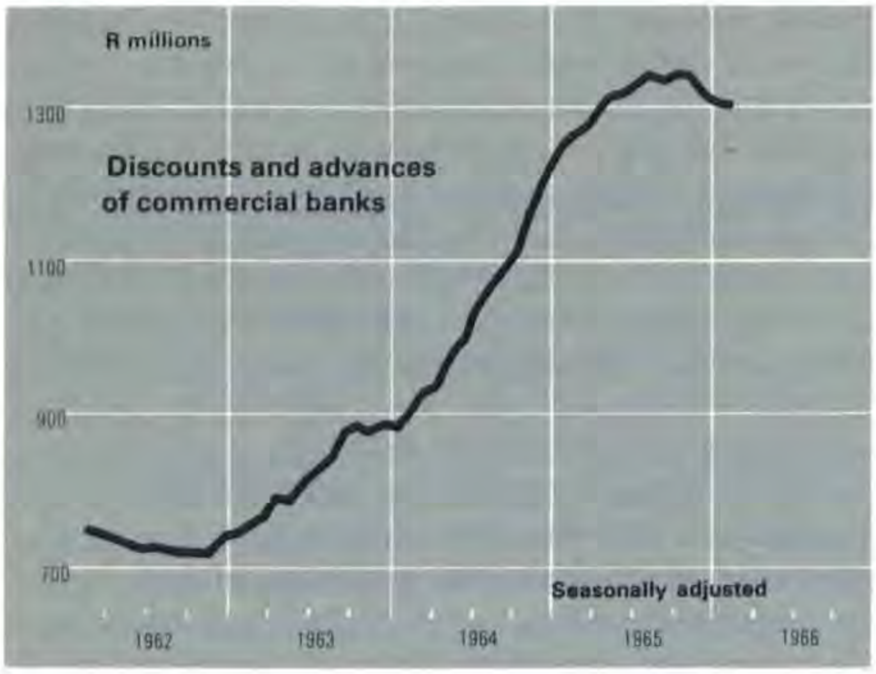
R millions

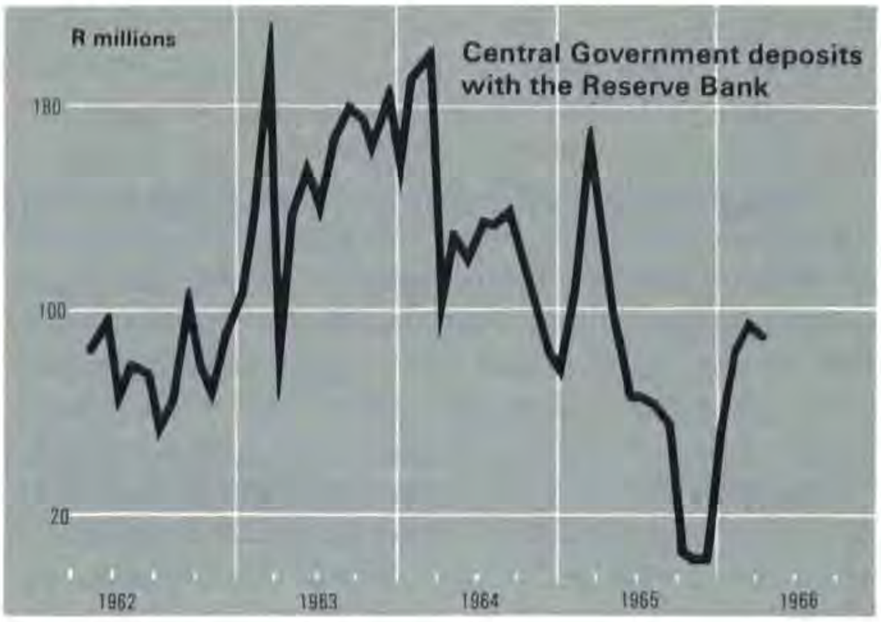
Period	Total discounts and advances, excluding Land Bank	Advances to Land Bank	Total discounts and advances	Total discounts and advances, seasonally adjusted
1965—1st quarter	+94·3	+ 1·9	+96·2	+58·6
—2nd quarter	+31·1	+12·8	+43·9	+37·0
—3rd quarter	−18·6	+ 2·7	−15·9	+12·2
—4th quarter	−57·3	+ 0·1	−57·2	−40·5
1966—January	+ 2·0	+ 4·7	+ 6·7	− 1·2
—February	−14·4	− 0·7	−15·1	−44·8

The decline in commercial bank credit to the private sector from about the middle of 1965 was probably largely the result of the restrictive monetary policy applied by the authorities, which, in addition to increased minimum liquidity ratios, included a specific request to all monetary banking institutions on the 29th October to ensure that the total of their discounts, loans and advances to the private sector, excluding the Land Bank, as at the 31st March, 1966, did not exceed the aggregate of these items as at the 31st March, 1965. By the end of February, 1966, the "controlled credit" of the commercial banks as a group was some R57 million below the permissible level of the previous March.

Credit extended to the private sector by monetary hire-purchase and general banks, which had already tended to level off from about April, 1965, declined by R29 million during the fourth quarter to R380 million at the end of the year, which was about R22 million below the level of the previous March.

[2] i.e. after taking into account changes in government deposits with the monetary banking sector.





The "controlled credit" of merchant banks, on the other hand, increased against the general trend by R10 million between the end of September, 1965, and the end of January, 1966. Merchant bank acceptance facilities utilised (excluding their holdings of their own acceptances) showed little change during this period.

Finally, as a result of the improvement in the balance of payments and the changes in the monetary and banking situation referred to above, the Reserve Bank experienced a decline in the calls made upon it for financial accommodation and succeeded in reducing its discounts, advances and investments from R212 million at the end of September, 1965, to R152 million at the end of February. Of this decline of R60 million, a decrease in Land Bank bills accounted for R37 million, while loans to the money market declined by R17 million.

Government finance

After declining from R202 million at the end of February, 1965, to R2 million at the end of November, the Government's balances on the Exchequer and Paymaster-General Accounts increased to R95 million at the end of February, 1966, and then only declined to R90 million at the end of March. The improvement between November and the end of February was largely attributable to seasonal changes in Exchequer issues and receipts (other than borrowing), but also resulted from increased net borrowing through issues of Treasury bills and government stock, a substantial part of which was taken up by monetary banking institutions.

Of a government loan stock of R77 million falling due for redemption on the 15th February, R6 million was converted into 6 per cent 25-year stock and R53 million into 5 per cent 3-year stock, the balance of R18 million being repaid in cash. In addition, new subscriptions to these loans amounted to R70 million, namely R42 million in the case of the 3-year stock (to which the Public Debt Commissioners contributed only R4 million) and R28 million in the case of the 25-year stock (to which the Public Debt Commissioners contributed R6 million).

Capital market

Increase in share prices

Capital market conditions in general remained tight throughout the period October, 1965, to February, 1966, which under the circumstances had a desirable stabilising effect on the economy. The underlying buoyancy and optimism in the economy was such, however, that the prices of all the major classes of shares, after reaching a low point round about the middle of the second half of 1965, recovered to a considerable extent, as indicated in the following table:

Share price indices (1958=100)

Type of share	Lowest figure for 1965		February, 1966
	Month	Index	
Gold-mining	November	136	143
Coal-mining	September	116	122
Financial:			
Mining houses	November	184	190
Other mining	October	195	210
Industrial	September	208	223
Industrial and commercial	September	224	238

The average yield on gold-mining shares fluctuated around the level of 8·76 per cent attained in November, 1965, while that on industrial and commercial shares declined under the impact of rising prices to 5·88 per cent in December, after having for the first time in three years exceeded 6 per cent in August, 1965.

Building societies under pressure

The building societies continued to feel the effects of the tight capital market conditions. During the three months December to February, owing partly to seasonal factors, they experienced a net inflow of new funds of only R8 million, compared with an average quarterly figure of R21 million during 1965. This naturally limited their scope for lending, and their mortgage and other loans outstanding increased by only R14 million during this period, as against a quarterly average of R35 million during 1965.

At the end of 1965, when the societies had to meet the new statutory requirements in respect of liquid assets and prescribed investments for the first time, their *excess* liquid assets and prescribed investments amounted to R8 million and R83 million, respectively. By the end of February, these excess amounts had increased to R26 million and R92 million, respectively.

Monetary policy

Although aware of the fact that the various restrictive monetary and fiscal measures applied earlier had, in conjunction with the operation of natural economic forces, considerably reduced the inflationary over-spending in the economy, the monetary authorities remained of the opinion that the required "cooling-off" of the economy had not yet proceeded far enough to permit of a significant relaxation of these measures. It was true that the gold and foreign exchange reserves had increased substantially since September, 1965, but, as mentioned earlier, this was the result, not of a surplus on current account, but mainly of an inflow of capital, a large part of which represented short-term funds. And while this inflow performed a useful bridging function, it did not, of course, solve the underlying problem of general overspending. The authorities felt, therefore, that before the restrictive policy could be significantly relaxed there would have to be stronger indications of a reduction in the inflationary pressure on prices and a considerable further improvement in the balance of payments on current account. The need to transform the current payments deficit into a surplus, for at least a period, clearly still required a considerable degree of discipline over expenditure in both the private and public sectors.

Moreover, as pointed out earlier, the facts that the cyclical economic upswing had levelled off from about the middle of 1965, and that certain economic indicators had actually declined from their peak levels, did not mean that aggregate monetary demand had become insufficient. On the contrary, if seasonal movements are eliminated, the balance of payments on current account up to the end of February still showed a small deficit, while internal economic conditions continued to be characterised not only by full employment of labour and other factors of production but also by some measure of inflation. Account also had to be taken of such potential inflationary factors as the recent salary increases in the public service and the increase in private sector liquidity during the last quarter of 1965 as a result mainly of the capital inflow and the increase in net credit extended by the monetary banking sector to the Government.

In view of all these considerations, the Reserve Bank's credit directive to monetary banking institutions was extended for a further six months to the 30th September, 1966, with some modification. The monetary banks were, namely, allowed to increase their credit to the private sector during this period by an amount not exceeding $2\frac{1}{2}$ per cent of the amount of such credit outstanding at the 31st March, 1965, on condition that such additional credit was made available only directly to genuine farmers for essential living and farming requirements, or to persons and concerns engaged in supplying these requirements directly to the farmer or in purchasing farm produce directly from the farmer.