SOUTH AFRICAN RESERVE BANK

ANNUAL ECONOMIC REPORT

1964

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A Review of Economic and Financial Conditions in the Republic of South Africa to be presented to Stockholders at the Forty-fourth Ordinary General Meeting to be held on 19th August, 1964.

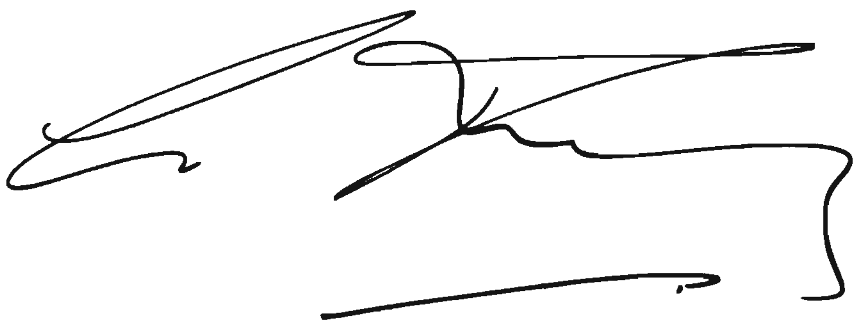
HIERDIE VERSLAG IS OOK IN AFRIKAANS BESKIKBAAR

PREFACE

This is the Fourth Annual Economic Report that has been issued by the Bank, and aims at providing a factual and relatively detailed description and analysis of the various basic trends and developments in the economy of the Republic during the past year.

The information which, it is hoped, will prove to have been presented in a readily assimilable form, necessarily has some bearing upon likely developments in the near future as well, and provides the essential background to the comments on current and prospective conditions which I shall make at the Annual General Meeting of Stockholders on 19th August.

GERARD RISSIK, Governor, South African Reserve Bank. August, 1964



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THE SOUTH AFRICAN ECONOMY IN 1963/64
A SUMMARY

During the year ended June, 1964, the economic upswing in South Africa received fresh impetus from a substantial increase in fixed capital outlays in both the private and public sectors. At the same time, private consumer spending continued to rise, although its rate of increase declined after the third quarter of 1963. Current Government outlays and inventory investment again increased considerably, but merchandise exports fluctuated around a horizontal level, while the gold output increased only moderately.

These increases brought the economy to a position of virtually full employment and created or aggravated certain labour and other "bottlenecks" which, in turn, gave rise to demand induced price and wage increases in certain sections of the economy. At no stage, however, did a situation of **general** inflationary overspending develop, and the price level showed only a moderate rise. Factors which contributed to this high degree of internal stability were substantial increases in imports and local production, the slowing down in the rate of increase of consumption, certain stabilising forces of a self-regulating nature in the monetary and financial field, and a conservative fiscal and monetary policy.

Once the slack in the economy had been more or less taken up, the rate of increase of the real gross national product understandably declined. It nevertheless attained the relatively high annual figure of about 6 per cent during the first half of 1964.

In the existing circumstances, the balance of payments on current account remained surprisingly strong. Despite the substantial further rise in imports, it showed only a negligible deficit during the first half of 1964. Moreover, if seasonal movements are excluded, there would appear to have been a small surplus during this period. The capital account, on the other hand, remained unfavourable, so that the total gold and foreign exchange reserves declined moderately between January and June, 1964.

Largely as a result of a substantial increase in commercial and other bank credit, the supply of money and near-money more than kept pace with the rise in gross national product. But since this increase in bank credit was accompanied by a slight decline in the Reserve Bank's gold and foreign exchange reserves, it brought about a significant reduction in the liquidity ratios of banking institutions and, therefore, in their ability to create further credit. For these and various other reasons, the Treasury bill and related money market rates, as well as the most important deposit and lending rates of banking institutions and building societies, moved upwards towards the end of the period under review.

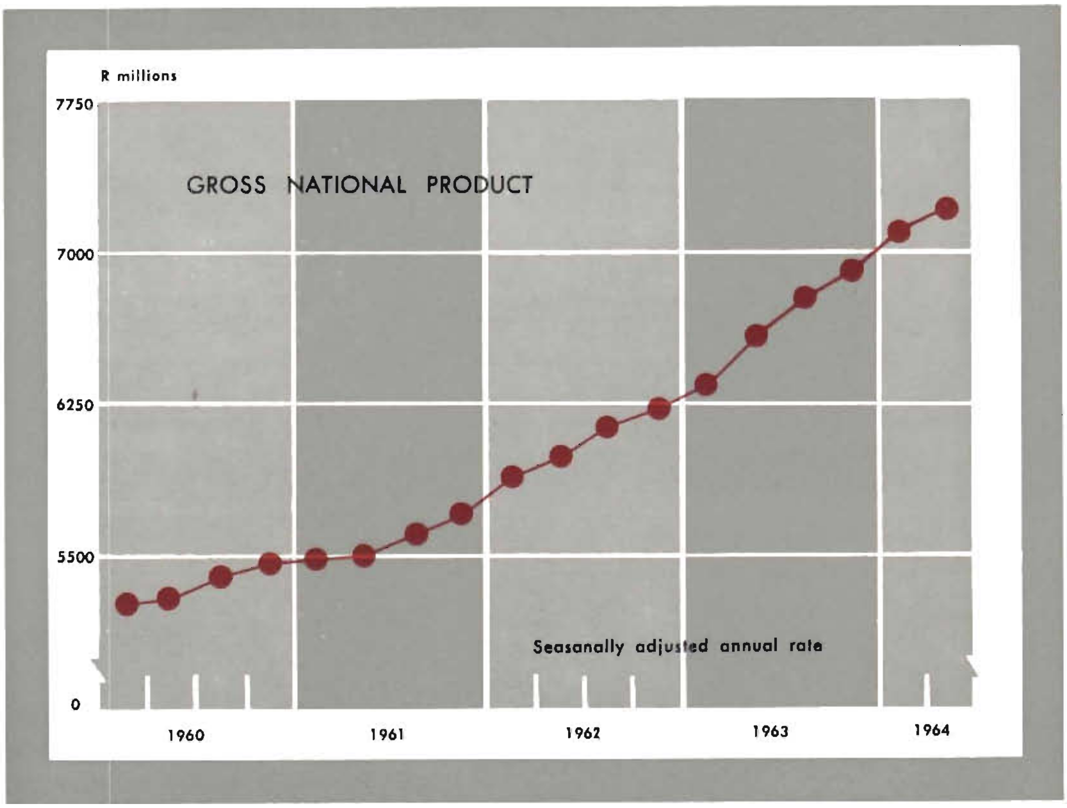
In the capital market the relationship between supply and demand became more normal during the course of the year, **inter alia** owing to the substantial rise in new issues which accompanied the continued economic expansion. During the second quarter of 1964 stock exchange turnover and security prices declined noticeably.

As economic conditions changed, the emphasis in monetary and fiscal policy gradually shifted from stimulation of the economic upswing to the maintenance of stability and in July, 1964, Bank rate was raised from 3½ to 4 per cent.

INTERNAL ECONOMIC CONDITIONS

Continued Economic Upswing with Both Internal and External Stability

From an economic and financial point of view, the year ended June, 1964, was one of the best ever experienced in South Africa. As expected, the economic upswing continued into its third year and before the end of 1963 brought the economy to a position of virtually full employment of human and other resources. Since the total demand for goods and services showed every sign of continuing to increase and as the monetary and banking situation was exceptionally liquid at the time, this naturally raised the possibility of general demand inflation and even of balance of payments difficulties. But while certain labour and other bottlenecks either emerged or became more serious and were accompanied by demand induced price or wage increases in certain sections of the economy, there was no significant diffusion of these inflationary tendencies and at no stage did the situation develop into one of *general* inflationary overspending. Similarly, while the surplus on the current account of the balance of payments in the circumstances declined substantially, the gold and foreign exchange reserves remained at a relatively high level and the balance of payments position did not give rise to concern. Indeed, the outstanding feature of the South African economic scene during the past twelve months was the way in which the economy, once it had reached the full employment "ceiling", succeeded in adjusting to the new conditions and in combining further rapid growth with a considerable degree of both internal economic stability and balance of payments equilibrium.



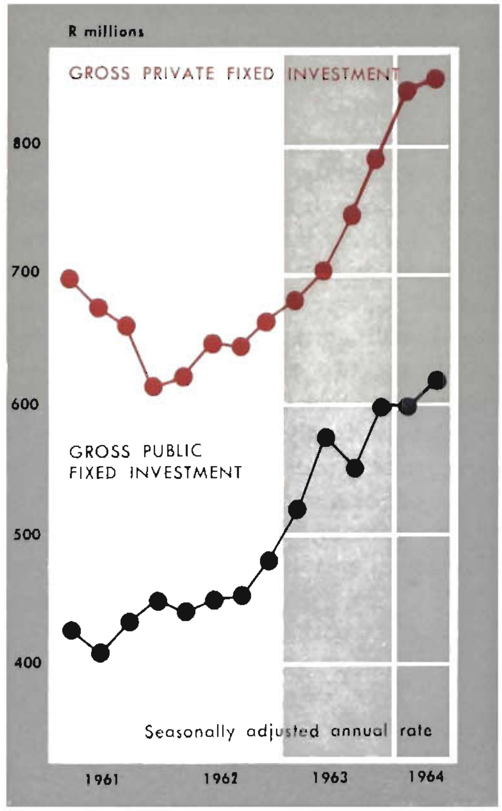
Further Rise in Gross National Product

Once the slack in the economy had been taken up, the *real* gross national product understandably could not continue to increase at the abnormally high annual rate of about 12 per cent attained during the second and third quarters of 1963, but nevertheless succeeded in advancing further during the last quarter of 1963 and the first half of 1964 at the still relatively high annual rate of about 6 per cent. This means that the real income per head of the population increased during these three quarters at a rate of about $3\frac{1}{2}$ per cent per year, which under full employment conditions must be considered extremely satisfactory.

For the year ended June, 1964, as a whole, the gross national product is provisionally estimated at about R7,000 million, compared with R6,330 million during the previous year. This represents an increase of $10\frac{1}{2}$ per cent at current prices and about 8 per cent if allowance is made for price increases.

Pronounced Increase in Fixed Investment

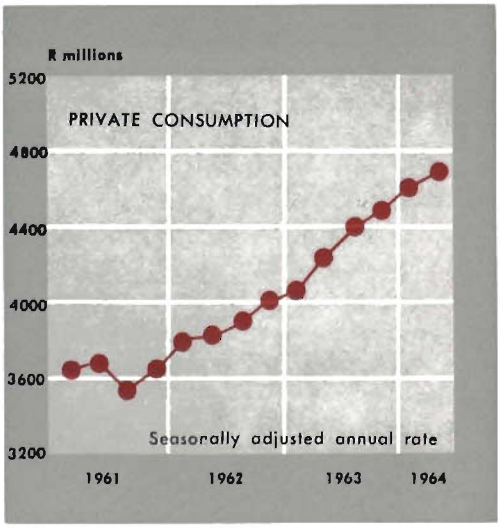
The main reason for the further increase in gross national product during the course of 1963/64 was a sharp upward movement in capital outlays on plant, equipment and construction in both the private and public sectors. This increase in fixed investment came at an opportune moment. Initially the upswing had derived its impetus from an increase in merchandise exports, gold output and current Government expenditure, and then, during 1962/63, from a strong recovery in private consumption; private fixed investment had somewhat disappointingly remained reluctant to rise, while public fixed investment had increased only moderately. Since consumer outlays could not be expected to continue playing the role of prime expansionary factor indefinitely, and as merchandise exports and gold output taken together were no longer rising significantly, the tempo of economic development after about the middle of 1963 depended to a large extent on the behaviour of fixed capital outlays. It was, therefore, gratifying that the long awaited upsurge in private fixed investment occurred more or less at that particular juncture, just when it was most needed. And when it finally began to make its expansionary influence felt, it did so with considerable vigour.



For the year ended June,1964, gross private fixed investment as a whole amounted to about R800 million, which represented an increase of no less than 19 per cent over the figure for the previous year. Agriculture contributed little to this upward movement, but expenditure on residential building and outlays by both manufacturing and commercial enterprises on plant, equipment and construction increased strongly. Even mining investment, which had shown a declining tendency since the middle of 1961, recovered to some extent after the middle of 1963.

Fixed investment by the Government and other public authorities (excluding public corporations) increased by about 12 per cent to a figure of R460 million for the year 1963/64, the main contribution coming from the South African Railways and Harbours. In addition, fixed capital outlays by public corporations rose by 39 per cent to R132 million, as the projects announced at an earlier stage came increasingly to be implemented.

The result was that *total* fixed investment increased by as much as R210 million or 18 per cent between 1962/63 and 1963/64, and during the latter period amounted to R1,390 million, which constituted 20 per cent of the gross national product, compared with an average of 18½ per cent during the two preceding years. The importance of this upward movement in investment not only for the continuation of the current expansion phase of the business cycle but also for the longer term growth of the economy, hardly needs to be emphasised.



Further Rise in Private Consumption and Current Expenditure by Public Authorities

Partly as a result of the secondary stimulating effects of the increase in investment, private consumption continued to rise during the past year, although its rate of increase declined noticeably after the third quarter of 1963. For the year ended 30th June, 1964, it reached a level of about R4,500 million, which exceeded that of the previous year by R430 million or approximately 11 per cent.

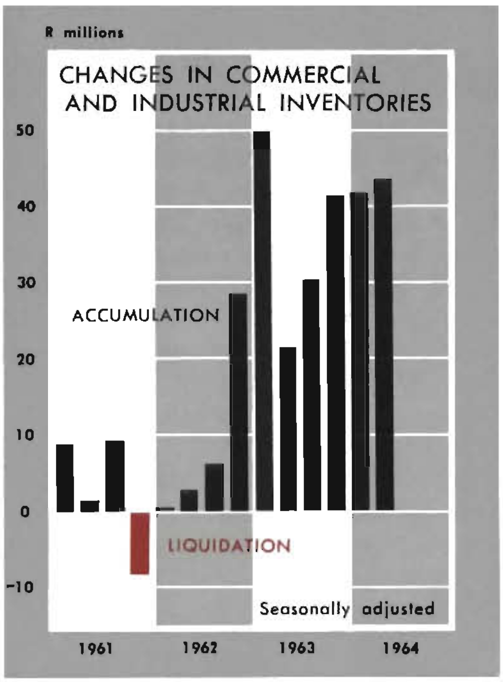
As during the previous year, this increase occurred mainly in the field of durable consumer goods. Expenditure on motor cars, for example, which had already risen by about 34 per cent during 1962/63, increased by a further 35 per cent during the

year ended June, 1964, while outlays on "furniture, furnishings and household equipment" rose by about 10 per cent.

The expansionary effect of private consumption was further reinforced by a continuation of the marked upward tendency in the current expenditure of the Government and other public authorities. This component of total spending increased by a further R137 million or 17 per cent, compared with 15 per cent during the previous year.

The increases in fixed investment, private consumption and current Government outlays during the past year were accompanied by an increase of R136 million in total stocks of goods, mainly owing to a substantial further increase in commercial and industrial inventories.

Continued Accumulation of Inventories



Little Expansionary Influence Exerted by Merchandise Exports and Gold Output

Merchandise exports did not reveal any further upward tendency during 1963/64, but fluctuated around a more or less horizontal level, while the gold output increased at a considerably lower rate than during the preceding years. The expansion of general economic activity during this period was therefore not, as often in the past, attributable in large measure to increases in these important components of total spending on the domestic product, but was almost entirely the result of higher domestic current and capital outlays. In other words, the further economic upswing of the past year was not "imported", but largely of domestic origin.

Increase in Total Saving

In view of the changes in the pattern of total spending, particularly the substantial further rise in private consumption, personal saving declined quite considerably during the past year. But this decline was more than offset by an increase in company saving (retained profits) and the more or less automatic rise in depreciation allowances as a result of the increase in the stock of capital goods. Since public "saving", i.e. the current surplus of the Government and other public authorities, remained at more or less the same relatively high level reached during the previous year, the net final result was an increase in gross domestic saving.

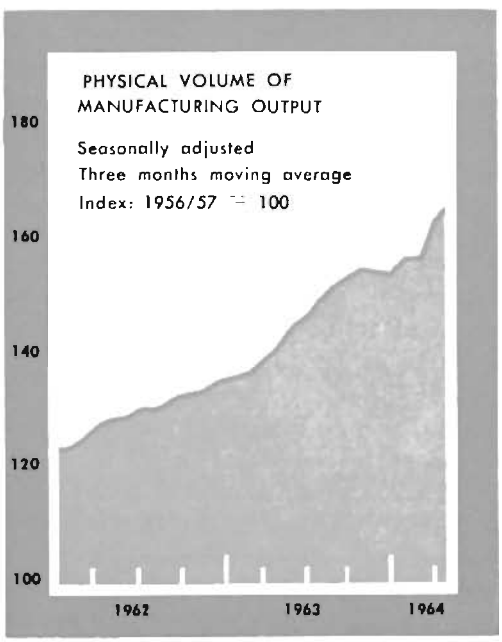
Further Expansion in Income Generated by Manufacturing, Commerce, Mining and Transport

With the notable exception of agriculture, all the main sectors of the South African economy contributed to and shared in the increased prosperity of the year ended June, 1964. The income generated by manufacturing and commerce, for example, increased by as much as 19 and 15 per cent respectively, while the income from gold mining rose by 3 per cent and that from other forms of mining by 17 per cent. The contribution of transport increased by roughly 9 per cent.

Mainly as a result of unfavourable climatic conditions, important sections of agriculture did not have a good year and the contribution of this sector as a whole to the domestic product actually declined by about $4\frac{1}{2}$ per cent, compared with an increase of nearly 6 per cent during the previous year.

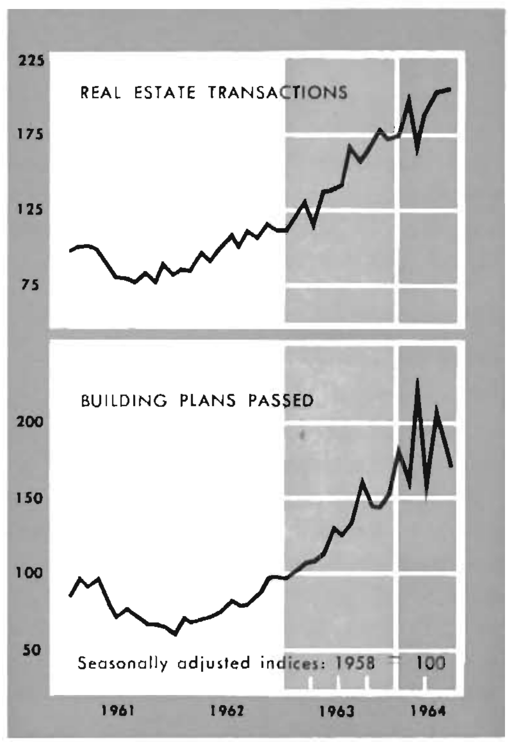
Continued Rise in Manufacturing Output

As the economy reached a state of virtually full employment towards the end of 1963, the seasonally adjusted index of the physical volume of manufacturing output, which had risen sharply during 1962 and the first three quarters of 1963, tended to level off. During the first half of 1964, however, it resumed an upward movement and during the twelve months ended June, 1964, was on average about 16 per cent higher than during the previous year. The branches of secondary industry responsible for the largest contributions to this increase were those producing metal products, basic metals, non-metallic mineral products, products of petroleum and coal, chemicals and chemical products, and electrical machinery.



Further Increase in Building Plans and Real Estate Transactions

A further feature of the economic expansion of the past year was the continued upward movement to new record levels in building plans passed and real estate transactions.



Labour Bottlenecks

In the prevailing circumstances, the seasonally adjusted index of registered unemployment, which applies to all race groups except the Bantu (for whom satisfactory statistics are not yet available), understandably continued to decline. At the end of June, 1964, the number of registered unemployed amounted to only about 15,400, which is less than 1 per cent of the labour force comprising the relevant groups and therefore, by international standards, exceptionally low.

Indeed, in the labour field it was not unemployment which constituted a problem during the past year, but rather the opposite, namely an insufficient supply of certain classes of skilled manpower. Such shortages were evident, for example, in the building, iron and steel, general engineering and motor industries, and these bottlenecks not only prevented total production and income from increasing even more rapidly than they actually did but, as the year progressed, also gave rise to a certain amount of inflationary pressure in the branches of industry concerned.

Reasons Why Inflationary Pressures Remained Limited

Despite the strong expansionary influences at work in the economy, both the wholesale and consumer price indices (1958 = 100) increased only moderately during the course of the past year. The former moved up from 104.9 in June, 1963, to 106.7 in June, 1964, while the latter changed from 107.0 to 109.5. Moreover, the latter increase was mainly the result of a rise in food prices, which was particularly noticeable during March and April.

The fact that the economy could thus pass through the third year of the current expansion phase of the business cycle and absorb the substantial increases in fixed investment, private consumption and current Government expenditure referred to above, without experiencing more than a modest increase in the price level, requires explanation. As mentioned earlier, the stage appeared to be set for general demand inflation as far back as the last quarter of 1963. Some observers even held the opinion that an increase of 3 to 5 per cent in the price level would be the inevitable price which would have to be paid for the sustained expansion in the economy. The main reasons why an increase in the price level of this magnitude did not occur, would appear to be the following:

(1) The scope which existed in the balance of payments allowed a considerable amount of potential inflationary steam to escape through the "safety valve" of imports. After having already risen by 24 per cent during 1963, seasonally adjusted imports, taken at an annual rate, increased by a further 13 per cent during the first half of 1964. This not only served to augment the supply of consumer and capital goods, as well as raw materials, but, through increasing competition from abroad, also promoted efficiency and helped to prevent costs from rising unduly in South African industries. Although this pronounced upward movement in imports was probably largely the natural result of the increase in internal economic activity, much of the credit for the efficient use of this "safety valve" is due to the policy of the import control authorities, who wisely relaxed their restrictions in good time and to a greater extent than is perhaps generally realised.

(2) Despite the various bottlenecks referred to above, production in general increased substantially in response to the rise in demand, even after the slack in the economy had been more or less taken up.

(3) From the side of demand, the economy was assisted in adjusting to the new conditions by the opportune decline in the rate of increase of private consumption which, as mentioned earlier, occurred more or less at the stage when the economy reached the "ceiling" of full employment during the last quarter of 1963.

(4) Although the Budget introduced by the Minister of Finance in March, 1963, had included certain expansionary measures and, in fact, would appear to have made an important contribution to the continued prosperity in the economy, the current surplus of the Government and other public authorities during 1963/64, as mentioned above, remained at the same relatively high level reached during the previous year, and this helped to prevent private sector spending from rising excessively. Moreover, as will be pointed out in more detail later on, the Minister in his 1964 Budget, as a matter of policy, refrained from reducing taxation generally or stimulating the economy in other ways which might be inflationary.

(5) In the monetary and financial field, as will be shown at greater length in a later section of this Report, important stabilising forces of a self-regulating nature came into operation towards the end of the year under review, while a gradual shift of emphasis in the direction of greater caution occurred in the official credit policy of the Reserve Bank. These changes helped to preserve a high degree of stability in the internal economy.

Surplus on Current Account Absorbed by Rising Imports

As was expected in view of the sustained increase in internal economic activity, the surplus on the current account of the balance of payments continued to decline during the course of the past year and eventually disappeared altogether. Thus, although the twelve months ended June, 1964, still yielded a current surplus of R79 million, an actual current deficit of R6 million was registered during the first half of 1964. If seasonal movements are excluded, however, there was still a small surplus during both the first and second quarters of 1964.

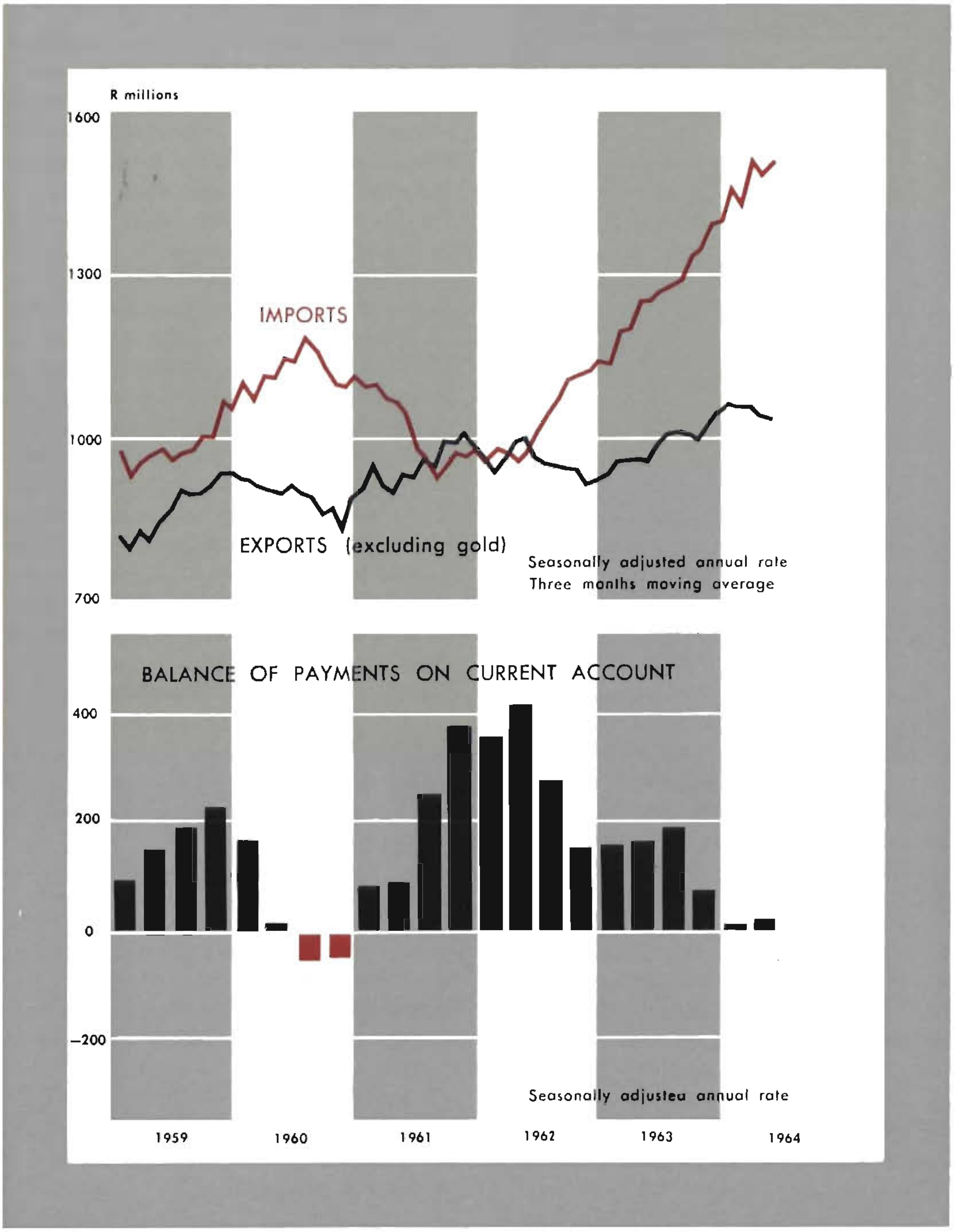
The main reason for this "deterioration" in the current account was the continued rise in imports referred to already, the major increases occurring in the categories chemicals, machinery and vehicles. This upward movement brought imports to a level of R1,416 million for the year ended June, 1964, which was no less than R445 million or 46 per cent above the figure for 1961/62. The fact that such an increase could occur without producing a significant deficit in the current account serves as another illustration of the scope which existed in the balance of payments during the past few years and which, after a period of hesitation, was eventually utilised for economic development.

The deterioration in the current account would have been more pronounced had it not been for the satisfactory performance put up by merchandise exports and the net gold output. The former increased by R116 million to R1,066 million for the year, while the latter expanded by R40 million to R699 million. In the case of exports the rise was partly attributable to an increase in volume and partly to an increase in the prices of such important South African export products as wool, maize, sugar, copper and diamonds.

As far as the remainder of the current account is concerned, net service and transfer payments to the rest of the world showed an increase of about R14 million, compared with the previous year, mainly owing to larger freight and insurance payments on the higher import bill.

Balance of Payments on Current Account (R millions)

	1962				1963				1964	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Actual Surplus (+) or Deficit (−)	82	110	63	52	26	37	43	42	-7	1
Seasonally Adjusted Annual Rate	360	432	280	156	160	168	196	76	12	30


R millions
1600
1300
1000
700
IMPORTS
EXPORTS (excluding gold)
Seasonally adjusted annual rate
Three months moving average
BALANCE OF PAYMENTS ON CURRENT ACCOUNT
400
200
0
–200
Seasonally adjusted annual rate
1959
1960
1961
1962
1963
1964

Further Substantial Net Outflow of Private Capital

Despite the continued expansion of internal economic activity, the net identified outflow of private capital during the past year amounted to as much as R115 million, compared with R121 million during the previous twelve months. At one stage, towards the end of 1963, it appeared as if the outflow was subsiding, but during the first quarter of 1964 it increased to a record quarterly figure of R55 million. It is now clear that the improvement during the last quarter of 1963 was mainly due to a large inflow of short-term capital in the form of trade credits extended to South African importers by foreign suppliers, and that the subsequent deterioration in the capital account was largely the result of a sharp reversal of this movement, which may have represented a switch from foreign to domestic financing of trade.

Apart from these fluctuations in the movements of short-term funds, the private capital account was, as during the previous year, dominated by withdrawals of foreign capital from the South African private sector through net sales on the Stock Exchange by foreigners of quoted South African securities to South African residents. These net sales amounted to no less than R93 million out of the total net identified outflow of private capital of R115 million. Not all of this money left the country, however. A considerable part of it was either invested in the special Blocked Rand and Non-Resident Bonds issued by the South African Government (repayable in equal annual instalments and freely transferable in foreign currency on the expiry of each instalment) or kept in blocked accounts with South African banks, and therefore appears elsewhere in the balance of payments, namely as an inflow of capital to the official and banking sector.

The large net outflow through the Stock Exchange was mainly attributable to the permit and arbitrage schemes of exchange control relaxation, which remained in operation during the past year. In view, however, of the disappearance of the surplus on the current account of the balance of payments, the authorities, from about the third week of May, gradually reduced the allocations under the arbitrage scheme, with the result that the net outflow through the Stock Exchange declined to R15 million during the second quarter of 1964, compared with an average of R22 million during the preceding seven quarters.

Net Identified Movements of Private Capital (R millions)

	1962				1963				1964	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Stock Exchange Transactions	-3	-5	-15	-27	-16	-20	-23	-31	-25	-15
Other Long-term	4	-3	-5	-28	-15	-2	-1	-28	8	-5
Short-term	-4	-7	-6	24	3	-14	-1	51	-38	-7
Total	-3	-15	-26	-31	-28	-36	-25	-8	-55	-27

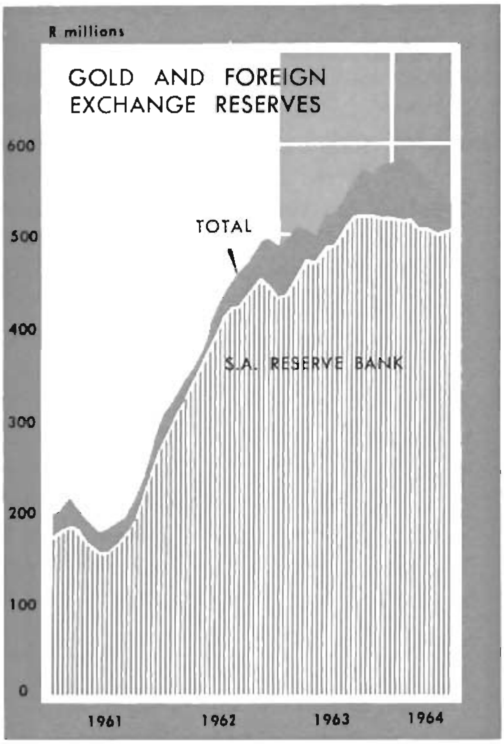
As far as other long-term capital movements during 1963/64 are concerned, it is known that contractual repayments of uranium and Escom foreign loans accounted for about R20 million, which means that an inflow of capital in other forms, such as direct investment, must have occurred.

Movements of Official and Banking Capital

In contrast to the substantial net outflow of private capital, official and banking capital showed a net inflow of about R28 million during the year ended June, 1964. The Government and the Reserve Bank made repayments on overseas loans to the extent of R37 million, but this outflow was more than offset by the investment of blocked funds in Blocked Rand and Non-Resident Bonds of the South African Government, as well as movements of short-term Government trade credits and commercial bank funds.

Reversal of Upward Movement in Gold and Foreign Exchange Reserves

Despite the decline in the current surplus and the continued net outflow of capital, the total gold and foreign exchange reserves held by the Reserve Bank, the commercial banks and the Government continued to rise moderately during the second half of 1963 and reached a month-end peak of R583 million in January, 1964, which was no less than R408 million higher than the low-point of R175 million registered at the end of May, 1961. Subsequently, however, as the current surplus was transferred into a



deficit while capital, on balance, continued to flow out, the reserves began to decline moderately and by the end of June, 1964, had fallen to a level of R540 million.

This reversal of the long upward movement in the reserves, which had lasted for more than two and a half years, had been expected for some time and, although it was naturally taken into account in the framing of monetary policy, caused no concern to the monetary authorities. Not only were the reserves still at a relatively high level, but the reversal of their upward movement was also interpreted as a natural reflection of the fact that the country was simultaneously developing at a very rapid rate and substantially reducing its net foreign indebtedness.

As during 1962/63, the *Reserve Bank's* gold and foreign exchange holdings during the past year were at times considerably lower than the *total* official reserves, particularly during the period September, 1963, to March, 1964. This was partly attributable to the holding of Treasury balances abroad, but largely the result of the policy of allowing the commercial banks to invest amounts abroad under cover of special forward exchange agreements with the Reserve Bank — the so-called "swop arrangements". At the end of December, 1963, the commercial banks held as much as R43 million in this form, in addition to their normal foreign exchange holdings. But subsequently, as the liquidity of the banks tightened, most of these funds were repatriated and by the end of June only R8 million remained abroad.

Accumulated Net Outflow of Private Capital Through Stock Exchange During Past Five and a Half Years

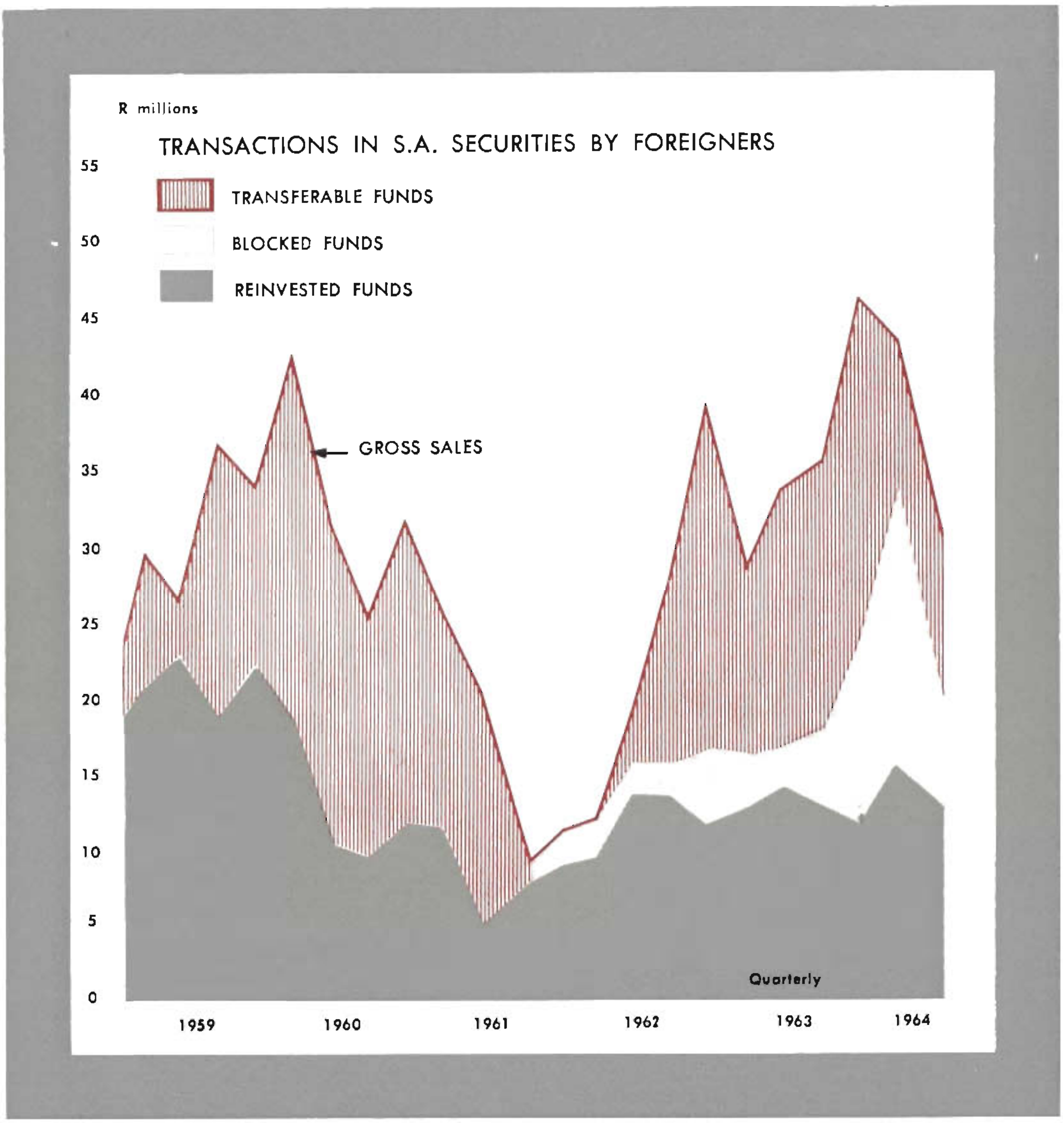
The net outflow of private capital through the Stock Exchange of R93 million included in the above balance of payments estimates, brought the total accumulated net outflow from the South African private sector in this form during the past five and a half years up to the substantial amount of about R340 million. *Gross* sales by foreigners of South African securities to South African residents during this period amounted to about R640 million, but roughly R300 million of this total was reinvested by foreigners in securities of the South African private sector.

A study of these gross sales by foreigners over the past five and a half years reveals that they have fluctuated considerably. Thus, after attaining a high level during the first half of 1960, when a substantial flight of capital was experienced from the country, these sales declined gradually, although the gap between sales to and purchases from South African residents representing the net amounts transferable from South Africa, remained fairly large. But following the extension of exchange control to transactions in listed South African securities between the Johannesburg and foreign stock exchanges in June, 1961, gross sales declined sharply, while the gap between sales and purchases virtually disappeared. In terms of the exchange control at that stage, the proceeds of sales of South African securities by foreigners to South African residents could only be reinvested in listed South African securities or placed in blocked accounts with authorised South African dealers in foreign exchange.

Sales by foreigners increased strongly from the second quarter of 1962, when Blocked Rand Bonds were first issued by the South African Government to foreigners and the first allocations under the permit scheme of exchange control relaxation were made, and were further stimulated by the introduction of the arbitrage scheme in September, 1962. A new peak was eventually reached in the last quarter of 1963, partly owing to the popularity of the three-year

Non-resident Bonds which replaced the original five-year Blocked Rand Bonds during September, 1963, and partly as a result of liberal allocations of foreign exchange under the arbitrage and permit schemes.

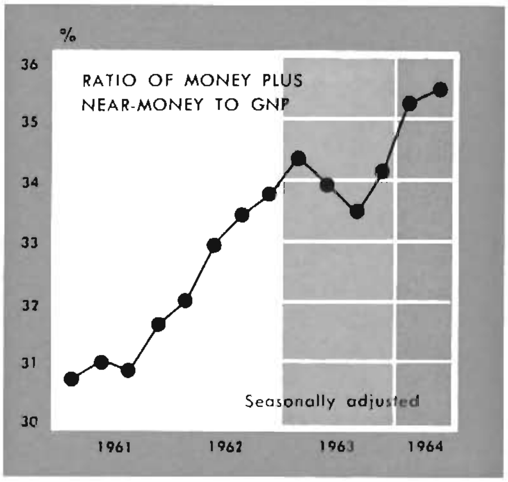
Finally, after the issue of Non-resident Bonds was temporarily discontinued from March, 1964, and smaller allocations were made under the share repatriation schemes, gross sales by foreigners declined noticeably.



MONETARY AND BANKING SITUATION

Gradual but Significant Change in Monetary and Banking Situation

The continuing upswing in economic activity and the accompanying change from surplus to deficit in the balance of payments naturally was not without its effect on the monetary and banking situation of the country. Thus, while monetary and banking conditions remained conducive to a high rate of investment and consumer spending during most of the past year, they changed gradually as the year progressed, and by the middle of 1964 the position differed in significant respects from that which had prevailed a year earlier.



Sustained Rise in Money and Near-Money

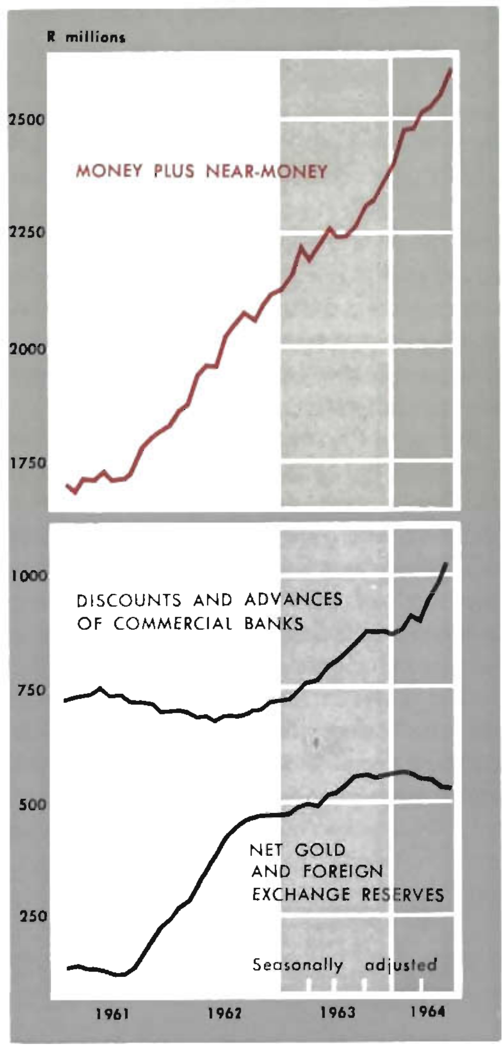
The change referred to above was not apparent as far as the liquidity of the private sector was concerned. At no stage during the past year did the supply of money and near-money[1] in the hands of the private sector show any persistent tendency to decline. On the contrary, the seasonally adjusted ratio of money and near-money to gross national product, which had remained at a relatively high level during 1962/63, tended to rise even further during the course of the past year and amounted to more than 35 per cent during the second quarter of 1964. Indeed, the further rise in the supply of money and near-money during the past year brought the total increase between June, 1961, and June, 1964 (i.e. over the three years since the approximate start of the current upswing) to R923 million, which represents a rise of 54 per cent, compared with no more than 6 per cent during the preceding three years, and indicates the extent to which the expansion of general economic activity during the past three years was facilitated by conditions of substantial monetary ease.

1) Near-money includes interest-bearing deposits held with the "banking sector", as well as Treasury bills, short-term Government stock and tax redemption certificates outside the banking sector. "Banking sector" includes the Reserve Bank, commercial banks, National Finance Corporation, discount houses and part of the Land Bank.

Significant Change in "Causes" of Increase in Money and Near-Money

But while the supply of money and near-money more than kept pace with the rise in gross national product, significant changes occurred in the main "causes" of this increase during the first half of 1964. Thus, whereas the increase during 1963 had been associated with both a favourable balance of payments and an expansion of bank credit, the increase during the first half of 1964 was largely the net result of two opposing influences, namely an unfavourable balance of payments and a further substantial rise in bank credit, particularly commercial bank credit. In other words, during the latter period the deficit in the balance of payments tended to reduce the liquidity of the private sector, but this effect was more than offset by the sharp increase in money and near-money created by the banking system. Although fluctuating considerably at times, the flow of tax and loan funds to and from the Government sector played a relatively minor part in influencing private sector liquidity over the year 1963/64 as a whole.

The significance of this change in the basic forces affecting the supply of money and near-money was that it inevitably brought about a significant decline in the liquidity ratios of commercial and other banking institutions, and thereby placed a limit on their ability to continue creating additional liquidity for the private sector. In short, in helping to maintain the exceptionally liquid state of the private sector in a rapidly expanding economy, the banks understandably brought about a decline in their own liquidity. This, in turn, had other important effects, for example on interest rates, which will be dealt with later on.

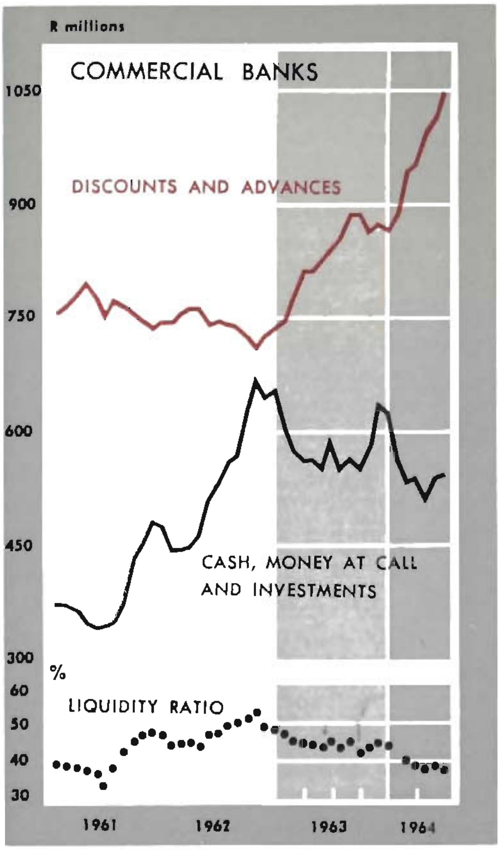


Continued Upward Trend of Commercial Bank Credit [2]

The increase in the commercial banks' total loans, discounts and advances between June, 1963, and June, 1964, amounted to as much as R209 million or nearly 25 per cent, as against an increase of 13 per cent over the preceding twelve months. Moreover, after allowing for seasonal changes (and excluding advances to the Land Bank), about three-quarters of this increase took place during the second half of the period under review, i.e. between January and June, 1964. This substantial increase would appear to have been closely associated with the strong upward tendency shown during this period by investment, consumption, imports, stock exchange turnover (until April) and economic activity generally.

On the other hand, mainly owing to the change in the balance of payments position, the banks' cash, money at call and investments showed a slightly downward tendency over the year 1963/64. As usual, however, the total of these assets fluctuated considerably as a result of shifts of funds to and from the public sector.

The result of these various changes was that the banks' average liquid asset ratio declined from 45.3 per cent in June, 1963, to 38.4 per cent in June, 1964, while certain individual banks had liquidity ratios well below the average during the latter month. In absolute terms, by far the larger part of the fluctuations in the banks' liquid assets showed up as changes in their holdings of money at call with discount houses, which rose from R54 million to R128 million between July and November, 1963, and then declined to R38 million at the end of June, 1964.

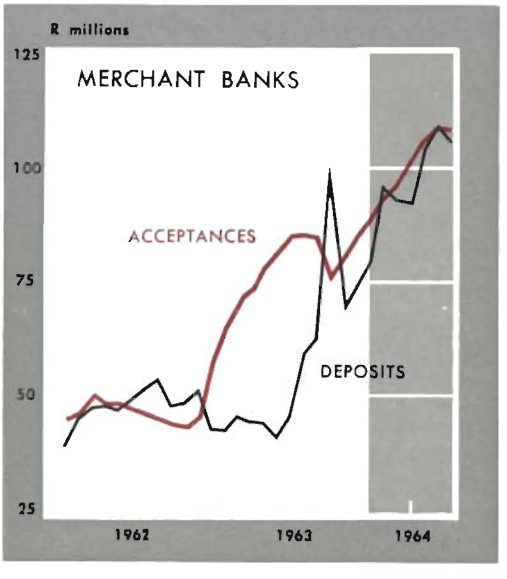


2) Towards the close of the period under review, namely in June 1964, important new legislation in the field of money and banking was passed by Parliament in the form of the Banking Amendment Act and the Building Societies Amendment Act. The nature, purposes and significance of these legislative changes will be discussed by the Governor of the Reserve Bank in his Address to Stockholders at the Bank's Ordinary General Meeting on the 19th August, 1964.

Sustained Rise in Acceptances of Merchant Banks

The activities of merchant banks, like those of commercial banks, reflected the rising demand for short-term credit during the past year. After having already increased from a low point of R44 million in October, 1962, to R86 million in June, 1963, their acceptances recorded an almost uninterrupted further expansion to a level of R108 million at the end of June, 1964, and, in fact, during this period increased at a faster rate than the commercial banks' discounts and advances. One reason for this was probably the relative cost advantage which attached to acceptance credits as against commercial bank overdrafts.

Deposits with merchant banks increased even faster than their acceptance liabilities over the year as a whole, passing the R100 million mark in April and reaching R105 million in June, 1964.



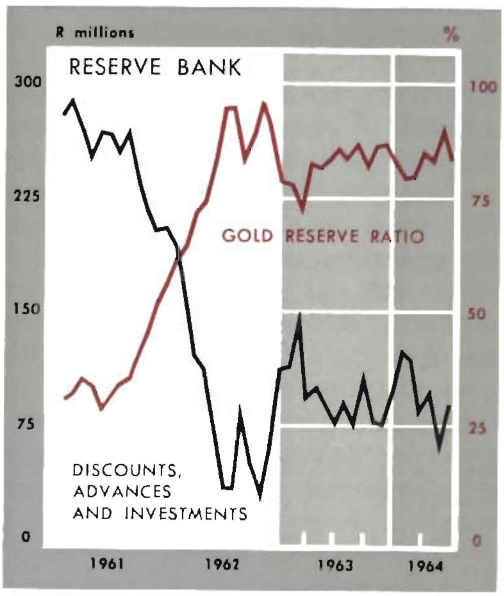
Change in Investment Policy of Discount Houses

Although fluctuating sharply as a result of shifts of tax and loan funds to and from the Government sector, the total call money held with the National Finance Corporation and the discount houses showed little change over the year 1963/64 as a whole. Moreover, the fluctuations within the year were considerably dampened by the official policy of placing Government funds with the discount houses from time to time with a view to easing the strain caused by the shifts referred to above. Thus, the authorities increased their funds held with discount houses from R5 million at the end of January, 1964, to a record level of R65 million at the end of March, 1964, which at that stage represented about 45 per cent of the houses' total call money liabilities. Subsequently the amount was reduced to R30 million in April and then fluctuated between R27 million and R50 million during the rest of the period under review.

An important feature of the investing activities of discount houses during the past year was a continuation of the downward tendency in their holdings of Treasury bills, which had already become apparent during the previous year. Thus, from a level of R47 million in June, 1963, these holdings declined to R25 million in June, 1964. At the same time, the houses' holdings of the more profitable bankers' acceptances increased slightly, so that at the end of June, 1964, they amounted to over three times as much as their investments in Treasury bills, as against the slightly more than 1 to 1 ratio which had prevailed on average during the second half of 1963.

Relatively Low Level of Reserve Bank Credit

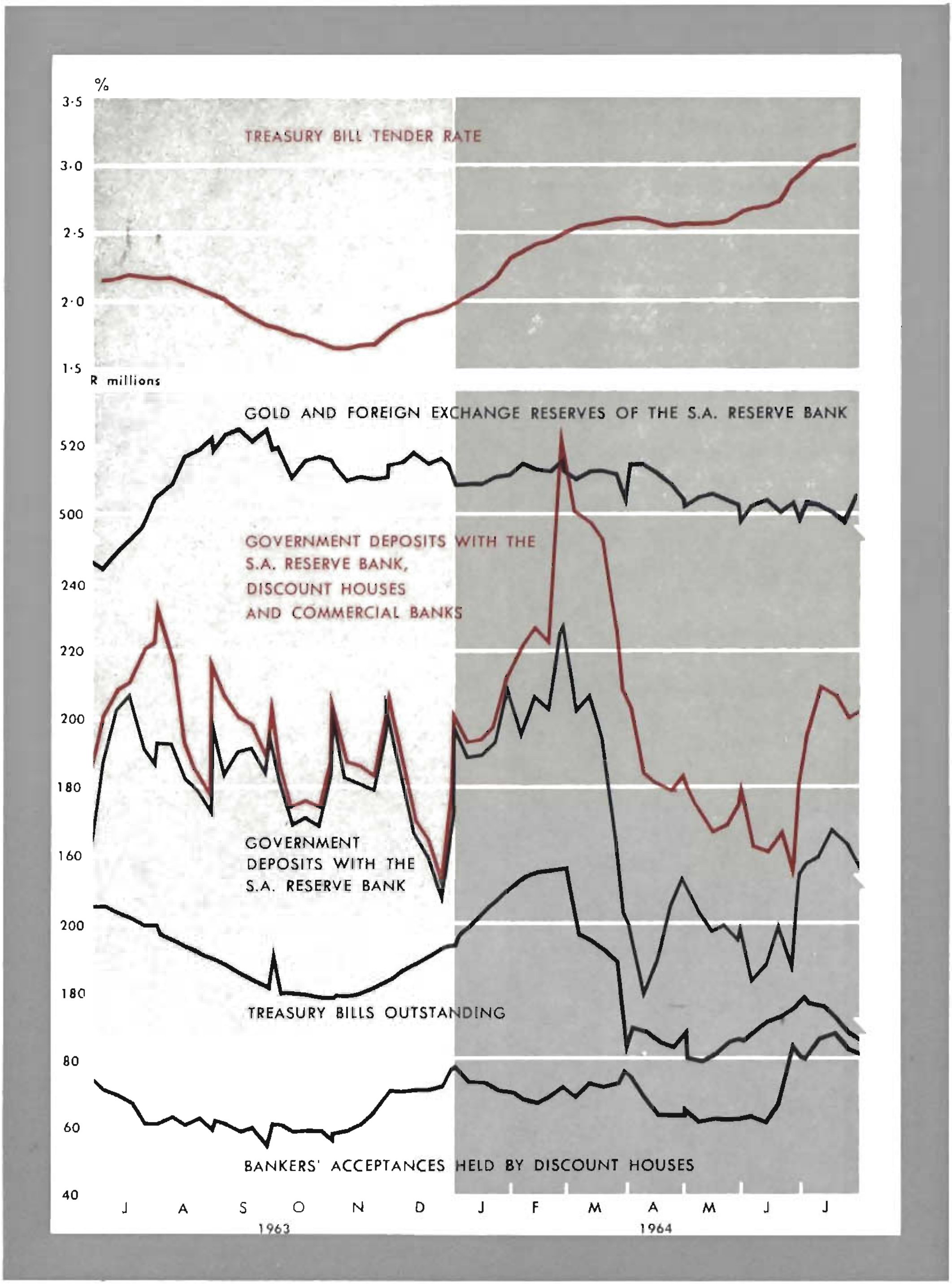
Reserve Bank credit remained relatively low throughout the past year. Although the Bank's total discounts, advances and investments did at times increase in response to temporary tightenings of money market conditions as a result *inter alia* of shifts of funds to the Government sector, they remained between R75 million and R100 million at most month-ends. Since the Bank's gold and foreign exchange holdings did not change much over the year, its legal gold reserve ratio accordingly remained relatively stable at the high level of between 80 and 90 per cent. In other words, unlike the liquidity ratio of the commercial banks and most other banking institutions, the Reserve Bank's "liquidity ratio", and, therefore, its money creating potential, remained high throughout the past year.



Decline Followed by Upward Tendency in Treasury Bill and Related Money Market Rates

The Treasury bill tender rate and other related short-term interest rates showed marked changes during the past year. After having moved upwards during the first half of 1963 to a temporary peak of 2.21 per cent towards the end of July, the Treasury bill rate declined fairly sharply to 1.68 per cent early in November. Then it began a new upward movement which lasted until about March, 1964. This was followed by two months of little change, but from about the end of May it increased rapidly and by the 31st July had risen to 3.19 per cent, which was the highest rate attained since April, 1962.

Different factors appear to have influenced the movement in short-term interest rates at different stages during the past year. The decline in the Treasury bill rate between July and November would appear to have been mainly attributable to (1) the unexpectedly large increase in the Reserve Bank's holdings of gold and foreign exchange during the third quarter, which had as its internal counterpart a new easing of money market conditions, and (2) a decline in the amount of Treasury bills outstanding from about R200 million in July to R179


%
3·5
3·0
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TREASURY BILL TENDER RATE
R millions
GOLD AND FOREIGN EXCHANGE RESERVES OF THE S.A. RESERVE BANK
520
500
GOVERNMENT DEPOSITS WITH THE
S.A. RESERVE BANK,
DISCOUNT HOUSES
AND COMMERCIAL BANKS
240
220
200
180
160
GOVERNMENT
DEPOSITS WITH THE
S.A. RESERVE BANK
200
180
TREASURY BILLS OUTSTANDING
80
60
40
BANKERS' ACCEPTANCES HELD BY DISCOUNT HOUSES
J A S O N D J F M A M J J
1963
1964

million at the beginning of November, the result largely of a reduction in the amount of bills offered at the weekly tender.

The main reasons for the subsequent rise in the rate until March seem to have been (1) an increase in the amount of Treasury bills outstanding to R216 million at the end of February, 1964, (2) the investment policy of discount houses of reducing their holdings of Treasury bills and increasing their investments in the more profitable bankers' acceptances, and (3) a substantial build-up of Government funds with the Reserve Bank from R148 million towards the end of December to R228 million at the end of February, 1964, which naturally exercised a tightening effect on the money market. The shift of funds to the Government sector during January and February would naturally have exerted stronger upward pressure on money market rates at the time if the authorities had not placed a substantial amount of these funds with discount houses in order to relieve the strain.

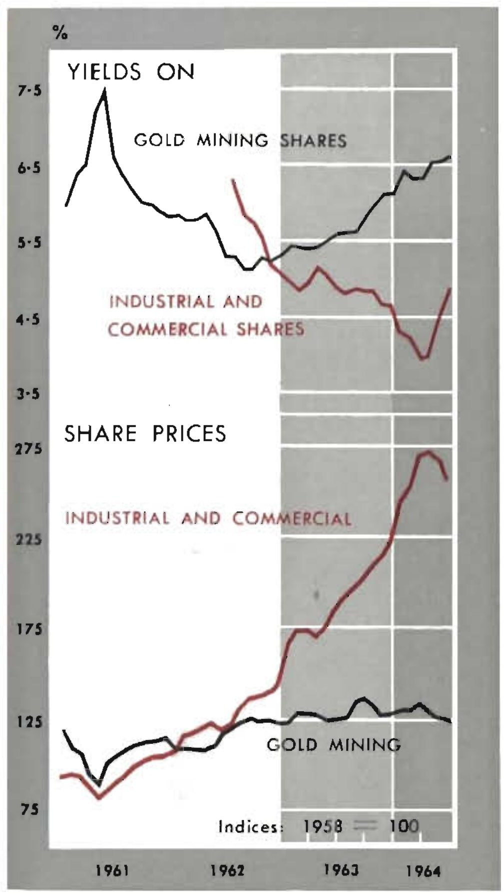
The temporary interruption of the upward movement in short-term rates during April and May would appear to have been mainly attributable to a new decline in both the amount of Treasury bills outstanding and Government deposits with the Reserve Bank, while the resumption of the upward tendency in the rate during June and July seems to have been largely the result of a new increase in Government deposits with the Reserve Bank, coupled with a distinct preference on the part of discount houses for bankers' acceptances as against Treasury bills. Another contributory factor was a change in the Reserve Bank's discounting procedure from the 21st May, to which reference will again be made.

CAPITAL MARKET

Gradual Return to More Normal Conditions in Capital Market

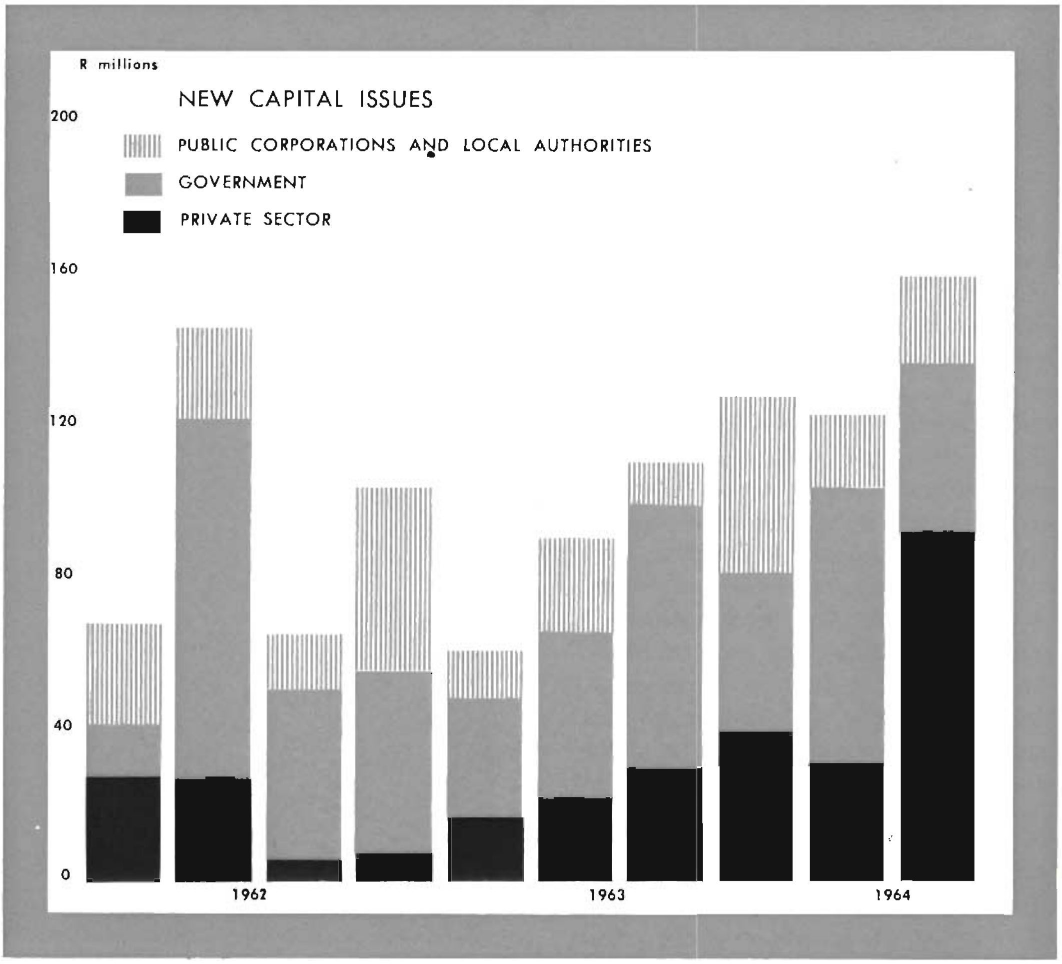
After two extraordinary years, during which the economy had some difficulty in finding immediate productive use for all its savings, the relationship between supply and demand in the capital market gradually became more normal during the course of the past year. When the period under review began, there was still an abundance of long-term funds seeking avenues of investment and this, together with the actual and expected improvement in economic conditions, contributed to a further rise in both stock exchange turnover and the prices of industrial and commercial shares. But gradually conditions changed and towards the end of the period, after the average yield on industrial and commercial shares had fallen to below the 4 per cent level, stock exchange turnover as well as security prices declined noticeably.

These changes were not induced by any actual or expected levelling-off or reversal of the upswing in general economic activity.



On the contrary, they were to a large extent symptoms of the continuing prosperity in the economy. Thus, on the one hand, the substantial rise in fixed investment brought with it an increasing demand for capital, as indicated by the fact that new capital raised by the Government, local authorities, public corporations and the private sector increased to a total of about R520 million during the year 1963/64, compared with about R320 million during the preceding twelve months. In addition, the supply of scrip was increased as a result of the continued operation of the arbitrage and permit schemes of exchange control relaxation.

On the other hand, as a result of the internal expansion and the accompanying deterioration in the balance of payments, the "spilling-over" of liquidity into medium and long-term securities, which had for some time been a feature of the capital market, tended to cease. The gradual "return to normal" was, therefore, the result of forces operating from the side of demand as well as supply.



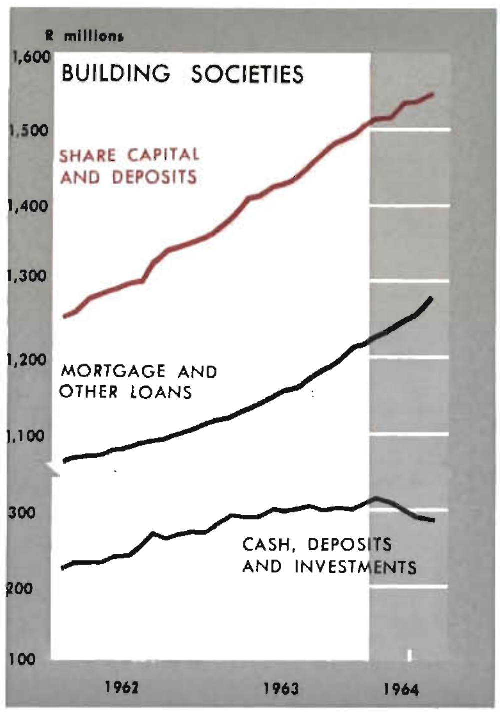
Relative Stability in Gilt-Edged Market

Conditions in the gilt-edged market remained fairly stable during most of the past year and the pattern of interest rates quoted by the Reserve Bank for transactions in Government stock remained at the relatively low levels in operation since November, 1962. Towards the end of this period, however, moderate upward pressure was exerted on gilt-edged rates and the Reserve Bank found itself called upon to buy a modest amount of Government securities. To test the market such purchases were at times effected at rates exceeding the Bank's normal pattern by as much as 0.20 per cent.

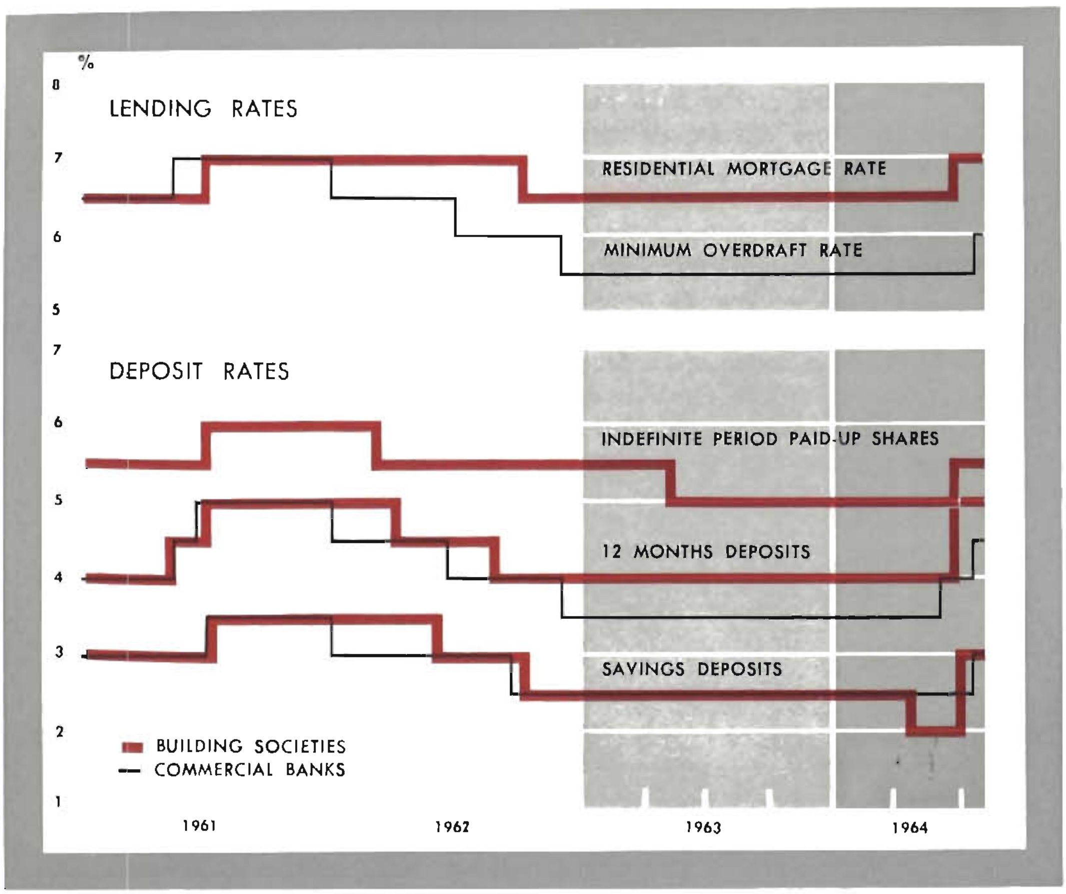
There was also some tendency during recent months for the margin between rates on Government stock and those on municipal and public utility securities to widen, partly owing to the exclusion of the latter from the new definition of liquid assets as embodied in the amending legislation for banking institutions and building societies referred to earlier.

Increased Lending by Building Societies

The changing conditions in the capital market significantly affected the position of building societies, particularly towards the close of the period under review. Although they experienced a considerable further increase in their resources during the past year, mainly owing to a substantial rise in their share capital, the demand for their mortgage loans increased so strongly that they eventually found themselves unable to meet it completely, even after running down their cash, deposits and investments by a not inconsiderable amount. The societies held considerably more than the legally required minimum in long-term gilt-edged securities, particularly municipal stock, but in view of the changed supply-demand relationship in the capital market, coupled with the exclusion of these securities from the definition of liquid assets in the new banking and building society legislation, they experienced some difficulty in selling these investments in a falling market.



For these and other reasons the societies deemed it necessary to raise their interest rate structure. They started by raising their rates on fixed deposits of 15 months and longer from 4 to 4½ per cent on the 30th April. But this proved to be insufficient, particularly since the commercial banks, which had allowed their fixed deposit rates to remain somewhat below those of the building societies during the preceding period of abnormal liquidity, followed on the 2nd June by bringing their rates up to the level then paid by building societies. The Association of Building Societies thereupon, on the 17th June, recommended to their members a general increase in rates on both deposits (including savings deposits) and shares, as well as an increase from 6½ to 7 per cent in the rate on new mortgage loans, leaving it to individual societies to decide what to do about the rate on existing loans. Most societies in the end decided also to raise the latter rate.



Change in Attitude of Insurance Organisations to Equities

Insurance organisations understandably adjusted their investment policies as capital market conditions changed. Thus, while their holdings of ordinary shares (excluding investments in subsidiary companies) increased by R19 million during 1963, compared with R11 million in 1962, there was no further increase in this form of investment during the first quarter of 1964 (the latest period for which statistics are available). With share prices at a peak and yields exceptionally low for South African conditions, insurers for the time being preferred to direct their new funds into other directions, such as property investment. Some of the larger institutions also engaged in property development schemes through their subsidiary companies and this was partly responsible for a rise of R10 million during the first quarter alone in the investments of insurers in shares of subsidiary companies, as well as for a substantial increase in loans extended to subsidiary companies.

Continued Growth of Pension Funds

Pension funds experienced an increase in total assets of no less than R170 million during 1963, compared with about R160 million during 1962. Of this increase, Government, Provincial and Railway pension funds accounted for R88 million, which was largely directed to investments in Government stock through the Public Debt Commissioners.

Private pension funds, on the other hand, did not add to their holdings of Government stock, but increased their investments in shares and private debentures by about R40 million during 1963 and by another R8 million during the first quarter of 1964, compared with R23 million during 1962. As usual, they also invested a substantial amount in stocks of public corporations and local authorities, as wel as in long-term loans to local authorities.

MONETARY AND FISCAL POLICY

Gradual Shift of Emphasis in Monetary and Fiscal Policy

As economic conditions changed during the course of the past year, the emphasis in monetary and fiscal policy gradually shifted from stimulation of the economic upswing to the maintenance of stability. In this process three phases can be distinguished.

First Phase: Moderate Expansionary Policy

During the first phase, which lasted until roughly the fourth quarter of 1963, the monetary authorities still held the view that it was necessary and desirable to assist the recovery in economic activity and, therefore, welcomed the fact that the large and sustained balance of payments surplus of the two preceding years had brought about a monetary and banking environment which was conducive to an increase in total investment and consumer spending.

It is true that certain measures were taken during this phase to ease the pressure of liquidity, particularly when the balance of payments surplus increased somewhat unexpectedly during the third quarter of 1963 and the Treasury bill rate began a new downward movement. Thus, commercial banks were allowed to increase the amounts held by them abroad under cover of "swop arrangements" with the Reserve Bank, while more liberal allocations were made under the "arbitrage" scheme of exchange control relaxation. In addition, although there was a reduction in the amount of Treasury bills offered at the weekly tender from July onwards, the Treasury continued to issue such bills and to borrow internally in other ways, even though its balances with the Reserve Bank were already at a very high level and it clearly did not require the funds. But these measures were merely intended to moderate the downward tendency in the Treasury bill and other related short-term interest rates and to prevent undue disturbances in the financial structure; they were not aimed at restraining the expansion of investment or consumption in any way.

Second Phase: No Need for Further Stimulation

Gradually conditions changed, however, and before the end of 1963 the second policy phase began as the Treasury and the Reserve Bank came to feel that the upswing no longer needed any special encouragement but could be relied upon to look after itself. In arriving at this viewpoint, the monetary authorities were not only influenced by the upturn which had in the meantime occurred in private fixed investment, but also by the indications that the economy had reached a state of virtually full employment and that labour and other bottlenecks were developing.

But while taking their foot off the accelerator, the authorities saw no necessity for applying the brake at that stage. The danger of inflation naturally had to be taken into account, but in view of such factors as the relatively high gold and foreign exchange reserves, the substantial scope for a further rise in imports, the high level of commercial and industrial inventories and the ability of the economy to increase production still further, it was decided to allow the upswing to develop further and to delay applying restrictive measures until it became quite clear that they were called for. In this regard the official reasoning was that doing "too much too soon" to prevent inflation would be just as harmful to the economy as doing "too little too late".

In accordance with this policy, the Minister of Finance did not announce any special disinflationary measures when introducing the 1964/65 Budget in March of this year. The 5 per cent rebate in the case of personal tax payers was retained and, apart from additional allowances to civil and military pensioners, and certain tax adjustments, such as a decrease in transfer duty on real estate transactions up to R15,000 and a smoothing out of the marginal personal income tax rate, no important changes were effected. The Minister did stress, however, that while nothing should be done to check the economic expansion, it had become clear that in the field of economic and fiscal policy generally, the emphasis should be shifted from stimulation of growth to the maintenance of stability. Notwithstanding the large surplus on Revenue Account and the strong cash position of the Government, he therefore refrained from reducing taxation generally in view of its probable inflationary consequences.

In the field of credit and interest rate policy the shift in emphasis was also evident. Thus, while the monetary authorities did not view the substantial further increase in commercial and other bank credit during the first four months of 1964 with any alarm, but accepted it as a natural corollary to the continuing upswing in general economic activity, they permitted the Treasury bill and related interest rates to rise, the policy of placing Government funds with discount houses being merely intended to ensure an *orderly* upward movement in these rates.

Import control policy, as mentioned in an earlier section of this Report, likewise reflected official recognition of the need to avoid the building up of inflationary pressures in the internal economy. Not only were substantial further relaxations announced from time to time, but administratively great care was taken to ensure an adequate supply of goods in the economy. This liberal import policy was one of the main reasons why the need to adopt generally restrictive monetary or fiscal measures did not arise.

Third Phase: More Cautious Attitude towards Credit Creation

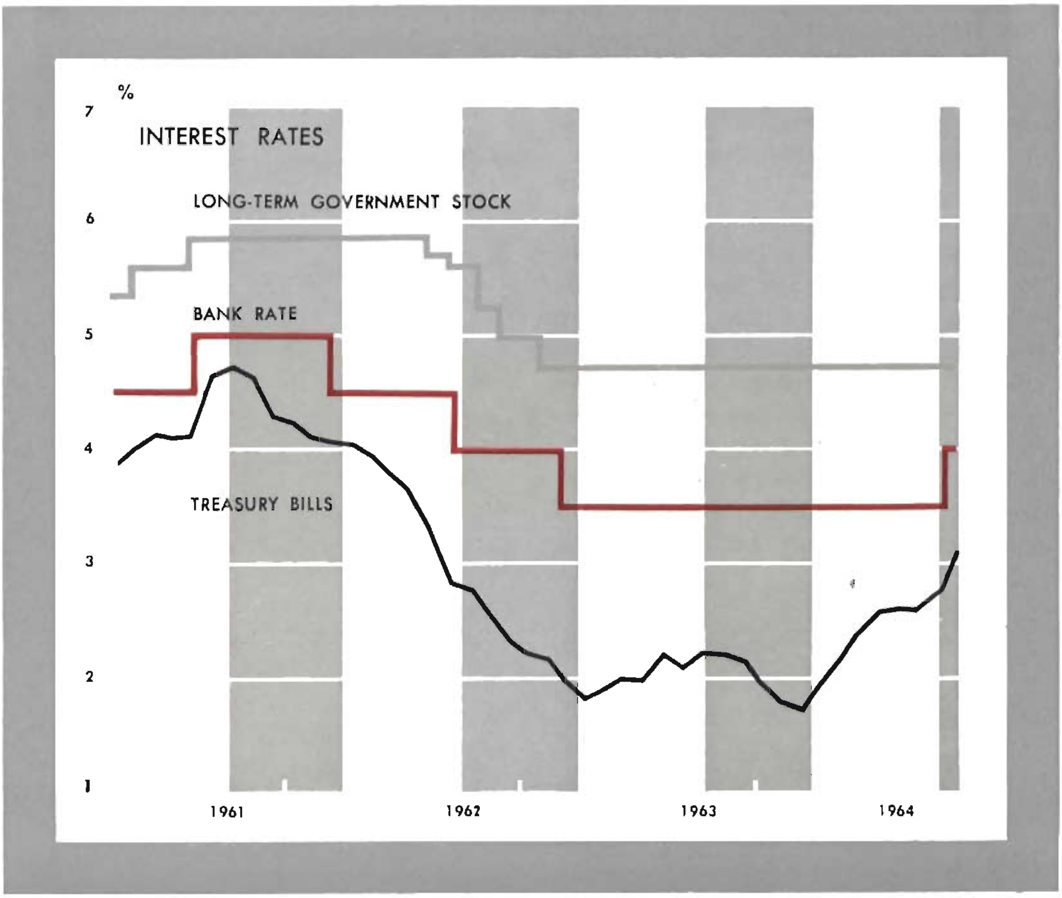
Towards the middle of the second quarter of 1964 a further shift of emphasis occurred in short-term economic policy, marking the beginning of the third phase referred to above. During this phase the monetary authorities came to feel that while there was still no evidence of either general inflationary overspending or balance of payments difficulties and while a policy of general credit contraction was still not called for, the economic upswing had nevertheless reached a stage where a more cautious attitude towards credit creation was necessary. In particular, some concern was felt over the extent to which various classes of banking institutions were creating credit for such purposes as consumption and speculation. Two years earlier the monetary authorities had deemed it necessary and desirable to stimulate consumption, which had declined quite noticeably during 1961. But by the second quarter of 1964 consumer spending had risen to a new record level and since current Government outlays and fixed investment in both the public and private sectors also appeared to be increasing further at a rapid rate, the authorities felt that the time had arrived to take steps which would render some assistance in preventing consumption from becoming excessive and thereby overstraining the economy.

In accordance with this assessment of the situation, the Bank acted on more than one front. In the first place, it announced on the 21st May that the procedure which it had followed since May, 1962, of quoting a separate rate, namely $\frac{1}{2}$ per cent above the current average tender rate, for the discount of Treasury bills and for advances against the security of these bills, was no longer considered appropriate and that it would, therefore, revert to the more customary money market procedure of applying Bank rate to such accommodation. This policy change made the existing Bank rate more effective and the resultant increase in the cost of Reserve Bank credit probably contributed to the new upward movement in the Treasury bill tender rate from the end of May onwards, a tendency which the Bank welcomed.

Secondly, the Bank held a series of meetings with the main classes of banking institutions, as well as certain other financial institutions, with a view to obtaining their co-operation in forestalling the extension of an excessive amount of consumer and speculative credit.

Thirdly, after the usual consultation with the Treasury, the Bank announced an increase in Bank rate from 3½ to 4 per cent with effect from the 15th July, 1964. In keeping with the viewpoint set out above, the Governor, when announcing the change, pointed out that "this adjustment represents neither a positive disinflationary measure nor a warning sign that, in the view of the monetary authorities, the economy is experiencing conditions of general inflationary overspending and/or balance of payments difficulties". He went on to stress that "it merely reflects official recognition of the fact that the continued increase in general economic activity and the accompanying changes in the balance of payments have understandably brought about a gradual return to more normal supply-demand relationships in both the money and capital markets".

Following the increase in Bank rate, the commercial banks announced an increase of ½ per cent in their discount and overdraft rates, as well as several upward adjustments in their deposit rates. The rate



on savings deposits, for example, was raised from $2\frac{1}{2}$ to 3 per cent, while that on fixed deposits of 12 to 18 months was increased from 4 to $4\frac{1}{2}$ per cent.

An important reason why the monetary authorities did not deem it necessary during this third phase to adopt more restrictive measures, was their recognition of the fact that important stabilising forces of a self-regulating nature had come into operation during this period. As pointed out earlier, the continued upswing in economic activity had been accompanied, on the one hand, by a substantial rise in commercial and other bank credit and, on the other, by a large increase in imports, which had helped to bring about a deficit in the balance of payments. The inevitable result of this was a significant decline in the liquidity ratios of commercial and other banking institutions, which meant that their ability to create additional credit without assistance from the Reserve Bank, had by the end of the period under review become limited. This, in turn, implied that the Reserve Bank, which in view of its high legal reserve ratio still had considerable scope left for credit creation, would from that stage onwards be the main source of liquidity and, therefore, in a favourable position to exercise control over both the creation of money and near-money and interest rates.