SOUTH AFRICAN RESERVE BANK • ANNUAL ECONOMIC REPORT

A Review of Economic and Financial Conditions in the Republic of South Africa to be presented to Stockholders at the Forty-fifth Ordinary General Meeting to be held on 24th August, 1965.

HIERDIE VERSLAG IS OOK IN AFRIKAANS BESKIKBAAR

PREFACE

The period covered by this Economic Report witnessed some highly significant changes in the economy of the Republic. Basically, the country moved, after some three years of rapid but relatively stable growth, into a period where real growth was still very substantial, but was accompanied to an increasing extent by inflationary pressures and strain on the balance of payments.

These developments, and the counter-measures that were taken, are described and analysed in some detail in the accompanying pages, and will serve as the background to my remarks at the Bank's Annual General Meeting to be held on 24th August.

GERARD RISSIK, Governor, South African Reserve Bank. August, 1965.

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THE SOUTH AFRICAN ECONOMY IN 1964/65
A SUMMARY

During the year ended June, 1965, the economic upswing in South Africa continued well into its fourth year and, despite the adverse effects on certain sections of agriculture of unfavourable weather conditions, the real gross national product increased further by approximately 5 per cent. Indeed, the expansion of monetary demand showed such sustained vigour that considerable inflationary pressure developed in the economy. This inflation found its expression partly in an accelerated rise of prices and costs but mainly in rapidly rising imports and a growing deficit on the current account of the balance of payments. Since the net inflow of foreign capital during this period was relatively small, the official gold and foreign exchange reserves declined substantially.

The main cause of the inflationary overspending would appear to have been a rise of 20 per cent in total public and private fixed capital outlays, which greatly exceeded the increase in domestic saving and was partly financed in an inflationary way. In addition, inventory investment and current Government expenditure increased considerably. These various increases generated additional money income on a large scale and thus helped to bring about a further substantial rise in private consumption. Consumers were also encouraged to spend more by the ready availability of consumer credit in its various forms.

The excessive increase in total monetary demand was greatly facilitated by a rise of nearly 29 per cent in commercial bank discounts and advances, which was the main factor responsible for the considerable further increase in the supply of money and near-money at a time when the balance of payments deficit was tending to drain funds from the economy. Certain other kinds of banking institutions also contributed materially to the general overspending.

In both the money and capital markets the demand for loanable funds greatly exceeded the supply, so that, despite a considerable shift of Government funds to the private sector over the year as a whole, conditions tightened and the entire interest rate structure moved upwards.

In order to counteract the inflationary pressures upon prices and the balance of payments, the authorities applied various restrictive monetary measures, including the raising of Bank Rate in three stages from $3\frac{1}{2}$ to 5 per cent and the imposition of supplementary liquidity requirements on the commercial banks. Although these measures were moderate and slow to take effect, they did assist in bringing about a slowing down of the rate of increase of bank credit during the second quarter of 1965. Together with the working of natural disinflationary forces, such as the deficit on the balance of payments, this helped to arrest or reverse the inflationary upward movement of such economic indicators as bank debits, building plans passed, real estate transactions and motor car sales. Total capital outlays, consumption and current Government expenditure, however, continued to rise strongly and to exert considerable pressure upon prices and the balance of payments.

INTERNAL ECONOMIC CONDITIONS

Continued Economic Upswing Accompanied by Inflationary Overspending

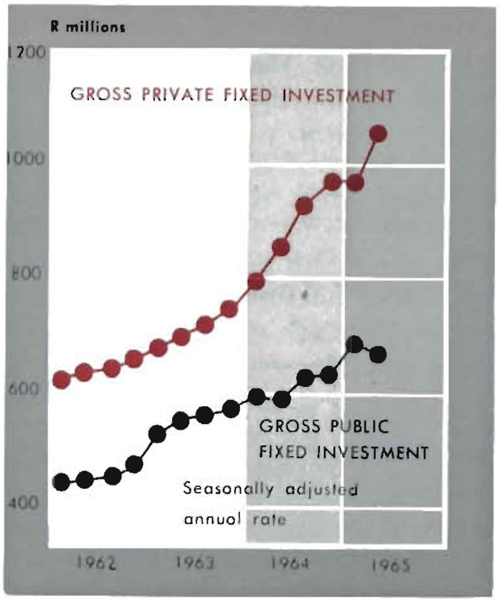
The year ended June, 1965, was a year of continued prosperity for the South African economy. But it was also a year of inflationary overspending on both capital and consumer goods. The total monetary demand for goods and services increased so strongly that it could not be met in full by an expansion of domestic production, particularly since the economy was not only already at full employment but also experiencing labour shortages and other bottlenecks. The inevitable result was an acceleration of the rate of increase of both wholesale and consumer prices and the emergence of a substantial and growing deficit on the current account of the balance of payments.

Pronounced Further Rise in Fixed Investment

The basic cause of the excessive rise in monetary demand would appear to have been a substantial further increase in both private and public capital outlays on plant, equipment and construction, which in the absence of a sufficiently high level of domestic saving, was partly financed in an inflationary manner.

Gross *private* fixed investment amounted to about R980 million during the year ended June, 1965, which represented an increase of R190 million or 24 per cent over the figure for the previous year. While agriculture contributed relatively little to this upward movement, expenditure on residential building increased by 34 per cent and fixed capital outlays by manufacturing, commercial and mining enterprises by 51, 9, and 12 per cent, respectively.

At one stage, during the first quarter of 1965, private fixed investment showed a tendency to level off, but then registered a substantial further increase during the second quarter. In general, the momentum of the private investment boom turned out to be even greater and more sustained than had been anticipated.



The Government and other public authorities (excluding public corporations) also increased their fixed investment considerably, namely by about 18 per cent to a level of R520 million for the year 1964/65. Fixed capital outlays by public corporations, however, showed little change, although they remained at a relatively high level.

The result was that *total* fixed investment increased by R270 million or 20 per cent to a figure of R1,630 million, which constituted as much as 21 per cent of the gross national product, compared with 19 per cent during 1963/64 and an average of 18 per cent during the two preceding years.

Substantial Increase in Inventory Investment

In addition to the upsurge in fixed investment, inventory investment, i.e. the net addition to inventories, increased from R134 million in 1962/63 and R140 million in 1963/64 to R260 million in 1964/65, mainly owing to a rise in manufacturing and commercial stocks. This increase was most pronounced during the latter half of the year under review and, as will be shown later, helped to put considerable pressure on the balance of payments.

Further Rise in Private Consumption and Current Expenditure by Public Authorities

Private consumption expenditure, which had risen by 13 per cent during the year ended June, 1964, increased by about 9 per cent during 1964/65 to a level of R5,075 million. This further rise would appear to have been partly the result of the secondary stimulating effects of the increase in public and private investment, which naturally generated additional income on a large scale. It was, however, also facilitated by the ready availability of consumer credit in its various forms, particularly during the earlier part of the period under review.

But while total consumer outlays continued to rise throughout 1964/65, the number of new motor cars sold reached an upper turning point in September, 1964, and then began a fairly sharp downward movement. Nevertheless, for the year ended June, 1965, new motor car sales were still nearly 11 per cent higher than during the previous year.

The effect of the increase in 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 11 per cent to R980 million, compared with 13 per cent during the previous year.

Little Expansionary Influence Exerted by Merchandise Exports and Gold Output

Unlike investment, consumption and current Government expenditure, exports of goods and (non-factor) services, including the gold output, showed only a small rise during the past year, namely R68 million or about 3½ per cent, and therefore contributed relatively little to the inflationary increase in spending.

Insufficient Rate of Saving

Gross domestic saving increased by only R80 million or 5 per cent during the year ended June, 1965, which contrasted sharply with the rise of 26 per cent in gross domestic investment, i.e. fixed plus inventory investment. Significant increases were shown by company saving (retained profits) and public "saving", i.e. the current surplus of the Government and other public authorities, but personal saving declined by R75 million or 16 per cent.

Further Rise in Manufacturing Output

Despite the state of full employment prevailing in the economy, the index of the physical volume of manufacturing output continued to rise strongly and was on average 10 per cent higher during 1964/65 than during the previous year. Although this rate of increase was lower than that of 16 per cent attained during the previous year, it still represented an impressive performance and brought the total increase in this index between 1961/62 and 1964/65 to 41 per cent. Moreover, while the index tended to increase more slowly towards the end of 1964, partly owing to a decline in food production as a result of adverse weather conditions, it showed a new acceleration during the first half of 1965. This may already have been a reflection of the increase in productive capacity resulting from the substantial rate of fixed investment in manufacturing during the preceding two years.

The branches of secondary industry responsible for the largest contributions to the increase in manufacturing output during the past year were those producing metal products, transport equipment, non-metallic mineral products, basic metals, textiles and machinery.

Building and Real Estate Transactions

For the third year in succession, the value of "building plans passed" increased substantially, bringing the total rise since 1961/62 to 226 per cent. During these three years the value of buildings completed accordingly showed a progressively rising rate of increase. During the second quarter of 1965, however, the seasonally adjusted index of "building plans passed" declined for the first time since the fourth quarter of 1961.

Real estate transactions showed a similar behaviour by rising further during the first half of the year under review and then declining during the first half of 1965.

Continued Pressure on Labour Market

Although, as will be indicated later on, the inflationary over-spending of the past year found its main expression in a large balance of payments deficit, it also aggravated the shortage of certain classes of skilled manpower and exerted strong upward pressure on salaries and wages in such sectors of the economy as the steel and building industries, the South African Railways and Harbours and the public service.

In these circumstances, the seasonally adjusted index of registered unemployed Whites, Coloureds and Asiatics continued to decline and during the second quarter of 1965 reached its lowest level in thirteen years.

Price Inflation

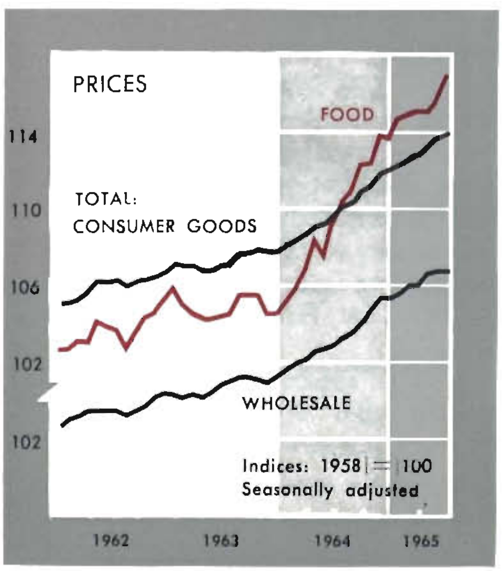
The excessive increase in aggregate demand also resulted in an accelerated rise in prices, particularly during the second half of 1964, when the general upward tendency was reinforced by sharp increases in agricultural and food prices as a result mainly of adverse weather conditions in many agricultural regions.

Wholesale prices increased by 3.6 per cent between June, 1964, and June, 1965, compared with an average annual increase of only 1.2 per cent during the ten years 1953 to 1963. During the second half of 1964 the annual rate of increase amounted to as much as 4.5 per cent, i.e. after correction for seasonal tendencies, but during the first half of 1965 it declined to 2.6 per cent. During the latter period the rise was caused mainly by increases in the prices of manufacturing and mining products.

The consumer price index showed similar tendencies. After rising at an average annual rate of 2.1 per cent between 1953 and 1963, it registered an increase of 4.0 per cent during the year ended June, 1965. This addition consisted of a seasonally adjusted annual rate of increase of 4.6 per cent during the latter half of 1964 and a reduced rate of increase of 3.4 per cent during the first half of 1965.

Food prices as such increased by as much as 7.2 per cent during the year. During the second half of 1964 they actually increased at an annual rate of 8.3 per cent, but then showed a somewhat smaller rise of 5.8 per cent per year during the first half of 1965.

It may be significant, however, that, after rising more slowly during the first quarter of 1965, consumer prices again increased at a faster rate during the second quarter of 1965.

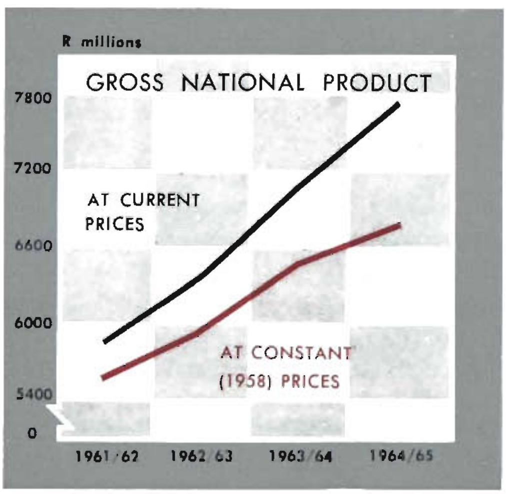


Substantial Further Increase in Gross National Product

In these circumstances, the discrepancy between the rates of increase of the gross national product in monetary and real terms naturally widened compared with the preceding years. Thus, while the gross national product increased by about $8\frac{1}{2}$ per cent in *monetary* terms (i.e. valued at current prices) to R7,700 million in 1964/65, it showed a rise of only about 5 per cent in *real* terms, compared with an average of $7\frac{1}{2}$ per cent during the three preceding years. This nevertheless represented a more than satisfactory rate of real economic growth.

Excessive Rise in Gross Domestic Expenditure

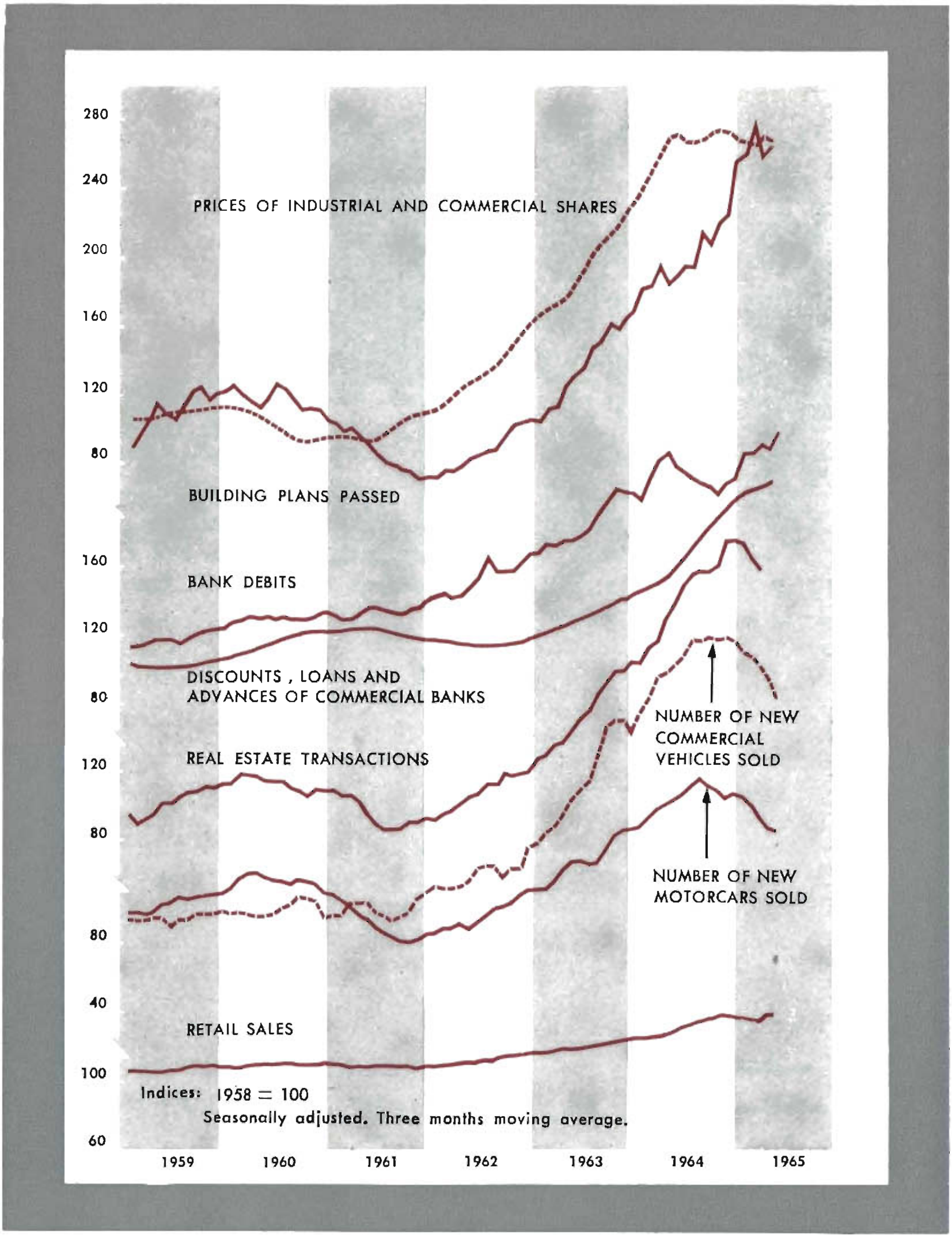
But whereas the gross national product at current prices increased by about $8\frac{1}{2}$ per cent, gross domestic *expenditure,* i.e. the total of consumption, investment and current Government expenditure, increased by as much as 13 per cent, the discrepancy implying a substantial deficit on the balance of payments on current account. In the absence of a significant net inflow of foreign capital, this naturally resulted in a substantial decline in the official gold and foreign exchange holdings. In other words, gross domestic expenditure increased during the past year at a rate which is clearly excessive and cannot be maintained. It was the realisation of this which in due course led the monetary authorities to adopt various measures designed to reduce the rate of increase of total spending to a more maintainable level, as will be discussed more fully in a later section of this Report.



End of Cyclical Economic Upswing?

During the second half of the period under review, i.e. the first half of 1965, there were certain changes in economic indicators which suggested that, after more than three and a half years, the cyclical economic upswing was finally tending to level off. As the accompanying graph shows, certain important economic indicators such as bank debits, building plans passed, real estate transactions, sales of both new motor cars and commercial vehicles, retail sales and industrial and commercial share prices either levelled off or began to decline after reaching an upper turning point. In addition, the disinflationary effects of the adverse weather conditions began to be felt in certain agricultural areas.

But, as indicated earlier, total domestic investment, consumption and current Government expenditure continued to rise strongly during this period and were again partly financed in an inflationary way. The pressure of monetary demand upon prices and the balance of payments therefore remained considerable and, in fact, appeared to be even greater during the second quarter of 1965 than during the first.


280
240
200
160
120
80
PRICES OF INDUSTRIAL AND COMMERCIAL SHARES
BUILDING PLANS PASSED
160
BANK DEBITS
120
DISCOUNTS , LOANS AND
ADVANCES OF COMMERCIAL BANKS
80
NUMBER OF NEW
COMMERCIAL
VEHICLES SOLD
120
REAL ESTATE TRANSACTIONS
80
NUMBER OF NEW
MOTORCARS SOLD
80
40
RETAIL SALES
100
Indices: 1958 = 100
Seasonally adjusted. Three months moving average.
60
1959
1960
1961
1962
1963
1964
1965

BALANCE OF PAYMENTS

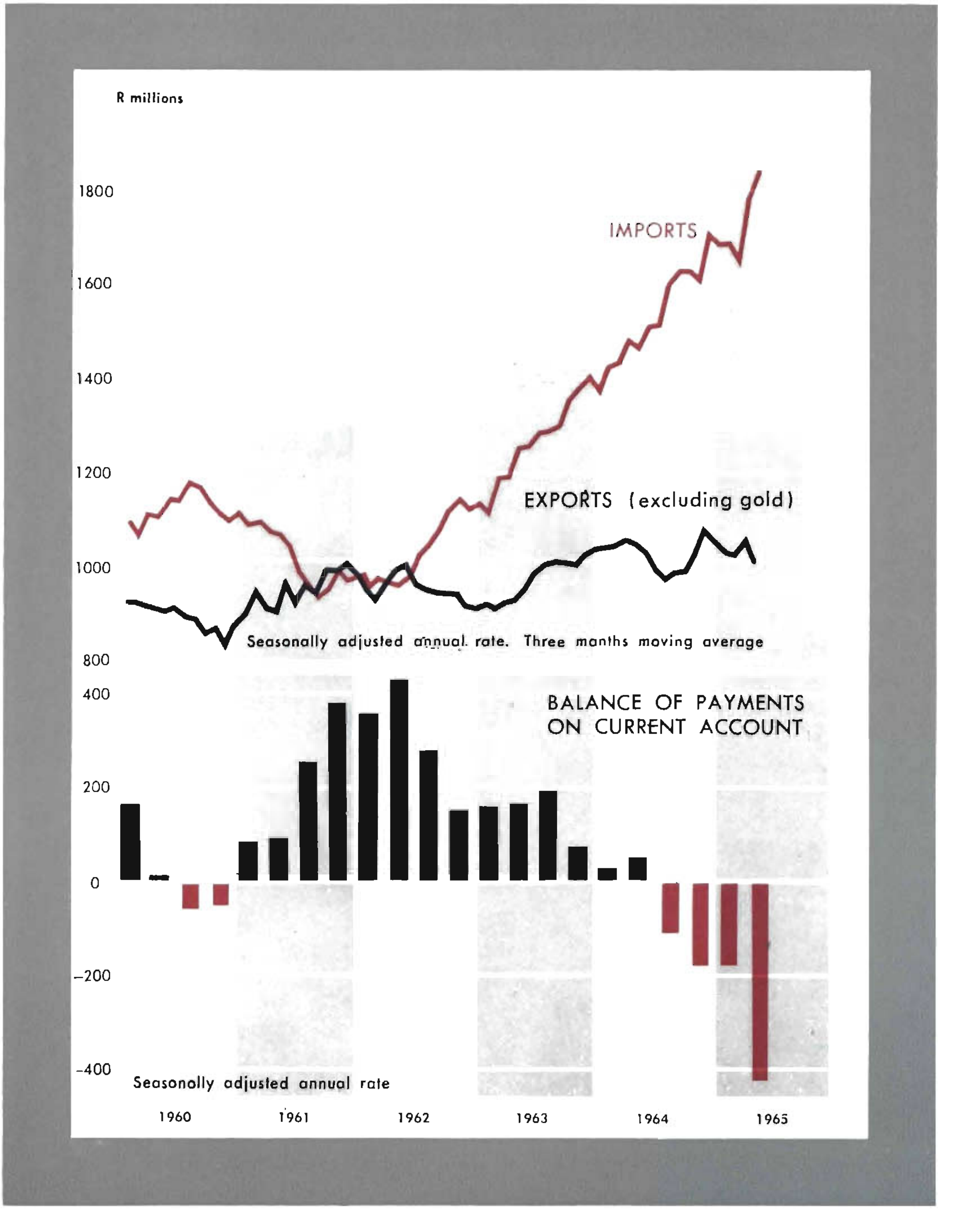
Increasing Deficit on Current Account

The inflationary overspending in the South African economy was clearly reflected in the balance of payments developments during the past year. Thus, the surplus on current account, which had been a major feature of the economic scene during the preceding five years, was transformed into a deficit of R228 million for the twelve months ended June, 1965. Moreover, if allowance is made for seasonal movements, this deficit became progressively larger until, taken at an annual rate, it reached the exceptionally high figure of R420 million during the second quarter of 1965. This deficit contrasted sharply with the peak surplus of R432 million (annual rate) registered exactly three years earlier, during the second quarter of 1962.

The main reason for the marked deterioration in the current account was the behaviour of imports, which for the third consecutive year increased by more than 20 per cent to reach a total of R1,752 million for the year 1964/65. This upward tendency became particularly strong towards the end of the year under review and during the second quarter of 1965 imports actually amounted to a seasonally adjusted annual rate of about R1,900 million.

Balance of Payments on Current Account (R millions)

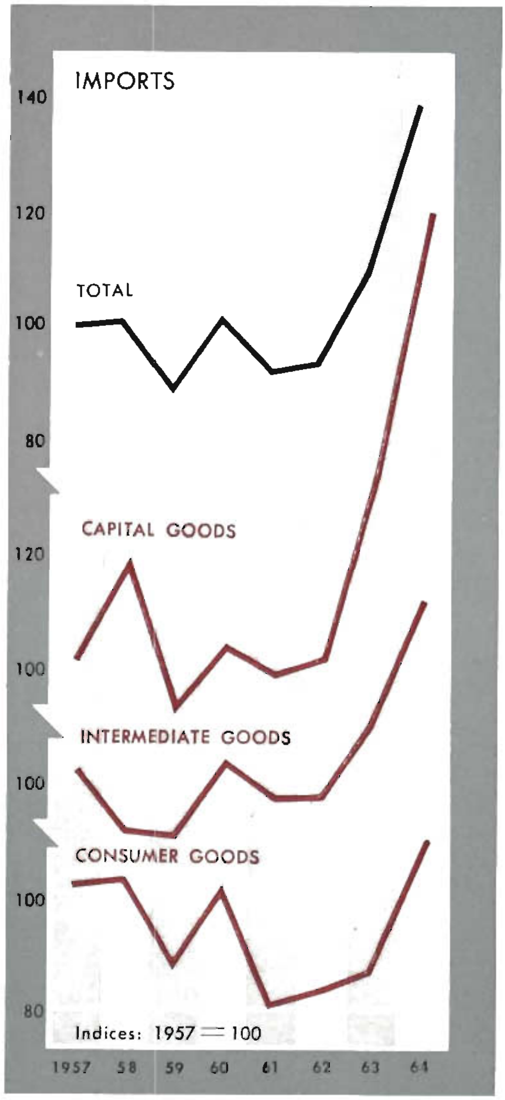
	1963				1964				1965	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Actual Surplus (+) or Deficit (—)	26	38	43	40	-6	6	-34	-22	-57	-115
Seasonally Adjusted Annual Rate	160	168	196	76	28	52	-116	-188	-188	-420

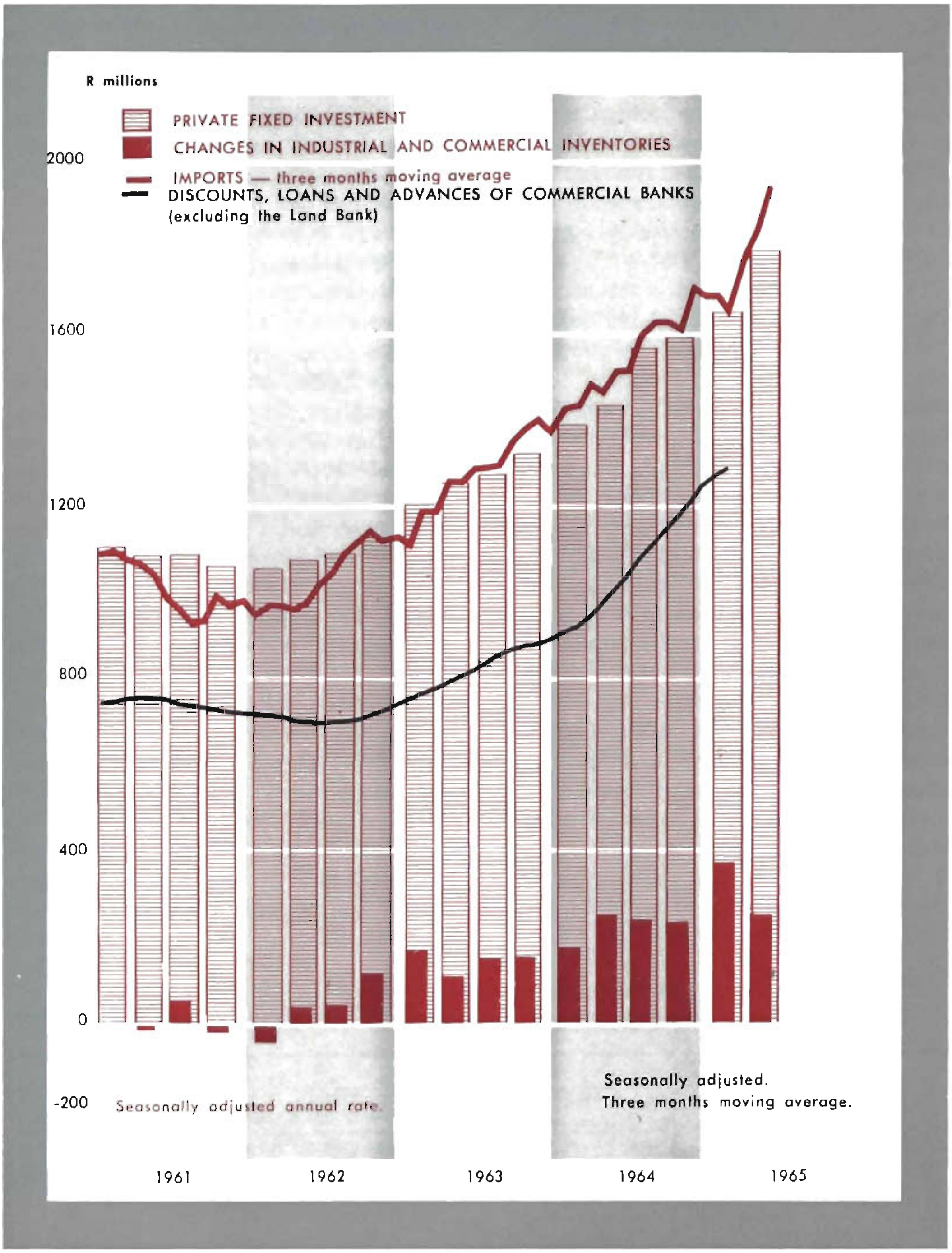

R millions
1800
1600
1400
1200
1000
800
IMPORTS
EXPORTS (excluding gold)
Seasonally adjusted annual rate. Three months moving average
400
200
0
−200
-400
BALANCE OF PAYMENTS
ON CURRENT ACCOUNT
Seasonally adjusted annual rate
1960
1961
1962
1963
1964
1965

The main increases in imports were registered in capital and intermediate goods, including raw materials, and would appear to have been closely associated with both the sharp rise in fixed and inventory investment during this period and the accompanying increase in bank credit.

The importance of the increase in imports as a "safety valve" for allowing potential inflationary steam in the economy to escape, can hardly be over-emphasised. Under the existing conditions of full employment and bottlenecks, the tremendous further rise in public and private capital and consumer outlays could not possibly have been met by an increase in local output alone, and would in all probability have created serious "demand-pull" inflation if the supply of consumer and capital goods as well as raw materials had not been substantially augmented by imports. By providing competition from abroad, the high level of imports also promoted efficiency and helped to prevent costs from rising more sharply in South African industries. As the situation developed, however, it became clear that imports were rising to a level which could not be maintained indefinitely.

Another reason for the deterioration in the current account was a decline in the exports of maize, sugar, wool and other agricultural products as a result of adverse weather conditions. Fortunately, this decrease was partly neutralised by an increase in exports of manufactured products, so that total merchandise exports reached a figure of R1,066 million for the year 1964/65, which was only R9 million less than during the preceding twelve months. In addition, the net gold output increased by R64 million to R764 million, so that merchandise exports and gold output taken together still increased by about R55 million. Net invisible payments to the rest of the world, however, increased by R40 million, mainly owing to an increase in freight, insurance and investment income payments.




R millions
PRIVATE FIXED INVESTMENT
CHANGES IN INDUSTRIAL AND COMMERCIAL INVENTORIES
IMPORTS — three months moving average
DISCOUNTS, LOANS AND ADVANCES OF COMMERCIAL BANKS
(excluding the Land Bank)
2000
1600
1200
800
400
0
-200
Seasonally adjusted annual rate.
Seasonally adjusted.
Three months moving average.
1961
1962
1963
1964
1965

Small Net Inflow of Private Capital

If the errors and omissions in the balance of payments estimates are included under private capital movements, there was actually a net inflow of such funds of R14 million during 1964/65, compared with a net outflow of R88 million during 1963/64 and R98 million during 1962/63.

This substantial decrease in the net outflow of private capital was mainly attributable to the virtual termination of the withdrawal of foreign funds from the South African private sector through sales of South African securities by foreigners to South African residents on the Johannesburg and foreign stock exchanges. Allocations under the "arbitrage" and "permit schemes" of exchange control relaxation were gradually reduced from May, 1964, and eventually suspended in August of that year. From then onwards the proceeds of sales of South African securities by foreigners on the Johannesburg Stock Exchange could only be invested in the special Non-Resident Bonds issued by the South African Government or deposited in a blocked account with an authorised South African dealer in foreign exchange, i.e. if not reinvested in ordinary quoted South African securities. The net outflow of foreign funds from the South African private sector through stock exchange transactions consequently declined from R91 million during the year 1963/64 to only R2 million during the year 1964/65. During the first half of 1965 the total purchases by foreigners on the Johannesburg Stock Exchange actually exceeded their sales by about R4 million.

Further evidence of new interest shown by foreigners in South African securities was provided by the fact that, despite the cessation of the allocations under the arbitrage and permit schemes of exchange control relaxation, the gap between the London and Johannesburg prices of South African securities declined to only about 5 per cent at the end of June, 1965, compared with 19 per cent a year earlier and 25 per cent during September, 1964. Moreover, in July this gap virtually disappeared.

A further important reason for the improvement on private capital account was a change in other long-term capital movements from a net outflow of R20 million during 1963/64 to a net inflow of about R17 million during 1964/65. This reversal was mainly brought about by a substantial increase in net long-term investments by foreigners in South African organisations controlled from abroad and was probably related to the boom conditions in the economy. The inflow of new long-term

Net Movements of Private Capital (R millions)

	1963				1964				1965	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Stock Exchange Transactions	-16	-20	-23	-30	-26	-12	-2	-4	2	2
Other Long-term	-16	-1	-1	-29	15	-5	5	2	2	8
Short-term	3	-14	-1	51	-43	-17	11	18	-20	1
Errors and Omissions	—	15	15	-6	15	9	11	-18	-9	5
Total Private Capital	-29	-20	-10	-14	-39	-25	25	-2	-25	16

foreign capital more than offset contractual repayments of about R16 million on Escom, uranium and other foreign loans of the private sector.

Short-term private capital movements, including errors and omissions, as usual fluctuated considerably and showed a net inflow of R22 million during the second half of 1964 followed by a net outflow of R23 million during the first half of 1965.

Small Net Inflow of Official and Banking Capital

Official and banking capital again showed a moderate net inflow, namely R19 million, compared with R21 million during 1963/64. But although these amounts were roughly similar, significant changes occurred in the composite items. Thus, whereas the Government and the Reserve Bank had made no drawings on foreign loans during 1963/64, they drew no less than R52 million on such loans during 1964/65 in order to support the declining gold and foreign exchange reserves. These borrowings included drawings on the revolving credits made available to South Africa by American and German banks and on a term loan obtained from a group of American banks.

On the other hand, whereas investments by foreigners in the special Non-Resident Bonds issued by the Government had amounted to R27 million during 1963/64, they only attained a figure of R2 million during 1964/65.

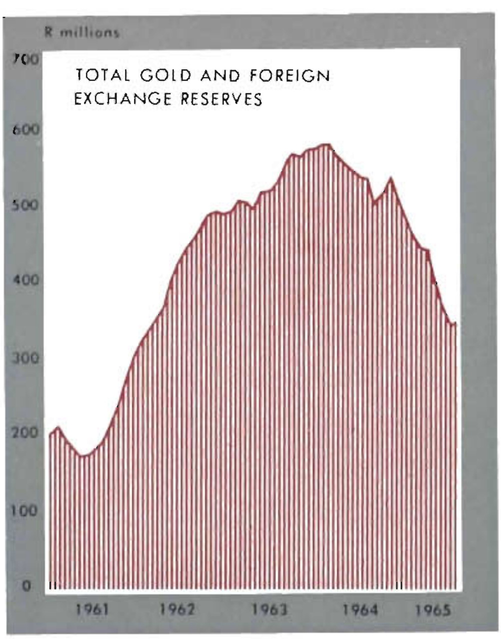
Substantial Decline in Gold and Foreign Exchange Reserves

Despite the improvement in the capital account of the balance of payments, the deficit on current account was so large during 1964/65 that the total gold and foreign exchange reserves held by the Reserve Bank, the commercial banks and the Government declined to R344 million at the end of June, 1965, compared with R540 million a year earlier and the peak figure of R583 million attained in January, 1964. The decline was especially sharp during the first half of 1965, when, despite drawings of R45 million by the Government and the Reserve Bank on foreign loans, the decrease amounted to R145 million.

Net Movements of Official and Banking Capital (R millions)

	1963				1964				1965	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Official Loans:										
Drawings	—	—	—	—	—	—	—	7	35	10
Repayments	-2	-8	-3	-25	-3	-7	-3	-12	-5	-5
Other Long-term	7	4	8	5	17	-6	-1	-1	-5	2
Other Short-term	12	4	10	1	20	4	-9	1	11	-6
Total Official and Banking Capital	17	—	15	-19	34	-9	-13	-5	36	1

From the analysis presented earlier, it is clear that the reserves were, on the whole, well used during the past year in the interests of economic growth, in the sense that their decline was to a large extent a reflection of the substantial additions made to the country's productive capacity and stocks of goods in general. As indicated earlier, they were also well used in the interests of stability by permitting an inflow of competitive goods and services to supplement the output of the hard-pressed internal economy and thus to prevent the existing moderate inflationary pressure from getting out of hand. Naturally, however, the declining tendency in the reserves could not be allowed to continue indefinitely and, as will be set out in some detail later on, the authorities applied various remedial measures during the course of the year.



MONETARY AND BANKING SITUATION

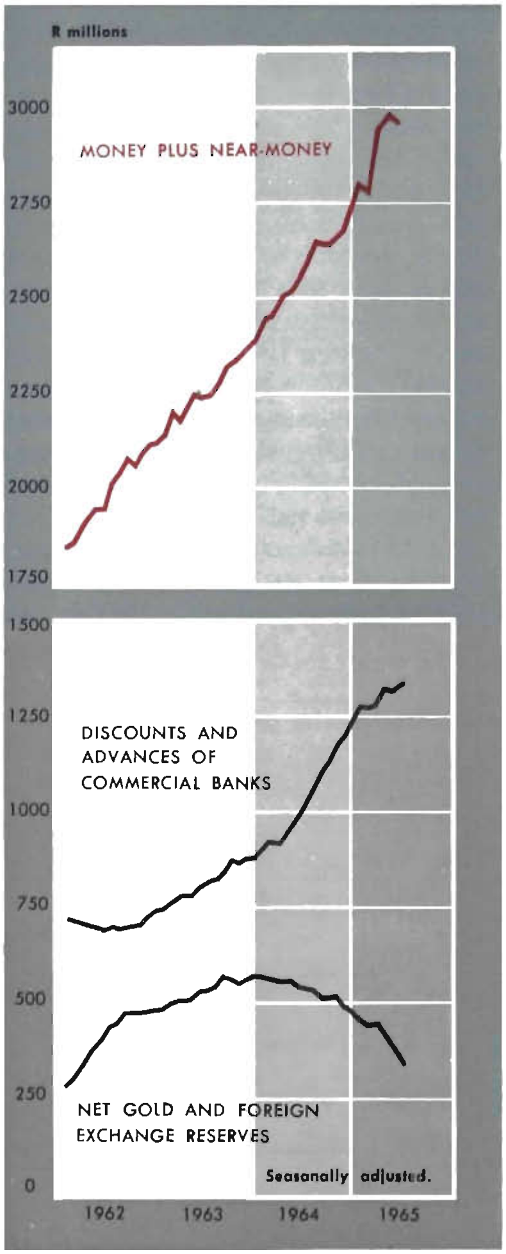
Importance of Monetary Factors in Inflationary Situation

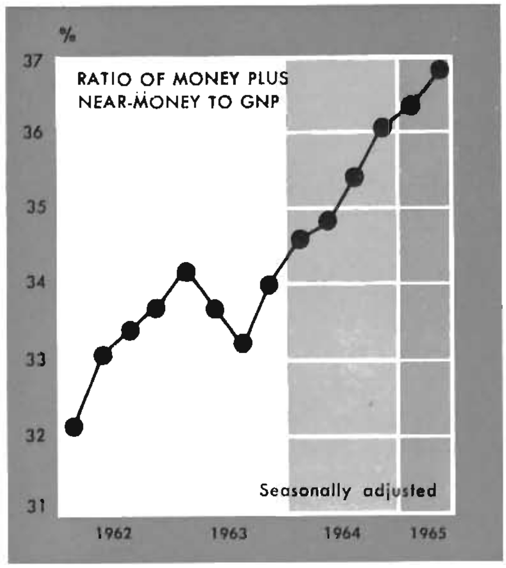
Monetary factors made a crucially important contribution to the inflationary over-investment and over-consumption of the past year. Despite the substantial decline in the official gold and foreign exchange reserves, the supply of money and near-money in the hands of the private sector increased further by a near record amount, mainly owing to an unprecedented rise in bank credit supported by a large shift of Government funds to the private sector. Without this addition to the liquidity of the private sector, it is highly improbable that total spending would have risen to the extent that it did, particularly since the supply of loanable funds arising out of genuine saving and the activation of existing money would then almost certainly have proved insufficient to finance the abnormally large capital outlays planned by both the public and private sectors. Interest rates would then probably also have risen much more and much sooner. In other words, the considerable and continued creation of money and near-money prevented natural economic forces, particularly the balance of payments deficit, from slowing down the excessive rate of increase of total capital and consumer spending to the level necessary to achieve sustained real growth with stability.

Sustained Rise in Money and Near-money*

The increase in money and near-money during the first 11 months of 1964/65 amounted to R308 million or 12 per cent and was mainly attributable to a rise of R339 million in total credit extended by the banking sector to the private sector, as against R214 million during 1963/64. A further contributory factor was a net movement of funds from the Government sector to the private sector over that period of R80 million, compared with a mere R2 million during 1963/64. These increases more than offset the contractionary effect of a decline of R157 million in the net gold and foreign exchange reserves during these 11 months.

* 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.



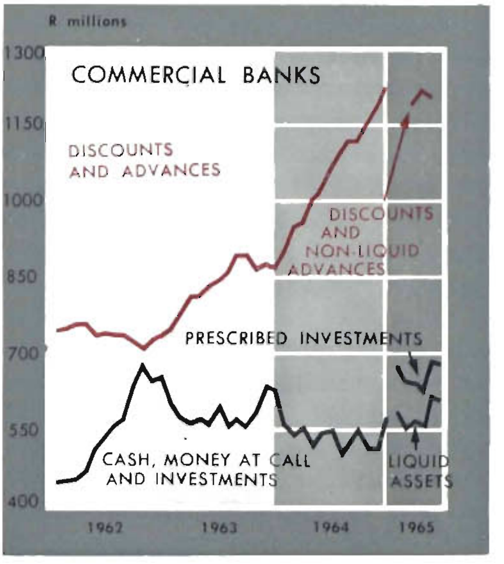


Over the past four years the supply of money and near-money has increased by about R1,220 million or 72 per cent, compared with less than R200 million or 13 per cent during the preceding four years. Moreover, the ratio of money and near-money to gross national product increased from below 31 per cent during 1961 to about 36 per cent during 1964/65. This provides some indication of the extent to which, first the recovery in real income after 1960/61, and then the building up of inflationary pressures, were facilitated and encouraged by an environment of abundant liquidity and easy credit

Inflationary Rise in Commercial Bank Credit

Although an unusually large increase of R28 million was registered in the Land Bank's cash credit advances to farmers, co-operatives and control boards during

1964/65, the continued rise in credit extended by the banking sector to the private sector was largely accounted for by the activities of the commercial banks. The increasingly rapid expansion of commercial bank discounts and advances during the past four years is apparent from the following table:



Discounts and Advances of Commercial Banks

	CHANGE R millions	CHANGE %
1961/62	− 7	− 0.9
1962/63	+ 97	+13.1
1963/64	+209	+24.8
1964/65	+303	+28.9

As a rough approximation, therefore, commercial bank discounts and advances may be said to have increased by about R100 million during 1962/63, R200 million during 1963/64 and R300 million during 1964/65. Moreover, although their rate of increase slowed down noticeably during the second quarter of 1965, they still showed a rise of about R45 million during these three months.

Despite this further increase in their credit extension and the decline in gold and foreign exchange reserves, the commercial banks' average ratio of liquid assets (old definition) to liabilities to the public only declined from 38.4 per cent in June, 1964, to about 33 per cent in June, 1965. The fact that this decline was so small must be largely attributed to the return flow of Government funds to the private sector, to which reference will again be made, and the repatriation of funds previously held abroad under special "swop" arrangements with the Reserve Bank, although at certain stages the banks' liquidity was also prevented from declining further by other developments, such as the conversion by the banks of advances into bills qualifying as liquid assets. The buoyancy of the banks' liquidity ratio naturally meant that they could continue expanding their discounts and advances.

In addition, the Banking Amendment Act which came into operation in January, 1965, reduced the normal minimum liquidity ratios for commercial banks from 30 per cent against total liabilities to 30, 20 and 5 per cent against short, medium and long-term liabilities, respectively. Although the definition of liquid assets was considerably tightened at the same time, the net effect was to increase still further the ability of the commercial banking system to expand its credit to the private sector.

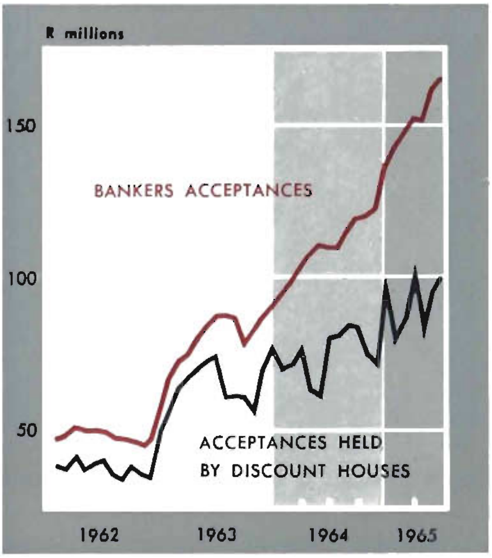
In view of all these circumstances, the Reserve Bank, in terms of the new Banks Act, imposed progressively more stringent supplementary liquidity requirements on the commercial banks, as will be set out in more detail later on. Despite these additional requirements, however, the banks continued to hold substantial amounts of excess liquid assets throughout this period.

Increased Use Made of Acceptance Credits

In addition to the considerable expansion of commercial bank credit, merchant bank acceptance liabilities, which had already risen from a low point of R44 million in October, 1962, to R108 million at the end of June, 1964, increased further to R164 million at the end of June, 1965, i.e. by close to 50 per cent in one year. Moreover, like commercial bank discounts and advances, they continued to rise towards the end of this period.

Since, however, the amount of call money available in the money market did not show a corresponding rise but actually declined somewhat, the discount houses experienced increasing difficulty in discounting all the acceptances offered to them, despite the fact that they increased their ratio of investments in acceptances to Treasury bill holdings from about 3 to 2 during 1963/64 to about 3 to 1 during 1964/65.

The merchant banks themselves accordingly increased their holdings of acceptances from R22 million in June, 1964, to R35 million in June, 1965. Since their deposits only increased from R105 million to R110 million during this period, their increased investment in acceptances was partly made at the expense of their holdings of Government stock and Treasury bills. Significant amounts of acceptances were also taken up during the year by other financial institutions.



Role Played by Hire-Purchase, General and Savings Banks

In assessing the contribution made to the inflationary financing of capital and consumer outlays during the past year by "hire-purchase", "general" and "savings banks", it is important to distinguish between those institutions in these three categories which are considered to fall under the broader group known as "monetary banking institutions", and the rest. "Monetary banking institutions", in terms of the Regulations under the new Banks Act, include the Reserve Bank, the National Finance Corporation, discount houses, commercial banks, merchant banks and those other banking institutions *which operate on a significant scale with short-term deposits ranking as money or near-money* and which are for that reason required to maintain a minimum balance with the Reserve Bank.

Out of a total of 44 hire-purchase, general and savings banks, nine qualify at present as monetary banking institutions, including three institutions which are subsidiaries of commercial banks. The remaining 35 operate almost entirely with medium and long-term deposits which largely represent genuine savings of the public. Unlike the monetary banking institutions, they accordingly do not, to any significant extent, create money or near-money when they extend credit, and do not normally add much to the supply of loanable funds *independently of the public's savings*. Their activities, therefore, do not have the same inflationary significance as those of monetary banking institutions.

During the past year it would appear that the nine monetary banking institutions referred to above did, as a group, help materially to bring about the state of general overspending, while the remaining 35 hire-purchase, general and savings banks as usual played a relatively neutral role. Thus, out of an increase of R233 million or about 50 per cent in total deposits with all hire-purchase, general and savings banks over the nine-months' period from June, 1964, to March, 1965, the nine monetary banking institutions accounted for R216 million. Similarly out of an increase in the total discounts and loans of these three groups of banking institutions of R136 million during this period, the share of the monetary banking institutions was R123 million.

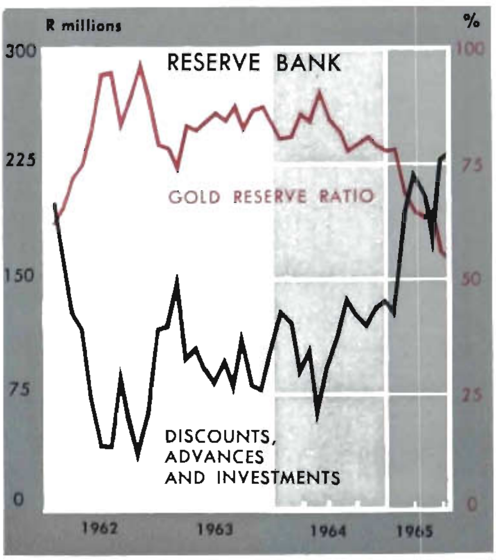
In analysing the role played by these nine monetary banking institutions, however, account must be taken of the fact that about four-fifths of the increase in their deposit liabilities would appear to have taken the form of medium and long-term deposits which, in view of the new legal restrictions on the early repayment of fixed and notice deposits, can perhaps not justifiably be considered as close money substitutes or "near-money" and which to a significant extent would appear to have emanated from genuine saving by the public. Nevertheless, while their activities probably had less inflationary significance than those of the commercial banks from the point of view of the creation or activation of money and near-money, some of them did serve to channel more scarce savings into the financing of consumption than appeared to be desirable under the prevailing inflationary conditions.

It is further of interest to note that the three subsidiaries of commercial banks included in the nine monetary banking institutions under discussion reinvested R85 million of the increase of R125 million in their deposits during the nine months in question with either their "parent" banks or the National Finance Corporation and other banking institutions. This helps to explain the abnormally large difference between the additional amount deposited with these nine institutions during this period (R216 million) and the increase in their discounts and loans (R123 million).

Finally, such data as are available for the nine monetary banking institutions for April and May, 1965, suggest that their deposit liabilities remained about constant at the level reached in March, 1965, and that credit extended by them increased only slightly.

Rise in Reserve Bank Credit

As a result of the substantial further rise in the demand for capital and credit at a time when the balance of payments deficit was draining funds from the internal economy, the Reserve Bank was called upon during the past year to grant increased financial accommodation in a variety of ways. Its total discounts, advances and investments, which during 1963/64 had generally remained between the relatively close limits of R75 million and R100 million, accordingly increased from R91 million at the end of June, 1964, to R132 million at the end of December and R226 million at the end of June, 1965.



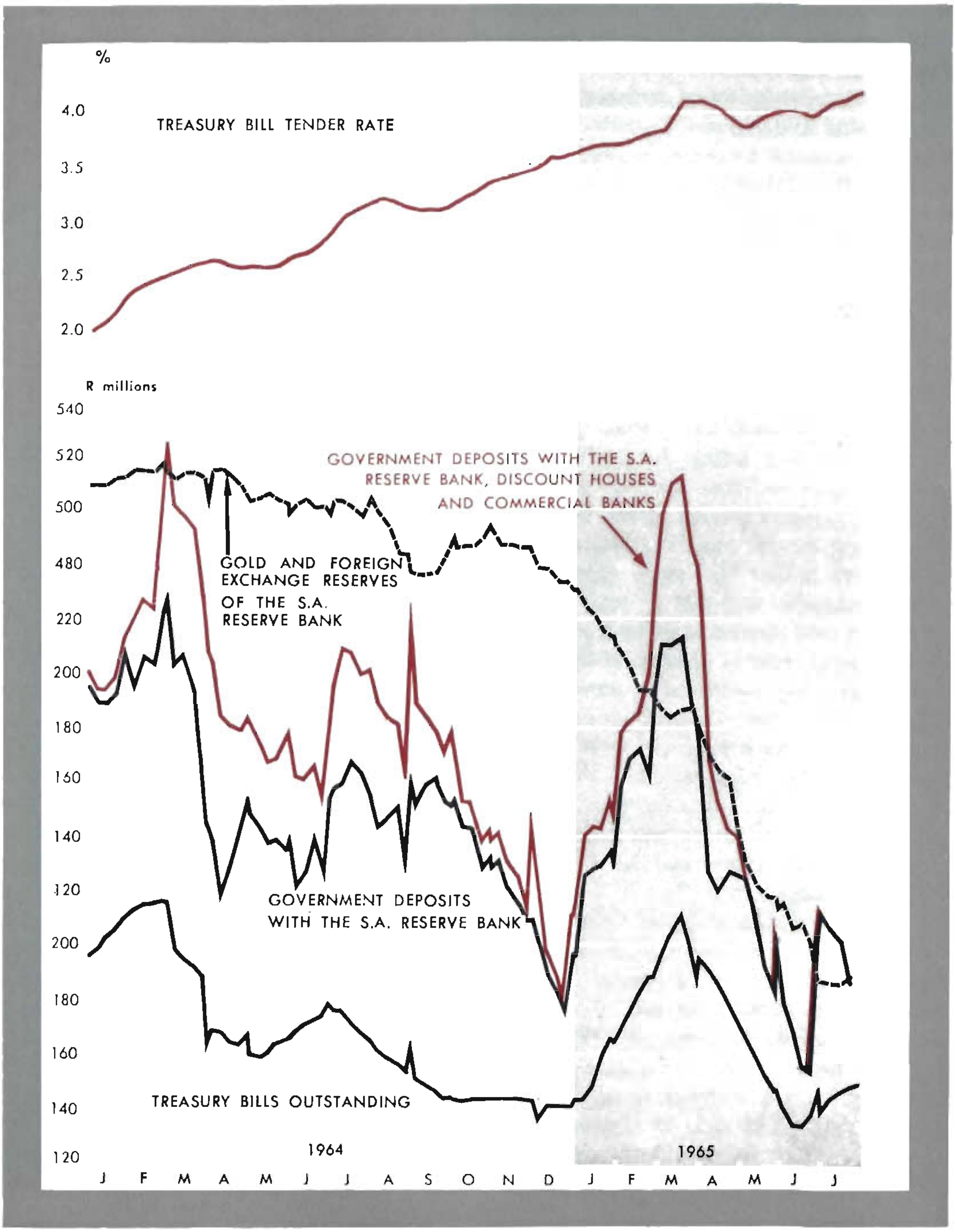
Rise in Short-Term Interest Rates

During the past year the Treasury bill tender rate and related money market rates, although fluctuating at times, continued the upward trend which started towards the end of 1963. By the 30th July, 1965, a rate of 4.19 per cent had been reached, compared with the low point of 1.68 per cent registered in November, 1963, and 2.86 per cent at the end of June, 1964.

As usual, different factors influenced the movement of short-term interest rates at different stages during the past year, but the main reason for the continued upward tendency in these rates was the accelerated decline in the gold and foreign exchange reserves.

Government deposits as usual fluctuated considerably, and to relieve the strain which this placed upon the money market, fairly large amounts of Government funds were at times deposited with discount houses and commercial banks. By the beginning of May, 1965, however, all these funds had been withdrawn. On the other hand, the tightening effect of this withdrawal was more than offset by the extremely rapid decline in Government deposits with the Reserve Bank after March, 1965, as a result of which the Treasury bill rate increased only moderately during the second quarter.

Call money rates and most other deposit rates throughout the banking system tended to show even larger increases than the Treasury bill rate during the past year. This was the result of keen competition for funds among the various banking institutions which, in turn, was largely a natural reflection of the changes which occurred during this period in the underlying eco-



%
4.0
3.5
3.0
2.5
2.0
TREASURY BILL TENDER RATE
R millions
540
520
500
480
220
200
180
160
140
120
200
180
160
140
120
GOVERNMENT DEPOSITS WITH THE S.A. RESERVE BANK, DISCOUNT HOUSES AND COMMERCIAL BANKS
GOLD AND FOREIGN EXCHANGE RESERVES OF THE S.A. RESERVE BANK
GOVERNMENT DEPOSITS WITH THE S.A. RESERVE BANK
TREASURY BILLS OUTSTANDING
1964
1965
J F M A M J J A S O N D J F M A M J J

nomic situation and, in particular, in the relationship between the demand for and supply of loanable funds. Thus, on the one hand, the inflationary overspending on both capital and consumer goods was accompanied by an abnormal increase in the *demand* for virtually all forms of credit while, on the other hand, the *supply* of loanable funds was affected by both a substantial decline in personal saving and a large deficit on the overall balance of payments, which naturally tended to drain liquid assets from the banking system as a whole.

In these circumstances, certain general, hire-purchase and savings banks, in an attempt to draw sufficient funds to meet the abnormal demand for their credit facilities, raised their deposit rates in stages to relatively high levels. The main commercial bank subsidiaries followed by substantially increasing their deposit rates and, as pointed out earlier, reinvested most of the additional funds they succeeded in attracting in this way with their "parent" commercial banks. Not all the commercial banks, however, had subsidiaries of this kind and eventually the deposit rate agreement which existed among the banks was terminated, whereupon the commercial banks raised their own deposit rates. In the meantime, the merchant banks had also found it necessary to increase their various rates for funds, so that by the first quarter of 1965 virtually the entire structure of deposit rates had moved upwards. By February, 1965, for example, certain banking institutions were quoting as much as $6\frac{3}{4}$ per cent on fixed deposits of 12 to 18 months, while as much as 4.20 per cent was being paid by some institutions on 30 days' notice deposits.

Under the existing conditions, lending rates in general also tended to rise, particularly as Bank Rate, which had been increased from $3\frac{1}{2}$ to 4 per cent on the 15th July, 1964, and from 4 to $4\frac{1}{2}$ per cent on the 8th December, was further raised to 5 per cent on the 5th March, 1965. The minimum overdraft rate of commercial banks, for example, was increased to 6 per cent in July, 1964, to $6\frac{1}{2}$ per cent in December and to 7 per cent in March, 1965.

Deposit Rate Control

But while the monetary authorities welcomed the general upward tendency in interest rates, it was felt that the keen and not entirely free competition among banking institutions for deposits had brought about an excessive increase in certain deposit rates, which tended to distort the interest rate structure and the flow of funds between the various kinds of banking institutions and to exert undue upward pressure upon certain lending rates, particularly the mortgage rates of building societies. In addition, they felt that hire-purchase, general and savings banks might, by offering higher deposit rates than commercial banks and building societies, attract considerable additional funds which would enable them to expand their credit extension to the private sector still further and thus facilitate the inflationary overspending. It was also feared that such a movement of deposits might leave the building societies unduly short of funds.

The Reserve Bank, therefore, in terms of powers given to it under the Currency and Exchanges Act of 1933 and with effect from the 22nd March, imposed the following set of maximum deposit rates on all commercial banks, merchant banks, discount houses and building societies with deposits exceeding R10 million and on all general, hire-purchase and savings banks with deposits exceeding R30 million:

Type of Deposit	Maximum Rate of Interest Per Annum[1])
Demand deposits withdrawable by cheque	Nil
Other demand deposits, including call loans; and deposits withdrawable within a period, or subject to notice of withdrawal, not exceeding 7 days	1/8 per cent below the current average tender rate for Treasury bills.
Savings deposits; and deposits withdrawable within a period, or subject to notice of withdrawal, exceeding 7 days but not exceeding 30 days	4 per cent
Deposits withdrawable within a period, or subject to notice of withdrawal,	
exceeding 30 days but not exceeding 90 days	$4\frac{1}{4}$ per cent
exceeding 90 days but not exceeding 6 months	$4\frac{1}{2}$ per cent
exceeding 6 months but of less than 12 months	$5\frac{1}{4}$ per cent
of 12 months or more	$5\frac{1}{2}$ per cent
Paid-up indefinite shares of building societies	6 per cent

1) Excluding commission paid by building societies to agents for collection of deposits.

In the case of all banking institutions and building societies with deposits not exceeding R10 million and all general, hire-purchase and savings banks with deposits not exceeding R30 million, an additional $\frac{1}{4}$ per cent was allowed on deposits other than cheque deposits, other demand deposits and deposits withdrawable within a period or subject to notice of withdrawal not exceeding 7 days.

Until the 26th July, deposit rates continued to be pegged at the above levels except for small amendments with a view, for example, to allowing for the payment of commission to agents for the collection of deposits by all banking institutions other than commercial banks (which are legally prohibited from operating through agents), and not just by building societies as originally permitted. From the 26th July, however, two new types of deposit rates were permitted, namely $5\frac{3}{4}$ per cent for deposits of 24 months or more but less than 36 months, and 6 per cent for deposits of 36 months or more.

As is already apparent from the facts presented earlier, an important influence was exercised on financial and monetary conditions during the past year by certain developments in the field of Government finance. As the accompanying graph shows, Central Government deposits with the Reserve Bank, commercial banks and discount houses fluctuated around the exceptionally high level of R200 million during most of 1963/64, but then declined from R172 million at the end of June, 1964, to R79 million at the end of June, 1965. Prior to the introduction of the P.A.Y.E.-system of tax collection in 1963, these deposits had shown a regular seasonal pattern consisting of an increase during the fourth and first quarters, followed by a decline to a very low level during the second and third quarters. After the introduction of the P.A.Y.E.-system early in 1963, however, the seasonal decline in income tax receipts during the second and third quarters of the year was greatly reduced. At more or less the same time, the Government also increased its net borrowing, not because it needed all the additional funds, but to provide investment outlets for the money market and the Public Debt Commissioners. The result was a substantial build-up of Government deposits during 1963. But after reaching the record figure of R262 million in February, 1964, these deposits began a sharp downward movement, which was only interrupted by the usual seasonal increase early in the third quarter and then, more noticeably, in January and February, 1965.

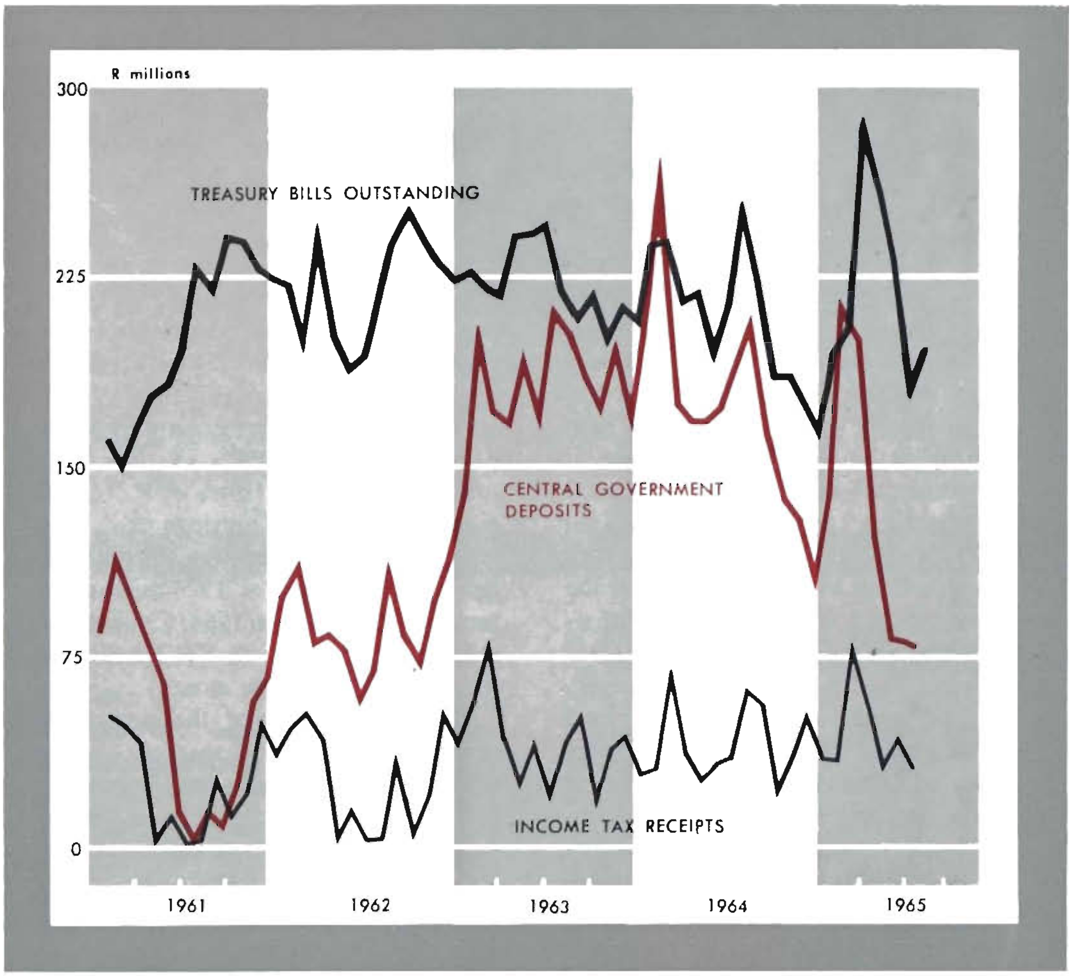
The downward tendency in Government deposits over the year mainly reflected a decline of R122 million in the Exchequer balance. This, in turn, was the result of an excess of *total* Government issues over receipts of R295 million, which was financed to the extent of only R173 million through net borrowing. The Revenue Account, as such, continued to show a substantial surplus, but issues on Loan Account increased considerably while net borrowing

Exchequer Receipts and Issues (R millions)

	July/June 1960/61	July/June 1961/62	July/June 1962/63	July/June 1963/64	July/June 1964/65
Revenue Account:					
Receipts	730	748	899	965	1,111
Issues	661	745	811	892	1,055
Net Receipts	69	3	88	73	56
Loan Services and Recoveries (net)	-151	-151	-148	-225	-322
Other Receipts (net)	12	15	7	10	-29
Excess of Total Issues Over Receipts	-70	-133	-53	-142	-295
Net Borrowing	42	147	162	147	173
Change in Exchequer Balance	-28	14	109	5	-122

showed a rise of only R26 million compared with the previous year. In other words, the Government financed a considerable part of its expenditures on Loan Account during 1964/65 by running down its balance with the Reserve Bank. This contrasted sharply with the position during the three preceding years, when net borrowing had exceeded the excess of total issues over receipts, with a consequent increase in Government deposits.

This method of financing a part of the increased public sector outlays by allowing the Government's deposits to be drawn down, naturally had implications for both the capital market and the banking sector. In general, it tended to offset the contractionary effect on bank liquidity of the balance of payments deficit and to reduce the effectiveness of the imposition of supplementary liquid asset requirements on commercial banks.



CAPITAL MARKET

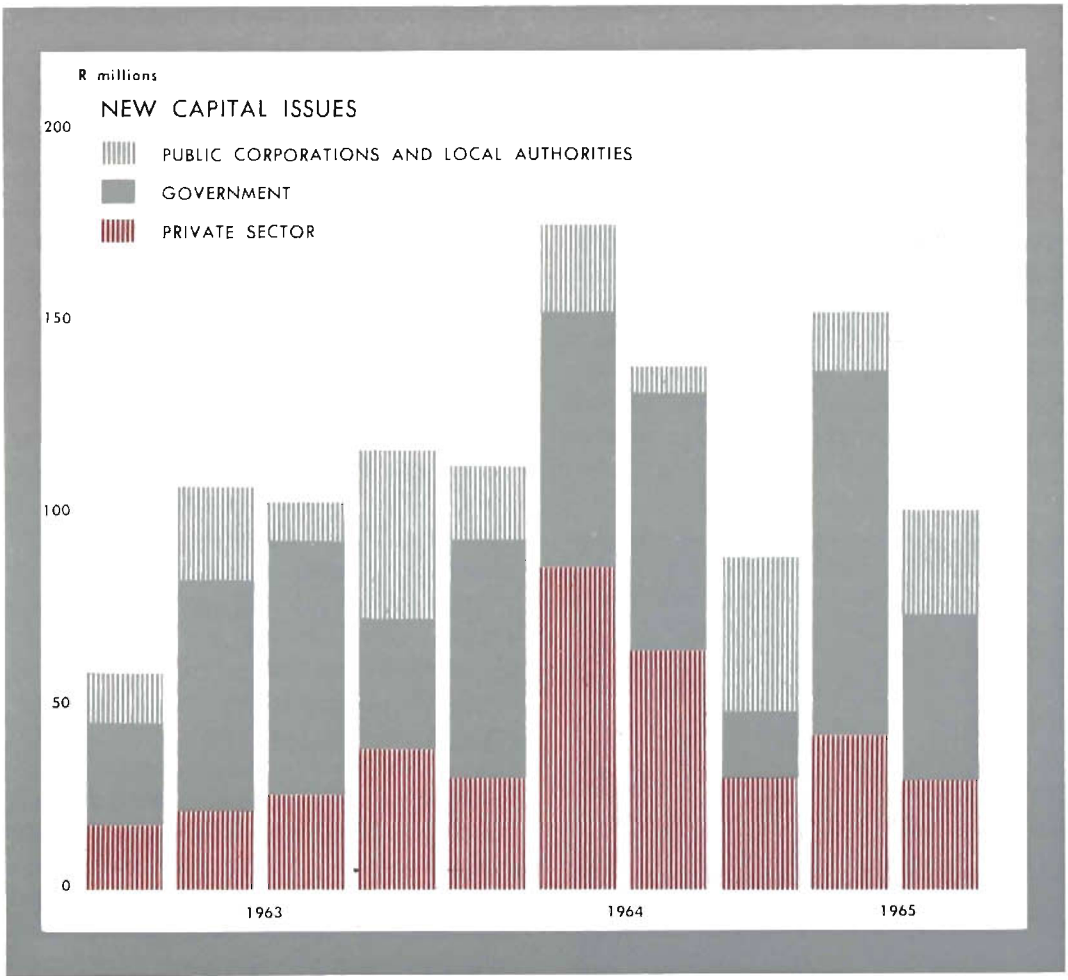
General Tightening of Capital Market

In the absence of a sufficiently high level of domestic saving, the considerable further rise in fixed capital expenditures in both the public and private sectors during the past year tended to bring about a progressive tightening of conditions in the capital market. This tightening would probably have been more severe and would have become noticeable at an earlier stage if the Government had not, as explained earlier, financed part of its increased capital outlays by allowing its balance with the Reserve Bank to run down, and if the private sector had not financed part of its capital spending by means of bank credit. Nevertheless, despite the inflationary creation of additional money, the total supply of loanable funds still fell short of the increased demand and the entire interest rate structure understandably moved upwards. Indeed, towards the end of the period under review the capital market was operating under more strain than at any time during the previous three years.

Continued High Level of Net New Issues of Marketable Securities

One indication of the underlying strength of the demand for capital was the fact that net new issues of marketable securities by the private sector, public corporations and local authorities amounted to about R254 million during the twelve months ended June, 1965, which was only slightly lower than the high figure of R277 million registered during the previous year. In addition, the Government was responsible for net new stock issues of R223 million, which brought the total for 1964/65 up to R477 million, compared with R502 million during the previous twelve months.

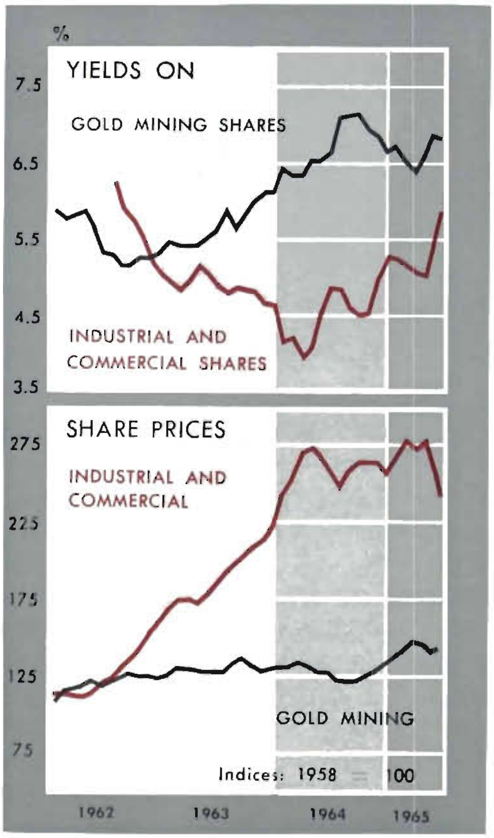
Towards the end of the period under review, however, as market conditions tightened and interest rates increased, it became more difficult to raise funds by means of issues of marketable securities and increased use had to be made of alternative methods of financing the high level of capital outlays.



Share Prices and Yields

The behaviour of the index of industrial and commercial share prices under these conditions was interesting. By the middle of 1964 this index (1958=100) had declined to 258, compared with the peak of 273 reached in April, 1964. But then followed a new upward movement which eventually, after a temporary decline during the fourth quarter, brought the index to a new peak of 278 in April, 1965. The main reasons for this new increase would appear to have been (1) the high degree of optimism prevailing in the economy, based partly on favourable company reports; (2) higher dividend declarations; (3) the growing inflationary pressure; and (4) the cessation, from August onwards, of allocations of sterling under the "arbitrage scheme" of exchange control relaxation, which reduced the addition to the supply of scrip on the Johannesburg Stock Exchange through sales of South African securities by foreigners to South African residents. During this period both insurance companies and pension funds invested substantial amounts in ordinary shares.

Subsequently, however, as the extent of the balance of payments deterioration became wider known and the monetary authorities announced remedial measures, the mood of the share market appeared to change somewhat, and the index of industrial and commercial share prices declined to 241 in June, while the average yield on these shares increased to 5.8 per cent, compared with the low point of 4.0 per cent registered in March, 1964.



The price index of gold mining shares behaved somewhat differently. After reaching a peak of 135 in March, 1964, it declined gradually to 123 in September. During the next six months, however, it showed a fairly strong upward movement, partly owing to an increased foreign demand for South African gold mining shares which, in turn, appeared to be associated with rising uncertainty regarding the future of the international monetary mechanism. Although this index declined somewhat again after reaching a peak of 149 in March, 1965, it remained at a relatively high level during the second quarter of 1965.

Strong Upward Pressure on Gilt-Edged Rates

In the gilt-edged market, the changes in the underlying demand-supply relationships were in sympathy with those in the rest of the capital market. Strong upward pressure was exerted upon interest rates and the Reserve Bank increased its pattern of rates for Government stock on three occasions between December, 1964, and April, 1965, bringing the rate for maturities exceeding $10\frac{1}{2}$ years to $5\frac{1}{2}$ per cent.

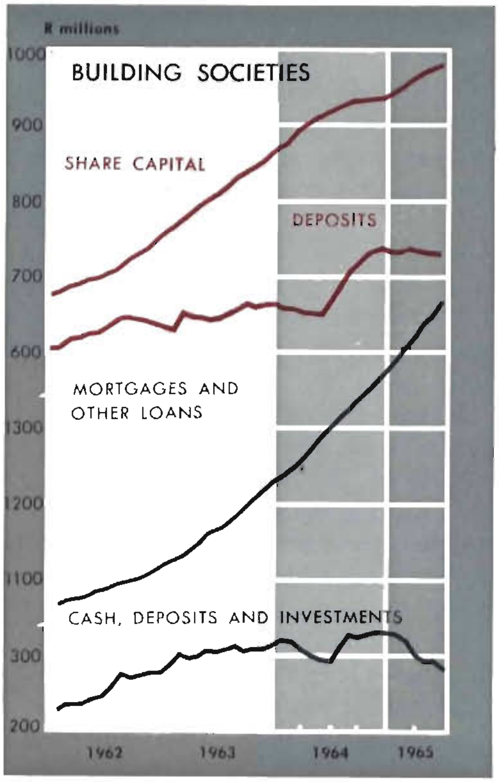
Despite these rate adjustments, the Bank was called upon to purchase a certain amount of Government stock, so that its holdings of such stock increased from R37 million at the end of June, 1964, to R54 million at the end of December, 1964, and R93 million at the end of June, 1965. Some of these transactions were effected at rates exceeding the Bank's pattern by as much as 0.25 per cent.

An interesting feature of the gilt-edged market during the past year was the fact that insurance companies emerged as net sellers of Government stock, while they invested substantial additional amounts in stocks of municipalities and public corporations.

Increased Lending by Building Societies

The building societies experienced an even greater increase in their aggregate share capital and deposits during 1964/65 than during the previous year, namely R149 million as against R119 million. At first, this was largely the result of a sharp rise in their fixed and savings deposits following the increase in their deposit rates in June, 1964. But during the first half of 1965 it was entirely a reflection of a rise in their share capital, which more than offset a moderate decline in savings deposits and a levelling-off in fixed deposits. The decline in savings deposits was partly attributable to the new Building Societies Act which came into operation in January, 1965, and which, with a view to restoring the genuine savings character of building societies as a basis for certain important concessions, reduced the upper limit for savings accounts from R10,000 to R6,000 and prohibited limited liability companies from opening such accounts. The increase in share capital, on the other hand, would appear to have been partly the result of the imposition of deposit rate control in March, in terms of which the societies were allowed to pay 6 per cent on shares but not more than $5\frac{1}{2}$ per cent on fixed deposits of 12 months and more.

Nevertheless, despite this considerable further increase in their resources, the building societies eventually found themselves unable to meet completely the abnormally strong and increasing demand for their mortgage loans which was in part, at least, associated with the general overspending, even after running down their liquid assets and other "prescribed investments". Thus, although their total outstanding mortgage and other loans con-



tinued to rise strongly, their "mortgage loans granted but not paid" began to decline gradually after reaching a peak in November, 1964.

In an attempt to increase their resources, many societies raised their rates on savings deposits to the legal limit of 4 per cent. This, together with the fact that they were paying commission on new funds at the legal maximum rate of $\frac{1}{2}$ per cent and attracting relatively more in the form of share capital and relatively less in the form of deposits, naturally increased the average cost of their funds, and eventually, in July, 1965, even the larger societies were forced to raise their mortgage rates to $7\frac{1}{2}$ per cent, as the others had done previously.

MONETARY AND FISCAL POLICY

During the course of the past twelve months heavy reliance came to be placed upon monetary policy as a means of counteracting the inflationary pressures in the economy. As it became increasingly evident that total capital and consumer outlays were rising at an excessive rate and that this overspending was being facilitated by the creation of large amounts of money and near-money by the banking system, various monetary measures were brought into play with a view to increasing the cost and restricting the rate of increase of credit and reducing the excessively high ratio of money and near-money to gross national product. The intention of this, in turn, was to assist in reducing the rate of increase of total monetary demand to a level more commensurate with the rate of increase of the real gross national product, thereby diminishing the inflationary pressure in the economy and relieving the strain on the balance of payments.

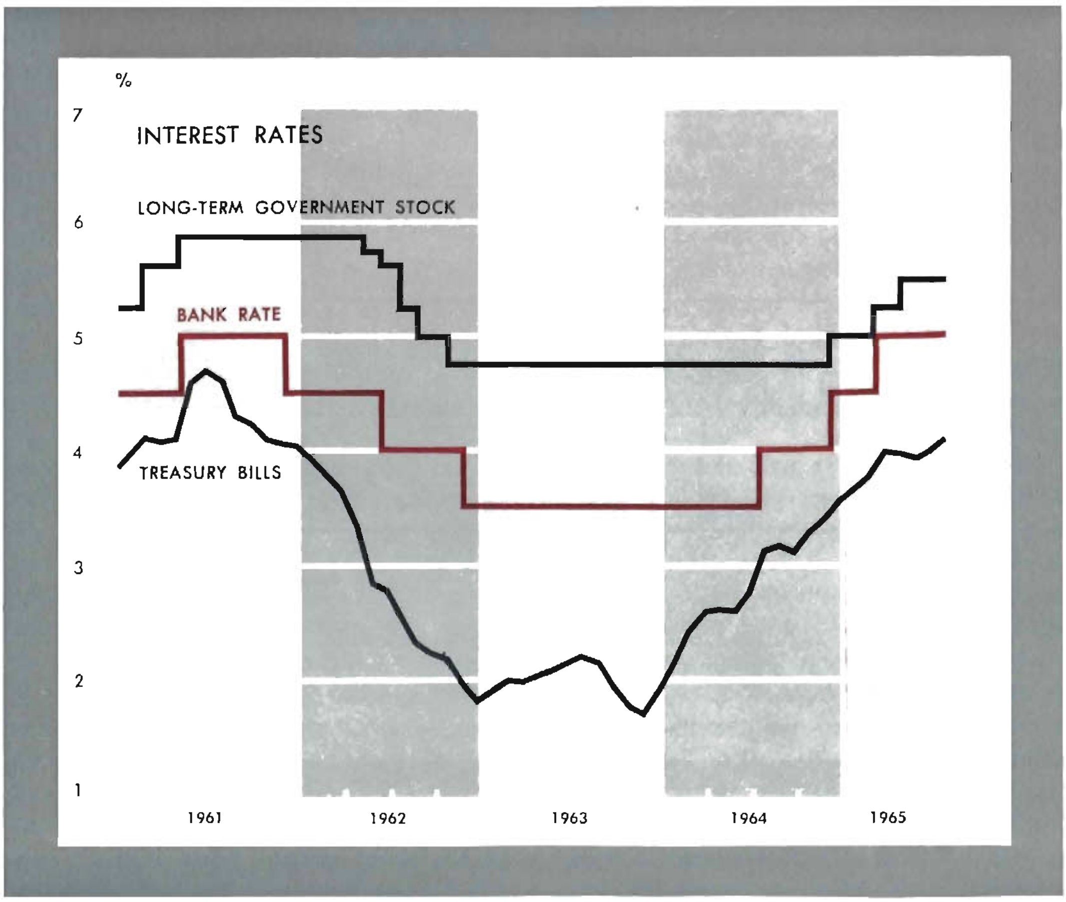
Although these monetary restraints were at first very moderate, they were introduced at a relatively early stage. Thus, the Reserve Bank, as far back as June, 1964, held a series of meetings with the main classes of banking institutions and urged them to adopt a cautious credit policy, laying particular emphasis on the need to prevent the extension of an excessive amount of consumer and speculative credit. Bank Rate was also raised from $3\frac{1}{2}$ to 4 per cent on the 15th July, 1964. Further measures were not deemed necessary at that stage as there appeared to be reason to believe that appreciable reliance could be placed upon the operation of certain stabilising forces of a self-regulating nature.

The most important of these forces appeared to be the contractionary effect which the balance of payments deficit was exercising on the liquidity of the banks and therefore on their ability to create money and near-money. The average liquidity ratio of the commercial banks, for example, had already declined from 44.4 per cent at the end of 1963 to 38.4 per cent by the middle of 1964, and in view of the anticipated further deficit in the balance of payments, it seemed likely to continue its downward movement. In this manner, through its direct and indirect effect on imports, the undue expansion of bank credit was expected to bring about its own natural corrective.

Unfortunately, however, certain unforeseen developments provided the banks with additional liquid assets and enabled them to continue financing the strongly rising capital and other expenditures in an inflationary manner. These developments included (1) the unexpectedly large movement of Government funds to the private sector during the fourth quarter of 1964 referred to earlier; (2) the net inflow of private capital during the second half of 1964, which temporarily tended to offset the effect of the growing current account deficit; (3) the conversion by the banks of overdrafts into trade bills and the inclusion of the latter under "liquid assets"; and (4) the repatriation by the banks of funds previously held abroad under special "swop arrangements" with the Reserve Bank.

Realising the implications of these developments, the monetary authorities introduced additional anti-inflationary measures during the fourth quarter of 1964. The Reserve Bank, for example, held a further series of meetings with banking institutions in October, during which it emphasised the vital importance of slowing down the rate of increase of credit in general, including credit for so-called productive purposes. Other steps included a more restrictive attitude towards rediscounting by the Reserve Bank, the withdrawal of Treasury funds from the money market, and a second increase in Bank Rate on the 8th December, namely from 4 to 4½ per cent, accompanied by an increase of one quarter per cent in the Bank's pattern of interest rates for Government stock.

In the official statement explaining the December Bank Rate increase, the Reserve Bank declared categorically that the economy was "moving into the early stages of demand inflation" and that this infla-



tionary tendency was "being facilitated by the existence of a relatively large amount of money and near-money in relation to the gross national product" which, in turn, was "to a large extent attributable to a considerable rise in credit extended to the private sector by various classes of banking institutions during the course of 1964".

Further anti-inflationary steps were to follow soon afterwards, as it became clear that the existing measures were still too moderate to cope with the inflationary pressure in the economy. Moreover, as mentioned earlier, one of the effects of the Banking Amendment Act which came into operation in January, 1965, was to reduce the liquidity requirements of the commercial banks, thereby further increasing their ability to create money. Under the prevailing conditions of keen and sometimes unbridled competition, this ability was used to the full.

The authorities therefore had no choice but to go a stage further in applying a restrictive monetary policy and on the 5th March, 1965, the Minister of Finance announced a whole series of additional disinflationary steps. These measures were the following:

(1) Bank Rate was increased further to 5 per cent;
(2) the ratio of liquid assets to be held by the commercial banks against their short and medium-term liabilities to the public were increased by four per cent, that is, to 34 and 24 per cent respectively;
(3) the Reserve Bank raised its pattern of rates for Government stock by 0.30 per cent, bringing the rate for stocks with maturities exceeding three years but not three-and-a-half years to $4\frac{1}{2}$ per cent and that for maturities exceeding $10\frac{1}{2}$ years to $5\frac{1}{4}$ per cent; and
(4) it was announced that the Reserve Bank might decline accommodation or charge penalty rates for any institution which in its view had been extending credit to an excessive degree and/or for non-essential purposes, and that it might also refuse to purchase, or apply penalty rates to the purchase of, prescribed assets, such as long-term Government or municipal stock, if, in its view, such purchases resulted from, or would encourage, excessive and/or undesirable credit extension.

During the week preceding this announcement the Governor of the Reserve Bank also held discussions with the representatives of the main types of banking institutions and again impressed upon them the need for a substantial reduction in the rate of increase of credit for all purposes, but particularly in the case of credit for non-essential consumption. In addition, he requested those banking institutions which had until the end of 1965 to comply with the more stringent liquidity requirements of the amended Banking Act, to subject themselves voluntarily to the higher liquidity requirements which were to be applied to the commercial banks.

This approach left no doubt that in their attempt to correct the inflationary overspending in the economy, the monetary authorities were prepared to allow certain interest rates to rise. At the same time, and for the reasons mentioned earlier, maximum deposit rates were prescribed for all banking institutions and building societies, with effect from the 22nd March, which naturally tended to moderate the upward movement in interest rates generally.

Although the main emphasis in the official anti-inflationary policy was placed upon monetary measures, the Budget introduced by the Minister of Finance in March, 1965, also included certain steps to prevent the inflationary tendencies in the economy from getting out of hand. Thus, apart from pruning the amount of R540 million requested by Departments on Loan Account to R447 million and emphasising the importance of voluntary saving under the existing conditions, the Minister instituted a loan levy of 5 per cent on the income tax of persons and companies (excluding gold mining companies), with a maximum currency of seven years. In the case of individuals, however, the levy would not be payable where it amounted to less than R5. The Minister also imposed a surcharge of 5 per cent on the income tax of all companies other than gold mining companies and proposed the transfer of R30 million of the current year's Revenue to Loan Account, i.e. in addition to the R110 million surplus from 1964/65.

In the nature of the case, the disinflationary monetary measures announced in March were slow to take effect. The commercial banks' discounts, loans and advances, for example, increased by R24 million and R34 million during March and April, respectively. Moreover, during these two months their liquidity position was prevented from deteriorating further not only by the substantial movement of funds from the Government to the private sector during this period, but also by the fact that the Government's 1958-68 loan moved into the three-year category and thus became "liquid".

For these reasons, the monetary authorities further increased the liquidity requirements in respect of commercial banks in three stages, namely by an additional 2 per cent against both short and medium-term liabilities with effect from about the 21st May (the date of certification of the monthly return as at 30th April), by a further 2 per cent from about the 21st June and by a final 2 per cent with effect from about the 21st July. This raised the minimum liquidity ratios for commercial banks to 40 and 30 per cent of short and medium-term liabilities, respectively, which were the maximum percentages permitted by law.

During the second quarter of 1965 the Reserve Bank also started quoting penalty rates for accommodation to certain banking institutions which, in its view, had been extending credit to an excessive degree and/or for non-essential purposes.

An additional step was the further raising by the Bank of its pattern of rates for certain maturities of Government stock by 0.25 per cent on the 29th April. This was done in recognition of changes in demand-supply relationships in the gilt-edged market and in order to discourage the sale by banking and other financial institutions of medium and long-term gilt-edged securities to the Bank with a view to extending additional credit to the private sector.

Up to the end of June, 1965, the various restrictive monetary measures discussed above would appear to have had only a moderate effect. Bank credit in general continued to expand and, as mentioned earlier, the presssure upon prices, costs and the balance of payments increased further. It would appear to be significant, however, that the *rate of increase* of commercial bank discounts, loans and advances slowed down noticeably. Indeed, after rising by R24 million in March and R34 million in April, they registered a small decline of R4 million in May, followed in June by an increase of only about R15 million (of which advances to the Land Bank accounted for about one-third). Credit extended by other monetary banking institutions also increased much less rapidly and in some cases tended to level off during the second quarter.

The reasons why the authorities placed considerable reliance on restrictive monetary measures to cure the inflation and balance of payments difficulties must be sought in their diagnosis of the prevailing short-term tendencies in the South African economy. The official view was that the *root cause* of these problems was the inflationary overspending on both capital and consumer goods by both the public and private sectors, which was made possible or facilitated by the excessive creation of money and near-money by the banking system. The only really effective way of dealing with this situation was, therefore, to reduce the rate of increase of total monetary demand (gross domestic expenditure), which had amounted to about 13 per cent in 1964, to a figure more in accordance with the expected rate of increase of the real gross domestic product, which was judged to be in the vicinity of 5 to 6 per cent. In these circumstances it was felt that undue reliance should not be placed upon measures such as direct control of prices, wages, profits, imports, etc., which would have dealt mainly with the symptoms of the problem and not with the basic causes thereof.

A severe tightening of import control, in particular, did not appeal to the authorities, as this would have diminished the supply of goods without significantly reducing the excessive rate of increase of the monetary demand for goods and services. While this might temporarily have taken some of the strain off the gold and foreign exchange reserves, it would, in the prevailing circumstances, almost certainly have diverted a substantial part of the demand for foreign goods to the already over-strained internal market, thereby aggravating the internal inflationary pressures and also undermining the balance of payments position in the longer run. Moreover, to have reversed the downward tendency in the gold and foreign exchange reserves, import control would have had to be applied not merely to luxury consumer goods but also to essential capital goods and raw materials. The authorities therefore preferred to attack the real causes of the imbalance by means of monetary policy.