SOUTH AFRICAN RESERVE BANK
ANNUAL ECONOMIC REPORT

1966

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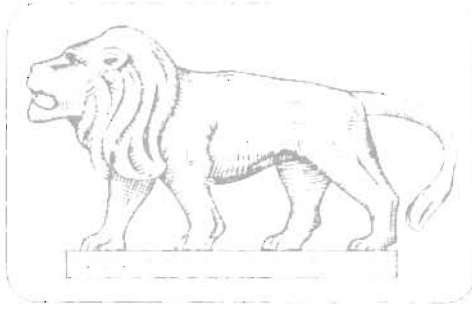

A Review of Economic and Financial Conditions in the Republic of South Africa to be presented to Stockholders at the Forty-sixth Ordinary General Meeting to be held on 23rd August, 1966.

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PREFACE

This Economic Report seeks to set out graphically and statistically the significant trends in our economy as affecting our external and internal position. It further seeks to correlate and explain these trends and their implications in as lucid a manner as possible.

In the remarks which I shall make at the Annual General Meeting of the Bank on 23rd August, I shall in large part endeavour briefly to describe and discuss the various monetary policy measures to which these trends gave rise, and to set out what appear to be their implications for the immediate future. Accordingly, the Economic Report should be regarded as forming the background to my remarks.

GERARD RISSIK
GOVERNOR SOUTH AFRICAN RESERVE BANK
AUGUST, 1966

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INTERNAL ECONOMIC CONDITIONS

Improvement in Balance of Payments but Continued Internal Inflation

The year ended June, 1966, was another year of full employment, prosperity and rapid growth for the South African economy. It was also a year in which the overall balance of payments improved rapidly and substantially, with the result that the gold and foreign exchange reserves increased to a new record level at the end of this period. Although this improvement was to a large extent attributable to a substantial net inflow of both short and long-term capital and a deliberate import control policy of reducing inventories of imported goods, it was also indicative of some reduction in the rate of increase of the underlying monetary demand for capital and consumer goods and services. Aggregate demand still remained excessive, however, and continued to exert upward pressure on prices and costs. So strong and sustained, in fact, was the inflationary pressure that the existing anti-inflationary measures had to be extended and progressively intensified with a view to restraining the rate of increase of total capital and consumer spending.*

* The various anti-inflationary measures applied during the past year will be discussed in some detail by the Governor of the Reserve Bank in his Address at the Bank's Annual General Meeting on the 23rd August.

Vigorous and Extended Boom Between 1961 and 1965

These developments and the current situation in the economy can best be understood if viewed against the background of the preceding four years. From about the middle of 1961 until roughly the middle of 1965 the Republic experienced a cyclical economic upswing which, after a slow and hesitant start, developed into a vigorous and extended boom and brought about an exceptionally rapid and large increase in the general standard of living. At first the main expansionary influence was a substantial rise in gold output and merchandise exports. Then consumption expenditure began to increase strongly and, finally, from about 1963, investment expenditure assumed the role of main generator of expansion. Throughout this period the upswing was greatly facilitated and encouraged by an exceptionally large increase in the supply of money and near-money.

The accompanying table shows the large absolute and percentage increases registered between 1961 and 1965 by the gross domestic product, the gross national product and the main components of gross domestic expenditure, i.e. private consumption, current government expenditure, gross domestic fixed investment (capital

outlays on machinery, plant, equipment, building and construction) and inventory investment. These statistics illustrate the remarkable economic growth achieved by the South African economy during this period. At the same time they afford an impression of the tremendous momentum developed by the boom during the course of the four years and of the pressure which this must have exerted on the country's available labour, capital and other resources. Thus, whereas the gross domestic product increased by as much as 27 per cent between 1961 and 1965 in *real* terms, i.e. valued at constant prices, it increased by no less than 40 per cent in *money* terms, i.e. valued at current prices, reflecting price increases averaging 2.6 per cent per year. Furthermore, gross domestic expenditure increased by an even higher percentage between these two years, namely 54 per cent, which implies a deterioration in the balance of payments on current account. In fact, imports of goods and services showed an exceptionally large increase of 74 per cent, compared with a rise of 24 per cent in gold output and exports of goods and services.

What these figures indicate, is that total spending on capital and consumer goods and services increased at such a rate during this period that the South African economy could not increase its production fast enough to cope with the rising demand. The inevitable result was a tremendous increase in imports and, particularly

Gross Domestic Expenditure, Gross Domestic Product and Gross National Product 1961 and 1965

	1961	1965	Increase 1961-1965	Percentage increase 1961-1965	Average percentage increase per year
	R millions	R millions	R millions	%	%
Private consumption expenditure	3,582	4,966	1,384	39	8.5
Current expenditure by general government	584	966	382	65	13.4
Gross domestic fixed investment	1,097	1,784	687	63	12.9
Change in inventories	68	349	281	....	....
Residual item	-142	-96	46	....	....
GROSS DOMESTIC EXPENDITURE	5,189	7,969	2,780	54	11.3
Exports of goods and non-factor services	1,630	2,015	385	24	5.4
Less Imports of goods and non-factor services	1,208	2,103	895	74	14.9
EXPENDITURE ON GROSS DOMESTIC PRODUCT	5,611	7,881	2,270	40	8.9
Less Net factor payments to rest of world	219	224	5	2	0.6
GROSS NATIONAL PRODUCT	5,392	7,657	2,265	42	9.2
REAL GROSS DOMESTIC PRODUCT (at 1958 prices)	5,309	6,738	1,429	27	6.1
REAL GROSS NATIONAL PRODUCT (at 1958 prices)	5,083	6,536	1,453	29	6.5

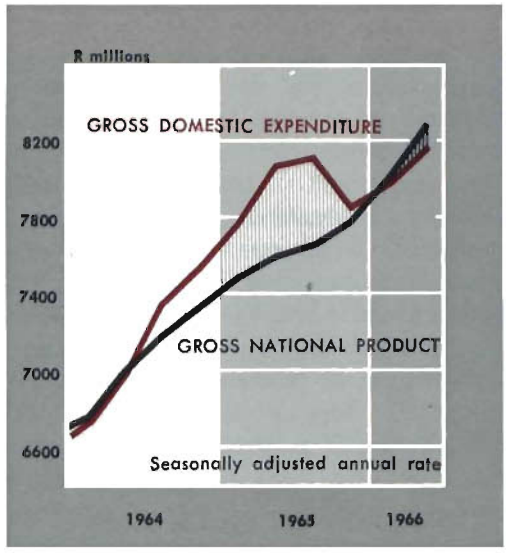
towards the end of this period, increased upward pressure on prices and costs. In other words, the rate at which gross domestic expenditure increased between 1961 and 1965, namely an average annual rate of 11.3 per cent, was not maintainable.

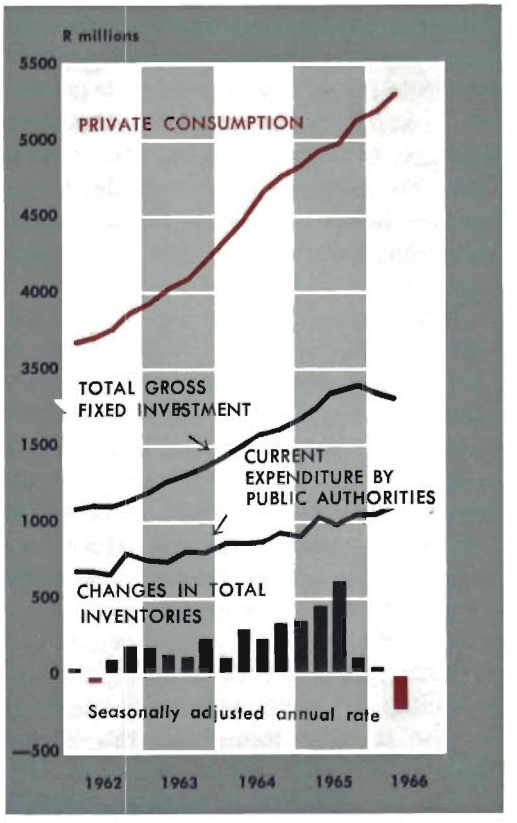
By the middle of 1965, in fact, a position had been reached which, while by no means critical, was far from satisfactory. The reserves had declined steadily for nearly eighteen months and inflationary pressure was being experienced in the internal economy. Previously the large increase in imports of goods and services, which during 1963 and 1964 had amounted to as much as 24 and 21 per cent respectively, had helped considerably to keep internal inflation at bay, not only by augmenting the supply of capital goods, raw materials, consumer goods and services, but also by providing an important element of competition from abroad. By the middle of 1965, however, gross domestic expenditure had increased to a level so far in excess of gross national product, and the balance of payments deficit had accordingly become so large, that substantial further increases in imports could no longer be afforded. The situation therefore called for a temporary reduction in gross domestic expenditure or, at the very least, a marked decline in its rate of increase.

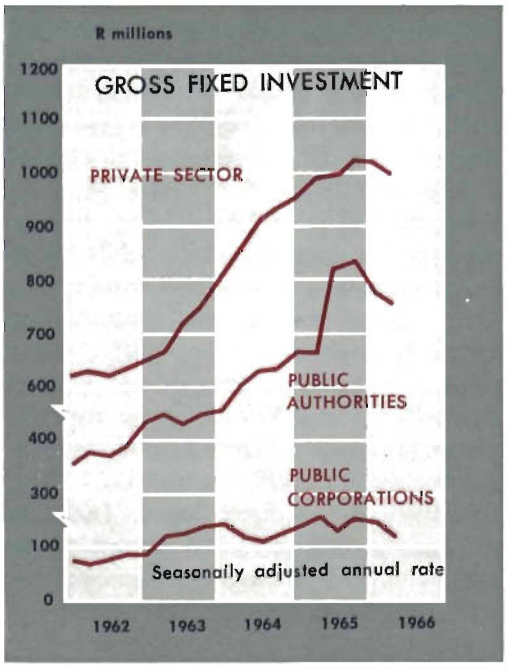
Levelling-off in Gross Domestic Expenditure during 1965/66

During the course of the year ended June, 1966, gross domestic expenditure did in fact, for the first time since 1961, show a tendency to level off. Thus, after rising further during the third quarter of 1965, it declined noticeably during the fourth quarter, before increasing again during both the first and second quarters of 1966. Moreover, during the latter two quarters it was actually slightly lower than the gross national product, which had continued to increase steadily in the meantime, as indicated in the accompanying graph.

This levelling-off tendency in total expenditure was, however, mainly attributable to a sharp decline in inventory investment during the fourth quarter of 1965 and the first half of 1966, which was at least partly brought about by the stricter application of import control from October onwards and therefore not entirely the result of "natural" economic forces and the credit restrictions. Of the other components of gross domestic expenditure, both private consumption and current government expenditure continued to rise strongly throughout this period, while public and private investment first







increased further during the fourth quarter of 1965 before declining again during the first and second quarters of 1966. At best, therefore, there could only have been a reduction in the rate of increase of the underlying monetary demand for goods and services during the course of 1965/66. In these circumstances, the inflationary pressure in the economy persisted.

Fixed Capital Outlays

It is nevertheless significant that during 1965/66 as a whole, private fixed investment increased by a much smaller percentage than during the two preceding years, namely by 5 per cent, as compared with 22 per cent in 1963/64 and 21 per cent in 1964/65. This was mainly attributable to a decline in the rate of increase of fixed investment in manufacturing from 26 per cent in 1963/64 and 40 per cent in 1964/65 to 3 per cent in 1965/66. Moreover, as mentioned earlier, private fixed investment declined noticeably during the first and second quarters of 1966.

On the other hand, fixed capital outlays by public authorities increased during the past year by as much as 27 per cent, compared with 12 per cent in 1963/64 and 19 per cent in 1964/65. The main contributions to this exceptionally large in-

crease were made by general departments of the central government (an increase of 43 per cent), mainly on water works and housing, the Railways and Harbours (40 per cent) and provincial administrations (23 per cent). Fixed investment by public corporations showed little if any further increase during 1965/66 but, as during the two preceding years, remained at a relatively high level.

The sustained vigour of the investment boom in the economy as a whole can also be gauged from the fact that the ratio of total fixed investment to gross domestic product amounted to the unusually high figure of 22 per cent in 1965/66, compared with 19, 20 and 21 per cent in 1962/63, 1963/64 and 1964/65, respectively.

Further Rise in Private Consumption and Current Government Expenditure

Private consumption increased during 1965/66 by about R345 million or 7 per cent, compared with 10 per cent in 1963/64 and 12 per cent in 1964/65. At the same time current expenditure by the Government and other public authorities increased by about R126 million or 14 per cent, compared with 14 per cent in 1963/64 and 11 per cent in 1964/65. This was partly attributable to an increase in salaries and in defence expenditures.

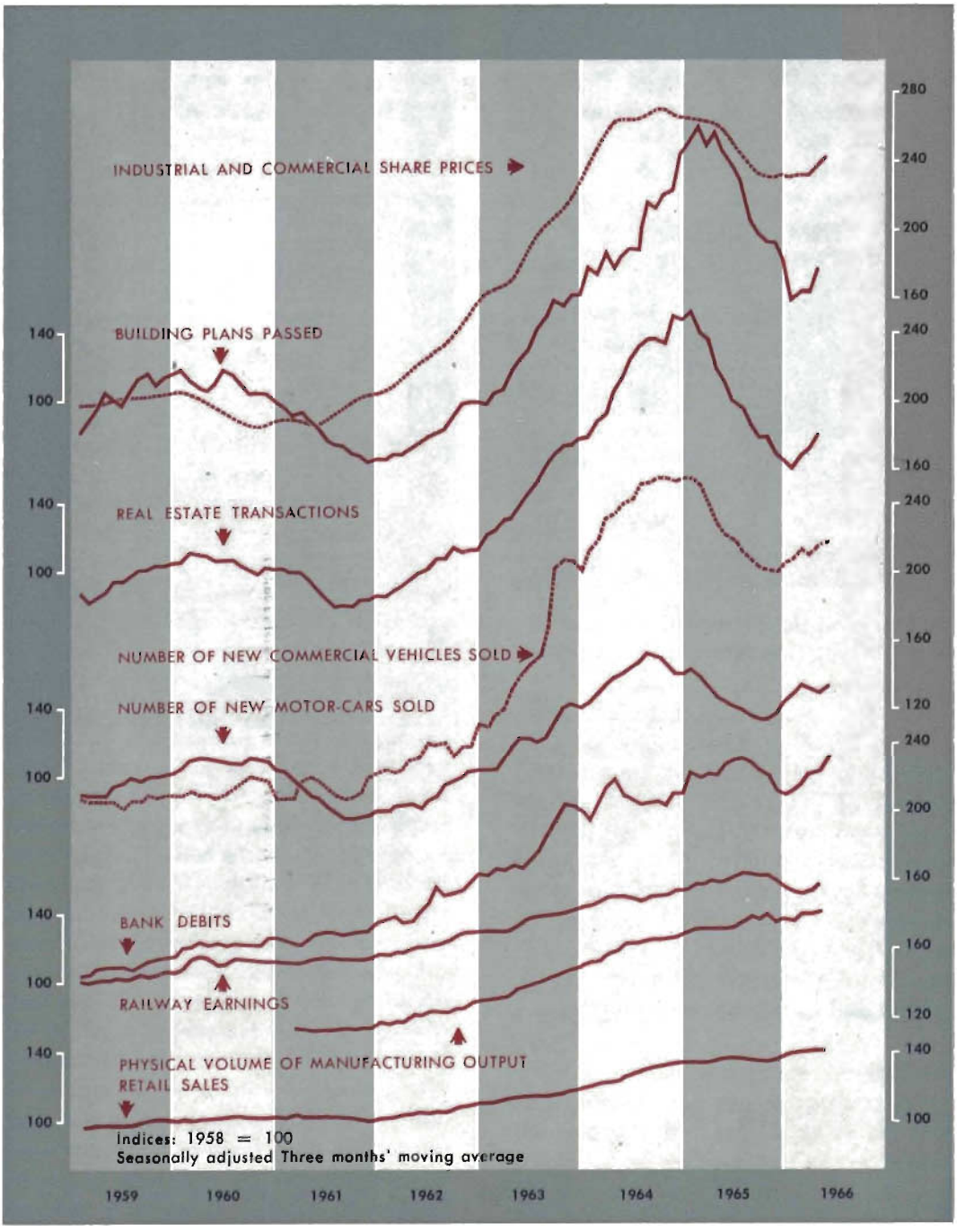
Increase in Saving

Despite a substantial decline in public saving, i.e. in the current surplus of public authorities, gross domestic saving increased by about 13 per cent during 1965/66, compared with 3 per cent in 1964/65. According to preliminary indications, this was mainly the result of a substantial increase in personal saving, which had actually declined during the preceding year.

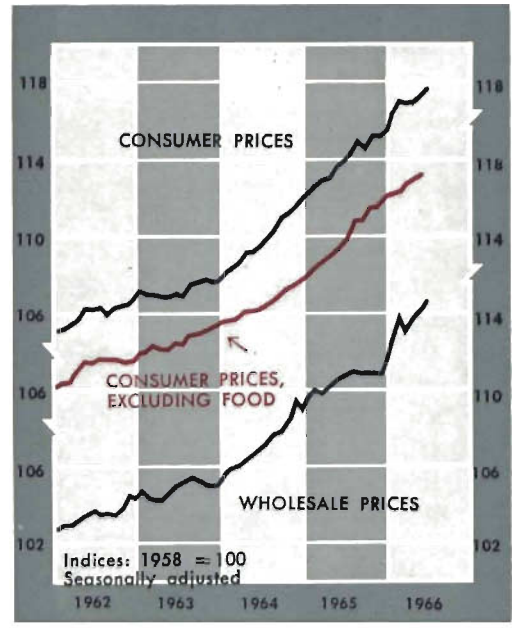
General Economic Indicators

The impression that both total spending and general economic activity remained at a very high level throughout 1965/66, even though the economic upswing had shown signs of levelling-off from about the middle of 1965, was confirmed by the behaviour of various seasonally adjusted production and employment indices, as well as that of such other economic indicators as share prices, building plans passed, real estate transactions, number of new motor vehicles sold, bank debits, retail sales, etc. As the accompanying graph shows, there was even a tendency for some of the indicators which had declined or levelled off at some stage during 1965, to rise again from about the middle of the last quarter of 1965.

It was noticeable, for example, that the seasonally adjusted index of the physical volume of manufacturing output, after levelling off during the second half of 1965, resumed its upward movement during the first half of 1966. To the extent that this resulted from increased productivity and the utilisation of excess capacity in industry, it tended to mitigate


INDUSTRIAL AND COMMERCIAL SHARE PRICES
BUILDING PLANS PASSED
REAL ESTATE TRANSACTIONS
NUMBER OF NEW COMMERCIAL VEHICLES SOLD
NUMBER OF NEW MOTOR-CARS SOLD
BANK DEBITS
RAILWAY EARNINGS
PHYSICAL VOLUME OF MANUFACTURING OUTPUT
RETAIL SALES
Indices: 1958 = 100
Seasonally adjusted Three months' moving average
140
100
280
240
200
160
120
1959
1960
1961
1962
1963
1964
1965
1966

the inflationary pressure. During 1965/66 as a whole the index was on average about 5 per cent higher than during the previous year, which represented roughly half the rate of growth between 1963/64 and 1964/65. The branches of industry which made the most important contribution to this increase were those producing metal products, machinery and food.



Price Inflation

The continuation of the inflationary pressure during the past year is evident from the substantial rise in both consumer and wholesale prices during this period. Thus, between June, 1965, and June, 1966, the seasonally adjusted consumer price index increased by 3.2 per cent, compared with 4.1 per cent during the preceding year and an average annual rate of increase of 2.0 per cent during the ten years 1953 to 1963. This further increase during 1965/66 was only partly attributable to a rise in food prices. Indeed, if food is excluded, the index shows an even greater rise during this period, namely of 3.4 per cent.

The seasonally adjusted wholesale price index showed similar tendencies. Compared with an increase of 3.6 per cent during the year ended June, 1965, it increased by 3.5 per cent between June, 1965, and June, 1966, and during the second half of the latter period, i.e. the first half of 1966, actually increased at an annual rate of 5.6 per cent. During the year as a whole the prices of South African and imported goods increased at roughly similar rates.

Improvement in Current Account

One of the outstanding developments in the South African economy during the past year was the rapid improvement in the current account of the balance of payments. During the third quarter of 1965, the seasonally adjusted balance of payments on current account still showed a deficit, taken at an annual rate, of R400 million. But by the first quarter of 1966 this deficit had been transformed into an annual surplus of R88 million, and during the second quarter a seasonally adjusted annual surplus of R148 million was registered.

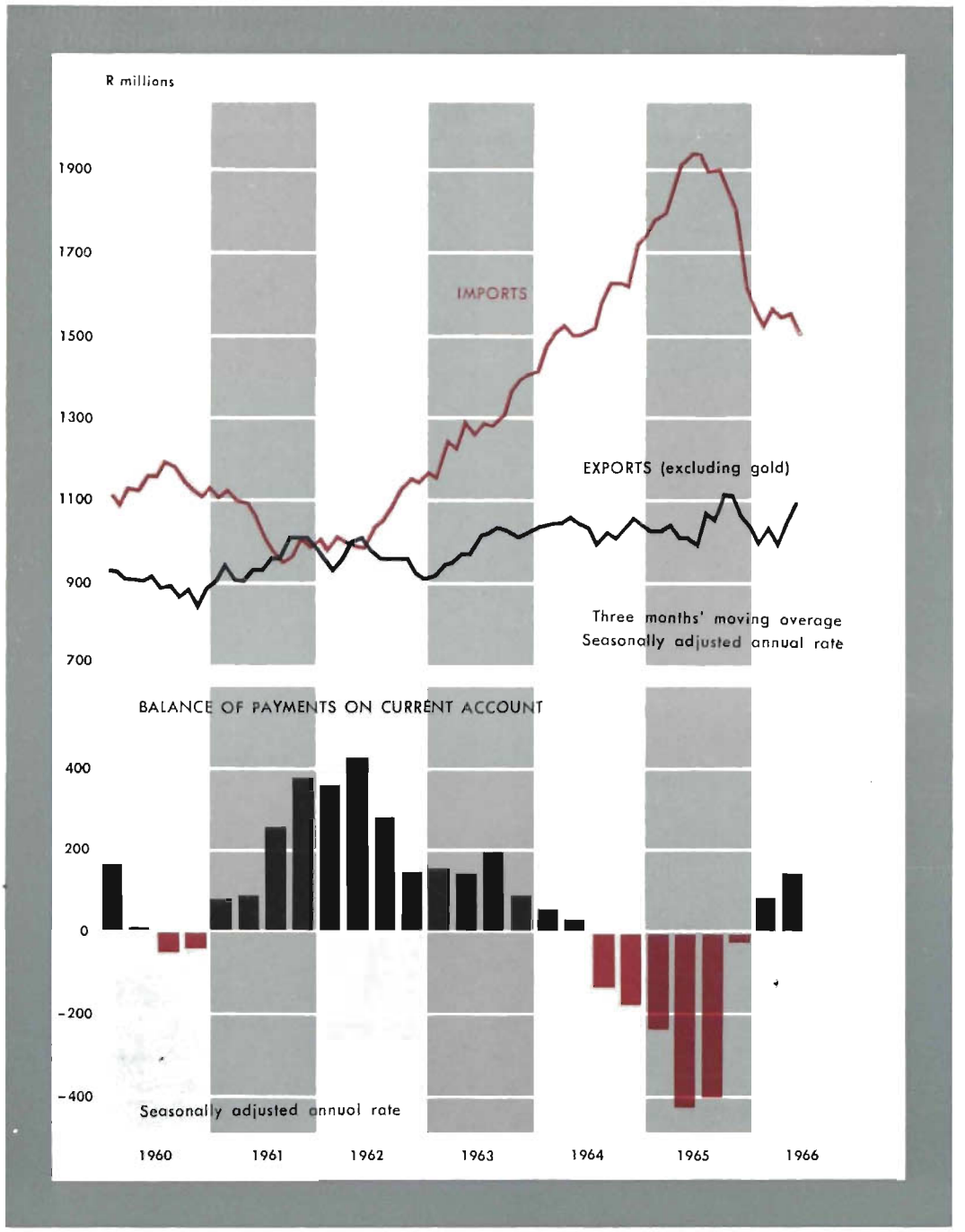
The main reason for this marked improvement was a sharp declining tendency in imports which began round about the middle of 1965 and continued throughout the past year. During the second quarter of 1966, for example, if seasonal influences are eliminated, imports amounted to an annual rate of only R1,500 million, compared with R1,924 million in the third quarter of 1965. Although this downward tendency was particularly noticeable in the classes "manufactured goods" and "machinery and transport equipment", it occurred fairly generally.

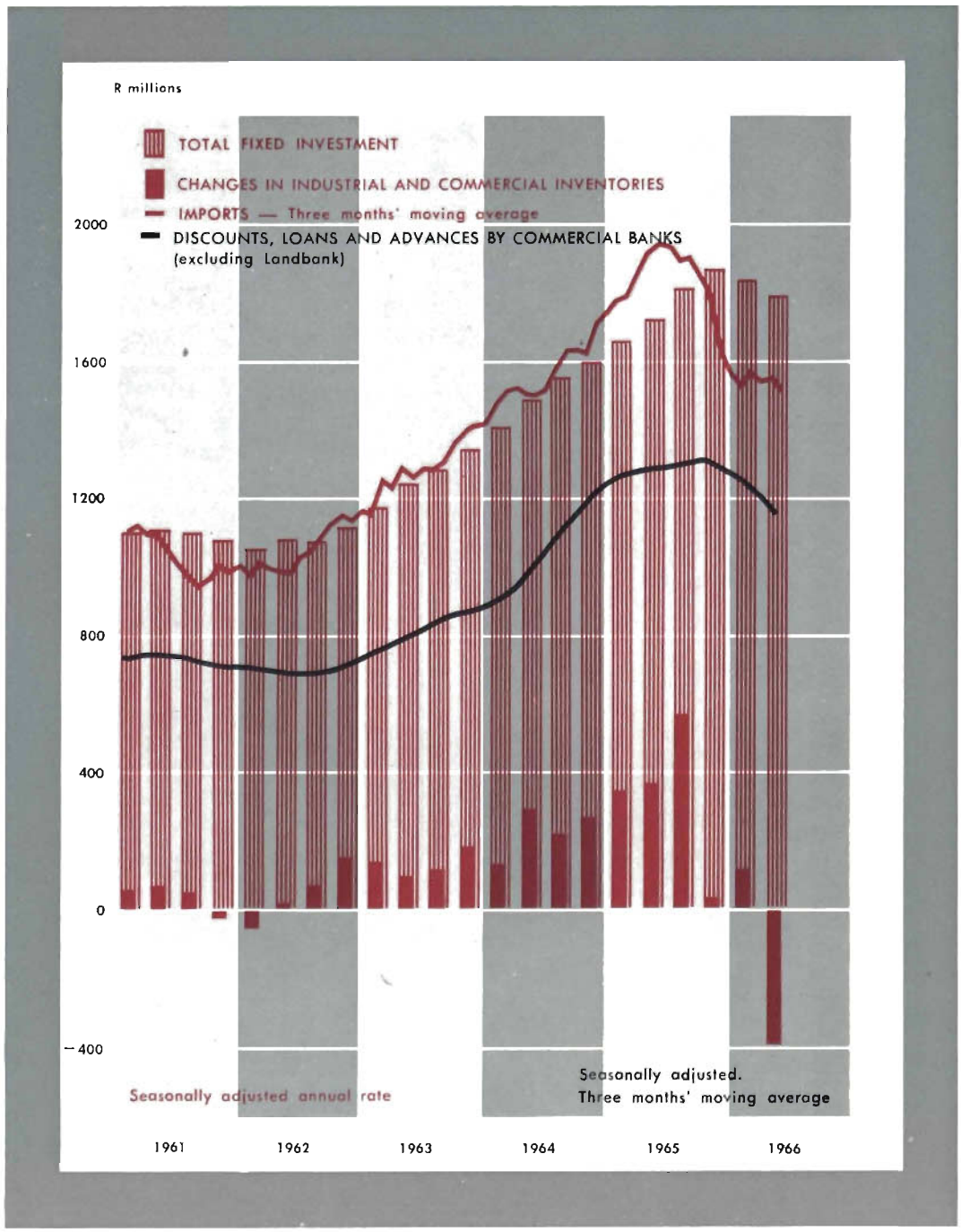
The decline in imports was probably related to the slowing down in the rate of increase of the underlying monetary demand for goods and services, which, in turn, would appear to have been partly a natural reaction to the excessive inventory and fixed investment of the previous quarters, and partly the result of the restrictive credit policy applied by the authorities. But, as mentioned earlier, an important reason for the sudden fall in imports was the stricter application of import control on capital goods and raw materials from October onwards, so that the behaviour of imports during the past year was not entirely "natural".

Merchandise exports showed wide fluctuations during the course of 1965/66, but for the year as a whole were some R40 million higher than during the preceding twelve months. This increase was mainly the result of a further rise in the exports of manufactured goods, while agricultural exports, which had declined sharply during the previous year, also improved, especially wool and fruit exports. The net gold output showed an increase of R16 million compared with the previous year, while net invisible payments to the rest of the world declined by about R32

Balance of Payments on Current Account (R millions)

	1964				1965				1966	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Actual Surplus (+) or Deficit (−)	-4	5	-35	-22	-73	-123	-93	18	7	26
Seasonally Adjusted Annual Rate	56	36	-132	-184	-236	-424	-400	-24	88	148


R millions
1900
1700
1500
1300
1100
900
700
IMPORTS
EXPORTS (excluding gold)
Three months' moving average
Seasonally adjusted annual rate
BALANCE OF PAYMENTS ON CURRENT ACCOUNT
400
200
0
-200
-400
Seasonally adjusted annual rate
1960
1961
1962
1963
1964
1965
1966


R millions
TOTAL FIXED INVESTMENT
CHANGES IN INDUSTRIAL AND COMMERCIAL INVENTORIES
IMPORTS — Three months' moving average
DISCOUNTS, LOANS AND ADVANCES BY COMMERCIAL BANKS (excluding Landbank)
2000
1600
1200
800
400
0
−400
Seasonally adjusted annual rate
Seasonally adjusted.
Three months' moving average
1961
1962
1963
1964
1965
1966

million, mainly owing to lower net freight, insurance and investment income payments and higher net transfer receipts from abroad.

Substantial Net Inflow of Private Capital

The improvement in the current account was accompanied by a net inflow of private capital of as much as R202 million during 1965/66, compared with a small net inflow of R36 million during 1964/65 and an average annual net outflow of R88 million during the years 1959 to 1963. Short-term capital movements, including errors and unrecorded transactions, accounted for R108 million of this inflow, leaving a net inflow of long-term funds of R94 million.

This substantial inflow of long-term private capital mainly took the form of direct investment in new or existing foreign-controlled South African resident organisations. In addition, total purchases by foreigners of South African securities on the Johannesburg Stock Exchange exceeded their sales by about R12 million during 1965/66. The increased interest shown by foreigners in South African securities was also illustrated by the fact that, despite the cessation of foreign currency 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 1 per cent at the end of June, 1966, and was at times even negative.

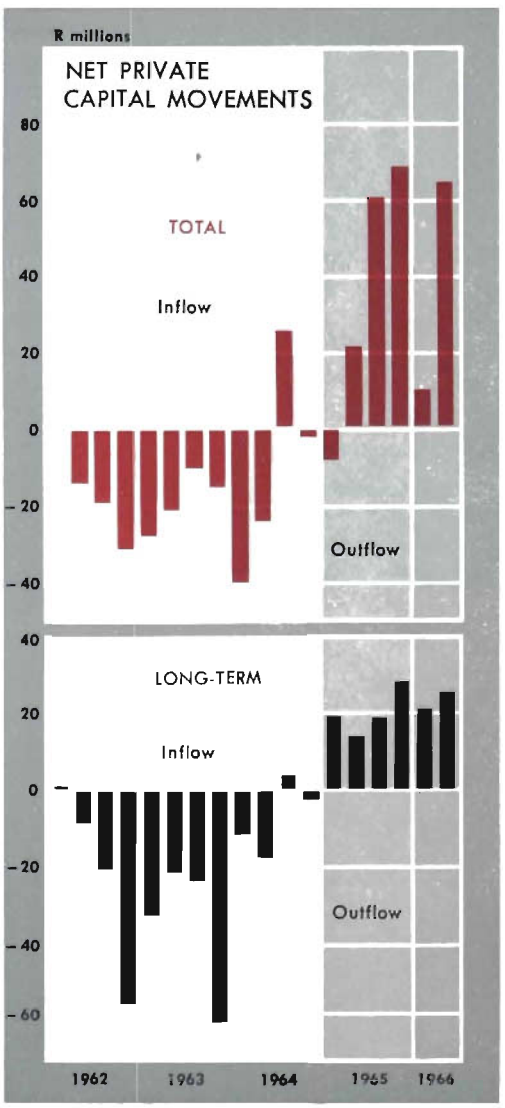
In view of the boom conditions existing in the economy, the related tightening of conditions in the capital market and the credit restrictions applied by the authorities, it had been anticipated that there would be some net inflow of private capital during the past year. But the extent of the inflow during the second half of 1965 and again during the second quarter of 1966 was considerably greater than had been expected. On the one hand, this was a favourable development, as a substantial part of the inflow represented long-term capital for productive investment in the Republic, while even the short-term capital helped to relieve the pressure on the balance of payments and the reserves at an opportune time. On the other hand, the capital inflow undoubtedly contributed to the domestic inflation, not only by helping to increase the supply of money and near-money in the economy but also by creating new inflationary expectations, which tended to offset the effects of the restrictive credit policy.

Net Movements of Private Capital (R millions)

	1964				1965				1966	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Stock Exchange Transactions	-26	-12	-2	-4	2	2	6	-2	4	4
Other Long-term	15	-5	6	2	17	12	13	30	17	22
Short-term (including errors and unrecorded transactions)	-29	-7	21	—	-27	7	41	40	-11	38
Total Private Capital	-40	-24	25	-2	-8	21	60	68	10	64

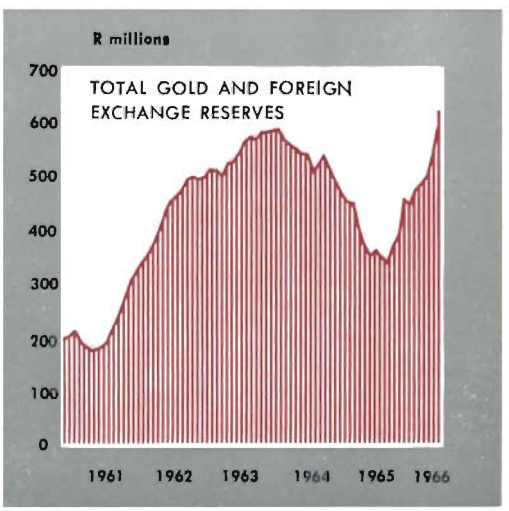
Substantial Net Inflow of Central Government and Banking Capital

The net inward movement of private capital was supplemented by a net inflow of central government and banking capital amounting to R68 million during 1965/66, compared with a net inflow of R27 million during the preceding year. The Government and the Reserve Bank drew as much as R97 million on foreign loans during this period, including revolving credits made available by American and German banks and loans from American, British, French, Italian and certain other European banks, but this amount was partially offset by repayments and other capital movements.



Sharp Rise in Reserves

As a result of the improvement in the current account and the net inflow of foreign capital, the total gold and foreign exchange reserves held by the Reserve Bank, monetary banking institutions and the Government increased from a low point of R340 million at the end of September, 1965, to R578 million at the end of June, 1966, and to an estimated new month-end record of R612 million at the end of July. This increase of R272 million was the sharpest rise ever recorded in South Africa during any period of ten months.



Inflationary Influence of Monetary Factors

Monetary factors continued to make a crucially important contribution to the inflation in South Africa during the past year. Despite the application of severe restrictions on bank credit extended directly to the private sector, the supply of money and near-money* in the hands of the private sector increased from R2,214 million at the end of June, 1965, to R2,524 million at the end of June, 1966, i.e. by R310 million or about 14 per cent, while the ratio of money and near-money to gross national product increased from the already high figure of 29 per cent during the second quarter of 1965 to 30 per cent during the second quarter of 1966. Without this addition to the liquidity of the private sector, it is improbable that total capital and consumer spending would have risen as much as it did. The supply of loanable funds emanating from 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 sector, and interest rates would probably have risen more and sooner. The extensive use of bank credit as a substitute for genuine saving was therefore inflationary in the sense that it facilitated and encouraged the over-investment and over-consumption.

* The definitions of money and near-money were revised by the Reserve Bank during the past year. "Money" now consists of coin and bank notes held outside the monetary banking sector and domestic demand or call deposits held by the private sector (including for this purpose the Railways and Harbours and local authorities) with the monetary banking sector. "Near-money" consists of domestic short-term deposits (other than demand deposits) and medium-term deposits, including savings deposits, held by the private sector with the monetary banking sector.

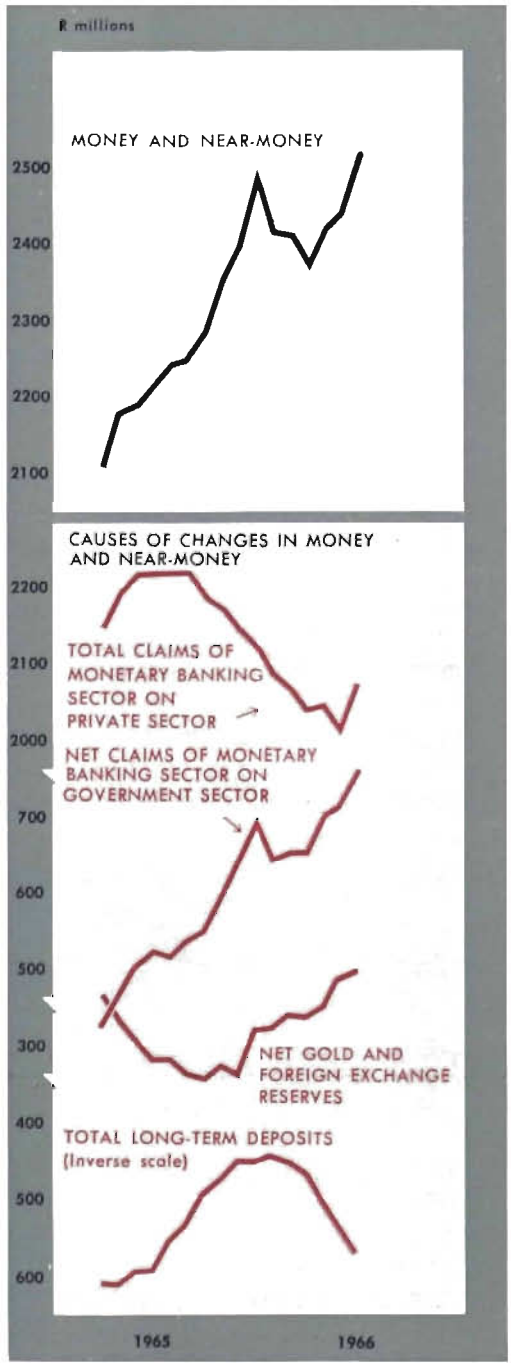
"Short-term" deposits are deposits payable in less than 30 days or subject to less than 30 days' notice.

"Medium-term" deposits are deposits payable after not less than 30 days but less than six months or subject to not less than 30 days' but less than six months' notice.

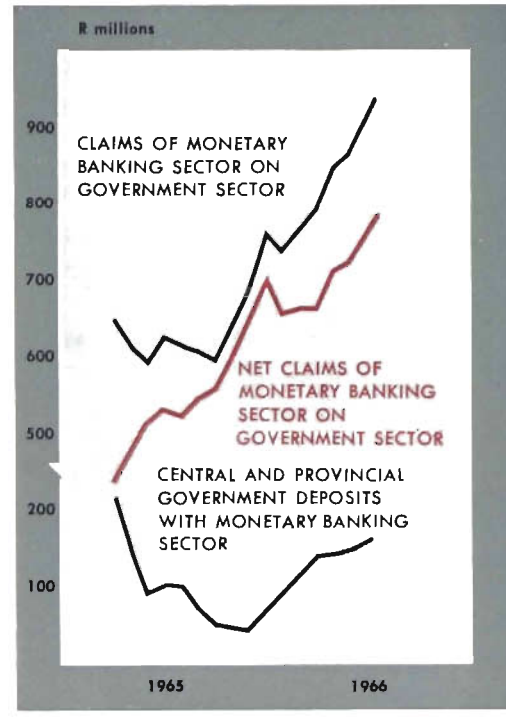
"Monetary banking sector", in turn, is defined to include the South African Reserve Bank, commercial banks, merchant banks, the National Finance Corporation, discount houses, the short-term business of the Land Bank, and all other registered banking institutions of which the monthly average amount of demand deposit liabilities during the preceding calendar year amounted to at least R1 million and of which the monthly average amount of short and medium-term deposit liabilities during the preceding calendar year collectively amounted to at least one-third of the total deposit liabilities of such an institution or at least R30 million.

Reasons for Increase in Money and Near-Money

The accompanying table summarises the main statistical "causes" of the quarterly changes in the total quantity of money and near-money during the past year. It shows, on the one hand, that the claims of the banking sector (the Reserve Bank, commercial banks, merchant banks, National Finance Corporation, discount houses, etc.) on the private sector declined during every quarter of 1965/66 except the last, and by as much as R140 million over the year as a whole. This appears to have been largely the result of the restrictive credit policy of the monetary authorities. But the table also shows that the desirable contractionary effect of this decline was more than offset by three other influences. The first of these was the increase of R127 million in the net gold and foreign exchange reserves (i.e. net of short-term foreign liabilities) over the year as a whole. The second was a net shift of R23 million from long-term deposits, which are not considered to be near-money, into short and medium-term deposits with monetary banking institutions, although the tendency was reversed during the second half of the period under discussion. But the third and most important influence was an increase of R243 million in the *net* claims of the banking sector on the government sector. The latter increase, in turn, arose from a total increase of R305 million in the banking sector's holdings of Treasury bills (R97 million), government stock (R182 million) and other claims (R26 million), which was offset to an amount of only R62 million by an increase in government deposits.



What happened in effect was the following: As a result of the favourable balance of payments the liquid assets, and therefore the money creating ability, of the monetary banks were greatly increased. Since these banks were prevented by the Reserve Bank's credit directive from creating money and near-money by extending additional credit to the private sector, they invested heavily in Treasury bills and government stock. The government sector managed to sterilise a part of the funds obtained in this way during the first half of 1966, but since it had to use the rest to finance part of its expenditures, additional money flowed to businesses and households while the banks experienced a "return flow" of funds, which enabled them to invest further amounts in Treasury bills and government stock. The end result was a considerable increase in the quantity of money and near-money in the hands of the private sector. Notwithstanding the restrictions on bank discounts and advances, the private sector accordingly found itself in an even more liquid state in June, 1966, than a year earlier.

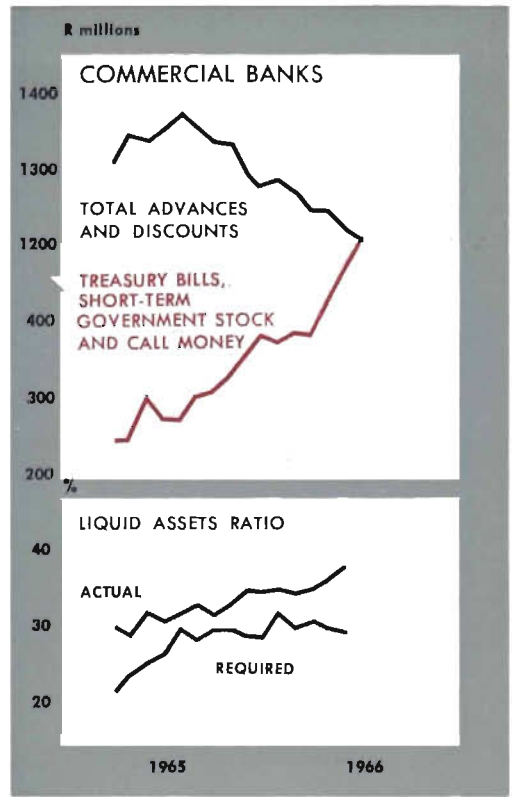


Causes of Changes in Money and Near-Money
(Changes in consolidated assets and liabilities of monetary banking sector)
(R millions)

	1965		1966		Total 1965/66
	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	
Changes in money and near-money:					
Money	-23	106	-39	128	172
Near-money	96	96	-78	24	138
Total money and near-money	73	202	-117	152	310
Causes of changes:					
Net gold and foreign exchange reserves	-26	69	18	66	127
Claims on government sector	-28	165	32	136	305
Government deposits (increase —, decrease +)	55	-19	-74	-24	-62
Net claims on government sector	27	146	-42	112	243
Claims on private sector	-33	-66	-79	38	-140
Long-term deposits (increase —, decrease +)	102	40	-16	-102	23
Other assets and liabilities	3	13	2	39	57
Total change	73	202	-117	152	310

Decline in Commercial Bank Credit to the Private Sector

After increasing spectacularly by R97 million (13 per cent) during 1962/63, R209 million (25 per cent) during 1963/64 and R302 million (29 per cent) during 1964/65, the total discounts and advances of commercial banks declined by R146 million or 11 per cent during 1965/66. This decline would appear to have been largely the result of the restrictive monetary measures applied by the authorities, which *inter alia* included increased minimum liquidity ratios and a specific request to all monetary banking institutions on the 29th October to ensure that the total of their discounts, loans and advances to the private sector, excluding the Land Bank, as at the 31st March, 1966, did not exceed the aggregate of these items as at 31st March, 1965. In February, 1966, this request was extended to the 30th September, 1966, but the monetary banks were allowed to increase their credit to the private sector during this period by an amount not exceeding 2½ per cent of the amount of such credit outstanding at the 31st March, 1965, on condition that such additional credit was made available only directly to genuine farmers for essential living and farming requirements, or to persons and concerns engaged in supplying these requirements directly to the farmer or in purchasing farm produce directly from the farmer. On the 8th July, 1966, this directive was again extended, this time to the 31st March, 1967. In actual fact, the "controlled credit"* of the commercial banks amounted to only R1,161 million at the end of June, 1966,



which was R127 million below the figure of March, 1965.

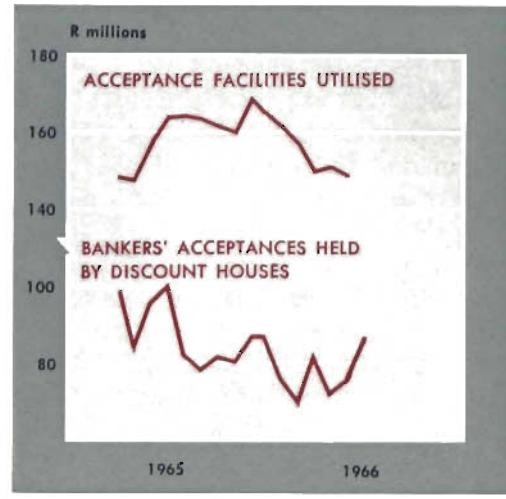
Rise in Liquid Assets of Commercial Banks

But while the commercial banks' discounts and advances declined during the past year, their total liquid assets increased from R611 million in June, 1965, to R841 million in June, 1966, i.e. by

* "Controlled credit" consists of the total of the relevant monetary banks' domestic and foreign discounts, loans and advances *other than* (i) call loans to discount houses, (ii) bills of and advances to the Land Bank, and (iii) loans and advances to the S.A. central government and provincial administrations, the S.W.A. administration, the government of the Transkei and the S.A. Railways and Harbours.

R230 million. Various factors contributed to this increase, including the surplus on the overall balance of payments from October onwards and the Government's increased borrowing from the banks by means of Treasury bills and short-term stock. Despite the fact that their minimum liquidity ratios were maintained at the maximum limits of 40, 30 and 5 per cent of short, medium and long-term liabilities, respectively, the *excess* liquid assets held by the commercial banks amounted to 10 per cent of their total liabilities to the public at the end of June, 1966, compared with the low point of 1.9 per cent at the end of July, 1965, and again at the end of September.

Of the increase of R230 million in the commercial banks' liquid assets during the year ended June, 1966, R133 million took the form of a rise in their holdings of Treasury bills and short-term government stock, and R105 million represented call money held with discount houses and the National Finance Corporation, most of which also found its way into Treasury bills and short-term government stock via these institutions. In other words, while the commercial banks succeeded in reducing their outstanding credit to the private sector by a substantial amount, they directly or indirectly increased their credit to the government sector by a larger amount.



Merchant Banks and Monetary Hire-Purchase and General Banks

The experience of merchant banks and monetary hire-purchase and general banks during the past year was similar to that of the commercial banks. The "controlled credit" of the merchant banks, for example, amounted to R52 million at the end of June, 1966, which was R8 million or 13 per cent below the figure of March, 1965, while their acceptance facilities utilized, which had risen from R148 million in March, 1965, to a peak of R169 million at the end of November, subsequently declined to R148 million at the end of June, 1966. Similarly, the "controlled credit" of monetary hire-purchase and general banks declined from R402 million at the end of March, 1965, to R381 million at the end of June, 1966, i.e. by 5 per cent.

At the same time, the total liquid assets of these institutions, and particularly their holdings of Treasury bills and short-term government stock, showed a substantial increase, indicating that they, too, extended additional credit directly and indirectly to the government sector during this period.

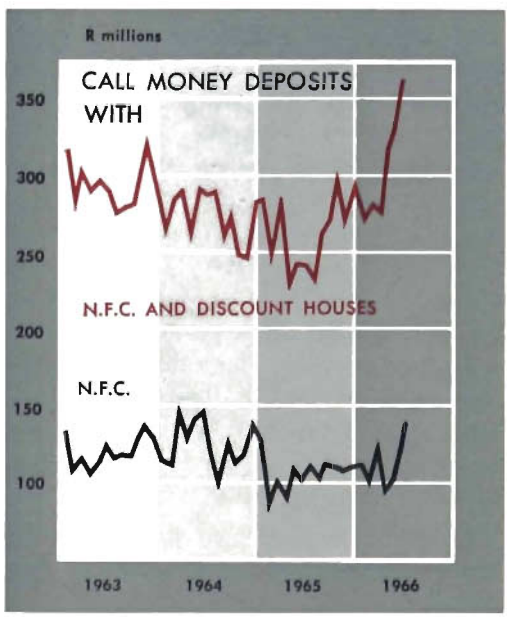
Increase in Call Money

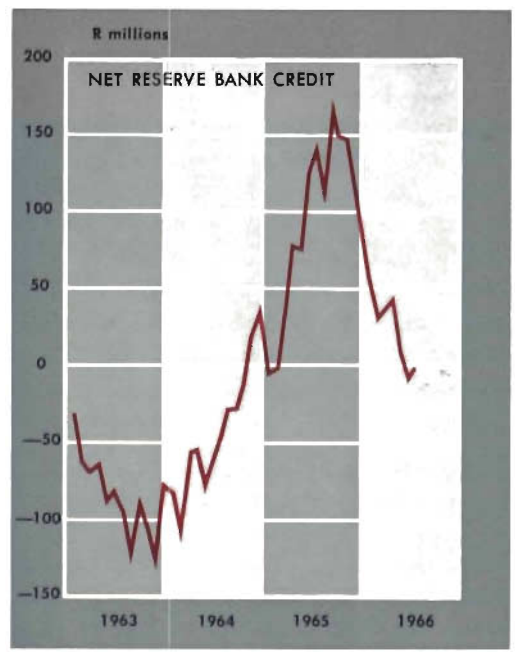
In the existing circumstances it is not surprising that the total amount of call money held with the National Finance Corporation and the discount houses increased from a low point of R223 million in April, 1965, to R362 million at the end of June, 1966, the highest level in more than three years. The discount houses experienced the bulk of this increase, while call deposits with the National Finance Corporation fluctuated around a fairly horizontal level. At the end of June, call money with the discount houses amounted to a record R242 million, compared with R120 million held with the National Finance Corporation.

In accordance with the official credit policy, the discount houses, despite the considerable increase in their resources, reduced their holdings of bankers' acceptances during the course of the year, while substantially increasing their holdings of Treasury bills, including "tap" bills, and short-term government stock.

Decline in Reserve Bank Credit

A further feature of the monetary and banking situation during the past year was a decline from a peak of R171 million in September, 1965, to minus R13 million at the end of June, 1966, in the Reserve Bank's net domestic credit, i.e. in its total domestic discounts, advances and investments less central and provincial government deposits. This decline, which contrasted sharply with the strong upward movement of the two preceding years, was associated with the favourable turn in the balance of payments, which greatly in-





creased the liquidity of the banks and thus their ability to create money for the government sector, and thereby reduced the dependence of both the banking and the government sector on the Reserve Bank for financial accommodation.

Short-Term Interest Rates

After rising steadily during 1964 and the first half of 1965, the Treasury bill tender rate and related money market rates levelled off during the second half of 1965 and declined during the first half of 1966. Thus, after remaining between 4.1 and 4.3 per cent for about 25 weeks from the middle of July, 1965, the Treasury bill rate reached a peak of 4.43 per cent on the 28th January, before declining to 3.71 per cent on the 8th July, 1966. On that date, however, Bank Rate was raised and the Treasury bill rate subsequently increased to 4.14 per cent on the 5th August.

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 levelling off and decline in these rates was the substantial increase in the Reserve Bank's gold and foreign exchange reserves referred to earlier. Another important reason was the fact that private monetary banking institutions, including the discount houses, were prevented by official measures from increasing their credit to the private sector and therefore tended to invest more in Treasury bills than they would otherwise have done. These influences more than offset the upward pressure exerted on the Treasury bill rate by the increase in the balances on Exchequer and Paymaster-General accounts with the Reserve Bank from R2 million at the end of November, 1965, to R159 million at the end of July, 1966.

The decline in the Treasury bill rate would have been even greater if the authoities had not taken various steps to counteract the internal inflationary effects of the increase in the gold and foreign exchange reserves. Thus, the commercial banks were encouraged to hold funds abroad under cover of special forward exchange arrangements ("swop arrangements") with the Reserve Bank, which at times amounted to as much as R39 million during the past year. In addition, the amount of tender Treasury bills outstanding was increased from a low point of R106 million in October, 1965, to R230 million at the end of July, 1966, while special issues of "tap" Treasury bills were made to the discount houses and commercial banks, the outstanding amount of such bills reaching a peak of R86 million in May, 1966.

Changes in Flow of Funds to Banking Institutions and Building Societies

During the year ended March, 1966, significant changes occurred in the flow of funds to the various classes of banking institutions and to building societies. In the first place, as the accompanying table shows, the total savings and time deposits and building society shares held with commercial banks, merchant banks, hire-purchase banks, savings banks, general banks and building societies increased by only R54 million during the year ended March,

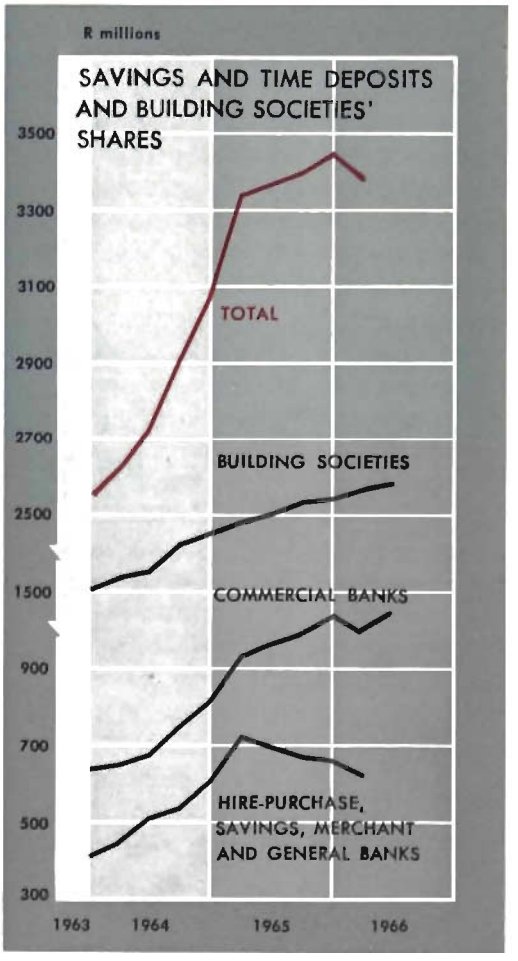
1966, after having risen by R709 million during the previous twelve months.* Indeed, total fixed and notice deposits, which had increased by as much as R615 million between March, 1964, and March, 1965, *actually declined* by R92 million during the year ended March, 1966, while building society shares increased by only R57 million during 1965/66, compared with R69 million during the previous year.

In addition to any natural increase which there might have been in the liquidity preference of private households and businesses as a result of the inflation, two main factors would appear to have been responsible for this startling decline in the popularity of fixed and notice deposits and for the smaller addition to building society shares. The first was the introduction of the new Banks and Building Societies Acts

Changes in Savings and Time Deposits and Building Society Shares during 1964/65 and 1965/66 (R millions)

	Change between March, 1964 and March, 1965	Change between March, 1965 and March, 1966
Savings deposits:		
Commercial banks	+ 10	+ 55
Hire-purchase, savings and general banks	+ 15	+ 4
Building societies	− 1	+ 30
Total	+ 24	+ 89
Fixed and notice deposits:		
Commercial banks	+276	+ 10
Merchant banks	− 7	+ 1
Hire-purchase, savings and general banks	+265	− 98
Building societies	+ 81	− 5
Total	+615	− 92
Building society shares	+ 69	+ 57
Total	+709	+ 54

* It should be noted, however, that the figure of R709 million mentioned here contains "double-counting" to the extent that certain hire-purchase, savings and general banks, in particular the three subsidiaries of commercial banks included in these groups, during 1964/65 received from the public considerable amounts of interest-bearing deposits, a large part of which was, in turn, reinvested by them with commercial banks as well as with other banking institutions. In the same way, as deposits were withdrawn from these institutions during 1965/66, they reduced their holdings of deposits with other banks. If allowance is made for this fact in respect of the three commercial bank subsidiaries *vis-à-vis* their parent banks only, the total increase in interest-bearing funds with banking institutions and building societies during 1964/65 amounted to R615 million rather than R709 million, and to R137 million (instead of only R54 million) during 1965/66.



from the beginning of 1965, which *inter alia* placed restrictions on the repayment of fixed and notice deposits and building society shares before maturity or before the required notice had been given, and therefore reduced the liquidity of these deposits and shares. The authorities had anticipated that some shift from longer to shorter term deposits would occur as a result of this influence. The second factor was the imposition in March, 1965, of a detailed set of maximum interest rates for the various classes of deposits accepted by banking institutions and buildings societies, and for building society shares. By keeping deposit rates somewhat below their natural levels, this control, which remained in operation until the 8th July, 1966, served to reduce the attractiveness of deposits and building society shares in relation to that of alternative investments, such as mortgage participation bonds, shares in mutual funds, debentures, etc., and thereby encouraged the employment of funds outside the banking system.

The deposit rate control did, however, succeed in channeling such deposits as became available mainly to the commercial banks and building societies and away from hire-purchase, savings and general banks, which was one of its objectives. As the table shows, the latter institutions experienced a decline in fixed and notice deposits of R98 million during the year ended March, 1966, compared with an increase of R265 million during the previous twelve months, while their savings deposits, which had risen by R15 million in 1964/65, increased by only R4 million during 1965/66. Although, as already indicated, the commercial banks and building societies also suffered as a result of the decline in popularity of interest-bearing deposits and shares, the commercial banks at least still experienced a small increase and the building societies only a small decline in their fixed and notice deposits, while their savings deposits increased by R55 million and R30 million, respectively. The scope for hire-purchase and general banks to channel additional funds into the financing of consumption was, however, restricted later in the year by a more direct method, namely through the credit directive issued by the Reserve Bank to all monetary banks in October, 1965, and this was one reason why the deposit rate control was eventually abolished.

Exchequer Account 1965/66

As during the preceding year, certain developments in the field of government finance exerted an important influence on financial and monetary conditions during the past year. The most important of these developments were the methods used to finance the excess of total Exchequer issues over receipts (other than borrowing), which during the year ended March, 1966, amounted to the record figure of R276 million. As the accompanying table shows, the Public Debt Commissioners were able to invest a *net* amount of only R16 million in government securities during 1965/66, compared with R211 million in 1963/64 and R245 million in 1964/65. In actual fact, the Public Debt Commissioners contributed R64 million to the Exchequer account during 1965/66, but against this has to be set their net sales of government securities to monetary banks and other parties amounting to R48 million. The reduction in their contribution was largely due to unexpected and heavy withdrawals

Exchequer Finance 1962-1966
(R millions)

	Financial Years Ended March					April-June 1966
	1961/62	1962/63	1963/64	1964/65	1965/66	
Excess of total issues over receipts	121	133	113	269	276	107
Financing:						
Change in foreign debt held by:						
Public Debt Commissioners	—	—	—	—	14	8
Others	−27	−19	−32	8	−3	−20
Change in domestic debt held by:						
Public Debt Commissioners	93	70	211	245	2	10
Private non-bank sector	} 42	} 99	} −4	−81	50	51
Monetary banking sector				90	115	129
Change in Exchequer balance (increase −, decrease +)	12	−18	−63	7	97	−72

of funds from the Commissioners by the Railways and Harbours, the Defence Special Equipment Fund, the provincial administrations and the Coinage Fund. The result was that whereas the Commissioners had during previous years been the main source of loan funds to the Treasury, they supplied only 5.8 per cent of the amount required to finance the excess of total issues over receipts during 1965/66.

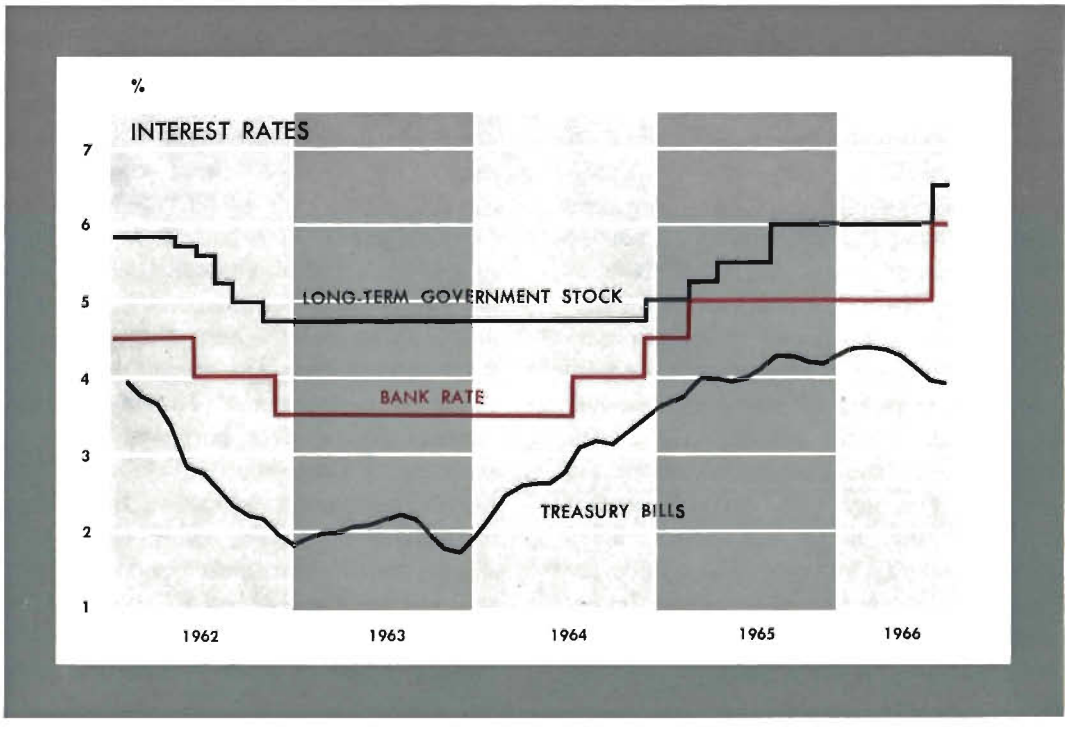
In these exceptional circumstances the Government found itself unable to finance all its expenditures in a completely non-inflationary manner. It did succeed in borrowing a net amount of R50 million from the domestic private non-bank sector during the year ended March, 1966, but had to increase, directly or indirectly, its indebtedness to the banking sector by the issue of Treasury bills and government stock to the extent of about R115 million and at the same time reduce the Exchequer balance by R97 million. Its *net* indebtedness to the banking sector therefore increased by R212 million during the year.

Developments during April-June, 1966

During the first three months of the current financial year, i.e. the second quarter of 1966, the Exchequer showed an excess of issues over receipts of R107 million, as against R50 million in the corresponding quarter of 1965. The Government reduced its foreign debt (excluding the small amount held by the Public Debt Commissioners) by R20 million and borrowed net amounts of R18 million from the Public Debt Commissioners, R51 million from the private non-bank sector and R129 million from the monetary banking sector during this period. Part of the latter amount was, however, borrowed purely as a matter of stabilisation policy in order to provide investment outlets to the exceptionally liquid banking sector, and a substantial part of the funds obtained in this way was sterilised with the Reserve Bank, as indicated by the fact that the Exchequer balance increased by R72 million during this quarter.

Tight Conditions in Capital Market

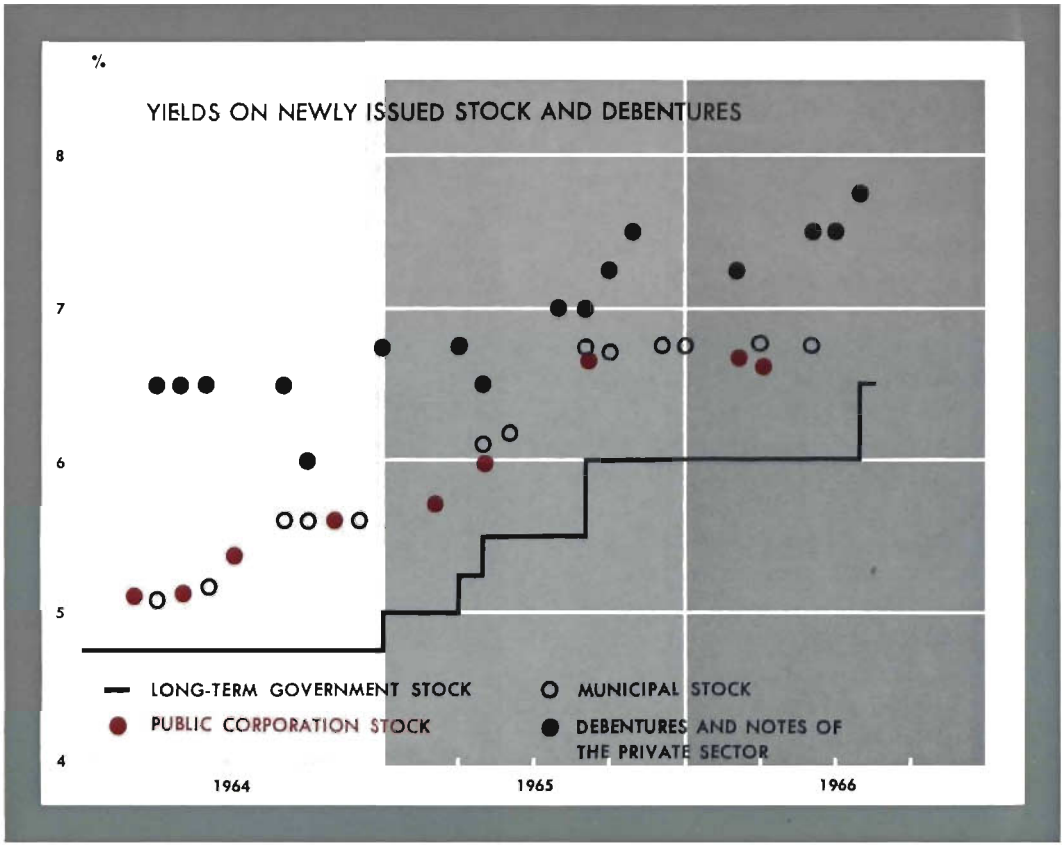
Although capital market conditions showed marked variations in certain respects during the course of the past year, they generally remained relatively tight. In the existing inflationary conditions the demand for loanable funds continued to exceed the supply, notwithstanding the substantial further increase in the quantity of money and near-money. Naturally, this tightening would have been more severe and would have become noticeable at an earlier stage, with desirable stabilising effects on the economy, if new money had not been created on such a large scale as a substitute for genuine savings. This factor therefore prevented the tendency for capital expenditure to exceed the available supply of savings from having its full effect on capital market conditions.



Upward Pressure on Rates on Fixed Interest Bearing Securities

Nevertheless, despite the increase in the supply of money and near-money and the net inflow of foreign capital, strong upward pressure was exerted during the past year on interest rates on gilt-edged and other fixed interest bearing securities. At the beginning of this period the effective yield to redemption on long-term government stock was 5.5 per cent, while that on municipal and public corporation securities, as reflected by new issues, amounted to approximately 6.2 per cent. New debentures and notes of the private sector offered a yield of about 7 per cent at that stage. On the 16th August, 1965, however, the Reserve Bank increased its pattern of rates for transactions in government stock by ½ per cent, which brought the rate for long-term stock to 6 per cent. The yield on municipal and public corporation securities accordingly moved up to about 6.7 per cent and that on private debentures and notes to about 7½ per cent.

More recently, on the 8th July, 1966, after yields on new issues of private debentures had increased to as much as 7¾ per cent, the Reserve Bank increased its rates



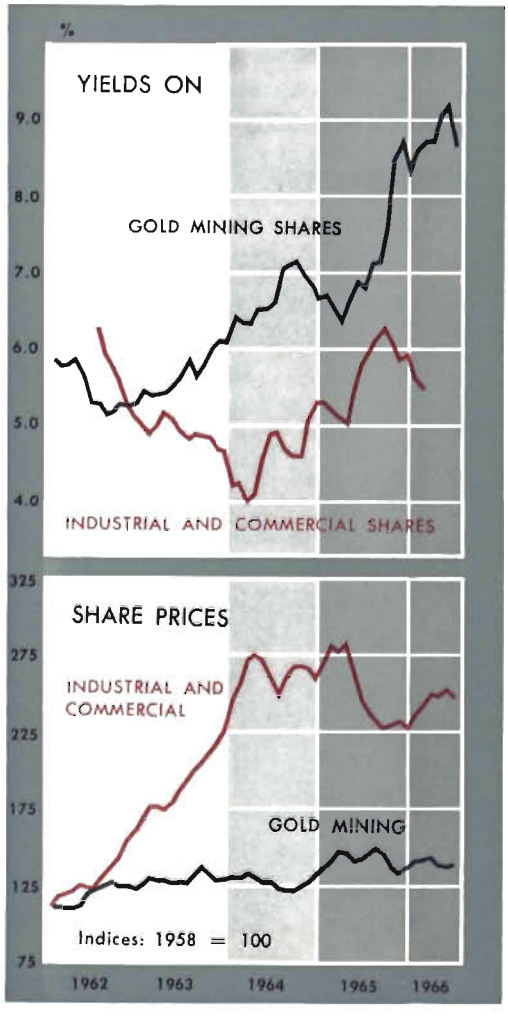
for government stock with maturities of $10\frac{1}{2}$ years and longer on a graduated scale, starting with 6 per cent for maturities of $10\frac{1}{2}$ years and longer to $6\frac{1}{2}$ per cent for maturities of 25 years and longer.

Fluctuations in Share Prices and Yields

After registering peak levels early in the second quarter of 1965, the prices of the major classes of shares showed a declining tendency which lasted until the middle of the second half of the year. Among the factors responsible for this decline were the rapid decline in the reserves at that stage, the imposition of restrictive monetary measures in March and a sudden upsurge in new issues of securities by private enterprises as the realisation dawned that bank credit would not be allowed to rise much further and that the economy in general might become less liquid.

From September onwards, however, as the reserves recovered spectacularly and the liquidity of the private sector increased to an abnormally high level, thereby removing the necessity for many companies to resort to the capital market, the prevailing business mood became very optimistic again and the prices of most classes of shares increased once more. But this recovery did not last long and from about March, 1966, after the Reserve Bank's credit directive to the monetary banks had been extended and business expectations had become more sober, the prices of certain types of shares levelled off while gold mining share prices actually declined somewhat.

The average yield on industrial and commercial shares increased to a peak of 6.2 per cent in September, 1965, before declining to about 5.2 per cent in June, 1966, while the average yield on gold mining shares moved upwards during most of the past year and amounted to 8.7 per cent in June, 1966.



Building Society Lending Affected by Tight Capital Market Conditions

The experience of the building societies during 1965 provided another symptom of the pressure exerted on the available resources in the economy by the excessive capital and consumption expenditure in general. Thus, compared with R154 million in 1964, the increase in the building societies' resources during 1965 amounted to only R84 million. Fixed deposits actually declined by R2 million, while savings deposits and share capital increased by R13 million and R73 million, respectively. As pointed out earlier, however, building societies still fared well by comparison with hire-purchase, general and savings banks.

In the circumstances, the building societies found themselves unable to meet completely the abnormally strong demand for their mortgage loans which was, partly at least, a symptom of the inflationary boom conditions. They nevertheless increased their outstanding loans by R140 million during 1965, compared with R146 million during 1964. This was possible because they were able to liquidate some of their excess liquid assets and other investments to the extent of R63 million during this period. A large proportion of the increase in their loans, however, represented advances in respect of previous commitments, as mortgage loans granted but not yet paid out declined by R96 million during the year.

The stringent conditions under which the societies operated eased somewhat during the first half of 1966. The inflow of new deposits amounted to R23 million during this period, compared with only R11 million during the whole of 1965, while share capital increased by R18 million. Mortgage and other loans, on the other hand, showed a modest rise of only R29 million, leaving the societies with some additional scope for lending and investment activities.

Following the unpegging of deposit and share rates on the 8th July, 1966, and the increase in Bank Rate and long-term government stock rates, most building societies increased their mortgage rate by 1 per cent to 8½ per cent and raised their rate on savings deposits from 4 to 4½ per cent, that on fixed deposits for 12 months or longer to 6½ per cent and that on paid-up and subscription shares by ½ per cent to 6½ per cent and 6 per cent, respectively.

Investment Policy of Insurers during Recent Years

A feature of the investment policy of insurers during recent years has been a shift, in relative terms, of their investment funds from the public sector to the private sector. At the end of 1962, for instance, their holdings of government, municipal and public corporation stock plus their outstanding loans to local authorities amounted to 28 per cent of their total assets. This proportion declined to 24 per cent at the end of 1965, while their investments in securities of the private sector increased from 18 per cent of total assets at the end of 1962 to 24 per cent at the end of 1965.

During this three-year period the investment of insurers in government stock

as such declined not only in relative, but also in absolute terms. Net redemptions of government stock during this period amounted to R16 million, which brought their holdings of such stock to only 4.5 per cent of total assets. Their investment in municipal and public corporation stock and loans to local authorities increased by R53 million during this period, so that a total net amount of R37 million was invested in the public sector. But total assets of insurers increased by R383 million during the period under review, which means that no less than R346 million was directed to investment outlets in the private sector. Securities absorbed R165 million of this amount, mortgages R71 million, real estate R40 million, loans R27 million, cash and deposits R24 million, and other assets R19 million.

Increased Investment in Securities of the Private Sector by Private Pension Funds

Private pension funds followed an investment policy similar to that of insurers during recent years and directed a proportionately larger part of their new funds to securities of the private sector and less to the public sector. At the end of 1962 their holdings of government, municipal and public corporation stock plus their outstanding loans to local authorities amounted to 55 per cent of total assets, but this percentage declined to 52 at the end of 1965. During the same period their investments in securities of the private sector increased from 16 per cent to 23 per cent of total assets. This relative decline in their holdings of public sector securities was to a large extent attributable to the fact that during the period under consideration their holdings of government stock increased by only R1 million and stood at 3.4 per cent of total assets at the end of 1965, compared with 4.7 per cent at the end of 1962.

The total resources of private pension funds increased by R296 million between 1962 and 1965, of which R158 million was directed to investment outlets in the private sector. Of the latter amount, securities absorbed R117 million, mortgages and real estate R27 million, cash and deposits R10 million, and other assets R4 million.