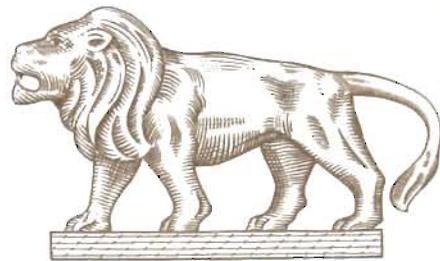
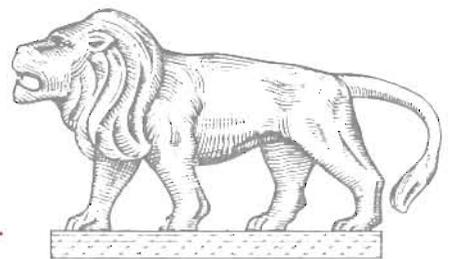


SOUTH AFRICAN RESERVE BANK ANNUAL ECONOMIC REPORT



1967

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A review of economic and financial conditions in the Republic of South Africa presented as background to the Chairman's Address to Stockholders at the Forty-seventh Ordinary General Meeting to be held on 22nd August 1967.

**HIERDIE VERSLAG IS OOK IN AFRIKAANS
BESKIKBAAR**

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INTERNAL ECONOMIC CONDITIONS

New upswing in monetary demand in 1966

Significant cyclical changes occurred in the South African economy during 1966 and the first half of 1967. After declining during the second half of 1965, the total monetary demand for goods and services began a new upward movement from about the first quarter of 1966 and this was accompanied by an upswing in a wide variety of economic activities and transactions. Since the existing situation was one of full, even over-full, employment of productive factors, the growth rate of physical production and real income could not be increased sufficiently to match the accelerated increase in expenditure, so that the inflationary pressure which still existed as a legacy of the previous upswing tended to increase.

Disinflationary monetary and fiscal measures

Realising that these developments constituted a new threat to the economic stability of the country, the authorities appreciably tightened monetary and fiscal policy in July and

August, 1966. Bank Rate was increased from 5 to 6 per cent, the rate on long-term government stock was raised from 6 to $6\frac{1}{2}$ per cent and the Reserve Bank's pattern of rates on government stock adjusted accordingly, deposit rate control was lifted, the direct control of bank discounts and advances to the private sector was extended, various taxes were increased and legislative action to force insurers, pension funds and unit trusts to hold more government stock was announced. At the same time, import control was relaxed.

In December additional disinflationary steps to intensify and complement the earlier measures were taken. These included new restraints on expenditure by the public sector, a substantial further relaxation of import control, a tightening of the direct restrictions on bank credit and a more restrictive money market policy aimed at making the existing Bank Rate more effective. *General* price control was not imposed, but it was indicated that the Government would be prepared to extend price control on a selective basis where such action appeared to be justified.

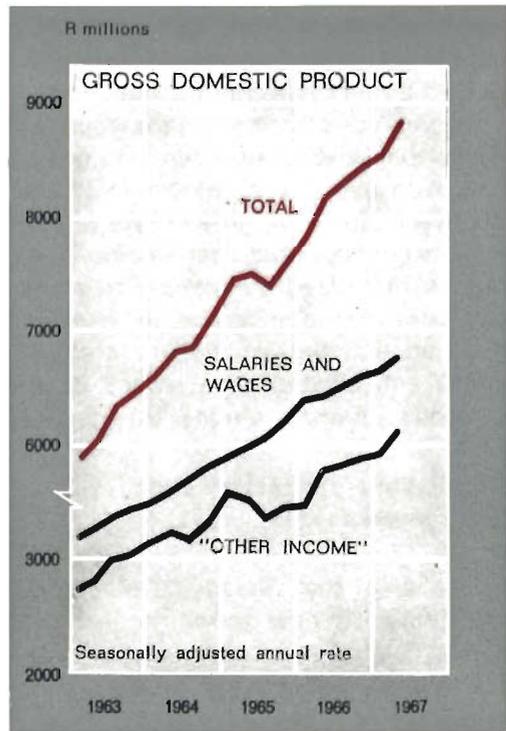
Further restrictive fiscal measures were announced by the Minister of Finance in his Budget in March 1967, including substantial increases in loan levies and company tax, while the Reserve Bank's pattern of rates for short and medium-term government stock was adjusted upwards in March and April. Soon afterwards, in May, import control was relaxed still further. This was followed in June by an announcement that the minimum liquidity ratios for merchant, hire-purchase, general and savings banks would be increased from the end of July. Finally, in August a proclamation was published in the Government Gazette giving the Reserve Bank the power to issue directives to banking institutions in regard to their credit extension and imposing penalties if these directives were not complied with.

Slower rate of increase in total spending during 1967 but persistent inflation

Although the new upswing in total spending turned out to be extremely vigorous, the official disinflationary measures prevented the rate of inflation from rising during the second half of 1966 and, during the first half of 1967, brought about a tightening of the financial situation and a slowing down of the rate of increase of total monetary demand. But economic activity in virtually all sectors of the economy remained at a very high level and by the middle of the year it was clear that the inflationary pressure had by no means been eliminated.

Further rise in gross domestic product

After rising very rapidly during the first half of 1966, gross domestic product in money terms increased at a progressively slower rate during the second half of that year and the first quarter of 1967. This was partly the result of a decline in the value added by agriculture, but a broadly similar tendency was shown by gross domestic product, excluding agriculture. During the second quarter of 1967, however, the rate of increase of gross domestic product accelerated sharply, largely owing to a substantial increase in the

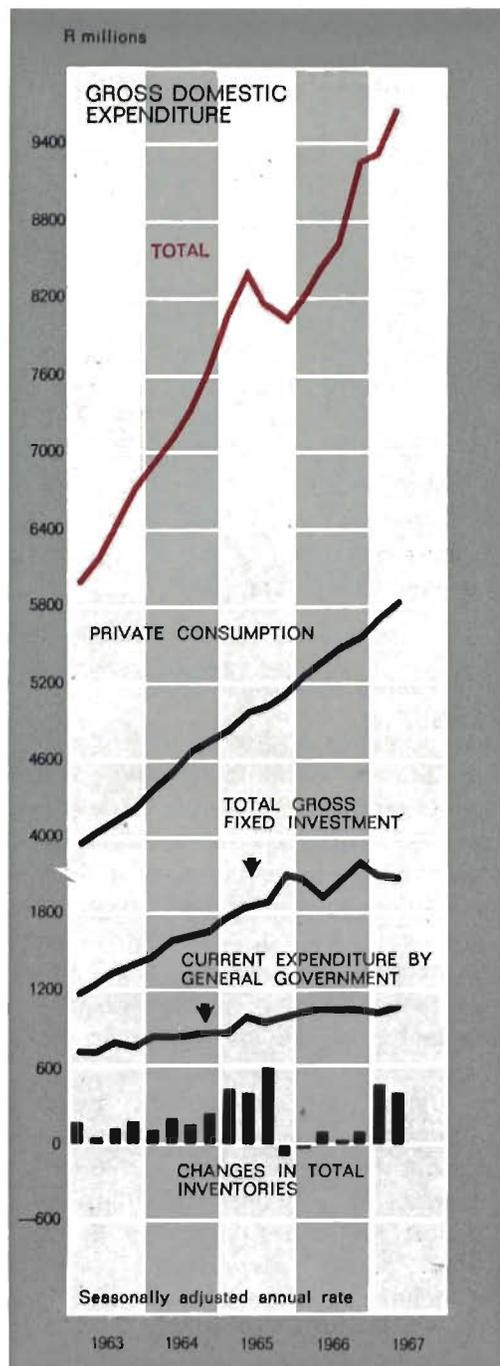


value added by agriculture. After taking into account price changes, there would appear to have been little increase in *real* gross domestic product during the fourth quarter of 1966 and the first quarter of 1967, but a substantial increase during the second quarter of 1967.

Although the rate of increase of salaries and wages also declined noticeably from the second quarter of 1966, the slower rise in gross domestic product during the second half of that year and the first quarter of 1967 was largely a reflection of a levelling-off tendency in "other income", i.e. in the gross profits of companies and of self-employed persons. During the second quarter of 1967, however, "other income" increased fairly substantially as a result of a rise in profits realised in agriculture.

Fluctuations in gross domestic expenditure

Following its decline during the second half of 1965, gross domestic expenditure, i.e. the total of fixed capital outlays, inventory investment, private consumption and current government expenditure, resumed an upward course in the first quarter of 1966 and accelerated to an annual rate of increase of roughly 16 per cent during the second half of that year, before slowing down to a tempo of about 12½ per cent per year during the first half of 1967.



This latter slowing down differed in important respects from the decline in total spending during the second half of 1965. On that occasion, gross domestic expenditure had declined mainly as a result of a sudden and substantial fall in inventory investment, which had largely been brought about by the stricter application of import control and had only partly reflected a slowing down in the rate of increase of the underlying monetary demand. By contrast, the more recent reduction in the rate of increase of total spending occurred despite a continued high level of inventory investment and a substantial relaxation of import control in July and December, 1966.

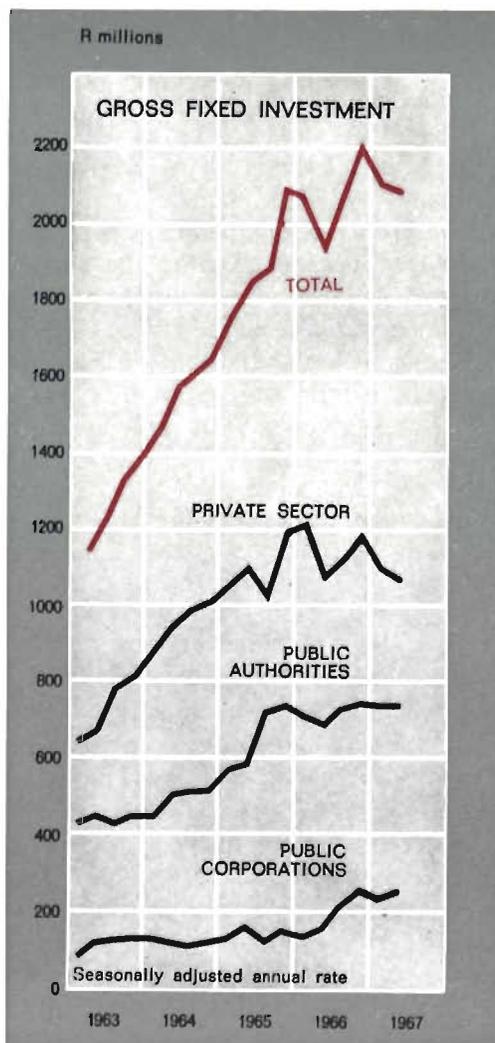
Reversal of upswing in fixed investment

The main reason for the more recent slowing down in the rate of increase of total spending was a fairly sharp downturn in private fixed capital outlays after the end of 1966, particularly in manufacturing, commerce, non-residential construction and private residential building. In this, the general tightening of the monetary and financial situation played its part.

Public fixed investment behaved differently. After rising to a very high peak in the fourth quarter of 1966, fixed investment by public authorities levelled off during the first half of 1967, while public corporations likewise maintained their capital spending during the first half of 1967 at the exceptionally high level to which it had risen

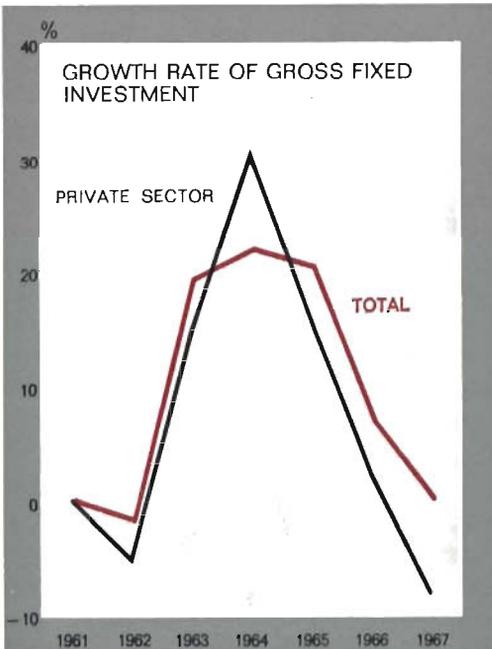
by the fourth quarter of 1966. Total public and private fixed capital outlays accordingly showed a marked upward movement during the second half of 1966, followed by only a moderate downward tendency during the first half of 1967.

If a somewhat longer-term view is taken, it appears that total domestic



fixed investment, after rising by an average annual rate of roughly 21 per cent between 1962 and 1965, increased by only about 7 per cent during 1966 as a whole, and during the first half of 1967 amounted to a seasonally adjusted annual figure which was only moderately higher than that of the previous year. The new upswing in fixed capital outlays during the second half of 1966 may, therefore, prove to have been short-lived.

Nevertheless, the ratio of gross domestic fixed investment to gross domestic product still amounted to as much as 22½ per cent during the first half of 1967, which is relatively high compared with the average of about 21 per cent during the entire post-war period.

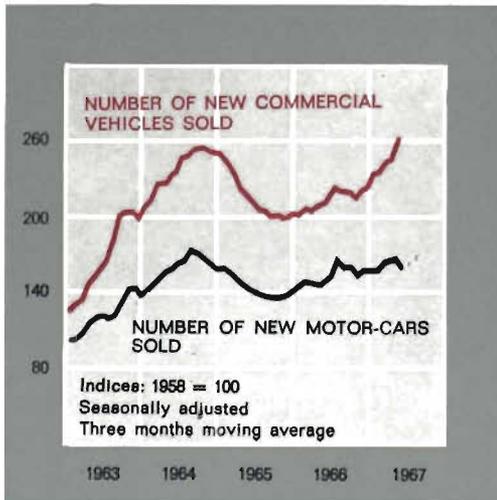


High level of inventory investment

The high level of inventory investment during the fourth quarter of 1966 and the first half of 1967, to which reference was made earlier, brought the total addition to stocks during the twelve months ended June 1967 to about R250 million, compared with R183 million during the previous year. If it had not been for this somewhat abnormal behaviour of inventory investment, associated with the imports for strategic stockpiling and business optimism, the rate of increase of gross domestic expenditure would almost certainly have slowed down more during the first half of 1967.

Private consumption and current government expenditure

The further increase in gross domestic expenditure during the course of the first two quarters of 1967 was also partly the result of a rise in private consumer spending at an annual rate of roughly 8½ per cent, which was only slightly below the rate of the preceding year. Although motor car sales increased strongly throughout 1966 and the first quarter of 1967 and only levelled off during the second quarter, total expenditure on durable consumer goods tended to rise at a somewhat slower rate during the first half of 1967 than during the course of 1966. But this was more or less offset by an acceleration in the rate of increase of expenditure on non-durable goods and services.



Current expenditure by general government followed a somewhat different pattern of behaviour than the other components of total spending. After rising sharply until the third quarter of 1966, it actually tended to decline during the next two quarters before rising again during the second quarter of 1967. These changing tendencies were mainly attributable to fluctuations in defence spending.

Rise in exports and imports

A further factor which contributed to both the new upswing during the course of 1966 and the subsequent reduction in the rate of increase of total monetary demand, was the behaviour of total exports of goods and services, including the gold output. After declining slightly during the first quarter of 1966, these exports increased substantially during the third quarter, but then tended to level off.

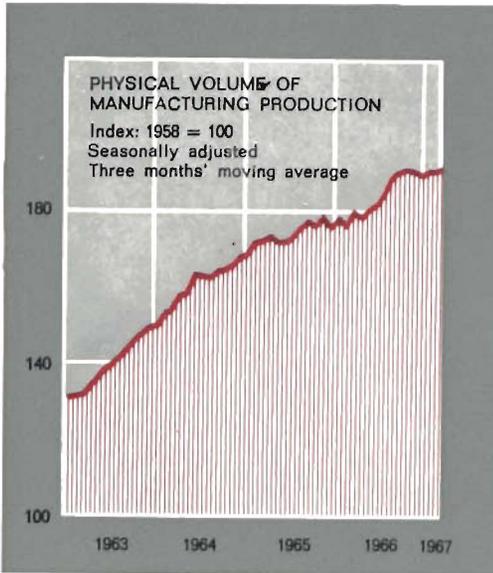
The upward movement in exports during the course of 1966, taken together with the simultaneous rise in gross domestic expenditure, brought about such a strong increase in total demand that the domestic economy, already fully extended as it was, was unable to increase its production sufficiently to supply all the required additional goods and services. This resulted in a sharp rise in total imports of goods and services, particularly after import control was relaxed in July 1966.

Little change in total saving

Gross domestic saving fluctuated around a more or less horizontal trend during 1966 and the first half of 1967. During the year ended June 1967 there was a noticeable rise in the current surplus of public authorities and in provision for depreciation, while corporate saving (retained earnings) showed little change. Personal saving, however, declined substantially during this period as a whole.

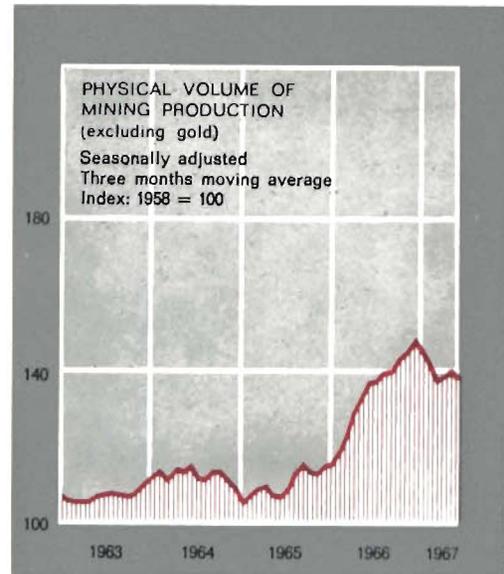
Levelling-off in manufacturing output

After rising noticeably towards the middle of 1966, the seasonally adjusted index of the physical volume of manufacturing output levelled off completely between September 1966 and March 1967. Nevertheless, it was still about 6.3 per cent higher during the first three months of 1967 than during the corresponding period of 1966.⁴ The main categories responsible for this increase were food and transport equipment.



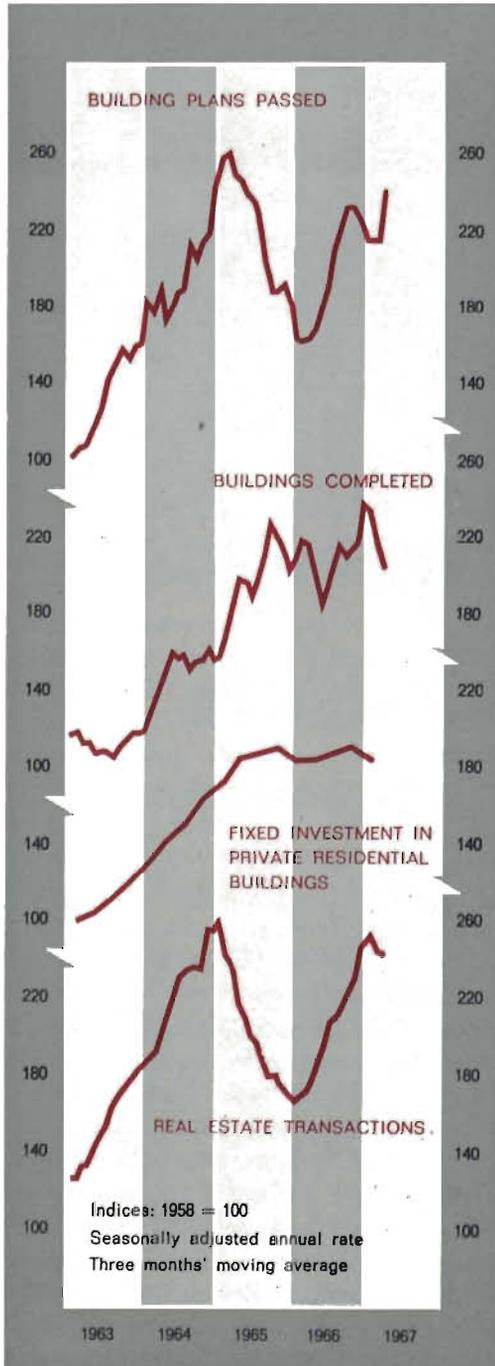
Mining output

While the output of gold varied around an approximately horizontal line during 1966 and the first six months of 1967, other mining production, particularly that of copper, increased at an exceptionally rapid rate during 1966 to a peak in December. During the early months of 1967, however, it declined temporarily, partly as a result of adverse working conditions produced by heavy rains. During 1966 as a whole, mining production other than gold was 23 per cent higher than during the previous year. This contributed materially to the rise in exports and the renewed upswing in economic activity in general during the course of that year.



New upswing in building, construction and real estate transactions

As in most other sectors of the economy, there were signs of a new upswing in the building and construction industry during the past year, after activity had declined during the first half of 1966 below the record level of 1965. The value of "building plans passed", for example, after reaching a low point in the first quarter of 1966, moved up rapidly again, and in April 1967 actually surpassed the previous peak attained in January 1965. Similarly, the downward tendency in the value of "buildings completed" was transformed into a strong new upswing from about the middle of 1966, while fixed investment in private residential buildings also showed a new upward



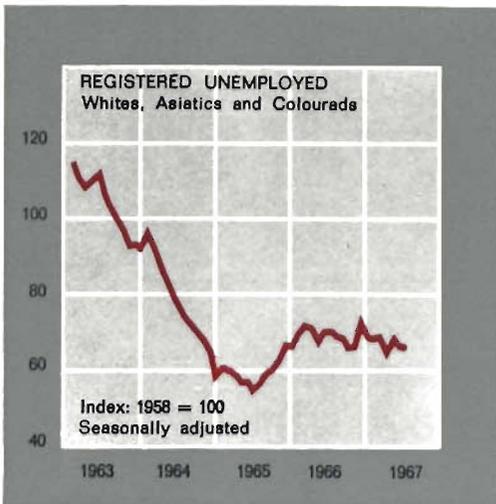
movement during the second half of 1966. The value of real estate transactions, which had declined from a peak at the end of 1964 to a low point early in 1966, moved sharply upwards throughout the rest of 1966, before levelling off during the first four months of 1967. During the latter period it was about 47 per cent higher than during the corresponding period of the previous year.

Rise in employment, wages and salaries

Excess demand continued to exert pressure on labour resources during 1966 and the first half of 1967. Employment declined somewhat in gold mining and in the South African Railways and Harbours, but increased further in manufacturing, construction and most other sectors of the economy. In manufacturing, for example, average monthly employment was 4.8 per cent higher in 1966 than in 1965. During the first quarter of 1967, however, employment in this sector tended to rise at a slower rate.

The seasonally adjusted index for registered unemployed Whites, Coloureds and Asiatics fluctuated around a more or less horizontal line throughout 1966 and the first six months of 1967. In June 1967 it amounted to 68.9, compared with 72.9 a year earlier and 71.6 in December 1966.

In these tight labour market conditions, wage and salary earnings con-



tinued to rise. Moreover, flowing mainly out of the continued demand inflation, considerable new demands for higher remuneration were made during the first half of 1967 by employees in the public sector as well as in various parts of the private sector and by the middle of the year had, in themselves, become a significant factor in the total economic picture.

Further rise in prices

After rising by 3.8 per cent between December 1965 and December 1966, the seasonally adjusted consumer price index increased further at an annual rate of 3.3 per cent between December 1966 and June 1967. While the increase in food prices accelerated from 4.4 per cent during 1966 to an annual rate of 4.9 per cent during the first half of 1967, the rate of increase of other prices declined from 3.5 per cent during 1966 to 2.7 per cent during the first half of 1967.

The behaviour of the seasonally adjusted wholesale price index likewise confirmed that upward pressure was still being exerted upon prices. After rising by 4.5 per cent between December 1965 and December 1966, it only slowed down to an annual rate of increase of 3.3 per cent between the latter date and June 1967. During this latter period, wholesale prices of South African agricultural, forestry and fishing products increased at an annual rate of no less than 6.6 per cent, compared with 2.3 per cent in the case of manufactured products.

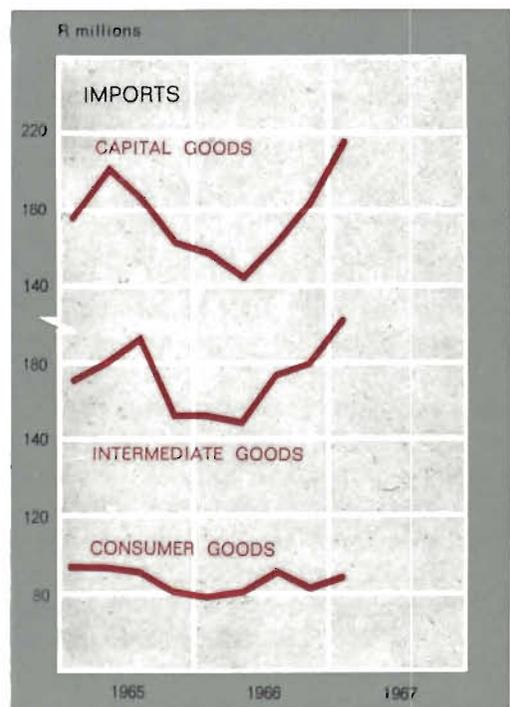
BALANCE OF PAYMENTS

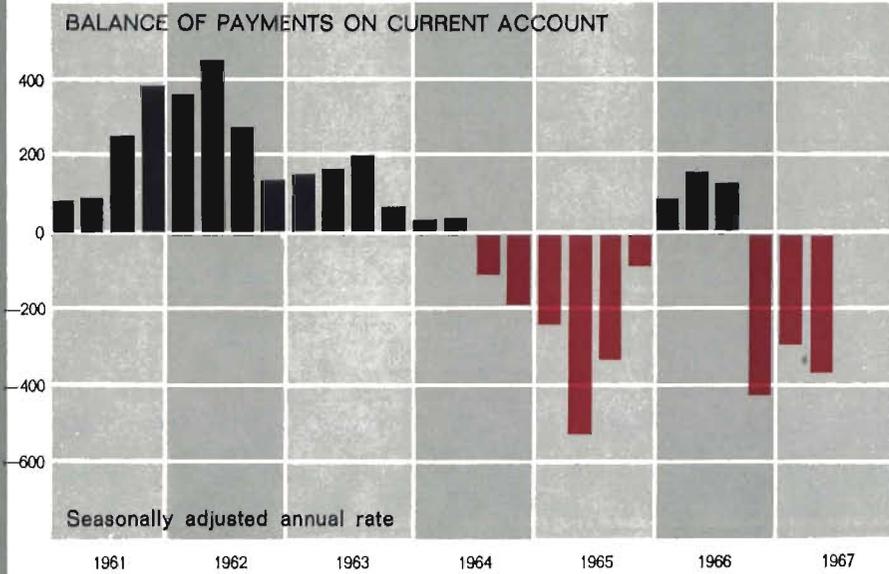
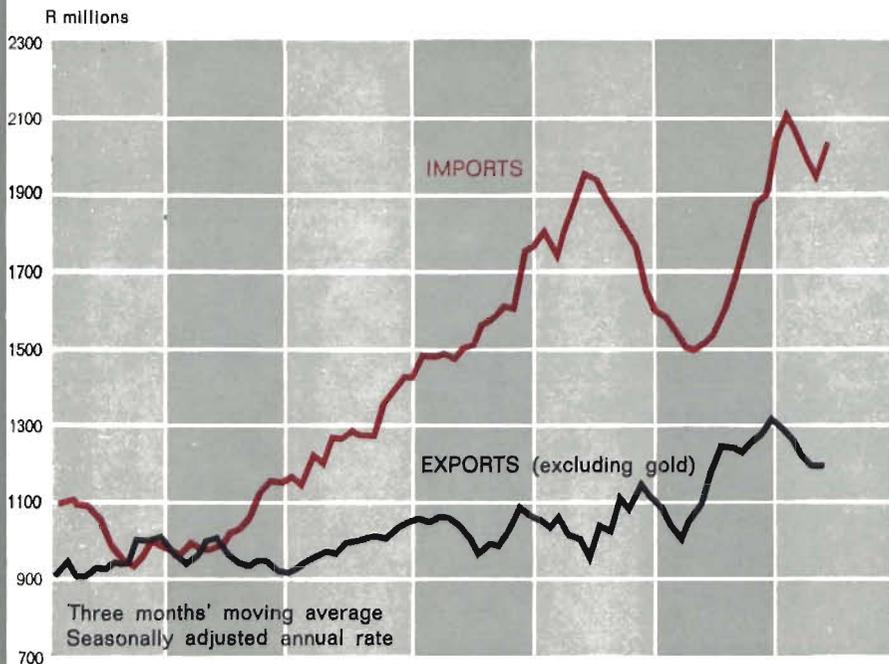
Rise in imports followed by levelling-off tendency

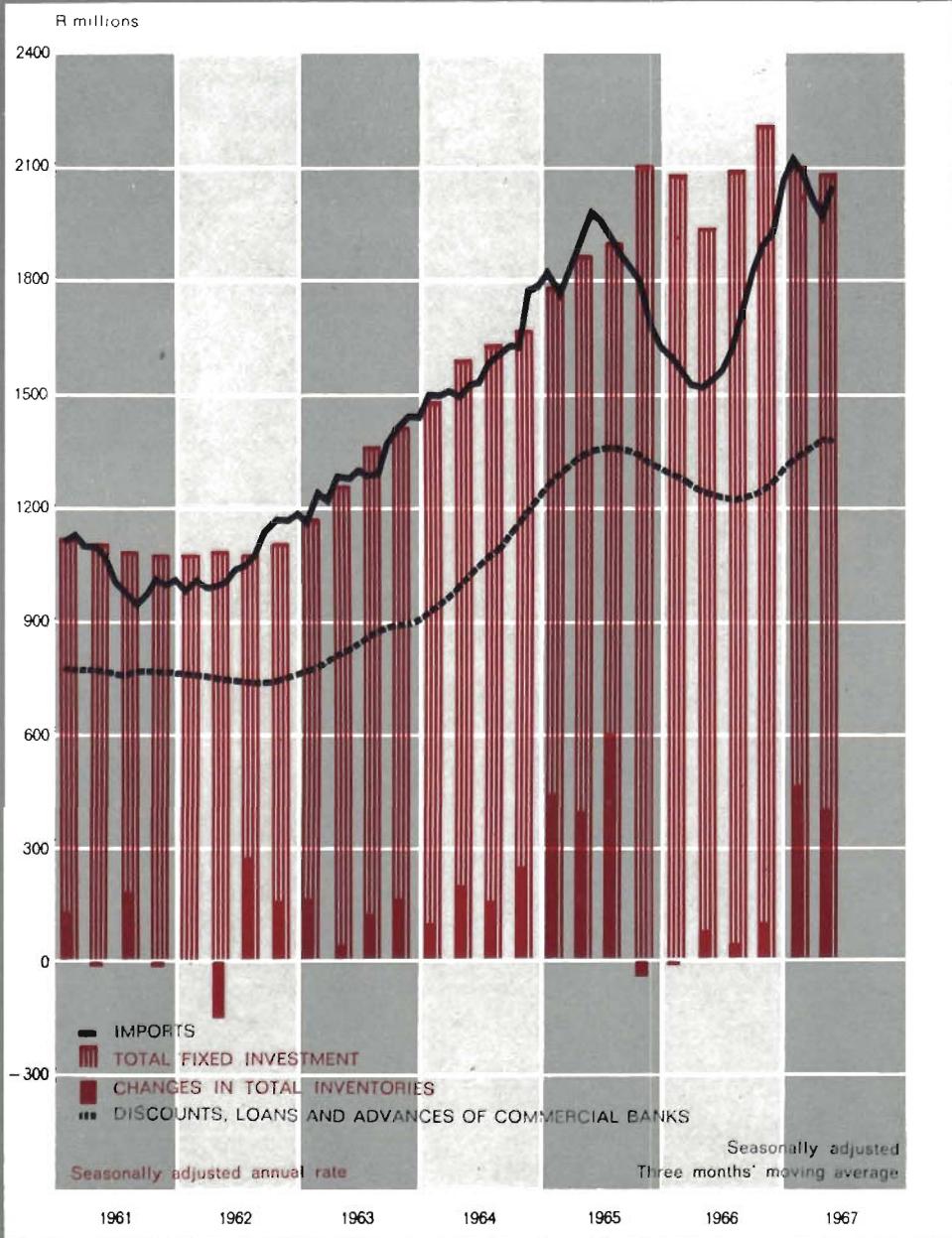
The renewed upswing during the course of 1966 in fixed and inventory investment, exports and general economic activity naturally increased the demand for imported as well as locally produced goods and services. In addition, as mentioned earlier, import control was relaxed in July 1966 as a disinflationary measure which the record level of the gold and foreign exchange reserves made possible. The result was that imports rose from a seasonally adjusted annual rate of less than R1,500 million in April 1966 to R2,250 million in January 1967, the main increases being registered in the categories capital and intermediary goods.

Import control was further relaxed in December 1966 and again in May 1967, and during the first half of 1967 considerable progress was also made in implementing the official policy of stockpiling strategic imported commodities. However, total imports did not increase further after January, but

actually tended to level off at an annual rate of just over R2,000 million. This suggested that the disinflationary monetary and fiscal measures were increasingly taking effect.







Increase in merchandise exports

The upward movement in imports during the second half of 1966 was accompanied by a sharp increase in merchandise exports, namely from a seasonally adjusted annual rate of about R962 million in April to new record levels of about R1,300 million towards the end of the year. This rise was mainly accounted for by increases in the exports of copper, diamonds and pig iron. Subsequently, during the first half of 1967, exports tended to move downwards again, although they remained at a much higher level than during the corresponding period of 1966. South Africa's net gold output, as defined for balance of payments purposes, moved horizontally at about R770 million per year throughout 1966 and the first half of 1967.

Re-emergence of deficit on current account

Mainly as a result of these developments and an accompanying increase in net invisible payments to the rest of the world, fairly substantial quarterly deficits re-emerged in the balance of payments on current account from the fourth quarter of 1966 onwards, as indicated in the accompanying table. After adjustment for seasonal changes and taken at an annual rate, the current deficit amounted to R420 million during the fourth quarter of 1966, but then declined to R290 million and R360 million during the first and second quarters of 1967, respectively.

Balance of payments on current account
(R millions)

	1965				1966				1967	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
Actual balance	-69	-139	-92	6	5	37	22	-77	-85	-96
Seasonally adjusted annual rate	-236	-524	-332	-84	80	160	128	-420	-290	-360

Continued net inflow of private capital

As indicated in the accompanying table, both long and short-term private capital continued to flow into the country throughout 1966 and the first half of 1967, bringing the total net inflow of funds of this kind during the two and a half years ended June 1967 to R429 million. Of this figure, R231 million represented long-term capital, which mainly took the form of direct investment in foreign controlled South African resident organisations; net purchases by foreigners of South African securities on the Johannesburg Stock Exchange amounted to only about R20 million. The short-term inflow of R198 million during this period included substantial credits received by South African residents from foreigners to finance trade transactions.

Coming as it did after six consecutive years of net private capital out-

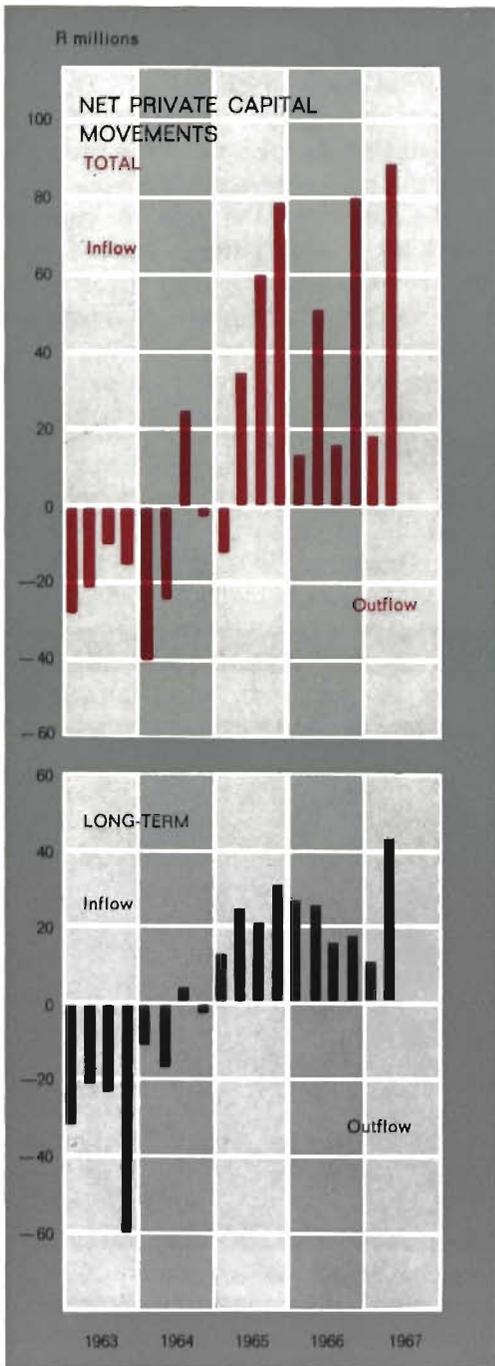
flow, this inflow was much larger and more sustained than expected and was not entirely an unmixed blessing. Thus, while it helped to relieve the pressure on the balance of payments, it tended at times to offset the effects of the restrictive monetary and fiscal measures. This was particularly true during the first half of 1966, when it coincided with a fairly large surplus on the current account of the balance of payments.

Small net outflow of central government and banking capital

The net inward movement of private capital was partially offset by a net outflow of central government and banking capital of R11 million during 1966 and R44 million during the first half of 1967. This was largely a reflection of the repayment of foreign loans by the Government and the Reserve Bank.

Net movements of private and official capital
(R millions)

	1965				1966				1967	
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.
PRIVATE:										
Long-term	13	25	21	31	27	26	16	18	11	43
Short-term (including errors and unrecorded transactions)	-25	10	39	48	-14	25	—	62	7	46
Total private	-12	35	60	79	13	51	16	80	18	89
OFFICIAL	36	10	22	28	11	8	-28	-2	-8	-36
TOTAL	24	45	82	107	24	59	-12	78	10	53

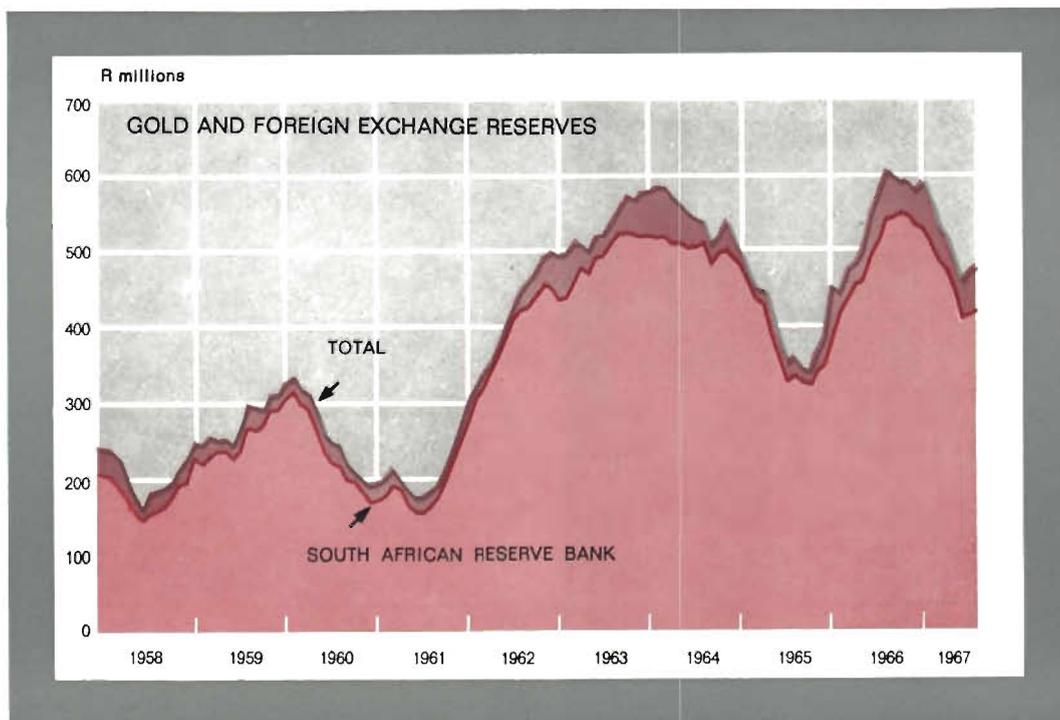


Decrease in gold and foreign exchange reserves

After rising by the record amount of R264 million in ten months to reach R604 million at the end of July 1966, the total gold and foreign exchange reserves held by the Reserve Bank, the rest of the banking sector and the Government declined moderately to R589 million at the end of 1966 and then, more rapidly, to R455 million at the end of May 1967. During the sub-

sequent two months the reserves increased unexpectedly to about R475 million at the end of July.

From the figures given earlier, it is evident that the decline in the reserves over the past twelve months was mainly the result of the rise in imports, which to a large extent resulted from the relaxation of import control. In view of the high level of inventory investment during the past year, it may be interpreted as largely an exchange of reserves of foreign currency for reserves of goods.



MONETARY AND BANKING SITUATION

Tightening of financial markets

During the course of the past twelve months, as the new upswing in total spending and economic activity got under way, the demand for loanable funds of virtually all kinds increased strongly. At the same time, the various restrictive monetary and fiscal measures and the substantial relaxation of import control succeeded in slowing down the increase in the supply of these funds. The inevitable results were a progressive tightening of financial markets and a further rise in interest rates. Although these changes were gradual, they were quite substantial taken over the year as a whole.

Levelling-off tendency in money and near-money

Considerable light is shed on this tightening of the general financial situation by an analysis of the changes in the quantity of money and near-money¹⁾ during 1966 and the first half of 1967. Indeed, as during the immediately preceding years, *monetary* changes again dominated the developments in the credit market as a whole.

During 1966 there was still an increase of about 6 per cent in total money and near-money. The main reasons for this were the surplus on the overall balance of payments during most of this period and a considerable increase in credit extended by the banking sector to the private sector. The net claims of the banking sector on the government sector also increased further, but by considerably less than during 1965.

* "Money" is defined as 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.

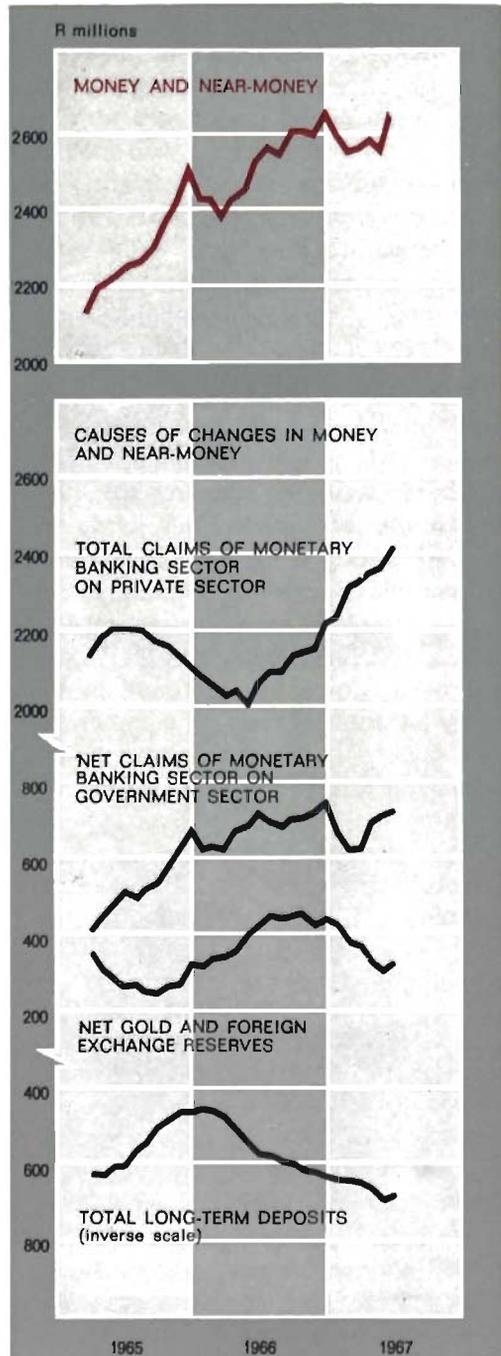
"Short-term" deposits are deposits payable in less than 30 days or subject to less than 30 days' notice.

"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.

During the first half of 1967, however, the situation showed signs of improvement. Thus, after rising to a record peak of R2,644 million at the end of December 1966, total money and near-money declined to R2,546 million at the end of February 1967, but this was largely owing to seasonal factors. It then fluctuated around a level of roughly R2,560 million during the subsequent three months before rising sharply to R2,681 million in June, i.e. a figure only R37 million higher than that of December 1966. One reason why the increase over this six-month period was relatively small, was a decline of R109 million in the net gold and foreign exchange reserves between the end of December 1966 and the end of June 1967. But two other important influences operated in the same direction. The first was a "shift" from money and near-money to long-term deposits amounting to R44 million during this period. And the second was a decline of R15 million in the net claims of the banking sector on the government sector, which contrasted sharply with increases in these net claims of R158 million, R49 million and R24 million during the second half of 1965 and the first and second halves of 1966, respectively.

The over-all position would have been more favourable had there not been a substantial further increase in bank credit extended directly to the private sector, as indicated by an increase of R198 million in the claims of the banking sector on the private sector during the first half of 1967.



Causes of changes in money and near-money
(Changes in consolidated assets and liabilities of the monetary banking sector)
(R millions)

	Second half of 1965	First half of 1966	Second half of 1966	First half of 1967
Changes in money and near-money:				
Money	83	88	48	17
Near-money	192	-54	73	20
Total	274	34	121	37
Causes of changes:				
Net gold and foreign exchange reserves	62	103	6	-109
Claims on government sector	122	147	114	-109
Government deposits (increase —, decrease +)	36	-98	-90	94
Net claims on government sector	158	49	24	-15
Claims on private sector	-99	-40	147	198
Long-term deposits (increase —, decrease +)	142	-118	-55	-44
Other assets and liabilities	11	40	-1	7
Total	274	34	121	37

Increase in bank credit to private sector

This increase in bank credit to the private sector occurred notwithstanding the fact that early in December 1966 the Reserve Bank had requested the monetary banks to ensure that their discounts, loans and advances to the private sector, excluding the Land Bank, would be at least $7\frac{1}{2}$ per cent lower at the end of September 1967 than at the end of March 1965, with the qualification that this limit might be exceeded by $2\frac{1}{2}$ per cent in respect of

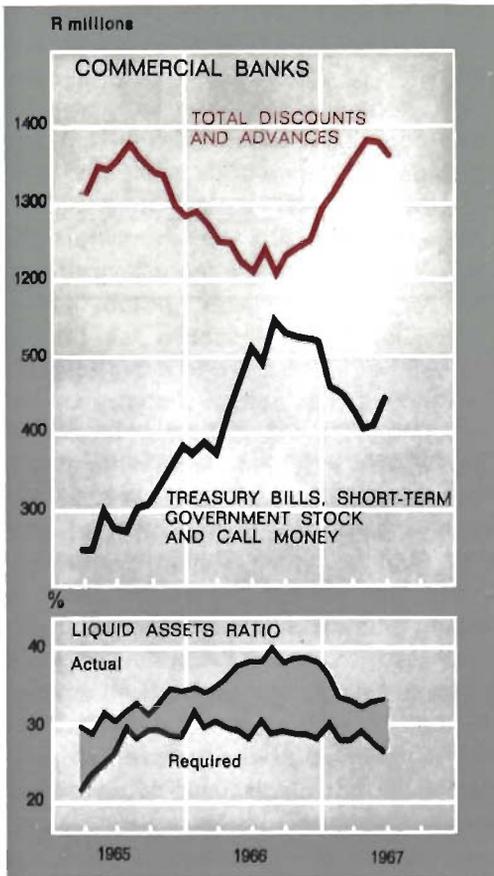
credit extended by them for agricultural purposes.

At the time this request was made, the monetary banks' discounts, loans and advances to the private sector were well below the old "ceiling" and only slightly higher than the new reduced limit set for September 1967. In setting this date, allowance had been made for the usual seasonal increase in bank credit during the first quarter of the year. During the first half of 1967, however, as the balance of payments deficit and the government sector's financing operations jointly operated in the direction of reducing

the quantity of money and near-money, the private sector's demand for bank credit increased sharply and the monetary banks allowed their discounts, loans and advances to the private sector to rise substantially — in fact, to an extent considerably in excess of the normal seasonal requirements.

By the end of April, the discounts, loans and advances of commercial banks and monetary hire-purchase, general and savings banks had risen

to about R138 million above the ceiling set for September 1967, although this figure included various amounts which had been authorized above the ceiling, such as credit to certain public corporations and to finance special imports deemed to be of strategic importance. During May and June, however, the banks did succeed in reducing their discounts, loans and advances to the private sector, excluding the Land Bank and, of course, the special items mentioned earlier.



Longer-term view of increase in money and bank credit

At a first glance, the official policy of restricting bank credit to the private sector to a level *below* that of March 1965, i.e. a level which prevailed more than two years ago, appears to be severe, even if allowance is made for the various exemptions referred to earlier. And it has, in fact, been argued recently that bank credit should at least have been allowed to rise during the past two years at the same rate as gross domestic product. But this reasoning fails to take into account the fact that during the period preceding March 1965 bank credit had shown an abnormal upsurge, which had contributed greatly to the excessive rise in the liquidity of the private sector and to the building up of inflationary pressure. In order to assess the true significance of recent monetary and banking developments and, in particular, the severity of the credit squeeze,

it is therefore misleading to use March 1965 as a base period.

The present monetary and banking situation can perhaps best be assessed against the background of the six years ended June 1967, i.e. the period since the beginning of the 1961-65 economic upswing. As the accompanying table shows, total money and near-money increased by no less than 98 per cent or 12.0 per cent per year during this period, compared with 72 per cent (9.4 per cent per year) in the case of gross domestic product and 76 per cent (9.9 per cent per year) in the case of gross domestic expenditure plus exports. The ratio of money and near-money to gross domestic product is estimated to have increased from roughly 26 per cent in 1961 to 29 per cent in 1966, compared with an average of 27 per cent during the ten years 1955 to 1964.

One factor which contributed to this virtual doubling of the supply of money and near-money in six years was an increase in the net gold and foreign exchange reserves of R245 million. But far and away the main "cause" was an increase of R1,421 million, i.e. an annual average rise of R237 million, in total bank credit, of which credit to the private sector accounted for R1,127 million. In other words, bank credit to the private sector contributed about four times as much as credit to the government sector and five times as much as the increase in gold and foreign exchange reserves to the increase in money and near-money over the past six years.

Of this exceptional upsurge in bank credit to the private sector of R1,127 million, discounts, loans and advances accounted for R979 million, to which commercial banks contributed R569

Changes in money and near-money and related data, 1961-67

	Increase 1961-67		Average percentage increase per year
	R millions	Percentage	
Gross domestic product	3,942	72	9.4
Gross domestic expenditure plus exports	5,129	76	9.9
Money and near-money	1,396	98	12.0
Gold and foreign exchange reserves (net)	245	258	23.7
Bank credit to:			
Government sector	294	66	8.8
Private sector	1,127	98	12.1
Total	1,421	89	11.2

million, merchant banks R40 million, monetary hire-purchase, general and savings banks R296 million and the Reserve Bank, National Finance Corporation, discount houses and Land Bank taken together R75 million.

These figures, analysed in conjunction with other available statistics, leave no doubt that bank credit increased at an excessive rate over the past six years and contributed greatly to the inflation during the latter half of this period. It was a classical case of new money created by the banks being used to an inordinate extent to finance rapidly rising fixed capital outlays.

Decline in liquid assets of banks

The deficit in the balance of payments after July 1966 and the fact that the government sector's net indebtedness to the banking sector did not rise further, not only restrained the upward movement in money and near-money, but also reduced the liquid assets of monetary banks. This, together with the substantial increase in credit extended by these banks during the past year, had the important effect of reducing the *ratio* of their liquid assets to their liabilities to the public and bringing it closer to the legally required minimum than it had been for fifteen months. In the case of the commercial banks, for example, their *surplus* liquid asset ratio declined from 11.1 per cent at the end of August 1966 to 3.3 at the end of April, before rising again to 6.9 per cent at the end of June as the banks' discounts and advances declined and the gold and foreign

exchange reserves increased once more.

The significance of the surplus liquidity ratio of monetary banks stems, of course, largely from the fact that it is normally one of the main factors determining the extent to which these banks can create money and near-money, i.e. when there is no direct limitation upon their credit to the private sector as at present. As far back as 1965, the legally required minimum liquidity ratios for commercial banks had been raised in stages from the normal ratios of 30, 20 and 5 per cent of short, medium and long-term liabilities to the public, respectively, to 40, 30 and 5 per cent, respectively, as a supplementary method of credit control. At that stage it had not been possible to raise the ratios for other banking institutions, as they had been allowed a year to comply with the liquid asset requirements of the new Banks Act, which had only come into operation in January 1965.

In June 1967, however, the authorities took the further step of announcing that the minimum liquidity ratios for all merchant, hire-purchase, general and savings banks would, with effect from the end of July, be increased from the normal ratios of 30, 20 and 5 per cent of short, medium and long-term liabilities to the public, respectively, to 34, 24 and 5 per cent, respectively. Once a ceiling had been placed upon credit extended to the private sector by *all* monetary banks in October 1965, there had been no urgent need to raise the minimum liquidity ratios for these institutions as a method of credit

control. Moreover, as a result of the favourable balance of payments during the ten months ended July 1966 and the simultaneous existence of the credit ceiling, these banks had in any case maintained large excess holdings of liquid assets during 1966. But subsequent changes in the monetary and banking situation made it desirable, in the interests of equity as well as stability, to bring the minimum ratios for these institutions into closer alignment with those for commercial banks.

Decline in call money

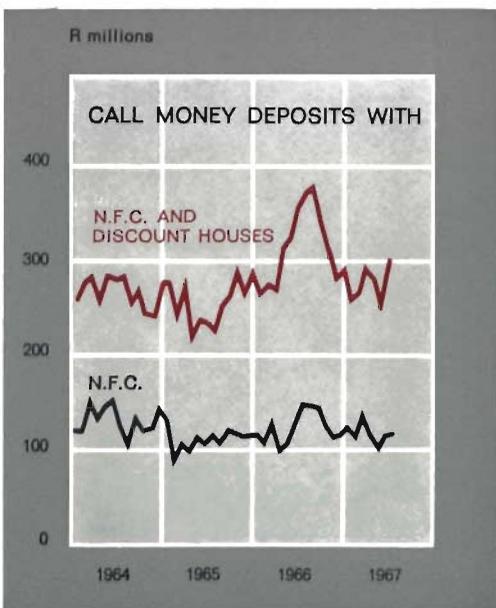
The less liquid conditions in the economy also resulted in a decline in the amount of call money held by banking institutions and others with discount houses and the National

Finance Corporation, namely from a peak of R381 million at the end of August 1966 to R254 million at the end of May 1967. During June, however, this figure increased again to R304 million.

Upward tendency in short-term interest rates

As a result of the changing demand-supply relationships in the money market referred to above, short-term interest rates understandably moved upwards during the past year. The Treasury bill tender rate, for example, increased from a low point of 3.71 per cent on the 8th July 1966 to 5.00 per cent at the end of March 1967. It then declined temporarily to 4.75 per cent on the 12th May before rising again to 4.96 per cent on the 4th August. Other related short-term interest rates, such as those on acceptance credits and inter-business loans, showed similar tendencies. In addition, the Reserve Bank's pattern of rates for short and medium-term government stock was raised in two stages, namely in March and April, 1967, which brought the rate on stock with a maturity of 3 to 3½ years up to 5⅔ per cent.

The increase in Bank Rate from 5 to 6 per cent on the 8th July 1966 was followed by an increase from 7 to 8 per cent in the minimum lending rate of the commercial banks and an equivalent upward adjustment in their other lending rates. Later, in June 1967, the banks increased some of their lending rates still further.

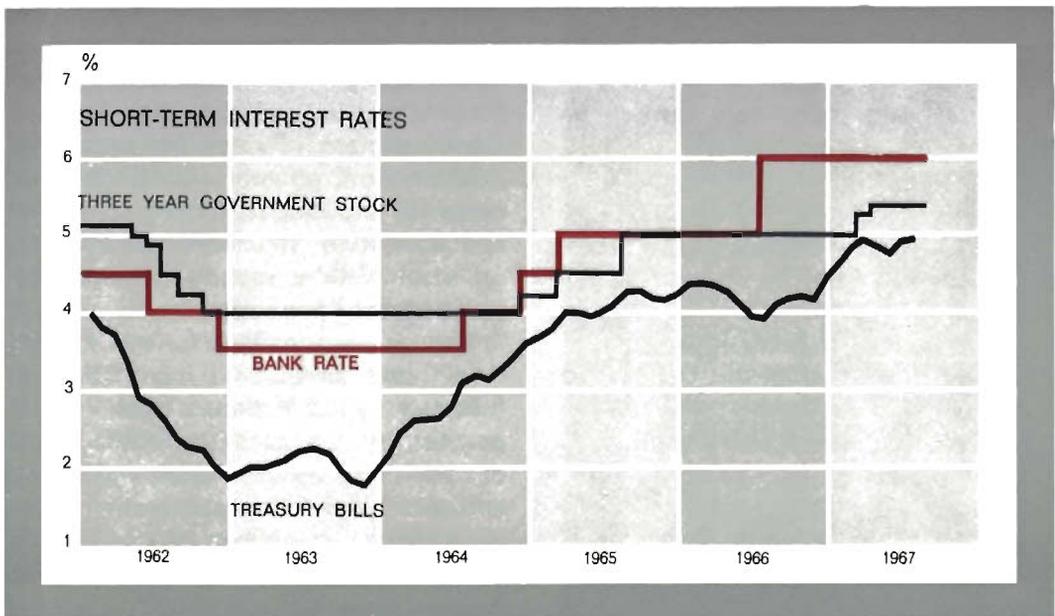


Although the Treasury bill rate began its upward movement immediately after the increase of 1 per cent in Bank Rate, it increased only moderately between July and November, so that the margin between these two rates remained abnormally large during this period, namely between $1\frac{3}{4}$ and 2 per cent.

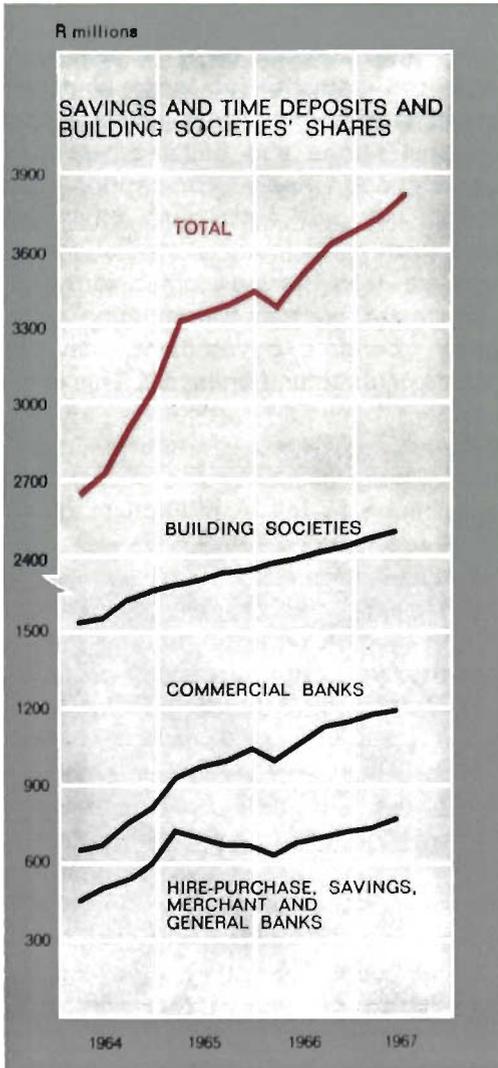
On the 7th December, however, it was announced that "with a view to removing a part of the excessive money in the economy from the spending stream and rendering it harmless", the Treasury would issue more Treasury bills to banks as well as ordinary business concerns and sterilise the proceeds with the Reserve Bank, while tax redemption certificates would also be offered to companies

and other taxpayers on favourable terms. It was expected that this would bring money market rates into better alignment with Bank Rate and commercial bank lending rates.

This policy was, in fact, only implemented during December 1966 and January 1967, as the need for it disappeared soon afterwards, at least temporarily. During the first quarter of 1967 the decline in the gold and foreign exchange reserves of the Reserve Bank and a partly seasonal shift of tax and other funds from the private to the public sector tightened the money market so considerably that money market rates moved upwards of their own accord, until by the end of March the margin between the Treasury bill



building societies had already increased their rates on deposits and shares by between $\frac{1}{2}$ and 1 per cent. These developments again showed how closely interrelated the various financial markets in South Africa have become.



Improvement in Exchequer finance 1966/67

It will be recalled that, owing to special circumstances, Government expenditure had been financed to an important extent by funds obtained from the banking sector during the financial year ended March 1966, which had complicated the task of curbing inflation. In view of the importance of co-ordinating fiscal and monetary policy, the Minister of Finance announced various measures in the Budget of August 1966 to ensure that government expenditure would henceforth be financed as far as possible without recourse to the banking sector. Apart from restraints on expenditure, various taxes were increased and special tax-exempt bonds, called First Series Savings Bonds, were made available to the public. In the meantime, the interest rate on long-term government stock had been raised to $6\frac{1}{2}$ per cent in July 1966, while the legislation requiring insurance companies, pension funds and unit trusts to hold more

government stock was introduced soon afterwards.

As the accompanying table shows, these measures proved to be effective. During the first quarter of the 1966/67 financial year, i.e. the second quarter of the calendar year 1966, the net indebtedness of the Exchequer to the banking sector still increased by R57 million. But after the Budget had been presented in August, the position improved very rapidly and during each of the three remaining quarters of the financial year the Exchequer's net indebtedness to the banking sector was actually reduced. For the year as a whole, it eventually showed an increase of only R24 million, compared with R213 million during the previous year. In actual fact, the banking sector's holdings of Treasury bills and government stock increased by R61 million over the year, but this was partially offset by an increase of R36 million in the Exchequer balance. This substantial improvement in government finance was achieved despite the fact that the total Exchequer deficit, excluding borrowing, increased from R277 million in 1965/66 to R341 million in 1966/67.

Net contribution of Public Debt Commissioners

One of the main reasons for the encouraging developments in Exchequer finance during 1966/67 was an increase in the *net* contribution of the Public Debt Commissioners from R16 million in 1965/66 to R165 million in 1966/67. The Public Debt Commissioners actually invested as much as R237 million in government securities during this period, but against this has to be set their net sales of such securities amounting to R72 million. These sales were made mostly to the banking sector, in particular to discount houses. This meant that the Public Debt Commissioners' relative share in the

financing of the total Exchequer deficit, which had declined from 91 per cent in 1964/65 to only 6 per cent in 1965/66, increased again to 49 per cent in 1966/67.

Increased contribution by private non-bank sector

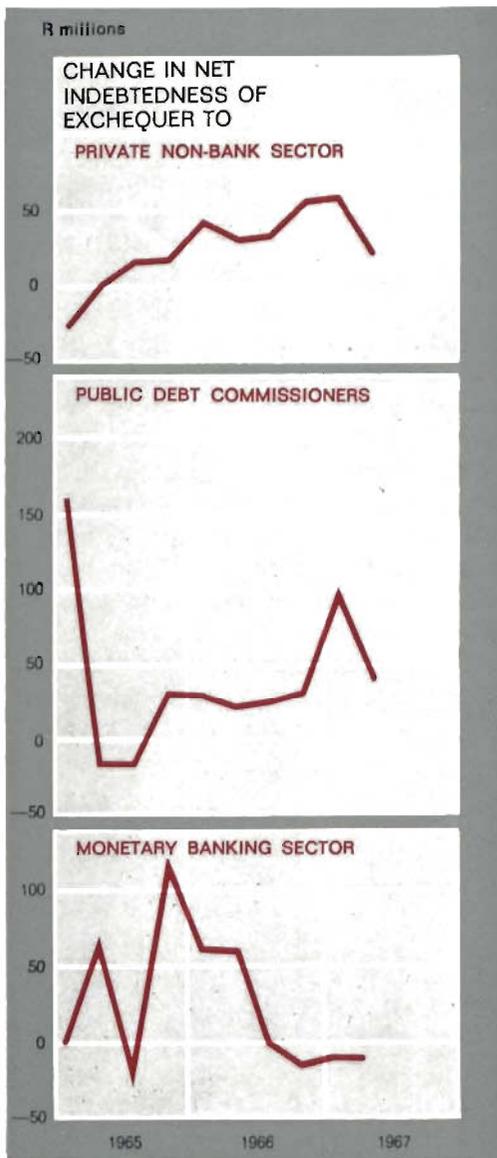
Another major factor which helped to bring about the improvement in government finance, was an increase in net investment in government securities by the private non-bank sector from R65 million in 1965/66 to R167 million in 1966/67, i.e. an increase of R102 million. This was partly attributable to certain special transactions but mainly the direct result of the measures

Exchequer finance (R millions)

	Financial years ended March		1966/67				Total	1967 Apr.— Jun.
	1964/65	1965/66	Apr.— Jun.	Jul.— Sept.	Oct.— Dec.	Jan.— Mar.		
Total deficit, excluding borrowing	268.7	276.9	106.8	53.2	45.4	135.2	340.6	40.9
Financing:								
Change in indebtedness to:								
Foreign sector	5.5	— 11.0	2.7	4.4	— 19.3	— 3.1	— 15.3	— 23.0
Private non-bank sector	— 78.4	64.9	27.5	30.2	53.5	55.6	166.8	18.4
Public Debt Commissioners	244.8	16.4	19.9	21.7	29.2	94.5	165.3	37.8
Paymaster-General and social security funds	—	— 6.2	— 0.5	—	—	—	— 0.5	20.0
Sub-total	171.9	64.2	49.7	56.3	63.3	147.0	316.3	53.2
Monetary banking sector:								
Change in holdings of government securities	90.3	115.3	129.3	63.9	— 4.7	— 127.8	60.7	24.4
Change in Exchequer balance (increase —, decrease +)	6.7	97.4	— 72.2	— 67.0	— 13.2	116.0	— 36.4	— 36.7
Sub-total	96.9	212.7	57.2	— 3.1	— 17.9	— 11.8	24.3	— 12.3
Total financing	268.7	276.9	106.8	53.2	45.4	135.2	340.6	40.9

referred to earlier. Insurers and pension funds increased their holdings of government stock by R36 million and R38 million, respectively, while R16 million was received through the issue

to individuals of the First Series Savings Bonds announced in the Budget in August 1966, and R6 million through the issue of Tax Bonds in March 1967.



Budget for 1967/68

In the Budget of March 1967 further fiscal measures were taken to reinforce and supplement monetary policy. To begin with, the surplus on the 1966/67 Revenue Account, presently estimated at R35 million, and the credit balance of R36 million on Loan Account at the end of March 1967 were not used to finance Exchequer expenditures in 1967/68, but kept on deposit with the Reserve Bank or invested with the External Procurements Fund. Several tax increases were also announced, including a surcharge of 10 per cent on the basic tax of $33\frac{1}{3}$ per cent of taxable income payable by companies (excluding gold and diamond mines) and an increase in the customs and excise duty on motor cars. In addition, the loan levy on individuals liable for central government income tax of R100 or more was raised from 5 to 15 per cent of the income tax payable, while the loan levy on companies (excluding gold and diamond mines) was increased from 5 to 10 per cent. This meant that, altogether, a company would pay 40 per cent of taxable income, of which $36\frac{2}{3}$ per cent would be tax and $3\frac{1}{3}$ per cent loan levy. Gold and diamond mines would be liable for a 5 per cent loan levy.

Exchequer
Cash budget
(R millions)

	1966/67 Provisional results	1967/68 Budget
EXPENDITURE		
Revenue account	1,245.0	1,387.3
Loan account	510.0	533.8
Total	<u>1,755.0</u>	<u>1,921.1</u>
REVENUE (excluding borrowing)		
Customs and excise	345.0	380.5
Inland revenue	820.1	919.0
Posts, telegraphs and telephones	120.9	138.6
Loan recoveries and other credits	127.1	120.2
Total	<u>1,413.1</u>	<u>1,558.3</u>
TOTAL DEFICIT (excluding borrowing)	341.9	362.8
Plus redemptions:		
Domestic	219.8	253.4
Foreign	73.1	52.3
Sundry items	16.4	11.2
TOTAL BORROWING REQUIREMENTS	<u>651.2</u>	<u>679.7</u>
FINANCING		
Foreign loans (conversions plus new loans)	6.2	80.4
Domestic conversions	219.8	253.4
Domestic new loans — P.D.C.	237.1	160.0
Stock	196.2	60.0
Non-marketable debt	55.5	133.0
Treasury bills	—27.6	—
Change in cash balance (increase —, decrease +)	—36.0	—7.1
TOTAL FINANCING	<u>651.2</u>	<u>679.7</u>

As the accompanying summary of the Budget on a cash basis shows, it is hoped that despite an expected increase in total expenditure on Revenue and Loan Account of R166 million or 9.5 per cent, the Exchequer will be able to avoid any increase in its net indebtedness to the banking sector during 1967/68.

Two features of the way in which it is expected that the total borrowing requirements will be met, require comment. The first is the exceptionally large expected increase in non-marketable debt of R133 million. This figure includes not only loan levies totalling R73 million, but also an amount of R60 million in respect of Savings Bonds, Tax Bonds and Treasury Bonds. The second feature is the relatively small net amount of R60 million which the Treasury intends to draw from the private non-bank sector through stock issues. One reason why a larger amount was not budgeted for was the need to leave a larger share of the local capital market to the municipali-

ties and public corporations, especially Escom, whose borrowing requirements during the current financial year are substantial.

Results during period April to June 1967

Exchequer finance got off to a reasonable start during the first quarter of the new financial year. Compared with increases of R64 million and R57 million during the April-June quarters of 1965/66 and 1966/67, respectively, the Exchequer's net indebtedness to the banking sector showed a decrease of R12 million during the April-June quarter of the 1967/68 financial year. This was, however, only after the Exchequer had borrowed a net amount of R20 million from the Paymaster-General Account. In other words, without this transaction, the Exchequer would have increased its net indebtedness to the banking sector by R8 million.

CAPITAL MARKET

Further tightening of capital market

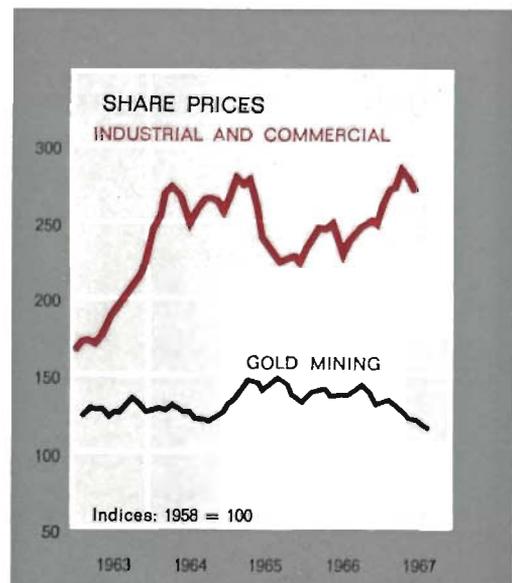
The excessive use of bank credit as a substitute for increased saving during recent years prevented capital market conditions from tightening as much or as soon as they would otherwise have done. During the year ended June 1967, however, the creation of money and near-money was brought under greater control while the demand for loanable funds still remained exceptionally strong, so that the imbalance between demand and supply in the capital market was revealed more clearly and, in accordance with official financial policy, capital market conditions did indeed tighten further.

Divergent tendencies of gilt-edged and equity yields

In these circumstances, further upward pressure was exerted on interest rates on fixed-interest-bearing investments. The Reserve Bank increased its rate on long-term government stock from 6 to $6\frac{1}{2}$ per cent on the 8th July 1966, while yields on long-term public corporation and local authority stock, as reflected by new issues, increased between the middle of 1966 and the middle of 1967 from 6.7 to 7.2 per cent

in the case of public corporation stock, and from $6\frac{3}{4}$ to $7\frac{1}{4}$ per cent in the case of local authority stock. The yield on newly issued debentures of companies increased from about $7\frac{1}{2}$ to 8 per cent during this period.

Even larger increases were registered in mortgage rates during the past year. The building societies' mortgage rate, for example, increased from $7\frac{1}{2}$ to $8\frac{1}{2}$ per cent, while the rate on mortgage loans extended by insurers and private pension funds likewise increased from about $7\frac{1}{2}$ per cent to a

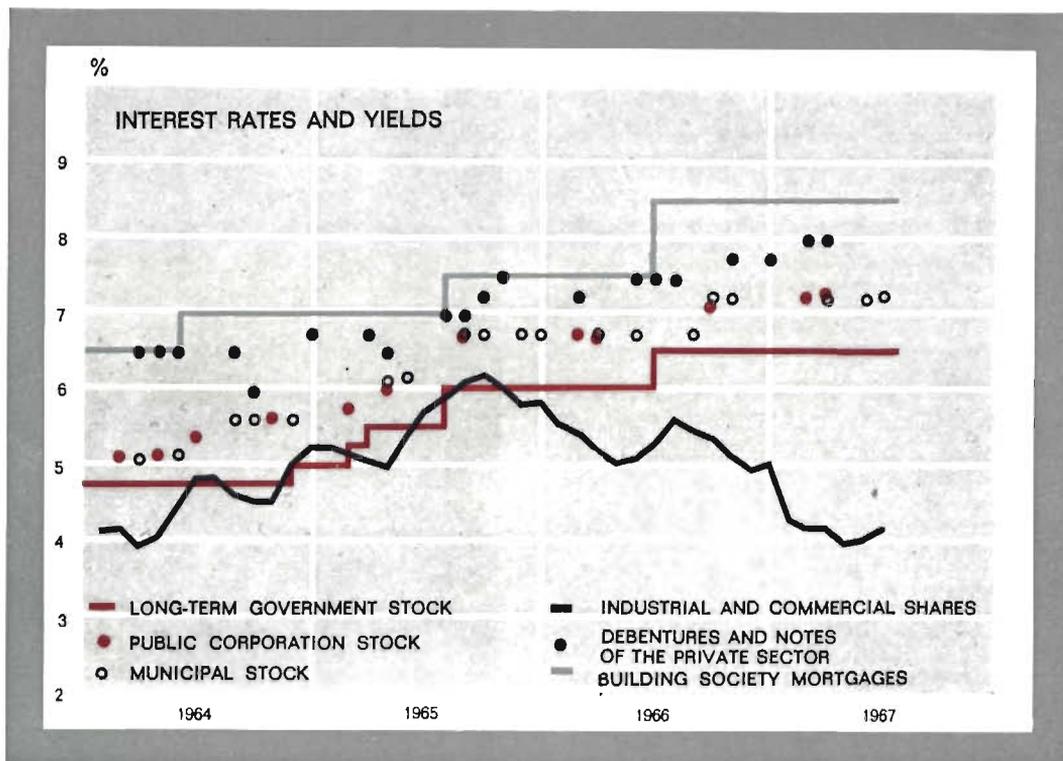


level ranging from 8 to 8½ per cent.

Contrary to these movements of rates on fixed-interest investments, yields on most classes of ordinary shares showed a marked further decline during most of 1966/67, reflecting a strong upward movement in the prices of these shares which was not matched by higher average dividend payments and earnings. The average yield on industrial and commercial shares, for example, declined from 5.3 per cent in June 1966 to 4.0 per cent in April before rising to 4.2 per cent in June 1967, as the upward movement in share prices was finally reversed. This meant that the gap between this

yield and that on government stock, i.e. the "reverse yield gap", widened from about 0.7 per cent in June 1966 to 2.5 per cent in April before declining slightly to 2.3 per cent in June 1967.

The main explanation for this divergent behaviour of gilt-edged rates and dividend yields on industrial, commercial and other shares must be sought in the persistent inflationary conditions, and in the optimistic, perhaps over-optimistic, growth expectations of investors which were in evidence at least until April of this year. Since then, however, the mood on the Stock Exchange seems to have been somewhat uncertain.

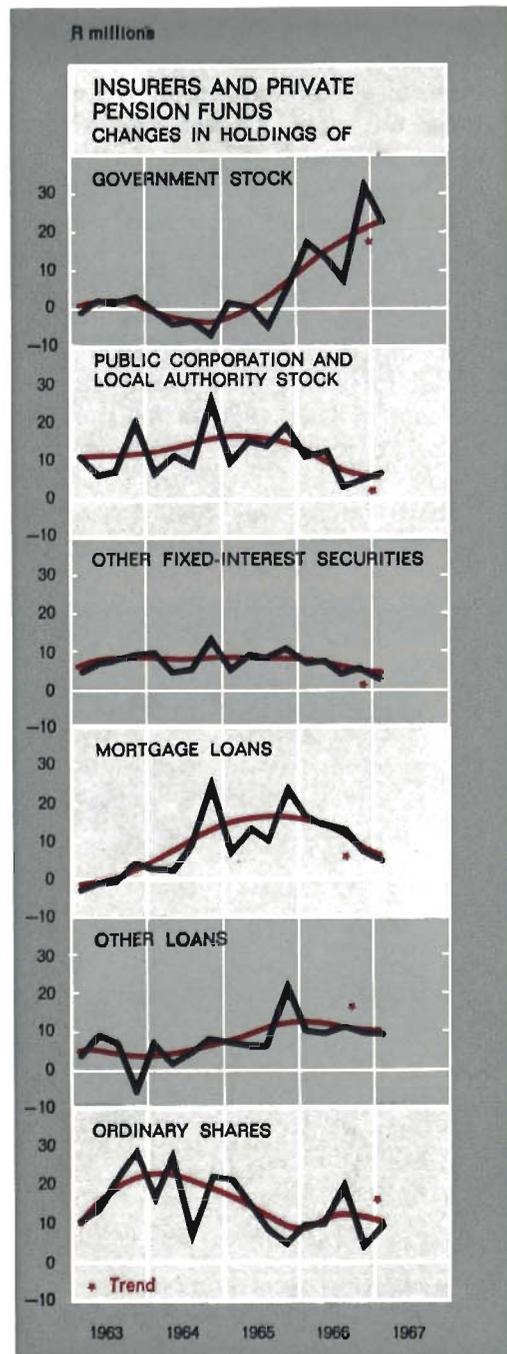


Insurers and private pension funds

As may be expected, relative interest rates and yields again played a basic role in the investment policies of insurers and private pension funds. During 1966 and the first quarter of 1967, as the rates on fixed-interest investments increased appreciably, these institutions allocated a smaller proportion of their new investment funds to ordinary shares and a larger proportion to fixed-interest securities. During this period there was also a substantial shift to government securities within the fixed-interest group of security investments, which was largely related to the new statutory investment requirements for these institutions which came into operation towards the end of 1966.¹

¹ In terms of these legislative amendments, long-term insurers were required to raise their holdings of prescribed assets from 25 to 30 per cent of their net liabilities and to maintain a minimum amount of their prescribed assets, namely 10 per cent of their net liabilities, in the form of government securities. Prior to these amendments, short-term insurers already had to maintain prescribed assets amounting to 30 per cent of their net liabilities, but in terms of the amendments they were also required to include in their prescribed assets government securities amounting to 10 per cent of their total assets. Pension funds already had to maintain prescribed assets amounting to 40 per cent of their total assets and in terms of the amendments these assets had to include government securities amounting to at least 10 per cent of their total assets.

It was further provided that if the holdings of government securities of any insurer were below the new required level on the 1st October 1966, it had to add an amount equal to at least 15 per cent of the increase in its net liabilities to its holdings of government securities during each subsequent financial year, provided that it complied fully with the new requirements after a period of five years. In the case of pension funds which had inadequate holdings of government securities on the 1st October 1966, a minimum addition to these holdings amounting to 20 per cent of the increase in their total assets had to be made during each subsequent financial year.



In fact the high level of interest rates on long-term government stock and, possibly, expectations that they would not rise further, appear to have encouraged the institutions to add more to their holdings of such stock during the last quarter of 1966 and the first half of 1967 than was strictly necessary in terms of the legal amendments.

Unit trusts

An important role was played in the capital market during the past year by the recently established unit trusts, of which there are now six in operation. Notwithstanding the over-all shortage of funds in the capital market and the intense competition from other financial institutions, these trusts were able to attract funds amounting to R36 million during the year ended June 1967, compared with R8 million during the preceding twelve months.

Since unit trusts invest largely in ordinary shares, their activities helped to maintain the demand for such shares, despite the decline in the proportion of new investment funds allocated to equities by insurers and private pension funds during this period. The advent of the trusts therefore helps to explain the rather "bullish" behaviour of the market during the period preceding May 1967.

Statutory investment requirements were also introduced for unit trusts towards the end of 1966, in terms of which they were required to maintain an investment in approved securities amounting to 10 per cent of the market value of their portfolios. These ap-

proved securities had to include government securities equal to at least 5 per cent of the market value of their portfolios. At the end of June 1967 their holdings of approved securities amounted to 11 per cent of the market value of their portfolios, of which 9 per cent was accounted for by government stock.

Building societies

The tendencies in the economy in general and in the capital market in particular naturally also affected the building societies. On the one hand, the inflationary rise in total spending, coupled with the high rate of immigration, helped to bring about an abnormally strong demand for their mortgage loans. On the other hand, the ready availability of alternative forms of investment such as investments in unit trusts or participation mortgage schemes, which provided either the prospect of capital appreciation or exceptionally high interest rates, reduced the relative attractiveness of building society deposits and shares, as indeed of all fixed-interest deposits.

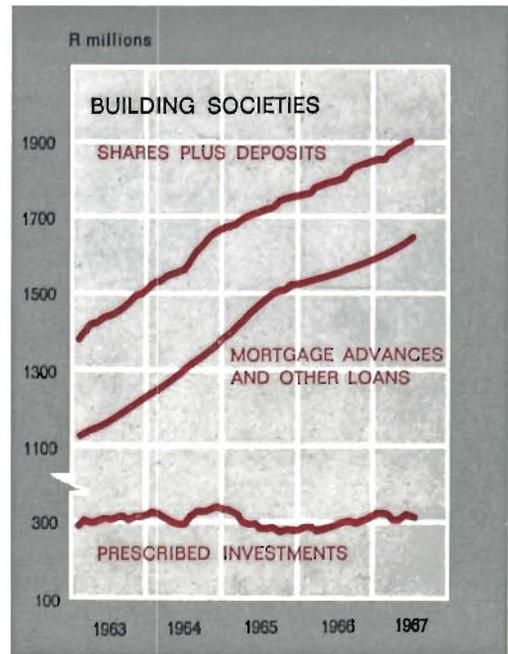
In order to compete effectively for funds, not only with banking institutions but, more particularly, with the rest of the capital market, building societies therefore found it necessary to raise their borrowing rates in two main stages during the past year. The first stage was in July 1966 when, following the termination of deposit rate control, they increased their rates on fixed deposits for 12 months and longer from $5\frac{1}{2}$ to $6\frac{1}{2}$ per cent and on indefinite

shares from 6 to 6½ per cent, while increasing their rates on subscription shares and savings deposits by ½ per cent to 6 and 4½ per cent, respectively. At the same time, their mortgage rate was increased from 7½ to 8½ per cent.

The second stage followed in March 1967, when a further tightening in the market for fixed-interest-bearing funds induced them to increase their rates on fixed deposits and indefinite shares by a further ½ per cent to 7 per cent. On this occasion, however, their lending rates were not increased and they were later assisted in maintaining these rates by a legal amendment which exempted them for one year from the requirement of transferring to their statutory reserves the usual amount of at least 10 per cent of their net profit for the financial year.

These interest rate increases proved to be quite effective and during the year ended June 1967 the societies' resources increased by as much as R107 million, compared with R83 million during the preceding twelve months. Their fixed deposits increased by R103 million and their savings deposits by R23 million, while their share capital declined by R19 million. This represented a marked change in the composition of their new funds, as fixed deposits had shown no increase during the preceding twelve months when the rate on such deposits had been pegged by deposit rate control at ½ per cent below that on indefinite shares, while share capital and savings deposits had increased by R42 million and R41 million, respectively.

The larger inflow of new funds during 1966/67 enabled the building societies to increase their mortgage and other loans outstanding by R96 million and at the same time to add an amount of R16 million to their liquid assets and other prescribed investments. During the previous year, they had increased their loans by R79 million but had found it necessary to liquidate their prescribed investments by R2 million. Moreover, during 1966/67 the amount of mortgage loans granted but not yet paid out, which had declined by R41 million during the preceding twelve months, increased by R41 million, indicating the greater lending activity of the building societies during the more recent period.



Participation mortgage schemes

Participation mortgage bonds, issued under schemes which are managed mostly by trust companies, again proved to be a popular investment medium during the past year, although not as popular as during the preceding twelve months. Thus, whereas the outstanding amount of mortgages granted under participation mortgage schemes had increased by no less than R98 million during 1965/66, it increased by R39 million in 1966/67.

In terms of an amendment to the Participation Bonds Act in June 1967, the conditions applicable to the raising

of funds through participation bonds were brought more in line with those applicable to other financial intermediaries. The minimum size of such a bond was, for example, fixed at R20,000, while a minimum investment period of three years, with certain exceptions, was laid down. Previously, investors could invest relatively small sums in these bonds and could readily withdraw their money by the transfer or cession of their rights, which had tended to give these investments an unfair advantage over fixed deposits with banking institutions and building societies and shares of building societies.

