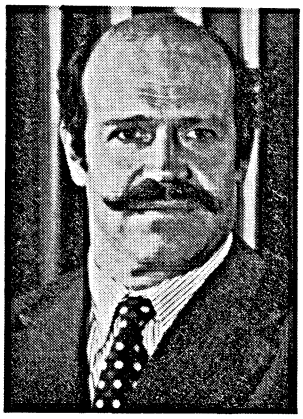
THE BACKGROUND OF THE 1977 BUDGET*



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In hierdie voordrag ontleed dr. Smit die Suid-Afrikaanse ekonomie tot en met die huidige tyd en die gevolglike doelwitte van die 1977-begroting. Die diagnose fokus hoofsaaklik op sekere probleemareas: die betalingsbalans en reserweposisie, die groei en produksie en indiensneming, inflasie en die omvang van subsidies ten koste van die belastingbetaler. Die skrywer waarsku egter daarteen dat ons nie die sterk punte moet miskyk nie, iets wat 'n mens al te maklik doen in die huidige pessimistiese klimaat

Abraham Lincoln once said that, in order best to judge what to do and how to do it, we should first know whither we are tending. This essentially is the problem of diagnosis, whether political, medical or economic. Practical diagnosis is quite different from purely intellectual debate and the innocent joys of the ivory tower. Politicians, medical doctors and businessmen have to do something — or perhaps have to refrain from doing something else. In a discussion among members of the Board of Governors of the Federal Reserve System of the USA, one Governor, who wished to pursue an activist monetary policy, was reprimanded by another with the remark: "Don't just do something, stand there". This is sometimes also the dilemma facing the businessman or the policy-maker: should he do something or should he stick to the status quo? We shall return to this point later.

I have been asked to give an analysis of the economy up to the present time and the consequent objectives of the Budget. In this analysis or diagnosis, I shall focus mainly on problem areas, but we should not make the mistake of overlooking the strong points, something which I think we are all too prone to do in the present rather pessimistic climate.

Problem Area Number One: The Balance of Payments and Reserve Position

Problem area number one is undoubtedly the weak balance of payments and reserve position. The balance of payments and reserve position seems a rather obscure concept, something that concerns a few backroom people at the Reserve Bank and the Treasury; at times it is seen by at least some of our fellow-businessmen mainly as a bugbear trotted out to prevent honest free traders from importing all they want to satisfy the people's demand for every kind of luxury and frivolity.

In reality the balance of payments and reserve position is a matter of life and death for the economy. A weak balance of payments and reserve position means the death of economic growth. It also gives a lot of scope for that most virulent disease afflicting free enterprise economies around the world, inflation. Let us examine these ideas further.

The balance of payments and reserve position is a dual concept. The balance of payments refers to the *flow* of foreign exchange payments into and out of the country. The reserve position refers to the *stock* of foreign exchange and gold held by South Africa. The two concepts are interrelated, because if there is a net *flow outwards,* the reserve holdings or *stock* of gold and foreign exchange falls. Conversely, if the flow inwards is greater than the flow outwards, i.e. a net *flow inwards,* the stock of gold and foreign exchange reserves rises. The balance of payments and reserve position is quite simply the cash flow and the liquidity of South Africa *vis a vis* the rest of the world. When economists say that we have a weak balance of payments and reserve position, it is simply their jargon for saying that our country's foreign exchange payments are bigger than our receipts and that we are pretty low on spare cash as well. This is a very serious matter for virtually any country, but especially for South Africa. Our economy is one of the most open in the world when it comes to the flow of trade, payments and investments to and from the rest of the world. Our balance of payments is subject to positive and negative swings running into billions of rands either way.

South Africa's share of international trade on average over a period of years is only about 1% of the total, but it is still about the 17th largest individual share among the market economies of the world. Moreover, imports and exports together make up a total of well over fifty per cent of our gross domestic product. The South

African rand is one of the 16 most important currencies of members of the International Monetary Fund used to determine the value of the Fund's Special Drawing Rights, but South Africa's foreign reserves are far from comparable to our relative position in international trade and finance. How do we compare in this respect with other countries? Total international reserves of members of the I.M.F. and Switzerland on average over a recent five year period represented anything from about 26% to 43% of total world imports, or roughly 33% on average. World gold reserves are included in this figure at the former official price. This ratio of about one third reserves relative to the value of annual imports is a global average including financially the weakest as well as the strongest countries. The ratio for Switzerland, with its huge gold holdings valued at the old official price, is usually of the order of seventy per cent. Compared to the world average of about 33%, South Africa's gold and foreign exchange reserves at present levels represent less than 10% of our annual imports. Even if the gold component of our reserves were revalued, e.g. on a basis similar to that used at the beginning of the year by Italy, the total value of our gold and foreign exchange reserves would still be less than 20% of our annual imports. This is very far below the international average of about 33%. Considering the vulnerability of South Africa to violent fluctuations in the gold price and earnings from primary commodity exports, without even mentioning military requirements, it is obvious that our foreign reserves should be far, far higher than they are. It is said that there are also costs to holding a higher level of reserves, but it is quite clear that the present inadequate reserve level imposes even higher costs in the form of restrictive policies preventing growth; repeated devaluations of our currency and accompanying inflationary pressures; the loss of foreign confidence and a weakening of confidence internally; and vulnerability to international economic and political pressures.

A Swiss investor who would have put 12 million francs into South Africa eight years ago would have received an equivalent of R2 million, which today is worth less than 6 million francs. A doubling of the value of his investment over the past 8 years in rands would still leave him worse off in terms of Swiss francs than if he had invested his money at an interest rate of one or two per cent in Switzerland. I am not quoting an actual case, but a purely illustrative one. It makes the point that a consistently strong balance of payments and reserve position and consistent strength for our currency, the rand, is an essential pre-requisite if South Africa is again to become attractive to international investors. South Africa still has great natural resources, lively initiative, a well developed infrastructure and many other of the very best things, but the exchange rate performance of the rand will have to be improved very much if we want to recover a sound rating with the international investing community. This means a consistently strong balance of payments and reserve position.

The stimulatory policies of President Carter might well lead to a resurgence of inflation in another year or so, but probabilities are high that our export earnings and the gold price will benefit further from policy directions in the USA. I must, however, express a cautionary word or two about the gold markets. They will continue to be vulnerable to abrupt changes in investor and speculator interest; to possible US Treasury gold sales whenever the price of gold rises strongly, particularly if such strength is accompanied by pressure on the US dollar in the exchange markets; and by potential Russian gold sales, not only to cover possible crop failures, but also their heavy commitment to the West for interest and loan repayments. In this respect, I disagree strongly with those who comfortably and, I regret to say, irresponsibly, predict a steady rise in the gold price during 1977. I should hope that we have learnt well enough over the past two years not to become victims of our own wishful thinking.

A structural problem weakening the longer term outlook for our balance of payments is the absence of a coherent energy and transport policy. Other than the excellent decision to proceed with Sasol II, the need to reduce our dependence on motor-cars for urban commuting in order to save on oil imports has so far received virtually no effective attention — over three years after the great energy shock of December 1973. The problem is aggravated by the failure also of most other oil-importing countries to do anything effective.

There is good reason to be confident that, fortunately, the outlook for our balance of payments and reserve position has improved dramatically over the past six months. It should be remembered, incidentally, that the restrictive measures introduced in last year's Budget only started operating in full vigour about six months ago. The outlook has improved not only because of the fortuitous strengthening of the gold price over the past six months, but as a result also of the steep decline of imports effected by the restrictive fiscal and monetary policies of the authorities. The modest revival in economic activity in the USA, Germany and Japan is also helping substantially to boost our export earnings. Our own efforts have, however, also played a significant part, because the flow of earnings from the Richards Bay and Saldanha projects has started at a most welcome time.

This well illustrates the need not to accept outside events like the ebb and flow of the gold markets and of economic activities in other countries in a fatalistic manner, but to keep up our own best efforts.

On balance I am confident that we are soon going to see a substantial short-term strengthening of our gross foreign reserves; the net reserve position is possibly already better as a result of some repayments of short-term foreign loans. I hope that our authorities will sell gold out of reserves whenever the market is particularly strong, in order to raise the foreign exchange component of our reserves. We could then better avoid forced sales of gold later into a weak market. Ideally, our foreign exchange reserves ought to be built up to a sufficiently high level over time so that we may reach a position in due course of not having to make any sales from our gold reserves, but to rely only on sales of current production, or slightly less than current production. It is desirable eventually to increase also the level of our gold reserves over time, as it still is the best reserve asset for a sovereign country.

Problem Area Number Two: The Growth of Production and Employment

Problem number two is without question the growth of production and employment. Stimulatory policies are, alas, not possible without ample foreign reserves. Any stimulation of demand, whether for investment or consumption, would immediately increase the demand for imported goods, weaken the balance of payments and run down the foreign reserves even further. Given the low level of reserves that we have, the low level of foreign investment and the economic and other risks to which South Africa is exposed, there is absolutely no choice but to postpone general stimulatory policies until our balance of payments and reserve position is far stronger. The reserves-to-imports ratio that I have quoted above implies that, if we want to get into a position of average strength, we need to maintain roughly three times more reserves than we have at present, i.e. more than two thousand million rands. A figure such as this cannot be absolute, because R1000 million reserves increasing at a rate of 100 or 200 million rands per week would put us in a far stronger position than say 2000 million rands of reserves falling at a rate of 100 to 200 million rands of reserves falling at a rate of 100 to 200 million rands per week. That is why one should look at the balance of payments — the *flow* — as well as the reserves — the *stock* — in determining the over-all strength of our balance of payments and reserve position. Considering that our country has only its own feet to stand on in the world, we should in fact work for *better* than average strength in our balance of payments and reserve position. This implies even higher figures than I have quoted. I am convinced that our underlying economic and financial strength, especially if we tackle the main problem areas vigorously, is sufficient to bring this goal well within our reach.

The reasons for the frustration of our need for growth in production and employment go back quite a few years. During the gold price boom until the end of 1974, which also overlapped with an international commodity price boom until about the end of 1973, the economic behaviour of South Africa was at least in some respects like that of the Grasshopper as contrasted to that of the Ant. The gold and commodity boom gave us fortuitous and luxuriant growth virtually unrelated to our own efforts. We have been forced over the past two years to weather much sterner times. I am, however, confident that, figuratively speaking, spring is in the air. We may expect a resumption of some growth in production and employment very soon after a strengthening of our balance of payments and reserve position, which I suspect is already underway. Led by improving exports, a generally better gold market and the re-building of inventories that have been running down for a considerable time, a spontaneous revival of activities might be sprung upon as sooner and more strongly than our weary spirits can foresee.

Uppermost in all our minds must undoubtedly be the question of black employment, under-employment and unemployment. Many of the discussions on this vital subject shed more heat than light and more emotion than objectivity. The same goes for the question of Black/White wages and the "wage gap". Those who plead stimulation of the economy to increase black employment, overlook the fact that black under-employment and unemployment is perhaps not so much a result of a weak phase in the business cycle as it is a long-term structural problem. It cannot be dealt with by short-term stimulation, simply because no degree of stimulation will be adequate to ensure full employment for the black population. The real cause, the high rate of black population growth, is a subject that is not discussed nearly enough in serious and objective economic terms. It is long overdue that this problem should be openly and frankly discussed by concerned people, without fear or favour and free of the prejudices of inverted racism and reverse discrimination. It might well be found that the extraordinarily high rate of black population growth in South Africa as compared with population growth rates of other developed market economies is the main obstacle to better education, better housing, higher living standards, as well as being the main cause of black unemployment and under-employment. The economy of South Africa, however rich its resources are, is definitely overburdened in trying to catch up, let alone move ahead of a black population growth of over 3% p.a. including illegal immigrants from neighbouring countries. This question can only be dealt with by structural measures. I should place family planning at the top of all priorities in this area.

An effective programme of family planning clinics will produce modest, but rapidly increasing economic gains much quicker than is generally realised: reduced demands for scarce medical services and housing; a higher percentage of economically active persons and a lower percentage of economically inactive persons in the population pyramid; and an improvement with respect to the poverty datum line for black families, to mention only a few of the most obvious immediate gains. A lassez faire attitude that the normal growth of the South African economy can take care of this existing rate of population growth is inappropriate and irresponsible. A well managed and vigorously growing South African economy, improved education and training, and the growth of more remunerative employment opportunities in greater numbers is certainly to the advantage of the black and all other population groups, but a special effort is needed on the family planning front if the position of black people is to be improved.

A few remarks on the matter of black wages are also called for. The public debate on this issue has produced the strange phenomenon of self-professed free market economists calling unconditionally for higher black wages in the midst of structural unemployment and under-employment. I am sure that we are all familiar with the many current stories of how people raise the wages of their black employees by fifty per cent and reduce the number of employees by ten, twenty, thirty or fifty percent. Many others have been shifting to more capital intensive methods of production. Well-meaning but fuzzy-minded people who plead for higher black wages, which we all favour on humanitarian grounds, would do well to pause and think about the market mechanism which reduces the demand for labour when the price increases. Our top priority in this area is to have the maximum number of people employed at liveable wages, rather than to have many fewer employed at high wages, and ever larger numbers unemployed. It is neither socially nor economically sensible to create an additional kind of gap: between blacks that are employed and those that are unemployed. We should instead be promoting more employment by labour-intensive methods of production wherever feasible and appropriate and by regional development. On top of the population explosion, the movement of blacks from undeveloped regions to the cities and towns requires a vigorous and sustained effort in the regions as well.

Problem Area Number Three: Inflation

Our third major problem area is inflation. The rate of inflation in South Africa is still nearly twice as high as the average of our main trading partners. This is no doubt largely the result of circumstances beyond our control, but I believe that it would be self-deception to ignore that it is perhaps equally much or perhaps even more so, the result of circumstances that we could have controlled but did not. Government spending and inflationary methods of financing it have certainly been attracting their share of the criticism for giving rise to inflationary pressures. Without distracting from the need to maintain the strictest fiscal discipline, we should be open-minded enough to recognise some other causes as well. Two of the most important internal causes, other than excessive Government spending and inflationary financing in the past are, first, the failure of private enterprise (along with the Government) to control costs and prices during the bonanza years when everyone was so flush with money and profits were sleek and fat; and secondly, the salaries and wages explosion of recent years, that fed on the same easy money psychosis.

I am glad to say that the mid-term outlook in both of these respects is immeasureably better now than a year or two ago. Many businesses who still have their doors open today are in the position because they have cut back ruthlessly on costs. I hope that the Government is doing the same. Calls for higher salaries and wages to compensate workers for the continuing rise in the cost of living are certainly heard all the time and deserve sympaty, but neither the public sector nor private business has the income or profitability that would make it a practical matter to pay increases in salaries and wages. Organised labour is probably also more interested in preserving existing jobs and incomes than in courting eye-ball to eye-ball confrontations with employers. That would be too costly to all concerned.

The inflation rate is still very high, but I believe that it contains an important element of increased prices and tariffs that does not really represent inflation in the conventional sense. The very steep increases in certain administered prices over the past year, particularly of electricity, steel and railway rates, contain an element of saving and investment, in so far as part of the increases is being used to finance capital investment programmes. This is a painful, but inevitable and healthy shift of financial resources from consumption into savings and investment. It has certainly raised the price level and further increases of this nature are to be expected, but not *ad infinitum.* This method of savings and investment, however painfully achieved, is improving the over-all balance between the supply of, and demand for goods and services in the South African economy.

A major problem area though not directly within the purview of the Budget, is the insidious inflation that accompanies the system of controlled prices. In theory, the idea is to prevent the wicked producers from ganging up on the defenceless consumers, enriching themselves with excessive profits by increasing prices of basic necessities. In practice, the system of price control results in many cases not in any effective restraint of maximum prices, but in an underpinning of the cost structures of the weakest and least efficient producers. It would be a big mistake to think that this applies only in agriculture, it might apply even less there than in some other areas. Controlled prices have created a system of producing at cost plus a margin, whatever the cost might be. It is in fact a method of subsidising inefficient producers at the expense of the consumers. A cold, hard look at the entire system of controlled prices is long overdue.

Problem Area Number Four: Extensive Subsidies

Problem area number four is the extent of subsidies at the expense of the taxpayer. Questioning the need for food subsidies might be considered to be akin to denouncing motherhood, but food subsidies can and should be questioned. Despite the strains and stresses we are experiencing, I am confident that the South African economy is productive enough for workers to be able to earn the wages necessary to buy their own food. Food subsidies are responsible for many anomalies and a considerable amount of waste. The same applies to rail passenger subsidies. Many other subsidies exist and could with benefit be exposed to the light of objective and dispassionate examination.

What then should have been the objectives of the Budget? This brings us back to the Governor of the Federal Reserve System who said "Don't just do something, stand there".

Our balance of payments and reserve position tells us clearly and firmly that we can't just do something, we have to stand by strict discipline in our fiscal and monetary policies. The weakness or absence of growth in the economy at present cries out for something to be done to stimulate growth, but the cash is simply not available, not in terms of foreign exchange, nor in terms of tax revenues and loan capital flowing into the Government's coffers. It would be a mistake to introduce stimulatory measures with alacrity even when the balance of payments and reserve position starts strengthening, because we have aery long way indeed to go to get into a strong and sound position that will enable us to maintain continuous growth, which we need. Premature stimulation would only cast us back into a vicious circle of stop-go policies, a weak exchange rate, a lack of confidence at home and abroad and increasing economic and social problems. That is not to say that distress areas should be neglected. Special measures to assist those hardest hit are called for to the extent that they are affordable and on a very strictly selective basis.

Our problem area number three, the continuing high rate of inflation, calls for no relaxation in the restrictive policies until inflation is well and truly beaten and drubbed. Once upon a time, we could take pride in saying that South Africa numbered among the countries that had the least inflation in the world. It was hard to find any country who outperformed us. These days, we have to look around very hard for countries of substance with higher rates of inflation than ourselves. It has become impossible to find any but the sickest economies of the developed world whose inflation rates are higher than ours. In Western Europe and North America, it is only Italy and the U.K. among the major countries whose inflation rates are higher than ours. Both Australia and New Zealand have higher inflation rates than ours, but we should not forget that their policies for some years before had been determined by social experiments rather than by economic facts, with fairly predictable results. It is a sad day when we have to compare the state of our economy with some of the worst afflicted economies of the world in order to find any cause for comfort.

There can be little doubt that the over-all objective of the Budget must be to restore the South African economy to its accustomed soundness and vigour and to restore confidence at home and abroad. I am confident that this can be done. Our most pressing problems will then be more manageable than many of us can now imagine, and we would again see the sparks flying in the workshop of Africa.

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