

## **LOWER DEFICITS AS THE ECONOMY RECOVERS, ABILITY TO CONTROL SPENDING IN QUESTION**

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### **Introduction**

While acknowledging that SA faces a hill, “the highest, perhaps, we have yet to climb”, in terms of job creation and poverty alleviation, Finance Minister Pravin Gordhan’s second Medium-Term Budget Policy Statement (MTBPS) provided a more upbeat outlook for the economy and the fiscal position than was the case in the February Budget. In fact, the Treasury now sees GDP growth returning to 4% per annum a year earlier (2012) than the BER.

**Table 1: Macroeconomic forecasts altered significantly**

|                            | Feb '10 Budget |      |      | Oct '10 MTBPS |      |      |      |
|----------------------------|----------------|------|------|---------------|------|------|------|
|                            | 2010           | 2011 | 2012 | 2010          | 2011 | 2012 | 2013 |
| Real GDP growth            | 2.3            | 3.2  | 3.6  | 3.0           | 3.5  | 4.1  | 4.4  |
| CPI inflation              | 5.8            | 6.1  | 5.9  | 4.4           | 4.7  | 5.0  | 5.2  |
| Current account (% of GDP) | -4.9           | -5.3 | -5.8 | -4.2          | -4.9 | -5.3 | -5.8 |

**Source:** Budget Review / MTBPS

In an update of its macroeconomic projections (table 1), the Treasury said that it now expected GDP growth between 2010 and 2012 to average 0.5 percentage points (%pts) higher than previously estimated, while at 4.7%, CPI inflation was projected to average 1.2%pts lower. Furthermore, the current account deficit is now forecast to be in a better position over the medium-term expenditure framework (MTEF). In terms of growth, the biggest upward revision (0.7%pts) is for 2010.

The most significant outcome of the improved GDP growth outlook is that 2010/11 **government revenue** is set to be R22.6bn higher than forecast in February. Combined with a somewhat lower total expenditure forecast, the **budget deficit** (as a % of GDP) is projected to be 0.9%pts lower.

The improvement goes beyond the current fiscal year

**Table 2: Medium-term expenditure framework (MTEF)**

| R billion             | 2010/11          |               | MTEF estimates |               |               |
|-----------------------|------------------|---------------|----------------|---------------|---------------|
|                       | Budget (Feb '10) | MTBPS         | 2011/12        | 2012/13       | 2013/14       |
| <b>Revenue</b>        | <b>738.4</b>     | <b>761.0</b>  | <b>843.0</b>   | <b>931.7</b>  | <b>1040.2</b> |
| % of GDP              | 27.3             | 28.4          | 28.7           | 28.9          | 29.1          |
| <b>Expenditure</b>    | <b>907.0</b>     | <b>904.1</b>  | <b>977.2</b>   | <b>1059.1</b> | <b>1154.2</b> |
| % of GDP              | 33.6             | 33.7          | 33.3           | 32.8          | 32.3          |
| <b>Debt service</b>   | <b>77.6</b>      | <b>67.6</b>   | <b>78.9</b>    | <b>93.1</b>   | <b>107.5</b>  |
| % of expenditure      | 8.6              | 7.5           | 8.1            | 8.8           | 9.3           |
| <b>Budget balance</b> | <b>-168.6</b>    | <b>-143.1</b> | <b>-134.2</b>  | <b>-127.4</b> | <b>-114.0</b> |
| % of GDP              | -6.2             | -5.3          | -4.6           | -3.9          | -3.2          |

**Source:** MTBPS

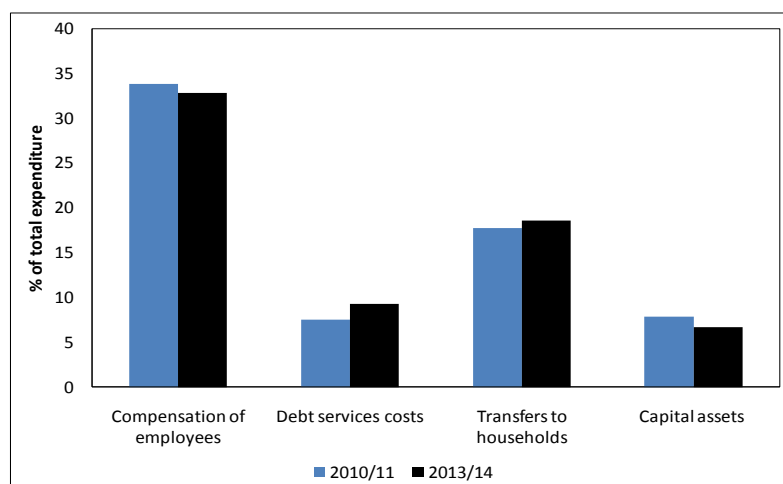
with the budget shortfall between fiscal years 2010/11 and 2012/13 now forecast to average 0.5%pts lower at 4.6%. Revenue is set to be (on average) R15.7bn higher, but the added income has not resulted in higher budgeted expenditure, which remains largely unchanged compared to February. The budget shortfall is forecast to narrow to 3.2% of GDP during the 2013/14 fiscal year.

Despite the improved budget deficit numbers, SA still faces fiscal challenges. The Treasury estimates the **structural budget deficit**, i.e. the shortfall if the economy was performing at its potential growth rate, at 4.1% of GDP for 2010/11 - it is set to remain relatively large at 3% by 2013/14.

**Total government debt** is set to rise from 32.8% of GDP in 2010/11 to 40.9% during 2013/14. Having said that, because of the lower budget deficits, the **general government borrowing requirement** is now projected to be lower (5.6% of GDP for 2010/11 versus 6.7% previously estimated). However, public corporations such as Eskom and Transnet are now forecast to borrow on average R22bn more over the period 2010/11 to 2012/13 in order to finance their infrastructure investment plans. As a result, the **public sector borrowing requirement** (PSBR) remains elevated, albeit narrowing to 6.1% of GDP by 2013/14 from 10.1% during 2010/11.

**Infrastructure expenditure**, both from general government and public corporations, is estimated at R811bn over the next three fiscal years. Of interest is that in the 2009 MTBPS, the figure was R872bn (subsequently scaled down to R846bn in the February 2010 Budget). So while the MTBPS highlights that infrastructure spending "remains the cornerstone of government's strategy to support growth", the numbers have been (albeit remaining substantial) revised down over the past year. In terms of the growth rates, public sector infrastructure spending growth is set to moderate to 1.8% (in nominal terms) during 2012/13, before picking up to 4.7% the following fiscal year. In real terms, it means that growth is actually declining in the latter years. Furthermore, as a % of GDP, public sector infrastructure expenditure is expected to decline from 9.1% in 2010/11 to 7.9% during 2013/14 – unless new projects are identified, the GDP growth impetus from infrastructure spending will be minimal in the final MTEF years.

**Figure 1: Expected composition of government expenditure**



Source: MTBPS

It is also important to realise that the projected budget deficits are based on government reigning in the growth in real **non-interest spending** to 2.7% over the next three years. In our view, this may be a tall order given that the fiscal framework makes provision for average annual growth in public sector compensation of 6.3%, i.e. significantly lower than what the outcome for 2010/11 is likely to be (closer to 7.5%). Give that around a third of government expenditure goes to the compensation of employees, a higher than expected salary bill could result in higher than expected expenditure growth.

Alternatively, the MTBPS notes: "Should wage growth continue to accelerate in excess of revenue growth, the sustainability of government employment, investment and other goods and services will be undermined." Indeed, figure 1 on the previous page indicates that even under current projections, government spending on capital assets (as a % of overall spending) is set to moderate over the MTEF period.

The main avenue through which government aims to finance the projected deficits remains to issue government bonds. The February expectation for bond issuance over the next number of fiscal years (ranging between R140bn and R150bn) remained largely unchanged.

#### **No major moves on the rand bar further exchange control liberalisation**

The weeks leading up to the 2010 MTBPS were almost a replay of last year – the 2009 MTBPS followed calls from Cosatu that the rand should be pegged at a certain level to prevent volatility/increase competitiveness. This year the currency concerns received a global flavour with a number of countries (including Brazil, Thailand and South Korea) announcing measures to try and stem the appreciation of their currencies.

In line with our expectations and recent comments by Treasury DG Lesetja Kganyago, SA did not follow a country such as Brazil by (for example) announcing a tax on foreign portfolio inflows in the MTBPS. This is in line with Treasury's view that it is better to find a multilateral solution to ensure a more stable international financial environment.

However, further exchange control relaxation was announced, which may over time (although it is by no means guaranteed) contribute to a weaker currency. Of interest is that Gordhan mentioned that government recognized that in some instances the announced measures may need to be "strengthened or reversed as circumstances change". The measures (the SARB will release more details next week) include:

- It is proposed that qualifying international headquarter companies be allowed to raise and deploy capital offshore without exchange control approval. This regime will be effective from 1 January 2011.
- SA emigrants are currently allowed to remit up to R8 million of capital offshore upon emigration. The rest of the assets are blocked and can only be released upon the payment of a 10% exit levy. Treasury proposes releasing emigrants' blocked assets without any exit levy applying to free those assets.
- It is proposed that the R4 million offshore investment limit for individuals, which is a lifetime limit, be increased to R4 million per annum, subject to compliance with all tax and financial integrity legislation.

- The prudential framework for foreign investment by private and public pension funds, including the Government Employees Pension Fund, will be reviewed to support portfolio realignment and offshore diversification.

### **Macroeconomic implications**

The rand lost as much as 1.5% versus the US dollar yesterday to trade back above the key R7/\$ level at R7.05, indicating that the exchange control relaxation may have had an impact. However, the dollar also strengthened somewhat versus the euro – the exact cause of the softer rand is thus uncertain.

In line with the press release issued following a special cabinet meeting on Monday regarding SA's **new growth path**, the MTBPS argues that "a combination of looser monetary policy and tighter fiscal policy will support demand while moderating the build-up of imbalances arising from strong capital inflows." Given the global focus on countries with high budget deficits and the necessity to reign in excessive debt, it is gratifying that government remains committed to prudent and countercyclical (i.e. that spending should be curtailed when the economy recovers) fiscal policy. However, because GDP growth is set to remain below potential for some time, inflation is not a concern over the short term and SA still faces a huge unemployment problem, the MTBPS argues that monetary policy should remain accommodative.

There can be at least two interpretations of such a view: either it raises the likelihood of a further interest rate cut(s) or it simply means that (as in many developed countries) SA interest rates may remain at current lows for longer than previously imagined.

Although one has to acknowledge that (in combination with the better than expected September CPI inflation figure of 3.2% y-o-y), the MTBPS view on macro policy makes a rate reduction in November a distinct possibility, at this stage we continue to favour the second interpretation, i.e. that interest rates will remain at the current accommodative level for longer. How the rand exchange rate responds in the weeks leading up to the mid-November interest rate meeting will also be of critical importance.

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