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BER comment: 2010/11 Budget

BUDGET SUSTAINS SHORT-TERM FISCAL STIMULUS; ENFORCES LONG-TERM SUSTAINABILITY

- Introduction
- Expenditure proposals – R112bn added over the medium term in a more targeted way
- Tax proposals – significantly less relief
- Macroeconomic policy - steady as she goes
- Conclusion

Introduction

Against the backdrop of a still challenging (albeit improving) macroeconomic environment, Finance Minister Pravin Gordhan presented a Budget that aims to put SA on a more inclusive economic growth path, but at the same time dispelled any doubts about government's commitment to prudent fiscal and monetary policies. While continuing to address the needs of the poor and unemployed by further increasing the amounts allocated to social grants and introducing a wage subsidy to stimulate unskilled youth employment, Gordhan reaffirmed the independence of the SA Reserve Bank (SARB) and resisted calls from the ANC's alliance partners to alter the inflation targeting regime or SA's exchange rate policies.

In terms of the key fiscal ratios, the revised forecast (compared with the October 2009 Medium-Term Budget Policy Statement, or MTBPS) for the 2009/10 budget deficit is 7.3% of GDP – a post-1994 high – but lower than the 7.6% expected earlier. Going forward, despite a marginal downward adjustment to the Treasury's projection for government revenue, the 2010/11 Budget sees higher nominal expenditure growth (8.6% versus 7.6%) for the 2010/11 fiscal year – this is in line with president Jacob Zuma's State of the Nation address last week that mentioned that the uncertain pace of economic recovery requires that government stimulus measures must remain in place over the short term.

Despite the mix of lower revenue/higher expenditure, upward adjustments to the Treasury's GDP forecast for 2010-2012 (table 1) resulted in unchanged budget deficit forecasts (as a % of GDP) through fiscal year 2012/13 compared with October last year (table 2 on the next page). However, in nominal terms, the budget shortfall is now set to average R151.5bn over the next three fiscal years against R145.2bn forecast in October 2009.

Table 1: Treasury more optimistic about the economic outlook

	Oct '09 MTBPS			Feb '10 Budget			
	2009	2010	2011	2009	2010	2011	2012
Real GDP growth	-1.9	1.5	2.7	-1.8	2.3	3.2	3.6
CPI inflation	7.1	6.3	6.0	7.1	5.8	6.1	5.9
Current account (% of GDP)	-4.9	-5.7	-6.1	-4.3	-4.9	-5.3	-5.8

Source: Budget Review, 2010 / MTBPS, 2009

Even with the more positive GDP forecast, the Treasury remains fairly conservative when compared with the latest Reuters GDP growth consensus view of 2.6% and 3.5%. In terms of inflation, Treasury's forecast is more or less in line (albeit marginally higher in 2011) with the market.

The higher nominal budget deficits have resulted in a further upward revision to the national government borrowing requirement, which is now expected to average R166bn over the next three fiscal years. On average, more than 75% of the financing of the borrowing requirement will be done through the issuance of long-term government bonds, which are set to amount to R137.7bn in 2010/11 (coming down to R117bn during 2012/13). Government also plans to increase the issuance of global bonds to \$2bn in the next two fiscal years and \$3bn thereafter. Despite higher national government borrowings, the overall **public sector borrowing requirement** (including state-owned enterprises, or SOEs, such as Eskom and Transnet) is now expected to average more than R10bn less (R264bn against R275.1) than projected in October over the medium term. This is largely because of a reduced borrowing requirement from the SOEs as the expectation for public sector infrastructure spending has been downscaled slightly (see below).

Expenditure proposals – R112bn added over the medium term in a more targeted way

After a projected 17% surge in 2009/10, helped higher by a significant rise in public sector wages, government expenditure is forecast to post average growth of 8.2% (2% in real terms) over the budget period versus 7.7% (1% real) expected in October. During the period 2005/06 – 2008/09, real spending rose by a much faster 7.2%, indicating that government plans to play its part in moving SA back to a more sustainable fiscal position at the end of the budgeting period.

Table 2: Medium-term budget framework

R billion	2009/10		Medium-term estimates		
	MTBPS	Budget '10	2010/11	2011/12	2012/13
Revenue	657.5	657.5	738.4	827.7	922.3
% of GDP	27.3	26.8	27.3	27.9	28.0
Expenditure	841.4	835.3	906.9	977.4	1058.6
% of GDP	35.0	34.1	33.6	32.9	32.1
Debt service	60.0	57.6	71.4	88.5	104.0
% of GDP	2.5	2.4	2.7	3.0	3.2
Expenditure (excl interest payments)	-	777.7	835.6	888.9	954.6
% of GDP	-	31.7	31.3	30.0	29.0
Budget balance	-183.8	-177.8	-168.6	-149.6	-136.3
% of GDP	-7.6	-7.3	-6.2	-5.0	-4.1

Source: Budget Review, 2010

Table 3: Additional MTEF allocations (2010/11 – 2012/13)

R billions	
Provincial equitable share	21
Compensation of employees adjustments	12
Social grants	12.2
Education and skills development	14.1
Health care	12.4
Justice, crime prevention & policing	4.8
Rural development	2.4
Job creation, infrastructure & environment	16.4
Human settlements & local government	8.9
Other adjustments	8.0
Total	112.2

Source: Budget Review, 2010

If debt service costs are excluded, nominal **non interest spending** is set to rise by an average of 7.1% through 2012/13.

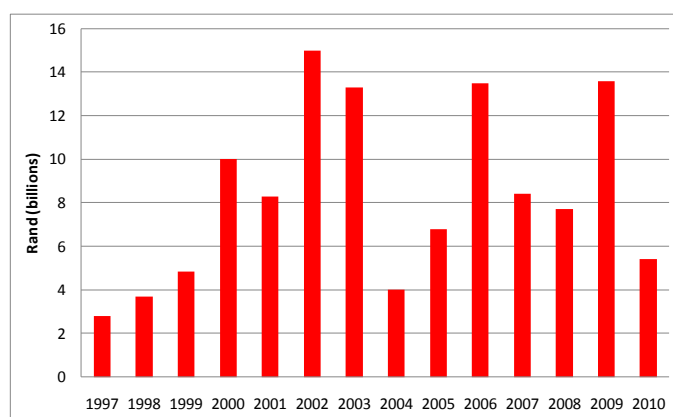
Table 3 provides a breakdown of the additional allocations to key spending areas when compared with the 2009 Budget. The more than R12bn increase in social grants is mainly a result of the extension of the child support grant to age 18 – the Treasury estimates that this will increase the number of grant recipients from 9.1 million in December 2009 to 11.5 million during March 2013. In terms of job creation, the Treasury announced some sector specific support measures, i.e. R1.8bn for **clothing and textile** production incentives and R1.8bn for the **automotive production development programme**. A further R2.5bn has been set aside to increase labour intensity in the expanded public works programme. In a move to reduce the high rates of youth unemployment, the Budget proposes a subsidy to employers that will lower the cost of hiring young people who do not have any work experience. Preliminary estimates suggest that 800 000 people could qualify for the scheme.

Of interest is that spending on **public infrastructure** has been reduced to R846bn (in nominal terms) over the next three fiscal years versus R872bn projected in the MTBPS. In terms of the growth rates, the pattern is interesting – the MTBPS saw the growth rate of public sector infrastructure slowing down from 13.1% in 2010/11 to just 2% during 2012/13. Now the pattern moves from 11.4% (i.e. slower at first) to 6% in 2012/13. This seems to suggest that some of the projects have been postponed and not necessarily cancelled, which is in line with recent media reports arguing that financing constraints have caused the delay of some projects such as the construction of the Kusile power station.

Tax proposals – significantly less relief

The Treasury's revised estimate is that tax revenue for 2009/10 will be R68.9bn lower than budgeted for in February 2009, but R1.4bn higher than estimated in the MTBPS. With large, albeit declining, budget deficits forecast for the next number of years, no major personal tax relief was expected in this year's budget. In the end, government provided personal income tax cuts worth R6.5bn to (partially) compensate consumers for the impact that higher inflation had in pushing them into higher tax brackets. This 2010/11 personal tax cut is half the R13bn put into consumer pockets last year.

Figure 1: 2010/11 Personal income tax relief lowest since 2004



Source: Budget Reviews



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BER comment: 2010/11 Budget

Furthermore, the 2010/11 budget proposes net tax relief (this number includes the impact of higher indirect taxes) of only R450 million, substantially less than the R4.6bn in 2009/10 and R10.5bn during 2008/9. This is because of indirect tax hikes (25.5c/litre rise in the fuel levy, as well as higher sin taxes and the introduction in September 2010 of an environmental tax on new passenger vehicles amounting to 2 to 4% of the purchase price) that are set to cost the consumer R6.3bn. After remaining flat around 24% in 2010/11, the tax burden as a % of GDP is expected to increase in the next number of years to 24.8% of GDP during 2012/13.

Minister Gordhan warned that tax hikes may be in the offing in coming years in order to fund spending commitments if other revenue sources disappoint. In terms of the mining sector, the **mining royalties regime** will, after being delayed for a year in 2009, be introduced during 2010.

Macroeconomic policy - steady as she goes

Speculation was rife before the Budget regarding an announcement on the **inflation targeting regime**, which has received wide criticism from the ANC's alliance partners. Although acknowledging that the global financial crisis emphasized the need for central banks to take a broader view (i.e. to include GDP growth, employment trends, asset prices, financial sector stability and exchange rate competitiveness) in managing inflation, Gordhan (correctly) argued that SA's inflation targeting framework already incorporated such flexibility.

The important point is that during periods when the economy is suffering growth strains, the time frame over which inflation is brought to within the target range should be extended. As we expected, the 3 to 6% inflation target range was kept unchanged and no other monetary policy changes were suggested. The same was true for the rand with Gordhan not bowing to pressure to fix the value of the currency as a measure to avoid the daily currency volatility. The Minister acknowledged the need for a stable and competitive real exchange rate, but argued that "in today's world this cannot be translated into a straightforward fixed price of the rand".

He repeated the comments in the MTBPS that the SARB would continue to take steps to counter rand volatility and "lean against the wind" during periods of rapid capital inflows, including reserve accumulation and further exchange control reform. Speaking of exchange controls, the Minister announced a change in the framework under which banks will operate. Government has finalised reporting measures for prudential foreign exposure limits on banks, resulting in a liberalisation of exchange controls. Under the new rules, banks will be able to acquire direct and indirect foreign exchange exposure of up to 25% of their total liabilities. This will allow SA banks to finance their clients' capital and trade flow needs globally.

Conclusion

Perhaps the best way to comment on the Budget is to have a look at the financial market reaction. Judging by the fact that the rand strengthened by almost 10c versus the US dollar to levels below R7.60/\$ and government bond yields declined, the financial markets seem to be relieved that no policy changes were announced.

Of crucial importance is that the Treasury affirmed a commitment to reduce the budget deficits going forward. This is important as figure 2 on the next page indicates that based on the Treasury's projection for SA's budget and current account deficit in 2010, we are in bad company in terms of our emerging market peers. However, one has to bear in mind that SA's overall debt to GDP ratio remains



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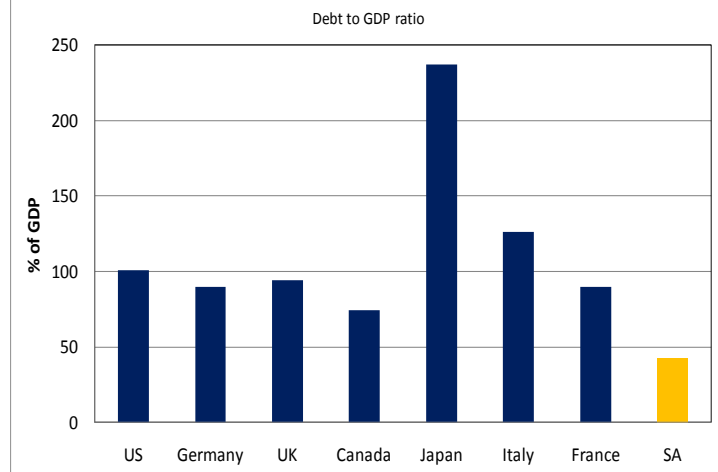
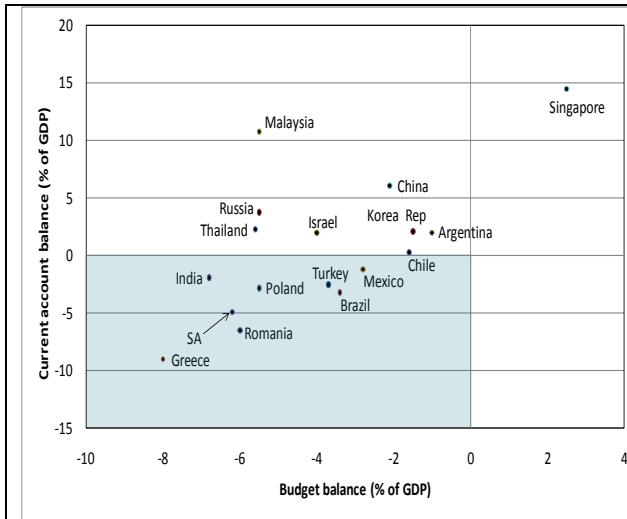
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BER comment: 2010/11 Budget

significantly below many of the countries listed. Indeed, figure 3 compares SA's projected debt ratio in 2012 to the G7 countries – at 43.1% of GDP, SA's overall debt is expected to remain significantly below this group of countries, although it increases from below 30% currently.

Figure 2: SA in bad twin deficit company, but...

Figure 3: ... has more fiscal space than most



Source: JP Morgan & IMF forecasts, National Treasury forecast for SA

Given that the Budget remained fairly stimulatory, if anything it should argue against a further interest rate reduction in March, but next week's (24 February) announcement on **Eskom's electricity tariffs** and the release of the **2009Q4 GDP numbers** (23 February) may have a bigger bearing on the decision. Our call remains for no further rate cuts.

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