SOUTH AFRICA: Medium-term budget signals no shift left

by Alberto Behar

Friday, October 30 2009

EVENT: On October 27, Finance Minister Pravin Gordhan presented his first Medium Term Budget Policy Statement (MTBPS).

SIGNIFICANCE: By outlining priorities over a three-year horizon, the MTBPS offers a first clue as to any potential shifts in policy. However, any changes in fiscal projections for the current fiscal year shown in the MTBPS do not reflect changes in policy, but rather an update of the existing framework due to unforeseen circumstances.Go to conclusion

ANALYSIS: President Jacob Zuma's rise to the leadership of the ANC was strongly supported by the left-wing of the party -- prompting speculation of an impending leftward shift in economic policy under his administration (**see SOUTH AFRICA: Zuma policy preferences remain unclear - September 29, 2009**). In the absence of any clear signal yet from Zuma, attention turned this week to Finance Minister Pravin Gordhan. His maiden Medium Term Budget Policy Statement (MTBPS) offered him a setting to establish the cabinet's stance.

MTBPS function. The MTBPS has two roles:

- It is an update to the February budget due to unforeseen circumstances, for example natural disasters. This is by and large a list of non-discretionary administrative changes, but is formally presented to parliament as a legislative amendment for its approval.
- It outlines in broad terms the updated budget projections and spending priorities for the three-year period ahead. This sometimes includes clues to the following budget, but could offer an indication of medium-term shifts in fiscal policy.

The first role concentrates on particular changes for the remainder of the fiscal year. The second role is very general. The MTBPS is not the forum for presenting changes in discretionary spending or in tax rates -- which is the role of the budget in February each year.

Deficit projections. There has been a large shift in fiscal stance since fiscal year 2008-09, as the country entered recession (GDP is forecast under the MTBPS to contract by 1.9% in the calendar year 2009):

- **Deterioration**. The MTBPS forecasts a 2009-10 deficit of 7.6% of GDP -- double the February forecast of 3.8%. Compared to a 1% deficit in 2008-09 (and surpluses before that), this represents one of the biggest swings in fiscal stance among the G20 -- comparable in order of magnitude with the United Kingdom and United States. Because it coincided with the change in government, the deterioration could be mistaken for a dramatic policy shift.
- **No policy shift**. However, the February budget -- presented under former Finance Minister Trevor Manuel, who now heads the National Planning Commission (**see SOUTH AFRICA: New planning ministries face constraints - October 19, 2009**) -- anticipated a change in fiscal stance, due to the announcement of a sustained capital expenditure programme over many years. Under the programme, spending of 715 billion rand (93.5 billion dollars) in 2008-09 was planned to rise to 834 billion in 2009-10 (**see SOUTH AFRICA: Falling revenues limit budget options - February 13, 2009**). The MTBPS spending forecast is revised slightly to 841 billion rand -- due in large part to higher than foreseen public sector salary increases.

- **Tax shortfall**. Tax revenue this year, which was in February only expected to fall moderately relative to earlier projections, is now expected to be a further 83 billion rand lower -- accounting for the majority of the 90 billion rand rise in the deficit projection since then.

Budget deficit evolution

Measure	2008-09 (actual)	2009-10 (budget forecast)	2009-10 (MTBPS forecast)	2012-13 (MTBPS forecast)
Expenditure (billion rand)	715	834	841	1,053
Revenue (billion rand)	692	740	658	921
Deficit (billion rand)	23	94	184	132
Deficit (% of GDP)	1%	3.8%	7.6%	4.2%

Source: National Treasury, South Africa

Medium-term fiscal plans. Growth is expected to return in the fourth quarter of 2009 and tax receipts are expected to recover, but the government warns this is subject to considerable uncertainty regarding the global economic outlook:

- Despite the deterioration in finances, the MTBPS expressed its commitment to maintaining the infrastructure spending programme.
- While the fall in tax receipts is cyclical in nature, the capital spending plans are contributing to a sustained planned structural deficit over the medium term.
- The government debt-to-GDP ratio, which fell from 48% in 1996 to 23% in 2008-09, is expected to rise to 41% by 2012-13 (with foreign debt at 5% of GDP). This debt ratio is low relative to its developing country peers, as well as many rich countries.

Gordhan warned that the planned expenditure plans must be sustainable. However, he has hinted at the need to raise taxes in the event of further revenue shortfalls rather than the need to pare spending ambitions, as his predecessor might have done.

Cabinet priority areas. Gordhan also announced a list of priority spending areas, stressing that these are determined cabinet-wide and not restricted to the Treasury. Relative to the previous (October 2008) MTBPS, the commitment to education, health, rural development, and fighting crime are preserved:

- In line with Zuma's election platform, job creation is emphasised explicitly as a direct priority and not only as the outcome of improved education.
- The fight against crime is broadened to include a fight against corruption, which was also part of the ANC election campaign.

Foreign exchange and inflation. In a sign of continuity, Gordhan referred to the policy recommendations of the Harvard growth panel, which had been asked for advice by the government of former President Thabo Mbeki (**see SOUTH AFRICA: State considers 'Harvard Group' policies - June 20, 2008**):

- The only Harvard panel recommendation that the Mbeki government ignored was to maintain a competitive exchange rate. The Reserve Bank has been known to be accumulating reserves for some time to counter rand strength. However, Gordhan's explicit statement in support of such actions represents a change on the government's part (**see SOUTH AFRICA: Rand appreciation strains policy-making - October 12, 2009**).

- Gordhan also made a surprise announcement of a further relaxation of exchange controls. The purpose is to reduce red tape involving foreign exchange transactions and it is designed to be business-friendly. Proposed reforms include removing a 180-day deadline for companies to convert their foreign exchange into rand; doing away with the 250,000 rand advance payment needed for imports; and allowing South African companies to open foreign bank accounts without prior approval. Also, the limit for outward investment applications will be raised ten-fold to 500 million rand.
- While exchange control relaxation is generally not supported by the left, the possible weakening effects of the increased outward investment limit on the currency will be approved by export-oriented business and labour alike.
- A weaker currency, together with large planned increases in electricity costs -- as a result of state power company Eskom's expansion of generation capacity (**see SOUTH AFRICA: Eskom still faces financing shortfall - January 22, 2009**) -- could have an upward impact on the inflation rate, which would work against the aims of increasing competitiveness.
- Gordhan made an explicit reference to a possible rethink on the nature of inflation targeting in consultation with incoming Reserve Bank Governor Gill Marcus -- whose term begins on November 9. Such debates are taking place globally, but it is thought that Manuel and outgoing Governor Tito Mboweni would not have been as willing to do this (**see SOUTH AFRICA: Marcus will pursue continuity at SARB - July 28, 2009**).

Outlook. Over the medium term, the commitment to expansionary fiscal policy, which is largely investment expenditure, will result in a structural budget deficit. The coincidence with recession will have a favourable expansionary side effect. The debt-to-GDP ratio will rise. The forecast weakening of the fiscal position, the relaxation of exchange controls and uncertainty over inflation targeting may have a weakening effect on the currency, but this will be viewed by many as another favourable side effect.

CONCLUSION: The increased deficit projection is largely due to lower-than-anticipated tax revenues, rather than a deliberate countercyclical expansionary fiscal policy change brought about by Gordhan. While the medium-term outlook mentions sustained government investment programmes and a structural deficit, these plans represent continuity with the previous government. However, the commitment to such plans in the wake of deteriorating finances may concern some observers.

Return to top of article

Primary Keywords: AF, South Africa, economy, debt, exchange rate, fiscal, foreign investment, monetary, policy

Secondary Keywords: electricity, infrastructure, prices