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Economic Commentary

Medium Term Budget Policy Statement

A more upbeat outlook, with higher revenue growth reducing the budget deficit over the MTEF period

- A more upbeat speech as the outlook for both the global and local economies looks better than at the time of the February 2010 budget
- The government has revised its growth forecasts for the MTEF period upwards, and inflation is now expected to remain within the target range for the next three years.
- The budget deficit has been revised downwards over the MTEF period, mainly on the back of higher revenue estimates.
- The Minister reiterated the government's concern with the impact of the overvalued rand exchange rate and stressed that South Africa faces a policy dilemma in dealing with the strong currency as is the case with other emerging economies.
- Exchange controls are to be relaxed further, and this will be announced by the South African Reserve Bank next week.

Economic background and assumptions

The Medium-Term Budget Policy Statement (MTBPS) contained few real surprises. The speech built on the government's New Growth Strategy, which aims at infrastructure and skills development, boosting savings as well as a competitive exchange rate in order to improve the economy's competitiveness and ability to create jobs.

On the growth front, the Minister was more upbeat than at the time of the February 2010 budget speech, with the improvement in economic conditions, both globally and locally, facilitating the upward revision of growth forecasts. Extensive monetary and fiscal stimulus measures have supported the economy, but risks to the outlook remain. The Minister stressed the importance of co-ordinated multilateral action to solve global imbalances rather than unilateral action.

Growth forecasts have been revised upwards, with economic activity projected to improve over the Medium-Term Expenditure Framework (MTEF) period (2010/11 – 2012/13). The economy is now expected to grow by 3% in 2010, compared with February's estimate of 2,3%, supported mainly by a stronger-than-anticipated recovery in consumer spending and exports. In contrast, the forecast for growth in fixed investment spending has been revised downwards substantially. The job market remains weak, with a further 86 000 jobs lost during the third quarter of this following the loss of almost 1 million jobs during the recession.

Over the MTEF period, the Treasury's forecasts suggest a relatively muted recovery compared with the previous upswing. Growth in household consumption expenditure will be contained by already high debt levels, stricter credit criteria and modest growth in disposable incomes. Fixed investment spending will also remain modest, growing on average by just above 5% over the next three years.

Export growth is forecast to pick up further momentum next year, although this may turn out to be too optimistic particularly if global growth disappoints. In contrast, growth in imports is expected to slow. Overall, the current account deficit is forecast to widen, mainly due to higher imports and an increase in payments to foreign holders of domestic equities and bonds. Inflation is forecast to remain below the upper limit of the target band over the next three years.

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Table 1 : Budget assumptions: initial and revised estimates for calendar years

	2009		2010		2011		2012		2013
	Actual	Feb-10	Oct-10	Feb-10	Oct-10	Feb-10	Oct-10	Oct-10	
%									
Real gdp	-1.8	2.3	3.0	3.2	3.5	3.6	4.1	4.4	
Real gde	-1.8	3.1	4.1	3.5	4.2	3.8	4.5	4.9	
Real pce	-3.1	0.9	2.6	2.6	3.4	2.9	4.1	4.5	
Real gfcf	2.3	5.8	0.8	7.8	5.6	8.7	5.0	5.9	
Real gce	4.7	4.7	4.9	4.1	4.3	3.6	4.2	3.7	
Exports	-19.5	3.8	4.1	3.9	5.7	5.4	6.6	7.6	
Imports	-17.4	6.8	8.4	4.9	7.8	5.6	7.9	8.7	
Current account to gdp	-4.0	-4.9	-4.2	-5.3	-4.9	-5.8	-5.3	-5.8	
Gdp deflator	7.3	6.6	6.1	7.3	5.3	6.5	5.5	5.6	
CPI	7.1	5.8	4.4	6.1	4.7	5.9	5.0	5.2	

Source: National Treasury

The National Treasury's growth projections over the next three years are more optimistic than Nedbank's forecasts.

We forecast slightly weaker growth this year, with the economy expected to grow by 2,8% and by 3% and 4,2% in 2011 and 2012 respectively.

Table 2 : Budget assumptions: initial and revised estimates for fiscal years

	2009/10	2010/11		2011/12		2012/13		2013/14
	Actual	Feb-10	Oct-10	Feb-10	Oct-10	Feb-10	Oct-10	Oct-09
Gdp (R bn)	2,455.6	2,699.9	2,683.9	2,967.6	2,933.5	3,295.7	3,227.9	3,568.7
Real gdp (%)	-1.3	2.9	3.5	3.4	3.6	3.6	4.2	4.5
Gdp inflation (%)	7.2	7.1	5.6	6.3	5.5	7.2	5.6	5.8
CPI	6.4	5.7	4.1	6.2	4.8	5.9	5.1	5.2

Source: National Treasury

Fiscal policy and revised MTBPS

The Minister highlighted the benefits of the government's fiscal prudence during the boom years, with the fiscal space created over that period enabling government to maintain key spending priorities during the difficult economic downturn.

The Minister stressed that South Africa needs to maintain the sustainability of its finances and find a balance between continued real growth in expenditure while reducing the future interest cost burden on the fiscus.

Table 3 : Consolidated government fiscal framework

	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Estimate	Medium-term estimates		
R billion					
Revenue	666.9	761.0	843.0	931.7	1,040.2
% rise		14.1%	10.8%	10.5%	11.6%
% of gdp	27.2%	28.4%	28.7%	28.9%	29.1%
Expenditure	832.5	904.1	977.2	1,059.1	1,154.2
% rise		8.6%	8.1%	8.4%	9.0%
% of gdp	33.9%	33.7%	33.3%	32.8%	32.3%
Budget balance	-165.6	-143.1	-134.2	-127.4	-114.0
% of gdp	-6.7%	-5.3%	-4.6%	-3.9%	-3.2%
Nominal gdp	2,455.6	2,683.9	2,933.5	3,227.9	3,568.7

Source: National Treasury

Revenue

The improvement in economic activity over the past year has facilitated an increase in tax revenues. A rise in consumer demand has boosted value-added tax collections, while the increase in customs duty benefitted mainly from higher imports of vehicles and components.

Tax revenue is projected to increase over the MTEF period, with the revenue estimate for 2010/11 up by R31 billion compared to the estimate in the February 2010 budget. A recovery in tax revenue as a proportion of gdp to 26,4% of gdp by 2013/14 from 24,4% in 2009/10 is projected, with tax revenue averaging 26% of gdp over the MTEF period.

Revenue growth has been raised to around 11% per year over the MTEF period.

Expenditure

Government's spending priorities remain focused on education, health, infrastructure development and job creation.

Expenditure decreases by R2,5 billion in the current fiscal year compared to the figure presented in February 2010, mainly due to lower state debt costs on the back of the stronger rand and lower interest rates, as well as a R2 billion saving by national departments. Government's wage bill goes up by R6,2 billion in 2010/11, and another R670 million has been set aside for occupation-specific dispensation salary adjustments in the Justice and Health departments.

Expenditure increases by R17,9 billion, R28 billion and R43,2 billion over the next three fiscal years to 2013/14, respectively. Additionally, cabinet has agreed to raise spending by R67 billion compared to the figure presented in the February 2010 budget over the MTEF period, with details to be provided in the February 2011 budget.

The deficit and financing

The projected deficits for 2010/11 and the next three fiscal years reduce significantly, mainly due to higher revenue. The deficit for the current fiscal year falls to 5,3% of gdp from the 6,5% projected in the February 2010 budget, with the lower-than-budgeted expenditure also behind the decrease.

Table 4 : Main budget net borrowing requirement and financing

	2009/10	2010/11		2011/12	2012/13	2012/13
R billion	Actual	Budget	Revised	Medium-term estimates		
Main budget balance¹	-166.9	-174.9	-142.1	-146.2	-145.3	-0.131
Extraordinary payments	-0.671	-	-0.572	-0.120	-	-
Extraordinary receipts	6.4	-	2.5	0.1	-	-
Financing requirement	-161.1	-174.9	-140.2	-146.3	-145.3	-130.8
Domestic short-term loans (net)	49.8	22.0	22.0	20.0	20.0	20.0
Domestic long-term loans (net)	118.9	137.7	137.7	129.1	120.2	102.8
Foreign loans (net)	23.3	11.6	-2.4	4.8	-3.5	-8.3

Source: National Treasury

Other issues

Minister Gordhan also addressed the controversial issue of the appreciating rand in this year's MTBPS speech. The Minister made it clear that government views the rand at its current levels as overvalued, but highlighted that other emerging markets are in a similar situation as capital inflows to emerging markets in general have surged over the past year. Net private capital flows to emerging markets could reach US\$825 billion in 2010, up very sharply from US\$581 billion in 2009. National Treasury feels that the surge in capital inflows to emerging markets is both structural and cyclical in nature. The structural element consists of pension funds in industrialised countries increasing their exposure to developing countries on the grounds that economic growth and therefore investment returns in emerging markets will outpace those of industrialised countries over the medium term. However, the cyclical or speculative element consists mainly of the carry trade, with international investors taking advantage of extremely low interest rates in industrialised countries to invest in countries with higher interest rates. Minister Gordhan feels that the challenge for South Africa is to figure out how to continue attracting long-term inflows while limiting exposure to volatile and potentially disruptive short-term inflows.

Given this context, the Minister announced the following measures in an attempt to stem the upward march of the rand:

- National Treasury and the Reserve Bank will continue to purchase foreign exchange reserves, with these purchases funded by revenue overruns in 2010/11 and debt issuance.
- The Reserve Bank will also 'sterilise inflows associated with foreign direct investment flows using foreign exchange swaps.'
- Exchange controls and offshore investment limits on individuals will be increased to encourage diversification and remove unnecessary limitations on offshore investments.
- Added to this, restrictions on the 'blocked' assets of emigrants will be lifted.
- Qualifying international headquarter companies will be allowed to raise and deploy capital offshore without exchange control approval, effective from 1 January 2011.
- Exchange controls on domestic companies will be changed to remove barriers to international expansion.
- The prudential framework for foreign investment by private and public pension funds will be reviewed to encourage offshore diversification, especially to other African countries and other emerging markets. A second draft of regulation 28 of the Pensions Fund Act will be published shortly and will take effect next year.

The Minister mentioned that the details of these broad exchange control reforms will be announced by the Reserve Bank, and this is expected next week.

Finally, Minister Gordhan indicated that National Treasury will monitor the impact and effectiveness of the tax measures implemented by other emerging markets to counter currency appreciation and will consider taking further steps to moderate the impact of capital inflows on the rand and the local economy. This final statement suggests that tax measures to stem short-term or speculative capital inflows may still be on the cards for February next year, but much can change before then.

Comment and Implications

There was nothing controversial in today's budget, with Minister Gordhan setting out how government intends to chip away at the budget deficit over the next three years as the economy recovers. On balance, the fiscal framework remains disciplined and prudent, with a focus of reducing the deficit and total debt in a gradual fashion without resorting to severe cuts in essential state services. The markets are likely to take heart from the better than expected deficit and debt estimates, while also embracing the guiding principle of restricting borrowing to meeting infrastructure needs.

However, Minister Gordhan did not provide much clarity on the details of government's growth plan or clear up any of the current uncertainty over government's future economic policies. The Minister again reiterated government's commitment to job creation, broadly indicating that today's MTBPS is consistent with the 'requirements of a new growth path' released following yesterday's special Cabinet meeting. Despite speculation in the run up to the MTBPS that more direct measures to weaken the rand would be announced, the Treasury stuck to a measured approach by lifting exchange controls on capital outflows further and continuing to fund the Reserve Bank's purchases of foreign reserves. However, Minister Gordhan made it clear that Treasury is open to tax measures to contain rand strength if these prove effective in other economies.

Today's MTBPS is reassuring as it confirms government's commitment to sound macroeconomic policies, amidst a highly uncertain policy environment over the past year and growing tension from the left for more radical economic reforms.

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