

Economics

South Africa: Public finance report

MTEF October 2009



27 October 2009

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Medium Term Budget Policy Statement (MTBPS)

The new Finance Minister, Pravin Gordhan, delivered the first MTBPS under the new Presidency with grace. Acknowledging in the first few lines of his speech that amid the challenging times facing the economy, there is also vast opportunity to react boldly so as to overcome the challenges facing the economy in this period. The economy has shed around 500 000 jobs, while the number of people in queues to obtain unemployment insurance doubled since April last year. Corporate liquidations are soaring, while the global economic environment remains uncertain. Against the backdrop of a substantially weaker economic setting, the Minister highlighted several promises including sustained delivery of services and development; prioritisation of budgeting efforts; diligence in the management of public finance so that future generations are not burdened; strong emphasis on savings within all spheres of government; and policy consistency with room for engagement and review. These assurances are cut from same cloth as Manuel's era. Importantly, it's been reinforced that wastage will not be tolerated, especially since more needs to be achieved with smaller resources. The Minister highlighted that the recession forced them to extend the budget towards investment in job creation, tapping into rural, infrastructure and social development as a means to create greater opportunities. These factors together with focus on the re-skilling of workers, support for industries under duress or those requiring restructuring support and focus on innovation and overcoming climate challenges, were highlighted as part of the framework of the response to the economic crisis, which will be further developed and implemented from next year.

The medium-term strategic framework emphasised priority areas over the MTEF period and will aim at:

- Job creation;
- Improving the quality of education and skills development to broaden employment opportunities and raise productivity;
- Strengthening the public health system;

- Fighting crime through strengthening the criminal justice sector, and eradicating corruption; and
- Reducing rural poverty by through rural development.

What is new?

The Minister announced further reforms to lower the cost of doing business, including the following: the current R50m limit for company applications for outward investment has been raised to R500m; the 180-day rule within which companies need to convert their foreign exchange into rand has been removed; and the R250 000 limit on advance payments for imports has been abandoned. Regarding limits on individuals, the foreign capital allowance for residents has been raised to R4m from R2m, and the single discretionary allowance from R500 000 to R700 000. The National Treasury also proposed that the current exchange control regulatory framework for approving investments will be modernised and announced in the 2010 Budget. Importantly, these announcements do not coincide with the recent rumours of a fixed-exchange rate policy. The main budget allowed for an additional R78bn for the allocation to new priorities or to respond to new pressures over the next three years. Provincial government will receive 51% of these funds, mainly to accommodate higher personnel costs, and for spending on education, health and housing. A further portion of 16% will be allocated to municipalities to compensate for the rising costs of providing free electricity. This should allay some concerns that these costs would have had to be covered by consumers in middle- and higher income areas. Support for key export sectors will also be stepped up. In promoting labour-intensive absorption of infrastructure projects managed by government departments, a wage-based incentive programme has been introduced to encourage the effective use of budgets. This includes a reimbursement of R50 of the daily wage of each person hired, granted that the job target threshold has been exceeded. This subsidy will be rolled out for environmental, cultural and social projects. This will support government's commitment to create 4.5m short-term jobs over the next five years (equivalent of 2 million full-time low skilled jobs for the unemployed workforce). No

additional information was provided on the details to the national health insurance scheme.

Background economic assumptions

With an estimated budget deficit of 7.6% of GDP (relative to 3.8% of GDP in the Budget Review), government's countercyclical approach dovetails the current accommodative monetary policy stance, which will assist in the economy's recovery over the next year. As illustrated by Treasury's macroeconomic projections, the recovery in GDP will be slow. In our opinion, real economic growth of 1.5% next year seems somewhat bearish when viewed against consensus forecasts of 2.4% and our own view of 3% next year. Importantly, any upward surprise will contribute to a more favourable budgeting process in a year's time, which could earn the new Minister some accolades. Encouragingly, a stronger prognosis on government consumption expenditure reinforces our view of a firm growth trajectory for 2010. Household consumption, which will be significantly weighed by household debt deleveraging, is more or less in line with our assumptions of 1.3% growth next year, sustaining a similar trajectory over the medium term. Interestingly, government's assumptions around the path of fixed capital formation over the next few years are considerably more optimistic than our current view of an average 5.1% over the next three years. Indeed, government expects capital formation by public enterprises to accelerate rapidly, growing by around 17% in real terms over the next three years (see Table 4 below). This trajectory will place considerable pressure on the import requirement in respect of the much-needed electricity and transport infrastructure development programmes, which will again place upward pressure on the current account deficit next year. Imports are seen rising more fervently by 2011, which again raises the economy's medium-term financial vulnerability. By 2012 the economy is seen bearing a current account deficit of nearly 7%, which is particularly burdensome if such weak economic growth of 3.2% were to materialise (we expect growth of nearly 4% in 2012). The deficit prognosis is considerably higher than our current account deficit forecast of 5.3% of GDP in 2012, exposing yet again the risk of the return to a structural trade deficit, emphasising the need for government to up its focus on raising the local content of infrastructure developments. Moreover, in the current environment of rand strength, the risk of import substitution is a huge threat for the sustainability of the manufacturing sector. Given these assumptions, it appears that government may be lobbying for a longer period of expansionary monetary policy. In view of the generally unfavourable inflation prognosis, which is expected to average 6% in 2011 (we expect 5.8%), this may be wishful thinking. Moreover, the MTBPS highlights the need for greater coordination between business, labour and government to mitigate inflation persistence. This suggests that the abandoning of inflation targeting, or increasing inflation tolerance, should not be expected in the future. That said, the Minister opened the door for further debate, awaiting the newly elected governor of the Reserve Bank to take office.

Table 1: Macroeconomic projections*

	2009 est	2010	2011	2012
Household consumption	-3.1 (-0.2)	0.9 (1.9)	2.3 (3.2)	2.5
Gross fixed capital formation	3.5 (3.7)	4.4 (5.7)	7.1 (9.0)	6.6
Government consumption	5.4 (4.0)	4.7 (4.0)	3.6 (4.0)	4.2
Gross domestic expenditure (GDE)	-3.4 (0.2)	1.7 (4.0)	3.3 (5.0)	3.8
Exports	-19.8 (-1.4)	3.8 (3.3)	4.5 (4.9)	5.6
Imports	-20.3 (-3.7)	4.2 (6.7)	6.2 (7.7)	7.3
GDP growth %	-1.9 (1.2)	1.5 (3.0)	2.7 (4.0)	3.2
Headline CPI %	7.1 (5.8)	6.3 (5.3)	6.0 (4.7)	5.7
Current account % of GDP	-4.9 (-6.3)	-5.7 (-6.9)	-6.1 (-6.9)	-6.9

* February Budget assumptions in brackets

Source: National Treasury

The 2009/10 – 2012/13 Medium Term Expenditure Framework (MTEF)

The Minister made use of the opportunity to update the 2009/10 Budget numbers. Total consolidated government revenue is now expected to be R658bn and projected expenditure is R841bn. These estimated revenue and expenditure values result in a sizable Budget deficit of R184bn for the fiscal year or R88bn more than expected in the main Budget. This represents 7.6% of the projected GDP and is expected to decline to 4.2% in 2012/13 of GDP.

The overall tax burden (revenue/GDP ratio) is anticipated to average around 29% over the next three years. Government has indicated in the past that a tax burden of 25% is seen as optimal. Under current conditions, this does not mean that tax cuts are imminent. The expenditure/GDP ratio is anticipated to decline from 34.6% next year to 33.8% by the end of the MTEF period.

Table 2: Consolidated government budget 2010/11 – 2012/13*

Rbn	2009/10 est.	2010/11	2011/12	2012/13
Revenue	658 (740)	744 (814)	833 (896)	921
Expenditure	841 (834)	906 (900)	976 (953)	1 053
Deficit/ Surplus	-184 (-94)	-162 (-86)	-142 (-57)	-132
<i>As % of GDP</i>				
Revenue	27.3 (29.9)	28.4 (30.3)	29.1 (30.3)	29.6
Expenditure	35.0 (33.7)	34.6 (33.5)	34.0 (32.3)	33.8
Deficit/ Surplus	-7.6 (-3.8)	-6.2 (-3.2)	-5.0 (-1.9)	-4.2

* February Budget assumptions in brackets

Source: National Treasury

Consolidated expenditure of the different services that government provides is provided in Table 3. The table reflects a moderation in spending growth, accompanied by a reprioritisation of spending. Education remains the single highest expenditure item. The highest individual average annual growth rates over the MTEF period are for housing and community development (12.3%) and environmental protection (10.4%). Spending on general public services is budgeted to grow by only 4.3% over the medium term. The reprioritisation resulted in recreation and culture contracting by 9.5% and economic affairs by 3.8%. Non-interest expenditure is expected to grow by 6.9% over the MTEF period while state debt cost is budgeted to increase by a whopping 18.1%. Consequently, total expenditure is anticipated to grow by 7.8% over 2009/10 – 2012/13.

In the recent release by the World Economic Forum of the Global Competitiveness report, severe ails to the economy were highlighted as poor security, business costs related to crime and violence, insufficient protection from crime by the police and the poor health system. On these metrics, South Africa scored amongst the top ten worst performing countries out of a total of 133 countries. South Africa ranked 127th out of 133 countries on the health of the workforce. It therefore comes as no surprise that significant spending concentration needs to be maintained on these grounds. Moreover, as the share of public spend on healthcare and social protection as a per cent of total consolidated expenditure will ease to 18% over the medium term from 25% in the current financial year, the quality of expenditure needs to be sharpened significantly.

Table 3: Consolidated expenditure (Rbn)*

	2009/10	2010/11	2011/12	2012/13
General public services	49 (51)	53 (54)	56 (56)	56
Defence	34 (35)	37 (36)	39 (38)	42
Public order and safety	78 (76)	86 (83)	96 (93)	102
Economic affairs	183 (180)	169 (178)	156 (161)	163
Environmental protection	6 (6)	6 (6)	7 (7)	7
Housing amenities	70 (73)	79 (82)	90 (92)	99
Health	90 (87)	101 (98)	109 (105)	115
Recreation and culture	8 (8)	6 (6)	5 (5)	6
Education	144 (140)	160 (156)	175 (170)	185
Social protection	121 (118)	132 (129)	145 (140)	157
Non-interest expenditure	781	835	890	954
State debt cost	60 (55)	71 (60)	86 (67)	99
Total	841 (834)	906 (900)	976 (953)	1 503

* February Budget assumptions in brackets Source: National Treasury

Table 4 provides the budget for expected infrastructure spending over the next three years. Government's previous R787bn infrastructure projects up to 2011/12 have been revised to R805bn. However, total projects over the MTEF will increase to R872bn. National departments and municipalities will spend somewhat less, but provincial departments will spend somewhat more compared to the main Budget values. Public private partnerships will dip seriously in the next fiscal year, but increase again strongly in 2011/12. This is not unexpected given the current focus on cash preservation among private business enterprises. Non-financial public enterprises spending will increase strongly to R146.1bn in 2010/11 compared to the main Budget amount of R131.3bn. The bulk of infrastructure spending will go towards these enterprises.

Table 4: MTEF infrastructure expenditure estimates (Rbn)*

	2009/10 revised	2010/11	2011/12	2012/13
National departments	8.0 (8.0)	8.7 (8.6)	10.6 (12.9)	10.5
Provincial departments	41.9 (39.9)	48.0 (46.5)	53.4 (52.4)	56.3
Public private partnerships	2.7 (13.9)	4.6 (11.7)	15.2 (11.7)	13.4
Extra-budgetary entities	7.8 (7.0)	8.2 (7.5)	8.6 (8.1)	8.3
Non-financial public enterprises	127.0 (119.6)	146.1 (131.3)	153.4 (145.8)	152.6
Total	237.4 (237.9)	268.5 (259.4)	298.8 (290.1)	304.8

* February Budget assumptions in brackets

Source: National Treasury

Indeed, in the February Budget, infrastructure allocations for the current financial year recorded 9.6% of GDP. This has been revised to 9.9% of GDP, while the ratio is expected to improve to 10.2% and 10.4% of GDP in 2010/11 and 2011/12, respectively, relative to 9.7% and 9.8%, respectively, in the National Budget earlier this year. However, by 2012/13, this ratio will ease to 9.8% of GDP. The bulk of the revisions is ascribed to a lower infrastructure prognosis for non-financial public enterprises (state-owned entities). Maintaining commitment to infrastructure development in the economy is seen as crucial as this will support the economic recovery over the medium term, while aiding government coffers in the ability to service loans and debt redemption. Overall this bodes well for the economy's credit rating as the absence of infrastructure spending continuity would have had damaging repercussions to future foreign direct investment prospects, thus raising the economy's external financial vulnerability in servicing the current account and other liabilities.

Table 5 illustrates the financing requirements of the Budget as a percentage of GDP. National government borrowing is projected to reach R176bn in 2009/10 and to decline gradually to R145bn by 2012/13. As a result of the worsening position as far as the Budget deficit is concerned, public debt rises to 41% of GDP in 2012/13 from

22.6% of GDP in 2009/10. Public sector borrowing as a ratio of GDP jumps to 11.8% in 2009/10 and then decline gradually to 8.4% in 2012/13. The significant increase in debt stock implies that the debt servicing costs will rise from 2.3% of GDP in 2008/09 to 2.5% in 2009/10 and 3.3% of GDP by the end of the MTEF period. The predominant driver of the higher Public Sector Borrowing Requirement (PBSR) in 2009/10 versus the Budget Review was the deterioration in the main budget balance, accounting for 87% of the revised increase of R99bn, and 63% of the total PBSR. However, in the 2011/12 financial year, increased capital investment expenditure, and thus borrowing needs, by the State Owned Enterprises (SOEs) account for nearly 45% of the total borrowing requirement. As such, the borrowing requirement will be supported by the significant funding requirements of the planned infrastructure programme of the non-financial public enterprises (Eskom and Transnet).

Table 5: Fiscal trends*

	2009/10	2010/11	2011/12	2012/13
PBSR (% of GDP)	11.8 (7.5)	11.2 (6.5)	9.4 (5.3)	8.4
Interest on public debt (% of GDP)	2.5 (2.2)	2.7 (2.2)	3.0 (2.3)	3.3
Ned loan debt¹ (year-end Rbn)	703 (635)	895 (728)	1 083 (810)	1 280
(% of GDP)	29.2 (25.6)	34.2 (27.1)	37.8 (27.4)	41.1
Foreign debt (% of GDP)	4.2 (4.3)	4.5 (4.1)	4.9 (4.1)	5.4

* February Budget assumptions in brackets

¹Net loan debt is calculated with due account of the bank balances of the National Revenue Fund (balances of government's accounts with the Reserve Bank and commercial banks).

Source: National Treasury

As far as non-financial public enterprises are concerned, Eskom is anticipated to borrow about R120bn over the next three years, depending on the level of tariff increases. Government will also increase the callable capital of the Development Bank of Southern Africa, enabling it to increase lending by about R102bn over the next 5 years. The Land Bank will also be recapitalised to allow it to focus on the extension of development lending.

The details to the funding of the PBSR are listed in Table 6. Foreign debt as a percentage of government debt remains relatively small because the country maintains deep and liquid capital markets. While this may be questioned by some, this is prudent government management, as over the next several years, the risk of debt servicing and capital payments on foreign loans will increase substantially as foreign central banks increase interest rates to more normalised levels. The rand's volatility can also not be ignored. Foreign loans nonetheless almost double compared to the main Budget. Domestic short-term loans are projected to increase to an average of about R20bn in the next three years, up from the budgeted R15.4bn in 2009/10. Domestic long-term loans are expected to increase from an almost insignificant R3.8bn in 2009/10 to R17.3bn in 2012/13.

Table 6: Financing of net borrowing requirement*

	2009/10 revised	2010/11	2011/12	2012/13
Domestic short-term loans	49.7 (15.4)	21.0 (12.4)	20.0 (6.0)	20.0
Domestic long-term loans	115.8 (61.5)	128.9 (61.6)	116.5 (52.0)	104.2
Foreign loans	11.5 (3.8)	14.1 (8.3)	15.6 (7.8)	17.3
Total[#]	175.8 (90.4)	167.6 (82.3)	155.6 (66.5)	145.1

* February Budget assumptions in brackets

[#]Includes change in cash and other balances

Source: National Treasury

Finally, as far as the division of revenue is concerned, revenue allocated to national government will continue to decline steadily over the next few years to 46.9% of the Budget, while revenue to local authorities will steadily creep up to 9.1% by 2012/13.

Table 7: Division of revenue % shares

	2008/9 revised	2009/10	2010/11	2011/12
National	50.1	51.1	49.6	48.2
Provincial	42.2	41.6	42.4	43.5
Local	7.7	7.3	8.0	8.3

Source: National Treasury

Conclusion

The Minister of Finance had to deal with difficult economic, social and political issues in preparing his first Medium Term Budget Policy Statement and Medium Term Expenditure Framework. The economy is in a severe recession, social problems seem to be growing and some new policy directions had to be factored in. A delicate balancing act was required. Like the rest of the world revenue streams have been under tremendous strain in 2009/10, pushing up the deficit to 7.6% of GDP. Over the next three years the deficit is budgeted to gradually decline to 4.2% of GDP. Total consolidated expenditure is projected to increase by 7.8% over the next three years. Furthermore a reprioritisation of spending and the elimination of wasteful spending also form part of the MTBPS. A more efficient economy through further investment in infrastructure and health and education is a major priority for the government over the medium term. The Minister also announced some exchange control regulation, support for wage-based programmes and support for short-term job creation. Given the limited scope to manoeuvre that the Minister had, the Budget represents the best that we could hope for.

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