

The MTEF – more than serendipity

The South African economy, her markets and the benign influence of fiscal policy

The fiscal deficits – a benign environment



Source: MTBPS 2004

Building the foundation for the next 10 years – Confidently

- The Medium Term Budget Policy Statement sets the correct context – and it increases the pace.
- Fiscal policy remains conservative – despite the more stimulatory fiscal position. It is not expected to prevent private sector participation. If anything, it is focused on enhancing delivery through private/public co-operation.
- The news on the relaxation of foreign currency exchange controls is welcomed and we believe positive for the rand as well as interest rates going forward.
- We see South Africa's risk rating improving on the back these steps and growth-enhancing policies.
- The fiscal policy settings continue to enhance the broader macroeconomic framework, and complement other policy settings. The emphasis on timing policy measures is positive.
- The policy environment, we believe, remains supportive of real economic growth of at least 4% against a backdrop of a benign inflation environment. We see a 3% rate of inflation as the most likely outcome given the fiscal settings.

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Drawing the context, setting the pace

Finance Minister Manuel, DG Lesetja Kganyago and their team's Medium Term Budget Policy Statement was presented with the usual mix of sound economics, practical steps and elegant form. And, as markets have grown accustomed to, have been welcomed by a broad set of stakeholders.

Budget Deficits



Source: MTBPS 2004

“The Medium Term Budget Policy Statement’s point of departure is a medium term strategic framework that recognises the limits of the State’s resources and the importance of promoting a vibrant competitive market-based economy.”

MTBP 2004S, Chapter 1

A sound fiscal policy framework that balances the demands of an emerging and growing economy with the budget constraints it faces

Context – capacity building, policy sequencing, embracing change

The context for fiscal policy continues to be set with consistent realism about not only the importance of capacity building, but also the commitment to policy sequencing. Translated: making sure that policy is appropriately timed so as to ensure efficiency in implementation.

The Treasury continues to sharpen its focus, continues to crystallize the government’s ambitions into well defined goals. This is even evident in the fact that the first chapter, usually titled Overview, clearly announces the focus: A framework for accelerated growth and broad-based development.

The central theme that has been used to focus policy has been the integration of the First and Second Economies whilst building a security net to alleviate poverty and thus enhance human capital formation. In this regard Mr Manuel

quoted from President Mbeki's speech in May 2004 where he referred to "three pillars" of South Africa's economic policy making.

The transparency in policy – a vital factor in driving down the costs of policy making - continues.

The dissemination of these economic goals throughout the sphere of policy making is an important factor in aligning energies around a central focus for those not only making policy, but also implementing it. Communicating a single, well-understood message to market participants remains of great value in diminishing the costs of policy making by creating a greater understanding as well as managing expectations.

The pace – higher gear, improved efficiency

The pace has most definitely picked up as reflected in the more expansive, stimulatory stance of fiscal policy. The deficit for the next fiscal year is now expected at 3.5% (of GDP), although the deficit is pulled back towards 3% towards the end of 2007 (see the table).

Main Budget Framework

	2003/04	2004/05	2005/06	2006/07	2007/08
Total revenue (Rbn)	299.4	328.2	363	399	440.5
% of GDP	24.3	24.5	24.7	25	25.1
Deficit as % of GDP	-2.4	-3.2	-3.5	-3.2	-2.7

The question is not whether the government increases its expenditure, but rather, what are the consequences of an increase in expenditure given the particular macroeconomic context.

We see the increases in expenditure welcomed given not only the plight of the second tier economy, but also the fact that the growing and more efficient economy can afford the additional demand for capital from the government sector. Furthermore, the fact that the expenditure is focused on modernising and deepening South Africa's infrastructure is most welcomed.

It remains, however, important that delivery and efficiency is enhanced through improving management capacity.

Highlighting the highlights

The MTBPS of 2004 has reaffirmed the young democracies coming of age.

The MTBPS of 2004 has reaffirmed the young democracies coming of age. The bold move on foreign exchange control relaxation coupled with well defined goals as to how growth will be enhanced whilst boosting investment affirms South Africa's renewed sense of prosperity and growing confidence. Importantly, pro-growth measures are balanced with the realities of the challenges facing the Second Economy in a modern, information and technology driven global economy. It is therefore encouraging to note that not only are programmes being more sharply focused on service delivery to the poor, but that the delivery process itself is to be sharpened to ensure that the right people receive relief.

Foreign exchange control relaxation - Building confidence, nurturing trust

The Treasury announced the following relaxations of foreign exchange controls (Chapter 2, MTBPS 2004):

- 1 Exchange control limits on new outward foreign direct investments by South African corporates are abolished. Application to the South African Reserve Bank's Exchange Control Department is still required for monitoring purposes and for approval in terms of existing foreign direct investment criteria, including demonstrated benefit to South Africa. The South African Reserve Bank reserves the right to stagger capital outflows relating to very large foreign investments so as to manage any potential impact on the foreign exchange market.
- 2 South African corporates will be allowed to retain foreign dividends offshore. Foreign dividends repatriated to South Africa after 26 October 2004 may be transferred offshore again at any time for any purpose.
- 3 As announced in the 2004 Budget, foreign companies, governments and institutions may list on South Africa's bond and securities exchanges. This aims to promote foreign investment into South Africa and to support the positioning of South Africa as a regional financial centre better able to cater for the capital raising needs of the continent. To further support these aims, South African private individuals will now be able to invest, without restriction, in inward listed instruments on South African exchanges.

We see the further relaxation of foreign exchange controls as positive for the rand in that it fosters greater confidence by enhancing fair value price making. It also allows the financial markets to adjust more easily to pricing signals, thus alleviating the real economy of the burden of adjusting to changes in the broader economic environment.

Although the South African institutional investor has not seen a change in legislation guiding offshore allowances, two issues should be noted. Firstly, that the issues regarding offshore allowances remain under discussion and that canes will be forthcoming. Secondly, the institutional investor will be able to invest an additional 5% (above the current offshore limitation) in a foreign

listing on the JSE should that company have its operations largely based in Africa.

Deepening economic growth - Increasing the rate of investment

The government's key goal is to up the investment to GDP ratio from 16% to 25% by 2014. The MTBPS prioritises infrastructure development through the vehicles of public-private sector partnerships.

These initiatives reaffirm the government's commitment to developing the modern First Economy – and – enlarging it by building the bridge between South Africa's first and second economies.

Economic Empowerment – building the bridge between the First and Second economies

Empowerment takes place at many different levels with a clear effort on the part of government to empower by facilitating greater economic growth in especially the Second Economy. As the Minister noted in his speech, development is set in motion by

- 1 The expanded public works programme aims to extend job creation into a widening array of public services and infrastructure needs.
- 2 New directions in housing and municipal grants seek to give greater impetus to community development.
- 3 Small and micro-enterprise development is set to be boosted by regulatory reforms, micro-credit initiatives and business support
- 4 A progressive expansion of investment in skills is under way, including growing numbers of registered learners in workplace opportunities, revitalisation of further education and stepped up financial assistance for students.
- 5 Land restitution, land reform and agricultural support programmes aim to expand the opportunities and resources of rural communities.

Black economic empowerment remains a key objective of policy making in ensuring that economic development remains “broad-based.” The government's approach remains a very lucid one: balancing the need to increase ownership of black people in corporate South Africa with building, deepening and broadening the economy by growing human capital and creating greater access to the First Economy for those trapped in the second economy. In this regard, the efforts by the major banks in launching the uMzansi bank account is particularly welcomed.

Features of expenditure patterns:

Real growth of non-interest expenditure of 4,3% a year.

Increases over the 2004 Budget baseline allocations total R50 billion.

An increase in the budget deficit to 3,5% of GDP in 2005/06, thereafter declining to 3,2% in 2006/07 and 2,7% by the final year of the framework.

Continued surpluses of the consolidated social security funds.

Growth in consumption expenditure and transfers to households during the first two years of the framework, while capital expenditure increases throughout in line with Government's commitment to infrastructure development.

Social services, income support and human development

We need to acknowledge that our social security net is under severe strain. Rapid growth in disability and foster care grant applications indicate both rising income support needs and apparent deficiencies in administrative systems. A sustainable social security system must balance bringing in everyone who is entitled to grants and keeping out everyone who is not entitled to them.

Trevor Manuel, MTBPS Speech 2004

The proposals to enhance delivery of social services are once again around building capacity, creating greater efficiencies in the creation of a single Social Security Agency and tightening procedures for obtaining grants.

The Revenue line

“it is not our borrowing but our revenue capacity that is the foundation of our fiscal position. After a decade of fundamental reforms of our tax structure and improvements in revenue administration, these foundations are firm.”

Trevor Manuel, MTBPS Speech 2004

And this really is the crux, that which lies at heart of the government's success in policy making. The South African economy has continued to expand and with a government noted for its fiscal conservatism along with a modernisation drive in tax collection, the development plans for the next five years have become increasingly affordable.

The key developments in taxation policy (Chapter 5) are as follow:

- 1 Policy measures announced in the 2004 Budget and given effect in the Revenue Laws Amendment Act of 2004 include broad based employee equity participation, tax relief for investments in South Africa from countries within the Common Monetary Area, clarity and more consistency for taxation of government grants to exempt entities and the tax treatment of hybrid financial instruments.
- 2 2005 Budget tax proposals will focus on simplifying tax compliance for small enterprises, revised tax treatment of health care benefits and deductions against motor vehicle allowances and amendments to facilitate the hosting of the FIFA World Cup in 2010.
- 3 Retirement funding arrangements, a review of mining industry taxation and fiscal reform relating to protection of the environment are also under consideration.

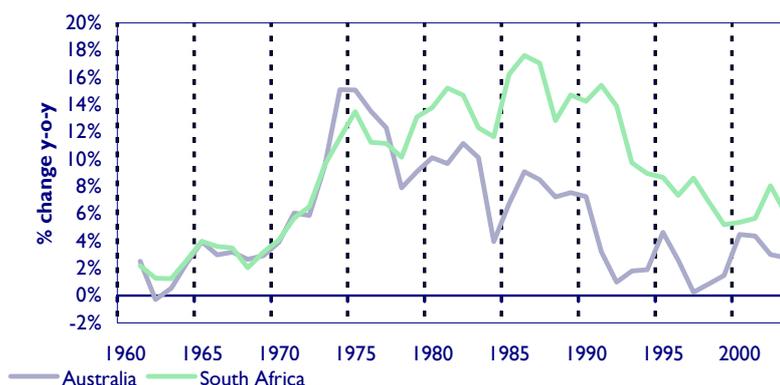
Implications

2004 has been characterised by a great deal of reminiscing by all walks of life in the still young democracy. And yes, it has been time in reflection well spent to understand just how far we have come in not only opening up our markets, but how far we have come in integrating society.

As exciting as it was to take stock, it is even more exciting to consider the vast opportunities offered by the South African economy given the sound policy framework, endogenous growth drivers, and sense of confidence.

Given that fiscal policy remains very much on track, we cannot but see the inflation rate moving towards the lower end of the targeted range.

Inflationary trends



The relaxation in the foreign exchange control regime will only serve to support the rand through the fostering of more confidence in this open and free economy.

Thus, we continue to argue for a reduction in the currency risk premium. Bond yields have made considerable progress and we believe that this will remain very much intact. Those that had been hoping for a cheaper buy above have missed the opportunity.

The South African economy is expected to continue to expand, well supported by the government's efforts in not only building infrastructure, but

by encouraging greater private sector participation through the public-private sector initiatives.

It is important to recognise that there are significant endogenous growth drivers at play, drivers strengthened by sound policy as well as a positive demographic momentum as the domestic market becomes more integrated – not only in terms of technology, but also in terms of the human capital base.

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