national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

SPEECH BY DIRECTOR GENERAL OF THE NATIONAL TREASURY LUNGISA FUZILE AT THE REUTERS ECONOMIST OF THE YEAR BREAKFAST

13 APRIL 2012

1. Introduction

Good morning ladies and gentlemen. It is my pleasure to be here with you to recognise your contribution to the economics profession. I would like to extend my congratulations to the winner of this year's award for producing the most accurate forecasts in 2011.

Forecasting the twists and turns of the South African economy is no easy task, especially given the increase in uncertainty that the world has witnessed since the start of the global crisis in 2008. Yet forecasting remains an important and necessary job which helps many people and organisations to shape their financial and investment decisions. I urge you to stay committed to this task, even though it can be disheartening when events outside of your control cause you to be way off the mark!

Ladies and gentlemen, at the risk of being accused of self aggrandisement, I wish to draw your attention to the fact that the National Treasury's forecasting track record stacks up relatively well against local and global benchmarks. The IMF recently observed that that South Africa's record in forecasting real economic growth was good.

However, we have tended to underestimate inflation and there have been wide discrepancies between our forecasts of tax and actual revenue collected.

Our record is mixed when compared with the Reuters consensus. In 2010, we were below consensus but a strong pick-up in growth at the end of the year saw the final growth numbers coming in stronger than the Reuters average. In 2011, we were below consensus again, but GDP growth disappointed even our pessimistic forecasts, the reasons for which I will return to later.

Let me share with you some thoughts on the current global economic environment before concluding with a discussion on the performance of the domestic economy and the outlook for fiscal policy.

2. Global economic outlook

2011 was supposed to be the year when the global economy would bounce back from the deep recession and return to a more self-sustaining growth path.

The year started on an optimistic note with the IMF projecting global GDP growth of 4.4 per cent and 6.5 per cent for emerging and developing economies. The first Reuters consensus forecast poll put GDP growth for South Africa at 3.5 per cent, while the Treasury's Budget projection was 3.4 per cent. The latest estimates suggest that global growth dipped below 4 per cent, while growth in emerging and developing countries slowed to just over 6 per cent. South Africa's growth was below initial expectations at around 3.0 per cent.

The slower than expected rate of growth was influenced by the following factors:

- The rise in the price of oil in response to the wave of “Arab Spring” demonstrations.
- The devastating earthquake and Tsunami in Japan, which halted production in some of the world’s largest manufacturing plants, thus disrupting global supply chains.
- The escalation of the European fiscal crisis and the bizarre debate over the US debt ceiling spooked financial markets.
- Capital flows to emerging and developing countries reversed as the risk appetite declined. As if that was not enough, floods in Thailand severely disrupted production in another major manufacturing hub.

I think you will agree with me that even the most qualified and experienced economists in the world could not have factored all of these shocks into their forecast assumptions (even if they had, very few people would have believed them!).

But that is in the past. Let me look to what 2012 holds. Already we have been shocked by the sharp rise in the price of oil as political tension has risen in the Strait of Hormuz. European markets, which seemed placated by the actions of the European Central Bank to boost liquidity in the banking sector, are again questioning the fiscal sustainability of countries like Spain. And everyone is keeping a close watch on political and economic events in China as growth in that economy slows.

Growth forecasts for 2012 reflect a heightened sense of caution. In its January World Economic Outlook update, the IMF projected global growth of only 3.3 per cent for 2012. Advanced economies were expected to grow by only 1.2 per cent, dragged down by a recession in the Eurozone. Growth in emerging and developing countries was projected to moderate to 5.4 per cent, as the authorities in China adopted measures to deflate the housing bubble.

The IMF's updated forecasts will be released next week, but we do not expect any major upward revisions. As Madame Christine Lagarde, the IMF's managing director, cautioned yesterday: "We have seen some improvement in the economic climate. But let me also underline this point: the risks remain high; the situation fragile."

There has been some positive economic news in the United States and Japan in recent months, but the situation in Europe remains extremely tenuous. The fundamental issue of high debt levels in peripheral countries will take time to resolve, especially if growth stagnates and political commitment to reform falters in countries like Spain. The world is slowly coming to realise that there are no quick fixes to Europe's troubles, although the ECB's actions have bought politicians a bit more time to seek agreement on how to secure the future of the currency union.

Growth has also declined in many countries due to structurally lower levels of investment and employment. This will compound the medium-term impact of fiscal consolidation and private sector deleveraging on GDP growth, especially in highly indebted countries like the US. This is one reason why discussions on the Framework for Strong, Sustainable and Balanced Growth within the G-20 are focusing on the structural reforms that are needed to raise productivity, investment and employment in a more sustainable manner.

On the positive side, China is showing a greater determination to tilt the balance of growth sources towards consumption. Such a rebalancing will open export opportunities for developing countries over the medium term. It will also help to reduce volatility in capital flows and exchange rates emanating from large-scale accumulation of reserves to maintain the renminbi peg to the dollar.

This is part of the long term shift in global trade and investment patterns that has pushed up the contribution of emerging markets to global GDP growth over the past decade. These shifts in the global economy provide considerable opportunities for growth and employment in South Africa and the African continent. China, according to World Bank projections, could shed 85 million manufacturing jobs in the coming years as the economy's comparative advantage moves away from labour-intensive production and as wages for unskilled labour rise. South Africa can capture a greater share of world manufacturing through focused efforts to achieve a competitive position in global production networks and supply chains.

Prospects for the African continent remain positive as factors such as the commodity boom, improved political stability and prudent macroeconomic policies have fuelled a sharp increase in African growth over the past decade. Between 2000 and 2016, Sub-Saharan Africa is forecast to almost double its share of global GDP, with per capita incomes rising by 110 per cent based on purchasing power parity.

Along with rising economic importance, emerging economies are also gaining political importance on the global stage. Groupings like the BRICS have become more formalised in recognition of the fact that traditional patterns of trade and investment have shifted away from historical north-south relationships. The inclusion of South Africa in the BRICS grouping represents an expanded terms of reference for the group, which seeks to strengthen economic and political linkages between the largest emerging economies across five continents.

South Africa can make a positive contribution to the policy-driven agenda for cooperation and collaboration among the BRICS countries. This agenda includes infrastructure financing, transport and communications, financial market development, research and development, building effective institutions, and fostering South-South trade and investment. Our close links with the rest of Africa mean the benefits of such cooperation will have large potential spill overs for the wider continent.

3. <u>Outlook for South African economy and fiscal policy</u>

All of the factors discussed above have an impact on the outlook for South Africa. In the 2012 Budget the Treasury projected that GDP growth would slow to 2.7 per cent in 2012 and gradually rise to 4.2 per cent over the medium term as the global economy strengthens. Economic data released since the Budget have generally been positive, which supports our view that the economy is on a more sure footing:

- Real GDP increased at a stronger-than-expected pace of 3.2 per cent in the fourth quarter of 2011. Both consumption and investment were more robust than anticipated. Encouragingly, growth in gross fixed capital formation strengthened across all sectors and categories. Even the residential building sector returned to growth after declining sharply over the past four years.

- Positive GDP data has been reinforced by an improving employment trend. Formal non-agricultural employment increased by about 23 000 persons in the fourth quarter and by 130 000 on an annual basis (or 1.6 per cent). The quarterly Labour Force Survey showed an increase of 179 000 jobs in the fourth quarter and a net increase of 365 000 jobs on an annual basis (2.8 per cent). Notable employment gains were made in trade and accommodation and manufacturing.

- Credit extension to households and corporates has strengthened considerably with total private sector credit extension rising by 7.9 per cent year-on-year in February compared with average growth of 5.6 per cent in the whole of 2011.

- The PMI was stronger-than-expected in the first quarter rising to 57.9 in February before falling back slightly to 55.1 in March. The positive news was confirmed by monthly expansions of manufacturing production in January and February pushing annual growth up to 4.1 per cent. However, the mining sector continues to be plagued by high levels of industrial action and safety related production shut-downs.

- Consumer price inflation remains above 6 per cent, fuelled by high food and petrol prices. However, food inflation moderated somewhat in February, which helped to reduce CPI inflation to 6.1 per cent from 6.3 per cent in January. The rise in the oil price is a concern and we recognise that the recent increases in the petrol price will eat into consumers' disposable income.

- The current account deficit narrowed slightly to 3.6 per cent of GDP in the fourth quarter of last year, but the widening of the trade balance this year confirms our view that the deficit will increase over the medium term as domestic demand and imports rise. The deficit remains comfortably financed by a mixture of FDI, portfolio flows and foreign borrowing.

The improved performance of the economy has been reflected in more buoyant fiscal revenues. The preliminary outcome for 2011/12 indicates a deficit of 4.5 per cent, which is marginally below the budget projection of 4.8 per cent.

The tax reforms announced in the 2012 Budget have further broadened the tax base and should generate sufficient revenue on an equitable and sustainable basis to support our fiscal objectives.

While it is important to take note of the deficit outcome for a particular year, we really should be concerned with the medium to long term trajectory of public finances. We are confident that we are on a sustainable fiscal path. Our fiscal policy is anchored on three medium term objectives:

- First, we are determined to contain real growth in public spending below the rate of growth in GDP. True to this commitment our current MTEF provides for a 2.6 per cent real spending against projected GDP growth of around 3.5 per cent. We are committed to a prudent path of expenditure growth which ensures that we live within our means.

- Second, we are committed to restoring a primary surplus (i.e. the difference between revenue and non-interest spending, and we expect to achieve this objective in 2014/15.

- The last anchor of our fiscal policy is that we intend to fully cover our operational expenditure with our own revenue. Since the recession of 2008/09, government has been borrowing to finance spending on recurrent costs such as compensation of employees, and goods and services. From 2014/15, we will borrow only to finance investment, not consumption. This will require a shift in the composition of spending towards investment.

It is against these anchors – rather than the deficit outcome for any particular year – that we should judge the sustainability of South Africa's fiscal policy.

Thank you.