MINISTRY OF FINANCE
REPUBLIC OF SOUTH AFRICA

Address to the Woolworths Board

"The evolution of fiscal and monetary policies in South Africa"

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1. Introduction

Good evening ladies and gentlemen. It is my pleasure to be with you here tonight as you deliberate on your corporate strategy for the next few years. I don't need to tell you that we are living in difficult and uncertain economic times, both at home and abroad. This makes effective communication between us as government and you as the business community ever more important.

I have been asked to provide some perspective on South Africa's fiscal and monetary policies, both to assist you in your planning, and to provide you with food for thought on how Woolworths as a business can assist government to attain its targets.
My remarks will focus on the evolution of our fiscal and monetary policy settings over the past 15 years and then assess how our approach has changed in response to the economic crisis the world has faced since 2008. I will conclude with some thoughts on the factors that will be important in shaping the future path of policy.

2. Fiscal policy

Let me start with fiscal policy, as this is the area most directly under the control of the Treasury.

Fiscal consolidation

The Treasury has received much praise for its management of fiscal policy over the past 15 years. We undertook a successful fiscal adjustment in the mid-1990s to avert a debt crisis by taking strong steps to reduce government dissaving and broaden the tax base through more efficient tax collection. Strong revenue growth through this period allowed government to consolidate debt and provide tax relief for households and companies.

The fiscal deficit declined from almost 8 per cent of GDP in the early 1990s, to a small budget surplus before the onset of the global crisis. This allowed South Africa's gross debt ratio to decline sharply from 49.5 per cent of GDP in 1995/96 to a low of 27.1 per cent in 2008/09.

By reducing the level of debt, we reaped the benefit of lower debt service costs, which in turn created space for strong real growth in non-interest expenditure in the 2000s. As a result, government was able to expand access to social services and create a social safety net for poor households. We were also able to step up much-needed investment in the country's logistics and services infrastructure.

The social wage

Today, social spending, which comprises social assistance, education, health, housing, recreation and community amenities, accounts for 58 per cent of government expenditure, up from 49 per cent a decade ago. The number of social grant beneficiaries reached 15.6 million by March 2012.

There is often concern that this level of spending on social grants - or "hand-outs" as people often refer to them - is unsustainable. But it is important to understand that grants are one of the main tools through which the Budget redistributes income from rich to poor households. Such redistribution is crucial to address high levels of poverty and inequality in our country. However, we understand that while grants are necessary, they are not sufficient to address inequality over the long term. For that we need to empower people with education and the skills to become productive members of society. The economy also needs to grow faster so that companies can expand investment and employ more people. In order to achieve our objective of reducing poverty and inequality over the longer term, government spending on social services has to complement rising employment, productivity and real wage improvements.

The Treasury will publish a long term fiscal report later this year that will consider the costs of current policies over the long term against the backdrop of projected economic and demographic trends. We are also working on policy proposals that concern the financing of the proposed national health insurance and reforms to social security systems. Preliminary indications are that the trajectory of social spending as it currently stands in the Budget is sustainable.

Countercyclical response to the boom

Between 2004 and 2007 the economy experienced what felt like an "economic boom". GDP growth averaged 5.3 per cent a year compared with 3.3 per cent between 2000 and 2003. The economy benefited from high commodity prices, a booming global economy, relatively low interest rates, easy credit conditions and higher rates of investment by the government and private sector. These were the golden years before the crisis and we know now that many of the factors driving this growth, especially in major developed countries like the US and Europe, were not sustainable.

Even at that time, the Treasury realised that some of the factors driving South Africa's boom, such as high commodity prices, were temporary. The fiscal stance was adjusted to reflect this reality. The budget deficit was kept very low and even measured a small surplus in 2007. The unusually large tax receipts arising from windfall gains in commodity prices and strong consumption growth were used to pay down debt and accumulate foreign exchange reserves to reduce the country's external vulnerability.

But even so, over the decade to 2009 real spending grew at a rapid pace of 9 per cent per annum (on average), which enabled a doubling of the social wage, rising capital budgets, growing social transfers, increased public employment and improved public sector wages. The ratio of public expenditure to GDP increased from a low of 22 per cent in 2001 to 29.2 per cent in 2010. Within that, investment expenditure by government and state-owned enterprises almost doubled, rising from 3.7 per cent of GDP to 7.2 per cent.

Response to the crisis

The buffer that was built up as a result of countercyclical fiscal policy during the boom put the economy in good stead when the financial crisis struck in 2008. When the economy fell into recession and tax revenues plunged, we were able to sustain spending on social grants, infrastructure investment, education and health by increasing borrowing. The public works programme was expanded to support employment and the benefit period for unemployment insurance was increased from 6 to 9 months. Fiscal policy was thus able to play a stabilising role in the economy during the crisis, which helped to minimise economic and social hardship. The fact that taxes were not increased to make up for the shortfall in revenues supported the recovery in business confidence.

There is no doubt that our fiscal response to the 2009 recession was robust and strong. Indeed, there are few countries amongst our peers in emerging markets that have increased their debt levels by as much as South Africa since 2008. Similarly, the increase in our primary deficit has been on a par with G-7 countries, which implemented very large fiscal stimulus programmes.

The consolidated government deficit increased from 1.1 per cent of GDP in 2008/09 to 6.5 per cent of GDP during the recession in 2009/10, before falling to an estimated 4.5 per cent in 2011/12. The medium-term estimates published in the 2012 Budget see the deficit falling back to 3 per cent of GDP in 2014/15.

Debt service costs are currently the fastest growing component of expenditure. By 2014 interest costs will amount to R109.1 billion, more than we spend on housing and community amenities! If interest costs are excluded from the numbers, the primary budget balance is expected to narrow to 0.3 per cent of GDP by 2014/15.

This will allow the stock of net debt to stabilise at 38.5 per cent of GDP. Even so, by 2014/15, government will have added more than R1 trillion to its stock of debt since 2008, a large share of which has been purchased by foreign investors in our bond market.

Returning to a sustainable fiscal path

Despite these large deficits and rising debt levels, we are confident that we are on a sustainable fiscal path. Our long-term decisions on fiscal policy are guided by three principles: (1) countercyclicality, (2) long-term debt sustainability, and (3) intergenerational equity. Essentially this means that we need to get back to a position where the budget can be flexible to adjust to shocks to the economy in the future.

To achieve this, and as outlined in the Budget, we need to keep real spending growth at a moderate pace, which is lower than it was prior to 2008. We need to stabilise growth of our debt. Plus, we need to shift the composition of our spending towards investment in productive assets, rather than consumption.

It is a great concern that the second fastest component of expenditure in the Budget is the government wage bill. This would not be a problem if productivity of public officials was also rising strongly, but we know that government falls short on many fronts where service delivery is concerned. Indeed, there is a growing perception that poor service delivery, waste and corruption are important constraints to economic growth. This underscores the need for us to do more with less, and to channel our efforts into projects and expenditures that will have lasting benefits for our people and our economy. Trevor Manuel in presenting the National Development Plan to Parliament last week identified an efficient and capable state as one of the country's three priorities.

Crucially, the private sector needs to grow for government to be able to collect the taxes that are necessary to finance expenditure. Without this, none of our fiscal plans would be credible. There are a number of enabling policies which fall out of the direct ambit of fiscal policy that are important to support a vibrant private sector.

3. Monetary Policy

The role of monetary policy

The way in which monetary policy is conducted has a huge impact on the private sector. Businesses thrive when inflation and interest rates are low; when there is certainty about the future; and consumers feel comfortable to spend their hard-earned incomes.

Monetary policy cannot deliver all of these conditions alone, but it can play a crucial supporting role in the economy by managing inflation pressures over the business cycle. This can be achieved much more easily if fiscal and monetary policy both move in a countercyclical direction to manage demand.

As businessmen, I don't need to tell you that low and stable inflation is good for the economy. It determines our competitiveness versus other countries and it helps to preserve the purchasing power of households. Permanently high inflation carries a range of serious economic costs. It drives up interest rates, reduces competitiveness, and lowers actual and potential economic growth. It also reduces the living standards of groups less able to protect their incomes from rising prices, including the poor, workers, and those living off of fixed incomes (pensions).

For these reasons, the common goal of all monetary frameworks, whether explicitly stated or not, is to manage inflation to preserve the purchasing power of the nation, and support growth.

Benefits of inflation targeting

Monetary policy has operated under an inflation targeting regime in South Africa since 2000 when many other international central banks also implemented the policy. One of the main benefits of inflation targeting is that it provides a clear nominal anchor for monetary policy, which is easily understood by the public i.e. a target level for inflation. Moreover, it compels the South African Reserve Bank (SARB) to be transparent about its goals and actions, which was not always the case under the previous eclectic regime.

These issues are extremely important for policy credibility and for managing inflation expectations effectively. If inflation is rising and inflation expectations are not anchored, then the cost of lowering inflation becomes much higher in terms of lost investment, lost exports and lost employment.

The Reserve Bank's track record with inflation targeting has been reasonably positive. The lively policy debates in the press around monetary policy in recent years suggest there is always room for improvement, but the following trends are evident if one looks back at the data since 2000:

- The average level of inflation and real interest rates has declined;
- Growth in real GDP and fixed investment has been higher and less volatile;
- Inflation expectations are lower and more stable than in the past;
- Monetary policy has generally been implemented in a countercyclical and flexible manner, which takes cognisance of the economic cycle;
- Communication between the SARB and the public has improved markedly and there has been active engagement between the Reserve Bank with key sectors of society, including business and trade unions;

- The independence of the SARB and its focus on the inflation target has improved policy credibility and helped to reduce the inflation risk premium in South Africa which is an important determinant of the cost of long term financing.

Despite these positive trends, we know that inflation is still volatile when there external shocks to food and commodity prices. The pass-through of exchange rate depreciation to wages and prices is also still high. This suggests that inflation expectations are not yet sufficiently anchored and that there is still a lot of inflation persistence in the economy, which cannot be dealt with by monetary policy alone, or at least the cost of doing so would be too high.

Complementary policies are needed to reduce inflation persistence such as increased competition and openness to reduce high mark-ups; wage setting that is linked to productivity; countercyclical fiscal policy; and a clear framework for determining administered prices. Many countries have also benefited from achieving a social compact between government, labour and business to support disinflation, competitiveness and employment creation.

Policy implementation

After the financial crisis it became clear that it was not enough for central banks to focus their attention on inflation. Indeed, in developed countries, an exclusive focus on inflation prior to the crisis meant that interest rates were kept too low for too long, fuelling a surge in hot money that flowed across the globe into commodities, stocks and house prices.

Rising asset prices encouraged greater lending by global banks, adding to the flow of new money. Since the monetary authorities did not take into consideration the overall systemic risks of the banking system or the build-up of debt in the economy, the cycle was allowed to continue unabated. Rapid innovation in the financial system added further risk, unimpeded by inadequate regulations.

South Africa’s Monetary Policy Committee (MPC) has always considered a range of factors in addition to the inflation forecast when setting interest rates. These include the level of GDP growth relative to the economy’s potential, the pace of credit growth, trends in commodity prices, capital flows and the exchange rate, and the current account deficit. The Minister of Finance formally mandated the MPC to include financial stability objectives in its deliberations in a letter to the Reserve Bank Governor in February 2010. Since then, there has been much closer cooperation between the SARB, the Treasury and the Banking Regulator regarding financial stability issues. Regulations such as the National Credit Act have received wide praise for reigning in reckless lending that might otherwise have occurred prior to the crisis.

That inflation targeting is implemented flexibly in South Africa is demonstrated by the Reserve Bank’s actions since the start of the crisis in the second half of 2008. The repurchase rate was cut by 6.5 percentage points between December 2008 and

November 2010. During that time the Bank instituted more frequent monthly Monetary Policy Committee meetings in order to respond to the crisis more timeously. Moreover, inflation was above the target range throughout much of 2009 because of shocks to food and oil prices, but this did not prevent policy from being eased.

Inflation was above 6 per cent again in late 2011 and the first half of 2012, but policy was not tightened. On the contrary, interest rates were reduced by another 50 basis points to 5 per cent at the MPC's last meeting in July because of deteriorating economic conditions. This was consistent with the actions of many other central banks around the world that have moved to ease policy this year to support growth.

The European Central Bank cut interest rates in July, although they are already close to zero, and it is widely expected that the US Federal Reserve could initiate a third round of quantitative easing measures in September.

It is too early to assess the impact of the recent interest rate announcement on consumers and businesses. The National Treasury's economic models suggest that for every half percentage point reduction in the interest rates, growth rises by 0.6 percentage points in about one year, provided that households and businesses do not respond by charging higher prices. The Reserve Bank has revised its forecast for GDP growth in 2012 down to 2.7 per cent (previously 2.9 per cent), and expects growth of 3.8 per cent in 2013. The latest Reuters consensus forecast for GDP growth is slightly less optimistic with 2.6 per cent for 2012 and 3.2 per cent for 2013. Inflation has been slightly lower than expected in recent months and the Reserve Bank's forecast for CPI inflation has been revised down to 5.6 per cent in 2012 (previously 6.0 per cent) and 5.1 per cent in 2013 (previously 5.5 per cent).

However, global food prices are currently experiencing a large shock due to severe drought in the US corn belt. Oil prices are also rising back towards US$120/bbl, which will likely have knock-on effects to petrol prices. Retailers like Woolworths will determine the extent to which these negative external shocks have knock-on effects to prices and wages in future, and ultimately affect interest rates.

Conclusion

The global economy remains in a precarious position almost four years after the collapse of Lehman Brothers. It seems that we should become accustomed to a new normal, where global growth will disappoint for a much longer period than previously expected. Many countries have little room for new fiscal or monetary stimulus measures, which will weigh on growth.

Knowing this, we have to focus harder than ever on getting our own house in order to ensure that our economy becomes more competitive and productive; and able to generate the jobs that our young people so desperately need.

Fiscal and monetary policies play a key role in allocating resources and creating a stable environment for investment and private sector growth. They are fundamental for providing a platform for growth, but they are not the only levers. More broadly, government's policies need to create an environment for business to thrive and expand, addressing the structural constraints that undermine economic growth, and drawing in those who are excluded from the formal economy. Progress on these issues will be critical for us as a nation to start unwinding our focal challenges of unemployment, poverty and inequality.

Thank you.