MINISTRY OF FINANCE
REPUBLIC OF SOUTH AFRICA

SPEECH BY MINISTER OF FINANCE: REUTERS' ECONOMISTOF THE YEAR.

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Nhlanhla Nene, Minister of Finance

Ladies and gentlemen

Thank you for the opportunity to share a few thoughs on economic forecasts with the country's top economists.

The National Development Plan reminds us that the world is expected to experience unprecedented changes over the next few decades. The NDP points to a confluence of diverse and numerous developments which will offer new opportunities. These developments include an explosion of urbanisation, revolutionary innovations in science and technology, climate change, global financial and monetary trends, and the balancing of economic power from developed to developing countries.

To take advantage of the opportunities while preparing prudently for the risks will require policies and actions that regulate and incentivise innovation, capitalise on recent trends and enhance the capacity to resolve conflicts and address challenges at a global level, necessitating a better understanding of the main drivers shaping trends.

And the ability of governments to navigate risks associated with these global and local developments will be determined by their insight into current circumstances and the foresight they develop about trends and possible futures.

It is in this context that the role of economic forecasting must be viewed. I read recently an article in the Financial Times[1] on professional forecasters in the US since the great recession. The author was so appalled by their record that one was reminded of the late economist John Kenneth Galbraith who once jokingly said: ‘the only function of economic forecasting is to make astrology look respectable!’

While Galbraith’s view may be extreme, the past five years have not been easy time for forecasters. The world is far less stable and predictable than most of us thought, and this truth has great consequences for forecasters, both in government and the private sector. The economics profession as a whole has been going through a period of soul-searching about the usefulness of existing models.

We as policymakers are struggling with difficult choices. For example, South Africa has both a wide current account and budget deficit, even though our economy has not rebounded and consumers are pessimistic about the future. This in itself is an unusual situation. Any standard economic model would predict that a weak domestic economy and weakening currency would quickly result in narrowing of the current account deficit. Instead, it has remained stubbornly high.

We are faced with the additional conundrum of needing to narrow these deficits, while giving continued support to the economic recovery. And unlike the past decade, we are now facing a period of high interest rates and lower commodity prices. In the past, easy credit and a commodity boom helped South Africa greatly to raise revenues and lower the costs of borrowing.

There are many other factors adding to our economic uncertainty. The tapering of quantitative easing is likely to continue to unsettle emerging markets. With the unresolved debt problems in Europe, the bond market is skittish, with the possibility of spiking interest rates or abrupt changes in demand for our debt.

The uncertain outlook in China also has significant implications for the South African economy. China is our biggest market for mineral resources and a significant slowdown in Chinese growth will reduce commodity prices. The future suddenly looks very different for South Africa, in a world with higher interest rates, falling commodity prices, and changing trade patterns.

So, as we move into an increasingly constrained fiscal environment, the credibility of forecasts becomes important, and the margin for error smaller. Indeed, many EU countries are starting to adopt so-called ‘structural balance rules’. Structural fiscal rules require policymakers to know the size of the output gap, and have a good sense of how the economic environment will evolve. As a result, despite their inaccuracy over the past five years, economic forecasts are likely to become an increasingly integral part of the budget process.

Forecasts published by the economists in this room already play a very important role in the budget process of South Africa. Our fiscal stance and expenditure ceiling are set to reflect the economic outlook, and our view on long-term potential growth. Given our limited fiscal space, and our commitment to countercyclical policy, economic forecasts are going to play an increasingly important role in our budget process.

As things stand, we at National Treasury begin our budget process by undertaking an internal forecasting process. Once the first draft of our forecast has been prepared, we compare it to the private forecasts that are available. We frequently refer to Consensus, Reuters and Bloomberg forecasts.

Our forecasts are often in line with those of the private sector. Where they differ significantly we interrogate the numbers to see what aspects need to reconsidered, or what additional information we may have that was not taken into account in the private sector forecasts.

Forecasts with the widest range of outcomes are particularly interesting, because they encourage us to think about what is driving the outlying numbers. Typically, private forecasters have a greater insight into the outlook of a particular sector. Although we only publish two economic forecasts, we update our forecasts four times a year and continuously track the changing direction of your estimates to inform our projections.

Despite these precautions, the fiscal outlook has been put under increasing pressure by the weakening economic outlook. The introduction of the expenditure ceiling was partly a response to downward revisions to the growth and revenue outlook.

So, can we build better forecasting models? Some economists have argued that the very nature of economic processes makes it near impossible to create accurate forecasts beyond the very short term. Others argue that forecasting in ‘normal’ times can produce accurate results, but that the unknowable tail risks are what matter for triggering extreme events, like the great recession of 2009.

Both views suggest that, for policymakers, the credibility of forecasts is as important as their accuracy. A recent review by the Bureau of Economic Research at the University of Stellenbosch compared forecasts of the Bureau with those of National Treasury, the International Monetary Fund (IMF), and a consensus forecast from the private sector. The Bureau found that forecasters perform significantly better than a pure trend forecast over a two-year period. They also found that all the forecasters' models come remarkably close to each other in terms of accuracy, at least in the short term.

But over the medium term, the accuracy drops off rapidly. From a budgeting perspective, three- to five-year forecasts are very important for making policy choices. If South Africa were to introduce a fiscal rule, for example, then greater emphasis would be placed on the credibility and accuracy of our longer-term forecasts.

Many governments have argued that introducing external expertise into the forecasting process is important for reducing bias, and improving credibility.

The Belgian fiscal authorities are bound by legislation to use the macroeconomic forecasts prepared by the National Accounts Institute. The government of the United Kingdom uses the fiscal and economic forecasts of the Office for Budget Responsibility, which is an independent agency outside of government.

Instead of establishing a formal body, the Chilean minister of finance selects a panel of private sector and academic economists. They attend one technical meeting every year, and submit individual projections some weeks later. After discarding the two extreme values, the fiscal authorities use the averages of these projections to calculate the output gap, and total tax revenues.

There is already some evidence that these reforms have improved the quality of government forecasts.

In conclusion, ladies and gentlemen, let me turn once more to the National Development Plan, which points out that the first half of the 21st century offers South Africa enormous economic opportunities. But the NDP also cautions that the first half of the 21st century also promises unprecedented challenges and risks, which will be driven by both external developments and internal dynamics.

In the global scheme of things, South Africa is too small an economy to affect the direction of the changes to come, so understanding and anticipating the drivers of change internationally could make the difference between economic success and failure. In the same vein, pre-empting domestic and regional developments and dangers will affect outcomes. Choices made now on the basis of these insights will largely determine whether or not South Africa will by 2030 have a stronger economy and a more socially equitable society.

I thank you.