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Liduduma lidlule!

The thunder will pass!

As this 2008 *Medium Term Budget Policy Statement* is tabled, a far-reaching global financial crisis is unfolding. While South Africa will unavoidably be affected by these developments, prudent macroeconomic and fiscal policies followed over the past decade mean that the economy is well placed to weather the storm.

Economic growth has averaged 5 per cent a year since 2003. Buoyant investment and favourable terms of trade have contributed to rising incomes and employment. Growth will be slower in 2008 and 2009, held back by domestic supply constraints and the international economic deterioration. However, South Africa's infrastructure investment expansion will continue over the decade ahead, alongside strengthening of initiatives focused on job creation and poverty reduction. Government policy remains focused on long-term growth and broad-based development, founded on a sustainable fiscal and financial framework.

Higher economic growth is dependent on further increasing investment in human and physical infrastructure, boosting domestic savings and improving international competitiveness. Making growth more labour absorbing requires further attention to microeconomic policies, enhancing the effectiveness of competition policy, removing impediments to job creation in the labour market and increasing public spending on infrastructure and labour-intensive services.

Introduction

Amid global turbulence, South Africa is supported by sound policy and healthy public finances

The world is experiencing a financial market crisis on a scale not seen since the 1930s. The prospects for global growth are poor and the short-term outlook is clouded by uncertainty. However, South Africa's longer-term economic expansion rests on sound economic policies, healthy public finances and resilient financial institutions, pursued steadily over the past 14 years. The growing economy, robust regulatory environment and developed capital markets provide favourable conditions for continued investment and growth in the period ahead.

Growth is bumping up against constraints in skills and infrastructure

The strong performance of the domestic economy over the past six years is attributable to both prudent economic policies and a supportive global environment, but the international outlook has deteriorated rapidly in recent months. In addition, six years of robust expansion have seen the economy push up against growth constraints – shortages of skilled labour and aging physical infrastructure. One of the outcomes of these capacity constraints is the rising current account deficit on the balance of payments.

The domestic economy is set to escape the worst effects of the global crisis

While the healthy state of the financial sector will help South Africa escape the worst effects of the financial market crisis, it is also evident that the global downturn will affect domestic growth prospects through lower export demand, financial volatility, exchange rate turbulence and uncertain expectations.

Projections for South Africa's output growth in 2008 and 2009 have been revised downward to 3.7 per cent and 3 per cent respectively. Depending on international developments, GDP growth is expected to recover to above 4 per cent in 2010 and beyond. After rising rapidly during 2008 due to higher food and fuel prices, the inflation outlook has improved.

Economic growth must be more inclusive and create more jobs

In the context of slower growth, employment-intensive development initiatives have to be prioritised. If South Africa is to achieve its target of halving unemployment from its 2004 level of 28 per cent to 14 per cent by 2014, growth must be more inclusive and absorb more labour. Improved social security arrangements also have a key role to play in adapting to a more uncertain economic outlook.

The proposed fiscal framework for the 2009 Budget takes into account both slower economic growth and the need to support continued infrastructure investment and social development in a context of heightened uncertainty. Government will continue to support reforms that reinforce financial-sector stability while encouraging national savings. Medium-term expenditure plans seek to bolster growth, accelerate job creation and broaden economic participation, while improving public service delivery in the following key areas:

- Education
- Health care
- Built environment infrastructure
- Fighting crime
- Improving rural livelihoods.

A discussion of these priorities can be found in Chapter 5.

Higher and more labour-intensive growth

South Africa and the international economy

Tough decisions taken early on are bearing fruit

Early decisions on macroeconomic policy, banking regulation, the gradual approach to exchange control liberalisation, the introduction of inflation targeting and our counter-cyclical approach to fiscal policy have enabled South Africa to benefit from the global environment, while providing a degree of protection from the worst effects of financial contagion.

The commodity price trend has reversed as growth prospects have slowed

Commodity prices have been exceptionally volatile. Oil and food price spikes have increased hardship for the world's poor and driven inflation higher internationally. In recent months, the commodity price trend has reversed as growth prospects have slowed, contributing to downward pressure on global inflation.

South Africa is well placed to adapt to the changed international environment because our financial system is not reliant on foreign banks, but an improved domestic savings performance is needed. Strong investment will continue to drive growth.

Openness to trade needs to be combined with protection in periods of turbulence

The Commission on Growth and Development published its findings earlier this year.[1] It showed that since 1945, those countries that succeeded in sustaining rapid growth and significantly reducing poverty within a generation pursued strategies that leveraged resources from the global economy. However, openness to global trade and finance has to be complemented by institutions that can provide protection during periods of heightened global risk. The fiscal and monetary policies pursued over the past 14 years have been designed to provide such protection, while enabling South Africa to benefit from global markets through trade and financial capital flows.

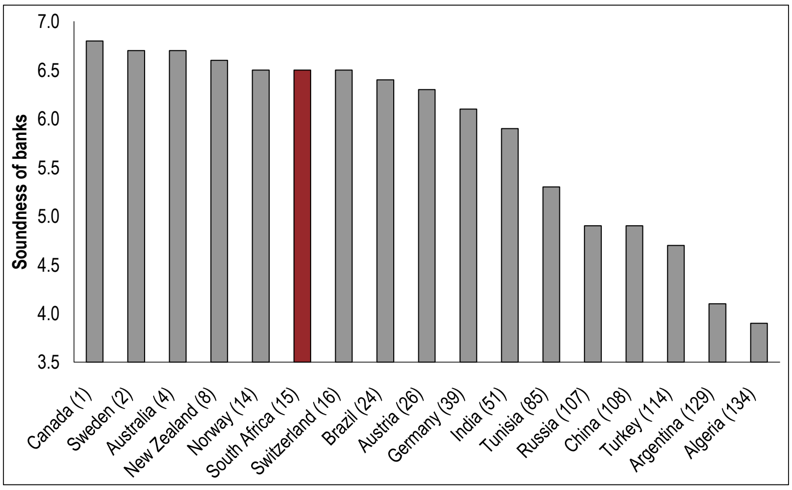
South African banks do not have significant exposures to global deleveraging

In recent months there has been exceptional volatility in the global financial system. Several major financial institutions have collapsed or required large bailouts, and there has been a general loss of confidence between institutions in the banking system. While these developments have important domestic implications, South African financial institutions do not have significant direct exposures to the US housing market or failed banking and credit institutions. As Figure 1.1 shows below, there is a high degree of confidence in South Africa's banking system. Nevertheless, the international credit crisis and the slowing global economy will raise the cost of accessing external finance and limit the growth of trade opportunities.

In countries where the banking crisis is most acute, the first round of policy responses included injecting liquidity and providing guarantees. When these steps failed to inspire confidence, a number of governments also undertook to purchase direct shares in their large banks. It appears that the latest measures are working to good effect, though there remains considerable uncertainty.

1 The Growth Report – Strategies for Sustained Growth and Inclusive Development, Commission on Growth and Development, 2008. (www.growthcommission.org)

Figure 1.1 Soundness of banks (country ranking in brackets)[2]



Soundness is measured between 1 (insolvent and may require a government bailout) and 7 (generally healthy with sound balance sheets).

Government monitors the banking system and will act as the need arises

Given the strength of the domestic banking system, its lack of direct exposure to global deleveraging and the continued efficiency of our interbank market, South Africa has not had to take any such measures. Nevertheless, government is monitoring the banking and financial sector and will take appropriate steps as the need arises.

Domestic economic policy considerations

The South African economy has grown by an average of 5 per cent a year for the past six years. During this period investment increased from about 15 per cent of GDP to more than 22 per cent. The unemployment rate declined from about 29.3 per cent in 2003 to 23 per cent today. Nearly 2 million net jobs were created during this period. Nevertheless, unemployment is unacceptably high, and a critical objective of economic policy over the next five years is to create work opportunities. Rising job creation depends on sustained growth, but also on making growth more labour-intensive. Government's economic policies must tackle these twin challenges.

Faster growth depends on higher productive capacity, savings and exports

During the period ahead, government will work to sustain economic growth by continuing to invest in areas that will boost South Africa's global competitiveness. Improving long-term growth prospects depends on rising investment in productive capacity, moderation of consumption expenditure and improved trade performance.

It is also important to recognise the causes and consequences of South Africa's aging physical infrastructure and poor skills base. Decades of underinvestment in physical infrastructure, from electricity generation to water supply, roads and rail have constrained the economy's ability to grow more rapidly.

Private investment has risen in telecommunications, manufacturing and tourism

Since 2001, both public and private investment have gathered momentum. Public investment in electricity generation, port operations, rail, airports, roads and public transport will support job creation in the short term and add much-needed capacity for higher

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2 Source: The Global Competitiveness Report 2008 – 2009, World Economic Forum, Executive Opinion Survey 2007, 2008.

growth in the medium to longer term. Similarly, private investment in mining, manufacturing, telecommunications and tourism has increased the productive capacity of the economy.

Government will strengthen the role of development finance institutions

One of the most critical challenges is to finance investment in a much tougher international financial environment. The budget will continue to support public spending on infrastructure. The large capital programmes of the state-owned enterprises are generally financed through operating surpluses and borrowing on the capital markets. Given more difficult credit conditions, government will support these enterprises in three ways: by continuing to align prices with long-run average costs to provide a suitable rate of return, by strengthening the development finance institutions to support larger infrastructure projects and by providing selective guarantees to the state-owned enterprises to cover their higher borrowing requirements.

South Africa has a strong financial sector and deep capital markets

South Africa's financial sector and deep capital markets have been key strengths in the country's economic development. The banking sector is well regulated and the gradual approach to exchange control liberalisation has enabled an orderly diversification of portfolios.

Earlier this year, the International Monetary Fund released its *Financial System Stability Assessment Report* for South Africa. The report notes that "South Africa's financial system is fundamentally sound and well-capitalised." It observes that the financial system is "diversified and spans a broad range of activities that are supported by an elaborate legal and financial infrastructure and a generally effective regulatory framework". The report also states that the country's major banks are compliant with the Basel II accord – an agreement updating international banking standards, including minimum capital adequacy requirements. Alongside sound financial institutions, however, economic progress requires investment in social and infrastructure development.

Increased resources for education and skills need to be used more effectively

Generations of apartheid education and limited progress in improving the quality of post-1994 education have reinforced skills shortages that inhibit higher growth. The emigration of skilled workers has exacerbated these shortages. South Africa is investing more resources in education and skills development and the 2009 Budget will add further resources in this area. It is important that these resources, and monies raised from the Skills Development Levy, be used more effectively.

A more inclusive growth trajectory has to be more labour absorbing. The 2009 Budget will see further resources allocated to employment-intensive programmes in the public sector, as well as incentives for private employers and non-governmental organisations to use more labour-intensive methods. In addition, rising investment in agricultural services and higher food production are likely to be positive for both employment and rural incomes.

Ways to encourage more energy-efficient production are being considered

Globally, the carbon trading market is maturing and beginning to have the desired effect of moving resources from energy-inefficient producers to more efficient ones. South Africa is exploring the use of similar market-based mechanisms to encourage companies to produce more efficiently. The proposed budget framework contributes to reducing electricity demand by promoting energy efficiency and investment in renewable energy sources, which also helps to limit CO_2 emissions. The proposed electricity levy, delayed until next year, will be broadened to cover other large carbon-producing enterprises.

In the context of heightened uncertainty globally, the key pillars of South Africa's macroeconomic policy provide a stable platform on which to foster more inclusive growth. Inflation targeting will remain the anchor for monetary policy, and fiscal policy will continue to be focused on raising domestic investment and addressing the service and infrastructure backlogs that prevent a more inclusive growth path, within a sustainable framework.

Reforms are required in trade and competition policy and in the labour market

At the same time, South Africa has to raise domestic savings and develop a more export-oriented economy that can take advantage of global opportunities. This requires a series of microeconomic reforms, particularly in areas relating to trade and industrial policy, competition policy and the functioning of the labour market. A more effective and capable state is required to improve the quality of education and health care; to broaden opportunities for the poor by providing access to housing, water, electricity and transport; and to reduce violent crime.

Budget reform

A deeper engagement with Parliament on the budget process

Over the past 14 years the budget process has been substantially improved. The National Treasury has deepened engagement with Parliament, government departments and civil society, and enhanced the quality of published information. Earlier this year, the *Estimates of National Expenditure* included explicit performance measures for each department and, in several cases, for programmes within departments. Efforts to improve the quality of the performance indicators used in the budget process and the data produced in relation to these indicators continue.

What is the Medium Term Budget Policy Statement?

Policy statement defines the parameters for next year's budget

The *Medium Term Budget Policy Statement* is a policy statement issued by the executive that defines the parameters for the following year's budget. It is not a budget, nor is it a "mini-budget". The purpose of the statement is to set out the policy context and direction so that departments, provinces and municipalities can prepare their budget plans for the next three years.

The policy statement sets out the economic context in which the budget is prepared, provides the country with government's official economic forecasts for a three-year period and, based on these factors, outlines the proposed fiscal stance. It sets out the budget priorities over the medium term and provides a division of revenue to finance services provided by national, provincial and local government.

Assessing public finances and accountability

Earlier this year the National Treasury, in partnership with the European Union, conducted a public expenditure and financial accountability assessment. The assessment scores a country on its financial management, budget process, procurement system, quality of published data and the audit process. This assessment is generally done in developing countries and is used by donor countries to assess the capacity of a country to absorb and manage donor aid. In the case of South Africa, where donor aid is a minor part of the budget, the assessment focused on public financial management.

EU body gives high marks for South Africa's public financial management

South Africa received 15 "A" rankings out of a total 28 indicators – the highest number received by any country that has been assessed, including some developed countries such as Norway. The report also identified room for improvement in the procurement system and reporting on donor aid.

Enhancing parliamentary oversight of the budget

Parliament receives extensive information on the budget process

South Africa's Parliament has evolved from a Westminster tradition, where the legislature played little or no role in the budget process. Today, Parliament engages extensively with the process and receives comprehensive information on the finances and performance of departments. Parliament also receives quarterly data on departmental and provincial spending trends.

The Constitution empowers Parliament to establish procedures to amend money bills as part of its role in overseeing the work of the executive. Parliament is presently debating proposals for such a procedure. The executive would still be responsible for drafting and tabling budgets, but Parliament would be empowered to consider and enact amendments to specific provisions of appropriation and revenue bills. In draft legislation, the procedure to amend money bills includes provisions requiring Parliament to take account of government's fiscal responsibilities and the short-, medium- and long-term implications of any changes.

Treasury welcomes enhanced oversight of departmental performance

It is expected that this reform will come into effect in the middle of 2009. It will require Parliament to build up expertise to be able to analyse money bills in greater detail. These reforms are welcomed as they will enhance Parliament's oversight of departmental performance and deepen the quality of engagement on the budget process.

Overview of the policy statement

Economic policy and outlook

Chapter 2 discusses the macroeconomic outlook and provides a perspective on the microeconomic policy changes required for higher growth and employment in the context of global financial market turmoil. In addition, the chapter includes a discussion of forthcoming changes to the consumer price index.

South Africa seeks to grow faster through increasing investment in productive capacity and to promote a more inclusive growth path through expanding employment. Achieving these objectives in a slowing global economy will be more difficult. Nevertheless, South Africa has the policy, institutional and regulatory frameworks to ensure continued economic growth and investment. It is important to further strengthen these frameworks and focus on microeconomic reforms.

Government targets improvements in education, health, and safety and security

The reforms needed to achieve higher and more inclusive growth lie in the areas of trade policy, industrial policy, labour market policy, competition policy and the performance of the state in the areas of education, health, and safety and security. Furthermore, the country needs even higher levels of investment in infrastructure, ranging from power generation to roads and ports.

The performance of the global economy is a key determinant of South Africa's economic performance. Growth in the seven most advanced economies is now projected to be close to zero, with some of these countries dipping into recession. Similarly, measures to curb rising inflation in India and China, as well as slowdowns in their major export markets, mean that growth in these two large trading economies is likely to cool down. Commodity prices have already fallen sharply on expectations of lower Asian demand.

African growth prospects buoyed by investment in mining, chemicals, tourism and transport infrastructure

Growth prospects in Southern Africa and Africa in general remain robust, with average growth of over 6 per cent projected for 2009 due to rising investment in mining, petrochemicals, tourism and transport infrastructure. South Africa is one of the largest investors on the continent and benefits from growing intra-African trade.

A period of slower consumption growth is needed to enable domestic saving to contribute more substantially to meeting the financing requirements of continued investment growth. Following several years of robust household spending, consumption expenditure growth is expected to slow from 2.8 per cent in 2008 to 1.6 per cent in 2009. However, the continued buoyancy of the construction sector in response to rising investments will be supportive of growth going forward. GDP growth is projected to slow from 5.1 per cent in 2007 to 3.7 per cent in 2008 and 3.0 per cent next year. As the global economy recovers and as the benefits of higher investment start to come through, growth prospects strengthen for 2010 and beyond.

In January government will introduce a new headline inflation measure

Consumer price inflation increased rapidly during 2008, driven by rising food and fuel prices. The inflation outlook is more promising, with oil prices falling and food prices moderating. With the introduction of a new basket of consumer prices based on updated consumption trends, the consumer price index will become the targeted measure of inflation. Chapter 2 describes this change in more detail.

Table 1.1 Macroeconomic projections, 2007 – 2011

Calendar year	2007	2008 Estimate	2009	2010 Forecast	2011
Percentage change unless otherwise indicated					
Final household consumption	7.0	2.8	1.6	3.2	3.7
Gross fixed capital formation	14.8	12.6	8.7	8.8	9.3
Real GDP growth	**5.1**	**3.7**	**3.0**	**4.0**	**4.3**
GDP at current prices (R billion)	**1 996.9**	**2 303.6**	**2 538.4**	**2 802.4**	**3 098.2**
CPI[1]	6.5	11.6	6.2	5.3	4.7
Current account balance (% of GDP)	-7.3	-7.6	-7.8	-8.9	-8.8

1. *CPIX in 2007 and 2008.*

Fiscal policy and revenue trends

Sound fiscal policy has prepared South Africa for the global storm

Chapter 3 discusses fiscal policy and Chapter 4 reviews tax trends. The economic environment has changed radically since the February 2008 Budget. However, sound fiscal policy enables government to adjust the fiscal framework without undue disruption. Fiscal policy will continue to balance mitigating global risks with support for higher investment, better public services and rising employment.

R170.8 billion added to spending plans

Given the fact that revenue growth is slowing, and in particular that corporate tax revenue is likely to fall next year, it is anticipated that the budget balance will revert from a moderate surplus in 2007/08 to a deficit in 2009/10. This budget framework adds R170.8 billion to spending plans for the next three years. A deficit of 1.6 per cent of GDP is expected in 2009/10.

Revenue growth averaged 17 per cent a year over the past four years, but it has slowed in the first six months of 2008/09, despite higher inflation levels. While tax collection is expected to be close to the budgeted figure, revenue as a share of GDP will be lower than expected. The budget framework takes into account that revenue growth is likely to moderate over the next two years in line with corporate profitability.

R60 billion loan to finance Eskom's capital investment programme

Public spending growth will continue to support investment in physical infrastructure, as well as higher investment in education and health. The budget includes R60 billion in loan financing to support capital investment by Eskom. Gross fixed capital formation by general government and public enterprises will continue to rise strongly, by 14.2 per cent a year in real terms. The public sector borrowing requirement increases to 3 per cent of GDP next year, reflecting strong public-sector investment plans. Government will support the investment programmes of its state-owned enterprises by strengthening the role of development finance institutions in financing large infrastructure projects and through targeted loan guarantees. In addition, government recognises that utility prices have to be adjusted to reflect the economic costs of delivering public amenities, while ensuring subsidised support for poor households.

Despite small budget deficit, government continues to be a net saver

Although a budget deficit is anticipated for the period ahead, government will continue to contribute positively to national savings, as growth in capital spending continues to exceed growth in recurrent expenditure.

Table 1.2 Consolidated national government, 2007/08 – 2011/12

	2007/08	2008/09	2009/10	2010/11	2011/12
R billion	**Outcome**	**Estimate**	**Medium-term estimates**		
Revenue	**584.6**	**653.5**	**712.8**	**783.5**	**869.2**
Percentage of GDP	*28.4%*	*27.6%*	*27.4%*	*27.3%*	*27.4%*
Expenditure	**558.0**	**650.3**	**754.3**	**814.5**	**868.6**
Percentage of GDP	*27.1%*	*27.5%*	*29.0%*	*28.4%*	*27.4%*
Budget balance[1]	**26.6**	**3.2**	**-41.5**	**-31.0**	**0.6**
Percentage of GDP	*1.3%*	*0.1%*	*-1.6%*	*-1.1%*	*0.0%*
Gross domestic product	*2 061.9*	*2 366.7*	*2 598.6*	*2 870.2*	*3 170.3*

1. A positive number reflects a surplus.

Medium-term budget priorities and the division of revenue

Continued emphasis on improved public-sector performance

The medium-term expenditure framework emphasises improving the quality of spending and enhancing public-sector performance. Budget priorities for the period ahead are focused on social solidarity and building a more equitable society, and include:

- Improving the quality of education and skills development to broaden employment opportunities and raise productivity.
- Strengthening the public health system, with a particular focus on enhancing human resource capacity and reducing infant and child mortality, maternal mortality, HIV and Aids, and tuberculosis.
- Fighting crime through strengthening the criminal justice sector, especially detective and investigative services, and improving court processes.
- Investing in built environment infrastructure to achieve universal access to water, sanitation, electricity, housing and public transport.
- Reducing rural poverty by taking steps to raise rural incomes and improve livelihoods, including through raising investment in agricultural services and increasing access to arable land.

These priorities are discussed in Chapter 5.

Additional support for the expanded public works programme

Over the next five years government will implement the second phase of its expanded public works programme, which will provide incentives to public institutions, nongovernmental organisations and, in some cases, private companies to use more labour-intensive methods in the delivery of both infrastructure and routine services.

Higher inflation affects the budget framework through higher nominal salaries, adjustments to social grants, increased fuel costs and more expensive medicines, food and textbooks. Adjustments to spending plans over the next three years to compensate for higher inflation amount to R59.0 billion.

Division of revenue reflects shifting priorities in favour of services and municipal infrastructure

The division of revenue between national, provincial and local government, presented in Chapter 6, reflects shifting government priorities in favour of social services and municipal infrastructure. Excluding the transfer to Eskom, the division of revenue indicates a bias towards provinces, given the strong emphasis on education and health spending. Municipalities also benefit from budget increases related to extending municipal and household services such as public transport, water, sanitation and electricity. Additional national spending is mainly for infrastructure, fighting crime, and improving the capacity and performance of the state.