The implications of fiscal issues for central banks: the South African experience

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Introduction

The South African monetary authorities have been fortunate in that fiscal issues have not in general complicated the conduct of monetary policy. A situation of fiscal dominance does not exist, and there is no pressure on the central bank to finance unsustainable government deficits. This note outlines recent developments in South Africa's fiscal policy, which demonstrate the extent to which fiscal prudence has contributed to a lower-inflation environment. A few comments are also made on the coordination of monetary and fiscal policy.

Fiscal policy and fiscal deficits

Prior to South Africa's transition to democratic rule in 1994, there were developments on the fiscal front that were of concern to the South African Reserve Bank. Since the early 1990s the budget deficit had been expanding relentlessly, reaching almost 8% of GDP in 1992/93. There was a concomitant acceleration in the debt/GDP ratio to around 50%, and the share of government expenditure devoted to interest payments increased to above 20%, making it one of the single biggest budget items. There were fears in some quarters that the new government, faced with major social and infrastructural demands, would not be in a position to reduce the deficit, and that eventually there would be recourse to the printing press.

As it turned out, macroeconomic discipline, and fiscal discipline in particular, became a central plank of macroeconomic policy as outlined in the Growth, Employment and Redistribution (GEAR) policy document published in 1996. This aspect of the GEAR framework has remained a crucial part of macroeconomic policy. The GEAR policy emphasised that fiscal policy would be conducted and financed in a non-inflationary way, and that monetary policy would be focused on achieving and maintaining low levels of inflation. No specific fiscal rules were put in place but a medium-term expenditure framework was introduced in terms of which a *Medium Term Budget Policy Statement* is published in the second half of every fiscal year. This statement provides revised fiscal projections for the current year and projections for the following three fiscal years.

With the restructuring of the budget framework, the fiscal authorities have been able to reduce the budget deficit to levels around 2% of GDP, primarily as a result of significantly improved efficiency in tax collections, and containment of expenditure increases. The improvement in tax collections was so significant that despite the marked decline in the deficit, government expenditure nevertheless expanded moderately in real terms, and the fiscal authorities were able to partly eliminate bracket creep and reduce tax rates, particularly personal tax rates. The government debt/GDP ratio has declined to 47% and interest payments have declined to 18% of total government expenditure.

The Medium Term Budget Policy Statement

On 29 October 2002 the Minister of Finance presented the Medium Term Budget Policy Statement 2002 to the National Assembly. This set out the macroeconomic context and fiscal policy considerations for the 2003/04 Budget and medium-term policy decisions.

It was announced that the priorities underlying planning for the Medium Term Expenditure Framework (MTEF) include:

- extending social assistance, health and education programmes administered by provincial governments;
- enhancing investment in municipal infrastructure and basic services in support of rural development and urban renewal strategies;
- expanding capacity in the safety sector to prevent and combat crime, including improvement of the functioning of the courts system;
- restructuring of higher education, including support for institutional mergers and investment in infrastructure;
- accelerating the land reform and land restitution programmes;
- re-engineering services to citizens provided by the Department of Home Affairs;
- increasing support for the national research and development strategy to enhance growth and technology advancement; and
- a growing international role through increased regional representation, support for the African Union and New Partnership for Africa's Development.

As indicated in Table 1, the government envisages that fiscal prudence will prevail at all levels of the public sector. The national government deficit is projected to average 2.1% of GDP over the three-year period 2003/04-2005/06 and the consolidated general government's borrowing requirement to average 2.5% of GDP. Similarly, the public sector borrowing requirement is projected to be contained at around 2.5% of GDP in the medium term.

Table1

Fiscal projections

	Revised estimates 2002/03	**Medium-term estimates**		
		2003/04	**2004/05**	**2005/06**
	In billions of rand			
National government				
Revenue	*273*	*302*	*330*	*358*
Expenditure	*292*	*329*	*358*	*388*
Deficit before borrowing	*19*	*27*	*28*	*30*
Consolidated general government borrowing requirement	18	31	32	36
Public sector borrowing requirement	18	31	33	38
	As a percentage of GDP			
National government				
Revenue	*24.3*	*24.4*	*24.4*	*24.4*
Expenditure	*26.0*	*26.6*	*26.5*	*26.5*
Deficit before borrowing	*1.6*	*2.2*	*2.1*	*2.0*
Consolidated general government borrowing requirement	1.6	2.5	2.4	2.5
Public sector borrowing requirement	1.6	2.5	2.5	2.6

The tax reforms in recent years have resulted in a consolidated tax policy regime and robust growth in government revenue. It was indicated that this would allow for a further moderate real reduction in the personal income tax burden in 2003, concentrated on lower- and middle-income earners.

The MTEF provides for real non-interest spending to grow at an average rate of 4.7% per annum and a continuous decline in debt servicing costs relative to GDP, releasing resources for spending on public services. Increased spending on health services, with special reference to a programme addressing the HIV/AIDS epidemic, was also announced in the Statement.

The MTEF places renewed emphasis on social spending, enabling increases in social grants, services provision and funds available for education and health services. The government's continued commitment to social upliftment is also evident in the envisaged growth in capital spending. The provision made for investment in new infrastructure and the rehabilitation of existing infrastructure resulted in an additional 3 billion rand earmarked for capital expenditure in fiscal 2003/04 with the upward trend expected to continue over the medium term.

The medium-term expenditure programme has injected a greater degree of predictability into government expenditure plans. There is no pressure on the South African Reserve Bank to finance government deficits. The importance of seigniorage is also limited and does not appear to have changed much in recent years. Calculated as the ratio to real GDP of the annual sum of deflated monthly changes in the money base, seigniorage fluctuated between –0.1% and 1.1% in the 1990-2001 period.

The decline in government budget deficits has had implications for the public sector borrowing requirement, which has declined substantially to around 2.5%. At the same time, although the government remains cautious about financing the deficit through foreign borrowing, increased recourse has been made to this source of finance. The combined effect of increased foreign borrowing and lower deficits has resulted in less pressure on long-term bond rates and reduced the cost of government borrowing. In fact, the declining deficit and the moderately increased foreign borrowing have led to a shortage of paper in the market, which has reinforced the downward pressure on long-term rates. Despite the increased recourse to foreign borrowing, government foreign debt ratios remain relatively low. In 2001, government foreign debt was below 7% of GDP, and 14% of total government debt.

It is clear, therefore, that with a broad and liquid bond market and continued fiscal discipline, there has been no recourse to inflationary financing of fiscal deficits, and this situation is expected to be sustained.

Coordination of monetary and fiscal policies

Although there has been little conflict between monetary and fiscal policy, until recently there has not been much explicit coordination between the monetary and fiscal authorities with respect to countercyclical policies. Apart from regular meetings between the Minister of Finance and the Governor of the Reserve Bank to discuss issues of mutual concern, standing committees have recently been set up to formalise communication and contact between the two institutions. One standing committee has among its various responsibilities the monitoring of monetary and fiscal policies.

As noted above, until recently the focus of fiscal policy had been on fiscal restructuring and the stabilisation of public debt, ensuring that the budget deficit is sustainable and increasing the efficiency of tax administration. Since 2001, fiscal policy has become explicitly more growth-oriented, and the potential for conflict with monetary policy has increased (although such conflicts are not necessarily inevitable).

Monetary policy has also not been explicitly countercyclical. Inflation targeting was introduced in February 2000. The first target for 2002 was set at 3-6% for the consumer price index excluding mortgage interest cost. When targeting was introduced, this measure was at 7.8% and rising. It turned down towards the end of 2000 and dropped below 6% in September and October 2001. Following the sharp depreciation of the rand in late 2001, the inflation rate rose substantially away from the target range, and inflation in 2002 was well above the target. Monetary policy has therefore been constrained by the objective of attaining the target and 2002 saw four successive interest rate increases of 100 basis points.

Fiscal policy over this period was tighter than expected in terms of the budget deficit, particularly in the fiscal year 2001/02. This gave room for manoeuvre in 2002 to reduce tax rates. However, this should not be seen as a specific countercyclical measure. Fiscal policy has not been explicitly countercyclical, and the tax reductions were aimed at compensating taxpayers for consistently higher than expected tax collections. If anything, the tax reductions in April 2002 worked against the monetary policy tightening of the Reserve Bank.

Conclusion

It is likely that the fiscal discipline that has been achieved in South Africa over the past few years will be maintained, despite the moderately expansionary growth-oriented focus introduced recently. Therefore, inflationary financing of the deficit is unlikely to pose a threat to monetary policy. Where the potential for tension emerges is that the relatively tight monetary policy required to meet the inflation targets could be undermined by a more expansionary orientation of fiscal policy. It is likely, however, that the recently introduced mechanisms for coordination will enable better management of this type of issue.