SPEECH BY

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ON THE

2016/17 MID-YEAR BUDGET REVIEW AND MEDIUM-TERM BUDGET POLICY STATEMENT FOR THE FY 2017/18-2019/2020 MTEF

08 November 2016

Honourable Speaker, Honourable Members,

I rise today to contribute to the 2016/17 Mid-Year Budget Review and Medium Term Budget Policy Statement for the FY 2017/18-2019/2020 MTEF as tabled in this August House by the Minister of Finance, Hon. Calle Schlettwein.

On 27 October this year, Hon. Schlettwein provided this August House with a comprehensive breakdown of Namibia's financial position. This work is commendable, as it is not customary to provide such a detailed account of our current position in the tabling of the mid-year budget review. From events that transpired since September last year, it is now obvious that a major realigning of expenditure to revenue is required. This is the stated purpose of the revised budget, allow me therefore to provide some background, according to my view, on the factors that have necessitated this move.

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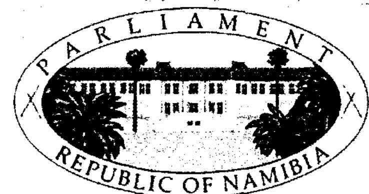

The financing constraints that Namibia is currently facing are by no means new. The first sign of a significant slowdown in economic output presented itself in the National Accounts, where the growth in Gross Domestic Product for 2015 was downgraded from 5.7% to 5.3%. This may not sound significant, but in reality it means that overall in 2015 the economy performed some 7% worse compared to 2014. That trend has not reverted, in fact during the current fiscal year, the situation has worsened.

When government started its counter-cyclical budgets in 2010, the reasons for this move were obvious. The rest of the world was in the midst of the great Financial Recession. In Namibia the signs were clear. The 2009 Fiscal Year showed a marked contraction with the economy shrinking by 1.1%. This was as a result of the direct impact of the international financial crisis.

The national budget for 2010 was designed to counter the fallout of the financial crisis and to restore growth to the Namibian economy. As mentioned often by the then Minister of Finance, Hon Saara Kuugongelwa-Amadhila, the budget was counter-cyclical meaning that Namibia grew its budget substantially at a time when most other economies were contracting. The result was an unprecedented six years of elevated economic growth. But this came at a price. Government debt exploded, from less than 16% of Gross Domestic Product, to over 40% at this point.

From all the facts available, it is clear that debt grew at a faster rate than total economic output. In any economy, this eventually inevitably leads to disaster, and this happens when the macro-economic tipping point for additional financing is exceeded and the government finds it difficult or very expensive to take on new debt. That is where we are now.

What saved Namibia in 2010 was the very modest government and national debt in comparison to Gross Domestic Product. Government debt stood at only 15.7% of GDP, the second lowest in southern Africa after Botswana, and very far from the debt levels in South Africa, Zimbabwe, Zambia and Angola. This small debt created what the

former Minister of Finance called "Fiscal Space." In the subsequent years, from 2010 to 2015, the Ministry of Finance effectively used this fiscal space to aggressively expand the budget. This inevitably led to budget deficits, all of which were financed very effectively through debt instruments in the local capital market. The result was average annual growth rates typically exceeding 5%, and even 6% in 2014, while the rest of the world stagnated or contracted. Our peers in southern Africa only posted moderate growth rates below 2.5%.

Honourable Speaker, Honourable Members,

This expansion of our debt had a tremendous impact on the local economy. GDP grew from around N$87 billion in 2010 to an estimated N$190 billion in 2016. It also grew the government's debt from the stated 15.7% level to an expected 37% according to the 2016/17 MTEF published by the minister at the end of February this year. In the National Accounts, published in August, the actual debt level came out at above 40%. This indicates that the finance ministry was well aware of the headwinds that undermined the economy this year when it published its 2016 budget just before the start of the new fiscal year. What the Ministry did not foresee, though, was the negative impact from a range of other economic variables.

The risks continued to grow during 2015, slow at first, but faster during the second half of the year. This lead to perceived higher risks on Namibian debt instruments in the South African market and the spreads between Namibian bonds and the benchmark South African bonds widened. In effect, the interest Namibia paid for its debt was higher than the similar-rated debt of South Africa. Locally, the risk on government bonds were seen to increase, leading to bigger discounts in the allotment of debt under existing bonds. In simple terms, it meant that government debt was becoming increasingly expensive. At some auctions, the lack of market participants forced the Bank of Namibia, not to allocate any new issuances.
At the end of October 2015, Namibia was already in trouble. The government's finances were only saved by the issuing of the now infamous US dollar-denominated Eurobond to the value of US$750

million. This money gave the dwindling foreign reserves a major boost, increasing reserves by some 57% while it provided the government with the liquidity it required to keep the wheels turning until the next budget. That was in February this year.

Honourable Speaker, Honourable Members,

From a policy point of view, the increase in debt was required to fund an expansion of government structures, and to start an ambitious construction programme. Were the economy to continue growing between 5% and 6%, the commensurate growth in government revenue would have maintained the fiscal integrity. When various negative factors, as I will explain later, all contributed to reduce government revenue, the result was a reduction in revenue growth and a rapid worsening of the debt to GDP ratio. This quickly brought the fiscus into a precarious position.

Honourable Speaker, Honourable Members,

<u>One can ask, What is different this year?</u>

The appropriate answer to this question comes from the Minister of Finance himself. In his budget review speech he said the **<u>fiscal space was used up</u>**.

This is exactly what happened. Our economy was beset by a number of negative factors, which had an impact on GDP leading to a lower outturn of revenue. Since expenditure remained as budgeted last year, lower revenues meant a bigger deficit. Already at the beginning of this fiscal year, the Ministry of Finance, in its published figures, assumed that total debt as a percentage of GDP for 2015, will marginally exceed 35%. During this year, as more data became available, it became apparent that last year's growth rate must be adjusted downward and that the revenue was considerably less than the budgeted N$56.8 billion. In fact it was lower by some 8%, which in budgetary terms, is a very big shortfall.

That shortfall carried over into this year with the result that the minister in his mid-year review estimated that government debt as a percentage of GDP, will probably exceed 43% if some drastic saving measures are not introduced. The need for curbing the expenditure side of the budget is what has led to the suspension and reduction by the Finance Minister, announced a little over a week ago. On this particular point, let me quote the minister to refresh our minds on the seriousness of our current predicament.

And I quote the minister:
"The overall appropriation expenditure was reduced by 7.4% (N$4.5 billion), N$3.5 billion from the Appropriation and N$1 billion reduction of interest payments. The revised Development Budget ceiling for all O/M/As fell from N$9.1 billion to N$6.5 billion, while the Operational Budget ceiling fell from N$52.1 billion to N$50.2 billion. This expenditure reduction is a response to weaker-than-anticipated levels of GDP and government revenue. With this fiscal consolidation, the forecast high deficit will be mitigated somewhat, which will support continued fiscal stability and put the public debt on a more sustainable path."

(Minister of Finance, Hon Calle Schlettwein in Parliament on 27 October 2016.)

Honourable Speaker, Honourable Members,

Government must accept responsibility for allowing such a crisis to develop, and in this regard it is deserving of severe criticism. As I pointed out in my introduction, the crisis was already apparent at the beginning of this fiscal year, as almost zero growth in budgeted expenditure attests to this. Perhaps what was not foreseen was the drastic reduction in revenue, but again, the signs were visible last year. The weakest point of the whole six-year counter-cyclical budgeting process, was the complete lack of an escape route, or an exit strategy. It was only after the tabling of this budget, when the Minister provided his first economic overview in May this year that he issued a warning of impending danger. Yet despite this no meticulously thought out

strategy was developed, save for the age old adage of the need to tighten the belts.

Honourable Speaker, Honourable Members,

Negative impact of a slowdown in the broader economy

It must be understood that if nominal GDP continued to grow as it did in the period 2010 to 2014, Namibia would not have had any problems. But it did not. For various reasons, cited by several local institutions, the economy started slowing last year, continuing into this year. In this regard, I want to borrow from the Bank of Namibia's November 2016 Economic Outlook Update. Citing worldwide economic conditions, the Bank of Namibia has stated that the global economy is projected to grow by only 3.1% this year. For this estimate, the bank has referenced the International Monetary Fund which downgraded their 2016 global economic outlook three times this year alone. Namibia will not escape the impact.

Furthermore, the Bank of Namibia stated:

1. Growth in Sub-Saharan Africa is expected to slow down to 1.4 percent in 2016 before recovering to 2.9 percent in 2017.
2. Risks to global growth have eased, following improved financial market sentiments, reduced concern about China's near-term prospects and the recent uptick recovery in some commodity prices.
3. The domestic economy is projected to slow down in 2016, before rising in 2017. Namibia's real GDP growth is projected to slow down to 2.5 percent in 2016, before accelerating to 4.0 percent in 2017. The projected growth rates represent a slowdown from the national accounts estimate of 5.3 percent for 2015. This contraction is mainly attributed to a projected decline in construction, diamond mining, [the] electricity and water sectors and the planned reduction in government expenditure.
4. Over the medium-term, growth will mainly be supported by the anticipated recovery in both agriculture and diamond mining as

well as improved growth in uranium mining, manufacturing, transport and communication.

Again, the Bank of Namibia is referencing the IMF, in the same way as Minister Schlettwein did when he offered us a breakdown of global and regional economic conditions in his mid-year review.

Honourable Speaker, Honourable Members,

While it is true that the direction of the global economy is not under our control, prudence in managing our own affairs required that we cut expenditure when it first exceeded the 40% threshold as a percentage of GDP. We should have done this last year. When expenditure reaches 40% of GDP, and debt grows faster than GDP, it is axiomatic that debt will also continue to grow as a percentage of GDP. The warning signs were already apparent in 2015. This fact is evident in this year's main budget, where for the first time, according to projections by the Ministry of Finance, the debt level would exceed 37%. This exceeds the maximum 35% debt to GDP ceiling as determined by Cabinet.

Members must make a clear distinction between the expenditure/GDP ratio and the total Debt/GDP ratio. They are not the same, but if the first deteriorates, the latter invariably follows.

Honourable Speaker, Honourable Members,

<u>On can ask, What must be done?</u>

Minister Schlettwein has been clear and unambiguous in terms of the necessary action to be taken, and I quote again:

"The key priority for the FY2016/17 Mid-Year Budget Review is to align expenditure to changes in public revenue and place public finances on a sustainable path. The elevated public debt, high budget deficits and increased liquidity constrains require timely policy response package to address these vulnerabilities. This entails implementing a three-pronged set of actions comprising expenditure

consolidation, revenue enhancement and implementing supportive structural reforms."

The Minister intends to achieve this goal by what he calls "Operational and Development Budget Suspensions." He also refers to this as fiscal consolidation, but what exactly does he mean in this regard? Essentially, what the Minister is saying, is that we need to align our expenditure with our estimated revenue for the remainder of the 2016/17 fiscal year, and that we then need to extend this realignment over the Medium Term Expenditure Framework so that we can reach a manageable, sustainable debt level in 2019. It seems Government is slowly realizing that one cannot live beyond one's means. All the while, this has to be done with the least impact on the execution of policy, which is to focus the government's spending on the core areas that are important for economic growth, social development, and supporting the most vulnerable segments of society.

In my opinion, the economy needs to regain its momentum, not through continued growth in debt, but through a decisive process of determining priorities, and then putting those areas of lowest priority, on the back-burner, or suspending them indefinitely. By suspending non-core and non-essential expenditure items, it is hoped to save N$5.5 billion, a saving that includes about N$1 billion in future interest payments.

Honourable Speaker, Honourable Members,

It will be difficult to continue suspending certain expense items without a noticeable impact on overall economic growth. If the ministry wants to save between 8% and 9% on expenditure, the impact on GDP may be as high as 12%. When the stalled growth in private sector credit extension is considered, a 12% reduction in nominal GDP growth will have a dramatic effect on the overall economy. It can lead to much bigger problems than what we now have. Once this downscaling becomes structural, i.e. structured into the value chains of the bigger economy, it will be more expensive in future to revive them, than to maintain them now.

Honourable Speaker, Honourable Members,

<u>The Perfect Storm</u>

Without repeating all the reasons for the slowdown in economic activity, let me state only the most important. The government's revenues were impacted consistently through 2015 and 2016 by the following factors:

1. Continued low commodity prices

There are many references in the mid-year review to the effect lower commodity prices have on the profitability of mining companies. Reduced profits, or even losses, mean reduced royalties and revenue for the government.

2. Implosion (47%) in diamond production

The diamond industry is the biggest contributor to government income from the extractive sector. When diamond production slumps, government revenue slumps.

3. The Impact of the drought on agriculture

Prevailing drought conditions have caused a severe contraction in agricultural output for the second year in a row. When agriculture declines, rural households suffer, putting more pressure on limited government reserves. It also affects employment in the commercial farming sector.

4. Water crisis in central areas.

The shortage of water has had a major impact on industries in the Khomas region, to such an extent that water-intensive industries have moved some of their output to South Africa. Reduced local output translates to reduced turnover and reduced profits, leading to reduced government revenue.

5. Fishing

The fishing sector is moving into its third year of declining revenues, mostly due to biological reasons. This has an impact on profit, and for

the government on revenue.

6. Mining - delay in full production ramp-up
As mentioned by the minister, operational hick-ups delayed the progress at the Husab mine, while the expansions at B2Gold will only lead to higher output during 2017.

7. SACU transfers which only grew negligibly
Namibia's cut from the revenue pool constitutes roughly one third of fiscal income. When SACU revenues decline due to a slump in economic activity in South Africa, Namibia gets less from this very important source of revenue.

8. Retail contraction in Angola due to low oil prices
Over a two-year period, crude oil came down from around US$80 per barrel to below US$50 per barrel. This had a huge impact on Angolan government revenues, which in turn, lead to a disastrous reduction in retail spending. This is having a major impact on Namibia's retail sector.

Honourable Speaker, Honourable Members,

Cumulatively, these factors have contributed to a worsening of the local economy, creating a perfect storm at a time when the economy was expected to be more robust.

Honourable Speaker, Honourable Members,

Growth Versus Inflation

A lower nominal growth rate is not necessarily bad but then inflation must be much lower, in the order of only 2% given the real growth of 2.5%. As a result of the economic stimulus from 2010 to 2014, the economy's output as a whole, doubled. Since such a large part of the government's expenses comprises personnel remuneration, liquidity in the retail sector was enhanced. In short, the very large number of people employed by the government, its offices and its agencies, poured a

massive amount of money into the system through the items they bought. As disposable incomes grew, so did retail sales, and more importantly, installment sales. This lead to a very high level of indebtedness of ordinary working families. During 2013 this figure came close to 90% but has receded to around 88% this year. But even at 88%, it is still very high. It shows that only 12% of disposable income is available to families for discretionary spending after all the monthly payments have been made.

To prevent further growth in household indebtedness, the Bank of Namibia started increasing interest rates. From the middle of 2014 to the first quarter of this year, the so-called repo rate increased from 5.5% to 7%. This added to the economic pressure from the resultant decrease in retail sales and installment sale transactions. I do not need to point out to you how precarious installment sales have become. Just talk to any car dealer and you will know that new vehicle sales have lost more than 40% of its momentum during 2015 and 2016.

The difficult conditions for households are further illustrated by the gradual decline in new credit to the private sector. In this regard, let me borrow from a recent report by PSG Namibia, a local investment management company.

I quote:

"Private sector credit extension (PSCE) growth ticked lower in September, mainly as a result of a decline in demand for credit from the residential sector. Therefore, PSCE growth remains on a broadly downward trend as August's slight rebound proved to be short-lived. PSCE growth decreased from 11.3% year on year in August to 11.1% year on year in September. Growth in credit extended to businesses picked up by a 100 basis points to 12.7% in September, while credit growth to individuals moderated by 70 basis points to 9.7%. The growth in mortgage credit, which accounts for more than 50% of total PSCE, slowed to 10.2% in September, compared to 10.6% in the preceding month."

Honourable Speaker, Honourable Members,

It is very important to take note of this trend. Families are borrowing less, or at a much slower rate. It indicates that the majority of Namibian families are overextended and now have to consolidate their debt. This is more or less the same position the government is in. It also shows that the explosive growth in the housing market is coming to an end as reflected by the considerable reduction in the demand for mortgage financing.

Honourable Speaker, Honourable Members,

Desperate Measures - Certificates of Good Standing

The Ministry of Finance issued this directive in August, that as from 01 September 2016 all Government departments, agencies and offices will refuse to settle accounts with private suppliers were these are not able to furnish Certificates of Good Standing. This lead to an immediate freeze in SME cash flows and the Ministry of Finance quickly had to rethink its strategy. On 22 September 2016, the Certificate of Good Standing policy was dropped overnight. Government resumed paying its accounts but some agencies like the Roads Authority are still under severe funding constraints. Although the drastic measure was necessary, and from what I read, very effective, it undermined credibility.

Suspension of infrastructure projects

The comprehensive list of reductions and suspensions at the end of the mid-year review, indicates that this revision has been done diligently and with a consideration of the detail of every single intended project. However, this will have a major impact on the construction sector and may lead to a second year of contraction. One also needs to consider who will be those hardest hit by such a suspension, namely those employed in the construction sector who are low earners and therefore fall into the low-income group, in other words, the poor will suffer the worst.

Debt Stabilization

This is the first and most pressing priority. This can only be achieved if GDP grows faster than debt. The budgeted total expenditure for this year is N$66 billion. Saving N$5.5 billion on this figure will reduce total expenditure to just above N$60 billion. But it will have a restraining effect on economic growth and it may turn out, that the debt to GDP ratio remains above 40%.

Development Finance Institutions

This strategy mentioned by the Minister of Finance needs more careful consideration. Many of the projects that feature in the capital budget, can be transformed to Public Private Partnership which will relieve a lot of pressure on the primary budget.

Honourable Speaker, Honourable Members,

In my opinion, Namibia does not find itself at the horizon of a financial black hole. The problems we are experiencing are mild compared to the debt and financing problems of Europe's periphery. In an African context, the Namibian economy ranks high, with productivity being one of its strongest pillars despite our small population and our small economy. I see the months ahead more as a financing challenge than an economic output challenge. As the Minister rightly said, local output will improve as more and more capital projects come on stream. For us, it is a matter of finding appropriate, affordable financing. Once the momentum is restored, financing should be much easier, allowing us to return to our primary policy interventions to build the Namibian economy.

Honourable Speaker, I support the Bill.