PRESENTATION TO THE PORTFOLIO COMMITTEE ON INTERNATIONAL RELATIONS AND COOPERATION

PROCESSES TO ALLEVIATE THE IMPACT OF FOREIGN EXCHANGE FLUCTUATIONS ON THE DEPARTMENT OF INTERNATIONAL RELATIONS AND COOPERATION BUDGET

Presented by: Gillian Wilson | 12 October 2016

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Table of contents

Budget performance overview

- In 2015/16, the Department of International Relations and Cooperation spent R6.6 billion or 101.7 per cent of its total adjusted appropriation of R6.5 billion, which represent an overspending of R112 million for the financial year

- The overspending is primarily due to exchange rate fluctuations in the last six months of the financial year which affected key expenditure items linked to the diplomatic missions abroad as well as an increase in membership contribution fees payable to multilateral organisations and foreign government institutions

- Foreign exchange exposure risk is significant and material owing to foreign services and transfers to foreign government and institutions

- Foreign services related expenses and transfers to foreign government and international institutions accounted for R4.8 billion or 73.8 per cent of the available budget in 2015/16

- Movements in the exchange rates have reduced purchasing power of available allocations

- The Rand depreciated considerably in response to developments in domestic and external environment

Budget performance overview

- The impact of fluctuations in currency are such that there were substantial variations between Rand denominated appropriations (fixed/budgeted rate) and foreign currency denominated transactions (spot or prevailing rate), resulting in a budgeting shortfall

- In 2015/16, the department received R720 million as supplementary funding for the differences between exchange rate projections used when the department compiled its budget and the foreign exchange rate realised when processing payments

- In addition, the department cost containment efforts on travel and subsistence, accommodation and restrictions on the number of delegations for the African Union and the Forum on China-Africa Cooperation Summits had reduced related expenditure and led to the realisation of R49.6 million in savings which were utilised to offset some of the shortfall

Operational areas of foreign exchange exposure

(i) Foreign services dispensation

- The annual cost of living adjustment (COLA) review is jointly determined by the Department of Public Service and Administration and Department of International Relations

- Other entitlements are in terms of expenses incurred with regard to schooling of dependent children, medical and related services, accommodation, hardship and travel allowances

- There are currently over 776 South African transferred officials abroad, consisting of DIRCO officials and officials from partner departments who are eligible in terms of the stated benefits and allowances under the foreign services dispensation policy and therefore representing the affected personnel

- Payments of goods and services and accommodation for transferred officials are incurred in foreign currency

Operational areas of foreign exchange exposure

(ii) Locally Recruited Personnel (LRPs) staff establishment

- Locally recruited personnel (LRPs) refers to the support and administrative services staff of a mission
- Services rendered include immigration clerks, housekeeping, library, interpretative and translation services, communication and marketing
- In the majority, LRPs are non-South African citizens whose basic conditions of employment are typically not complementary to those prescribed in terms of the South African public service but in line with the labour laws and regulations of the host country. This presents disparities in terms of length of service, conditions for termination of service (e.g. retirement age) and therefore resulting in rather ambiguous exit strategies being employed per locality
- In 2015/16, the department LRPs head count stood at 1 698 posts and accounted for R616.4 million or 9.5 per cent of total appropriations per cent as salaries, benefits and allowances

Operational areas of foreign exchange exposure

(iii) Operating payments: foreign office leases and municipal rates

- The department has a rented property portfolio consisting of +700 properties
- The rental and related costs incurred by the department are substantial and have attributed to the shortfall in funding during 2015/16
- Presently, the department spends an approximated R962 million per annum on operational leases for rented chanceries, residences and housing where no state owned accommodation is available in a specific country
- This category of expenses represent one of the operational areas of the department that are susceptible to fluctuations in the currency
- Inadequate regulatory frameworks, the absence of market established pricing models have subjected the department to unfair industry practices and exploitation. This is particularly prevalent within the African market where the rental housing industry is primarily controlled by monopolies and cartels who charge astronomical fees . The existence of such unfavourable conditions have exacerbated the funding pressures

Operational areas of foreign exchange exposure

(iv) Maintenance and refurbishment of state-owned international property portfolio

- The department manages a state-owned international property portfolio consisting of 133 offices and residential accommodation, with a current estimated market value of +R4.6 billion

- Most of these properties were acquired in the 1930s and 1940s, in the European and America regions

- Maintenance, upgrading and refurbishment costs incurred are substantial due to ageing infrastructure

- In 2015/16, the department spent over R209.3 million towards the acquisition of new infrastructure and development of land; funding existing infrastructure development, maintenance, renovation and refurbishment of state owned chanceries, official residences and staff accommodation

Operational areas of foreign exchange exposure

(v) Transfers to foreign governments and international organisations

- Spending towards transfers to foreign governments and international organisations amounted to R766.6 million (or 104.4 per cent), against an available budget of R734.3 million.
- This is due to an increase in spending resulting from the implementation of the new scale of assessments for the African Union (AU); inflationary-related increases in transfers to the Southern African Development Community (SADC) and the United Nations (UN)

Calculation of 2015 Budgeted exchange rates

Exchange rates			
Currency	2015 Budget	Departmental	Variations
Rand per US$	11.53	9.27	(2.26)
Rand per Euro	13.72	11.76	(1.96)
Rand per UK pound	17.93	14.11	(3.82)
Rand per JYen	0.11	0.09	(0.02)
Swiss Franc*	14.20	10.07	(4.13)

* Swiss Franc did not form part of the macro-forecasts used by National Treasury Economic Policy. Assumed budget rate of 14.20 Rand/Swiss franc is the prevailing rate at the time of compiling the 2015 Budget .

- Calculating discrepancies between the budget exchange rates assumed by the department and the 2015 Budget rates
- Understated budget means less US dollars purchased, therefore increased budget shortfall
- The exchange rate projections utilised by the Department in its original budget calculations were substantially below market projections

Management of foreign exchange movements and associated impact

Government-wide foreign exchange management

In August 2011, government approved the foreign exchange management framework to provide measures for the management of foreign currency exposures and the risks associated with changes in the rates of exchange between currencies

Implementation of the framework was suspended due to the level of system reconfiguration that would be required to accommodate the use of the a budget or fixed rate to convert departmental transactions at the SARB as well as due to concerns on the potential misrepresentation of the Balance of Payments (BoP) reporting system.

Currently, the National Treasury maintains two US dollar accounts on behalf of government with the SARB, namely the Foreign Currency Investment and Foreign Currency Accumulation Accounts to process all government foreign currency transactions and commitments

Payments are converted using a spot rate and charged against the relevant departmental (e.g. DIRCO) Paymaster-General (PMG) accounts

Budgeting

Foreign exchange profits or losses are treated on-budget

Therefore, government no longer recognise or records related transactions as extraordinary payments and receipts in the National Revenue Fund.

Shortfall in funding due to movements in the exchange rates are considered as part of the annual budget adjustment process

Management of foreign exchange movements and associated impact

Fiscal framework

The National Treasury introduced the expenditure ceiling in the 2012 Budget as a refinement of the MTEF introduced in 1998. The expenditure ceiling targets a nominal limit on main budget non-interest expenditure – the core spending over which government has direct legislative authority.

The allocations made through the MTEF provide an agreed-upon baseline from which departments prepare budgets. The expenditure ceiling is a measure that monitors and manages departmental spending levels in the context of a constrained fiscal framework.

The nominal expenditure ceiling implies difficult trade-offs when higher-than-expected outcomes exceed forecasts. This then implies that the purchasing power of budgeted allocations will decline .

The most significant risk to the fiscal framework would a breaching of the main budget nominal non-interest expenditure ceiling. Breaching the ceiling erodes credibility of the fiscal framework and has implications for the budget deficit targets

Accounting

The Office of the Accountant General (OAG) in the National Treasury has developed and issued the Modified Cash Standard (hereafter 'the Standard') which is generally recognised accounting practice (GRAP) for departments and sets out the principles for the recognition, recording, measurement, presentation and disclosure of information required in terms of the prescribed formats.

Cash payments arising from a transaction in a foreign currency should be recorded in South African Rand by applying at the spot exchange rate between South African Rand and the foreign currency to the foreign currency amount at the date of the cash flow.

Management of foreign exchange movements and associated impact

Departmental foreign exchange risk management

Whilst departments are prohibited in terms of Section 66 (2) of the Public Finance Management Act from engaging in explicit exchange rate hedging arrangements without the prior written approval of the Minister of Finance.

Departments should :

5.1 Ensure adequate internal risk exposure management systems: set of controls that efficiently and effectively manage the risks associated with transacting and recording foreign exchange

5.2 Develop appropriate and accurate early warning systems and mitigating measures

5.3 Prudent financial affairs of the department and cash flow management, <u>therefore avoid unauthorised expenditure</u>

Proposals on the management of foreign exchange risk

6. Policy consideration

The department needs to identify long-term measures , policy reforms and strategies to offset the impact of the weakening Rand. This may require:

- Rescheduling of existing foreign infrastructure projects. Develop a strategy to reduce maintenance costs of foreign properties
- Review of the foreign service dispensation basket of goods and services
- Reduction of voluntary membership fee contribution transfer payments
- Rationalisation of the locally recruited staff establishment. Consider a strategy that combines layoffs, including the suspended filling of vacant LRP posts and abolishment of redundant posts. Rightsizing and negotiate possible exit strategies with affected employees.
- Long-term view and strategic rationalisation of missions and descaling of services. Reducing the number of posted officials to affordable levels. Re-structure the establishment in missions according to standards and principles set by the Public Service Act.
- Implementation of cost containment measures on travel and subsistence, accommodation and restrictions on the number of delegations attending multilateral meetings and engagements abroad.

African Renaissance and International Cooperation Fund

- The ARICF primarily derives its revenue from Parliamentary appropriations and secondarily from interest generated from investments in the South African Reserve Bank's Cooperation for Public Deposits
- Over the audited period, revenue had declined from R390.1 million in 2014/15 to R289.4 million in 2015/16, at an annual average rate of 25.8 per cent due to Cabinet approved reductions of R530 million over the medium term on transfers to the Fund
- In 2015/16, the ARICF received R145.6 million in transfer payments from government
- Expenditure for local and foreign aid assistance decreased from R208.8 million in 2014/15 to R199.2 million for 2015/16
- Expenditure mainly provided for the economic stimulus package to Cuba (R110 million); the Timbuktu Manuscript Project (R7.2 million); technical support of the third general elections of Burundi (R38 million) and the deployment of the Cuban medical brigade in Sierra Leone (R3.9 million)
- At 31 March 2016, the Fund had a net cash flow from operating activities of R133.3 million. And closed its financial books with a cash and cash equivalent balance R2.3 billion

THANK YOU