national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

SOUTH AFRICA RELEASES THE 2007 ARTICLE IV REPORT

Introduction

Article IV reports are a result of bilateral discussions between the IMF and its member countries about economic and financial information as well as the country's economic development policies. The IMF currently has 185 member countries. The report provides crucial information such as the country's macro-economic situation, including developments in the monetary, fiscal and financial sectors of the economy. Of critical importance to the discussions are six key elements namely; GDP growth, fiscal position, balance of payments, exchange rate, labour market issues and monetary policy.

Assessment of the current economic environment

The overall assessment of the Report is optimistic about robust growth, rising employment and further improvement of the fiscal position and foreign reserves. There is agreement between South African authorities and the IMF about these economic prospects.

Real GDP growth is projected by the IMF at 4.8 percent for 2007 and 4.5 percent for 2008, from 5.0 per cent in 2006. The National Treasury has a more optimistic growth projection of about 5 per cent based on stronger capital formation and employment growth as well as continued strong total factor productivity (TFP) growth.

According to the Fund, the rapid growth in capital accumulation envisaged in ASGISA could relieve the most pressing capacity constraints (particularly in electricity and transport networks), whereas productivity-enhancing structural reforms could further raise the potential growth rate of the economy. The National Treasury projects GDP growth of around 5 per cent over the short to medium term. Over the longer-term, we also expect the potential growth rate of the economy to rise.

The Report notes that the continuation of considerably more rapid growth in domestic demand relative to domestic supply undermines the sustainability of the current growth path. The mismatch between demand and supply is reflected in South Africa's significant current account deficit and rising inflation. While we generally agree with that view, inflationary pressures are also being driven by adverse food and energy price developments. These should start to abate over the next year, lowering the contribution of food and energy price inflation to overall inflation. Government will also continue to raise its investment in infrastructure, thereby helping to alleviate capacity constraints and product price inflation. Furthermore, the SARB has frequently made public its approach to second round price pressures.

The Report noted that the current account deficit reflects a private sector savings-investment imbalance and that rising investment (leading to capacity constraints and rising imports of basic inputs such as cement and steel) becomes an increasingly important driver of the deficit. Over the longer term the increased capacity should reduce the demand for import goods, whilst raising export competitiveness.

Government is confident that the higher current account deficit is a short to medium term phenomenon caused primarily by rising domestic investment and secondarily by healthy household consumption driven by rising real incomes. It is expected that capital inflows will remain high in the medium term, as the South African economy continues to grow rapidly.

The widening of the current account deficit and high reliance on portfolio equity inflows relative to other emerging market economies have raised vulnerability to external shocks (e.g. a weaker appetite for emerging market assets, a substantial rise in global interest rates or a sharp decline in commodity prices) and to a “sudden stop” in capital flows. A deteriorating international environment combined with South Africa’s significant current account deficit has led government to increase domestic savings through a stronger fiscal position.

The Report notes that SA’s strong fundamentals (including a flexible exchange rate regime and low external debt compared to other emerging market economies) should mitigate the impact of adverse external shocks on the economy. According to the IMF, external debt would remain below 30 percent of GDP even if the current account deficit increased by 1 percent of GDP over the next five years. South Africa and the IMF agree on the need to continue prudent fiscal and monetary policies in order to improve external vulnerability.

The Report identifies the following causes of high unemployment:

- Rapid growth of female and unskilled labour supply, in combination with a structural shift in labour demand towards skilled labour;
- Long distances between places of residence and places of work, which raise the cost of job search and (in combination with the system of social grants) raise reservation wages; and
- Labour market regulations and practices that discourage job creation.

Assessment of current government economic policy

The IMF is supportive of the economic policies of the South African government.

The Report supports the Government's efforts to address the challenges of high unemployment and poverty while aiming to preserve macroeconomic stability. The IMF supports targeted initiatives to reduce unemployment but suggests that these initiatives should be evaluated to ensure the efficient allocation of resources.

The Report favours the identification and revision of labour market regulations and practices that limit job creation and recommended further initiatives to liberalise and simplify the trade regime. Efforts to improve productivity, raise employment levels, and improve real earnings levels are important goals of policy. Trade and labour market policy initiatives, such as tariff simplification or efforts to raise productivity should be identified by government.

The IMF cautioned against the possible economic distortions that could arise from the new industrial policy framework. The Fund noted that the framework was too broad, with the potential of having unintended conflicting objectives and too many interventions. The National Treasury recognises that interventions should be directed at changing market incentives faced by private and public firms, based on identified market failures or regulatory needs, subject to independent evaluations, and limited in duration.

The government's continued sound fiscal policies and improved public finances were commended by the IMF as a means of raising the level of government savings in order to mitigate the risks associated with the widening current account deficit. The Report is also positive about the focus of government expenditure – the upgrading of infrastructure and relieving pressing social needs.

Continued revenue buoyancy, as the Fund indicates, should be treated cautiously in future fiscal decisions, implying further increases in public sector saving and a somewhat slower growth in real government expenditure. The balance of allocations will continue to reflect the importance of public infrastructure development to the economy over the long term.

The Fund continues to support South Africa's approach to reserve accumulation and the desirability of further accumulation.

The Fund further supports reforms aimed at strengthening old-age income security and initiatives that reduce social and wealth disparities**.** These are important to improving the potential for people to engage in economic activity and enter the labour market.

The IMF notes that South Africa's financial sector is strong, resilient, sound and well regulated. The Report regards the continued enhancement of regulation and oversight in the financial sector as a useful means of maintaining stability in the context of the risks arising from rapid credit growth and the recent increase in household indebtedness. The IMF commended government's attempts to improve access to basic financial services by the poor, especially in non-urban areas.

The Fund continues to support the use of the inflation targeting framework as a means of anchoring inflation expectations in the economy.

Whereas ASGISA identified the volatility of the rand as a potential constraint on growth in exports, the IMF supports Government's approach of allowing the exchange rate to absorb negative economic shocks alongside a gradual and steady increase in foreign exchange reserve accumulation. Government believes that this is an important part of ensuring the stability and sustainability of growth in the domestic economy. The IMF found little evidence of significant exchange rate misalignment. Improving the competitiveness of the South African economy can only be permanently achieved through efforts to raise productivity and reduce costs of domestic factors of production.

The Report also supports the continued gradual relaxation of exchange controls which could improve the allocation of resources and help to reduce exchange rate volatility through deeper foreign exchange markets.

A copy of the full report is available on the National Treasury website at http://www.treasury.gov.za and the International Monetary Fund's website at http://www.imf.org

Issued by National Treasury

06 August 2007