September 2006
IMF Country Report No. 06/327

South Africa: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for South Africa

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 24, 2006 with the officials of South Africa on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of August 2, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 2, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for South Africa.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with South Africa

(In consultation with other Departments)

Approved by Michael Nowak and Adnan Mazarei

July 7, 2006

- The 2006 Article IV consultation discussions were held in Pretoria and Cape Town May 10-24, 2006. The mission met with the Minister of Finance, the Governor of the South African Reserve Bank, senior officials, and representatives from Parliament, business, trade unions, and the financial and academic communities.

- The staff team comprised Messrs. Lizondo (head), Cuevas, and Harjes (all AFR), Ms. Nkusu (PDR), Mr. Debrun (FAD), and Ms. Lukonga (MFD). Messrs. Arora and Burgess, the Senior and Deputy Resident Representatives in Pretoria, participated in the work of the mission.

- At the time of the 2005 Article IV consultation, Executive Directors commended the authorities for the remarkable economic progress achieved over the previous decade through sound macroeconomic policies and structural reforms. They noted, however, that serious economic challenges remained, including persistently high unemployment, widespread poverty, and large wealth disparities. Directors supported the authorities' approach to dealing with these problems through policies aimed at raising economic growth within a stable macroeconomic environment.

- Economic data for South Africa are generally of good quality and are provided to the Fund and the public in a timely manner. South Africa subscribes to the SDDS and publishes all data on the reserves template.

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Appendices

GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ARV	Anti-retroviral drugs
ASGISA	Accelerated and Shared Growth Initiative for South Africa
BEE	(Broad Based) Black Economic Empowerment
CMA	Common Monetary Area
CPI	Consumer Price Index
CPIX	CPI excluding the interest on mortgage bonds
EFTA	European Free Trade Association
EMC	Emerging market country
EPA	Economic Partnership Agreement
EU	European Union
FSAP	Financial Sector Assessment Program
FSB	Financial Services Board
FTA	Free Trade Agreement
JIPSA	Joint Initiative for Priority Skills Acquisition
MFN	Most Favored Nation
MOU	Memorandum of Understanding
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
ROSC	Report on the Observance of Standards and Codes
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SDDS	Special Data Dissemination Standard
SDS	Skills Development Strategy
SMEs	Small-and-medium-sized enterprises
TDCA	Trade Development and Cooperation Agreement
WTO	World Trade Organization

EXECUTIVE SUMMARY

Background

South Africa's recent economic performance has been strong. Real GDP growth reached 4.9 percent in 2005 and 4.2 percent in the first quarter of 2006, employment has risen, and inflation has remained within the target band for over two and a half years. The fiscal deficit fell from 1.5 percent of GDP in FY2004/05 to 0.3 percent in FY2005/06, reflecting buoyant revenues. However, the current account deficit rose to 4.2 percent of GDP in 2005, and further in early 2006. Owing to large capital inflows, international reserves continued to rise. Increased risk aversion in global financial markets in recent months led to rand depreciation, a correction in stock prices, and slightly higher sovereign spreads.

The economic outlook is largely positive. The main short-term risks arise from a possible worsening of the external environment. Unemployment, poverty, and inequality remain major challenges.

Policy discussions

Staff expressed support for the authorities' overall strategy, which seeks to spur growth and address social concerns while preserving macroeconomic stability.

Staff supported the plans for boosting investment in infrastructure and selected social programs over the next few years, which would imply a moderate expansionary fiscal impulse to the economy. Fiscal policy remains consistent with a declining path of public debt through the medium term.

Staff concurred with the Reserve Bank's assessment of the upside risks to inflation, on the basis of which the policy interest rate was raised in June 2006. Further interest rate adjustments may be needed to keep inflation within the target band over the medium term. The inflation-targeting regime continues to gain effectiveness and credibility, and staff suggested additional steps to further this trend.

The authorities remain committed to the flexible exchange rate, intervening only to increase reserves at times of rand strength. Under this policy, reserves buildup continued in 2005 and early 2006. Staff agreed with the authorities' view that there is room for a further increase in reserves. Staff also favored continued relaxation of capital controls, to be done at times of relative rand stability or strength.

The banking system is sound and well regulated. Near term prospects are favorable but pressures could emerge if interest rates rose markedly. The authorities are fully aware of these risks. There is progress in improving access to banking services by the poor and aligning regulations to international standards.

Staff supported the authorities' efforts to identify and address constraints on economic growth through the emerging Accelerated and Shared Growth Initiative for South Africa. Although the level and volatility of the exchange rate have been identified as possible constraints, there was agreement that the current flexible exchange rate system has served the country well and should be maintained.

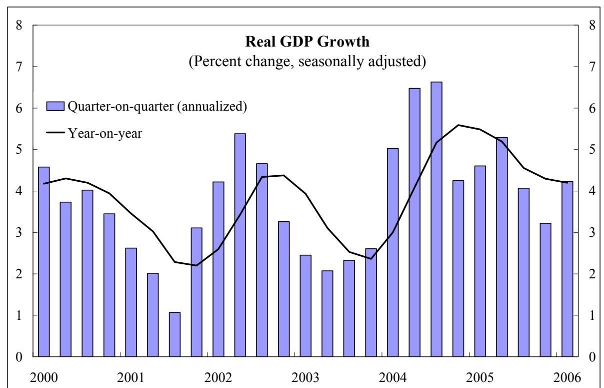
Staff supported efforts to increase employment, and favored further discussions among stakeholders to revise those labor market regulations and practices that may limit job creation. Staff also supported recent steps to simplify the trade regime and recommended further liberalization.

Staff expressed its support for official programs to address wide income and wealth disparities, including the broad-based Black Economic Empowerment and land reform initiatives.

I. Recent Economic and Policy Developments

1. **South Africa's recent macroeconomic performance has been strong owing to sound policies and a favorable external environment**. The current expansion is the longest on record. In recent years, rising commodity prices and improved sentiment in emerging markets contributed to strengthening the rand, which in turn eased inflationary pressures and permitted a large reduction in interest rates. As a result, South Africa experienced strong growth in domestic demand and output. Robust economic activity contributed to a further reduction in the fiscal deficit. However, expanding domestic demand led to a widening of the current account deficit, which was more than offset by capital inflows. Meanwhile, inflation remained within the target band. Asset prices rose rapidly, but the recent increase in risk aversion in global financial markets seems to have stopped that trend.

2. **Real GDP grew by 4.9 percent in 2005, the highest rate in over two decades**. Growth was driven by strong domestic demand, with private consumption and investment spending supported by continued low interest rates and improved sentiment.[1] Household consumption was also boosted by rising incomes and wealth effects from buoyant housing and stock prices. Public sector investment and consumption grew at healthy rates.



Source: South African Reserve Bank (SARB).

3. **Output continued to grow briskly in 2006**. After a slowdown in late 2005, partly reflecting temporary supply shocks, real GDP grew by 4.2 percent in the first quarter of 2006.

4. **The strong pace of economic activity led to employment gains**. Total (formal and informal) employment grew by 5.7 percent in the year to September 2005. However, the unemployment rate remained broadly unchanged at 26.7 percent, as labor force participation rose significantly during this period.

5. **Inflation and inflation expectations remained well within the 3-6 percent target band**. Twelve-month CPIX inflation was 3.7 percent in April 2006, though administered fuel price increases are likely to push it up in the near future.[2] Core inflation (CPIX excluding

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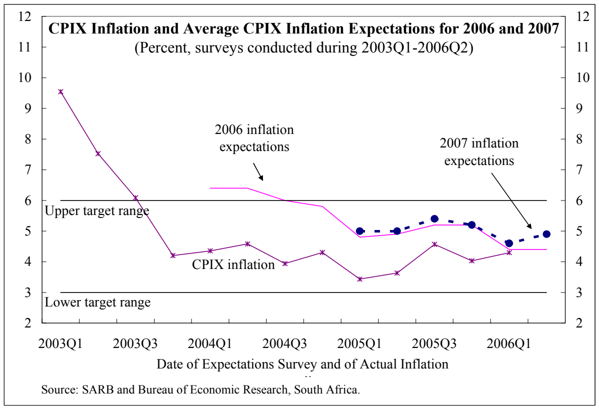
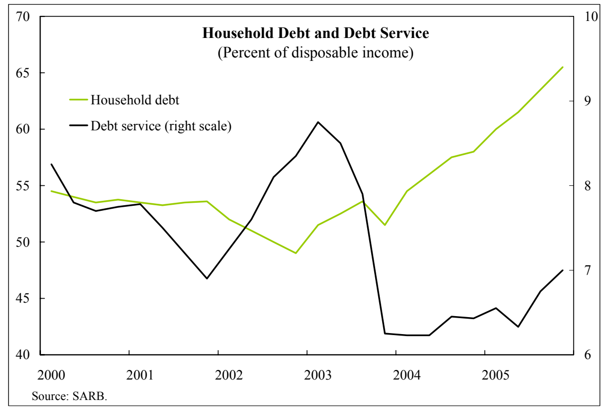
[1] Between mid-2003 and April 2005, the policy interest rate (repo rate) was lowered by a cumulative 650 basis points, to 7 percent. The rate was then kept unchanged until June 2006, when it was raised by 50 basis points.

[2] The CPIX—the measure targeted by the SARB—excludes interest payments on mortgage loans.

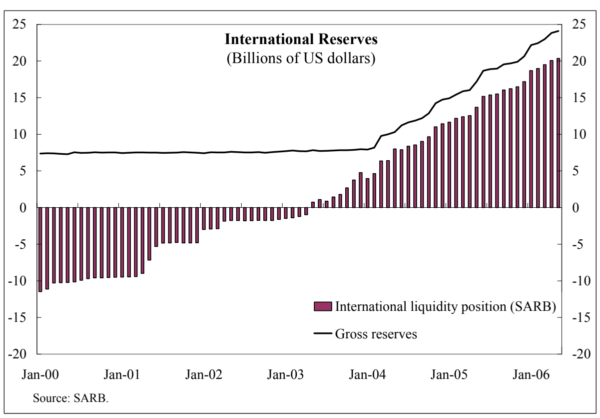
food and energy prices) remained subdued at about 3 percent. Expected average CPIX inflation rates for 2006 and 2007—measured on the basis of surveys conducted in April—were slightly above the mid-point of the target band.

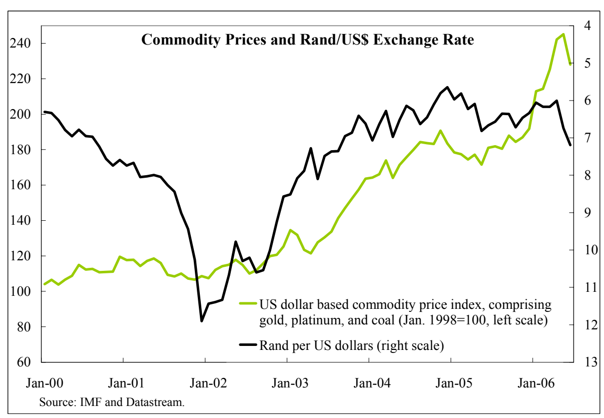




6. **Credit to the private sector has continued to grow rapidly**. Supported by low interest rates, M3 and credit to the private sector both expanded by 23 percent in the year to April 2006. While household sector debt rose markedly (from 58 percent of disposable income at end-2004 to 68 percent by the first quarter of 2006), household debt service remained moderate, at about 7 percent of disposable income.

7. **The South African Reserve Bank (SARB) has maintained a flexible exchange rate system, while continuing to build up international reserves**. The SARB has a publicly-announced policy of intervening in the foreign exchange market only to build up reserves at times of rand strength. Consistent with this policy, gross reserves have continued to grow; by May 2006, they reached US$24.1 billion, equivalent to over 200 percent of short-term external debt (or close to four months of imports).

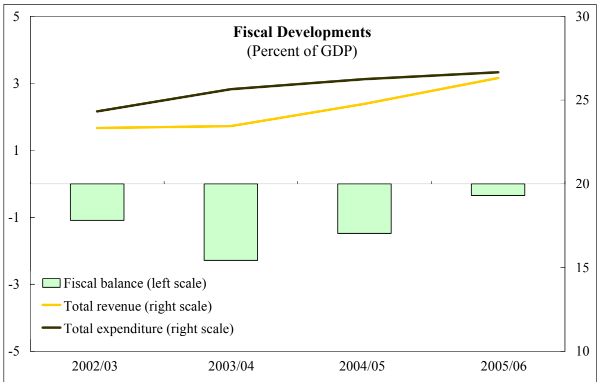




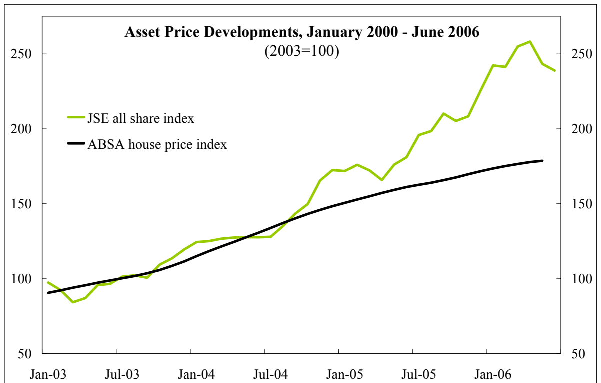
8. **After appreciating for a few years, the rand showed no clear trend in 2005 and has depreciated sharply in recent months**. Like other emerging market currencies, the rand came under pressure following the recent turbulence in global financial markets (Box 1).

9. **The current account deficit widened markedly in 2005 and early 2006, largely driven by strong domestic demand**. After reaching 4.2 percent of GDP in 2005, the current account deficit increased to 6.4 percent of GDP in the first quarter of 2006. With terms of trade broadly unchanged, the widening of the current account deficit mostly reflected volume growth in imports above that of exports, and large dividend payments to foreign shareholders. The deficit was more than covered by portfolio and FDI inflows. External debt declined to 19.3 percent of GDP by end-2005, from 20.2 percent a year earlier.

10. **The fiscal deficit fell to 0.3 percent of GDP in FY2005/06 from 1.5 percent a year earlier, bringing government debt down to 34.1 percent of GDP**.[3] The narrowing of the deficit mainly reflected a large increase in tax revenue, owing to strong economic activity and firm enforcement. As in most recent years, tax revenue was notably higher than anticipated in the budget. The cyclical part of the revenue increase seems to have been relatively small.[4]



Source: SARB.



Source: ABSA and Datastream.

11. **Asset prices continued to rise rapidly in 2005 and early 2006, but retreated somewhat in May and June**. Strong commodity prices, investor interest in emerging markets, and favorable growth prospects drove the Johannesburg Stock Exchange all-share index up by 43 percent in 2005 and a further 16 percent through April 2006, before it slid back during the emerging market sell-off that started in May. Residential property prices rose strongly in recent years, favored by low interest rates and a growing demand by an emerging black middle class. The rate of increase, however, slowed to 16 percent in 2005, from 33 percent the previous year, and slowed further in the first few months of 2006.

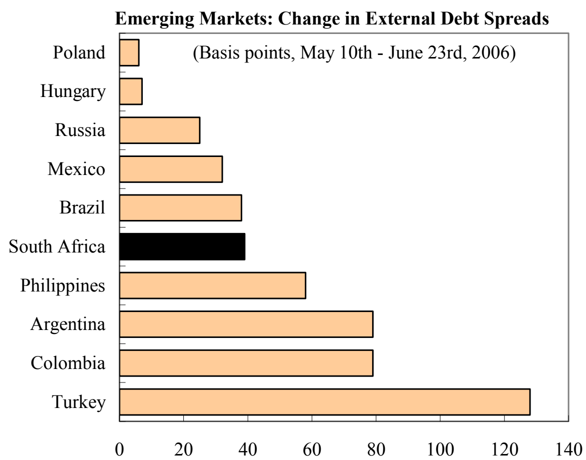
[3] The fiscal year ends in March.

[4] Chapter IV of the Selected Issues Paper presents estimates of cyclically adjusted balances for South Africa, which help separate the effects of economic fluctuations, from those of policy changes, on the deficit.

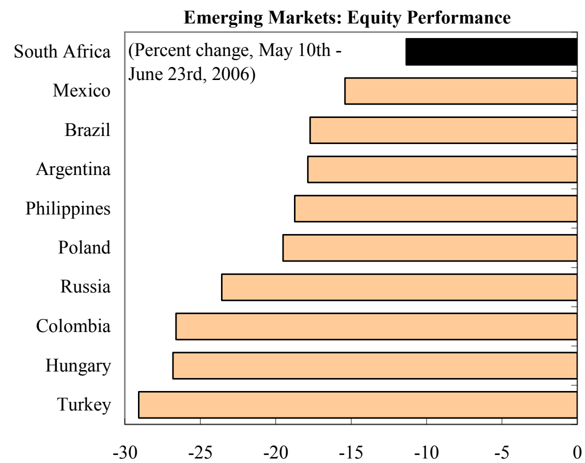
Box 1: Recent Developments in Financial Markets

Recent turmoil in global financial markets has had a significant effect in emerging market countries (EMCs), including in South Africa. Their currencies have come under pressure, their stock markets have fallen and their sovereign spreads have widened. Individual country experience, however, has differed widely across EMCs.

South Africa's stock market has held its ground relatively well compared to other EMCs and its sovereign spreads have risen modestly. Valued in local currency, South Africa's stock market retreated less than markets in most other EMCs, although it had also gained less earlier in the year. Also, South Africa's sovereign spreads rose only by about 40 basis points.

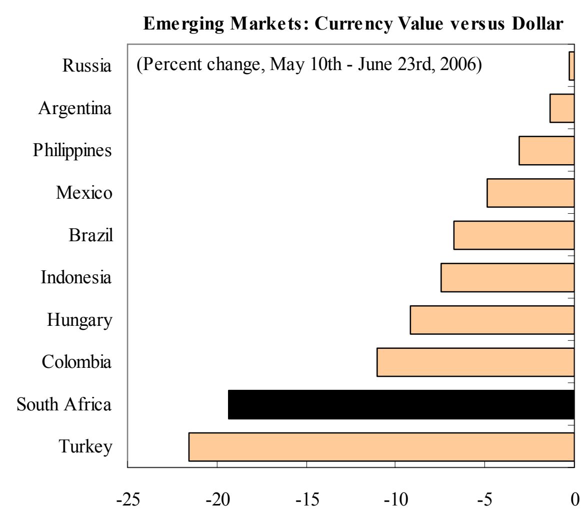


Source: Bloomberg.



Source: Bloomberg.

The rand, however, depreciated sharply against major currencies. It is difficult to explain such a sudden sharp decline on the basis of a single factor. Possible reasons, whose relative importance is hard to assess, include: (i) the current account deficit widened markedly in early 2006, raising South Africa's vulnerability to changes in international investor sentiment; (ii) prices for key South African export commodities weakened since mid-May; (iii) capital flows to South Africa have included large portfolio flows, which slowed down in June; and (iv) reportedly, some investors tend to sell short the rand at times of heightened volatility to cover their exposure to EMC currencies with less liquid markets.



Source: Bloomberg.

II. Policy Discussions

12. **South Africa has made remarkable economic progress since apartheid ended in 1994**. Skillful macroeconomic management and structural reforms have led to faster economic growth, lower and more predictable inflation, stronger public finances, a sound financial system, and an improved external position. The country has emerged as a driving force in the region and its stronger economic performance has benefited the rest of Africa.

13. **The country, however, still faces important economic and social challenges**. Unemployment and poverty remain high, wide income and wealth disparities persist, and the HIV/AIDS epidemic is severely undermining society's welfare.

14. **The government is currently formulating its Accelerated and Shared Growth Initiative for South Africa (ASGISA)**. This initiative seeks to achieve higher sustained economic growth, markedly reduce unemployment and poverty, and address other urgent social needs. The strategy is to remove the most binding constraints on growth, while preserving macroeconomic and financial stability.

15. **Against this background, the discussions with the authorities focused on:**

- Economic outlook and vulnerabilities;
- Macroeconomic policies and financial sector issues;
- ASGISA and other structural reforms to increase potential growth;
- Initiatives to reduce poverty and large wealth disparities;
- Regional spillover effects of developments in South Africa.

As in consultation discussions over the last several years, staff and the authorities were broadly in agreement regarding macroeconomic and, to some extent, structural policies.

Box 2: Summary of Previous Consultation Discussions

In previous consultations the Fund has generally shared the authorities' views on fiscal policy, inflation targeting, exchange rate policies, international reserves management, and exchange control liberalization. On structural policies, the Fund has supported South Africa's fiscal reforms, trade liberalization, and initiatives to reduce unemployment. It also encouraged revising aspects of labor legislation that constrain job creation, but progress in this area has been difficult, and the authorities continue to sponsor dialogue among stakeholders on the subject. The Fund considered that privatization, within an effective regulatory framework, could help enhance the efficiency of state-owned enterprises, but the authorities have favored an approach that focuses on the restructuring of large enterprises, together with the sale of their non-core assets. The Fund has also recommended further liberalization and simplification of the trade regime. While there has been some progress in this area, the authorities indicated that decisions on tariff levels would be considered in the context of the current multilateral trade negotiations.

A. Economic Outlook and Vulnerabilities

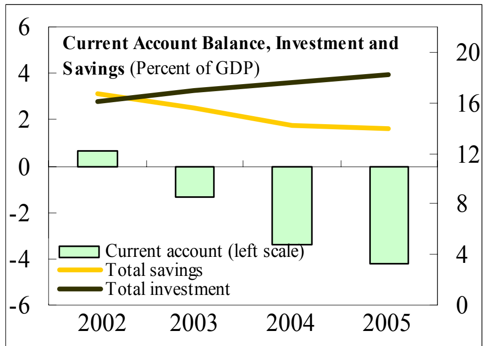
16. **The authorities and staff agreed that South Africa's short-term prospects remained broadly positive, although subject to risks from the external environment**. Several indicators suggest that growth will remain robust, with continued support from both public and private sector domestic expenditure. Staff projects output growth of 4.2 percent in 2006 and 4 percent in 2007, with an increase in the current account deficit in 2006 that should be partially reversed in 2007. Staff considers that inflation will rise from current levels and, given the recent depreciation of the rand, risks breaching the upper limit of the band. The authorities projected moderately higher economic growth than staff did. The authorities' baseline discussed with staff, prepared before the recent weakening of the rand, envisaged inflation to rise from current levels while remaining within the band.

17. **The main short-term risks to the positive outlook come from the external environment**. A disorderly adjustment of global imbalances or another hike in oil prices could slow growth globally, including in South Africa, especially if accompanied by a sharp fall in commodity prices. A more immediate risk would be the continuation of the slowdown of capital flows to emerging markets, which has contributed to a large depreciation of the rand. If the rand continues to weaken, resulting inflationary pressures may require substantial interest rate increases to keep inflation within the band over the medium-term. Under such a scenario, asset prices could drop and dampen economic activity through negative wealth effects. The banking system could be affected by the slowdown in activity and by a deterioration in household balance sheets, particularly because household mortgage debt at variable interest rates has risen rapidly in recent years. South Africa's vulnerability to external shocks has increased as a result of the widening current account deficit, but the country's strong fundamentals should help limit the adverse impact on the economy (Box 3). On the domestic side, rising household indebtedness presents some risks of its own (Box 4).

18. **Staff projects output growth of 4 percent over the medium term**. In view of South Africa's strong growth performance and upward revisions to GDP data for the years 1998-2004, staff estimates potential output growth at 4 percent. Since it is based on historical GDP data, this estimate may not fully capture the impact of ongoing structural changes. Successful implementation of further structural reforms, including under ASGISA, may also push this rate higher. Under the staff's baseline scenario, the fiscal deficit is projected to stay at about 2 percent of GDP and the current account deficit would gradually narrow after 2006 and stabilize at around 3.5 percent of GDP. The debt position appears sustainable under a variety of shocks; in most staff stress tests, government debt remains below 40 percent of GDP and external debt below 22 percent of GDP (Appendix IV).

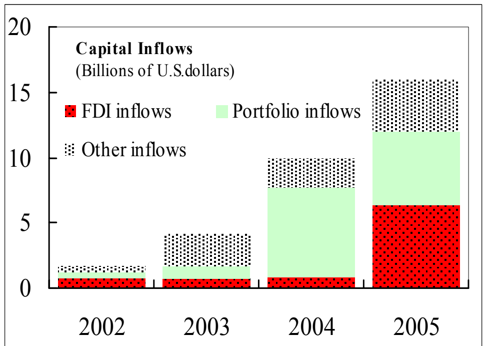
Box 3: Is South Africa Prepared for a Slowdown in Capital Inflows?

Current account. The deterioration in the current account balance in recent years reflected both a sharp increase in private consumption and higher private and public investment.



Source: SARB.

Capital inflows. Current account deficits have been easily financed by capital inflows, enabling the South African Reserve Bank (SARB) to steadily increase its international reserves. These inflows have recently been dominated by equity flows and in 2005 included a large foreign direct investment transaction when U.K.-based Barclays took over one of the four largest South African banks. Strong capital inflows have fueled an appreciation of the rand, which contributed to the current account deficits.



Source: SARB.

Risks to the capital account. The strong capital flows to South Africa of the last few years pose the risk of a marked slowdown—as seen in May-June in the context of a global rise in risk aversion and a partial retreat in commodity prices. Persistence of such a slowdown could put additional pressure on the rand, possibly requiring an interest rate hike to prevent a deterioration of inflation prospects. South Africa's ability to face these risks may be influenced by several factors that appear positive on balance. Nonetheless, lasting unfavorable external conditions could still affect South Africa.

- *Liquidity position.* A strong liquidity position should moderate adverse changes in investor sentiment and might help mitigate their impact. In the last several years the SARB has steadily increased its gross international reserves. In May 2006, reserves reached US$ 24 billion, over twice the amount of short-term foreign currency debt.

- *External debt.* As of end-2005, South Africa's external debt-to-GDP ratio was relatively low at 19 percent; foreign currency-denominated external debt was equivalent to only 12 percent of GDP.

- *Exchange-rate regime.* Fixed exchange rates may encourage excessive foreign exchange exposure, invite runs, and leave authorities without good exit strategies. Flexible regimes like South Africa's tend to discourage currency mismatches in private balance sheets and help absorb external shocks.

- *Financial sector.* In the major crises of the 1990s, banks that were poorly regulated, supervised and capitalized engaged in excessive lending, and made the crises more explosive through large currency mismatches. In contrast, South Africa's banking system is well regulated and sound. Banks balance sheets, however, remain sensitive to interest rate increases (Box 4).

B. Macroeconomic Policies and Financial Sector Issues

Inflation Targeting and Interest Rate Policy

19. **The inflation-targeting regime has continued to be implemented successfully and gain credibility**. Inflation has remained within the 3-6 percent target band for over two and a half years, and inflation expectations fell close to the mid-point of the band by early 2006.

20. **The authorities were satisfied with the current inflation targeting framework**. Staff suggested that, within the band system, the SARB explicitly target the mid-point of the band over the medium term to further anchor inflation expectations and help keep inflation within the band. The authorities, however, thought that the current regime had been working satisfactorily and were concerned that the staff's suggestion could be misinterpreted as a commitment to keep inflation continuously at the mid-point. Staff considered that this concern could be addressed by a clear communication of the proposed change in policy.

21. **The SARB has taken further steps to enhance the transparency of monetary policy**. It has started a peer review process of its macroeconomic forecasting model by international and local academics. It has also broadened the information provided in the Monetary Policy Committee's statements, including quantitative inflation forecasts. Staff suggested further expanding the forward-looking analysis in the SARB's *Monetary Policy Review*, mainly by providing more detail on the expected path of variables, like the output gap, that play an important role in the medium-term inflation forecast.

22. **Staff shared the SARB's view that the risks to the inflation outlook were on the upside**. On the one hand, CPIX inflation was below the mid-point of the band, inflation expectations were well contained, and unit labor costs had increased moderately. On the other, however, continued strong domestic demand growth, increasing oil prices, and a depreciating rand were likely to put further upward pressure on prices. Moreover, in the staff's view, the sustained rapid growth in credit and monetary aggregates suggested that monetary policy was somewhat expansionary.

23. **On June 8, the SARB raised the repo rate by 50 basis points.** The SARB projected that—with the repo rate remaining unchanged at 7 percent—CPIX inflation would breach slightly the upper limit of the target band early next year before coming back towards the mid-point of the band over the medium term. Continued weakness of the rand could put additional pressure on prices and require further adjustments in the repo rate. In recent weeks, inflation expectations—based on the yield differential between indexed and non-indexed bonds—have risen towards the top of the band, and forward markets are pricing in further increases in interest rates in the period ahead.

International Reserves, Exchange-Rate Policy and Capital Controls

24. **Staff supported the authorities' plans for some additional accumulation of international reserves**. Determining an optimal level of reserves on the basis of a cost-benefit analysis is challenging, particularly because of the difficulties in measuring the benefits of holding reserves. International reserves in South Africa as of end-2005 were broadly in line with the level indicated by a demand-for-reserves equation estimated by staff on the basis of cross-country data.[5] At the same time, however, a direct comparison of the country's reserves with those of a broad group of emerging economies suggests that South Africa's reserves, though comfortable in terms of short-term external debt, are relatively low in terms of other indicators, such as imports or GDP. Staff, therefore, shared the authorities' view that some additional accumulation would be warranted, but not urgent.

South Africa: Indicators of Reserve Adequacy at End-2005

		Other emerging markets[1]	
	South Africa	All countries	Independent float[2]
	(In percent, unless otherwise indicated)		
Ratio of international reserves to:			
Short-term debt[3]	184.2	147.5	118.1
Short-term debt plus current account deficit[3]	97.2	97.6	114.5
GDP	8.6	16.6	14.8
Imports of goods and services (in months)	3.6	4.9	5.1
Broad money	12.0	33.7	31.5

Source: Country authorities and IMF staff estimates.

[1] Median values for a group of 49emerging market countries chosen based on their access to international capital markets and their high level of financial development.

[2] Countries with independently floating exchange rate regime as defined by the IMF Annual Report on Exchange Arrangements and Exchange Restrictions (2005).

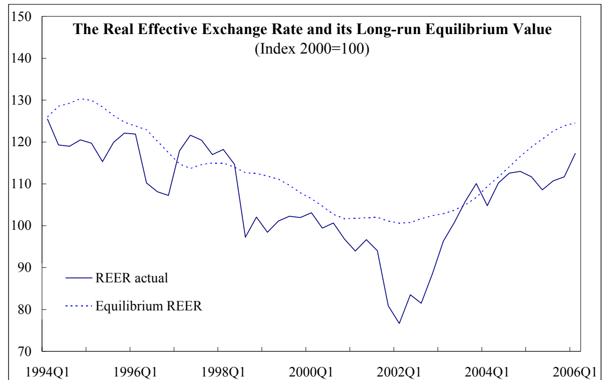
[3] Short-term debt at remaining maturity.

25. **Staff considered that the level of the exchange rate was broadly in line with macroeconomic fundamentals going into the recent period of heightened volatility**. [6] Following the rand's recovery from its steep depreciation in 2001/02, the trend appreciation of the rand was mainly driven by the positive trend in commodity prices. During May and June of this year, the rand weakened sharply, touching levels last observed in 2003 and early

[5] See Chapter III of the Selected Issues Paper.

[6] This observation and the associated figure are based on an estimated long-run equilibrium exchange rate that depends on macroeconomic fundamentals that include commodity prices, the fiscal balance, net foreign assets, the degree of openness, and the productivity and interest rate differentials with respect to South Africa's main trading partners. For details, see MacDonald, R. and Ricci, L., 2003, "Estimation of the equilibrium exchange rate for South Africa", IMF Working Paper, WP/03/44.

2004. The direction of the movement was in line with the recent weakening in commodity prices and deterioration in the external balance. However, it is difficult to draw definitive conclusions about the appropriateness of the current level of the rand on the basis of such short-term developments.



Source: SARB and IMF staff estimates.

26. **The authorities intend to continue liberalizing capital controls gradually**. They said that the steps taken in recent years had not led to major capital outflows or sustained pressures on the rand. The primary remaining restrictions comprise ceilings on portfolio outflows for institutional investors, prohibition of portfolio outflows by corporations, and ceilings on individuals' offshore investments. The authorities plan to replace quantitative limits on institutional investors with prudential regulations as part of broader reforms of the long-term insurance and pension funds industries. Staff supported continuing to relax controls, to be done at times of relatively rand stability or strength. Further progress in this area would allow greater diversification and, by deepening the foreign exchange market, could help reduce currency volatility over the medium term.

Fiscal Policy

27. **Thanks to structural reforms and successful fiscal adjustment in the late 1990s, South Africa's fiscal position is strong**. Over the last several years, the impact of strong expenditure growth on the deficit was offset by declining interest payments and revenue gains resulting from robust economic growth and improvements in revenue administration. Despite capacity constraints at the provincial and municipal levels, expenditure has generally been well targeted at social and infrastructure needs, in line with the objectives of accelerating growth and reducing poverty. Tax policy is generally sound, aiming at reducing tax rates while broadening the base.

28. **Fiscal discipline is firmly anchored in the medium-term expenditure framework and strong revenue performance**. The 2006/07 budget provides for a moderate stimulus. The deficit of the national government would increase by 1.2 percentage points of GDP, to 1.5 percent, mainly because of additional spending on economic infrastructure, education, health, welfare, housing, and community development, as well as improvements in administrative capacities and service delivery. On the revenue side, the budget reflects income tax relief for small businesses and individuals, and the removal of some distortionary municipal levies. The authorities' fiscal plans seem appropriate in view of the country's pressing social needs and emerging infrastructure bottlenecks. Staff projects a slight increase

in the deficit to about 2 percent of GDP by 2008/09.[7] These deficits are consistent with a further decline in the debt-to-GDP ratio over the medium term.

29. **The authorities do not expect capacity constraints to delay the planned increase in public sector investment**. Staff expressed some concerns that economy-wide shortages in certain skills, as well as reported complexities in some administrative processes (including procurement) could delay the execution of capital expenditure programs, especially at the subnational level. The authorities indicated that skills shortages were the main reason for underspending in provinces and municipalities (especially in rural areas where skilled professionals were harder to retain) and pointed to initiatives being introduced to address these shortages.

30. **There is progress in several areas of public sector policy**. Work on improving revenue forecasting is proceeding well; the new forecasting model for the corporate income tax is being tested and a value-added tax model is in preparation. The transfer of social grants administration to a national agency should improve service delivery. Also, the restructuring of state-owned enterprises is moving ahead, and proceeds from the sale of non-core assets will help finance the increased capital expenditure planned by some of these enterprises.

Financial Sector

31. **South Africa's financial system remains sound, supported by a favorable economic environment**. As of March 2006, banks' average capital adequacy ratio was 12.6 percent, well above the statutory minimum of 10 percent, non-performing loans amounted to only 1.3 percent of total loans, and provisioning remained at adequate levels (Table 7). Pension funds and collective investment schemes performed well on the back of what were, until recently, bullish equity markets. The insurance industry also maintained strong solvency ratios, but suffered an erosion of public trust owing to certain consumer protection and transparency problems uncovered last year, and is now facing intense competition from other financial institutions that provide savings products.

32. **Near-term prospects for the banking system are favorable, but pressures could arise if interest rates increase markedly** (Box 4).[8] The authorities are fully aware of the potential risks and are monitoring the situation closely. The banking system's exposure to

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[7] Official projections show somewhat lower deficits, reflecting an assumption of higher GDP growth.

[8] A recent Fitch report indicated that South Africa's banking system faced high macroprudential vulnerability due to the rapid growth in credit and asset prices, and the appreciation of the rand over the previous few years, but that the system was strong, and thus in a good position to deal with a deterioration of loan quality that might result from higher interest rates.

exchange rate risk is relatively low, given its small net open foreign exchange position and low shares of foreign-currency denominated deposits and loans.

33. **Intense competitive pressures and narrowing margins in the banking sector are encouraging innovation and presenting new challenges for regulators**. These innovations include cell phone banking, alliance with retail shops on the lending side, increased credit card issuance, and the emergence of asset-backed securities. Also, as part of their risk management, the large banks are active in the expanding derivatives market. The authorities have been assessing the risks of these new products and markets, and have been introducing appropriate regulations and legislation.

34. **The large banks, which account for about 90 percent of the banking sector, have sophisticated risk management systems, and bank regulation and supervision have been strengthened considerably**. The SARB is developing an econometric framework to assess the impact of macroeconomic events on credit risk. Staff suggested complementing these efforts with stress tests based on detailed information on individual institutions. The regulatory framework for supervision is being reviewed in preparation for Basel II, and banks are expected to comply with the January 1, 2008, deadline for implementation.

35. **The authorities have continued to make progress with financial sector initiatives to improve access to financial services for the poor**. Commitments to increase access are defined in the Financial Sector Charter. Banks have introduced low-cost ("Mzansi") accounts, which have been expanding rapidly, and Mzansi money-transfer facilities; similar low-cost insurance products are expected. Other significant developments include the introduction of legislation to enhance consumer protection, and the planned introduction of the regulatory framework for institutions specialized in basic financial services.

36. **The authorities were receptive to participating in an FSAP update for South Africa, and later in a regional FSAP, but the timing and scope need to be defined**.[9] The FSAP update would be very useful given important developments in the industry in recent years. A regional FSAP focused on stability and developmental subjects would also help identify and address issues of common interest to countries in the region.

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[9] South Africa's FSAP was completed in 2000. Several of its recommendations have been implemented, and others are being considered in the context of the review of the regulatory framework in preparation for Basel II.

Box 4. South Africa: Household Debt and Financial Stability

Household indebtedness has increased significantly but the debt servicing burden has remained low, helped by low interest rates. Increased consumer demand, and the slack in credit demand from cash-flush corporates, have led to high growth of home loans, vehicle financing, credit card and other personal loans. At end-2005, household credit amounted to the equivalent to 40 percent of GDP and accounted for 53 percent of total loans. Household debt reached 68 percent of disposable income by March 2006, but debt-servicing costs remained at 7 percent of disposable income.

Mortgages account for the bulk of household debt. Mortgage loans increased by 59 percent over 2004-05, and are equivalent to 85 percent of the total household credit. This increase is explained by: low interest rates; rapid real income growth; a growing black middle class; demographic shifts in favor of younger people; and efforts to make financing available to lower income groups (all of which have led to the emergence of new borrowers); and reduced taxes on property transfers.

The residential mortgage market is evolving along the lines of many developed markets in terms of greater competition, rising lending volumes and the emergence of third party mortgage brokers. As in some other developed markets such as the UK, the majority of loans carry variable rates (with the few that are fixed typically reverting to variable rates after one or two years). Other innovations, such as the flexible mortgages incorporating access or redraw facilities, allow borrowers to draw on their mortgages to finance other consumer activities. Mortgage originators have promoted increased competition for borrowers among banks and have led to compressed margins. Securitization has emerged as an alternative borrowing instrument for lenders.

These trends in consumer lending bear similarities with trends in other emerging markets, especially in Asia.

Household Debt Indicators for South Africa and Selected Asian Economies, as of end 2005

(In percent)

	Consumer loans/GDP	Consumer loans/Total loans	Mortgages/household loans	Gearing ratio
South Africa	40	53	85	66
Korea	44	49	51	44
Hong Kong SAR	57	41	80	...
Singapore	48	50	34	...
Taiwan Province of China	60	...	...	91

Source: Fitch Ratings Special Report March 7, 2006 , "*Managing Growth - The Challenge of Consumer Lending in Asia*"

The legal and regulatory environment is being strengthened. The legal process for residential mortgage foreclosure is well defined and relatively short, but the cycle from default to realization can take over 15 months. The recently issued regulatory framework for securitization of credits allows for capital relief only when the transfer constitutes a true sale.

The exposure of the banking system to interest-rate risk and a correction in property prices has increased in recent years: (i) The higher debt to income ratio and the prevalence of mortgages with variable interest rates imply that borrowers' debt-servicing capacity has become more sensitive to interest rates increases; (ii) the relatively low debt-servicing cost figure is based on aggregate data, and thus could mask pockets of weakness if debt is narrowly held, especially among lower income groups; (iii) default rates have declined and remain low, but some borrowers have not yet experienced a full interest rate cycle and problems could develop as rates rise; and (iv) with some lenders granting mortgages equivalent to the property value, they could suffer some collateral deficiencies if house prices fall.

Household defaults could have wider macroeconomic implications. While banks are well capitalized and should be able to absorb some deterioration in their loan portfolios, they could become much more conservative in their lending decisions, which may have a significant impact on household consumption.

C. Structural Policies

ASGISA

37. **While growth increased substantially over the past decade, it has not been sufficient to markedly reduce unemployment and poverty**. With this in mind, the authorities have launched the Accelerated and Shared Growth Initiative for South Africa (ASGISA), which aims to raise the rate of GDP growth to 4½ percent through 2009 and 6 percent during 2010-14 and halve the rates of unemployment and poverty by 2014. The authorities have begun to identify the binding constraints on growth and design policy measures to address them (Box 5).

38. **At a general level, the ASGISA growth targets appear reachable**. While staff estimated potential output growth at 4 percent under current policies, the authorities thought it could be higher. It was agreed that a precise estimation was difficult, as the economy was undergoing structural changes. In any case, the pickup in growth necessary to achieve the ASGISA targets does not seem out of line with the experience of countries that enjoyed "growth accelerations."[10]

39. **While ASGISA identified the level and volatility of the exchange rate as possible constraints on growth, both the authorities and staff agreed that the current flexible exchange rate system has served the country well and should be maintained**. While expressing concern about how past appreciation of the rand was affecting some sectors' ability to grow, the authorities considered, rightly, that the real exchange rate is not something that they could or should try to control. They also restated their commitment to increasing competitiveness through measures that raise productivity and reduce costs.[11] They saw volatility of the rand as a deterrent to investment but have not yet proposed specific measures to reduce exchange rate volatility, other than the continued accumulation of foreign exchange reserves. Staff found no compelling evidence to suggest that the exchange rate level and volatility were constraining growth. In addition, staff noted that the accumulation of international reserves so far and the consolidation of macroeconomic stability more generally had helped reduce somewhat the volatility of the exchange rate since 2001 to levels that are not far out of line with the experience of other emerging markets. Moreover,

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[10] South Africa's growth performance and growth targets are discussed in Chapter I of the Selected Issues Paper.

[11] A detailed discussion of competitiveness issues was included in the staff report for the 2005 Article IV consultation with South Africa (IMF Country Report No. 05/346). It indicated that South Africa's share of world export markets had remained broadly constant since the mid-1990s, but in volume terms it had declined. Survey-based indicators suggested the need to enhance education, availability of skilled labor, and infrastructure quality.

exchange rate flexibility can help the economy adapt more smoothly to significant external shocks.[12]

Box 5: Accelerated and Shared Growth Initiative for South Africa

Although ASGISA is still a work in progress, it has identified six key constraints to growth and is formulating proposals to address some of them: [1]

1. The level and volatility of the exchange rate. The volatility of the rand is thought to be deterring investment in tradable goods and services that are not commodity-based. The rand has also been perceived in some official circles as overvalued in the sense that economic resources have been diverted into narrow areas of investment.

2. Inadequate infrastructure and logistics. The government plans to invest the equivalent of about 20 percent of 2005 GDP over the next three years on: (i) transport, communications, and power provision, by public enterprises; (ii) housing and social institutions; and (iii) provincial projects (in agriculture, mining, and other areas).

3. Skills shortages. Measures in this area include the Joint Initiative for Priority Skills Acquisition (JIPSA)—a new committee with representatives from government, business, labor and education, tasked with identifying and addressing urgent skills shortages. The immediate focus will be on the skills needed for infrastructure development, public service delivery, and sectors identified under ASGISA as priorities (e.g., tourism).

4. Barriers to entry and competition. Competition policy is being reviewed to find ways to reduce input costs and promote "downstream" sectors like metal fabrication, machinery, and plastics. Discriminatory pricing practices that favor exports over domestic markets (so-called import parity pricing) have been targeted. Duties on certain steel products, for example, have been removed to facilitate greater import competition.

5. The regulatory environment. A current review includes plans to introduce one-stop shops for starting businesses, a system for analyzing regulatory impact, and improved planning at provincial and local levels. The Environmental Impact Assessment system will also be reformed.

6. Capacity limitations within government. Project Consolidate aims to improve provincial and local administration, including through the deployment of skilled professionals where they are most needed. Development finance institutions will also be reviewed.

Other initiatives being considered under the ASGISA framework include.

- *Sectoral investment and industrial strategies.* A number of sectors have been ear-marked for special support, starting with outsourcing and tourism (together expected to create half a million jobs). Investment in research and development will also be supported.
- *"Second economy" interventions,* including support for small and medium-size enterprises (SMEs) and Black Economic Empowerment through, for example preferential procurement; improved access to small-scale credit; and the provision of employment through the Expanded Public Works Program. The impact of labor laws on SMEs is also being reviewed.

[1] The government has consulted with a range of stakeholders, including a panel of international academic experts who will provide further advice over the next two years. For more details, see http://www.info.gov.za/asgisa/

[12] Chapter II of the Selected Issues Paper discusses exchange rate volatility in South Africa.

40. **The other ASGISA-identified constraints are considered in official and private circles to be critical for growth in South Africa, but most of them are outside the Fund's core area of expertise**. For instance, further infrastructure investment is clearly needed, but the specific allocation of additional investment is a microeconomic question. The same applies to competition and regulatory issues.[13] Staff therefore supported the authorities' efforts to address these constraints, but did not express a view on the specifics of the measures being considered or their likely impact on growth. At a broad level, staff suggested that there be a closer link between planned interventions and the ASGISA-identified constraints on growth to better target and prioritize growth-enhancing policies. Regarding the new industrial strategy being developed, staff suggested that interventions be transparent in order to avoid regulatory capture and ensure accountability, and that they be limited in duration (for instance with built-in sunset clauses), as any supported activity should ultimately be self-sustaining.

Labor Market

41. **A number of factors have contributed to South Africa's high unemployment rate**. Educational, economic, and geographical segregation during the apartheid regime left large parts of the population with poor skills, without economic resources or entrepreneurial experience, and away from urban centers—thus raising job-search costs and reservation wages. The skills problem was accentuated by a shift in labor demand toward skilled labor due to structural changes in the economy. Also, labor force participation rose significantly in the initial years post-apartheid, making it difficult for the economy to absorb all the new entrants into the job market. In addition, some labor market regulations and practices have raised labor costs and thus restricted job creation. The contribution of each of these factors, however, is difficult to ascertain.

42. **The authorities have introduced several initiatives to reduce unemployment**. These include: amendments to labor legislation in 2002, to increase flexibility in some employment conditions; the Skills Development Strategy (SDS), to enhance skills through training and learnerships; the Expanded Public Works Program, to provide temporary employment and on-the-job training in infrastructure and other projects; and measures to promote SMEs, which are labor intensive. Staff supported these initiatives. It also suggested removing the earmarked payroll levy that has been used to fund the SDS, and financing this program from general budget resources. This would reduce the cost of labor to firms.

43. **Employment could also be supported by revising labor market regulations and practices that discourage job creation**. Investors and employers' surveys indicate that

[13] Some of these areas, including the allocation of infrastructure investment, public enterprise reform, existing investment incentives, and public sector service delivery, are being supported by the World Bank.

some regulations reduce incentives to provide employment. In particular, dismissal procedures are complex and costly. Addressing this problem may require not only changes in regulations but also educating stakeholders, because some costs seem to arise from a misinterpretation of legal requirements. Centralized collective bargaining in some sectors, by which agreements between employers' representatives (usually large firms) and unions are "extended" to other firms in the sector, prevents smaller firms from negotiating agreements that reflect their own circumstances. The magnitude of the adverse impact of this practice on employment deserves further study.[14] More generally, staff favored using current discussions on labor market regulations that hamper SMEs to identify and revise regulations and practices that limit job creation more broadly. Also, staff suggested that in setting minimum wages due account be taken of their effect on employment.

Trade Policy

44. **South Africa' s trade regime was liberalized significantly in the 1990s, but recent progress has been more limited**. Over the last couple of years, the trade regime was simplified somewhat by a wider use of ad valorem duties. The number of tariff peaks (tariff lines carrying tariff rates above 15 percent) has been reduced, but remains rather high. The weighted average tariff rate has declined, partly reflecting the simplification of the tariff structure and the impact of preferential trading arrangements, but little progress has been made in reducing tariffs on a most favored nation (MFN) basis.

45. **Staff considered that further liberalization would enhance competition and support growth**. The authorities stated that South Africa' s tariff structure was not especially complex compared to those of other emerging markets or its trading partners. They also indicated that any revision of the structure would depend on the outcome of the Doha round and the conclusions of their industrial policy review.

46. **The authorities expressed support for multilateral trade liberalization efforts and also restated their plan to pursue further preferential trading arrangements**. They noted limited progress in multilateral trade negotiations, including under the Doha round. As a result, South Africa and its partners in the South African Custom Union (SACU) have pursued a number of preferential trade arrangements.[15] Agreements have been reached with the European Free Trade Area (EFTA) and Mercosur. South Africa's SACU partners and three other countries in the area are negotiating an Economic Partnership Agreement (EPA)

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[14] On the one hand, centralized collective bargaining at present covers a relatively small share of workers and a majority of the requests for exemptions are reportedly granted, suggesting that the impact on employment may be limited. On the other, the small share of workers in sectors under centralized collective bargaining could also be interpreted as the consequence of a significant adverse impact on employment in these sectors.

[15] Members of SACU are Botswana, Lesotho, Namibia, South Africa, and Swaziland.

with the EU, with South Africa participating in the negotiations as an observer.[16] Discussions between SACU and the US are also ongoing but have proved difficult. Other preferential trading arrangements, including with China and India, have been posited but no formal negotiations have yet been launched. Staff restated its position in favor of agreements that are broad-based, with simple and non-restrictive rules of origin, so as to limit trade diversion and complement multilateral liberalization.

D. Social Issues

47. **Official programs to address wide income and wealth disparities include the broad-based Black Economic Empowerment (BEE) and land reform initiatives**. Staff supported the thrust of these initiatives, which are important to enhance social cohesion and maintain broad support for sound economic policies.

48. **BEE is moving forward**. This program seeks to empower the black population though several channels, including voluntary sector-specific charters that set targets for several empowerment indicators such as black ownership, black participation in management, and skills development for black employees. The government takes into account progress toward these targets in its decisions regarding procurement, the granting of certain licenses, and other interactions with the private sector. The government plans to enact codes of good practice that clarify BEE implementation rules and thus reduce uncertainty for firms and investors. Staff thought it might be useful to assess the benefits and costs of the various empowerment programs so as to identify the most effective ways to ensure that the benefits of empowerment are distributed as broadly as possible.

49. **The land reform program is expected to become more proactive**. Progress with land reform has been relatively slow. The program, launched in 1994, set a target of 30 percent of agricultural land under black ownership by 2015. However, only 4 percent is under black ownership at present, partly due to delays in reaching agreement with current land owners under the "willing-buyer/willing seller" approach taken so far. A new approach being defined is expected to involve greater reliance on expropriation. The authorities stressed that land reform will continue to be grounded in well-defined legal principles. Staff agreed on the importance of avoiding measures that could erode confidence in the economy, and suggested that the new approach take into account the potential impact on agricultural output, and be made public as soon as feasible to reduce uncertainty in this area.

50. **South Africa has made progress towards the Millennium Development Goals (MDGs), but significant challenges remain, including in relation to HIV/AIDS**. Literacy

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[16] South Africa already has a bilateral trade agreement with the EU, the Trade Development and Cooperation Agreement (TDCA). The aim is to align the EPA with the TDCA to the extent possible.

and the provision of basic amenities have improved substantially, but other social indicators like child mortality and life expectancy have been adversely affected by HIV/AIDS, which has an estimated prevalence of 17-21 percent among the adult population.[17] The government has been expanding its program to provide anti-retroviral drugs (ARV) to the public. As of end-March 2006, a cumulative 130,000 patients were or had been under treatment through this program, up from 50,000 a year earlier. Given complementary efforts by the private sector, it is estimated that coverage of the public program would have to increase to 250,000 patients to provide universal access to ARVs.

51. **The economic impact of HIV/AIDS is uncertain**. Estimates of the adverse effect on annual growth rates range from ½ to 2½ percentage points. The major effects result from lower labor productivity, loss of labor, and higher production costs (including health costs). In recent surveys, a majority of firms in the mining, manufacturing and transport and storage sectors have reported such problems.

E. Regional Spillovers

52. **Because of the relatively large size of its economy and its growing linkages with other sub-Saharan African economies, developments in South Africa could have significant spillover effects on the region and the continent**.[18] South Africa accounts for well over one-third of sub-Saharan African GDP on a purchasing power parity (PPP) basis and nearly 40 percent of GDP at market exchange rates. During the period since 1980, South Africa has accounted for nearly a third of the expansion in sub-Saharan African GDP (PPP basis) and economic growth in South Africa and in the rest of sub-Saharan Africa have moved in tandem, with a correlation coefficient of over 80 percent.

53. **Trade and financial linkages between South Africa and the rest of the continent have grown since 1994, but they are substantial primarily for neighboring countries**. In Lesotho and Swaziland, trade with South Africa accounts for around 75 percent of total merchandise trade; on average for other sub-Saharan African countries it accounts for only 2¼ percent. Also, for the period 1998-2004, the stock of South African investment in Lesotho, Mauritius, Namibia, Mozambique, and Swaziland, averaged about 10 to 20 percent of those countries' GDP, while in sub-Saharan African countries as a whole it averaged 5 percent.

54. **South Africa's policy linkages with neighboring countries are also tight**. The currencies of Lesotho, Namibia and Swaziland are pegged at par to the rand through the

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[17] *UN 2006 Report on the Global AIDS Epidemic, Annex I.*

[18] The discussion of trade and financial linkages and of spillovers below draws on previous work by the staff, published as Arora and Vamvakidis, 2005, "The Implications of South African Economic Growth for the Rest of Africa," *South African Journal of Economics,* Vol. 73:2, June.

Common Monetary Area (CMA) Agreement with South Africa.[19] This has helped keep inflation low and reduce interest rates in the smaller countries, and brought closer financial integration across the region. At the same time, however, the appreciation of the rand during 2002-05 has put pressure on competitiveness in some instances. Fiscal policies are also linked through the SACU Agreement, as shared customs and excise duties (according to a negotiated formula) constitute a major part of fiscal revenues in Botswana, Lesotho, Namibia, and Swaziland. In recent years, growing imports by South Africa brought revenue windfalls for these countries. Over the longer term, however, further trade liberalization, including through South Africa's bilateral agreement with the EU, may lead to some region-wide pressure on government finances.

55. **South Africa's financial conglomerates, which dominate the domestic banking sector, are rapidly expanding in Africa**. This presents opportunities in terms of larger markets and risk diversification for these banks, as well as increased competition and efficiency in the financial markets in the countries in which they operate. However, their expansion also has significant stability and regulatory implications.[20] Current stability risks are limited, given the banks' strong financial performance. Operational challenges which the authorities are addressing include: (i) potential for moral hazard associated with too-big-to-fail institutions because of the systemic importance of these banks both in the home and host countries; and (ii) the need for strong information sharing arrangements between home and host supervisors. There are regional initiatives to harmonize the legal and regulatory frameworks for supervision. Plans are already advanced for the SARB to sign a multilateral Memorandum of Understanding (MOUs) with other members of the Southern African Development Community (SADC), which will facilitate information sharing and cooperation with supervisors in those countries.[21] Staff suggested that it also sign MOUs with the other African countries where South African banks operate. The prospective FSAP update will also provide an opportunity to discuss and address issues related to contingent crisis management plans and burden sharing arrangements to deal with potential regional crises.

III. Staff Appraisal

56. **South Africa has made substantial economic progress since democratization**. Prudent macroeconomic policies and structural reforms have contributed to stabilization and growth. GDP has been rising at an increasing rate, inflation has fallen and remains low under

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[19] Botswana is not part of the CMA, but pegs its currency to a currency basket comprising the rand and the SDR.

[20] Chapter V of the Selected Issues Paper discusses the regulatory and stability implications of the activities of South African banks in sub-Saharan Africa.

[21] The SADC has 14 country members, including South Africa.

the inflation targeting regime, international reserves have been strengthened, the public finances are sound, and the financial system is healthy. Furthermore, South Africa's strong performance has had positive spillover effects in the region.

57. **Recent economic performance has been strong and the near-term outlook remains broadly positive**. Thanks to sound policies and a favorable external environment, the country is enjoying a long economic expansion, with high growth, low inflation, and some employment gains. Robust economic activity has contributed to a further improvement in the fiscal accounts. However, the current account deficit has widened mainly as a result of domestic demand growth. The deficit has been more than offset by foreign direct investment and portfolio inflows, making possible a sustained accumulation of international reserves. Several indicators suggest that growth will remain robust, with continued support from both public and private sector domestic expenditure.

58. **The main short-term risks to the outlook arise from a possible deterioration of the external environment**. The turmoil in global financial markets during the last few months provides an example of these risks. The sell-off in emerging markets in general, together with the correction in commodity prices, has led to rand depreciation, a drop in stock prices, and a moderate increase in sovereign spreads. While South Africa will remain affected by global developments, the country's strong fundamentals should help limit the impact of adverse external shocks on the economy.

59. **The authorities continue to focus their efforts on addressing South Africa's major economic and social challenges**. Despite impressive progress so far, the country is still faced with very high unemployment, widespread poverty, and large income and wealth disparities.

60. **The overall approach involves implementing policies to raise economic growth on a sustained basis, together with focused efforts to reduce unemployment and address urgent social needs**. Preserving macroeconomic stability is high on the authorities' agenda in their efforts to promote high and sustained economic growth.

61. **The inflation-targeting framework has continued to gain effectiveness and credibility, and additional actions to further this trend could be considered**. It would be important to further increase transparency in the application of the inflation-targeting framework, including through the dissemination of the forward looking elements considered by the Monetary Policy Committee in its deliberations.

62. **In view of the risks to inflation, the increase in the repo rate in June was appropriate**. Inflationary pressures have been building, mainly from rising energy prices and more recently the rand depreciation. In addition, high credit and money growth suggested that monetary policy was somewhat expansionary. Further increases in the repo rate may be needed to keep inflation within the target band over the medium term.

63. **The planned increase in public sector expenditure is warranted and consistent with fiscal discipline**. The additional expenditure will seek to address important infrastructure bottlenecks and pressing social needs. The execution of some of these programs may prove challenging given implementation constraints. Importantly, current plans are anchored in a medium-term expenditure framework, and remain consistent with a declining path of government debt in relation to GDP. Medium-term fiscal planning could be further enhanced by a steadfast adoption of the improved revenue forecasting methodology.

64. **The flexible exchange-rate system, with occasional foreign exchange purchases by the Reserve Bank to strengthen the international reserves position, has served the country well**. The currency float is an integral part of the inflation-targeting regime and has helped the economy absorb external shocks. Any competitiveness concerns should continue to be addressed by measures to raise productivity and reduce costs. Gross international reserves have increased significantly over the last few years. While their level is now comparable to those in other emerging market economies according to some metrics, some further accumulation could be useful to bring South Africa more fully in line with this comparator group.

65. **The authorities have continued the gradual relaxation of capital controls, and further progress would be beneficial**. Additional relaxation of controls, to be implemented at times of relative rand stability or strength, would allow for greater diversification and could contribute to reduce currency volatility over the medium term.

66. **The financial system remains sound, and it will be important to continue enhancing regulation and oversight**. Indicators of financial sector soundness are broadly positive. The authorities are fully aware of the risks arising from the fast growth of bank credit to households, and should continue monitoring those risks closely. Major banks have sophisticated risk management systems and regulation and supervision have been strengthened considerably. The envisaged FSAP update should be useful in taking stock of financial sector developments over the last several years, identifying measures that could further strengthen the country's regulatory and supervisory frameworks, and assessing the banking system's vulnerability to shocks. Also, a regional FSAP would provide a valuable opportunity to review financial sector issues of common interest to countries in the region.

67. **The authorities' continued efforts to widen access to financial services for the poor are important**. The expansion of low-cost "Mzansi" accounts is a manifestation of progress in this area. Further advances are expected with the introduction of a regulatory framework for institutions specialized in basic financial services.

68. **The authorities' Accelerated and Shared Growth Initiative for South Africa (ASGISA) should provide a useful framework for designing and assessing growth-enhancing policies**. At a general level, the ASGISA growth targets appear reachable. ASGISA's potential contribution to growth will become clearer over time, as the policies

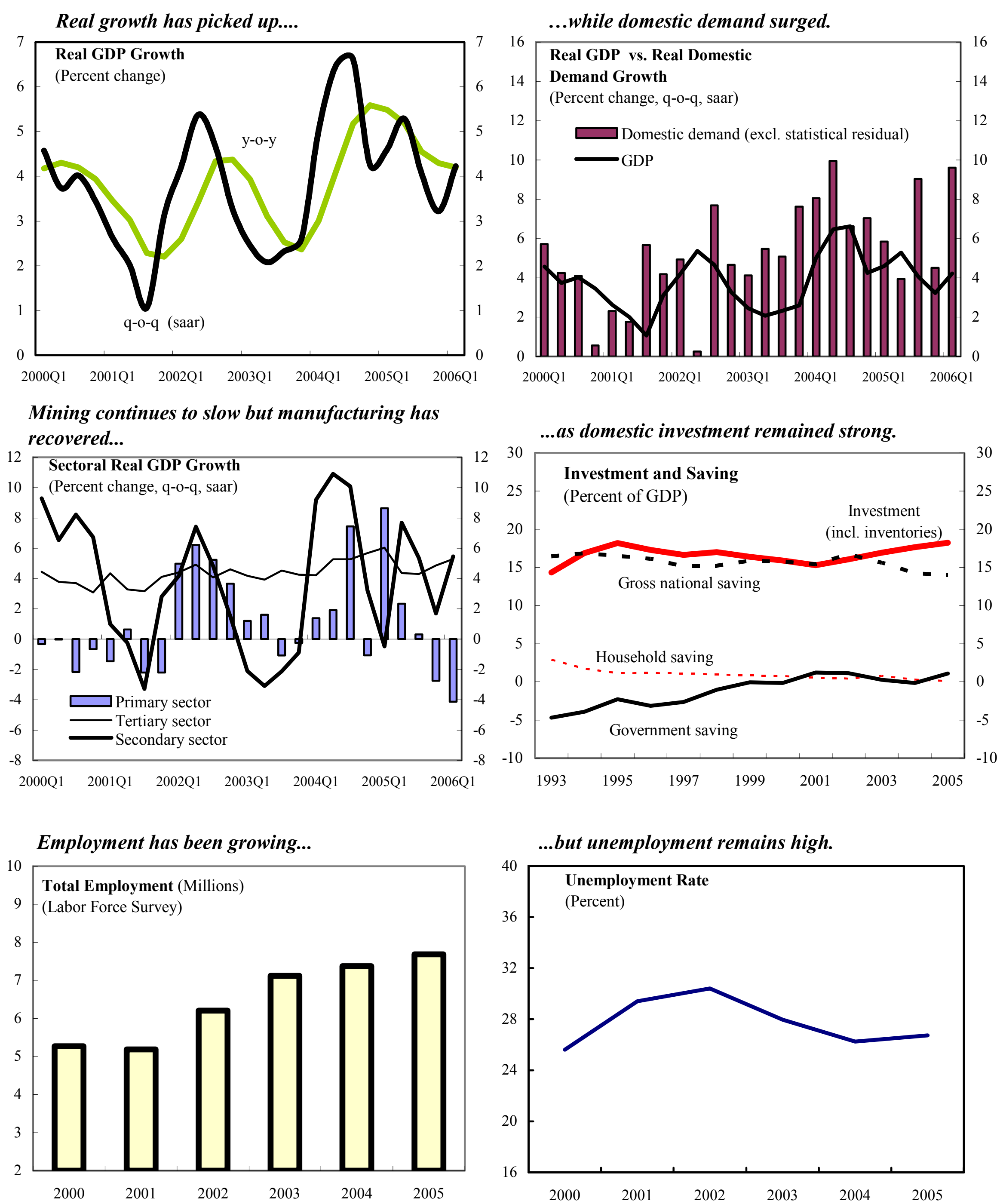
under this initiative are fully defined. Many of the constraints on growth identified under ASGISA are of a microeconomic nature and widely recognized to be critical for South Africa's growth potential. While the level and volatility of the exchange rate have also been identified as constraints on growth, the authorities' clear position against trying to control the exchange rate is welcome.

69. **A firm and reasoned effort to pursue additional labor market and trade reforms could contribute to raising growth**. The official initiatives to reduce unemployment—by enhancing workers' skills, implementing public work programs, and supporting the development of small and medium-sized enterprises—are well justified. At the same time, some labor market regulations and practices discourage job creation, although in some cases the severity of the impact is not fully understood. It will be important to identify and revise those regulations that are the most detrimental to employment. South Africa has continued to improve its trade regime, but additional efforts to simplify the tariff structure and lower most favored nation tariff rates are warranted.

70. **Addressing social disparities and the legacy of apartheid is a major national goal**. The success of the main initiatives in this area is critical to the continued improvement in the economic and social environment, and the ability of the government to sustain the economic reform effort. The authorities have been moving forward with the broad-based Black Economic Empowerment initiative. They also intend to speed up the land reform program, which has not been moving as fast as envisaged, keeping it grounded in well-defined legal principles.

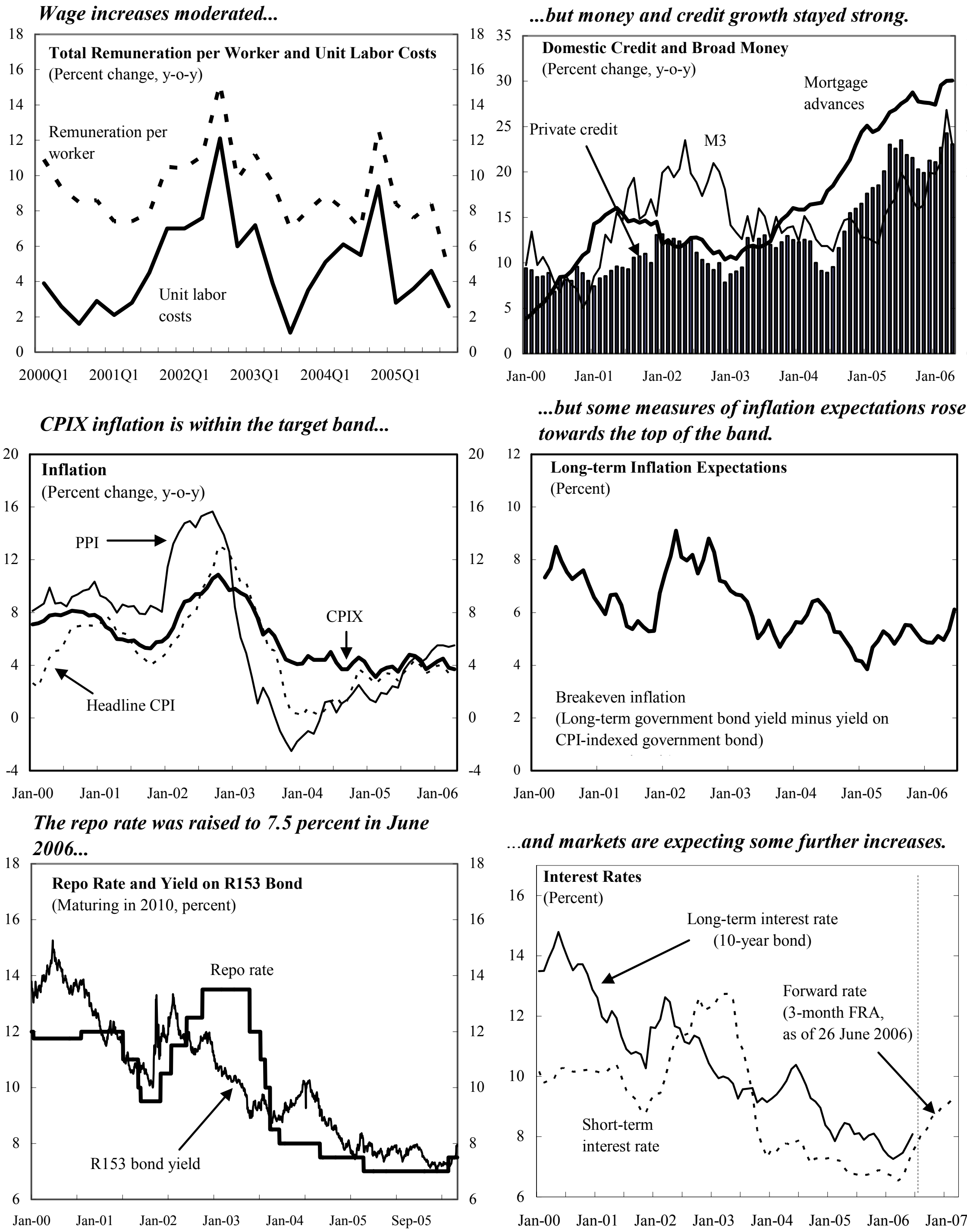
71. **It is expected that the next Article IV consultation will be held on the standard 12-month cycle.**

Figure 1. South Africa: Real Sector Developments



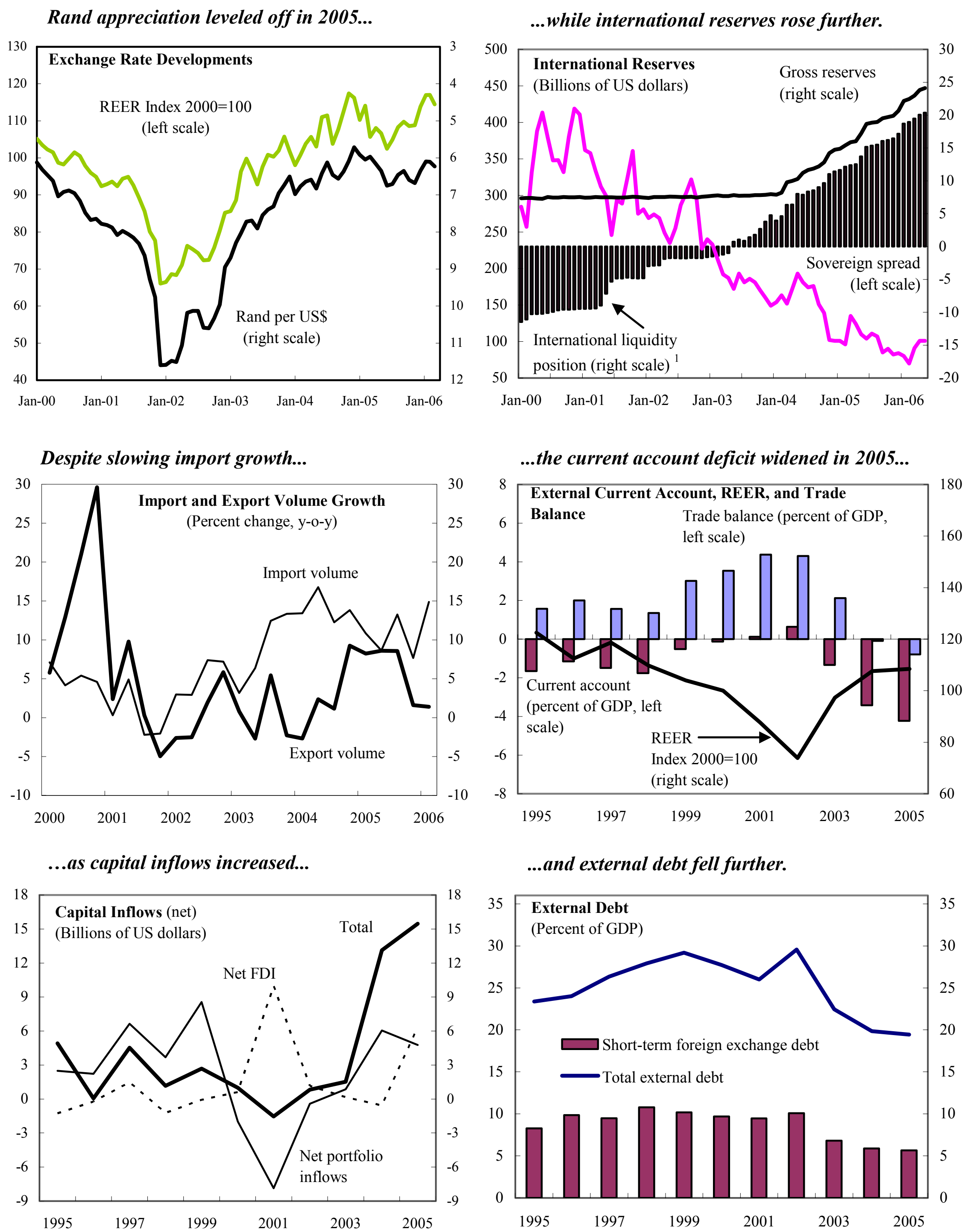
Source: SARB and IMF.

Figure 2. South Africa: Money, Prices and Interest Rates



Source: SARB, BER, Datastream, and IMF.

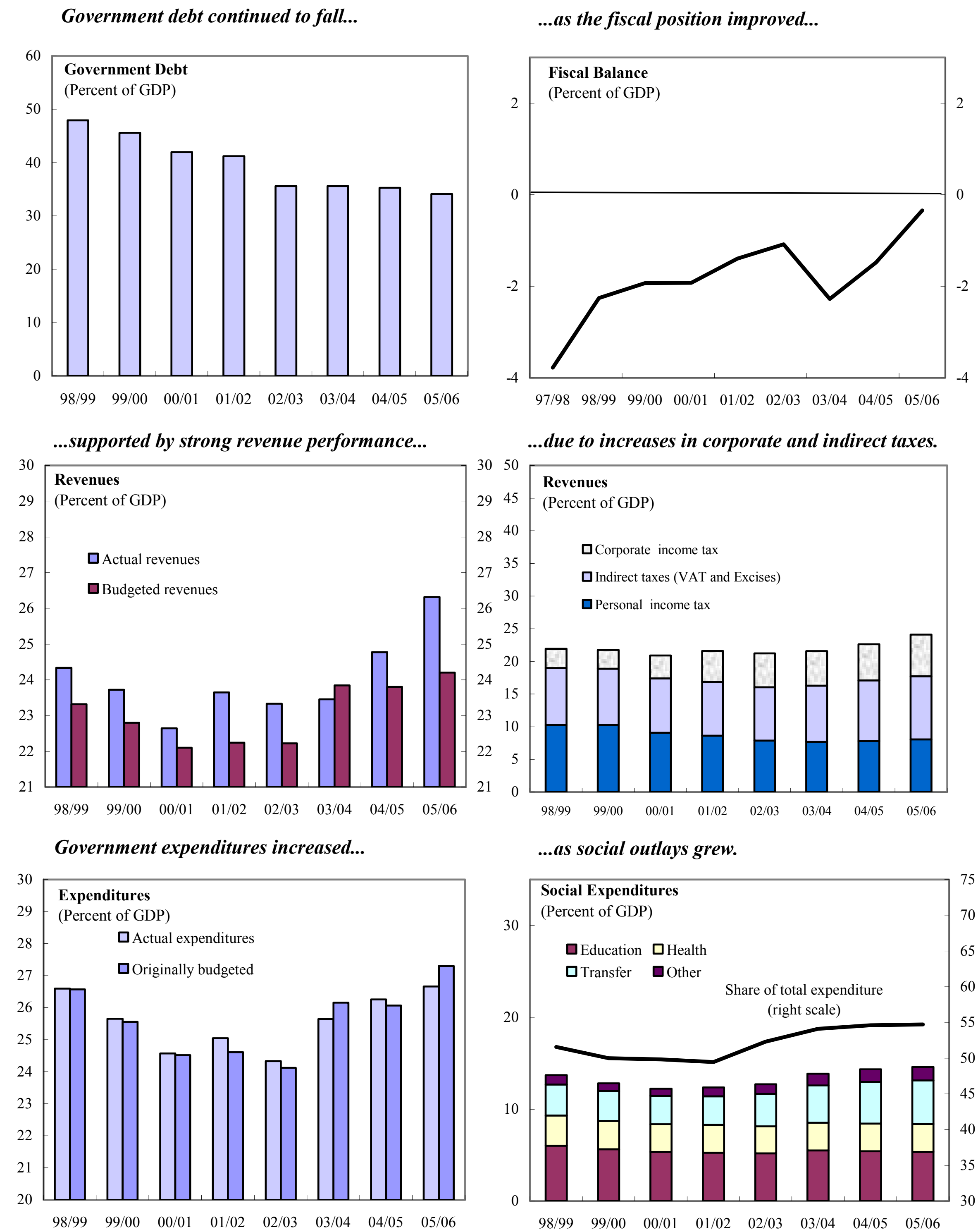
Figure 3. South Africa: External Sector Developments



Source: SARB and IMF.

[1] Gross reserves minus foreign loans received and minus forward position. The SARB's open position in the forward market was closed in February 2004.

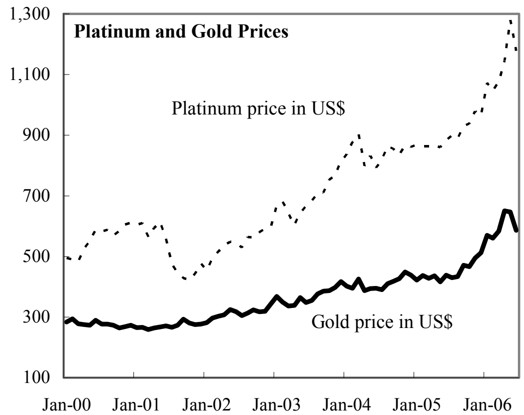
Figure 4. South Africa: Fiscal Developments



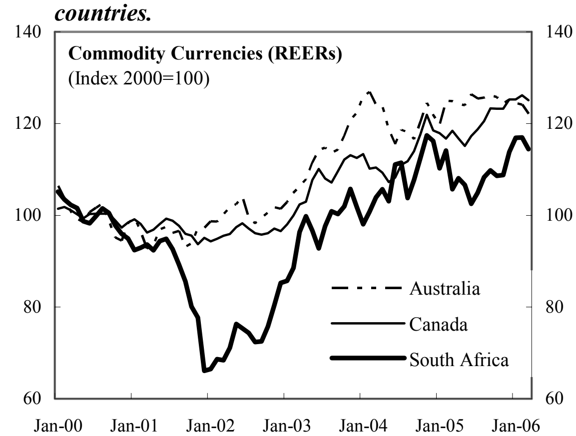
Source: National Treasury and IMF.

Figure 5. South Africa: Exchange Rates, Asset Prices and Spreads

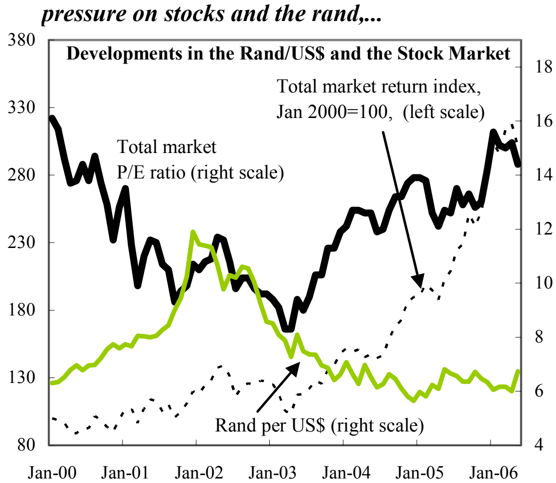
Metal prices rose through early 2006 and...



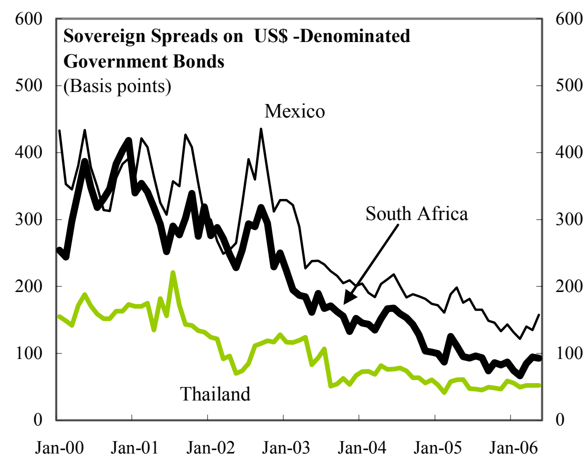
...supported the REER as in other commodity countries.



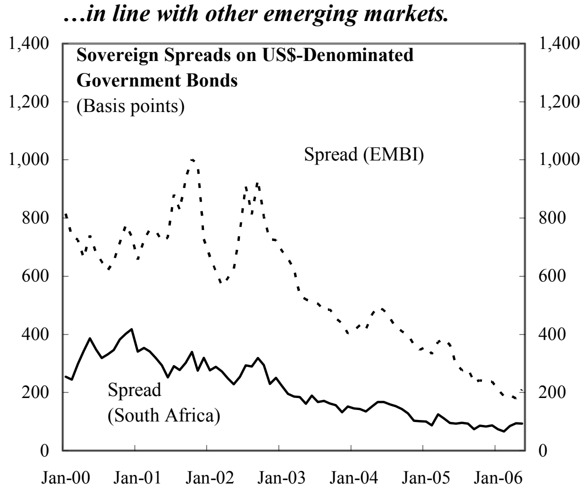
But recent nervousness in global markets has put pressure on stocks and the rand,...



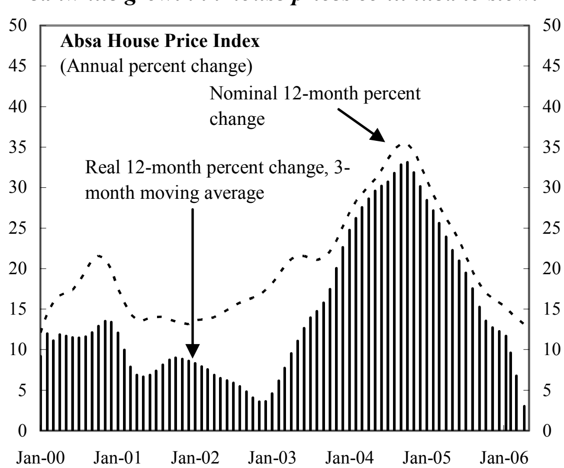
...while sovereign spreads have increased slightly...



…in line with other emerging markets.



Meanwhile growth in house prices continued to slow.



Source: SARB, Datastream, Absa, and IMF.

Table 1. South Africa: Selected Economic and Financial Indicators, 2002-07

Nominal GDP (2005): US$ 239 billion
Population (2005): 46.9 million
GDP per capita (2005): US$ 5,099

	2002	2003	2004	2005	2006 Proj.	2007 Proj.
	(Annual percent change, unless otherwise indicated)					
National income and prices						
Real GDP	3.7	3.0	4.5	4.9	4.2	4.0
Real GDP per capita	2.5	1.9	3.5	3.9	3.0	3.0
Real domestic demand	4.9	5.2	7.5	5.9	5.4	4.1
GDP deflator	10.5	4.4	5.6	4.7	5.8	4.5
CPI (annual average)	9.2	5.8	1.4	3.4	4.7	5.6
CPIX (end of period) [1]	10.8	4.0	4.3	4.0	5.9	5.4
Labor market						
Unemployment rate (percent)	30.4	28.0	26.2	26.7	26.4	25.6
Average remuneration (formal nonagricultural sector)	11.6	8.9	9.1	7.2	7.6	7.7
Labor productivity (formal nonagricultural)	3.2	4.9	2.5	3.8	2.9	2.0
Nominal unit labor costs (formal nonagricultural)	8.1	3.9	6.5	3.4	4.7	5.6
External sector						
Merchandise exports, f.o.b. [2]	2.6	21.6	25.0	13.5	13.4	8.2
Merchandise imports, f.o.b. [2]	4.6	30.1	38.1	17.0	16.0	7.8
Export (goods and services) volume	0.5	0.3	2.5	6.7	5.2	5.6
Import (goods and services) volume	5.1	8.8	14.1	10.1	9.4	5.4
Terms of trade	2.4	3.5	1.1	0.3	1.8	0.6
Nominal effective exchange rate [3]	-21.7	25.1	9.1	1.1	…	…
Real effective exchange rate [3]	-9.7	25.1	6.7	0.5	…	…
Money and credit						
Net domestic assets [4]	9.8	7.2	11.3	14.0	13.2	10.2
Broad money (including foreign exchange deposits)	18.1	12.9	13.1	19.9	16.7	11.1
Velocity (GDP/average broad money)	1.7	1.6	1.6	1.5	1.4	1.3
Bank rate/repurchase rate (period end, percent) [5]	13.5	8.0	7.5	7.0	…	…
	(Percent of GDP, unless otherwise indicated)					
Investment and saving						
Investment (including inventories)	16.1	16.9	17.6	18.2	18.8	19.3
Of which : public fixed investment (incl. public enterprises)	4.1	4.5	4.5	4.9	5.4	5.9
private fixed investment	10.9	11.3	11.7	12.3	12.7	12.8
Gross national saving	16.7	15.6	14.2	14.0	13.9	14.7
Public	1.1	0.3	-0.2	1.1	0.7	0.0
Private	15.6	15.3	14.4	12.9	13.2	14.7
National government budget [6]						
Revenue, including grants	23.3	23.3	24.2	25.9	26.1	26.1
Expenditure and net lending	24.5	25.3	25.9	26.5	27.4	27.8
Overall balance	-1.2	-2.0	-1.7	-0.6	-1.2	-1.7
National government debt	37.0	35.6	35.4	34.4	32.8	31.9
Borrowing requirement of the nonfinancial public sector	1.0	2.0	1.9	-0.3	1.5	2.6
External sector						
Current account balance	0.6	-1.3	-3.4	-4.2	-4.9	-4.6
Overall balance of payments	1.4	-0.4	2.7	2.2	1.7	0.4
Total external debt	29.7	23.0	20.2	19.3	18.8	18.4
Gross reserves (SARB, billions of U.S. dollars)	7.6	8.0	14.7	20.6	25.0	26.0
(months of total imports)	2.8	2.2	3.0	3.6	3.8	3.7

Sources: South African Reserve Bank (SARB); IMF, International Financial Statistics; and Fund staff projections.

[1] CPIX is the consumer price index (CPI) excluding the interest on mortgage bonds. It is the targeted definition of inflation.

[2] In U.S. dollars; annual percent change.

[3] Annual average, SARB. From December 2005 through March 2006 the rand appreciated about 1 percent in real effective terms.

[4] Contribution (in percentage points) to the growth of broad money.

[5] On June 8, the SARB increased the repo rate from 7 to 7.5 percent.

[6] Calendar-year figures, based on National Treasury data, and staff's GDP projections for 2006 and 2007.

Table 2. South Africa: National Government Main Budget, 2002/03-2007/08 [1]

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
				Est. [2]	Proj. [2]	Proj. [2]
			(Percent of GDP)			
Total revenue and grants	23.2	23.4	24.5	26.3	26.0	26.1
Tax revenue	22.9	22.8	24.1	25.8	25.5	25.5
Income tax	13.7	13.4	13.7	14.8	14.3	14.4
Of which : personal income tax (PIT)	7.9	7.7	7.8	8.1	7.7	7.9
corporate taxes (CIT+STC)	5.2	5.2	5.5	6.4	6.4	6.3
Indirect taxes	8.1	8.6	9.3	9.7	10.0	9.8
Of which : value-added tax (VAT)	5.9	6.3	6.9	7.3	7.7	7.5
Trade and other (less SACU payments)	1.0	0.8	1.0	1.3	1.1	1.3
Of which : trade taxes	0.8	0.7	0.9	1.2	1.4	1.3
Of which : SACU payments [3]	0.7	0.8	0.9	0.9	1.2	1.1
Nontax revenue	0.4	0.5	0.4	0.5	0.5	0.6
Total expenditure	24.3	25.6	26.0	26.7	27.6	27.8
Interest	3.9	3.6	3.4	3.3	3.0	2.8
Transfer to subnational governments	12.2	13.6	10.7	10.9	11.9	12.2
Other	8.3	8.5	11.8	12.5	12.7	12.8
Budgetary balance	-1.1	-2.3	-1.5	-0.3	-1.5	-1.7
Extraordinary payments [4]	-0.7	-0.6	-0.7	-0.3	0.0	0.0
Augmented balance	-1.8	-2.9	-2.1	-0.6	-1.5	-1.7
Financing	1.8	2.9	2.1	0.6	1.5	1.7
Domestic borrowing (net)	0.1	3.0	2.8	1.8	0.8	1.2
Foreign borrowing (net)	1.2	0.1	0.3	0.0	0.1	0.2
Privatization and other extraordinary receipts	0.7	0.1	0.2	0.4	0.1	0.1
Change in cash and other items	-0.2	-0.3	-1.1	-1.7	0.5	0.3
			(Billions of rand)			
Total revenue and grants	278.5	299.4	347.8	411.4	446.3	486.5
Tax revenue	274.0	292.8	341.6	402.9	436.9	475.9
Income tax	164.6	172.0	195.2	230.7	245.8	269.2
Indirect taxes	97.6	110.2	132.0	151.3	171.8	182.7
Of which : value-added tax (VAT)	70.1	80.7	98.1	114.3	131.2	140.4
Trade and other (less SACU payments)	11.8	10.6	14.4	20.9	19.3	24.0
Nontax revenue	4.4	6.6	6.2	8.5	9.3	10.6
Total expenditure	291.5	328.7	368.5	416.7	472.8	518.8
Budgetary balance	-13.0	-29.2	-20.7	-5.4	-26.5	-32.4
Extraordinary payments [4]	-8.0	-7.4	-9.8	-4.6	0.0	0.0
Augmented balance	-21.0	-36.6	-30.5	-9.9	-26.5	-32.4
Financing	21.0	36.6	30.5	9.9	26.5	32.4
			(Percent of GDP)			
Memorandum items:						
GDP (billions of rand)	1,198.3	1,281.3	1,419.9	1,563.2	1714.2	1863.6
Real GDP growth	4.0	2.7	5.1	4.6	4.2	4.0
Primary balance	2.8	1.3	2.0	2.9	1.5	1.1
Debt	35.6	35.6	35.3	34.1	32.3	31.8
Domestic	29.4	30.5	30.5	29.6	27.9	26.9
Foreign	6.2	5.0	4.9	4.5	4.4	4.9

Sources: South African authorities; and Fund staff estimates and projections.

[1] For fiscal year beginning April 1. National government comprises the central government and subnational spending financed by transfers from the national revenue fund.

[2] Staff projections based on the 2006 Budget Review.

[3] Southern African Customs Union (SACU) payments are based on a revenue-sharing formula.

[4] Provision of bonds to the South African Reserve Bank in settlement of the Gold and Foreign Exchange Contingency Account.

Table 3. South Africa: Nonfinancial Public Sector Operations, 2002/03-2006/07 [1]

	2002/03	2003/04	2004/05	2005/06 Est. [2]	2006/07 Proj. [2]	2007/08 Proj. [2]
				(Percent of GDP)		
General govt. (excl. local govts.)						
Total revenue and grants	24.7	25.0	26.3	28.0	27.5	27.6
National government	23.2	23.4	24.8	26.3	26.0	26.1
Provinces (own revenue)	0.5	0.5	0.4	0.4	0.4	0.4
Social security funds (own revenue)	0.9	1.1	1.0	1.2	1.0	1.1
Extrabudgetary and other	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	25.9	27.2	27.4	27.7	28.6	28.9
Current	24.8	26.0	26.3	26.7	27.0	27.8
Wages and salaries	9.2	9.4	9.2	9.2	9.4	9.4
Other goods and services	3.4	3.6	3.6	3.7	4.0	4.3
Interest	3.9	3.6	3.5	3.3	3.0	2.8
Transfers	8.3	9.5	10.0	10.5	10.6	11.3
Capital expenditure	1.1	1.2	1.2	1.1	1.7	1.4
Overall balance	-1.2	-2.2	-1.1	0.3	-1.1	-1.2
Public sector borrowing requirement (PSBR)	1.0	2.4	2.1	-1.0	2.4	2.6
National government [3]	1.1	2.7	2.0	0.2	1.4	1.7
Other government borrowing [4]	0.3	0.3	0.3	0.0	0.2	0.3
Nonfinancial public enterprises	-0.4	-0.7	-0.2	-1.2	0.7	0.7
				(Billions of rand)		
General govt. (excl. local govts.)						
Total revenue and grants	296.3	320.7	369.7	437.8	470.8	515.0
Total expenditure	310.1	348.6	385.0	433.3	489.9	537.9
Current	296.6	333.3	368.6	416.8	463.4	517.4
Wages and salaries	109.8	119.8	129.7	143.1	160.5	174.3
Other goods and services	40.4	45.8	50.1	58.4	68.7	79.8
Interest	46.8	46.5	48.9	50.9	52.1	53.0
Transfers	99.7	121.2	140.0	164.5	182.1	210.2
Capital expenditure	13.4	15.3	16.4	16.5	28.5	25.5
Overall balance	-13.8	-28.0	-15.3	4.5	-19.1	-22.9
Public sector borrowing requirement (PSBR)	12.1	30.5	29.3	-15.4	40.7	48.8
National government [3]	12.8	35.1	28.0	3.0	24.8	30.9
Other government borrowing [4]	4.1	4.0	4.3	-0.3	3.8	4.8
Provinces	3.0	2.5	2.4	-0.3	0.6	0.0
Local govts. and local enterprises	6.1	7.1	7.8	8.0	10.1	11.0
Nonfinancial public enterprises	-4.9	-8.6	-3.0	-18.1	12.0	13.0
Other	-5.0	-5.7	-5.9	-8.0	-6.8	-6.2
				(Percent of GDP)		
Memorandum items:						
Non-financial public sector debt (gross)	44.8	44.2	43.5	41.0	…	…
Social spending [5]	12.7	13.8	14.0	14.6	15.2	15.5
Defense spending	1.7	1.7	1.6	1.7	1.5	1.5

Sources: South African authorities; and Fund staff estimates and projections.

[1] For fiscal year beginning April 1.

[2] Staff projections based on the 2005 Medium Term Budget Policy Statement.

[3] Includes extraordinary payments.

[4] "Other" includes provincial and local governments, social security funds, other extrabudgetary institutions, and privatization receipts.

[5] Health, education, welfare and community development.

Table 4. South Africa: Balance of Payments, 2002-07

	2002	2003	2004	2005	2006	2007
					Proj.	Proj.
	(Billions of US dollars)					
Balance on current account	0.7	-2.2	-7.4	-10.1	-12.5	-12.5
Balance on goods and services	4.1	3.2	-1.5	-3.5	-5.6	-5.5
Exports of goods and services	36.4	46.4	57.1	64.9	73.0	79.1
Exports of goods	31.7	38.5	48.1	54.6	62.0	67.0
Nongold	27.5	34.3	43.7	50.4	55.6	60.4
Gold	4.1	4.2	4.4	4.2	6.4	6.7
Exports of services	4.7	7.8	9.0	10.2	11.0	12.1
Imports of goods and services	-32.3	-43.1	-58.6	-68.4	-78.6	-84.6
Imports of goods	-26.9	-35.0	-48.3	-56.5	-65.6	-70.7
Imports of services	-5.4	-8.1	-10.3	-11.8	-13.0	-13.9
Balance on income	-2.8	-4.6	-4.4	-4.9	-5.1	-5.1
Income receipts	2.2	2.8	3.3	4.6	5.3	5.8
Income payments	-5.0	-7.4	-7.6	-9.5	-10.4	-11.0
Balance on transfers	-0.6	-0.8	-1.5	-1.7	-1.8	-1.8
Capital flows (including errors and omissions)	0.8	1.6	13.2	15.5	16.9	13.5
Balance on capital and financial account	0.4	-1.9	6.9	11.0	16.9	13.5
Balance on capital account	0.0	0.0	0.1	0.0	0.0	0.0
Balance on financial account	0.4	-1.9	6.8	11.0	16.9	13.4
Direct investment	1.2	0.2	-0.6	6.3	5.2	4.7
Liabilities	0.8	0.7	0.8	6.4	5.3	4.8
Assets	0.4	-0.6	-1.4	-0.1	-0.1	-0.1
Portfolio investment	-0.4	0.9	6.0	4.8	5.1	5.4
Liabilities	0.5	1.0	7.0	5.7	6.1	6.5
Assets	-0.9	-0.1	-0.9	-0.9	-1.0	-1.0
Other investment	-0.4	-3.0	1.4	-0.1	6.6	3.3
Liabilities	0.0	1.9	1.7	3.5	3.7	3.9
Assets	-0.4	-4.9	-0.3	-3.6	2.9	-0.7
Errors and omissions	0.5	3.4	6.3	4.5	0.0	0.0
Overall balance of payments	1.5	-0.6	5.8	5.4	4.4	1.0
Gross reserves (SARB) [1]	7.6	8.0	14.7	20.6	25.0	26.0
International liquidity position of SARB [1, 2]	-1.6	4.8	11.4	17.2	21.5	22.5
	(Percent of GDP)					
Balance on current account	0.6	-1.3	-3.4	-4.2	-4.9	-4.6
Balance on goods and services	3.7	1.9	-0.7	-1.5	-2.2	-2.0
Exports of goods and services	32.7	27.9	26.6	27.1	28.5	29.1
Imports of goods and services	-29.1	-26.0	-27.3	-28.6	-30.6	-31.1
Capital flows (including errors and omissions)	0.7	0.9	6.1	6.5	6.6	4.9
Balance on capital and financial account	0.3	-1.1	3.2	4.6	6.6	4.9
Errors and omissions	0.4	2.1	2.9	1.9	0.0	0.0
Overall balance of payments	1.4	-0.4	2.7	2.2	1.7	0.4
Gross reserves (SARB) [1]	6.9	4.8	6.8	8.6	9.8	9.6
International Liqudity Position of SARB [1, 2]	-1.5	2.9	5.3	7.2	8.4	8.3
Memorandum items:						
Total external debt	29.7	23.0	20.2	19.3	18.8	18.4
Foreign currency debt	22.5	16.5	13.0	11.9	11.6	11.3
of which: short-term (at remaining maturity)	10.1	6.8	4.9	4.9	4.7	4.5
Total external debt service (in billions of US dollars)	4.7	5.9	6.1	5.4	6.4	6.8

Sources: South African Reserve Bank (SARB); and Fund staff estimates and projections.

[1] End of period.

[2] Gross reserves minus foreign loans and minus forward position. The SARB's open position in the forward market was closed in February 2004.

Table 5. South Africa: Monetary Survey, 2002-05

	2002	2003	2004	2005
	(Billions of rand)			
Net foreign assets	86.3	126.7	141.4	195.2
Gross reserves	167.0	214.5	229.6	297.8
SARB	66.0	52.9	82.8	130.5
Other monetary institutions	101.0	161.6	146.7	167.3
Liabilities	80.7	87.8	88.2	102.6
SARB	21.5	20.0	19.8	22.2
Other monetary institutions	59.2	67.8	68.4	80.4
Net domestic assets	629.6	681.4	772.8	901.1
Credit to government, net	58.2	45.8	42.6	0.9
Claims on government	84.9	104.2	116.1	107.4
Government deposits	26.7	58.4	73.4	106.5
Credit to private sector [1]	703.4	838.3	954.0	1,140.9
Other items, net	-132.0	-202.7	-223.9	-240.7
Broad money (M3)	715.8	808.0	914.2	1,096.2
Of which: M1	358.3	387.8	421.5	503.1
	(Annual percentage change)			
Net foreign assets	139.9	46.8	11.6	38.0
Net domestic assets	10.4	8.2	13.4	16.6
Credit to private sector	4.4	19.2	13.8	19.6
Broad money (M3)	18.1	12.9	13.1	19.9
	(Contribution to growth of M3, unless otherwise specified)			
Net foreign assets	8.3	5.6	1.8	5.9
Net domestic assets	9.8	7.2	11.3	14.0
Credit to government, net	4.4	-1.7	-0.4	-4.6
Credit to private sector [1]	4.9	18.8	14.3	20.4
Other items, net	0.5	-9.9	-2.6	-1.8
Memorandum item:				
Income velocity of M3 (GDP/average broad money)	1.74	1.64	1.60	1.51

Source: South African Reserve Bank (SARB).

[1] Part of the increase in private sector credit in 2003 is due to a change in accounting rules for derivatives.

Table 6. South Africa: Indicators of External Vulnerability, 2002-06

	2002	2003	2004	2005	2006	*date*
	(Percent of GDP, unless otherwise specified)					
Financial indicators						
Public sector debt [1]	37.0	35.6	35.4	34.4	...	
Broad money (percent change; 12-month basis)	18.1	12.9	13.1	19.9	23.0	*April*
Private sector credit (percent change; 12-month basis)	4.4	19.2	13.8	19.6	23.2	*April*
Repurchase rate (percent) [2]	13.5	8.0	7.5	7.0	7.5	*June*
Repurchase rate (percent; real) [2, 3]	2.4	3.8	3.1	2.9	...	
External indicators						
Exports of goods and services (percent change; U.S. dollar value)	2.3	27.6	23.2	13.6	…	
Imports of goods and services (percent change; U.S. dollar value)	4.4	33.6	36.0	16.6	…	
Terms of trade (percent change)	2.4	3.5	1.1	0.3	…	
Current account balance	0.6	-1.3	-3.4	-4.2	…	
Capital and financial account balance	0.3	-1.1	3.2	4.6	…	
Gross official reserves (billions of U.S. dollars) [2]	7.6	8.0	14.7	20.6	23.9	*June*
Short-term foreign liabilities of SARB (billions of U.S. dollars) [2]	1.0	0.5	0.4	0.4	0.4	
International liquidity position of SARB (billions of U.S. dollars) [2, 4]	-1.6	4.8	11.4	17.2	20.2	*June*
Short-term external debt by remaining maturity (billions of U.S. dollars)	11.2	11.3	10.5	10.9	…	
Short-term external debt plus open forward position (billions of U.S. dollars)	18.1	11.7	10.5	10.9	…	
Gross official reserves as a percent of the above	42.2	68.0	140.6	189.0	…	
Foreign currency-denominated external debt (billions of U.S. dollars)	25.0	27.3	27.9	28.4	…	
As a percent of total exports	68.9	59.0	48.8	43.8	…	
External interest payments (as a percent of total exports)	5.0	4.7	3.9	3.7	…	
Exchange rate (per U.S. dollar; period average) [5]	10.52	7.56	6.45	6.36	7.37	
Real effective exchange rate appreciation (period average; percent) [6]	-9.7	25.1	6.7	0.5	…	
Financial market indicators [2]						
Stock market index (1994=100)[5]	155.9	174.6	212.8	303.4	342.8	
Percent change [5]	-11.3	12.0	21.9	42.6	13.0	
Foreign currency debt rating–Standard & Poor's	BBB-	BBB	BBB	BBB+	BBB+	*June*
Foreign currency debt rating–Moody's [7]	Baa2	Baa2	Baa2	Baa1	A2	*June*
Spread of benchmark bonds (basis points) [8]	240	149	101	84	110	*June*

Sources: South African Reserve Bank (SARB); and Fund staff estimates.

1 National government debt, end of period.

2 End of period.

3 Deflated by the percent change in end-period CPIX (consumer price index less interest on mortgage bonds).

4 Gross reserves minus foreign loans and minus forward position. The SARB's open position in the forward market was closed in February 2004.

5 For 2006, as of June 26; stock market index change with regard to end 2005.

6 SARB.

7 Change in rating in 2006 reflects technical adjustment by Moody's.

8 Spread on dollar-denominated bond maturing in 2017 relative to comparable U.S. treasury bond. End of period.

Table 7: South Africa: Financial Soundness Indicators, 2002-06

	2002	2003	2004	2005	2006 [1]
	(Percent, unless otherwise indicated)				
Capital adequacy:					
Regulatory capital to risk-weighted assets	12.6	12.2	13.3	12.3	12.6
Regulatory tier 1 capital to risk-weighted assets	7.9	7.9	9.3	8.9	9.1
Asset quality:					
Nonperforming loans to total gross loans	2.8	2.4	1.8	1.5	1.3
Nonperforming loans net of provisions to capital	11.9	8.5	6.2	7.0	5.6
Large exposures (utilized) to capital	163.8	157.1	113.0	141.1	155.0
Share of mortgage advances in domestic private credit	40.7	39.6	43.3	46.2	45.3
Earnings and profitability:					
Return on assets (average)	0.4	0.8	1.2	1.1	…
Return on equity (average)	5.2	11.6	16.2	14.7	…
Interest margin to gross income	52.3	38.3	42.3	42.2	…
Noninterest expenses to gross income	60.4	74.8	68.6	61.0	…
Interest spread (annualized yield minus cost)	3.8	1.9	2.8	…	…
Liquidity:					
Liquid assets to total assets	4.7	4.7	4.7	4.8	4.5
Share of short-term deposits in total deposits	46.0	43.8	41.8	41.5	40.8
Exposure to FX risk:					
Maximum effective net open FX position to capital	2.6	0.9	0.9	1.1	…
Share of foreign currency loans in total lending	13.1	11.4	10.5	10.9	11.7
Share of foreign currency deposits in total deposits	4.4	2.7	2.7	2.7	2.7
Share of foreign liabilities in total liabilities	5.3	2.8	3.1	3.3	4.2

Source: South African Reserve Bank.

[1] As of March 2006.

Table 8. South Africa: Social and Demographic Indicators

(2004, unless otherwise specified)

Area		**Population**	
1.22 million square kilometers		Total (2005 mid-year estimate)	46.9 million
		Annual rate of growth	0.9 percent
Population characteristics		**Health**	
Population density (2005)	38.4 per sq. km.	Life expectancy at birth (2005)	
		Total (years)	47
Urban population (percentage of total, 2005)	58		
Proportion in capital city as a percentage of urban Population (census 2001)	8	Infant mortality per thousand live births (2005)	54
Population age structure (percent)		**Labor force**	
0-14 years	33		
15-64	63	Female (percentage of labor force, 2005)	46
65 and above	4		
Population below $2 a day, PPP basis (percent of population, 2000)	34.1		
GDP per capita at current prices		Percentage of employment (Formal sector, September 2005)	
In U.S. dollars (2005)	5,099	Agriculture	7
		Mining	5
		Industry [1]	25
		Trade	21
		Other services	42
Nutrition (1999)		**Education**	
Per capita calorie intake per day		Adult literacy (15+, percentage)	
Mean	2,424	Male	84
Median	2,358	Female	81
		Total	82

Sources: World Bank, *World Development Indicators*; UNDP, *Human Development Report*; Statistics South Africa; and staff estimates.

[1] Comprises the manufacturing, construction, and utilities sectors.

Table 9. South Africa: Millennium Development Goals, 1990-2003 [1]

	1990	1994	1997	2000	2003
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates				
Population below $1 a day (%) [2]	...	...	...	10.7	...
Poverty gap at $1 a day (%)	...	0.6	...	1.7	...
Percentage share of income or consumption held by poorest 20%	...	...	...	3.5	...
Prevalence of child malnutrition (% of children under 5)	...	...	...	...	...
Population below minimum level of dietary energy consumption (%)	...	...	...	...	...
2. Achieve universal primary education	2015 target = net enrollment to 100				
Net primary enrollment ratio (% of relevant age group)	87.9	...	91.3	89.6	89.0
Youth literacy rate (% ages 15-24)	88.5	89.7	90.5	91.3	91.8
3. Promote gender equality	2005 target = reduce education ratio to 100				
Ratio of girls to boys in primary and secondary education (%)	103.2	...	102.2	100.0	100.4
Ratio of young literate females to males (% ages 15-24)	99.7	99.8	99.9	99.9	100.0
Share of women employed in the nonagricultural sector (%)	...	39.5	...	...	...
Proportion of seats held by women in national parliament (%)	3.0	...	25.0	30.0	30.0
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds				
Under 5 mortality rate (per 1,000)	60.0	59.0	…	63.0	66.0
Infant mortality rate (per 1,000 live births)	45.0	45.0	…	50.0	53.0
Immunization, measles (% of children under 12 months)	79.0	76.0	82.0	77.0	83.0
5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	…	…	…	230.0	…
Births attended by skilled health staff (% of total)	…	82.0	84.4	…	…
6. Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc				
Prevalence of HIV (% ages 15-49) [3]	…	…	…	…	15.6
Contraceptive prevalence rate (% of women ages 15-49)	57.0	…	62.0	…	…
Number of children orphaned by HIV/AIDS (thousands)	…	…	…	660.0	1100.0
Incidence of tuberculosis (per 100,000 people)	186.2	306.4	391.7	465.0	536.4
Tuberculosis cases detected under DOTS (%)	…	…	72.0	96.0	…
7. Ensure environmental sustainability	2015 target = various [1]				
Forest area (% of total land area)	7.4	...	...	7.3	...
Nationally protected areas (% of total land area)	...	...	...	...	5.5
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	3.9	3.5	3.6	3.8	3.9
CO2 emissions (metric tons per capita)	8.3	8.2	8.1	7.4	…
Access to an improved water source (% of population)	83.0	…	…	…	87.0
Access to improved sanitation (% of population)	63.0	…	…	…	67.0
Access to secure tenure (% of population)	…	…	…	…	…
8. Develop a Global Partnership for Development	2015 target = various [1]				
Youth unemployment rate (% of total labor force ages 15-24)	…	…	45.0	44.2	…
Fixed line and mobile telephones (per 1,000 people)	93.6	106.5	157.2	304.5	410.5
Personal computers (per 1,000 people)	7.0	22.7	43.7	66.4	72.6
General indicators					
Adult literacy rate (% of people ages 15 and over)	81.2	82.9	84.1	85.2	86.0
Total fertility rate (births per woman)	3.3	…	3.0	…	2.8
Life expectancy at birth (years)	61.9	…	54.7	48.5	45.7

Source: World Bank, Statistics South Africa.

Note: In some cases the data are for earlier or later years than those stated.

[1] See for definitions and Goal 7 and 8 targets: World Bank at http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do

[2] Expenditure base. Information provided for 1994 (6.3 percent) is not strictly comparable as it refers to income base.

[3] Estimate for 2004. Source: Statistics South Africa.

APPENDIX I. SOUTH AFRICA: RELATIONS WITH THE FUND
(As of May 31, 2006)

I.	**Membership Status:** Joined 12/27/1945; Article VIII		
II.	**General Resources Account:**	SDR Million	Percent Quota
	Quota	1,868.50	100.00
	Fund holdings of currency	1,867.66	99.96
	Reserve position in Fund	0.84	0.05
III.	**SDR Department:**	SDR Million	Percent Allocation
	Net cumulative allocation	220.36	100.00
	Holdings	222.87	101.15
IV.	**Outstanding Purchases and Loans:**	None	

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	11/03/1982	12/31/1983	364.00	159.00
CCFF	12/22/1993	--	614.43	614.43

VI. **Projected Obligations to Fund:** None.

VII. **Exchange Rate Arrangement:**

The South African rand floats against other currencies. South Africa formally accepted the obligations of Article VIII, Section 2, 3, and 4 of the Fund's Articles of Agreement, as from September 15, 1973. On June 26, 2006 the exchange rate of the rand was US$0.1357=R1.

With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated.[22] They are free to purchase shares, bonds, and other assets without restriction and to repatriate dividends, interest receipts, and current and capital profits, as well as the original investment capital. Foreign companies, governments and institutions may list on South Africa's bond and securities exchanges.

Since 1995, exchange controls on capital transaction by residents have also been relaxed. Rather than allowing complete liberalization of a particular type of current or capital transaction, the authorities have pursued a strategy of allowing an increasing array of

[22] South Africa maintains restrictions on current payments and transfers to Iraq and on the transfer of funds to the Taliban, pursuant to UN Security Council resolutions 1267, 1333, 1390 and 1373.

transactions, with each subject to a quantitative cap that has been progressively raised over time. Exchange controls on outward foreign direct investment by South African corporates have been abolished. Application to the South African Reserve Bank's Exchange Control Department is still required for monitoring purposes and approval in terms of existing foreign direct investment criteria, including demonstrated benefit to South Africa. The South African Reserve Bank reserves the right to stagger capital outflows relating to large foreign investments so as to manage any potential impact on the foreign exchange market.

Most of the remaining restrictions are on portfolio outflows. Institutional investors are permitted to invest in foreign securities, subject to an overall limit of 15 percent of their total retail assets for retirement funds and long-term insurers. Investment managers registered as institutional investors for exchange control purposes and collective investment schemes management companies are restricted to 25 percent of total retail assets under management. Corporates may, upon application, be permitted to establish primary listings offshore under certain conditions. Private individuals are allowed to invest up to R2,000,000 offshore. In addition to the above, there are restrictions on, inter alia, the travel allowances (R160,000 for private individuals), the transfer of funds abroad by emigrants ("blocked funds"), and the investment of currency proceeds from exports (which must be repatriated within 180 days from accrual). The transfer of blocked funds in excess of R2 million for individuals and R4 million for families is allowed, provided a 10 percent exit levy is paid. Large amounts may be staggered to manage any impact on the foreign exchange market. Dividends and interest payments on the blocked funds are freely transferable abroad and travel allowances can be augmented if *bona fide* need is documented.

VIII. **Article IV Consultations**

The 2005 Article IV consultation was concluded by the Executive Board on September 3, 2005 (IMF Country Report No. 05/346 - September 19, 2005). South Africa is on the standard 12-month Article IV consultation cycle.

IX. **Technical Assistance**

A FAD mission took place in 2003 to discuss with the National Treasury their draft royalty bill (published in March 2003). A monetary and financial statistics mission took place in 2003, followed up by a visit during May -June, 2004.

A STA mission, supported by a labor statistics consultant funded by the World Bank, undertook a review of South Africa Labor Force Statistics in March 2005. The mission recommended steps to produce statistics that are more reliable, better quality, and more closely aligned with International Labor Organization (ILO) standards.

APPENDIX II. SOUTH AFRICA: RELATIONS WITH THE WORLD BANK GROUP

Between 1990 and 1994, the Bank resumed activities in South Africa through economic analysis and capacity building, resulting in papers and reports on the macroeconomy, education, health, agriculture, fiscal decentralization, labor markets, trade policy, and microfinance. During 1994-2004, the emphasis shifted towards policy advice and dialogue on municipal and welfare services, macroeconomic strategy, poverty, job-creation, medium-term expenditure framework, HIV/AIDS, and the business environment. Lending has been limited to the Industrial Competitiveness and Job Creation Project (approved for US$46 million and subsequently reduced to US$24.5 million at the government's request), which closed in September 2004; and a Technical Assistance Loan for the Municipal Financial Management Technical Assistance Project (MFMTAP), approved in 2002 for an amount of US$15 million. There is a large GEF-funded program for nature conservation and development: the C.A.P.E. Biodiversity Conservation and Sustainable Development Project (US$9 million); the Cape Peninsula Biodiversity Conservation Project (US$12.3 million); the Maloti-Drakensberg Transfrontier Conservation and Development Project (US$7.9 million); and the Greater Addo Elephant National Park Project (US$5.5 million). Most recently, since 2004, the emphasis in the evolving policy dialogue and knowledge work has been on growth and jobs, investment climate and SME development, municipal monitoring and financial management, land reform, and service delivery and impact evaluation. The Bank and South Africa will jointly be preparing a Country Partnership Strategy during FY07.

The International Finance Corporation's (IFC) committed portfolio has grown steadily from US$114 million in 2000 to US$229 million in 2006, IFC's second largest country portfolio in Africa after Nigeria. The IFC strategy for South Africa has three key objectives: i) supporting black economic empowerment, through leading acquisition transactions and support for SME/entrepreneurship; ii) developing financial markets and institutions; and iii) helping South African companies expand into Africa and globally. Recent transactions include the Hernic Ferrochrome mining project with Mitsubishi (US$30 million loan and equity); a bond issue guarantee with the City of Johannesburg (US$30 million); and the DBSA credit default swap to support securitization of their municipal bond portfolio ($18 million) as well as a loan to FirstRand Empowerment Trust (US$30 million) to finance the acquisition of FirstRand Limited's common shares.

South Africa has been a member of the Multilateral Investment Guarantee Agency (MIGA) since 1994. South African investors are the most active users of MIGA guarantees among Category Two countries, and currently have US$228.6 million of gross MIGA coverage (and US$107.1 million of net coverage) outstanding, or 4.2 percent of MIGA's overall portfolio. MIGA has one outstanding guarantee in South Africa, in the financial sector. Financed by a Swiss investor, the project has gross and net exposures of US$ 12.3 million.

APPENDIX III. SOUTH AFRICA: STATISTICAL ISSUES

Economic and financial data provided to the Fund are considered adequate for surveillance purposes. South Africa subscribed to the Special Data Dissemination Standard (SDDS) on August 2, 1996 and met the SDDS specifications for the coverage, periodicity, and timeliness of data and for dissemination of advance release calendars on September 18, 2000. A Report on Observance of Standards and Codes—Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) were published October 16, 2001 and are available of the IMF's external website.

Real sector

In June 1999, Statistics South Africa released a major revision of the national income accounts based on the United Nations' *System of National Accounts* (1993). The revision raised nominal GDP by some 13 percent for the 1993-98 period and raised the average annual rate of growth of real GDP from 2.2 percent to 2.7 percent for the 1994-98 period. In November 2004, the base year of the national accounts aggregates was changed from 1995 to 2000. At the same time, benchmarking was undertaken to more accurately reflect the structure of the economy, by incorporating new areas of the economy previously not covered or under-covered, to use new and improved data, and to incorporate methodological changes to the compilation of data. These changes resulted in an upward revision of the average annual real growth rate for the period 1998 to 2003 from 2.4 percent to 2.7 percent.

Reporting of real sector data for *International Financial Statistics (IFS)* is timely. Data reported for *Direction of Trade Statistics (DOTS)*, however, show substantial inconsistencies with external trade data reported for *IFS*, particularly exports.

Labor market statistics are published with lags of three months, and unemployment data are available only at a six month frequency. Given the seriousness of the unemployment problem, labor market analysis and policy design need to be based on better, more frequent and timely labor market data. A revision of the Labor Force Survey is underway.

The consumer price index (CPI) has as its target population all South African households living in metropolitan and urban areas, which represent approximately 56 percent of the total number of South African households and 75 percent of private consumption expenditures in South Africa. The CPI weights are based on an Income and Expenditure of Households Survey conducted from November 1999 to October 2000. Beginning with the April 2003 index, Statistics South Africa issued revisions to the Consumer Price Index for the period January 2002 to March 2003, reflecting the incorporation of more reliable data on residential rents.

Government finance

South Africa currently reports data for the consolidated central government and for regional and local governments for publication in the *Government Finance Statistics Yearbook.* It also reports monthly data covering the cash operations of the budgetary central government for publication in IFS. GFS data are compiled and disseminated domestically and internationally according to the GFSM 2001 framework. Data for social security funds and central government's extrabudgetary funds are reported on an accrual basis, starting in 2000 and 2002, respectively. Starting in 2005, the authorities will include additional non-cash data, as prescribed for their financial statements.

Monetary statistics

South Africa regularly reports monetary statistics for publication in *IFS*, although there is room for improving the timeliness of the data on nonbank financial institutions. The SARB is working on the implementation of the recommendations of the 2003 and 2004 monetary and financial statistics missions towards full implementation of the methodology recommended in the *Monetary and Financial Statistics Manual*.

Balance of payments

South Africa is a regular reporter of balance of payments data. Balance of payments data are broadly consistent with the fifth edition of the Balance of Payments Manual (BPM5). There are plans to publish more detailed information on "other services" in future. The South African authorities are also working with their partners in the Southern African Customs Union (SACU) to improve the coverage of intra-SACU trade flows.

Net errors and omissions in the balance of payments are large—they averaged 2.3 percent of GDP during 2003-2005—and vary significantly from quarter to quarter. Work is ongoing to improve the reliability and accuracy of balance of payments data.

The banking sector holdings of foreign currency have been removed from the official measure of reserves, in accordance with international practice in this area. South Africa disseminates its international reserve position in line with the requirements of the IMF's template on international reserves and foreign currency liquidity.

SOUTH AFRICA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(as of June 12, 2006)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	6/12/06	6/12/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/06	6/06/06	M	M	M		
Reserve/Base Money	4/06	5/30/06	M	M	M		
Broad Money	4/06	5/30/06	M	M	M		
Central Bank Balance Sheet	4/06	5/30/06	M	M	M		
Consolidated Balance Sheet of the Banking System	4/06	5/30/06	M	M	M	O, O, LO, O	LO, O, O, O
Interest Rates[2]	5/30/06	5/30/06	D	D	D		
Consumer Price Index	4/06	5/22/06	M	M	M	O, LO, O, O	LO, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2H 2005	2/23/06	A	S	S		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	12/ 05	3/30/06	M	Q	Q	O, O, O, O	O, O, O, O
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2005	3/30/06	Q	Q	Q		
External Current Account Balance	Q4 2005	3/22/06	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and Imports of Goods and Services [6]	4/06	5/31/06	M	M	M		
GDP/GNP	Q1 2006	5/22/06	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross External Debt	Q4 2005	3/22/06	Q	Q	Q		

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Monthly data for goods. Goods and services are published quarterly on the same schedule as the rest of the balance of payments.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC (published in October 2001, and based on the findings of the mission that took place during May 7–18, 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation, and revision studies.

Appendix IV. South Africa: Debt Sustainability and Medium-term scenario

South Africa: Selected Economic and Financial Indicators in the Medium Term, 2005-2011

	2005	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.
	(Annual percent change, unless otherwise indicated)						
National income and prices							
Real GDP	4.9	4.2	4.0	4.0	4.0	4.0	4.0
Real GDP per capita	3.9	3.0	3.0	3.1	3.2	3.2	3.3
Real domestic demand	5.9	5.4	4.1	4.1	4.0	4.0	3.9
GDP deflator	4.7	5.8	4.5	4.5	4.5	4.5	4.5
CPI (annual average)	3.4	4.7	5.6	4.5	4.5	4.5	4.5
CPIX (end of period) [1]	4.0	5.9	5.4	4.5	4.5	4.5	4.5
Labor market							
Unemployment rate (percent)	26.7	26.4	25.6	24.8	23.9	22.9	21.9
Average remuneration (formal nonagricultural sector)	7.2	7.6	7.7	6.5	6.5	6.5	6.5
Labor productivity (formal nonagricultural)	3.8	2.9	2.0	2.0	2.0	2.0	2.0
Nominal unit labor costs (formal nonagricultural)	3.4	4.7	5.6	4.5	4.5	4.5	4.5
External sector							
Merchandise exports, f.o.b. [2]	13.5	13.4	8.2	6.1	6.0	5.6	5.4
Merchandise imports, f.o.b. [2]	17.0	16.0	7.8	5.0	5.1	5.3	4.8
Export (goods and services) volume	6.7	5.2	5.6	5.5	5.5	5.4	5.4
Import (goods and services) volume	10.1	9.4	5.4	5.5	5.2	5.1	4.8
Terms of trade	0.3	1.8	0.6	0.9	0.4	-0.1	-0.1
Nominal effective exchange rate [3]	1.1	…	…	…	…	…	…
Real effective exchange rate [3]	0.5	…	…	…	…	…	…
Money and credit							
Net domestic assets [4]	14.0	13.2	10.2	...	...	...	...
Broad money (including foreign exchange deposits)	19.9	16.7	11.1	9.2	9.2	9.0	8.7
Velocity (GDP/average broad money)	1.5	1.4	1.3	1.3	1.3	1.3	1.3
Bank rate/repurchase rate (period end, in percent)	7.0	…	…	…	…	…	…
	(Percent of GDP, unless otherwise indicated)						
Investment and saving							
Investment (including inventories)	18.2	18.8	19.3	19.4	19.5	19.5	19.5
Of which: public fixed investment (incl. public enterprises)	4.9	5.4	5.9	5.9	6.0	6.0	6.0
private fixed investment	12.3	12.7	12.8	12.9	12.9	12.9	12.9
Gross national saving	14.0	13.9	14.7	15.3	15.6	15.8	16.0
Public	1.1	0.7	0.0	-0.3	-0.4	-0.3	-0.1
Private	12.9	13.2	14.7	15.6	16.0	16.1	16.1
National government budget [5]							
Revenue, including grants	25.9	26.1	26.1	26.1	26.1	26.1	26.1
Expenditure and net lending	26.5	27.4	27.8	28.1	28.2	28.1	27.9
Overall balance	-0.6	-1.2	-1.7	-2.0	-2.1	-2.0	-1.8
National government debt	34.4	32.8	31.9	31.8	31.0	30.0	29.0
Borrowing requirement of the nonfinancial public sector	-0.3	1.5	2.6	3.1	3.3	3.3	3.3
External sector							
Current account balance	-4.2	-4.9	-4.6	-4.2	-3.8	-3.6	-3.5
Overall balance of payments	2.2	1.7	0.4	0.7	0.6	0.6	0.3
Total external debt	19.3	18.8	18.4	17.8	17.4	17.0	16.6
Gross reserves (SARB, billions of U.S. dollars)	20.6	25.0	26.0	28.0	30.0	32.0	33.0
(months of total imports)	3.6	3.8	3.7	3.8	3.9	3.9	3.8

Sources: South African Reserve Bank (SARB); IMF, International Financial Statistics; and Fund staff projections.

[1] CPIX is the consumer price index (CPI) excluding the interest on mortgage bonds. It is the targeted definition of inflation.

[2] In U.S. dollars; annual percent change.

[3] Annual average, South African Reserve Bank.

[4] Contribution (in percentage points) to the growth of broad money.

[5] Calendar-year figures, based on National Treasury data, and staff's GDP projections.

Public and External Debt Sustainability

South Africa's public debt position appears sustainable. The ratio of total public debt to GDP has fallen from 48 percent in 1999 to 34.4 percent at end-2005.[23] Under the policies outlined in the 2006 budget and the medium-term expenditure framework, public debt should continue to decline to below 30 percent of GDP over the coming decade. Gross financing needs should remain close to 5 percent of GDP per year over the medium-term, slightly below the average of the past five years (Figure 1).

The declining trend in the public debt-to-GDP ratio appears to be robust to a variety of shocks, including weaker GDP growth, a lower primary balance, a 30 percent real depreciation of the exchange rate, and a 10 percent increase in the debt stock (Figure 1). Under most of these scenarios, the public debt ratio is only slightly above the baseline over the projection period. However, it remains higher over the forecasting horizon in the case of a hypothetical 10 percent debt shock, which is close to the total stock of recognized contingent liabilities (11.2 percent of GDP estimated in early 2005, including government guarantees and actuarial liabilities for pension and insurance funds).

South Africa's external debt is projected to decline gradually from its current level of almost 19 percent of GDP to about 17 percent of GDP by 2011. The current account balance is projected to remain in deficit during the entire projection period, reflecting the anticipated persistence of high oil prices and the continued strength of domestic demand. The deficit is projected to decline gradually over the medium-term to about 3½ percent of GDP by 2010-11, as domestic demand growth slows down. The deficit is envisaged to be largely financed by non-debt creating capital inflows, allowing for a gradual decline in the external debt-to-GDP ratio.

The outlook for South Africa's external debt and gross external financing needs is robust to a broad range of shocks (Figure 2). With rand-denominated debt accounting for close to 40 percent of external debt at end-2005, currency risk is low; the share of short-term debt in foreign-currency denominated debt was 41 percent in 2005, implying moderate rollover risk. The results of various stress tests indicate that the largest adverse short-term impact on the external debt would arise from a one-time 30 real depreciation of the rand in 2006, which would bring the debt-to-GDP ratio to just over 22½ in 2007 (Figure 2). This ratio is projected to decline gradually to about 14 percent of GDP by end-2011. Permanent adverse shocks to real GDP growth, to real interest rates, or to the non-interest current account, whether considered individually or together, would drive the debt-ratio to a maximum of about 21 percent by 2011.

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[23] Excluding local governments' and public enterprises' debt (1.5 and 6.7 percent of GDP at end 2005, respectively).

South Africa: Public Sector Debt Sustainability Framework, 2003-11
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance [9]
1 **Baseline: Public sector debt** [1]	35.6	35.4	34.4	**32.8**	**31.9**	**31.8**	**31.0**	**30.0**	**29.0**	**0.1**
o/w foreign-currency denominated	5.3	4.9	4.6	4.5	4.8	5.1	5.0	4.7	4.4	
2 Change in public sector debt	-1.4	-0.2	-1.0	-1.7	-0.8	-0.1	-0.8	-1.0	-1.0	
3 Identified debt-creating flows (4+7+12)	-1.8	-2.3	-2.5	-2.5	-1.4	-1.2	-0.8	-0.8	-0.8	
4 Primary deficit	-1.8	-2.1	-3.2	-2.3	-1.7	-1.4	-1.0	-0.9	-0.9	
5 Revenue and grants	25.0	25.8	27.5	27.6	27.6	27.6	27.6	27.6	27.6	
6 Primary (noninterest) expenditure	23.2	23.7	24.3	25.3	25.9	26.2	26.6	26.7	26.7	
7 Automatic debt dynamics [2]	-0.4	-0.6	0.7	-0.1	0.3	0.2	0.2	0.1	0.1	
8 Contribution from interest rate/growth differential [3]	1.1	0.2	0.1	-0.1	0.3	0.2	0.2	0.1	0.1	
9 Of which contribution from real interest rate	2.1	1.6	1.7	1.2	1.6	1.4	1.3	1.3	1.2	
10 Of which contribution from real GDP growth	-1.0	-1.4	-1.6	-1.3	-1.2	-1.2	-1.2	-1.1	-1.1	
11 Contribution from exchange rate depreciation [4]	-1.5	-0.8	0.6	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.3	0.5	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.3	-0.2	-0.4	-0.2	-0.1	-0.1	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.6	0.7	0.4	0.1	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) [5]	0.4	2.1	1.5	0.9	0.6	1.1	0.1	-0.3	-0.2	
Public sector debt-to-revenue ratio [1]	142.7	137.3	125.1	118.7	115.8	115.3	112.6	108.9	105.1	
Gross financing need [6]	5.5	6.1	3.6	5.2	5.0	4.7	5.3	4.7	4.3	
in billions of U.S. dollars	9.1	13.1	8.6	13.3	13.7	13.6	16.4	15.5	15.0	
Scenario with key variables at their historical averages [7]				**32.8**	**31.1**	**30.0**	**27.9**	**25.4**	**22.9**	**0.3**
Scenario with no policy change (constant primary balance) in 2005-2010				**32.8**	**31.3**	**30.2**	**28.1**	**25.5**	**23.0**	**0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	3.0	4.5	4.9	4.2	4.0	4.0	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) [8]	10.7	10.8	10.2	9.9	9.6	9.3	9.3	9.1	9.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	6.3	5.2	5.5	4.1	5.3	4.8	4.8	4.6	4.4	
Nominal appreciation (increase in US dollar value of local currency, in percent)	30.1	17.9	-11.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.4	5.6	4.7	5.8	4.3	4.5	4.5	4.5	4.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	9.3	6.6	7.6	8.4	6.9	5.3	5.4	4.4	4.0	
Primary deficit	-1.8	-2.1	-3.2	-2.3	-1.7	-1.4	-1.0	-0.9	-0.9	

Sources: South African National Treasury and Fund staff estimates.

[1] National government includes the central government, and provincial and local government activities financed with transfers from the central government.

[2] Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

[3] The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

[4] The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

[5] For projections, this line includes exchange rate changes.

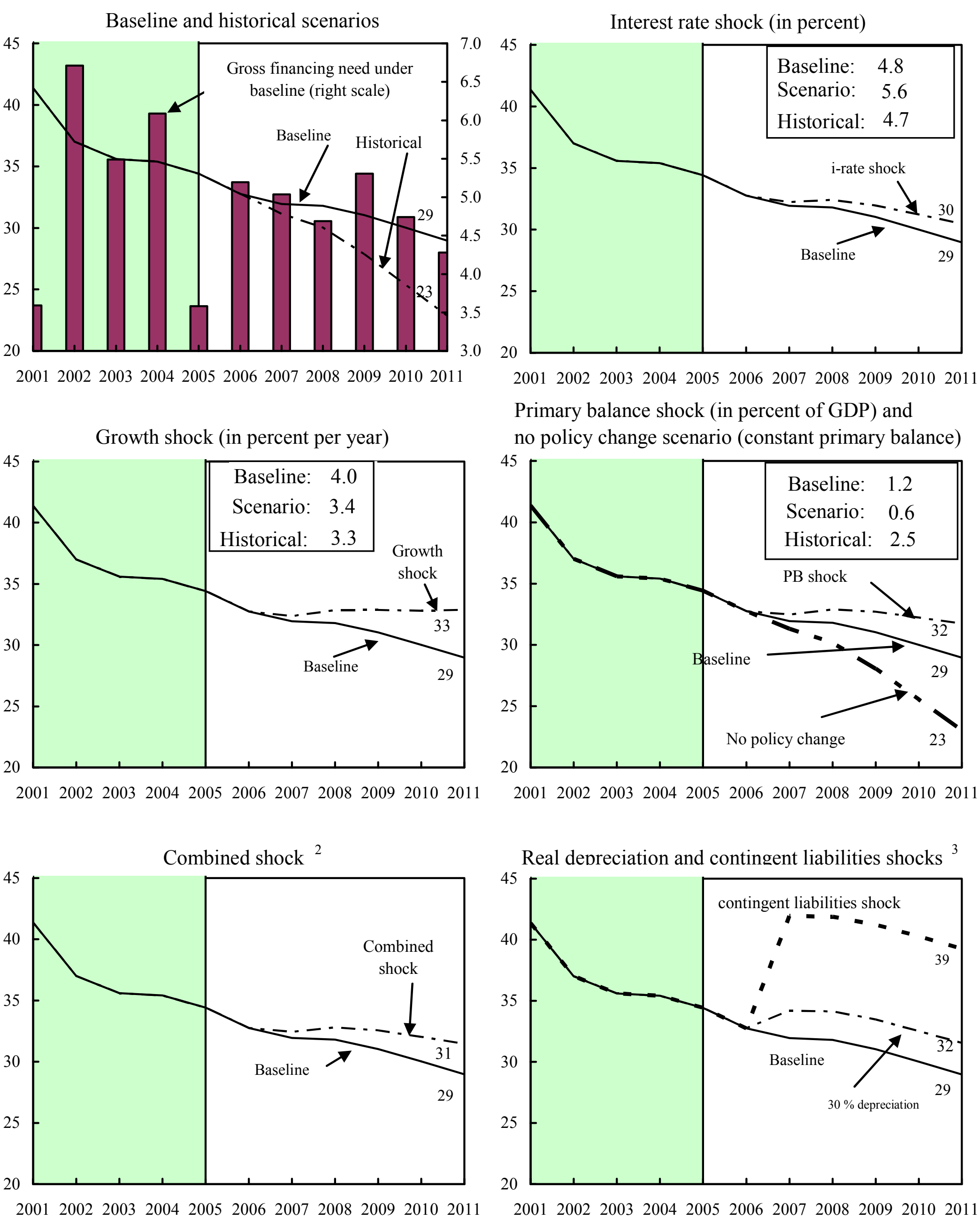
[6] Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

[7] The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

[8] Derived as nominal interest expenditure divided by previous period debt stock.

[9] Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. South Africa: Public Debt Sustainability: Bound Tests [1]
(Public debt in percent of GDP)



Sources: International Monetary Fund, South African authorities, and staff estimates.

[1] Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

[2] Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

[3] One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

South Africa: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account** [6]
Baseline: External debt	26.2	29.7	23.0	20.2	19.3	**18.8**	**18.4**	**17.8**	**17.4**	**17.0**	**16.6**	**-3.8**
Change in external debt	-1.6	3.5	-6.7	-2.8	-0.9	-0.5	-0.4	-0.5	-0.4	-0.4	-0.4	
Identified external debt-creating flows (4+8+9)	-3.5	-0.2	-7.2	-4.0	-2.4	0.1	0.1	-0.3	-0.5	-0.7	-0.8	
Current account deficit, excluding interest payments	-1.8	-2.3	0.0	2.4	3.2	3.8	3.5	3.1	2.8	2.6	2.4	
Deficit in balance of goods and services	-3.9	-3.7	-1.9	0.7	1.5	2.2	2.0	1.7	1.5	1.4	1.2	
Exports	30.0	32.7	27.9	26.6	27.1	28.5	29.1	28.8	28.8	28.6	28.5	
Imports	26.1	29.1	26.0	27.3	28.6	30.6	31.1	30.5	30.3	30.0	29.7	
Net non-debt creating capital inflows (negative)	-4.7	-0.1	-0.7	-3.1	-4.6	-4.0	-3.8	-3.7	-3.7	-3.7	-3.7	
Automatic debt dynamics [1]	2.9	2.2	-6.5	-3.3	-1.0	0.3	0.4	0.4	0.4	0.4	0.4	
Contribution from nominal interest rate	1.7	1.6	1.3	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1	
Contribution from real GDP growth	-0.9	-1.0	-0.6	-0.8	-0.9	-0.7	-0.7	-0.7	-0.7	-0.7	-0.6	
Contribution from price and exchange rate changes [2]	2.1	1.6	-7.3	-3.5	-1.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) [3]	1.9	3.7	0.5	1.2	1.5	-0.6	-0.6	-0.3	0.2	0.3	0.4	
External debt-to-exports ratio (in percent)	87.4	90.8	82.3	75.9	71.2	66.1	63.2	61.8	60.6	59.5	58.4	
Gross external financing need (in billions of US dollars) [4]	13.4	10.1	14.3	18.8	19.7	25.0	24.6	24.4	24.4	24.7	25.1	
in percent of GDP	11.3	9.0	8.6	8.7	8.2	9.7	9.1	8.4	7.9	7.5	7.2	
Scenario with key variables at their historical averages 5/						**18.8**	**14.4**	**10.4**	**6.7**	**3.2**	**-0.2**	**-4.0**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.7	3.7	3.0	4.5	4.9	4.2	4.0	4.0	4.0	4.0	4.0	
GDP deflator in US dollars (change in percent)	-13.2	-9.6	45.2	23.8	6.2	2.8	2.0	2.8	2.0	2.0	2.0	
Nominal external interest rate (in percent)	5.3	5.8	6.6	5.8	5.6	5.9	6.1	6.2	6.4	6.5	6.7	
Growth of exports (US dollar terms, in percent)	-4.2	2.3	27.6	23.2	13.6	12.5	8.4	6.1	5.9	5.5	5.4	
Growth of imports (US dollar terms, in percent)	-6.7	4.4	33.6	36.0	16.6	14.9	7.7	5.0	5.1	5.3	4.8	
Current account balance, excluding interest payments	1.8	2.3	0.0	-2.4	-3.2	-3.8	-3.5	-3.1	-2.8	-2.6	-2.4	
Net non-debt creating capital inflows	4.7	0.1	0.7	3.1	4.6	4.0	3.8	3.7	3.7	3.7	3.7	

Sources: SARB and Fund staff estimates.

[1] Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

[2] The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

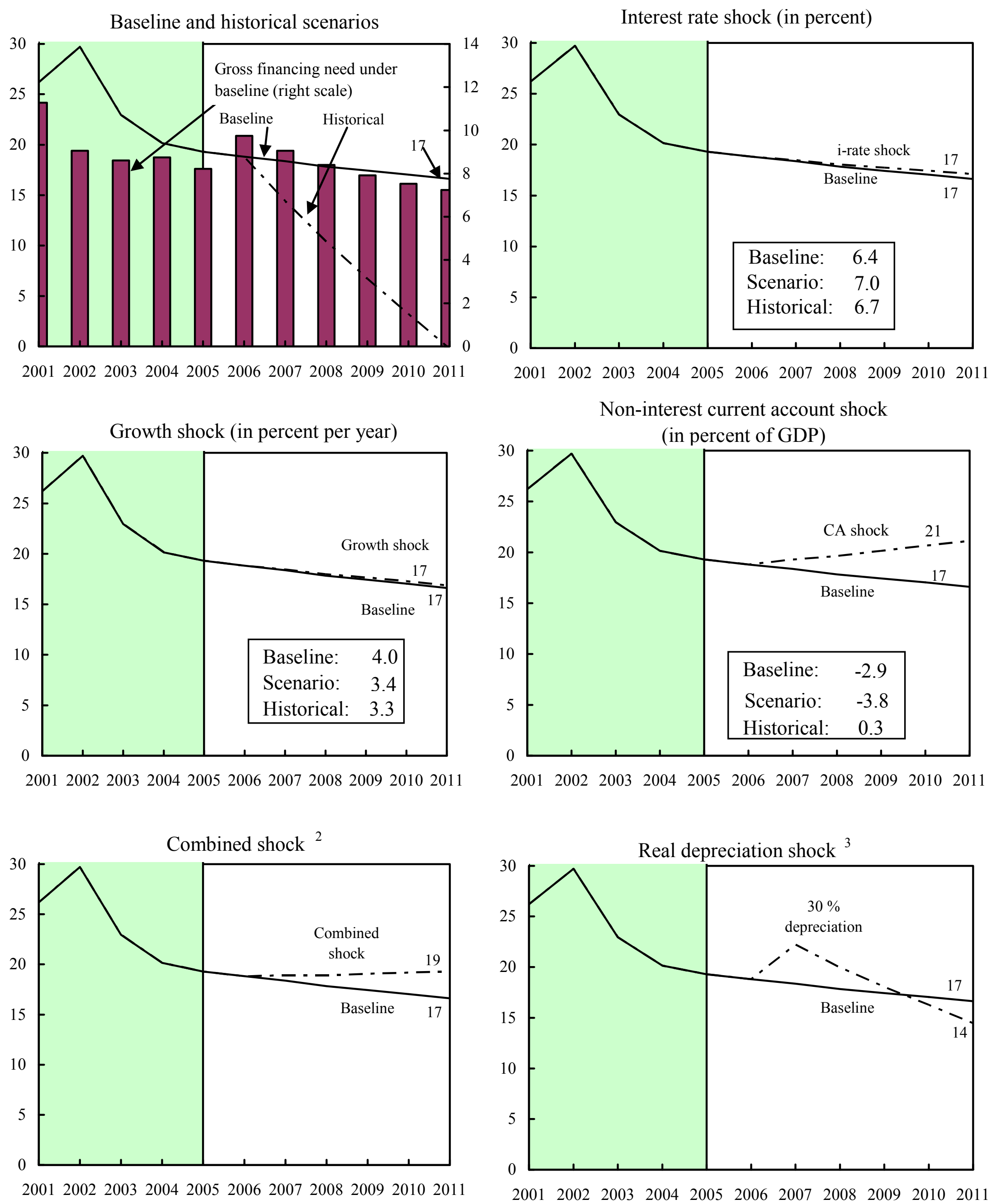
[3] For projection, line includes the impact of price and exchange rate changes.

[4] Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

[5] The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

[6] Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 2. South Africa: External Debt Sustainability: Bound Tests [1]
(External debt in percent of GDP)



Sources: SARB and Fund staff estimates.

[1] Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

[2] Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

[3] One-time real depreciation of 30 percent occurs in 2006.

APPENDIX V. SOUTH AFRICA: TENTATIVE WORK PROGRAM

Board meeting on the 2006 Article IV consultation	July 2006
Staff visit	December 2006

Statement by the IMF Staff Representative
August 2, 2006

1. This statement provides information that has become available since the staff report was issued. The thrust of the staff appraisal remains unchanged.

2. Recent data indicate that economic activity has remained robust, and inflationary pressures have been increasing. Manufacturing output growth accelerated in May to 5.2 percent (year-on year). Also, the purchasing managers' index (PMI) rose in June for the fourth month in a row and came out just below the all-time high registered in July 2005. Recent trade data indicate that the average monthly trade deficit in April-May has been only slightly lower than in the first quarter of the year. Employment in the formal non-agricultural business sector rose slightly during the first quarter of 2006 and, as of March, was up by 4.5 percent compared to a year earlier. Inflation rose to 4.8 percent (CPIX, year-on year) in June, in line with market expectations, mainly reflecting higher food and transport prices (the latter were affected by movements in world oil prices and the exchange rate).

3. South African financial markets have shown moderate volatility during July, along with an improvement in some key indicators. The rand has strengthened somewhat against major currencies, South Africa's sovereign spreads narrowed, and stock prices remained above their low levels registered in June. These movements were broadly in line with international market developments.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/102
FOR IMMEDIATE RELEASE
September 7, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation with South Africa

On August 2, 2006 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

Real GDP grew by 4.9 percent in 2005 and continued to grow strongly in 2006. High growth was driven by strong domestic demand, with private consumption and investment spending supported by low interest rates and improved sentiment. Household consumption was also boosted by rising incomes and wealth effects from buoyant housing and stock prices. After a slowdown in late 2005, partly reflecting temporary supply shocks, real GDP grew by 4.2 percent in the first quarter of 2006.

The strong pace of economic activity led to higher employment. Total employment grew by 5.7 percent in the year to September 2005. However, the unemployment rate remained broadly unchanged at 26.7 percent, as labor force participation rose significantly.

Inflation and inflation expectations remain well within the 3-6 percent target band. Twelve-month CPIX inflation was 3.7 percent in April 2006, though administered fuel price increases are likely to push it up in the near future.[2] Core inflation (CPIX excluding food and energy prices) remains

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

[2] The CPIX—the measure targeted by the South African Reserve Bank—excludes interest payments on mortgage loans.

subdued at about 3 percent. Expected average CPIX inflation for 2006 and 2007, measured on the basis of surveys conducted in April, were slightly above the mid-point of the target band. Credit to the private sector has continued to grow rapidly. Supported by low interest rates, credit to the private sector expanded by 23 percent in the year to April 2006. While household sector debt rose markedly (to 68 percent of disposable income by the first quarter of 2006, from 58 percent at end-2004), household debt service remained moderate, at about 7 percent of disposable income.

The South African Reserve Bank has maintained a flexible exchange rate system, while continuing to build up international reserves. The SARB has a publicly-announced policy of intervening in the foreign exchange market only to strengthen its external position at times of rand strength. Consistent with this policy, gross reserves have continued to grow, and by May 2006 reached US$24.1 billion, equivalent to over 200 percent of short term external debt.

After appreciating for a few years, the rand showed no clear trend in 2005 and depreciated in the first half of 2006. Like other emerging market currencies, the rand came under pressure and depreciated in May/June 2006 following turbulence in global financial markets.

The current account deficit widened markedly in 2005 and early 2006, largely driven by strong domestic demand. After reaching 4.2 percent of GDP in 2005, the current account deficit increased to 6.4 percent of GDP in the first quarter of 2006. With broadly unchanged terms of trade, the widening of the current account reflected volume growth in imports above that of exports, and large dividend payments to foreign shareholders. The deficit was more than covered by portfolio and FDI inflows. External debt declined to 19.3 percent of GDP by end-2005 from 20.2 percent a year earlier.

The fiscal deficit fell to 0.3 percent of GDP in FY2005/06, bringing government debt down to 34.1 percent of GDP by March 2006. The narrowing of the deficit mainly reflected a large increase in tax revenue, owing to strong economic activity and firm enforcement.

Asset prices continued to rise rapidly in 2005 and early 2006, but retreated somewhat in May and June. Strong commodity prices, investor interest in emerging markets, and favorable growth prospects drove the Johannesburg Stock Exchange all-share index up by 43 percent in 2005 and a further 16 percent through April 2006, before sliding back during the emerging market sell-off that started in May. Residential property prices rose strongly in recent years, favored by low interest rates and a growing demand by an emerging black middle class. The rate of increase, however, slowed to 16 percent in 2005, from 33 percent the previous year, and slowed further in the first few months of 2006.

Executive Board Assessment

Supported by well designed macroeconomic policies and structural reforms, growth in recent years has been strong, inflation has remained within the target band, and employment has increased. The public finances are sound, and international reserves have been rebuilt. Directors noted also that South Africa continues to face important challenges over the medium term, including reducing high unemployment, inequality and poverty, and staunching the HIV/AIDS epidemic.

Directors considered that the economic outlook for South Africa is broadly positive. Continued solid policy implementation and favorable external conditions should establish the foundations for sustained growth.

Directors viewed uncertainties in the external environment as the main source of risk to the outlook. A deceleration in global activity would affect South Africa owing to the structure of the country's exports. A more immediate risk would be a weakening sentiment for emerging market economies and a continuation of the recent slowdown in capital flows. Directors also noted that, in light of these factors, the external current account deficit could represent a point of vulnerability. Nonetheless, they considered that, based on its strong fundamentals, South Africa is well placed to face these risks.

Directors welcomed the tightening of monetary policy in June, noting that risks to the inflation outlook justified the decision. They also observed that interest rates may need to be raised further, especially if the depreciation of the rand threatened to pass through to general prices. Directors encouraged the authorities to continue to increase the transparency of the inflation targeting regime, which they noted had worked successfully so far. Relatedly, they noted that the flexible exchange rate regime had served the country well, providing a cushion against external shocks.

Directors welcomed the focus of public expenditure on investment and selected social programs within a framework that remains consistent with a gradual decline in public debt.

Directors noted the strength of the key indicators of financial soundness, and encouraged the authorities to continue enhancing regulation and oversight. Directors also welcomed the authorities' interest in participating in an update of the FSAP (Financial Sector Assessment Program) for South Africa and later in a regional FSAP.

Directors supported the government's goal of raising growth and reducing unemployment under the Accelerated and Shared Growth Initiative for South Africa. They agreed that attempting to influence the level of the real exchange rate through monetary policy to promote growth would be counterproductive and undermine the inflation-targeting regime. Directors considered that efforts to boost growth and employment could be complemented by further liberalization of labor markets and the trade regime. Directors expressed support for the main initiatives to reduce wealth disparities that were the legacy of the apartheid era, including land reform and Black Economic Empowerment.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

South Africa: Selected Economic Indicators, 2002-06
(Annual change in percent, unless otherwise indicated)

	2002	2003	2004	2005	2006 Proj.
Real GDP	3.7	3.0	4.5	4.9	4.2
CPI (metropolitan areas, annual average)	9.2	5.8	1.4	3.4	4.7
CPIX [2]	10.8	4.0	4.3	4.0	5.9
Broad money [2]	18.1	12.9	13.1	19.9	16.7
Unemployment rate (in percent)	30.4	28.0	26.3	26.7	26.4
National government budget balance (in percent of GDP) [3]	-1.2	-2.0	-1.7	-0.6	-1.2
National government debt (in percent of GDP)	37.0	35.6	35.4	34.4	32.8
External current account balance (in percent of GDP)	0.6	-1.3	-3.4	-4.2	-4.9
External debt (in percent of GDP)	29.7	23.0	20.2	19.3	18.8
Gross reserves (SARB, in months of total imports)	2.8	2.2	3.0	3.6	3.8
International liquidity position of SARB (in billions of U.S. dollars) [2]	-1.6	4.8	11.4	17.2	21.5
U.S. dollar exchange rate (rand per U.S. dollar) [2]	8.64	6.64	5.63	6.33	...

Sources: South African Reserve Bank; IMF, International Financial Statistics; and staff estimates and projections.

[1] The CPIX is equal to the CPI excluding interest payments on mortgage bonds.
[2] End of period.
[3] Calendar year.

Statement by Peter Ngumbullu, Executive Director for South Africa and John Mafararikwa, Senior Advisor to Executive Director
August 2, 2006

Background

The South African authorities have continued with implementation of sound macroeconomic and social policies, aimed at raising economic growth and reducing poverty, within a stable macroeconomic, social and political environment. The results are encouraging. The country's economic fundamentals have strengthened significantly and South Africa is making a major contribution in boosting Africa's ongoing economic strength, through its approach to macroeconomic policies, the growing trade links with the rest of the continent, contribution of South African Banks in African countries and its gradual capital account liberalization which is translating into sizable portfolio investment in Africa. Major strides have been made in addressing the significant social needs, including providing assistance to those affected by the HIV/AIDS pandemic. South Africa has demonstrated leadership in addressing difficult reforms such as reducing wide racial inequalities in income, wealth and land redistribution and their experience shows that doing so within the context of a growing economy is fundamental, complemented by skilful social and political management.

As an emerging market economy and regionally systemic country, the South African economy is not immune to global developments and challenges, as recent events have shown. They are fully aware of the need to adjust their policies to carefully manage the risks associated with possible further deterioration of the external environment, especially disorderly unwinding of global imbalances and the ongoing tightening of global liquidity conditions, in order to achieve their main objective of maintaining robust real economic growth. However, they are also aware of the limits of policy adjustments to a harsh external environment and look forward to progress being made in multilateral consultations on global imbalances. The South African Authorities are addressing the challenges that face the country in a comprehensive way and have unveiled a new framework, the Accelerated and Shared Growth Initiative of South Africa (ASGISA), which focuses on improvement of the growth path of the economy over the medium- to long-term. In this context, the authorities express their appreciation of the exchange of views with the staff during their missions and for well-written and balanced reports.

Growth performance

The South African economy continued its robust performance and real GDP grew by 4.9 percent in 2005. The low interest rate environment and rising incomes from buoyant housing and stock prices contributed to strong growth in domestic demand, with private consumption and investment spending increasing substantially. Public sector investments also increased in areas that are growth enhancing. Reflecting the strong growth, employment grew by a healthy 5.7 percent in the year to September 2005. The authorities consider that their prudent macroeconomic policies, complemented by ongoing deepening of structural reforms in the economy, including measures aimed at addressing wealth and social inequalities are contributing to raising potential GDP. They remain optimistic that growth will remain strong in 2006.

Fiscal policy and debt management

The fiscal performance of the South African authorities continued to be an anchor of the overall sustainability of the macroeconomic framework, and was again underpinned by robust revenue collections, and disciplined expenditure and debt management. The non-financial public sector registered a significant turnaround, posting a surplus of 0.7 percent of GDP in fiscal year 2005/06 compared to a deficit of 1.8 percent in the previous year. In fiscal year 2005/06 the first public-sector surplus ever was recorded. Revenue collections exceeded the original budget estimate by a considerable margin during this period, reflecting strong economic growth, improved tax administration and the benefits of structural reforms in the tax system. The most buoyant increases in tax revenue were registered by taxes on international trade and transactions, reflecting the rising import volumes stemming from the buoyant domestic expenditure and relative strength of the rand. Taxes on property as well as corporate income tax collections also rose briskly. On the other hand, expenditure by the national government in 2005/06 came very close to the original budgetary provision. While most categories of expenditure grew at a somewhat stronger rate than originally budgeted, interest paid on national government debt fell short of the originally budgeted projection.

Strong economic performance, sustainable fiscal policies and sound debt management contributed to continuous decline in the public debt for the past ten consecutive years. Total loan debt as a ratio of gross domestic product decreased from 35.3 percent at the end of March 2005 to 33.8 percent at the end of March 2006, while the share of external debt decreased from 13.8 percent to 12.6 percent during the same period.

Monetary policy and exchange rate developments

The South African authorities have continued to implement monetary policy within the inflation targeting framework with a firm commitment to ensure price stability, within the target range of 3-6 percent. Since September 2003, and during the past year, the inflation rate was again firmly controlled within the adopted target range. During its last meeting, the Reserve Bank of South Africa expressed concern about the inflation outlook in the short-term, stemming from high domestic demand and high oil prices and decided to increase the repo rate by 50 basis points from 7 to 7.5 percent. The central bank reiterated that it would continue to monitor economic developments and all the relevant risks which might have a bearing on the continued attainment of the inflation target. Regarding inflation targeting, the authorities are satisfied with the current framework which has gained confidence of market participants. They are focusing on further strengthening of institutional capacity in research and analytical skills before contemplating any possible modifications to the framework. Moreover, the economy is still undergoing fundamental reforms that have long-term implications on potential GDP. In this regard, a process has been initiated, involving peer review of its macroeconomic and forecasting model by international and local academics and broadening the information provided in the Monetary Policy Committee's statements.

While the South African currency has remained relatively stable over the last few years, recent global developments in the international financial and commodity markets have started to put pressure on the currency, and the re-rating of emerging market risks contributed to the depreciation of the rand, though it has strengthened lately. Several other emerging market countries also experienced some degree of weakening of their currencies. As stated in the staff report, the widening of interest spreads on international bonds remained well contained in the case of South Africa.

Balance of payments developments

The external current account recorded a deficit during 2005, reflecting strong domestic demand and the strength of the rand. The deficit on the current account was more than offset by the surplus on the financial account, which widened in the first quarter of 2006 as non-residents stepped up investment in South Africa. Net financial inflows to the value of R33.4 billion were recorded in the first quarter of 2006, compared to a net inflow of R22.8 billion in the fourth quarter of 2005. The inflow of portfolio investment capital during the first half of 2006 also benefited from an international bond issue of US$750 million. As a result of the inflows of capital, the overall balance of payments continued to record a surplus during the period under review. This was the tenth consecutive quarterly overall balance of payments surplus recorded since 2003. The authorities continue to make gradual but steady progress in removing capital controls, contributing to increase FDI to other countries particularly in Africa. Consistent with its policy of accumulating reserves when conditions are favorable, South Africa continued to accumulate international reserves during 2005/06. The country's gross international reserves increased to 3.6 months import cover. Also, South Africa's reserves-to-short term debt ratio is much higher than other emerging market economies, which will help to foster exchange rate stability and reduce vulnerabilities to external shocks.

Trade Policy

Since the 1990s, South Africa's trade regime has been liberalized significantly through simplification of the trade regime, wider use of ad valorem duties, reduction of tariff peaks and reduction in the weighted average tariff. In considering the pace of further trade liberalization, the authorities are disappointed by the lack of progress in the Doha round.

Nevertheless, they are pursuing preferential trade arrangements within the region, EU, US, Asia and South America. In pursuing these negotiations, the authorities are mindful of the implication on countries in the region, particularly within the SACU group, including the possibility of region-wide pressures on government finances.

Financial sector developments

South Africa's financial system remains sound and measures are being taken to continue enhancing regulation and oversight. Major banks have developed sophisticated risk management systems and regulation and supervision have been strengthened. The authorities are fully aware and are monitoring the risks associated with fast growing credit to household. They are looking forward to the envisaged FSAP update. South African banks are also major players in the region and in Africa as a whole and the authorities are stepping up cooperation with host countries. Regional initiatives are at an advanced stage in harmonizing legal and regulatory frameworks for supervision within the SADC grouping. Cooperation in these areas will also be strengthened with other African countries where South African banks operate.

Developments in the labor market

Reflecting the strong performance of the domestic economy, formal non-agricultural employment increased meaningfully over the period of March 2005 to March 2006. The number of employed persons in the formal non-agricultural sector increased by 312,000; an increase of 4.5 per cent over the year to March 2006. Employment gains were fairly widespread throughout the economy and both the private and public sectors expanded their employment during the period. Notwithstanding these gains, the authorities are aware that the level of unemployment in the country remains high. They have adopted the ASGISA framework to raise the growth potential of the economy over the medium- to long-term, with a view to particularly reducing unemployment and poverty. It is important to observe that the main causes of high unemployment in South Africa date back to the apartheid era, and these problems cannot simply be addressed by changing labor laws, but should be spearheaded by skillful political and social management of the reforms. It is therefore important that any framework, as is the case with ASGISA, enjoys widespread support among the key role players in the South African society, including government, the private sector, organized labor, and the non-governmental organizations.

Addressing social inequalities

The authorities are consolidating programs aimed at addressing racial inequalities in the distribution of wealth, land, ownership of business and employment opportunities. The authorities' Black Economic Empowerment (BEE) program is being implemented in a transparent manner, through various schemes with clear indicators and with cooperation from the private sector. Regarding land reform, the guiding principle has been willing-buyer/willing-seller. The experience so far points to the need for fine-tuning this policy with a view to accelerating land redistribution in a manner that is grounded in well defined legal principles, maintains confidence and mindful of the impact on agricultural output.

The Accelerated and Shared Growth Initiative for South Africa (ASGISA)

The core objective of the South African authorities is to halve poverty and unemployment by 2014, which requires maintenance of macroeconomic stability and a growth rate in excess of 5 per cent. Thus, the government has set a two-phase target. The first phase covers the period 2005-09, during which the government envisages an annual growth rate that averages 4.5 per cent or higher. It is worth noting that the South African economy has been, and is still undergoing fundamental structural transformation which translates into growth accelerations. This provides evidence that the growth potential of the economy is higher. Therefore, in the second phase, between 2010 and 2014, average GDP growth rate is expected to accelerate to at least 6 per cent. In developing this vision for accelerated and shared growth, government adopted a strategy for identifying and addressing “binding constraints” on achieving its growth objectives. The binding constraints include: (i) minimizing excess volatility in the exchange rate; (ii) addressing inadequate infrastructure and logistical bottlenecks to satisfy the needs of a rapidly growing economy by investing 20 percent of GDP for the next three years, mostly on power generation, power distribution, rail transport, harbours and an oil pipeline as well as housing and social institutions and provincial projects in mining, agriculture and other sectors; (iii) removing barriers to entry and competition; (iv) improving the regulatory environment; (v) addressing capacity limitations within government and improve absorption capacity; (vi) adopting sectoral investment strategies and increased support for SMEs; and (iv) addressing the shortage of skills.

Addressing skills shortage and education initiatives

The current growth acceleration is exposing the shortage of suitably skilled labor. The South African government plans to address these issues via medium-term educational interventions. Apart from interventions to address the skills challenge in the educational sphere, measures include the development of an Employment Services System (to close the information gap between potential employers and employees), and phase 2 of the National Skills Development Strategy. A new institution, the Joint Initiative for Priority Skills Acquisition (JIPSA) has been established to address the skills shortage. This is a structure led by a Committee of key ministers, business leaders, trade unionists, education and training providers, and other experts. The focus of the group will be to identify urgent skills needs, and provide effective solutions, such as special training programmes, bringing back retirees or South Africans and Africans working out of Africa, and drawing in new immigrants where necessary. It may also include mentoring and overseas placement of trainees to fast track their development. In addition, the government is also engaged in the development of a scarce skills database based directly on the expected needs of the over 100 individual projects included in ASGISA. Other key skills projects include the deployment of experienced professionals and managers to local governments to improve project development, implementation and maintenance capabilities.

Efforts to address HIV/AIDS and other diseases

The South African authorities embrace the significance of a healthy population and work force for sustained economic growth and development. They have intensified their campaign to reduce the incidence of HIV/AIDS, as well as other communicable diseases. Government's comprehensive HIV/AIDS management programme is firmly grounded and aligned to all of its development interventions, focusing on priority areas such as prevention, treatment, support services, development of health facilities, legal and human rights commitments, research, monitoring and surveillance. Currently, the National Comprehensive Plan for the Management, Care and Treatment guides the design and implementation of HIV/AIDS programmes and compares favourably with the best programmes globally. Expenditure on HIV/AIDS has increased substantially over the past five years; the number of patients under treatment has tripled and coverage is expected to be universal with the complementary efforts of the private sector.

Concluding remarks

The South African authorities have entered the second decade of democracy with the same commitment as during the first decade; to design and implement prudent macroeconomic policies aimed at improving the standards of living of all South Africans. The progress made thus far is commendable, and well-documented in the annual staff reports by the IMF. The authorities foresee an ongoing positive relationship with the IMF in the period ahead, particularly at a time when the IMF is reviewing its role and interaction with member countries. As in the past, the authorities will communicate their intention to have the staff report published at a later stage.