August 2007
IMF Country Report No. 07/274

South Africa: 2007 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 the2007 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 22, 2007, 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 11, 2007. 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 July 25, 2007 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 25, 2007 discussions of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for South Africa.

The document listed below has 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the
2007 Consultation with South Africa

Approved by Michael Nowak and Matthew Fisher

July 11, 2007

- The 2007 Article IV consultation discussions were held in Pretoria and Cape Town during May 9–22, 2007. The mission met with the Minister of Finance, the Governor of the South African Reserve Bank, senior officials, and representatives from the private sector and the academic community.

- The staff team comprised Messrs. Lizondo (head), Cuevas, and Gueorguiev (all AFR), Vacher (MCM), and Ms. Nkusu (PDR). Messrs. Nolan and Burgess, senior and deputy resident representatives in Pretoria, respectively, participated in the mission. Mr. Aboobaker, Senior Advisor to the Executive Director for South Africa, also took part in the discussions.

- At the time of the 2006 Article IV consultation, Executive Directors commended the authorities for their well-designed macroeconomic policies and structural reforms. They also noted that high unemployment and poverty remained serious challenges. Directors supported the authorities' strategy to deal with these problems through policies aimed at raising economic growth while maintaining 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.

- Relations with the Fund, relations with the World Bank Group, and statistical issues are presented in an informational annex to this report.

Contents Page

GLOSSARY

ARV	Anti-retroviral drugs
ASGISA	Accelerated and Shared Growth Initiative for South Africa
BEE	(Broad Based) Black Economic Empowerment
BLNS	Botswana, Lesotho, Namibia, and Swaziland
CGER	Consultative Group on Exchange Rate Issues
CMA	Common Monetary Area
CPI	Consumer Price Index
CPIX	CPI excluding the interest on mortgage loans
EMEs	Emerging Market Economies
EPA	Economic Partnership Agreement
EU	European Union
FSAP	Financial Sector Assessment Program
IMD	International Institute for Management Development
PPP	Public-Private Partnership
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
SMEs	Small-and-medium-sized enterprises
SOEs	State-owned enterprises
TDCA	Trade Development and Cooperation Agreement
TFP	Total Factor Productivity
WEF	World Economic Forum

Executive Summary

Background

South Africa's recent economic performance has been strong. Real GDP growth has been robust, employment has risen, the fiscal position has strengthened further, and the country has continued to bolster its international reserves. Strong domestic demand, however, led to a widening of the external current account deficit, which was financed by portfolio inflows. Also, inflation pressures intensified, leading to a recent breach of the inflation target band.

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

Policy discussions

Staff supported the authorities' overall strategy, which seeks to spur growth and reduce unemployment and poverty while preserving macroeconomic stability.

Staff agreed with the Reserve Bank that the inflation risks were on the upside, and considered that a tightening of monetary policy could be needed. In the event, the policy interest rate was raised in June, following the breach of the band with April inflation data.

The authorities remain committed to the flexible exchange rate regime, intervening only to gradually build up reserves, a policy supported by staff. Staff also supported the ongoing relaxation of capital controls, and favored reducing administrative compliance costs.

Staff agreed with the thrust of the government fiscal plans, including boosting investment in infrastructure and selected social programs, but favored maintaining a neutral fiscal stance in the next few years, which would imply a moderately lower rate of expenditure growth than currently planned. The government is developing a major social security reform.

The banking system is sound and well regulated. The authorities are well aware of the risks arising from rapid credit growth, and staff suggested steps to further enhance the monitoring framework. There is progress in improving access to banking services by the poor.

Staff supported the efforts to identify and address constraints on growth under the Accelerated and Shared Growth Initiative for South Africa. Although the volatility of the rand has been identified as a possible constraint, there was agreement that the current flexible exchange rate system should be maintained. Competitiveness concerns would continue to be addressed by measures to raise productivity and reduce costs.

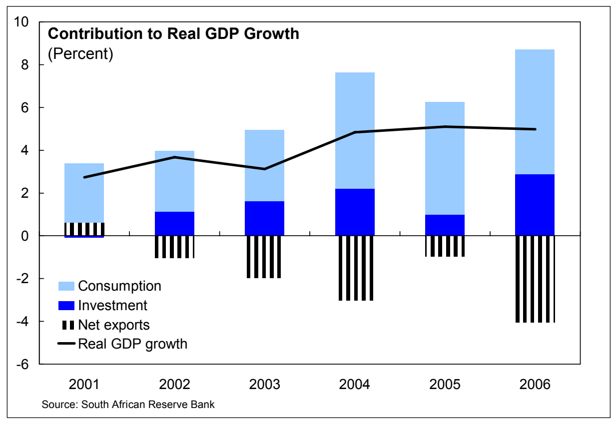
Staff supported efforts to increase employment, and favored the identification and revision of labor market regulations and practices that limit job creation. Staff also recommended further trade liberalization and simplification of the trade regime. South Africa's strong economic performance in recent years has benefited the wider region.

Staff supported the official initiatives to address wide income and wealth disparities.

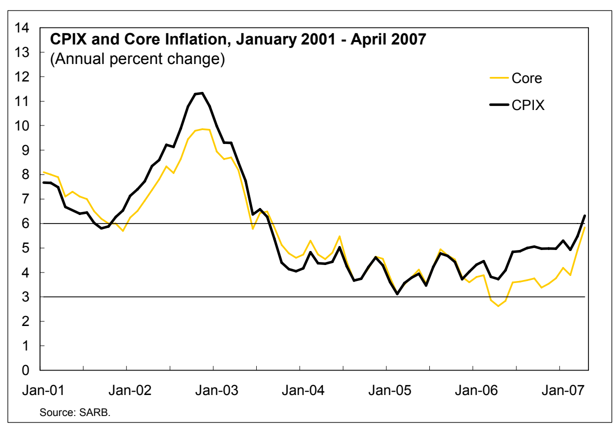
I. Recent Economic and Policy Developments

1. **South Africa has made significant economic progress in the past decade**. After sluggish growth in the early years of the political transformation, the country started to reap the benefits of sustained good macroeconomic management and structural reforms, recently supported by favorable external conditions. The economy is undergoing its longest expansion on record, and in recent years has experienced elevated growth in an environment of rapid credit expansion, booming asset prices, strengthening public finances, and rising international reserves financed by large capital inflows. At the same time, however, the external current account has widened markedly, and inflation pressures have recently intensified.

2. **The economy grew by 5 percent in 2006 for a third year in a row, and by 4.7 percent in the first quarter of 2007, driven by strong domestic demand**. Household consumption was fueled by growing disposable income, relatively low interest rates until late 2006, and wealth effects from rising asset prices. Private fixed investment remained buoyant, supported by strong business confidence. Public sector investment and government consumption also expanded robustly.

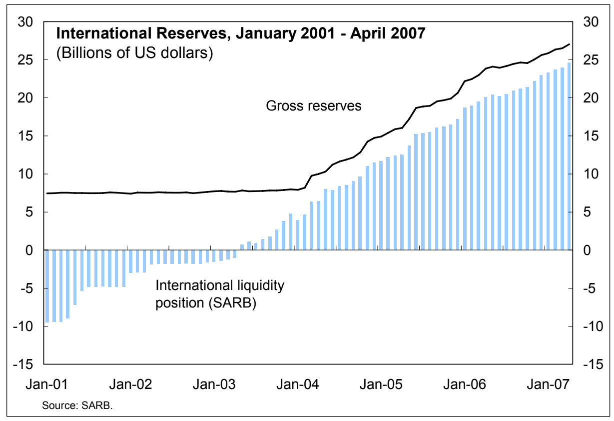


3. **The expansion in economic activity lifted employment, which rose by 4.1 percent in the year to September 2006**. The unemployment rate, however, declined only modestly, to 25½ percent, as labor force participation rose significantly. Remuneration per employee in the formal nonagricultural sector rose by 9.1 percent (y-o-y) in the last quarter of 2006.

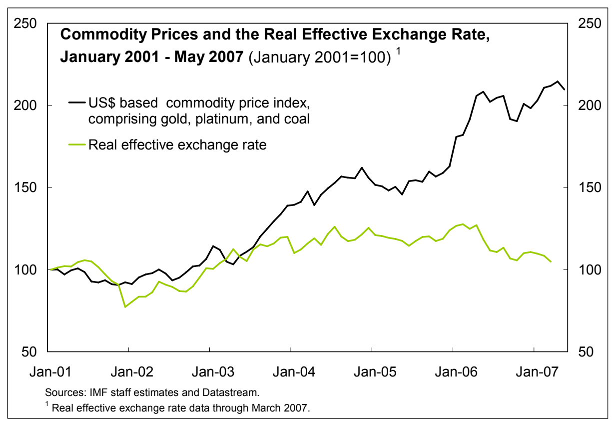


4. **Inflation pressures intensified lately, leading to a breach of the Reserve Bank's target band of 3–6 percent in April 2007, for the first time in 3½ years**. CPIX inflation increased during 2006, prompting the MPC to raise the policy interest rate (the repo rate) between June

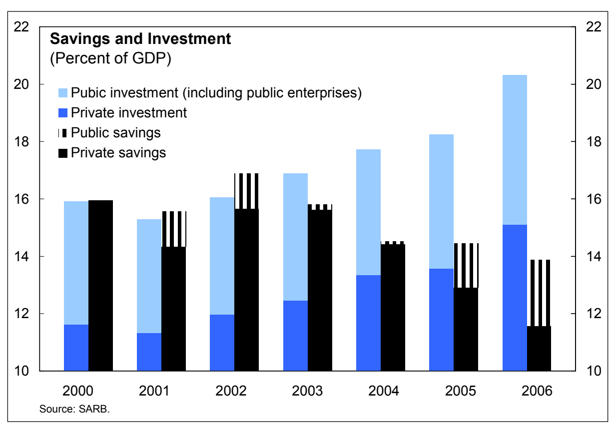
and December by a cumulative 200 basis points, to 9 percent.[1] Following a pause in the tightening cycle, an unexpectedly large jump in inflation to 6.3 percent in April led to an upward revision in the MPC's inflation outlook and an ensuing 50 bps increase in the repo rate in June.



5. **The SARB maintains a flexible exchange-rate system, while building up international reserves**. The SARB has a publicly-announced policy of intervening in the foreign exchange market only to purchase foreign exchange to gradually bolster its reserve position. By May 2007, gross reserves reached US$27.9 billion, equivalent to about 200 percent of short-term external debt, or 3.4 months of imports of goods and services.



6. **After depreciating markedly in mid-2006, the rand has fluctuated without a defined trend**. Like other emerging market currencies, the rand came under pressure following global financial market turbulence in May-June 2006, and depreciated by 10.6 percent in real effective terms between end-2005 and July 2006. Since then, the weakening effect of the rising current account deficit on the rand has been broadly offset by renewed strength in commodity prices and widening interest differentials with the U.S. and the Euro area.



7. **The external current account deficit widened significantly, to 6.5 percent of GDP in 2006 and 7.0 percent of GDP in the first quarter of 2007, reflecting the continued strength of domestic demand**. In 2006, growth in import volumes substantially exceeded growth in export volumes, while the terms of trade improved marginally. From a savings-

[1] The CPIX—the measure targeted by the SARB under its inflation-targeting framework—is the CPI excluding interest payments on mortgage loans.

investment perspective, investment rose by 2¼ percentage points of GDP and national savings declined slightly (with an increase in public savings partially offsetting a fall in private savings). The current account deficit was financed by portfolio inflows, mainly equity. External debt rose, but remains at modest levels of 22½ percent of GDP, with 37 percent of this debt being denominated in rand.

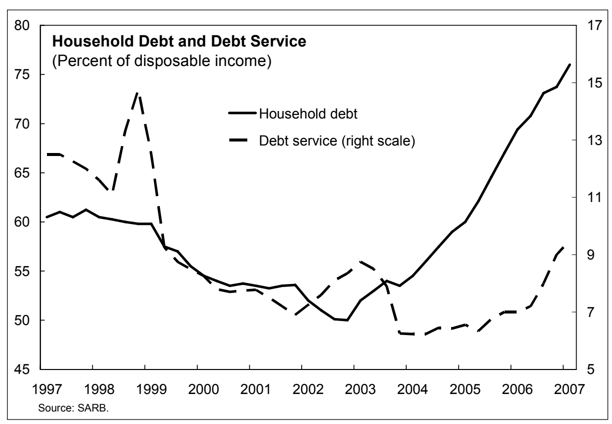
8. **Reflecting strong tax revenues, the national government's fiscal balance yielded a surplus of 0.6 percent of GDP in FY2006/07 after recording a deficit of 0.3 percent of GDP a year earlier**. As in recent years, booming demand and greater efficiency in tax collection contributed to large revenue gains beyond budgeted levels. On the expenditure side, a rise in social spending was broadly offset by a decline in interest payments and other spending. By end-2006, government debt had declined to about 31 percent of GDP.

National Government Main Budget [1]

	2004/05	2005/06	2006/07
	(Percent of GDP)		
Total revenue and grants	24.3	26.1	26.9
of which:			
Tax revenue	23.9	25.5	26.3
Income tax	13.6	14.6	15.6
Indirect taxes	9.2	9.6	9.8
Trade and other	1.0	1.3	0.9
Total expenditure	25.8	26.4	26.3
of which:			
Interest expenditure	3.4	3.2	2.9
Social expenditure [2]	13.8	14.3	14.8
Budget Balance	-1.4	-0.3	0.6
Memorandum items:			
Cyclically adjusted primary balance [3]	2.1	2.9	3.0
Debt	35.1	33.5	30.7
Domestic	30.2	29.2	26.3
Foreign	4.9	4.2	4.4

Source: South African authorities and IMF staff estimations.
[1] For fiscal year beginning April 1.
[2] Consolidated central and provincial government. Education, health, transfers, and other.
[3] Using tax-specific elasticities to tax-specific base gaps (see IMF Country Report 06/328).

9. **Credit growth has remained buoyant despite recent interest rate hikes, thereby raising household indebtedness**. Credit to the private sector grew by 25.1 percent in the year to April 2007, supported by rising incomes, wealth effects, employment, and confidence. On the supply side, intensified bank efforts to reach lower-income strata of the population contributed to the expansion. Lately, an increasing share of the new loans have reflected corporate sector borrowing. Household debt rose to 76 percent of disposable income by March 2007, up from 68 percent a year earlier. Households' debt service relative to disposable income has also risen, partly reflecting the recent increase in interest rates.



10. **Asset prices continued to rise strongly in 2006 and 2007**. The Johannesburg Stock Exchange all-share index surged by 40½ percent in the 12 months through May 2007, driven by strong commodity prices, favorable growth prospects, and positive assessments from rating agencies. Residential property prices also continued to rise, by 15½ percent in the 12 months to May 2007.

II. Policy Discussions

11. **The authorities' main objectives are to accelerate growth and reduce unemployment and poverty within a stable macroeconomic environment**. The government's Accelerated and Shared Growth Initiative for South Africa (ASGISA) seeks to relax key binding constraints on growth, and aims to achieve average growth rates of at least 4½ percent in 2005–09 and 6 percent in 2010–14, and halve the unemployment and poverty rates by 2014 from 2004 levels. Against this background, discussions with the authorities focused on the economic outlook and risks; policies to maintain macroeconomic and financial stability; structural reforms to raise growth and reduce unemployment; and regional implications of South Africa's developments and policies.

Box 1. Summary of Previous Consultation Discussions

Macroeconomic policies. There has been broad agreement on policies, as the Fund has generally supported the authorities' views on fiscal policy, inflation targeting, exchange rate policies, international reserves management, and exchange control liberalization.

Structural policies. The Fund has supported South Africa's fiscal and financial sector reforms, trade liberalization, and initiatives to reduce unemployment. It also encouraged identifying and revising aspects of labor legislation that constrain job creation, but progress in this area has been difficult. The Fund considered that privatization, within a proper regulatory framework, could help enhance the efficiency of state-owned enterprises, but the authorities favored instead the restructuring of the large enterprises, together with the sale of their noncore assets. The Fund has also recommended further liberalization and simplification of the trade regime; while there has been some progress, the authorities indicated that decisions on the tariff structure would depend on the outcome of the Doha round and the conclusions of their industrial policy review.

A. Outlook and Risks

12. **The authorities and staff agreed that near-term economic prospects are broadly favorable**. A broad range of indicators point to continued robust output growth, and the external environment is expected to remain benign. Staff's baseline scenario envisages output growth of 4¾ percent in 2007 and 4½ percent in 2008, the latter being somewhat below government projections. Inflation is expected to remain above the upper limit of the target band in the near term. Continued strength of domestic demand would keep the current account deficit relatively high, above 6 percent of GDP in 2007 and 2008.

13. **The main downside risks to the near-term outlook are a possible deterioration of the global environment and the potentially excessive pace of domestic demand**. Weaker appetite for emerging market assets, or a substantial rise in global interest rates, could reduce capital inflows to South Africa, prompting a sharp depreciation of the rand and thus

additional interest rate increases to keep inflation in the band. Household balance sheets would deteriorate, as mortgages at variable interest rates have grown strongly, potentially contributing to dampening growth. Also, a negative supply shock in world oil markets could slow growth globally, and in South Africa, especially if accompanied by a sharp fall in commodity prices. The widening current account deficit and high reliance on portfolio inflows have raised vulnerability to external shocks, particularly a "sudden stop" in capital inflows (Box 2). However, the country's strong fundamentals, including low external debt, a solid and improving reserves position, a sound financial sector, and adherence to a flexible exchange rate, should help limit the adverse impact of these shocks on the economy. The authorities agreed that the widening current account deficit implied some risks, but considered that South Africa would likely continue to attract significant capital inflows in the years ahead, especially given the abundant global liquidity. On the domestic front, staff considered that the continued rapid growth in domestic demand, in combination with capacity constraints—as evidenced for instance by the record high manufacturing capacity utilization, and emerging scarcity of energy, cement, and steel—could lead to further widening of the current account deficit and intensifying price pressures.

14. **Staff envisages *potential* real GDP growth gradually rising over the medium term to about 5 percent**. In this scenario, rapidly growing investment would relieve the most pressing capacity constraints—especially in electricity and transport networks—allowing faster sustainable growth than hitherto (text table). Other productivity-boosting reforms, including under ASGISA, would also contribute to the pick-up in potential growth. At 4¾ percent, average *projected* growth in 2007–12 would be slightly lower than potential growth, as the present positive output gap closes over that period. The external current account deficit would gradually narrow to around 4½ percent of GDP by 2012, although risks of a higher deficit remain if growth continues to be driven by domestic demand. The National Treasury projects sustained output growth rates above 5 percent in coming years under the assumption of higher potential growth than estimated by staff, resulting from more optimistic projected increases in fixed capital formation and employment, as well as the continuation of the very strong TFP growth experienced in recent years.

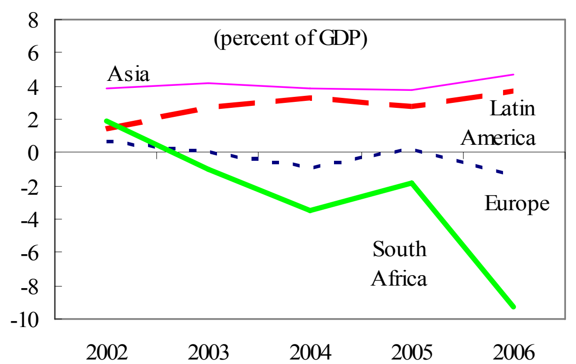
GDP growth and contributions (period average)

	1997-2001 actual	2002-2006 actual	2002-2006 potential (est.)	2007-2012 proj.	2007-2012 potential (est.)
Real GDP Growth	2.5	4.3	4.1	4.8	4.9
Contributions:					
- capital	0.7	1.2	1.2	1.6	1.6
- labor	1.9	1.2	1.4	1.4	1.4
- productivity	0.0	2.0	1.5	1.8	1.9

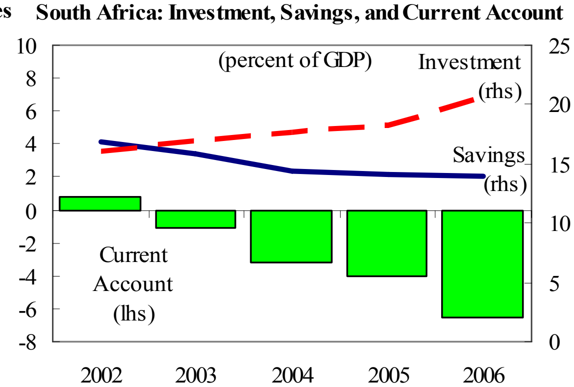
Box 2. Assessing the Risks from South Africa's Current Account Deficit [1]

Following a sharp swing from a small surplus in 2002 to a deficit of 6.5 percent of GDP in 2006, South Africa's current account balance is now something of an outlier among non-European emerging market economies (EMEs). Moreover, while many European EMEs (such as Turkey and Hungary) also have large current account deficits, a relatively larger share of their deficits are covered by direct investment inflows, which are considered a stable form of financing. South Africa, by contrast, is unusually reliant on portfolio equity inflows to finance its deficit (figure).

Emerging Markets: FDI-adjusted Current Account Balances



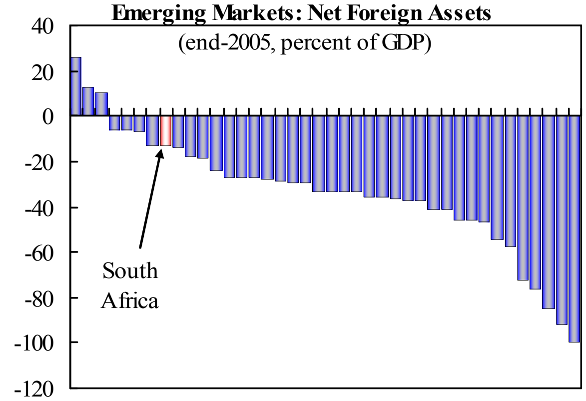
South Africa: Investment, Savings, and Current Account



An examination of the factors contributing to, and financing, the deficit yields several insights:

- The deficit reflects a private sector savings-investment imbalance (i.e., not fiscal origin).
- Rising investment appears to be an increasingly important driver of the imbalance (figure).
- The stock of external liabilities is low by EME standards; sizeable deficits for several years would be needed to push external liabilities to worrisome levels (figure).
- Recent developments indicate that the near-term outlook for portfolio inflows to South Africa is broadly favorable. In the year to early June, nonresident purchases of equities and bonds have amounted to about 2¼ percent of annual GDP. A J.P. Morgan survey also suggests that investors are underweight in South African equities relative to a neutral global portfolio allocation.

Emerging Markets: Net Foreign Assets



While these factors provide some reassurance that the current account position may not be an immediate threat, deficit levels of 6-6½ percent, financed by portfolio inflows, will continue to leave South Africa exposed to a "sudden stop" in capitals flows. Strong fundamentals are already in place that should help to limit the consequences of a sudden stop. Other policy measures, such as further accumulation of reserves, continued improvements in the structure of external debt, and reforms to enhance the flexibility and openness of the economy, might also help to reduce the likelihood and the costs of a sudden stop.[2]

[1] See Chapter I of the Selected Issues Paper.

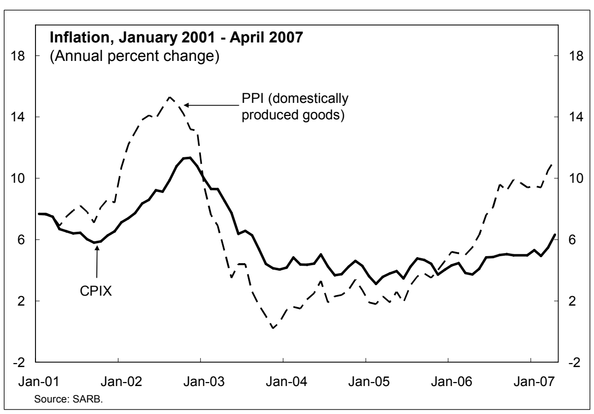
[2] Sectoral balance sheets are discussed in Chapter IV of the Selected Issues Paper.

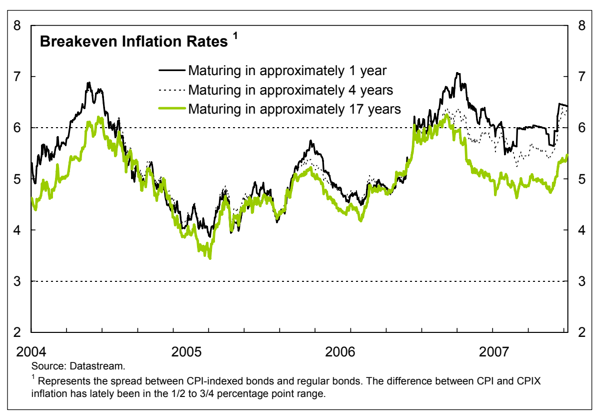
15. **South Africa's debt position appears sustainable under a variety of shocks.** In stress tests conducted by staff, government debt remains below 30 percent of GDP and external debt stays below 25 percent of GDP (Appendix I). Even with a current account deficit wider than projected by 1 percentage point of GDP in each year in the 2007-12 period, external debt would stay below 30 percent of GDP in all scenarios.

B. Preserving Macroeconomic and Financial Stability

Monetary Policy

16. **During the discussions, both the SARB and staff saw upside risks to the inflation outlook**. Staff noted that SARB projections at the time of the April MPC meeting showed a significant probability that inflation would breach the upper limit of the band for several quarters, and thus considered that some tightening may be needed to anchor inflation expectations well inside the band and prevent second-round effects from recent rises in fuel and food prices. SARB officials agreed fully on the importance of anchoring inflation expectations and addressing second-round effects, but had not seen compelling evidence in these areas. They noted, for example, that while forward-looking projections of inflation had shown inflation rising to the top of the band temporarily, measured price expectations appeared to be well-grounded. The MPC had therefore elected to "wait and see" how the 200 bps tightening in the second half of 2006 worked its way through the economy.





17. **On June 7, the MPC raised the repo rate by 50 basis points to 9½ percent**. Information available after the mission revealed an unexpectedly sharp jump in inflation in April. The MPC indicated that updated forecasts showed a deteriorated inflation outlook, with the baseline projection showing CPIX inflation marginally above the ceiling of the target band for most of the next several quarters. It also underscored that risks were strongly on the upside and that it would not hesitate to tighten policy further if necessary.

Exchange Rate Policy, Reserve Accumulation, and Exchange Controls

18. **There was agreement that the flexible exchange rate system should be maintained**. The current system is an integral part of the inflation targeting regime and helps provide a cushion against external shocks.

19. **Staff found no strong evidence of any significant exchange rate misalignment**. This assessment was based on the results of the most recent CGER (Consultative Group on Exchange Rate Issues) exercise and on additional work by staff (Box 3). While indicators based on the analysis of the current account pointed to a moderate overvaluation, those based on the relationship between the exchange rate and economic fundamentals pointed to an undervaluation. The authorities agreed that it was difficult to estimate an equilibrium value for the rand.

Box 3. Estimates of the Equilibrium Exchange Rate

The IMF's CGER exercise uses three approaches to assess the exchange rates of advanced and emerging market economies (see *Methodology for CGER Exchange Rate Assessments*, available at www.imf.org). As of February 2007, the two indirect methods based on evaluations of the current account, the external sustainability approach and the macro balance approach, suggested *over*valuation of the rand in the 10-15 percent range. The direct, equilibrium REER approach, indicates an *under*valuation of the rand of over 30 percent; the CGER exercise disregards this estimate because of data shortcomings.

The results from these types of analysis are sensitive to changes in specification. In the sustainability approach, if one wanted to stabilize South Africa's NFA at the average level for emerging market economies (instead of South Africa's much stronger level), the estimated *over*valuation of the rand would be cut in half. Re-estimating the macro balances equation with only emerging market economies rather than a mix of advanced and emerging countries reduces the estimated *over*valuation by about 1/3 as well. Re-estimating the equilibrium REER approach using only South African data (rather than panel data) and a somewhat different set of fundamentals would yield an *under*valuation of less than half the size of the CGER estimate.

20. **Staff supported the SARB's current policy of gradual accumulation of reserves**. While there is no specific target for the level of reserves, the policy aims at bringing reserves holdings broadly in line with those of other emerging markets. In relation to other countries, South Africa's holdings are broadly comfortable in terms of short-term external debt, but relatively low in terms of other indicators (table). Also, South Africa's holdings are markedly above the 100 percent of short-term external debt benchmark, but still below the sum of

short-term external debt plus the current account deficit, another commonly used benchmark.[2] On that basis, staff agreed that some further accumulation would be beneficial.

South Africa: Indicators of Reserve Adequacy at end-2006			
		Other emerging markets [1]	
	South Africa	All countries	Independent float [3]
	(Percent, unless otherwise indicated)		
Ratio of international reserves to:			
Short-term debt [2]	150.5	154.3	142.7
Short-term debt plus current account deficit [2]	73.7	111.5	119.3
GDP	10.0	17.8	12.9
Imports of goods and services (in months)	3.3	4.2	4.0
Broad money	12.8	30.7	27.6

Source: Country authorities and IMF staff estimates.

[1] Median values for a group of 48 emerging market countries.
[2] Short-term debt at remaining maturity.
[3] Countries with independently floating exchange rate regime as defined by the IMF Annual Report on Exchange Arrangements and Exchange Restrictions (2005).

21. **The authorities continue to relax exchange controls gradually**. Remaining controls apply to capital outflows by residents, and mainly comprise limits on overseas investment by institutional investors, the prohibition of portfolio investment abroad by corporates, and limits on offshore investment by individuals. Staff supported the relaxation of controls, as it allows for a better allocation of resources, and, by deepening the foreign exchange market, could help reduce exchange rate volatility over the medium term. Staff favored simplifying the administration of controls—for instance, replacing prior authorization with reporting requirements for investments within the allowed limits—to reduce compliance costs.

Fiscal Policy

22. **South Africa's fiscal position is strong**. Over the last few years, large revenue gains from robust economic growth and improved revenue administration more than offset the impact of high expenditure growth on the fiscal balance. Despite capacity constraints at subnational levels, expenditure has generally been well targeted at social and infrastructure needs.

[2] Reserves holdings are also above the "optimal level" estimated using the model in Jeanne, O., and R. Ranciere (2006), "The Optimal Level of International Reserves for Emerging Market Countries: Formulas and Applications," IMF Working Paper 06/229.

23. **The authorities envisage a broadly balanced budget in coming years**. In official projections, continued strong revenues would keep the national government's budget surplus at 0.6 percent of GDP in fiscal year 2007/8. Only modest deficits are projected for subsequent years, despite planned further rapid increases in noninterest expenditure over the medium term (7¾ percent a year in real terms) to relieve infrastructure bottlenecks and social needs, and to prepare for the 2010 FIFA World Cup. Government debt would fall considerably over the medium term. Staff projections suggest moderately stronger fiscal outcomes than official projections in coming years, mainly on account of higher revenue.

24. **Staff and the authorities exchanged views on the contribution of fiscal policy to demand management**. On the basis of staff estimates, the fiscal stance would remain neutral in 2007/8 and turn expansionary afterwards (table).[3] Staff supported the thrust of the government's fiscal plans but suggested that maintaining a neutral stance in coming years may be more appropriate given the concerns arising from the current account deficit. Even if revenues were higher than officially forecasted—as staff projected—a neutral stance would require a moderately lower (but still ample) average growth in expenditure than currently planned.[4] The authorities agreed that fiscal policy needed to be sensitive to the risks arising from external imbalances, and pointed to recent improvements in the fiscal stance in this regard. They added that the stance of fiscal policy would also remain mindful of the need for increased public spending to meet important social and investment priorities.

Cyclically adjusted fiscal balances, 2004/5 - 2009/10

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Overall balance [1]	-1.4	-0.3	0.6	0.8	0.0	0.0
Primary balance [1]	2.0	2.9	3.5	3.4	2.4	2.0
Cyclically adjusted primary balance [2]	2.1	2.9	3.0	2.9	2.0	1.8

Sources: National Treasury and IMF staff estimates.

[1] According to staff's fiscal and GDP projections.
[2] Using tax-specific elasticities to tax-specific base gaps (see IMF Country Report 06/328).

25. **The authorities have launched an initiative to reform social security**. It envisages a mandatory multi-pillar scheme covering old-age pensions, unemployment insurance, and death and disability benefits. Planned for 2010, the scheme would be funded by a payroll tax, while the budget would separately provide for a wage subsidy for low-wage earners to partly offset the associated increase in labor cost. The authorities explained that

[3] The cyclically adjusted primary balance is estimated with one of the methodologies outlined in IMF Country Report 06/328. The estimated cyclical revenue component in 2006/7 and 2007/8 is ½ percentage point of GDP.

[4] Staff estimates that maintaining a neutral fiscal stance through 2009/10 would imply an average real expenditure growth rate of 6¼ percent, compared with the planned 7¾ percent.

key features of the new system were still under study and remained to be discussed with stakeholders. Staff supported the goal of strengthening old-age income security, and concurred with the authorities on the need to proceed with caution due to the complexities of this undertaking and its potential effects on labor costs and work incentives. Staff also considered it important that the reform should ensure the full funding of liabilities, and, more broadly, limit possible adverse effects on the public finances, a view shared by the authorities.

26. **Treasury officials and staff discussed the pros and cons of increasing reliance on consumption taxation relative to corporate and personal income taxation in the medium term**. Staff considered that such a shift could reduce the variability of tax revenue and strengthen incentives to invest and work, but that it would require improving targeted social assistance to offset the impact of higher consumption taxes on the poor. The officials noted that the bases of VAT and excise taxes are already relatively broad with few exemptions. To generate significant further revenue from these taxes would, therefore, require an increase in their respective tax rates. They further noted that at present it might be difficult to introduce effective mechanisms to compensate many of the poor households adversely affected by such rebalancing. Staff suggested further study of these issues.

Financial Sector

27. **South Africa's financial system is generally sound and well regulated**. The banking sector is adequately capitalized and profitable, with an average capital adequacy ratio of 12.7 percent and a nonperforming loan ratio of 1.1 percent as of early 2007 (Table 7). Among the large banks—accounting for 84 percent of the sector in terms of assets—exposure to foreign exchange and interest rate risks is limited, and incipient securitization has contributed to improving balance sheet management. Banks expect to comply with the January 1, 2008 deadline for implementation of Basel II principles; the new regime is expected to have a neutral effect on their capital adequacy ratios. Pension funds, collective investment schemes and insurance companies have also performed well on the back of rising domestic asset prices, and compliance with prudential requirements remains strong.

28. **While welcoming the developmental benefits of recent rapid credit expansion, the authorities and staff agreed that it also created risks**.[5] Driven by buoyant credit and interest rate hikes in 2006, the ratio of debt service to income for households has risen, although it remains below historical highs for South Africa. While the bulk of credit growth takes the form of secured lending, the authorities have expressed concerns about the vulnerability of new borrowers, and there have been signs of some moderate deterioration in asset quality. In this regard, the recent entry into effect of the National Credit Act, although

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

likely to lengthen slightly the foreclosure process for nonperforming loans, is expected to increase banks' ability to assess the creditworthiness of individual households and limit risks from household credit.[6]

29. **In the context of rapid credit growth, further enhancements to the regulatory and monitoring framework could be considered**. Staff recommended: (i) collecting and regularly analyzing data on the distribution of household debt by income category, as aggregate numbers may mask pockets of weakness; (ii) conducting periodic stress tests on individual bank data—in addition to system-wide tests—encompassing credit, interest rate, liquidity and foreign exchange risks; (iii) monitoring more closely the effects of asset price developments on mortgage credit, including on the rate of re-mortgaging by households to finance consumption; and (iv) reinforcing prudential standards, such as on loan-to-value and debt service-to-income ratios.[7] The authorities broadly agreed with the recommendations, while indicating that implementation would need to take into account potential compliance costs, particularly given the ongoing intense preparations for Basel II.

30. **Staff discussed progress with financial development and regulatory issues**. Access to financial services is expanding, as the share of South Africa's population who do not benefit from formal financial services has declined to an estimated 49 percent in 2006 from 55 percent in 2004. Commitments under the Financial Sector Charter (FSC) have allowed the rapid expansion of low cost ("Mzansi") accounts, and introduction of money transfer facilities and insurance products, thus increasing access to basic financial services. The authorities also plan the introduction of a regulatory framework for cooperative and dedicated banks with the aim of further enhancing access to financial services.[8]

31. **The authorities confirmed their interest in an FSAP update for South Africa in early 2008**. Such an exercise could provide considerable benefits in view of the significant developments in the financial sector since the initial FSAP in 2001.

[6] The National Credit Act regulates the granting of consumer credit by all credit providers, including banks, microlenders, and retailers, to both enhance consumer protection and bolster banks' ability to manage their exposure to individual household risks.

[7] Recent country experiences suggest the adoption of maximum loan-to-value ratios in the 70-80 percent range.

[8] The dedicated banks bill aims at creating opportunities for existing banks and entities such as large retailers of the Post Office to offer basic banking services through separate entities.

C. Achieving Higher Growth

ASGISA

32. **ASGISA has identified six major constraints on growth**: (i) the relative volatility of the exchange rate; (ii) inadequate infrastructure and logistics; (iii) skills shortages; (iv) barriers to entry and competition in key economic sectors; (v) the regulatory environment, particularly the burden on small and medium enterprises (SMEs); and (vi) capacity limitations within the government. These constraints are being addressed, but most of them are outside the Fund's core area of expertise.

33. **The authorities indicated that exchange rate volatility is being addressed through sustained adherence to sound macroeconomic policies, assisted by a steady build-up of foreign reserves.** They, therefore, saw no need to depart from their current exchange rate policy. Given concerns about exchange rate volatility, staff noted the practice in some inflation targeting countries of announcing an explicit policy for intervening in the foreign exchange market under extraordinary circumstances.[9] Those countries specify conditions under which the central bank might consider foreign exchange intervention to calm nervous markets or signal large misalignments. If effective, such intervention could limit overshooting and thus reduce currency volatility. Staff indicated, however, that the track record of such policy was short and the ability to identify large misalignments was limited, and thus determining whether a similar policy would be advisable for South Africa required further analysis. The authorities were skeptical about the benefits of such policy in South Africa, given doubts about the effectiveness of intervention in the rand market, uncertainty about the appropriate level or range of the exchange rate to defend, and the significant costs and viability of large-scale sterilized intervention. On this basis, the SARB policy excludes commitments to support any particular level of the rand.

34. **Regarding infrastructure and logistic deficiencies, staff supported medium-term investment plans and efforts to enhance the efficiency of state-owned enterprises (SOEs)**. Work has progressed on several projects. In 2006, public enterprises raised their investment by 19 percent in real terms, in addition to the 9¾ percent real growth in government investment. In the medium term, energy and transportation SOEs plan further sizable investment expansion to relieve bottlenecks in electricity, port, and railway networks. Staff recommended that investment projects continue to be supported by *ex-ante* cost-benefit analysis and take into account implementation capacity, particularly since a large part of the program is to be undertaken by subnational governments and SOEs. The authorities noted that major investment projects do undergo rigorous review, especially if a state guarantee is requested. Moreover, they would like to increase the use of public-private partnerships

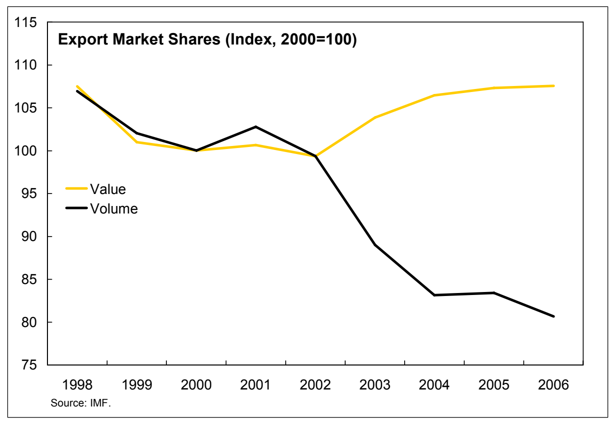
[9] See Chapter II of the Selected Issues Paper.

(PPPs) to help relieve implementation constraints in municipalities, but that this approach faced regulatory hurdles which would be addressed in the year ahead.

35. **Staff argued that the new industrial policy framework could introduce economic distortions**. The framework includes potentially conflicting objectives, and, while cross-cutting interventions (such as enhancing competition policy and supporting research and development) seem justifiable on economic grounds, the basis for sectoral interventions is less well-founded. To avoid large distortions, it would be important that interventions be based on identified market failures or regulatory needs, subject to independent evaluations, and limited in duration.

Competitiveness

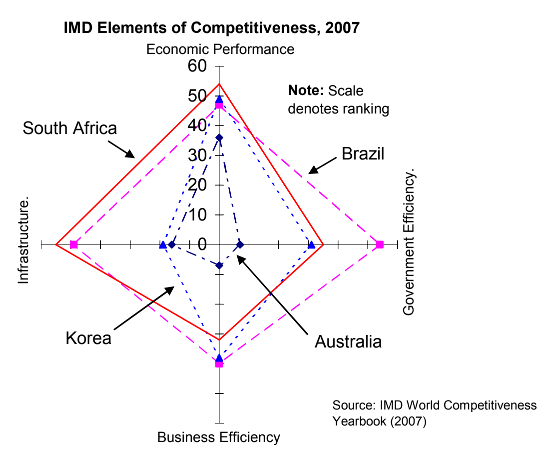
36. **An assessment of South Africa's international competitiveness paints a mixed picture**. The country's share of exports in world markets is at about the same level as in the late 1990s, with a rebound occurring since 2002 reflecting the upward trend in world commodity prices. In volume terms, however, South Africa's market share has been falling throughout the period. Survey-based indicators of competitiveness usually rank South Africa above or about the same level as the larger Latin American countries, but below Chile and the more dynamic Asian emerging markets (table). South Africa ranks well on business efficiency, followed by government efficiency. Its poorest ranking pertains to infrastructure, broadly defined to include physical infrastructure and human capital.



World Competitiveness Ranking [1]

	WEF	IMD	
	2006	2006	2007
Australia	18	6	12
Argentina	69	47	51
Brazil	66	44	49
Chile	27	23	26
China	54	18	15
Colombia	65	34	38
India	43	27	27
Korea	24	32	29
Mexico	58	45	47
South Africa	45	38	50
Memorandum items			
Number of countries ranked	125	53	55
South Africa's rank on infrastructure	49	52	55

[1] From the World Economic Forum (WEF) and the International Management Development (IMD). The years mentioned refer to the timing of the surveys.



37. **The authorities are addressing competitiveness concerns through measures to raise productivity and reduce costs.** Under ASGISA, they are strengthening infrastructure and logistics, with an emphasis on energy and transportation. Moreover, they are introducing in pilot form the practice of conducting regulatory impact assessments of new legislation, building capacity in local governments, and improving the skills of the labor force through training of workers and facilitating the immigration of those with scarce skills.

Labor Market

38. **While employment growth has recently picked up, unemployment remains very high**. South Africa's high unemployment is the result of several factors—some of them a legacy of the apartheid—including: (i) rapid growth of female and unskilled labor supply, together with a structural shift in labor demand towards skilled labor; (ii) long distances between places of residence and places of work, which raise the cost of job search and (perhaps together with the system of social grants) raise reservation wages; and (iii) labor market regulations and practices that discourage job creation. The individual effect of these factors is difficult to ascertain and merits further analysis.

39. **Staff supported current targeted initiatives to reduce unemployment**. These include skills development programs and public work programs. Staff suggested an evaluation of the effectiveness of these initiatives to ensure that resources are allocated efficiently. The authorities are also considering how best to reduce the complexity and delays in labor arbitration procedures. Staff recommended that adjustments in officially determined minimum wages and in public sector wages (the latter owing to its possible impact on private wage settlements) take into account their potential effect on employment.

Trade Policy

40. **The process of trade liberalization has largely stalled in recent years.** South Africa made significant progress in reducing tariffs and simplifying the trade regime in the mid-1990s, but relatively limited reform has occurred since then.[10] Staff suggested further lowering the overall level of protection and simplifying the tariff structure, for instance by reducing the number of tariff bands and tariff peaks. The authorities saw some merit in further liberalization, but argued that moves in this area needed to be informed by developments in ongoing multilateral and regional trade negotiations and the emerging industrial policy strategy, which seems to call for maintaining tariff protection on certain sectors, while reducing tariffs on selected inputs.

---

[10] In mid-2006, responding to a surge in imports, South Africa introduced quotas on imports of textiles and clothing from China, which are to remain in place through end-2008.

41. **The authorities stressed their preference for multilateral liberalization, but saw preferential trading arrangements as a useful second-best option**. Partly as a result of delays in negotiations under the Doha Round, South Africa and its partners in the Southern African Customs Union (SACU) have been negotiating preferential trading agreements.[11] Staff reiterated that these agreements should be broad-based, with simple and nonrestrictive rules of origin, to limit trade diversion and complement multilateral liberalization.

42. **South Africa is negotiating a review of its Trade Development and Cooperation Agreement (TDCA) with the European Union (EU)**. As South Africa's SACU partners (together with other African countries) are negotiating an Economic Partnership Agreement (EPA) with the EU, it has been agreed that the TDCA and EPA negotiations will be integrated into a single set of discussions. It is hoped that these negotiations will be completed by end-year, but significant issues remain to be resolved. The authorities noted that harmonization of the region's trading relationship with the EU, its most important external trading partner, would contribute to regional integration.

D. Regional Spillovers

43. **South Africa's strong economic performance in recent years has benefited the wider region (Box 4)**.[12] The success of the SARB's inflation targeting regime continues to ensure that inflation remains relatively low and stable throughout the Common Monetary Area (CMA).[13] The depreciation of the rand over the past year has mitigated concerns about competitiveness in Lesotho and Swaziland. The strength of domestic demand in South Africa has brought large revenue windfalls to BLNS via the SACU revenue-sharing arrangements.

44. **South Africa has indicated that it wishes to revisit the existing SACU revenue-sharing arrangements.** The authorities expressed concerns about the equity of the current arrangements. In view of possible moves to establish a broader customs union within the Southern Africa Development Community (SADC), they also noted the desirability of developing revenue-sharing arrangements that would facilitate the expansion of SACU.[14] Staff agreed with the authorities that changes to the revenue-sharing arrangements could

---

[11] In addition to South Africa, the SACU includes Botswana, Lesotho, Namibia, and Swaziland (BLNS).

[12] South Africa's expanding trade with and investment in the rest of sub-Saharan Africa is summarized in Sub-Saharan Africa Regional Economic Outlook, September 2006 (Box 2.3). The strong correlation between growth in South Africa and the rest of the region is also discussed in IMF Country Report 06/327.

[13] The Common Monetary Area (CMA) includes South Africa, Lesotho, Namibia, and Swaziland.

[14] The SADC comprises the SACU members and nine other southern African countries.

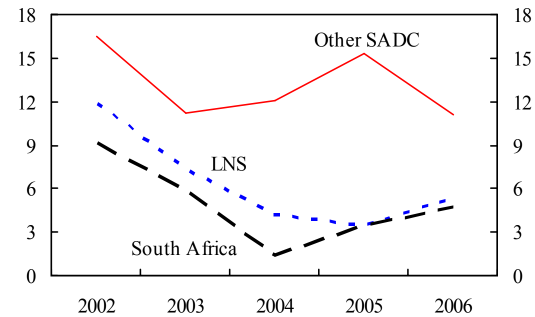
have a substantial fiscal impact on the smaller SACU members. Any changes agreed among the SACU partners would therefore need to take full account of such effects.

Box 4. South Africa and Southern Africa

South Africa is the dominant economy in Southern Africa, accounting for over two-thirds of the combined GDP of the 14 SADC members. Economic linkages between South Africa and its neighbors are already close in many instances, and are expected to intensify over time.

Common Monetary Area (CMA). The currencies of Lesotho, Namibia, and Swaziland are pegged at par to the rand through the CMA, and capital flows freely within the CMA.[1] As a corollary, interest rates in the smaller CMA countries are closely linked to those in South Africa, and inflation rates across the area differ by relatively modest amounts (figure).

Consumer Price Inflation in southern Africa (Percent) [1]



Source: IMF Staff Estimates.

[1] Other SADC refers to median for other SADC member states. LNS refers to average for Lesotho, Namibia, and Swaziland.

Southern African Customs Union (SACU). One of the world's oldest customs unions, includes the members of the CMA plus Botswana. Customs and excise duties collected in SACU are distributed to member countries according to an agreed formula. SACU payments, which constitute a major part of fiscal revenues in the BLNS countries, have increased significantly in recent years, reflecting both the strength of domestic demand in South Africa and the impact of a new sharing formula that became effective in 2005 (table).

SACU Revenue Payments

	Botswana		Lesotho		Namibia		Swaziland		South Africa	
As percent of:	FY02/03	FY06/07	FY02/03	FY06/07	FY02/03	FY06/07	FY02/03	FY06/07	FY02/03	FY06/07
Government Revenue (excl. grants)	11.1	19.0	53.7	61.1	24.9	42.7	49.6	63.0	4.5	3.7
GDP	4.1	8.0	19.4	36.9	7.8	14.9	12.4	22.0	1.0	1.0

Source: National authorities budget documentation, IMF staff estimates

Southern African Development Community (SADC). South Africa is central to economic integration within the SADC region, accounting for about 60 percent of all intra-SADC trade and 70 percent of its GDP. Outward investment by South African companies is expanding and South African banks operate in all 14 SADC member states.[2] South Africa and BLNS have already eliminated tariffs on imports from the rest of SADC as part of efforts to establish a SADC free trade area by 2008. In 2004, SADC Heads of State also agreed on plans to deepen regional integration through the establishment of a customs union, common market and, ultimately, monetary union. Implementation of this agenda will be challenging with a number of issues, including multiple and overlapping memberships of regional groupings, still to be resolved.

Labor market linkages. South Africa continues to attract large numbers of workers from neighboring countries, a pattern in place for decades. While data on labor inflows are generally poor, there are indications that labor inflows have picked up in recent years, reflecting both the demand-pull effects of South Africa's strong growth and skill shortages and also the supply-push effects of economic turmoil in some countries, notably Zimbabwe.

[1] Botswana is not part of the CMA but pegs its currency to a basket comprising the rand and the SDR.
[2] The integration of South African banks in the region and its supervisory implications are discussed in IMF Country Report 06/328.

45. **South Africa's economic linkages with the rest of the region have grown significantly, but there is scope for further expansion of ties beyond SACU.** The authorities see the expansion of trade and investment flows within SADC as an important contribution to the region's growth prospects, while noting that a significant push will be needed to achieve SADC's stated objective of a fully-functioning free trade area by end-2008. Many further obstacles would need to be overcome to establish a SADC customs union.

E. Equity Issues

46. **Staff expressed support for the government's initiatives to reduce social and wealth disparities**. Progress in these areas is critical for strengthening social cohesion and thus the government's ability to advance economic reforms.

- **Black Economic Empowerment (BEE)**. This initiative operates primarily through sector-specific voluntary "charters" that set targets for several empowerment indicators, including black ownership, black participation in management, and skills development. The government has recently enacted codes of good practice, which clarify implementation rules and thus should significantly reduce uncertainty about this initiative for firms and investors.

- **Land reform**. This initiative, launched in 1994, aims at transferring 30 percent of commercial agricultural land to previously disadvantaged groups by 2014, but so far only about 4 percent has been transferred. Regarding land restitution (return of land lost due to racially discriminatory laws), the government will continue with its approach involving negotiations with current owners, with resort to expropriation at fair value and according to well-defined legal principles if negotiations reach a deadlock. Regarding land redistribution (transfer of privately held land—not subject to restitution claims—supported by state resources), the government is broadening its efforts. It has launched a state-led approach, under which government agencies will proactively identify both land for redistribution and the potential beneficiaries who would acquire this land with state financial support. This initiative complements the previous beneficiary-driven approach, under which beneficiaries identify land they want and then ask the state for financial support. Staff understands that the acquisition of land for redistribution will continue to take place at prices freely negotiated with current owners.

F. Other Issues

47. **The HIV/AIDS epidemic has adversely affected social indicators, such as child mortality and life expectancy**.[15] The government's HIV/AIDS program has become more

[15] According to *UN 2006 Report on the Global AIDS Epidemic,* an estimated 17–21 percent of the adult population are infected.

extensive in recent years. By late 2006, an estimated 225,000 people had started ARV treatment under the public sector program (some 25–30 percent of the estimated number of people in need of treatment), aided by active donor support. The government launched a new national HIV/AIDS strategy in April 2007, aimed at halving the rate of new HIV infections and expanding access to proper treatment to 80 percent of HIV positive cases by 2011. The economic impact of HIV/AIDS is highly uncertain; a recent (2006) study by the Bureau of Economic Research estimates a reduction of ½ percentage point in long-term GDP growth.

III. Staff Appraisal

48. **South Africa has made considerable economic progress in the past decade**. Sound macroeconomic management and structural reforms, supported in recent years by favorable external conditions, have led to higher growth, lower and more stable inflation, sound public finances, a healthy financial system, and stronger international reserves. South Africa's steady expansion has benefited the rest of the region.

49. **Recent economic performance has been strong, although the external current account deficit has widened and inflation pressures have lately intensified**. Output and employment have continued to grow at a rapid pace by historical standards, and vibrant economic activity has contributed to a fiscal surplus, the first in several decades. But surging demand has produced a marked increase in the current account deficit, financed by portfolio inflows, and inflation pressures have risen, reflecting supply shocks and the buoyant demand.

50. **The near-term outlook remains broadly positive, with downside risks arising from possible external shocks and the continuing strong pace of domestic demand**. On the external side, the large current account deficit has raised the vulnerability to external shocks, including a decline in capital flows to emerging markets. The country's strong fundamentals should help limit the impact of those shocks on the economy. The main domestic risk is that demand, which is already pushing capacity constraints, would lead to further widening of the current account deficit and additional price pressures.

51. **In view of the inflation outlook, the increase in the repo rate in June was appropriate**. While inflation pressures partly resulted from supply shocks to food and energy prices, it is important that monetary policy act to contain their second-round effects on other prices and keep inflation expectations anchored. As noted in the June MPC statement, the risks to inflation are strongly on the upside, so further increases in the repo rate may be needed to bring inflation back within the target band over the medium term.

52. **The flexible exchange-rate system, with foreign exchange purchased by the Reserve Bank only to strengthen its international reserves, remains appropriate**. The floating exchange rate is an integral part of the inflation-targeting framework and helps the economy adjust to shocks. While the uncertainty surrounding estimates of an equilibrium exchange rate seems large, there is little conclusive evidence of any significant exchange-rate

misalignment. Competitiveness concerns should continue to be addressed by measures to raise productivity and reduce costs. Gross international reserves have increased significantly over the last years, but are still lagging behind those in other emerging markets according to some benchmarks. Some further accumulation could thus be useful as a buffer against external shocks.

53. **Continued progress in the relaxation of capital controls would be beneficial**. It would improve financial management by institutional investors, corporates, and individuals. Simplifying the administration of existing controls would reduce compliance costs, for instance by replacing prior authorization with reporting requirements.

54. **Fiscal policy is contributing to reducing macroeconomic risks, while addressing development needs**. With surpluses in the past and current fiscal years, fiscal policy is appropriate in view of the large current account deficits. Going forward, keeping the fiscal policy stance neutral would seem appropriate, until the current account deficit starts declining. Vigorous expenditure expansion is targeted at relieving important infrastructure bottlenecks and meeting pressing social needs. Success in the government's efforts to enhance implementation capacity at the subnational level would help achieve full and efficient execution of these programs.

55. **The upcoming social security reform will be a major undertaking**. The goal of strengthening old-age income security is welcome. The authorities are fully aware that the complexities of this effort and its potential effect on labor costs and work incentives call for caution in design and implementation, to avoid discouraging formal employment. It will be important to limit possible adverse effects on the public finances, including by ensuring full funding of created liabilities.

56. **The financial system remains sound and well-regulated; the monitoring framework could benefit from further enhancements given the rapid credit growth**. Major banks are actively preparing for the introduction of Basel II principles in 2008, and the authorities are carefully monitoring financial stability risks. Monitoring could be strengthened by regularly analyzing the distribution of household debt by income category and conducting stress tests on individual bank data. In the current buoyant environment, it would be important to consider reinforcing prudential standards on loan-to-value and debt service-to-income ratios. The forthcoming FSAP update should be useful in taking stock of developments in the past years and assessing the banking system's vulnerability to shocks.

57. **The authorities' development strategy, ASGISA, provides a valuable coordinating framework for the government efforts to raise growth and reduce unemployment and poverty**. The emphasis on relieving infrastructure bottlenecks, enhancing workers' skills, and improving microeconomic conditions should go a long way toward achieving those objectives. At the same time, it is important to avoid introducing market distortions by limiting state interventions to cases of market failures or regulatory

gaps. While exchange rate volatility has been identified as a constraint on growth, the authorities' restatement of their position against trying to manage the exchange rate is welcome.

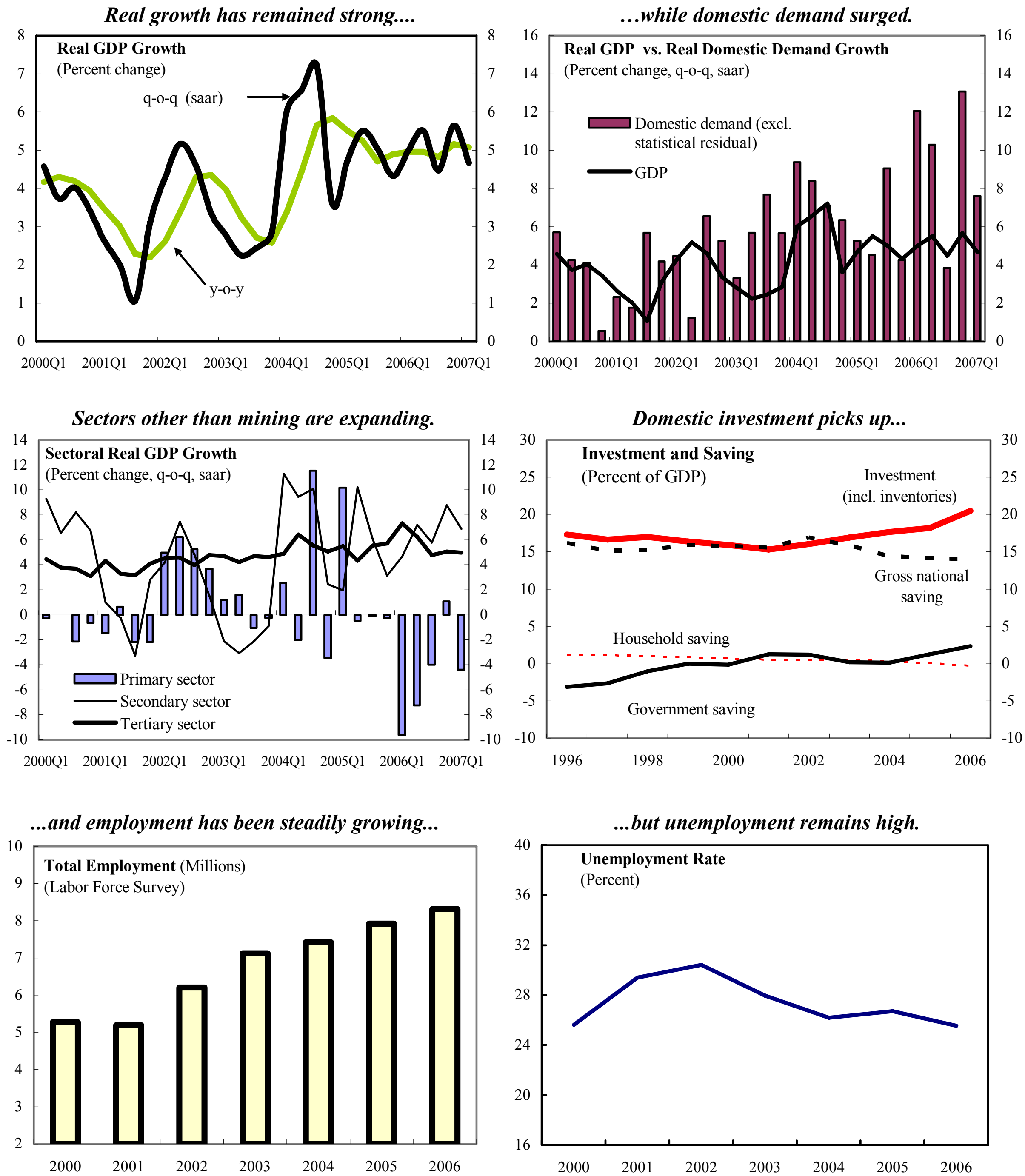
58. **Additional labor market and trade reforms could contribute to raising growth**. The initiatives in place to reduce unemployment—by enhancing workers' skills and implementing public work programs—remain well grounded. At the same time, it would be useful to identify and revise those labor market regulations and practices that discourage job creation. South Africa implemented significant trade reforms in the 1990s, but additional efforts to simplify the tariff structure and lower most favored nation tariff rates are warranted.

59. **South Africa's strong economic performance in recent years has benefited the wider region.** The strength of domestic demand in South Africa has brought substantial revenue windfalls to Botswana, Lesotho, Namibia, and Swaziland, via the SACU revenue-sharing arrangements. Any changes to these revenue-sharing arrangements, agreed among the SACU partners, would need to take full account of the fiscal impact on the smaller members. The expansion of trade and investment flows within the wider SADC would contribute importantly to the region's growth prospects.

60. **Addressing social disparities and the legacy of apartheid is important for the ability of the government to sustain economic reforms**. The authorities have enacted codes of good practice for their Black Economic Empowerment initiative that clarify implementation rules, reducing uncertainty for firms and investors. They are also reinforcing the land reform program to speed up implementation, while keeping it based on well-defined legal principles.

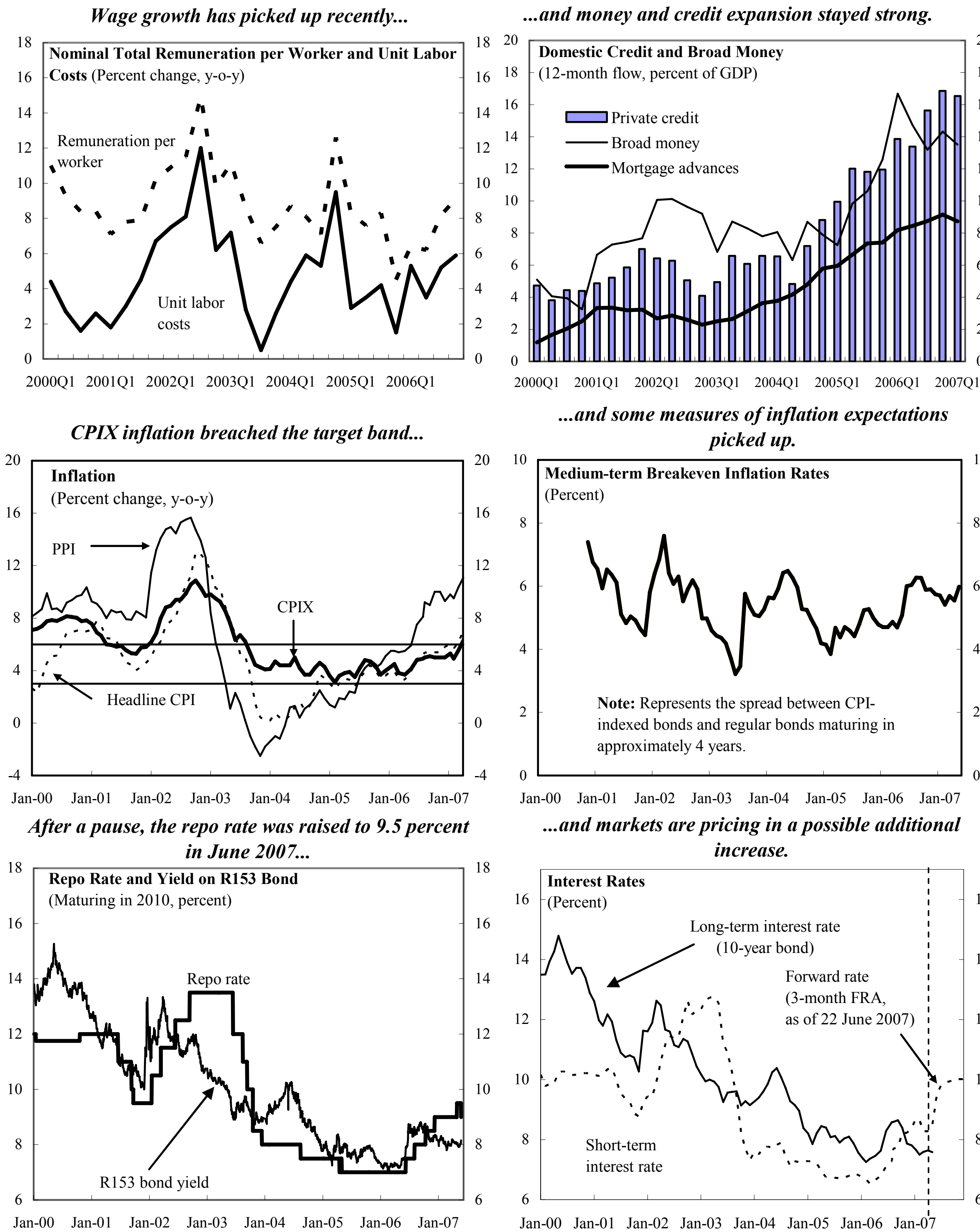
61. **It is expected that the next Article IV consultation will be held on the standard 12-month cycle.**

Figure 1. South Africa: Real Sector Developments



Source: SARB and IMF.

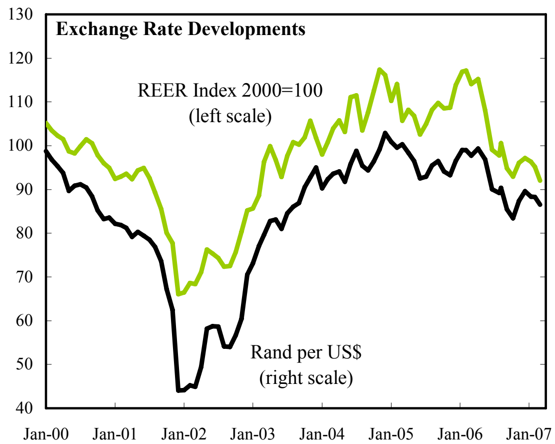
Figure 2. South Africa: Money, Prices and Interest Rates



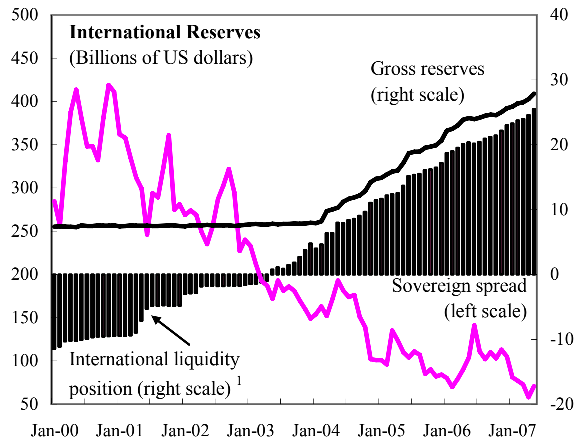
Source: SARB, BER, Datastream, and IMF.

Figure 3. South Africa: External Sector Developments

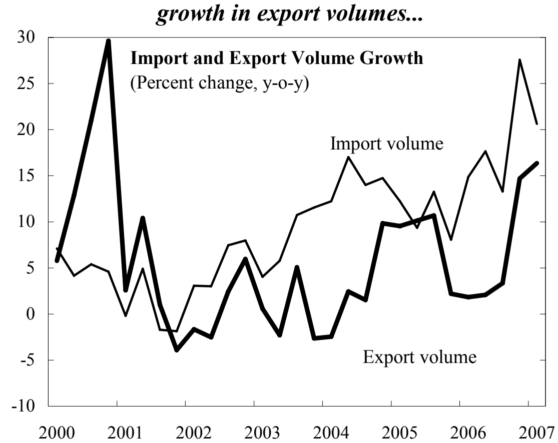
After depreciating in H2 2006, the rand has traded without a clear trend...



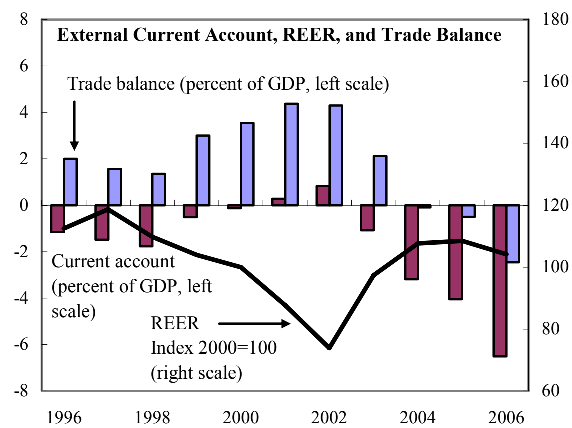
...while international reserves continue to rise.



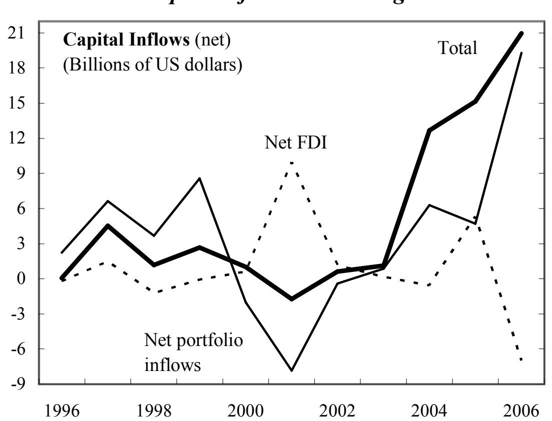
Growth in import volumes continues to exceed growth in export volumes...



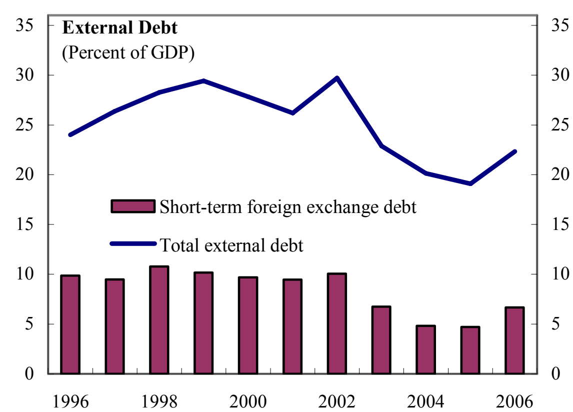
...further widening the current account deficit.



Capital inflows remain high...



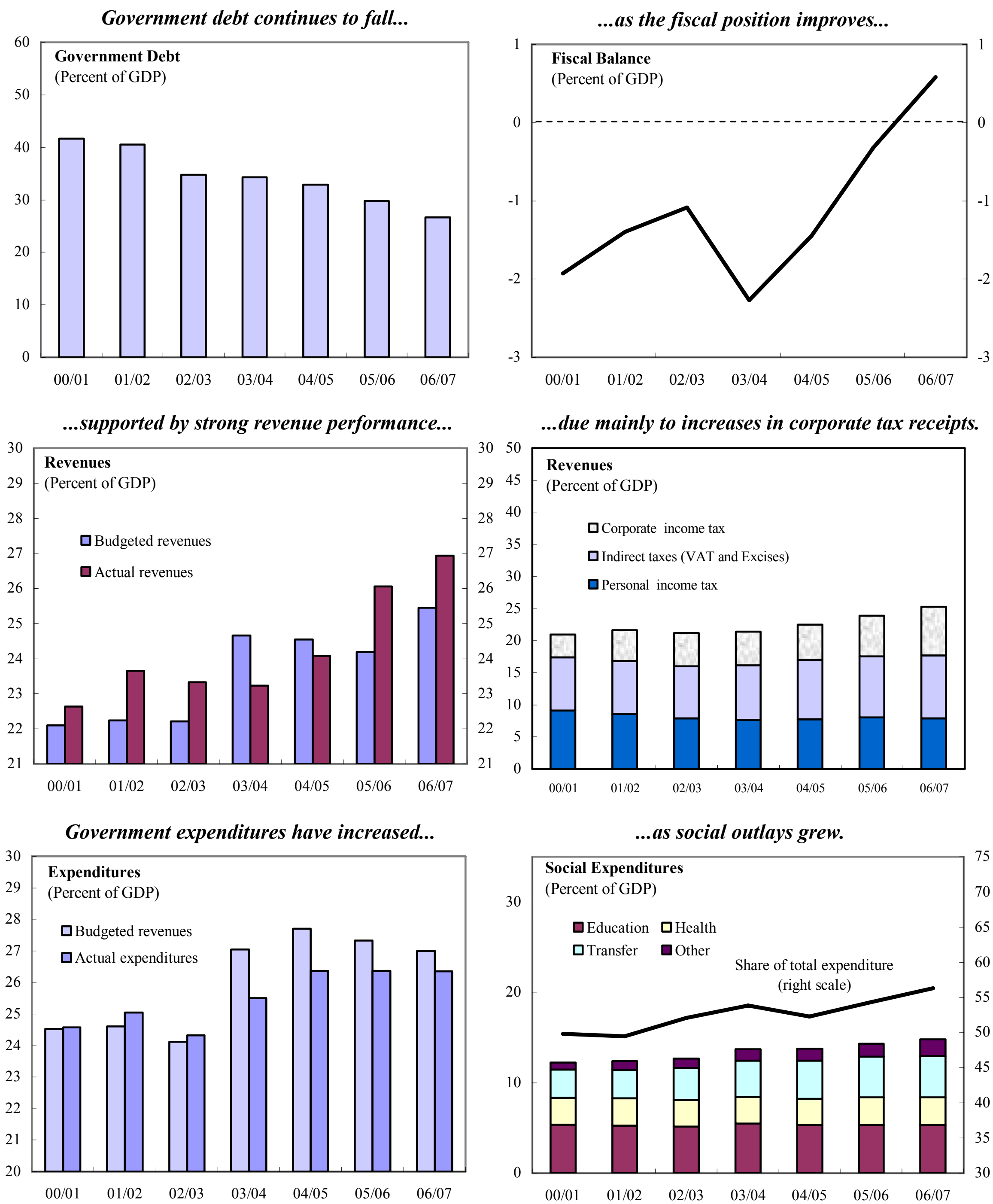
...but external debt remains low.



Source: SARB and IMF.

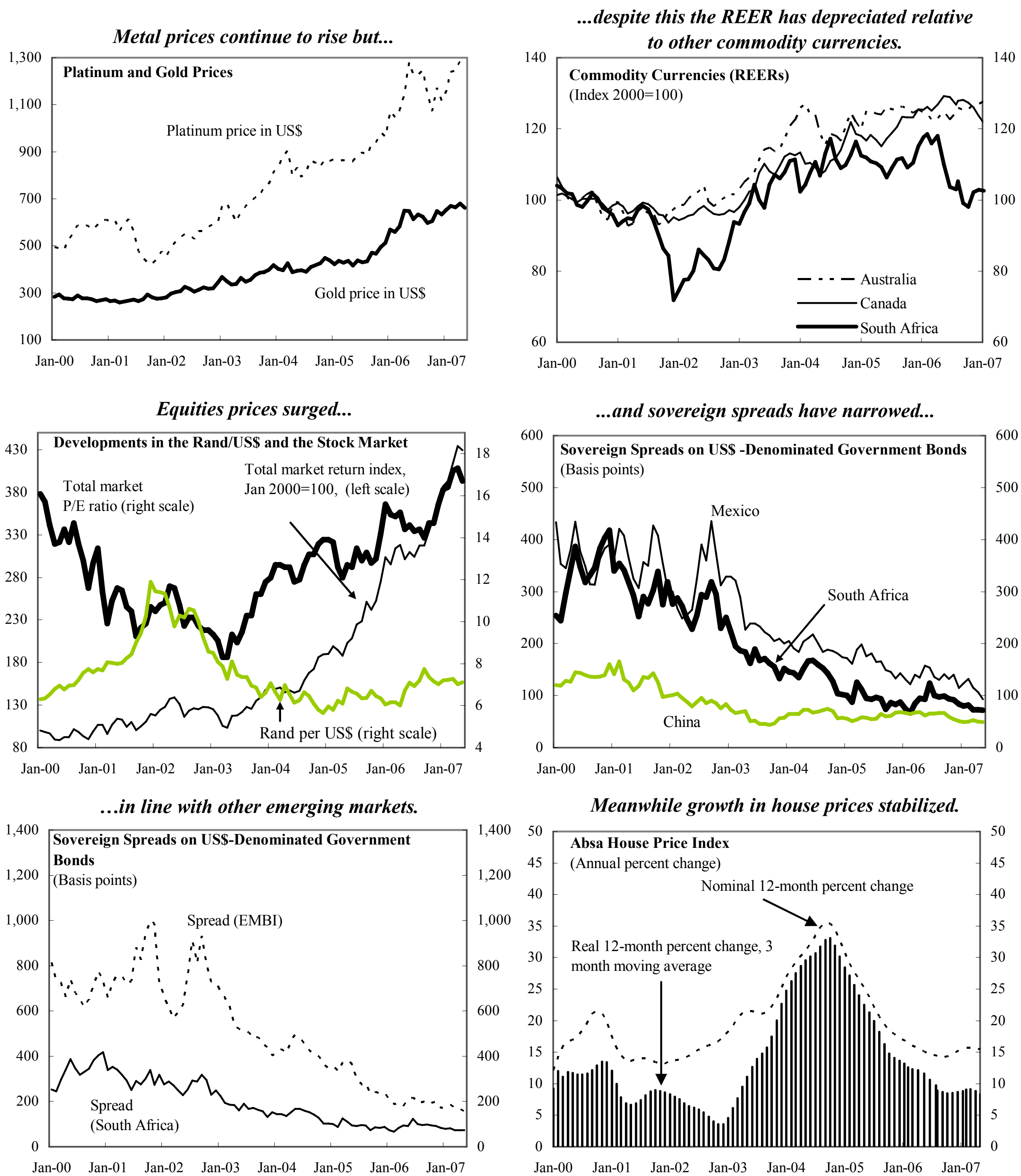
[1] Gross reserves minus foreign loans received and minus forward position. The SARB's open position in the forward market was closed in February 2004.

Figure 4. South Africa: Fiscal Developments



Source: National Treasury and IMF.

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



Source: SARB, Datastream, Absa, and IMF.

Table 1. South Africa: Selected Economic and Financial Indicators, 2003-08

Nominal GDP (2006): US$ 255 billion
Population (2006): 47.5 million
GDP per capita (2006): US$ 5,368

	2003	2004	2005	2006	2007 Proj.	2008 Proj.
	(Annual percent change, unless otherwise indicated)					
National income and prices						
Real GDP	3.1	4.8	5.1	5.0	4.8	4.5
Real GDP per capita	2.1	3.8	4.1	3.7	3.8	3.5
Real domestic demand	5.2	7.9	5.9	8.7	5.4	4.6
GDP deflator	4.6	5.8	4.7	6.9	8.0	6.5
CPI (annual average)	5.8	1.4	3.4	4.7	6.3	5.9
CPIX (end of period) [1]	4.0	4.3	4.0	5.0	6.1	5.3
Labor market						
Unemployment rate (percent)	28.0	26.2	26.7	25.5	24.2	23.1
Average remuneration (formal nonagricultural sector)	8.9	9.1	2.9	7.3	8.8	8.7
Labor productivity (formal nonagricultural sector)	5.0	2.7	4.1	2.4	2.5	2.5
Nominal unit labor costs (formal nonagricultural sector)	3.7	6.2	3.1	4.8	6.1	6.0
External sector						
Merchandise exports, f.o.b. [2]	21.6	25.0	15.0	15.9	8.8	6.8
Merchandise imports, f.o.b. [2]	30.1	38.1	17.0	24.5	8.9	7.4
Export (goods and services) volume	0.1	2.9	8.0	5.5	6.0	5.8
Import (goods and services) volume	8.1	14.5	10.7	18.4	7.5	5.9
Terms of trade	3.8	0.8	-1.4	0.5	1.4	0.4
Nominal effective exchange rate (period average) [3]	25.1	9.1	1.1	-5.6	-4.0	…
Real effective exchange rate (period average) [3]	25.1	6.7	0.5	-2.5	-3.4	…
Money and credit						
Net domestic assets [4]	7.2	11.3	14.6	15.4	19.9	16.5
Broad money (including foreign exchange deposits)	12.9	13.1	20.5	22.5	22.3	18.3
Velocity (GDP/average broad money)	1.6	1.6	1.5	1.4	1.3	1.2
Bank rate/repurchase rate (period end, percent) [5]	8.0	7.5	7.0	9.0	9.5	…
	(Percent of GDP, unless otherwise indicated)					
Investment and saving						
Investment (including inventories)	16.9	17.6	18.2	20.5	21.1	20.6
Of which : public fixed investment (incl. public enterprises)	4.4	4.3	4.6	5.2	5.6	5.8
private fixed investment	11.5	11.8	12.4	13.5	14.0	14.2
Gross national saving	15.8	14.4	14.1	13.9	14.6	14.6
Public	0.2	0.1	1.3	2.4	2.8	2.3
Private	15.6	14.3	12.9	11.6	11.8	12.2
National government budget [6]						
Revenue, including grants	23.2	24.0	25.6	26.7	27.5	27.6
Expenditure and net lending	25.2	25.7	26.2	26.3	26.7	27.5
Overall balance	-2.0	-1.7	-0.6	0.4	0.7	0.2
National government debt	35.4	35.1	33.9	31.4	28.3	25.7
Borrowing requirement of the nonfinancial public sector	2.0	1.7	-0.2	-0.9	-0.2	0.7
External sector						
Current account balance	-1.1	-3.2	-4.0	-6.5	-6.5	-6.1
Overall balance of payments	-0.4	2.7	2.2	1.7	1.1	1.0
Total external debt	22.9	20.1	19.1	22.4	21.7	20.5
Gross reserves (SARB, billions of U.S. dollars)	8.0	14.7	20.6	25.6	28.6	31.6
(months of next year's total imports)	1.6	2.6	2.9	3.3	3.5	3.6

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 loans. It is the targeted definition of inflation.

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

[3] For 2007, March relative to December 2006. From December 2005 to December 2006 the rand depreciated 16 percent in nominal effective terms and 10.7 percent in real effective terms.

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

[5] For 2007, as of June 22. Between June and December 2006 the SARB increased the repo rate from 7 to 9 percent.

[6] Calendar-year figures, based on staff's fiscal and GDP projections for 2007 and 2008.

Table 2. South Africa: National Government Main Budget, 2003/04-2009/10 [1]

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
					Proj. [2]	Proj. [2]	Proj. [2]
	(Percent of GDP)						
Total revenue and grants	23.2	24.3	26.1	26.9	27.7	27.6	27.2
Tax revenue	22.7	23.9	25.5	26.3	27.1	27.1	26.7
Income tax	13.3	13.6	14.6	15.6	16.0	15.9	15.8
Of which : personal income tax (PIT)	7.6	7.8	8.0	7.9	7.9	7.9	7.9
corporate taxes (CIT+STC)	5.2	5.5	6.3	7.6	8.1	8.0	8.0
Indirect taxes	8.5	9.2	9.6	9.8	10.0	10.0	9.7
Of which : value-added tax (VAT)	6.3	6.9	7.2	7.5	7.8	7.8	7.7
Trade and other (less SACU payments)	0.8	1.0	1.3	0.9	1.1	1.2	1.2
Of which : trade taxes	0.7	0.9	1.2	1.3	1.4	1.2	1.2
Of which : SACU payments [3]	0.8	0.9	0.9	1.4	1.2	0.9	0.9
Nontax revenue	0.5	0.4	0.5	0.6	0.6	0.6	0.5
Total expenditure	25.5	25.8	26.4	26.3	26.9	27.6	27.2
Interest	3.6	3.4	3.2	2.9	2.6	2.4	2.1
Transfer to subnational governments	10.4	10.6	10.8	11.5	12.0	12.7	12.6
Other	11.5	11.7	12.4	11.9	12.3	12.6	12.5
Budgetary balance	-2.3	-1.4	-0.3	0.6	0.8	0.0	0.0
Extraordinary payments [4]	-0.6	-0.7	-0.3	-0.2	0.0	0.0	0.0
Augmented balance	-2.8	-2.1	-0.6	0.3	0.8	0.0	0.0
Financing	2.8	2.1	0.6	-0.3	-0.8	0.0	0.0
Domestic borrowing (net)	2.9	3.1	1.8	0.3	-0.2	0.3	0.4
Foreign borrowing (net)	0.1	0.3	0.0	0.0	-0.1	-0.2	-0.3
Privatization and other extraordinary receipts	0.1	0.2	0.4	0.2	0.1	0.1	0.1
Change in cash and other items	-0.3	-1.4	-1.7	-0.9	-0.5	-0.1	-0.1
	(Billions of rands)						
Total revenue and grants	299.4	347.9	411.6	480.9	555.4	616.0	667.3
Tax revenue	292.8	341.7	403.1	470.3	544.2	603.5	655.2
Income tax	172.0	195.2	230.7	279.6	321.0	355.4	388.2
Indirect taxes	110.2	132.0	151.3	174.6	200.5	222.0	238.6
Of which : value-added tax (VAT)	80.7	98.2	114.3	134.5	157.0	174.7	188.8
Trade and other (less SACU payments)	10.6	14.5	21.0	16.0	22.7	26.1	28.3
Nontax revenue	6.6	6.2	8.6	10.6	11.2	12.4	12.2
Total expenditure	328.7	368.5	416.7	470.5	539.7	616.1	667.7
Interest	46.3	48.9	50.9	52.2	52.5	52.9	50.4
Budgetary balance	-29.3	-20.7	-5.1	10.4	15.7	-0.1	-0.4
Extraordinary payments [4]	-7.4	-9.8	-4.6	-4.2	-0.4	0.0	0.0
Augmented balance	-36.6	-30.5	-9.7	6.2	15.3	-0.1	-0.4
	(Percent of GDP, unless otherwise indicated)						
Memorandum items:							
GDP (billions of rand)	1,289	1,431	1,580	1,787	2,008	2,229	2,451
Real GDP growth	3.0	5.4	5.0	5.0	4.7	4.5	4.5
GDP deflator change	4.5	5.3	5.2	7.7	7.3	6.2	5.2
Primary balance	1.3	2.0	2.9	3.5	3.4	2.4	2.0
Debt	35.3	35.1	33.5	30.7	27.5	25.1	23.3
Domestic	30.3	30.2	29.2	26.3	23.4	21.4	19.9
Foreign	5.0	4.9	4.2	4.4	4.1	3.8	3.4

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 2007 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, 2003/04-2009/10 [1]

	2003/04	2004/05	2005/06	2006/07	2007/08 Proj. [2]	2008/09 Proj. [2]	2009/10 Proj. [2]
				(Percent of GDP)			
General govt. (excl. local govts.) [3]							
Total revenue and grants	24.9	25.8	27.7	28.6	29.3	29.3	28.8
National government	23.2	24.3	26.1	26.9	27.7	27.6	27.2
Provinces (own revenue)	0.5	0.4	0.4	0.6	0.5	0.5	0.4
Social security funds (own revenue)	1.1	1.0	1.3	1.1	1.1	1.1	1.1
Extrabudgetary and other	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	27.0	26.8	27.5	27.6	28.1	28.8	28.3
Current	25.9	25.7	26.3	26.4	26.8	27.4	26.9
Wages and salaries	9.3	9.1	9.0	8.8	8.9	9.0	8.8
Other goods and services	3.6	3.5	3.8	3.8	4.1	4.5	4.7
Interest	3.6	3.4	3.2	2.9	2.6	2.4	2.1
Transfers	9.4	9.7	10.3	10.9	11.2	11.6	11.4
Capital expenditure	1.2	1.1	1.3	1.2	1.3	1.4	1.4
Overall balance	-2.1	-1.0	0.1	1.0	1.2	0.5	0.5
Public sector borrowing requirement (PSBR)	2.3	2.0	-0.8	-0.9	0.0	1.0	1.0
National government [4]	2.7	2.0	0.2	-0.5	-0.8	-0.1	0.0
Other government borrowing [5]	0.2	0.3	-0.1	0.0	0.2	0.1	0.1
Nonfinancial public enterprises	-0.7	-0.2	-0.8	-0.4	0.7	0.9	1.0
				(Billions of rands)			
General govt. (excl. local govts.) [3]							
Total revenue and grants	321.1	369.7	437.1	511.9	588.4	652.5	706.3
Total expenditure	348.4	383.3	435.0	494.2	564.5	641.9	694.4
Current	333.5	367.0	414.7	472.7	537.8	611.0	660.0
Wages and salaries	119.9	129.5	141.4	157.3	179.7	201.1	216.7
Other goods and services	45.8	49.5	59.7	67.9	81.6	99.4	114.6
Interest	46.3	48.9	50.9	52.2	52.5	52.9	50.4
Transfers	121.3	138.3	162.2	195.2	224.0	257.7	278.3
Capital expenditure	14.9	16.4	20.3	21.5	26.7	30.9	34.4
Overall balance	-27.3	-13.6	2.2	17.7	23.9	10.5	12.0
Public sector borrowing requirement (PSBR)	29.7	29.3	-11.9	-16.7	0.1	22.0	23.9
National government [4]	35.1	28.0	2.7	-9.6	-16.6	-1.2	-0.8
Other government borrowing [5]	3.2	4.3	-2.3	0.7	3.1	2.2	1.2
Provinces	2.9	2.4	0.0	0.2	0.3	-1.3	-2.9
Local govts. and local enterprises	5.1	7.8	8.2	8.5	10.8	12.2	13.5
Nonfinancial public enterprises	-8.6	-3.0	-12.3	-7.8	13.6	21.0	23.5
Other	-4.8	-5.9	-10.6	-8.0	-8.0	-8.7	-9.4
				(Percent of GDP)			
Memorandum items:							
Non-financial public sector debt (gross)	43.8	42.8	40.3	38.2	...	...	...
Social spending [6]	13.7	13.8	14.3	14.8	15.5	15.5	15.4
Defense spending	1.8	1.6	1.7	1.5	1.5	1.5	1.3

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

[1] For fiscal year beginning April 1.

[2] Staff projections based on the 2007 Budget Review.

[3] Consolidated national and provincial governments.

[4] Includes net extraordinary payments.

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

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

Table 4. South Africa: Balance of Payments, 2005-12

	2005	2006	2007	2008	2009	2010	2011	2012
			Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of U.S. dollars)							
Balance on current account	-9.8	-16.6	-17.7	-18.1	-18.5	-18.4	-17.9	-17.5
Balance on goods and services	-2.2	-8.6	-9.4	-9.8	-10.4	-10.6	-10.7	-11.1
Exports of goods and services	66.5	76.2	82.9	89.3	95.1	101.2	108.3	115.5
Exports of goods	55.3	64.1	69.8	74.5	78.6	83.0	87.8	92.9
Nongold	51.1	58.9	64.0	68.6	72.5	76.8	81.6	86.8
Gold	4.2	5.2	5.8	5.9	6.1	6.2	6.2	6.1
Exports of services	11.1	12.0	13.1	14.7	16.5	18.2	20.5	22.6
Imports of goods and services	-68.7	-84.7	-92.2	-99.0	-105.5	-111.8	-119.0	-126.7
Imports of goods	-56.6	-70.4	-76.7	-82.3	-87.7	-92.9	-99.0	-105.6
Imports of services	-12.2	-14.3	-15.6	-16.7	-17.8	-18.9	-19.9	-21.1
Balance on income	-4.9	-5.3	-5.1	-4.8	-4.2	-3.7	-2.9	-1.7
Income receipts	4.6	5.9	6.9	8.1	9.5	11.2	13.1	15.4
Income payments	-9.6	-11.2	-12.0	-12.9	-13.8	-15.0	-16.0	-17.1
Balance on transfers	-2.6	-2.7	-3.3	-3.5	-3.8	-4.1	-4.3	-4.6
Capital flows (including errors and omissions)	15.2	21.0	20.7	21.1	21.5	21.4	21.1	20.7
Balance on capital and financial account	11.4	15.2	20.7	21.1	21.5	21.4	21.1	20.7
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	11.4	15.1	20.7	21.0	21.4	21.3	21.0	20.7
Direct investment	5.3	-7.0	1.0	1.1	1.1	1.2	1.3	1.4
Liabilities	6.3	-0.3	2.0	2.1	2.2	2.3	2.4	2.6
Assets	-0.9	-6.7	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1
Portfolio investment	4.7	19.3	13.6	14.8	15.8	16.9	18.1	19.4
Liabilities	5.7	21.3	15.7	17.2	18.3	19.6	21.0	22.4
Assets	-1.0	-2.0	-2.2	-2.4	-2.5	-2.7	-2.9	-3.1
Other investment	1.3	2.8	6.1	5.1	4.5	3.2	1.6	-0.1
Liabilities	4.8	9.2	13.7	14.9	15.9	17.0	18.2	19.5
Assets	-3.5	-6.4	-7.5	-9.8	-11.4	-13.8	-16.6	-19.6
Errors and omissions	3.8	5.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	5.4	4.4	3.0	3.0	3.0	3.0	3.2	3.2
Gross reserves (SARB) [1]	20.6	25.6	28.6	31.6	34.6	37.6	40.8	44.0
International liquidity position of the SARB [1, 2]	17.2	23.0	26.0	29.0	32.0	35.0	38.2	41.4
	(Percent of GDP, unless otherwise indicated)							
Balance on current account	-4.0	-6.5	-6.5	-6.1	-5.8	-5.4	-4.9	-4.5
Balance on goods and services	-0.9	-3.4	-3.4	-3.3	-3.3	-3.1	-2.9	-2.9
Exports of goods and services	27.5	29.8	30.4	30.0	30.0	29.9	29.9	29.8
Imports of goods and services	-28.4	-33.2	-33.9	-33.3	-33.3	-33.0	-32.8	-32.6
Capital flows (including errors and omissions)	6.3	8.2	7.6	7.1	6.8	6.3	5.8	5.3
Balance on capital and financial account	4.7	5.9	7.6	7.1	6.8	6.3	5.8	5.3
Errors and omissions	1.6	2.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	2.2	1.7	1.1	1.0	0.9	0.9	0.9	0.8
Gross reserves (SARB) [1]	8.5	10.0	10.5	10.6	10.9	11.1	11.3	11.3
International liquidity position of the SARB [1, 2]	7.1	9.0	9.5	9.7	10.1	10.3	10.5	10.7
Memorandum items:								
Total external debt	19.1	22.4	21.7	20.5	19.8	19.2	18.4	17.7
Foreign currency debt	11.6	14.0	13.6	12.8	12.4	12.0	11.6	11.1
Of which : Short-term debt (at remaining maturity)	4.7	6.7	6.3	5.9	5.6	5.3	5.0	4.7
Total external debt service (billions of U.S. dollars)	5.5	6.4	8.1	8.5	8.9	9.3	9.7	10.0

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, 2002-06

	2002	2003	2004	2005	2006
	Dec.	Dec.	Dec.	Dec.	Dec.
	(Billions of rand)				
Net foreign assets	86.3	126.7	141.4	195.2	274.3
Gross reserves	167.0	214.5	229.6	297.8	409.8
SARB	66.0	52.9	82.8	130.5	178.3
Other monetary institutions	101.0	161.6	146.7	167.3	231.5
Liabilities	80.7	87.8	88.2	102.6	135.5
SARB	21.5	20.0	19.8	22.2	19.3
Other monetary institutions	59.2	67.8	68.4	80.4	116.2
Net domestic assets	629.6	681.4	772.8	906.0	1,075.0
Credit to government, net	58.2	45.8	42.6	0.8	-29.5
Claims on government	84.9	104.2	116.1	107.4	112.4
Government deposits	26.7	58.4	73.4	106.6	141.8
Credit to private sector [1]	703.4	838.3	954.0	1,140.0	1,434.7
Other items, net	-132.0	-202.7	-223.9	-234.8	-330.2
Broad money (M3)	715.8	808.0	914.2	1,101.1	1,349.3
Of which: M1	358.3	387.8	421.5	503.1	605.7
	(Annual percentage change)				
Net foreign assets	139.9	46.8	11.6	38.0	40.5
Net domestic assets	10.4	8.2	13.4	17.2	18.7
Credit to private sector	4.4	19.2	13.8	19.5	25.8
Broad money (M3)	18.1	12.9	13.1	20.5	22.5
	(Contribution to growth of M3, unless otherwise specified)				
Net foreign assets	8.3	5.6	1.8	5.9	7.2
Net domestic assets	9.8	7.2	11.3	14.6	15.4
Credit to government, net	4.4	-1.7	-0.4	-4.6	-2.7
Credit to private sector [1]	4.8	18.8	14.3	20.3	26.8
Other items, net	0.6	-9.9	-2.6	-1.2	-8.7
Memorandum item:					
Income velocity of M3 (GDP/average broad money)	1.74	1.65	1.61	1.52	1.39

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, 2002-07

	2002	2003	2004	2005	2006	2007	*date*
	(Percent of GDP, unless otherwise specified)						
Financial indicators							
Public sector debt [1]	37.0	35.4	35.1	33.9	31.4	...	
Broad money (percent change; 12-month basis)	18.1	12.9	13.1	20.5	22.5	22.3	*April*
Private sector credit (percent change; 12-month basis)	4.4	19.2	13.8	19.5	25.8	25.1	*April*
Repurchase rate (percent) [2]	13.5	8.0	7.5	7.0	9.0	9.5	*June*
Repurchase rate (percent; real) [2, 3]	2.4	3.8	3.1	2.9	3.8	2.5	*April*
External indicators							
Exports of goods and services (percent change; U.S. dollar value)	2.6	27.5	23.6	15.1	14.5	...	
Imports of goods and services (percent change; U.S. dollar value)	4.8	32.7	36.5	17.2	23.3	...	
Terms of trade (percent change)	2.2	3.8	0.8	-1.4	0.5	...	
Current account balance	0.8	-1.1	-3.2	-4.0	-6.5	...	
Capital and financial account balance	0.3	-1.1	3.3	4.7	5.9	...	
Gross official reserves (billions of U.S. dollars) [2]	7.6	8.0	14.7	20.6	25.6	27.9	*May*
Short-term foreign liabilities of SARB (billions of U.S. dollars) [2]	1.0	0.5	0.4	0.7	2.6	…	
International liquidity position of SARB (billions of U.S. dollars) [2, 4]	-1.6	4.8	11.4	17.2	23.0	25.5	*May*
Short-term external debt plus open forward position (billions of U.S. dollars)	18.1	11.7	10.4	11.4	17.0	…	
Gross official reserves as a percent of the above	42.2	68.0	141.2	181.1	150.5	…	
Foreign currency-denominated external debt (billions of U.S. dollars)	25.0	27.3	27.9	28.1	35.8	…	
As a percent of total exports	68.3	58.5	48.3	42.2	47.0	…	
External interest payments (as a percent of total exports)	4.9	4.6	3.8	3.8	3.6	…	
Exchange rate (per U.S. dollar; period average) [5]	10.52	7.56	6.45	6.36	6.77	7.02	*May*
Real effective exchange rate appreciation (period average; percent) [6]	-9.7	25.1	6.7	0.5	-2.5	…	
Financial market indicators [2]							
Stock market index (1994=100) [5]	155.9	174.6	212.8	303.4	388.0	445.8	*May*
Percent change [5]	-11.3	12.0	21.9	42.6	27.9	14.9	*May*
Foreign currency debt rating–Standard & Poor's	BBB-	BBB	BBB	BBB+	BBB+	BBB+	*May*
Foreign currency debt rating–Moody's [7]	Baa2	Baa2	Baa2	Baa1	A2	A2	*May*
Spread of benchmark bonds (basis points) [8]	240	149	101	84	111	71	*May*

Sources: South African Reserve Bank (SARB) and IMF 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 loans).

[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 2007, as of end-May; stock market index change with regard to end-2006.

[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, 2002-07

	2002	2003	2004	2005	2006	2007 [1]
	(Percent, unless otherwise indicated)					
Capital adequacy:						
Regulatory capital to risk-weighted assets [2]	12.6	12.4	14	12.7	12.3	12.7
Regulatory tier 1 capital to risk-weighted assets [2]	8.7	8.9	10.5	9.7	9.0	9.3
Asset quality:						
Nonperforming loans to total gross loans [3]	2.9	2.4	1.8	1.5	1.1	1.1
Nonperforming loans net of provisions to capital [3]	13.2	8.5	6.2	6.4	5.6	6.2
Large exposures (utilized) to capital	163.8	157.1	113.0	128.8	147.1	150.2
Share of mortgage advances in domestic private credit [4]	40.7	39.6	43.3	46.2	47.7	47.4
Earnings and profitability:						
Return on assets (average)	0.4	0.8	1.3	1.2	1.4	1.4
Return on equity (average)	5.4	11.6	16.2	15.2	18.3	18.6
Interest margin to gross income	52.3	38.3	41.6	38.2	43.8	48.5
Noninterest expenses to gross income	60.4	74.8	68.5	61.5	48.5	55.2
Liquidity:						
Liquid assets to total assets	4.7	4.7	4.7	4.8	4.6	4.5
Share of short-term deposits in total deposits	65.9	68.4	65.7	64.6	65.6	62.5
Exposure to FX risk:						
Maximum effective net open FX position to capital	3.6	1.3	0.8	1.9	1.4	2.8
Share of foreign currency loans in total lending	13.1	11.4	10.5	10.7	11.0	10.7
Share of foreign currency deposits in total deposits [5]	5.9	3.1	3.3	3.7	4.7	4.9
Share of foreign liabilities in total liabilities [6]	5.3	2.8	3.1	3.4	4.3	4.5

Source: South African Reserve Bank.

[1] As of March 2007.

[2] Total (banking and trading book).

[3] The official definition of nonperforming loans comprises doubtful and loss loans. Doubtful are loans overdue for 180 days unless well secured, or with a timely realization of the collateral.

[4] Domestic private credit not seasonally adjusted.

[5] Foreign funding to total funding.

[6] Foreign funding to total liabilities (including capital).

Table 8. South Africa: Social and Demographic Indicators

(2006, unless otherwise specified)

Area		**Population**	
1.22 million square kilometers		Total	47.5 million
		Annual rate of growth	1.1 percent
Population characteristics		**Health**	
Population density	38.9 per sq. km.	Life expectancy at birth (2005)	
		Total (years)	45
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	32		
15-64	63	Female (percentage of labor force)	46
65 and above	5		
Population below $2 a day, PPP basis (percent of population, 2000)	34		
GDP per capita at current prices		Percentage of employment (Formal sector, September 2006)	
In U.S. dollars	5,368	Agriculture	8.5
		Mining	3.1
		Industry [1]	22.5
		Trade	23.9
		Other services	42.0
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, 1990-2005 [1]

	1990	1994	1997	2000	2003	2005
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates					
Population below $1 a day (%)	...	10.0	...	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	94
3. Promote gender equality	2005 target = 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	100.8
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	32.8
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	67.0
Infant mortality rate (per 1,000 live births)	45.0	45.0	…	50.0	53.0	54.0
Immunization, measles (% of children under 12 months)	79.0	76.0	82.0	77.0	83.0	81.0
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)	…	…	…	…	19.0	19.0
Contraceptive prevalence rate (% of women ages 15-49)	57.0	…	62.0	…	…	…
Number of children orphaned by HIV/AIDS (thousands)	…	…	…	660.0	780.0	1200.0
Incidence of tuberculosis (per 100,000 people)	186.2	306.4	391.7	465.0	536.4	718.3
Tuberculosis cases detected under DOTS (%)	…	…	72.0	96.0	…	82.7
7. Ensure environmental sustainability	2015 target = various [1]					
Forest area (% of total land area)	7.4	...	...	7.3	...	8.0
Nationally protected areas (% of total land area)	...	...	...	...	5.5	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	88.0
Access to improved sanitation (% of population)	63.0	…	…	…	67.0	65.0
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	60.1	...
Fixed line and mobile telephones (per 1,000 people)	94.3	107.5	158.4	302.3	473.1	...
Personal computers (per 1,000 people)	7.0	22.7	43.7	66.4	72.6	82.2
General indicators						
Adult literacy rate (% of people ages 15 and over)	81.2	82.9	84.1	85.2	86.0	82.4
Total fertility rate (births per woman)	3.3	…	3.0	…	2.8	2.7
Life expectancy at birth (years)	61.9	…	54.7	48.5	45.7	44.6

Source: World Bank, Statistics South Africa.

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

[1] For definitions of Goal 7 and 8 targets, see http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do

APPENDIX I: SOUTH AFRICA—DEBT SUSTAINABILITY AND MEDIUM-TERM SCENARIO

South Africa: Selected Economic and Financial Indicators in the Medium Term, 2005-2012

	2005	2006	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
	(Annual percent change, unless otherwise indicated)							
National income and prices								
Real GDP	5.1	5.0	4.8	4.5	4.5	4.8	5.0	5.0
Real GDP per capita	4.1	3.7	3.8	3.5	3.5	3.8	4.0	4.0
Real domestic demand	5.9	8.7	5.4	4.6	4.7	5.1	5.2	5.2
GDP deflator	4.7	6.9	8.0	6.5	5.2	5.2	5.2	5.2
CPI (annual average)	3.4	4.7	6.3	5.9	4.5	4.5	4.5	4.5
CPIX (end of period) [1]	4.0	5.0	6.1	5.3	4.5	4.5	4.5	4.5
Labor market								
Unemployment rate (percent)	26.7	25.5	24.2	23.1	22.0	20.8	19.6	18.5
Average remuneration (formal nonagricultural sector)	2.9	7.3	8.8	8.7	7.4	7.7	7.5	7.5
Labor productivity (formal nonagricultural sector)	4.1	2.4	2.5	2.5	2.5	2.8	3.0	3.0
Nominal unit labor costs (formal nonagricultural sector)	3.1	4.8	6.1	6.0	4.8	4.8	4.4	4.4
External sector								
Merchandise exports, f.o.b. [2]	15.0	15.9	8.8	6.8	5.4	5.6	5.8	5.8
Merchandise imports, f.o.b. [2]	17.0	24.5	8.9	7.4	6.5	6.0	6.6	6.6
Export (goods and services) volume	8.0	5.5	6.0	5.8	5.4	5.0	5.0	5.0
Import (goods and services) volume	10.7	18.4	7.5	5.9	5.9	5.8	5.7	5.7
Terms of trade	-1.4	0.5	1.4	0.4	0.6	1.2	1.2	0.8
Nominal effective exchange rate [3]	1.1	-5.6	…	…	…			
Real effective exchange rate [3]	0.5	-2.5	…	…	…			
Money and credit								
Net domestic assets [4]	14.6	15.4	19.9	16.5	…	…	…	…
Broad money (including foreign exchange deposits)	20.5	22.5	22.3	18.3	17.8	18.1	18.2	17.8
Velocity (GDP/average broad money)	1.5	1.4	1.3	1.2	1.1	1.1	1.0	0.9
Bank rate/repurchase rate (period end, in percent)	7.0	9.0	…					
	(Percent of GDP, unless otherwise indicated)							
Investment and saving								
Investment (including inventories)	18.2	20.5	21.1	20.6	20.8	21.2	21.4	21.9
Of which : public fixed investment (incl. public enterprises)	4.6	5.2	5.6	5.8	5.9	6.0	6.1	6.2
private fixed investment	12.4	13.5	14.0	14.2	14.4	14.5	14.7	14.8
Gross national saving	14.1	13.9	14.6	14.6	15.0	15.7	16.5	17.4
Public	1.3	2.4	2.8	2.3	2.1	2.1	2.1	2.1
Private	12.9	11.6	11.8	12.2	12.9	13.6	14.4	15.3
National government budget [5]								
Revenue, including grants	25.6	26.7	27.5	27.6	27.3	27.4	27.5	27.5
Expenditure and net lending	26.2	26.3	26.7	27.5	27.3	27.4	27.5	27.5
Overall balance	-0.6	0.4	0.7	0.2	0.0	0.0	0.0	0.0
National government debt	33.9	31.4	28.3	25.7	23.8	21.7	19.8	17.9
Borrowing requirement of the nonfinancial public sector	-0.2	-0.9	-0.2	0.7	1.0	1.1	1.1	1.1
External sector								
Current account balance	-4.0	-6.5	-6.5	-6.1	-5.8	-5.4	-4.9	-4.5
Overall balance of payments	2.2	1.7	1.1	1.0	0.9	0.9	0.9	0.8
Total external debt	19.1	22.4	21.7	20.5	19.8	19.2	18.4	17.7
Gross reserves (SARB, billions of U.S. dollars)	20.6	25.6	28.6	31.6	34.6	37.6	40.8	44.0
(months of next year's total imports)	2.9	3.3	3.5	3.6	3.7	3.8	3.9	...

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 loans. 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; staff projections, based on National Treasury data and staff's GDP projections.

Public and External Debt Sustainability

South Africa's public debt position is sustainable. The ratio of government debt to GDP has fallen from 48 percent in 1999 to 31½ percent at end-2006.[16] Under the policies outlined in the 2007 budget and the medium-term expenditure framework, public debt should continue to decline to about 18 percent of GDP over the next five years. Gross financing needs should also decline to below 2 percent of GDP per year in the medium-term, significantly below the average of the past five years (Figure 1).

The declining trend in the public debt-to-GDP ratio can withstand 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, and in the case of the "no policy change" scenario it even falls below. It remains higher in the case of a hypothetical 10 percent debt shock, which is close to the total stock of recognized contingent liabilities (9.8 percent of GDP by March 2006, 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 about 22½ percent of GDP to about 17¾ percent of GDP by 2012. The current account deficit is projected to decline gradually over the medium-term to 4½ percent of GDP by 2012, as domestic demand growth moderates. The deficit is envisaged to be largely financed by nondebt 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 about 37 percent of external debt at end-2006, currency risk is low; the share of short-term debt in foreign-currency denominated debt (47 percent in December 2006) implies 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, which would bring the debt-to-GDP ratio to about 25 percent in 2008 before declining gradually to about 12 percent of GDP by end-2012. The favorable debt profile reflects in part the projected continued reliance on nondebt inflows to finance the current account deficit. Permanent adverse shocks to real GDP growth, to real interest rates, or to the noninterest current account, whether considered individually or together, would drive the debt-to-GDP ratio to a maximum of about 24 percent by 2012.

---

[16] Excluding local governments' and SOE's debt (1.3 and 6.6 percent of GDP at end 2006, respectively).

Table 1. South Africa: Public Sector Debt Sustainability Framework, 2004-2012
(Percent of GDP, unless otherwise indicated)

		Actual			Projections						
		2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance [9]
1	**Baseline: Public sector debt** [1]	35.1	33.9	31.4	**28.3**	**25.7**	**23.8**	**21.7**	**19.8**	**17.9**	**-0.2**
	o/w foreign-currency denominated	4.6	4.5	4.6	4.2	3.9	3.5	3.2	2.9	2.6	
2	Change in public sector debt	-0.3	-1.3	-2.4	-3.1	-2.6	-1.9	-2.0	-2.0	-1.8	
3	Identified debt-creating flows (4+7+12)	-2.6	-2.5	-4.1	-4.9	-3.6	-2.9	-2.7	-2.5	-2.3	
4	Primary deficit	-2.2	-3.1	-3.8	-3.8	-3.1	-2.6	-2.4	-2.2	-2.0	
5	Revenue and grants	25.6	27.2	28.4	29.1	29.3	28.9	29.0	29.1	29.1	
6	Primary (noninterest) expenditure	23.4	24.1	24.6	25.3	26.2	26.3	26.6	26.9	27.0	
7	Automatic debt dynamics [2]	-0.9	0.6	-0.3	-1.0	-0.4	-0.2	-0.3	-0.3	-0.2	
8	Contribution from interest rate/growth differential [3]	0.0	0.1	-0.7	-1.0	-0.4	-0.2	-0.3	-0.3	-0.2	
9	Of which contribution from real interest rate	1.5	1.7	0.8	0.4	0.7	0.9	0.8	0.7	0.6	
10	Of which contribution from real GDP growth	-1.5	-1.6	-1.5	-1.3	-1.1	-1.1	-1.0	-1.0	-0.9	
11	Contribution from exchange rate depreciation [4]	-0.8	0.5	0.4	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.5	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	
13	Privatization and other extraordinary receipts (negative)	-0.2	-0.4	-0.2	-0.1	-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	0.7	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) [5]	2.3	1.3	1.6	1.7	1.0	0.9	0.7	0.5	0.5	
	Public sector debt-to-revenue ratio [1]	137.2	124.4	110.7	97.1	87.9	82.2	75.0	68.0	61.7	
	Gross financing need [6]	5.9	3.6	3.6	2.8	2.6	2.4	1.9	1.6	1.5	
	in billions of U.S. dollars	12.9	8.8	9.2	7.7	7.7	7.7	6.3	5.7	5.9	
	Scenario with key variables at their historical averages [7]				**28.3**	**26.6**	**24.8**	**22.8**	**20.6**	**18.4**	**0.2**
	Scenario with no policy change (constant primary balance) in 2007-2012				**28.3**	**25.1**	**21.9**	**18.5**	**14.9**	**11.3**	**-0.1**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
	Real GDP growth (percent)	4.8	5.1	5.0	4.8	4.5	4.5	4.8	5.0	5.0	
	Average nominal interest rate on public debt (percent) [8]	10.8	10.2	9.9	9.7	9.6	9.1	9.1	9.1	9.1	
	Average real interest rate (nominal rate minus change in GDP deflator, percent)	5.1	5.5	3.0	1.7	3.1	3.9	3.8	3.9	3.9	
	Nominal appreciation (increase in US dollar value of local currency, percent)	17.9	-11.0	-9.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, percent)	5.8	4.7	6.9	8.0	6.5	5.2	5.2	5.2	5.2	
	Growth of real primary spending (deflated by GDP deflator, percent)	6.3	8.2	7.4	7.7	8.2	5.0	6.0	6.1	5.5	
	Primary deficit	-2.2	-3.1	-3.8	-3.8	-3.1	-2.6	-2.4	-2.2	-2.0	

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 the local currency value of the 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.

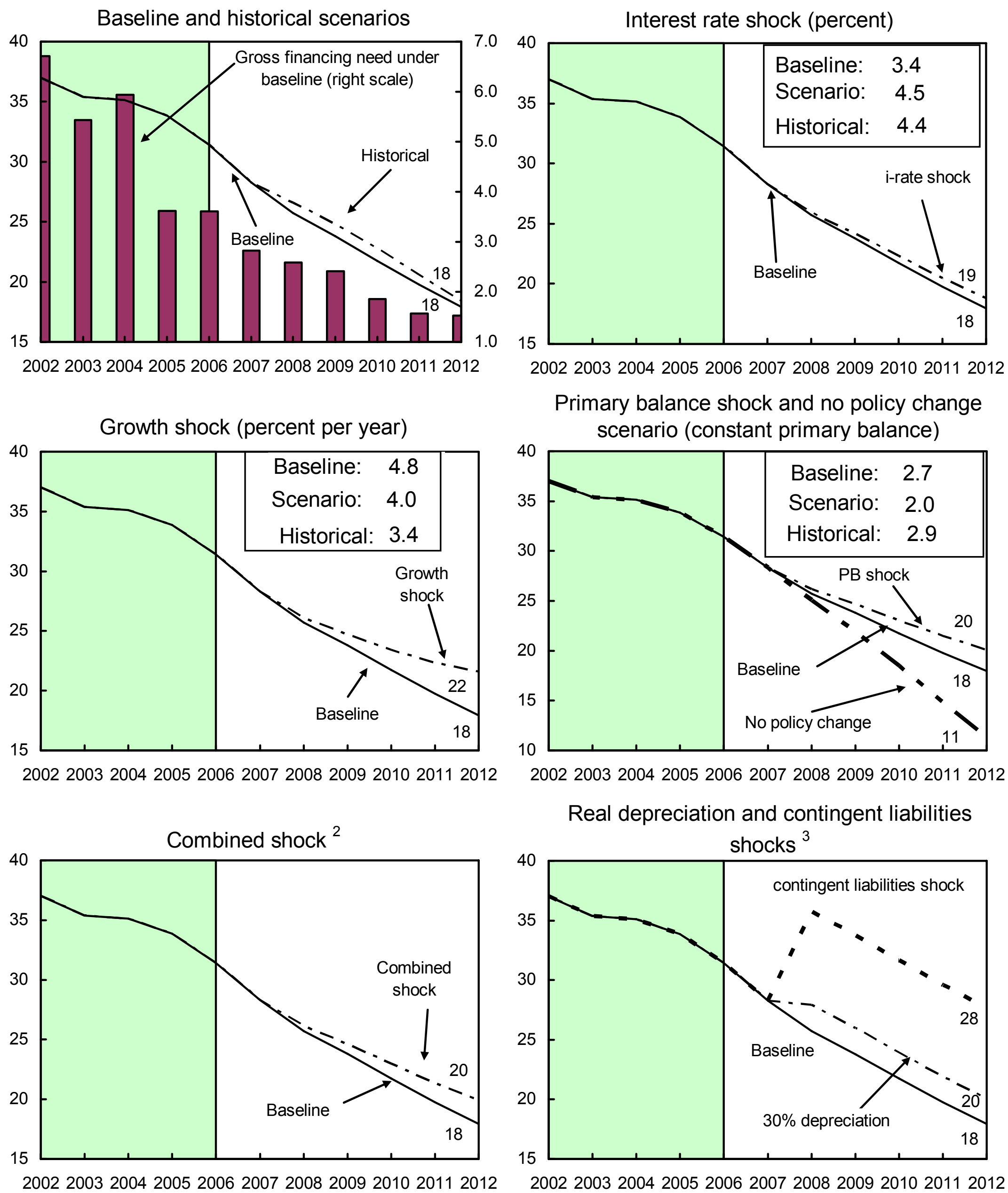
[6] Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

[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 a 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 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in the dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. South Africa: External Debt Sustainability Framework, 2002-2012
(Percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account [6]
1	**Baseline: External debt**	29.7	22.9	20.1	19.1	22.4	**21.7**	**20.5**	**19.8**	**19.2**	**18.4**	**17.7**	**-5.2**
2	Change in external debt	3.5	-6.8	-2.8	-1.0	3.3	-0.7	-1.2	-0.6	-0.7	-0.7	-0.8	
3	Identified external debt-creating flows (4+8+9)	-0.4	-7.5	-4.4	-3.0	2.0	0.5	0.2	0.0	-0.5	-1.0	-1.4	
4	Current account deficit, excluding interest payments	-2.5	-0.2	2.2	3.0	5.4	5.2	4.8	4.6	4.2	3.7	3.3	
5	Deficit in balance of goods and services	-3.8	-2.3	0.4	0.9	3.4	3.4	3.3	3.3	3.1	2.9	2.9	
6	Exports	33.0	28.1	26.7	27.5	29.8	30.4	30.0	30.0	29.9	29.9	29.8	
7	Imports	29.1	25.8	27.0	28.4	33.2	33.9	33.3	33.3	33.0	32.8	32.6	
8	Net non-debt creating capital inflows (negative)	-0.1	-0.7	-3.2	-5.1	-3.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	
9	Automatic debt dynamics [1]	2.2	-6.6	-3.4	-0.9	-0.4	0.3	0.3	0.4	0.3	0.3	0.3	
10	Contribution from nominal interest rate	1.6	1.3	1.0	1.1	1.1	1.3	1.2	1.2	1.2	1.2	1.2	
11	Contribution from real GDP growth	-1.0	-0.6	-0.9	-0.9	-0.9	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	
12	Contribution from price and exchange rate changes [2]	1.6	-7.3	-3.5	-1.1	-0.5	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) [3]	3.9	0.7	1.6	2.0	1.2	-1.2	-1.4	-0.6	-0.2	0.2	0.6	
	External debt-to-exports ratio (percent)	90.0	81.6	75.5	69.4	74.9	71.1	68.3	66.1	64.2	61.7	59.4	
	Gross external financing need (billions of U.S. dollars) [4]	9.9	13.9	18.3	19.3	28.7	35.8	35.5	36.1	36.2	35.9	35.7	
	percent of GDP	8.9	8.3	8.5	8.0	11.2	13.1	11.9	11.4	10.7	9.9	9.2	
	Scenario with key variables at their historical averages [5]						**21.7**	**17.1**	**12.9**	**9.1**	**5.8**	**2.9**	**-4.2**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (percent)	3.7	3.1	4.8	5.1	5.0	4.8	4.5	4.5	4.8	5.0	5.0	
	GDP deflator in US dollars (change in percent)	-9.6	45.4	24.1	6.2	0.5	1.7	4.6	1.9	2.0	2.0	2.0	
	Nominal external interest rate (percent)	5.8	6.6	5.8	5.8	5.9	6.1	6.2	6.4	6.5	6.7	6.9	
	Growth of exports (U.S. dollar terms, percent)	2.6	27.5	23.6	15.1	14.5	8.8	7.7	6.6	6.4	7.0	6.7	
	Growth of imports (U.S. dollar terms, percent)	4.8	32.7	36.5	17.2	23.3	8.9	7.4	6.5	6.0	6.4	6.5	
	Current account balance, excluding interest payments	2.5	0.2	-2.2	-3.0	-5.4	-5.2	-4.8	-4.6	-4.2	-3.7	-3.3	
	Net non-debt creating capital inflows	0.1	0.7	3.2	5.1	3.0	5.0	5.0	5.0	5.0	5.0	5.0	

[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).

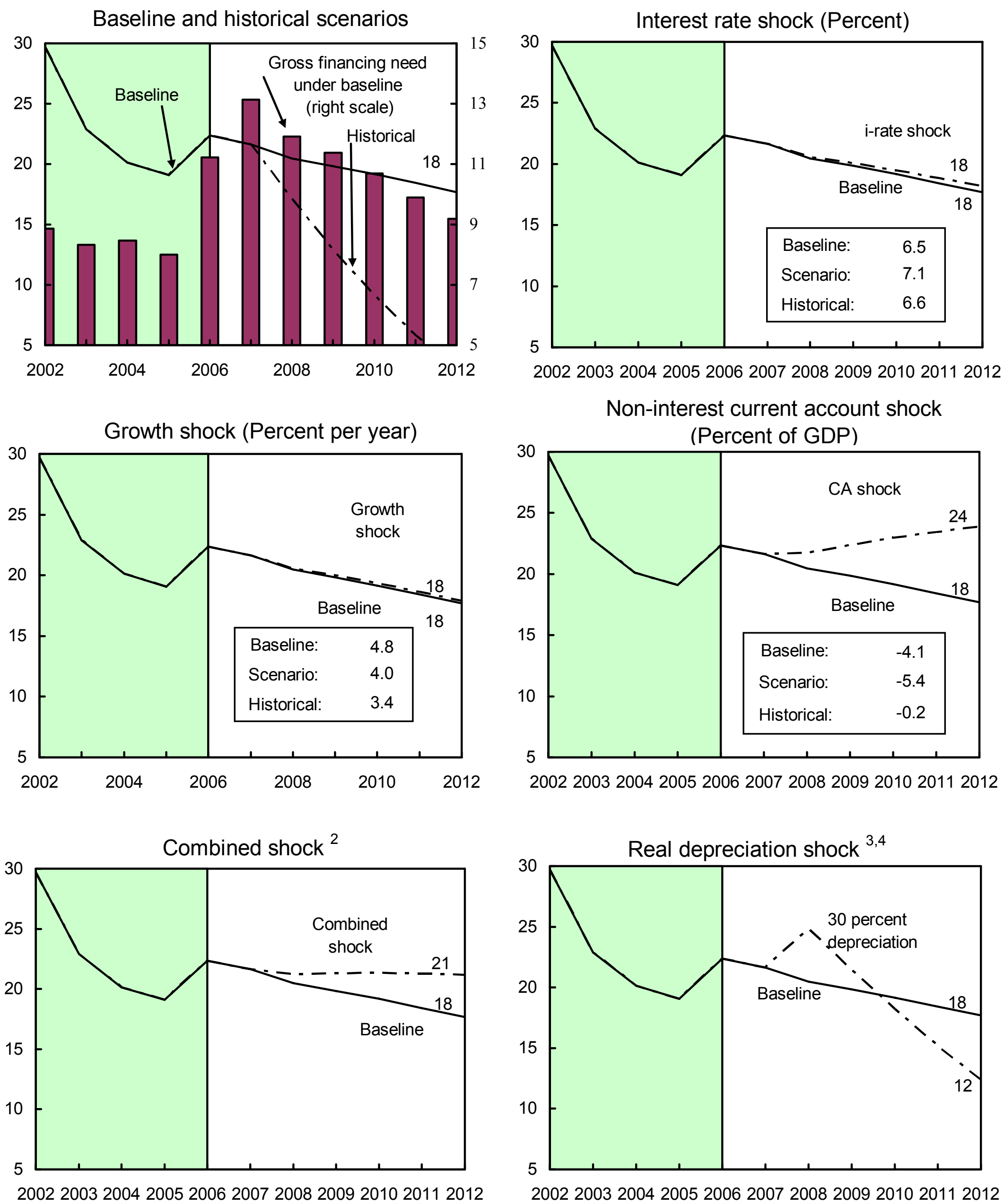
[3] For projection, line includes the impact of price and exchange rate changes.

[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: 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 current account balance.

[3] One-time real depreciation of 30 percent occurs in 2008.

[4] The depreciation lowers nominal GDP measured in US dollars below the baseline, while non-debt creating flows remain unchanged in U.S. dollar terms. As a result, they finance a larger portion of the current account, allowing the debt ratio to decline faster than in the baseline.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the
2007 Consultation with South Africa

Approved by Michael Nowak and Matthew Fisher

July 11, 2007

- **Relations with the Fund.** Describes financial and technical assistance by the IMF and provides information on the safeguards assessment and exchange system. South Africa has no outstanding purchases and loans from the Fund.
- **Relations with the World Bank**. Describes the World Bank Group's strategy and portfolio.
- **Statistical Issues.** Assesses the quality of statistical data. 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.

Contents Page

I. South Africa: Relations with the Fund

(As of April 30, 2007)

I. **Membership Status:** Joined 12/27/1945; Accepted the obligations of Article VIII, Sections 2,3, and 4 of the Fund's Articles of Agreement on September 15, 1973.

II. **General Resources Account:**	SDR Million	Percent Quota
Quota	1,868.50	100.00
Fund holdings of currency	1,867.66	99.94
Reserve position in Fund	1.15	0.06

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	220.36	100.00
Holdings	222.96	101.18

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs)**:**

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest		0.01	0.01	0.01	0.01
Total		0.01	0.01	0.01	0.01

VII. **Exchange Rate Arrangement:**

The South African rand floats against other currencies. South Africa maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for measures implemented solely for the preservation of national or international security which South Africa is in the process of notifying to the Fund pursuant to the procedures set out in Decision No. 144-(52/51) (August 14, 1952). On June 15, 2007 the exchange rate of the rand was US$0.1391=R1.

With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated. 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 transactions, with each subject to a quantitative cap that has been progressively raised over time. Regarding outward foreign direct investment by South African corporates, 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 2006 Article IV consultation was concluded by the Executive Board on August 2, 2006 (IMF Country Report No. 06/327 – September 2006). 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.

II. South Africa: Relations with the World Bank

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, land reform, 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, the emphasis in the policy dialogue and knowledge work has been on urban and rural development (urban and municipal development, land reform and agriculture, private sector development and the environment) and regional integration. Across sectors, capacity-building for public service delivery, also supported by a stepped-up in-country presence of the World Bank Institute, is the main theme. The Bank and South Africa are in the final phase of agreeing on a joint Country Partnership Strategy for 2007–11.

The International Finance Corporation's (IFC) committed portfolio has grown steadily from US$114 million in 2000 to $342 million in South Africa as of May 2007, the second largest in Africa after Nigeria. The IFC's strategy is to (i) support South African companies going north and going global; (ii) provide advice and financing within South Africa where there are underserved niches in the local market and where IFC can bring value added that complements local capabilities; and (iii) offer advisory services and related support for smaller business, with a focus on the informal sector and education

South Africa has been a member of the Multilateral Investment Guarantee Agency (MIGA) since 1994. As an investor country, South Africa is the most active user of MIGA guarantees among the category two countries and, and its investors account for US$251.8 million of the Agency's gross exposure. The current portfolio of investments sponsored by these investors is diverse, consisting of projects in the agribusiness, infrastructure, manufacturing and oil and gas sectors in such countries as Cameroon, Kenya, Mozambique, Syria, and Swaziland. As a host country, South Africa accounts for US$12.3 million of MIGA gross portfolio. This project, financed by Swiss investors, is in support of the country's financial sector.

III. South Africa: Statistical Issues

Economic and financial data provided to the Fund are 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 through the IMF's external website.

Real sector

In November 2004, the base year of the national accounts was changed from 1995 to 2000. At the same time, benchmarking was undertaken to reflect more accurately the structure of the economy, incorporate new areas of the economy previously not covered or under-covered, and to introduce other methodological changes to the compilation of data. These changes resulted in an upward revision of the average annual growth rate of real GDP for the period 1998 to 2003 from 2.4 percent to 2.7 percent. South Africa's national accounts are compiled according to the *SNA 1993*.

Reporting of real sector data for *International Financial Statistics (IFS)* is timely. Data reported for *Direction of Trade Statistics (DOTS)*, however, differ substantially with external trade data reported for *IFS*, particularly exports, due to balance of payments adjustments.

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 would benefit from better, more frequent and timely labor market data. A revision of the Labor Force Survey is underway and will be released quarterly starting late 2008.

The consumer price index (CPI) covers all households living in metropolitan and urban areas, which represent approximately 56 percent of the total number of households and 75 percent of private consumption expenditures. 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. After finalizing the ongoing analysis of the 2005 Income and Expenditure Survey, Statistics South Africa plans to update the weights in the CPI basket.

Government finance

South Africa currently reports data for the consolidated general government 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. Data are compiled and disseminated according to the GFSM 2001 framework. Data for social security funds and central government's extra budgetary funds have been reported on an accrual basis, starting in 2000 and 2002, respectively. Starting in 2005, the authorities have included additional noncash data, consistent with their migration to accrual accounting.

Monetary statistics

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

Balance of payments

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 the future. The 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, averaging 2.1 percent of GDP during 2003–06. Work is ongoing to improve the reliability and accuracy of balance of payments data.

The banking sector holdings of foreign-currency assets have been removed from the official measure of reserves, in accordance with international practice in this area. Data on international reserve position are disseminated 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 15, 2007)

<table>
<tr><th rowspan="2"></th><th rowspan="2">Date of latest observation</th><th rowspan="2">Date received</th><th rowspan="2">Frequency of Data[7]</th><th rowspan="2">Frequency of Reporting[7]</th><th rowspan="2">Frequency of publication[7]</th><th colspan="2">Memo Items:</th></tr>
<tr><th>Data Quality – Methodological soundness[8]</th><th>Data Quality – Accuracy and reliability[9]</th></tr>
<tr><td>Exchange Rates</td><td>6/14/07</td><td>6/14/07</td><td>D</td><td>D</td><td>D</td><td></td><td></td></tr>
<tr><td>International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]</td><td>5/07</td><td>6/08/07</td><td>M</td><td>M</td><td>M</td><td></td><td></td></tr>
<tr><td>Reserve/Base Money</td><td>5/07</td><td>6/14/07</td><td>M</td><td>M</td><td>M</td><td rowspan="4">O, O, LO, O</td><td rowspan="4">LO, O, O, O</td></tr>
<tr><td>Broad Money</td><td>4/07</td><td>5/31/07</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Central Bank Balance Sheet</td><td>5/07</td><td>6/14/07</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Consolidated Balance Sheet of the Banking System</td><td>4/07</td><td>5/31/07</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Interest Rates[2]</td><td>6/14/07</td><td>6/14/07</td><td>D</td><td>D</td><td>D</td><td></td><td></td></tr>
<tr><td>Consumer Price Index</td><td>4/07</td><td>5/30/07</td><td>M</td><td>M</td><td>M</td><td>O, LO, O, O</td><td>LO, LO, O, O</td></tr>
<tr><td>Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]</td><td>2H 2006</td><td>2/23/07</td><td>A</td><td>S</td><td>S</td><td rowspan="2">O, O, O, O</td><td rowspan="2">O, O, O, O</td></tr>
<tr><td>Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government</td><td>12/ 06</td><td>3/30/07</td><td>M</td><td>Q</td><td>Q</td></tr>
<tr><td>Stocks of Central Government and Central Government-Guaranteed Debt[5]</td><td>Q4 2006</td><td>3/30/07</td><td>Q</td><td>Q</td><td>Q</td><td></td><td></td></tr>
<tr><td>External Current Account Balance</td><td>Q4 2006</td><td>3/22/07</td><td>Q</td><td>Q</td><td>Q</td><td rowspan="2">LO, LO, LO, LO</td><td rowspan="2">LO, LO, LO, LO</td></tr>
<tr><td>Exports and Imports of Goods and Services [6]</td><td>2/07</td><td>3/31/07</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>GDP/GNP</td><td>Q4 2006</td><td>3/22/07</td><td>Q</td><td>Q</td><td>Q</td><td>O, LO, LO, LO</td><td>LO, O, O, O</td></tr>
<tr><td>Gross External Debt</td><td>Q4 2006</td><td>3/30/07</td><td>Q</td><td>Q</td><td>Q</td><td></td><td></td></tr>
</table>

[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 on October 16, 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 (respectively) source data, statistical techniques, assessment and validation, and revision studies.

Statement by the IMF Staff Representative
July 25, 2007

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

2. Recent indicators, such as manufacturing output and the purchasing managers' index, suggest that economic activity has remained robust, while showing some signs of moderation. Moreover, employment in the formal non-agricultural business sector rose slightly during the first quarter of 2007 and, as of March, was up by 2¼ percent compared to June 2006, the earliest data point available according to a revised methodology. Inflation rose to 6.4 percent (CPIX, year-on-year) in May, mainly reflecting higher food and fuel prices. The rand has lately strengthened somewhat against major currencies.

3. Market confidence remains high, as South Africa’s sovereign spreads remain low and stock prices are hovering around historic heights. By mid-July, net nonresident purchases of stocks and bonds have reached about 3 percent of GDP.

4. In a well-publicized event, the South African Reserve Bank (SARB) made its core forecasting model public in June. Staff welcomes this additional step in shedding light on an important component of the Bank’s already quite transparent inflation targeting framework.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/94
FOR IMMEDIATE RELEASE
August 6, 2007

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

IMF Executive Board Concludes Article IV Consultation with South Africa

On July 25, 2007 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

Real GDP grew by 5 percent in 2006 and continued to grow vigorously in early 2007. Growth was driven by strong domestic demand, with private consumption and investment spending supported by continuing robust consumer and business sentiment and low interest rates until late 2006. Household consumption was also boosted by growing disposable income and wealth effects from rising asset prices. Real GDP grew by 4.7 percent in the first quarter of 2007, indicating that conditions for business remained favorable.

The strong pace of economic activity led to higher employment. Total employment grew by 4.1 percent in the year to September 2006. However, the unemployment rate declined only moderately to 25.5 percent, as labor force participation rose.

Inflation pressures have intensified recently. After a prolonged period of remaining within the 3–6 percent target band, twelve-month CPIX inflation[2] came at 6.3 percent in April 2007, reflecting both rising food and fuel prices and demand pressures. Inflation expectations for the year ahead, as reflected in inflation-indexed bond prices, point to a

---

[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 SARB—excludes interest payments on mortgage loans.

reading above 6 percent, broadly in line with the South African Reserve Bank's (SARB) updated outlook. In response to the deteriorating inflation outlook, the SARB raised its policy interest rate from 9 to 9½ percent in June.

Credit to the private sector has remained buoyant despite recent interest rate hikes, expanding by 25.1 percent in the year ending in April 2007. Household debt rose markedly (to 76 percent of disposable income by the first quarter of 2007, from 69.4 percent a year earlier). Pushed in part by rising interest rates, household debt service has risen to about 9½ percent of disposable income, but remains below historic highs.

The 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 bolster its reserve position. Consistent with this policy, gross reserves have continued to grow, and by May 2007 reached US$27.9 billion, equivalent to over 200 percent of short term external debt. After depreciating markedly in mid-2006, the rand has fluctuated without a clear trend.

The current account deficit expanded to 6½ percent of GDP in 2006 and 7 percent in the first quarter of 2007, largely driven by strong domestic demand. The widening of the current account reflected primarily faster volume growth in imports than exports. The deficit was more than covered by large portfolio inflows, mainly equity. External debt nevertheless rose marginally to 22.4 percent of GDP by end-2006.

The fiscal balance of the national government turned into a surplus of 0.6 percent of GDP in FY2006/07, bringing government debt down to about 31 percent of GDP. The surplus, the first in several decades, reflected a large increase in tax revenue, owing to strong economic activity and continued enforcement efforts.

Asset prices continued to rise rapidly in 2006 and early 2007. Strong commodity prices, favorable growth prospects, and positive assessments by rating agencies drove the Johannesburg Stock Exchange (JSE) all-share index up by 38 percent in 2006 and a further 15 percent through May 2007. Residential property prices continued their steady rise, growing by 15½ percent in the year ending in May 2007.

Executive Board Assessment

Directors noted that South Africa has started to reap the benefits of sustained sound macroeconomic management and structural reforms, recently supported by favorable external conditions. The economy has experienced vigorous growth and rising employment accompanied by rapid credit expansion, booming asset prices, strengthening public finances, and rising international reserves. At the same time, however, the external current account deficit has widened markedly, and inflation pressures have recently intensified. Directors also noted that South Africa continues to face high unemployment and poverty, and welcomed the government's efforts to tackle these problems while pursuing policies aimed at maintaining macroeconomic stability.

Directors considered that the economic outlook for South Africa remains broadly positive. Going forward, a range of indicators point to continuing robust growth. Inflation is expected to remain above the upper edge of the target band in the near term, however, and continuing strength of domestic demand would keep the current account deficit at relatively high levels.

Directors saw the main risks to the outlook coming from the global environment and the strong pace of domestic demand. On the external front, the economy could be adversely affected by weaker appetite for emerging market assets, a global slowdown, or a sharp deterioration in the terms of trade. Directors noted that the widening current account deficit and high reliance on portfolio inflows have raised vulnerability to external shocks. However, they believed that the country's strong fundamentals should limit the adverse impact of these shocks on the economy. On the domestic front, Directors considered that a continuation of rapid growth in domestic demand, in combination with capacity constraints, could lead to further widening of the current account deficit and intensifying price pressures.

Directors welcomed the additional monetary policy tightening in June, noting that risks to the inflation outlook remained on the upside. They considered that interest rates may need to be raised further, to anchor inflation expectations well within the target inflation band. Directors supported the authorities' commitment to the flexible exchange rate regime, as this is an integral part of the inflation targeting framework and provides a cushion against external shocks, thus helping to promote external stability. They noted that there was little conclusive evidence of any significant exchange rate misalignment. Directors encouraged the authorities to continue to relax exchange controls gradually, in order to allow for better allocation of resources and ultimately reduce exchange rate volatility through a deepening of the market.

Directors commended the authorities for their continuing sound fiscal policies. They noted that the budget balance has turned into a surplus for the first time in several decades and public debt has been declining steadily. Moreover, expenditures are appropriately focused on upgrading infrastructure and relieving pressing social needs. Directors welcomed the authorities' intention to maintain a broadly neutral fiscal stance in the current fiscal year, and most Directors considered that keeping such a stance until the external current account deficit starts declining may be warranted.

Directors noted the strength and resilience of the financial system, and encouraged the authorities to continue enhancing regulation and oversight, especially in the context of the current buoyant credit environment and the recent increase in household indebtedness. They commended the authorities' efforts to improve access to basic financial services, especially outside of urban areas. Directors also welcomed the authorities' interest in an update of the Financial Sector Assessment Program for South Africa in 2008.

Directors supported the government's goals of raising growth and reducing unemployment under the Accelerated and Shared Growth Initiative for South Africa. Potential growth seems to have increased in recent years, and could increase even further with the envisaged strong capital accumulation and productivity-enhancing structural reforms. In that regard, Directors considered that efforts to boost growth and employment could be complemented by further initiatives to improve the functioning of labor markets and liberalize the trade regime, and cautioned against the possible distortions that might arise from industrial policy interventions.

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, 2003-07
(Annual percent change, unless otherwise indicated)

	2003	2004	2005	2006	2007 Proj.
Real GDP	3.1	4.8	5.1	5.0	4.8
CPI (metropolitan areas, annual average)	5.8	1.4	3.4	4.7	6.3
CPIX [1, 2]	4.0	4.3	4.0	5.0	6.1
Broad money [2]	12.9	13.1	20.5	22.5	22.3
Unemployment rate (percent)	28.0	26.2	26.7	25.5	24.2
National government budget balance (percent of GDP) [3]	-2.0	-1.7	-0.6	0.4	0.7
National government debt (percent of GDP) [3]	35.4	35.1	33.9	31.4	28.3
External current account balance (percent of GDP)	-1.1	-3.2	-4.0	-6.5	-6.5
External debt (percent of GDP)	22.9	20.1	19.1	22.4	21.7
Gross reserves (SARB, in months of next year's total imports)	1.6	2.6	2.9	3.3	3.5
International liquidity position of SARB (billions of U.S. dollars) [2]	4.8	11.4	17.2	23.0	26.0
U.S. dollar exchange rate (rand per U.S. dollar) [2]	6.64	5.63	6.33	6.97	...

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 loans.
[2] End of period.
[3] Calendar year.

Statement by Peter Gakunu, Executive Director for South Africa and Goolam Aboobaker, Senior Advisor to Executive Director July 25, 2007

1. The South African authorities would like to thank the Staff for a constructive report and an issues paper rich in information. The authorities would also like to indicate that they appreciate the frank engagement on the challenges confronting the country.

2. Prudent macro-economic policies over the past decade have resulted in impressive economic growth that is helping the country to make a serious impact on reducing unemployment and poverty. Poverty eradication and employment creation remain serious challenges going forward. Buoyant growth in South Africa has also been good for the Southern African Development Community (SADC) region as a whole and has greatly benefited members of the South African Customs Union (SACU).

Recent Economic Developments

3. The last three years in particular have seen the economy growing at an average rate of 5% but has slowed down marginally because of the general decline in mining. The higher rate has begun to impact on employment, which has grown in the past year by over 4%, although the numbers of unemployed continue to be unacceptably high.

4. The current account deficit widened to 6.5 percent in 2006 and increased to 7.0 percent of GDP in the first quarter of 2007 and continues to be funded via capital inflows into portfolio investments on the Johannesburg Securities Exchange (JSE). However the authorities believe that this deficit reflects rising investment rather than a growing fiscal imbalance. While they are concerned that such an unusually high deficit level exposes a country to a sudden stop in capital inflows, they consider that the relatively low external liabilities and the fact that fiscal policy is aimed at increasing the level of government savings should mitigate the risks posed by the current account deficit.

5. Further, the authorities share the view of Staff that sound macro-economic fundamentals, particularly the low external debt together with a well managed and stable financial sector and a flexible exchange rate regime would assist in mitigating this risk.

Monetary Policy Developments

6. The key development regarding monetary policy was the breach of the 6% inflation target, the first since the introduction of the inflation targeting framework in 2003. The Monetary authorities are conscious of the fact that there is an upside risk to inflation and that it has acted promptly recently when inflation, fuelled largely by buoyant oil and food prices, rose to 6.3 per cent in the past quarter with a 50 basis points interest rate hike; and is ready to tighten policy further if necessary.

7. The South African Reserve Bank (SARB) has continued with its policy of gradual reserve accumulation, and is committed to increasing reserves in line with other emerging market economies. At end June 2007, gross reserves stood at $28.3 billions and net reserves at $25.9 billions. The authorities see that there is room for sterilized reserves purchases to improve external vulnerability and mop up excess capital inflows.

8. The flexible exchange rate system had served the authorities well and as recognized by staff is not misaligned. However, it is difficult to estimate an equilibrium value for the rand. The volatility of the exchange rate has been reduced significantly and the accumulation of reserves has reduced exchange rate risk. Remaining exchange controls, including capital outflows by residents and portfolio investments, continue to be relaxed, while the National Treasury is also assessing the approaches of other countries to benefit from best practice.

Fiscal Policy

9. Public finances remain healthy as robust economic performance and improved revenue administration have led to increase in revenues. This, together with reduction in debt service costs has enabled the announcement of a budget surplus in the current financial year as well as a balanced budget over the Medium Term Expenditure Framework (MTEF) cycle despite projecting a significant increase in spending over the period.

10. The strong fiscal position has allowed the authorities to allocate substantial resources to social and economic programmes over the three year cycle. The public sector would continue to maintain an upward trend in investments in gross fixed capital formation as part of the ASGISA initiative, with the objective of modernizing crucial economic and social infrastructure and improving basic household infrastructure.

11. A central plank of government programme continues to be the eradication of poverty and the reduction of inequality and, in the light of both stronger economic performance and the greater fiscal space, the authorities have decided to embark on further reforms of the social security system. The reforms have several objectives, including lowering the costs of job creation, extending basic social security benefits to a larger number of workers and their families, and building on existing government-funded social assistance and social security programmes. Before finalization and launching of the proposed reforms, the authorities intend to enter into substantive discussions with principal stakeholders including organized businesses and trade unions.

12. With over 5.5 million people living with HIV (18.8 per cent of adult population, with women between the ages of 25-29 years worst affected), combating HIV/AIDS continues to be one of the major challenges confronting the authorities. Building on the Comprehensive Plan and earlier initiatives, the authorities launched a revised strategic plan in May 2007 with a budget of over R14 billion over the MTEF cycle. The plan has four main elements: prevention programmes; treatment, care and support of patients; monitoring, research and

surveillance; and Human and legal Rights. Currently, there are over 282,000 patients enrolled for public sector anti-retro viral treatment and over 300 facilities accredited to implement the comprehensive strategy.

Financial Sector

13. South Africa is served by a well run and managed financial system that is highly concentrated and profitable, but dominated by a few large banks and insurance companies. The system is also well regulated, with strong oversight shared between the Central Bank and the Ministry of Finance. The SARB undertakes regular reviews of the financial system using stress tests, analysis of corporate balance sheets and debt burdens. The results of the review are published twice a year.

14. The authorities acknowledge that the rapid credit expansion, particularly household debt, posed certain risks and highlighted the need for further enhancements to the regulatory and monitoring framework. They have therefore promptly effected the National Credit Act to provide some protection to consumers and simultaneously slow down the rate of credit extension. Consequently, non-performing loans had declined while household debt had started to decelerate. However, debt service costs remain at historic lows.

Structural Reforms for Accelerating Economic Growth and Competitiveness

15. Achieving higher and shared growth (ASGISA) is based on unlocking the six binding constraints which have been identified, namely, volatility of exchange rate; inadequate infrastructure and logistics; skills shortages; barriers to entry and competition; regulatory burdens on SMEs; and capacity limitations within the state. Significant progress has been made in addressing these constraints in the context of implementing the ASGISA initiative. Some of the policy responses also include undertaking a comparative study of the experience of some inflation targeting countries in interventions in foreign exchange markets; implementing dedicated projects at the DBSA and in the office of the Deputy President under the JIPSA, aimed at improving the capacity of sub-national governments for infrastructure development; identifying and acquiring priority skills both internally and externally; evaluating the skills development and public works programme to assess their effectiveness; and addressing competitiveness concerns in the economy through measures to increase productivity and reduce the cost of doing business.

16. Significant progress has also been achieved in the implementation of other key elements of the ASGISA initiative. The number of capital projects behind schedule has decreased; the programme to increase the numbers of artisans supported by businesses and trade union leaders is beginning to bear fruits; and, in close consultation with higher education authorities, a programme to produce an additional 1000 engineers has been launched.

17. For promoting industrial sectors, the ASGISA initiative places a sharper focus on tourism with an emphasis on an airlift programme, increasing safety and security of tourists and support for SMEs; on bio-fuels - concentrating on maize and sugar cane as fuel source with a target of 4.5 per cent of oil requirements to be met by bio-fuels by 2013; and on business process operations and outsourcing - reducing the cost of telecommunications and skills development.

18. Furthermore, the South African government takes quite seriously the practice of monitoring and evaluation, both through the ten year review exercise and by insisting that Ministers report on the implementation of government's programme of actions on a bi-monthly basis.

Regional Development

19. South Africa, with 6% of the population accounting for over a third (on a PPP basis) of SSA GDP has made significant impact on the African economy. Trade linkages with the rest of the continent, though starting from a small base, has begun to see significant increases. South African direct investments in other parts of Africa have started to take off, doubling since 2000 and standing at about $3.7 billion in 2004. There has been a marked increase in the number of South African companies operating on the continent. Sixty of the top 100 companies listed on the JSE have direct ownership of foreign affiliates in Africa, while another 26 are holding companies that have investments in Africa; South African banks operate in 17 countries.

20. South Africa belongs to a Common Monetary Area (CMA) that includes Lesotho, Swaziland and Namibia, the SA Customs Union (CMA plus Botswana) and the Southern African Development Community. It accounts for over two thirds of the combined SADC GDP and for about 60 % of intra-SADC trade. The determined economic growth has had significant spillover effects, particularly to the SACU members with a significant increase in revenue receipts by the BLNS countries. The authorities are in favor of stronger regional integration and the broadening of the Customs Union. The country also attracts a large number of migrants from neighboring countries as well as from afar. These developments reflect both the demand-pull effects of South Africa's strong growth and skill shortages, as well as the supply-push effects of economic turmoil in some countries.

21. The authorities are discussing with SACU members regarding the revenue sharing formula and they have given assurance that they would not make any uni-lateral changes to SACU or to its revenue sharing formula.