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IMF Executive Board Concludes 2012 Article IV Consultation with South Africa

On August 1, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

South Africa faces the immediate challenge of conducting policy under a highly uncertain global environment and making firm progress on reforms that promote the long-run inclusive growth needed for maintaining social cohesion.

Background

South Africa's high external openness and integration in the global financial markets have served the economy well. But, at the same time, they have exposed it to adverse developments in the global economy. The authorities' prudent macroeconomic and financial management has contributed to preserve macroeconomic stability, and, together with exchange rate flexibility, helped mitigate the domestic effect of changes in the external environment.

In 2011, the recovery from the recent downturn continued—although at a moderate pace—and GDP growth stood at 3 percent, reflecting robust domestic demand, especially private consumption. Despite the economic growth, which also led to employment creation, the unemployment rate remains stubbornly high. Inflation accelerated to just above the upper limit of the inflation target band on the back of higher food and fuel prices as well as exchange rate depreciation toward the end of the year, but has since declined. Core

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

inflation remains contained at 4½ percent. Despite the exchange rate depreciation in real terms, the 2011 current account deficit increased to 3¼ percent of GDP.

Although the 2012 GDP growth rate is likely to moderate to about 2.6 percent given the weak external conditions and heighted global uncertainty, it is projected to gradually recover over the medium term to its potential rate of about 3½ percent. Based on this trajectory, the output gap, which is estimated at about -1 percent in 2012, is likely to remain negative through 2014, thus contributing to the moderation of inflation.

Countercyclical macroeconomic policies continue to support economic activity. In 2011/12, the cyclically-adjusted deficit remained broadly stable at around 4 percent of GDP and the gross national government debt increased to just below 40 percent of GDP—some 12 percent of GDP higher than at the onset of the financial crisis. Although the level of the government debt is still manageable and does not pose any threat to fiscal sustainability, together with the fiscal deficit, it suggests that fiscal space to cope with future shocks has declined considerably.

The government's consolidation plans, as indicated in the 2012/13 budget, envisage a gradual decline in the cyclically-adjusted fiscal deficit, mainly reflecting a decline in public spending as a share of GDP. This would imply gross government debt peaking at about 42 percent of GDP in 2014/15 and declining gradually thereafter. The budget also envisages an improvement in the composition of spending through a reduction in the public sector wage bill, while increasing capital expenditures in line with past Article IV recommendations.

The South Africa Reserve Bank (SARB) cut the policy rate by 50 basis points to its record low-level of 5 percent this July, after keeping it unchanged since November 2010. The real policy rate has fluctuated around zero percent, and contributed to the recovery of credit to the private sector and fixed capital formation. If the external environment were to deteriorate further, the resulting moderation of inflation will allow the SARB greater room to respond.

The financial sector weathered the global financial crisis well. Financial institutions have remained well-capitalized and liquid, and banks' non-performing loans have partly recovered from the effects of the financial crisis. Although vulnerabilities remain, prudent supervision and the limited dependency on external funding have isolated the banking sector from the recent stress in global financial markets. Reforms to strengthen financial regulation, supervision, and crisis management, including the move toward the "twin peaks" model over the next few years are proceeding.

If not addressed, the stubbornly high unemployment rate could become politically and socially unsustainable. South Africa needs to build on its many policy successes to expand employment opportunities, secure better education and health outcomes, and build more efficient infrastructure to support inclusive growth, while maintaining macroeconomic and financial stability in a risky global environment. Active labor market policies can help in the short term, but a sustainable reduction in unemployment seems unattainable without labor and product market reforms.

Executive Board Assessment

Executive Directors commended the authorities for their continued prudent economic management in a highly volatile external environment. Directors noted that the immediate challenge for South Africa is to calibrate the policy mix to support growth in the face of weak external demand, while making progress on reforms that promote long-run inclusive growth and social cohesion. They stressed the importance of boosting employment and improving infrastructure and public services, while preserving macroeconomic and financial stability.

Directors broadly agreed that the pace of fiscal consolidation strikes the right balance between providing stimulus in the short run and ensuring long-term sustainability. They emphasized that the priority now is to rebalance the composition of spending away from the wage bill in favor of productivity-enhancing investments, complemented by steps to strengthen implementation capacity. Directors encouraged the authorities to improve tax collection and save any revenue over-performance, with a view to rebuilding fiscal buffers over the medium term. They welcomed the authorities' gradual approach to reforming the National Health Insurance and social security systems, paying careful attention to their design, including financing options.

Directors supported the current monetary policy stance, noting that the inflation targeting framework has provided a credible anchor for inflation expectations. With the balance of risks tilted to the downside, Directors agreed that monetary policy should remain accommodative, especially given the limited fiscal space. They stressed the need to remain vigilant and adjust policy as warranted.

Directors noted that South Africa's highly flexible exchange rate regime has helped smooth the effects of external shocks. They stressed the importance of wage moderation and increased competition in product markets to enhance external competitiveness. In view of heightened external risks and an expected increase in foreign liabilities, Directors generally supported a cautious build-up of reserve buffers, taking into account the cost of holding reserves.

Directors underscored that job creation is an urgent national priority to reduce the stubbornly high rate of unemployment, especially among the youth. They supported the government's targeted active labor market policy measures, including temporary public works programs. At the same time, sustained efforts are needed to address more fundamental structural problems, particularly with respect to the wage-setting mechanism, the insider-outsider problem in labor and product markets, and access to, and the quality of, health care and educational systems. Directors also supported the authorities' efforts to promote export diversification.

Directors observed that South Africa’s financial sector remains sound, liquid, and profitable. They encouraged continued vigilance in monitoring underlying risks, including banks’ dependence on short-term wholesale funding, and their large exposure to home mortgages and highly indebted households. Directors welcomed the implementation of Financial Sector Assessment Program (FSAP) recommendations, in particular, the ambitious program to strengthen the legal framework for bank supervision and improve crisis management. They looked forward to progress in achieving Basel III benchmarks. Directors welcomed the authorities’ gradual and cautious approach to liberalizing capital controls on residents and replacing them with prudential regulations.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with South Africa is also available.

South Africa: Selected Economic Indicators, 2008–2012
(Annual percent change; unless otherwise indicated)

	2008	2009	2010	2011	2012 Proj.
Real GDP	3.6	-1.5	2.9	3.1	2.6
CPI (end of period) 1,2	10.1	6.3	3.5	6.1	5.4
Unemployment rate (percent)	22.9	23.9	24.9	24.9	22.7
Broad money 2	14.8	1.8	6.9	8.3	9.9
National government budget balance (percent of GDP) 3	-0.7	-5.4	-5.4	-5.0	-4.8
National government debt (percent of GDP) 3	27.4	31.5	35.3	38.7	40.2
External current account balance (percent of GDP)	-7.2	-4.0	-2.8	-3.3	-4.8
External debt (percent of GDP)	26.6	27.6	28.7	27.3	32.0
Gross reserves (SARB, in months of next year's total imports)	3.8	5.9	5.3	4.9	4.8
International liquidity position of SARB (in billions of U.S. dollars) 2	33.5	39.0	43.4	47.9	47.7
U.S. dollar exchange rate (rand per U.S. dollar) 2	9.4	7.4	6.6	8.1	8.2

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

1. Since January 2009, a reweighed and rebased CPI replaced the previously used CPIX (the consumer price excluding the interest on mortgage loans) as the targeted measure of inflation.
2. End of period.
3. Calendar year.