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IMF Executive Board Concludes 2010 Article IV Consultation with South Africa

On July 7, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

South Africa's economic performance since the mid-2000s has been impressive. Economic growth has picked-up quite perceptibly against the backdrop of sound macroeconomic policy management and a favorable external environment. Tax collections improved significantly, allowing the fiscal deficit to decline and fiscal policy to be managed in a relatively counter-cyclical manner during the upswing. This in turn allowed government debt to be reduced substantially to 28 percent of gross domestic product (GDP) in 2007.

Growth started to slow down in early 2008, on account of the deteriorating external environment, power shortages, and the impact of the South African Reserve Bank (SARB)'s tightening cycle begun in mid-2006. The global financial crisis of late 2008 pushed an already slowing economy into its first recession since 1992. The economy contracted for three consecutive quarters beginning in the fourth quarter of 2008 and about 1 million jobs were lost since then.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Playing off strongly counter-cyclical policies and the global recovery, South Africa's economy has emerged from recession since the third quarter of 2009, and growth accelerated further to 4.6 percent in the first quarter of 2010, led by a rebound in the export-oriented and interest-sensitive sectors—mining, manufacturing, and financial services. From the demand side, however, private consumption growth remains anemic, reflecting high levels of indebtedness, and with ample unutilized capacity, investment growth is also weak. Consumer Price Index Inflation has stayed within the 3-6 percent target band since February and stood at 4.8 percent in April 2010. The stock market and the rand strengthened significantly through April from last year's lows amid large capital inflows. However, changes in global sentiment triggered by recent events in the euro area, caused portfolio inflows to abate, the local stock market to wobble, and the rand to weaken somewhat in May.

Fiscal policy has been strongly countercyclical. In the face of a large revenue shortfall in fiscal year 2009/10 (April-March), the authorities continued to implement an ambitious infrastructure investment program. This, together with a rapid increase in recurrent expenditure, in particular, wages, led to the deterioration of the fiscal balance in terms of GDP by 5.7 percentage points from 2008/09 to 2009/10. The fiscal year 2010/11 budget announced in February 2010 outlined an ambitious fiscal consolidation path, targeting a real growth of fiscal spending around 2-3 percent a year. Overall fiscal deficit is expected to fall gradually to 2½ percent of GDP under the staff's central growth forecast.

After a pause since August 2009, the SARB reduced the repo rate by another 50 basis points in March 2010 in response to an improved inflation outlook, but has kept the repo rate unchanged since then, citing broadly balanced risks to inflation outlook.

The South African financial sector weathered the global financial crisis without major problems. There was no need for public support, and capital adequacy ratios remained above their regulatory minima throughout the crisis period. Nevertheless, private sector credit growth has turned negative in recent months, compared to growth of 20 percent or so during 2005-2008. The recession has also led to a pronounced increase in impaired loans in the banking system to 6 percent of gross loans and advances in January 2010 from 4 percent in 2008. As a result, banks' profitability declined, although it remains positive, and the bank's balance sheets have been shrinking.

South African continues to maintain a floating exchange rate regime. Without seeking to influence the level of the nominal exchange rate, the SARB has been gradually buying foreign exchanges in recent months when presented with the opportunities provided by strong inflows. As of May 2010, gross international reserves stood at close to $42 billion, equivalent to 98 percent the sum of short-term external debt and the projected current account deficit in 2010.

The medium-term outlook is for the recovery to be sustained, provided that the global recovery continues. Output growth is projected to be 3¼ percent in 2010, gradually rising to 4½ percent over the medium term with the output gap expected to close by around 2013. Inflation is also expected to remain within the target band over the forecast horizon. The external current account, after narrowing temporarily in 2009, is expected to widen over the medium term as private demand recovers and the public investment programs continue to unfold.

Executive Board Assessment

Executive Directors commended South Africa's impressive economic performance in recent years, underpinned by prudent macroeconomic management, which provided room for a decisive easing of monetary and fiscal policies during the crisis. In addition, the banking system withstood the crisis without major problems, benefitting from a strong supervisory framework. While economic activity is recovering, South Africa faces several challenges. The overriding policy challenge is to reduce unemployment and income inequality through labor and product market reforms aimed at raising the country's growth potential.

Directors agreed that the current medium-term fiscal consolidation plan strikes the right balance between supporting the ongoing recovery and rebuilding fiscal space. They welcomed the authorities' intention to reduce the fiscal deficit through substantially lower real spending growth. In particular, Directors stressed the importance of avoiding another round of public sector wage increases exceeding inflation expectations and productivity gains, which could jeopardize the fiscal targets and distort wage negotiations in other sectors. Any revenue overperformance should be saved unless it is directed toward urgent development spending.

Directors noted that the inflation-targeting framework has served South Africa well. They agreed that inflation risks are evenly balanced and that the room for further rate cuts is narrowing. In the current highly uncertain environment, the South African Reserve Bank should nevertheless stand ready to move quickly in either direction. Directors welcomed the authorities' enhanced communication efforts surrounding monetary policy decisions, noting that this could help induce forward-looking inflation expectations, dampening the real cost of disinflation. They supported recent steps to integrate banking and financial sector stability issues within the monetary policy decision making framework, and to strengthen macro prudential analysis as part of a continued vigilant monitoring of financial sector soundness.

Directors supported South Africa's floating exchange-rate regime. They noted that the exchange rate may be moderately overvalued, while acknowledging a wide range of uncertainty surrounding this assessment. Directors saw merit in the authorities' intention of using the strong capital inflows to gradually build international reserves without influencing the exchange rate level. Interventions to help small and medium enterprises adversely affected by the strong rand should be transparent, time bound, and performance-tested.

Directors welcomed ongoing initiatives to increase investment in infrastructure and improve education and health services. They called for further far-reaching reforms to raise growth and create employment. Directors underscored the need to strengthen product market competition by stepping up the enforcement of competition policy, continuing to reduce nontariff barriers to trade, as well as creating an environment conducive for private sector participation in infrastructure projects. Continued development of domestic financial markets should also be a priority. Noting the sharp increase in unemployment resulting from the economic slowdown, Directors encouraged the authorities to reexamine labor market institutions, in particular with a view to reduce any policy distortions, and to ensure that businesses and unions have greater flexibility in the wage bargaining framework.

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 2010 Article IV Consultation with South Africa is also available.

South Africa: Selected Economic and Financial Indicators, 2006–10

(Annual percent change; unless otherwise indicated)

	2006	2007	2008	2009	2010 proj.
Real GDP	5.6	5.5	3.7	-1.8	3.2
CPI (metropolitan areas, annual average)	4.7	7.1	11.5	7.1	5.6
CPIX (end of period) [1,2]	5.0	8.6	10.3	6.3	5.8
Unemployment rate (percent)	25.5	22.7	21.9	24.3	24.8
Broad money [2]	22.5	23.6	14.8	1.6	19.2
National government budget balance (percent of GDP) [3]	0.4	0.8	-0.6	-5.3	-6.1
National government debt (percent of GDP) [3]	32.6	28.3	27.2	30.8	34.8
External current account balance (percent of GDP)	-5.3	-7.2	-7.1	-4.0	-4.5
External debt (percent of GDP)	21.8	26.3	25.9	27.5	28.0
Gross reserves (SARB, in months of next year's total imports)	3.1	3.7	5.1	5.2	5.0
International liquidity position of SARB (in billions of U.S. dollars) [2]	23.0	30.2	31.9	37.5	40.8
U.S. dollar exchange rate (rand per U.S. dollar) [2]	6.97	6.81	9.31	7.38	8.08

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 index excluding the interest on mortgage loans) as the targeted measure of inflation.
[2] End of period.
[3] Calendar year.