FOR AGENDA

SM/09/196

July 20, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **South Africa—Staff Report for the 2009 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2009 Article IV consultation with South Africa, which will be brought to the agenda for discussion on **a date to be announced**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of South Africa indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Gueorguiev (ext. 30024) and Mr. Ramcharan (ext. 35933) in AFR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 28, 2009; and to the African Development Bank, the European Investment Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with South Africa

Approved by Mark Plant and Aasim Husain

July 20, 2009

EXECUTIVE SUMMARY

Background: The global financial crisis has sharply altered the outlook for an already slowing economy. Large capital outflows lowered stock prices and depreciated the rand in late 2008. A sharp decline in external demand and a slump in commodity prices have pushed the economy into a recession. Inflows have returned and the rand has appreciated recently, but inflation risks have increased and the current account deficit is projected to widen again. The risks to the outlook are mainly on the downside. The banking system has remained liquid and well-capitalized, but impaired loans are rising as the economy weakens. Policies have been countercyclical, with a large investment-centered fiscal stimulus in FY 2008/9 followed by further easing in FY2009/10, and substantial monetary easing in the first half of 2009. Medium-term budget plans envisage a moderation in spending growth over the medium term.

Challenges: In the near term, the key challenge for macroeconomic policies is to strike the right balance between supporting domestic demand and maintaining price and external stability. A strong push for structural reforms to address the long standing barriers to growth and employment is urgently needed, also to insulate macroeconomic policies from recession-induced pressures.

Staff views: The expansionary fiscal stance is appropriate given the weak economic outlook, and strikes the right balance between supporting demand and preserving medium-term sustainability. If output turns out weaker than staff projects, the automatic stabilizers should be allowed to operate in FY2009/10 and FY2010/11, but spending growth would need to be moderated further when the economy recovers, in order to stabilize medium-term public debt at a prudent level. There are risks to the medium-term fiscal position, particularly if complementary reforms to improve public service delivery and enhance efficiency in infrastructure provision are delayed. The monetary policy stance has been appropriate. The scope for easing may have been exhausted if inflation is to be brought within the target range by end-2010, as the authorities intend.

Authorities' views: The authorities broadly shared the staff's assessment. They acknowledged the risks to their medium-term fiscal position, but emphasized that they intend to run a disciplined and pragmatic fiscal policy, including to take action well before net government and government guaranteed debt reaches their debt limit of 50 percent of GDP. They are also focusing on improving public service delivery. The South African Reserve Bank (SARB) noted inflation risks and indicated its intention to use monetary policy as needed to anchor inflation expectations and bring inflation within its target band. Supervisors intend to continue to ensure that banks' provisioning and capital buffers remain adequate to meet increasing risks, while strengthening the regulatory framework.

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GLOSSARY

ANC	African National Congress
ASGISA	Accelerated and Shared Growth Initiative for South Africa
CGER	Consultative Group on Exchange Rate Issues
CPI	Consumer Price Index
CPIX	CPI excluding the interest on mortgage loans
EM Europe	Emerging Europe
EMBI	Emerging Market Bond Index
EMEs	Emerging Market Economies
EPA	Economic Partnership Agreement
EU	European Union
FSAP	Financial Sector Assessment Program
FSB	Financial Services Board
IFS	International Financial Statistics
MPC	Monetary Policy Committee
NPLs	Nonperforming Loans
OECD	Organization for Economic Co-Operation and Development
PSBR	Public Sector Borrowing Requirement
REER	Real Effective Exchange Rate
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SOEs	State-owned enterprises
WEF	World Economic Forum
WTO	World Trade Organization

I. Background: A Recession Brings New Challenges[1]

1. **South Africa enjoyed a buoyant economy in the mid-2000s**. A favorable external environment and strong domestic demand, accommodated by rapid credit expansion, raised growth to 5 percent on average in 2004–07 and lowered the unemployment rate by 5 percentage points, despite growing labor force participation (Figure 1). Sound macroeconomic policies, underpinned by a consistent and transparent policy framework, contributed significantly to the expansion by strengthening public finances, maintaining single digit inflation, and improving external reserves. Rising employment, personal income, and wealth effects buoyed household consumption, while strong business confidence and high commodity prices supported private investment. Surging investment and a falling saving rate resulted in a widening current account deficit, which was financed largely by portfolio inflows. However, the demand-led expansion, together with soaring international food and fuel prices, also created inflation pressures and led the SARB to embark on a tightening cycle in mid-2006. The slowdown in the global economy, power shortages, and rising interest rate dampened growth starting in mid-2008.

2. **The global financial crisis of late 2008 sharply changed the outlook for an already slowing economy and posed new challenges for macroeconomic policies.**

- ***Large capital outflows,*** triggered by investor withdrawal from emerging market assets lowered stock prices and depreciated the rand (Figure 2). South Africa-specific factors, such as the high current account deficit and policy uncertainties created by the upcoming national elections in April 2009, also contributed to an elevated perception of risk.
- A ***sharp decline in external demand*** and ***a slump in the prices of some major export commodities*** weakened the economy further.

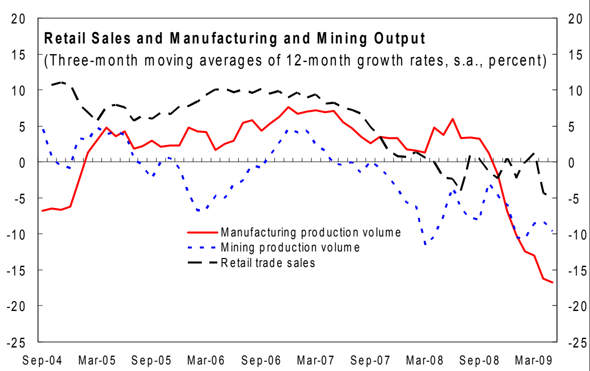
These shocks pushed the economy into a recession while the costs of borrowing in international markets rose significantly, as for other emerging market economies (EMEs).

3. **The national elections in April 2009 returned the African National Congress (ANC) to power.** The ANC won the elections by a comfortable margin and Parliament elected Mr. Zuma as President. The new government has emphasized its commitment to policy continuity in key areas and to improving the delivery of public services.

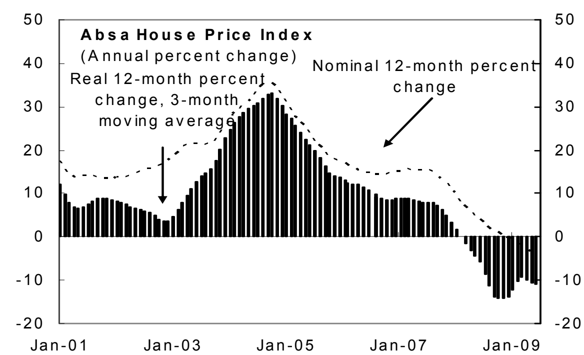
[1] The discussions were held during June 17–July 2, 2008. The mission met with the Minister of Finance, the Registrar of Banks, the Chief Economist of the South African Reserve Bank, other senior officials, and representatives of the financial and business sectors, trade unions, and the academic community. The staff team comprised Ms. Coorey (head), Messrs. Gueorguiev and Ramcharan and Ms. Aydin (all AFR), Ms. Stuart (SPR), and Mr. Espinosa (MCM). Mr. Nolan (senior resident representative in Pretoria) and Mr. Aboobaker (OED) also attended the meetings.

4. **Financial markets have begun to stabilize recently, driven by global shifts in financing to emerging market economies, rather than South Africa specific factors.** Starting in early 2009, portfolio inflows have returned, netting some US$6 billion for the year by end-June. The rand has now recovered its losses, returning in early June to its level (in nominal effective terms) as of mid-September when the acute phase of the crisis began. Similarly, the main stock market index, which first declined sharply as weakness in financial equities was compounded by weak commodity stocks, has recovered strongly since early March. After widening significantly, credit default swap and EMBI spreads have declined to pre-September 2008 levels (Figure 3).

5. **By contrast, output and demand remain weak, but recent indicators suggest that the pace of deterioration may be slowing.** Output fell by 1.8 percent (q-o-q, saar) in Q4:2008 and by a larger-than-expected 6.4 percent in Q1:2009. Manufacturing and mining output have contracted dramatically, but seemed to have bottomed out recently. Residential property prices have continued their downward trend. Consumer spending has fallen, but investment has remained resilient, partly due to higher public infrastructure spending. Indices of leading indicators and business and consumer confidence remain weak, but have shown some improvement recently. The economy lost over 200,000 jobs in early 2009, and unemployment rose to 23.5 percent in Q1:2009 from a low of 21.9 percent in Q4:2008.

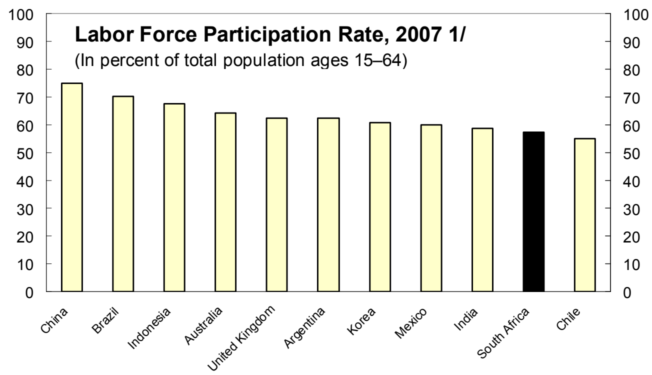


Sources: Statistics South Africa; and IMF staff calculations.



Source: Amalgamated Bank of South Africa (Absa).

6. **South Africa continues to face formidable medium-term structural challenges largely reflecting its apartheid legacy.** Even during the economic expansion of 2004–07, output growth was lower than that in many other EMEs. Despite strong employment growth over the past several years, the unemployment rate is very high at over 23 percent, even as labor force participation remains lower than in other emerging market economies. Income inequality, amongst the highest in the world, has improved only modestly over the past decade despite steadily rising public spending on social services and transfers.



Sources: World Bank, World Development Indicators; and Statistics South Africa.

1/ For South Africa, data represents 2009Q1.

Income Distribution, latest year

	Gini Index 1/	Share of Income Held By: Top 20 %	Bottom 20 %
South Africa	**58**	**62.7**	**3.1**
Brazil	55	60.8	3.0
Chile	52	60.0	4.1
Argentina	50	55.4	3.4
Mexico	48	53.3	3.9
China	42	51.9	5.7
Indonesia	39	47.3	7.1
India	37	45.3	8.1
United Kingdom	36	44.0	6.1
Australia	35	41.3	5.9
Korea	32	37.5	7.9

Source: World Bank, World Development Indicators.

1/ A measure of distribution of income or consumption, where 0 represents perfect equality and 100 represents perfect inequality.

7. **In the short term the central challenge for macroeconomic policies in this uncertain global environment is to strike the right balance between supporting domestic demand and maintaining price and external stability.** In the medium term, the challenge will be to ensure that the fiscal position remains sustainable given spending pressures and large external deficits, while a renewed push on structural reform addresses long-standing barriers that constrain growth and employment. Within this overarching theme, discussions focused on:

- ***assessing the economic outlook and risks***;

and policies to:

- ***support demand*** in the face of the large external shocks, while containing inflation pressures and current account vulnerabilities;
- ***ensure stability*** in the financial system given global and domestic risks; and
- ***safeguard medium-term growth prospects*** by ensuring that key constraints which also pose risks for the medium-term fiscal position are addressed, while existing structural policies are not undermined by pressures from the downturn.

II. Outlook: A Slowly Recovering Economy with Substantial Downside Risks

8. **The short-term outlook for South Africa remains subdued.** Output is expected to gradually recover, while inflation and the current account deficit are likely to remain elevated. Staff projects output to contract by about 2 percent of GDP in 2009 (Table 1), with a gradual recovery in the latter part of the year, supported mainly by the strong countercyclical policy response, but constrained by the still feeble recovery of partner country demand. Twelve-month inflation would slow through Q3:2009 due to weak activity and base effects, but then will pick up again, pushed by rising international energy prices, increases in regulated electricity prices, higher inflation expectations, and as base effects

from 2008 wear out. The current account deficit would narrow to about 6 percent of GDP in 2009 with the moderation of dividend payments in line with corporate profits, but would resume its widening to about 7–7½ percent of GDP over the medium term—provided external financing remains available—as private demand recovers and the public investment program unfolds.

9. **The restrained external financing environment resulting from the global financial crisis has affected potential output growth.** Staff has reduced its estimate of potential growth to 4 percent (from 5 percent previously), as private investment is not expected to continue growing at 2007–08 rates, given current projections for partner country demand, commodity prices, and diminished capital flows to EMEs. Medium-term growth remains underpinned by the large public infrastructure investment program to relieve bottlenecks in electricity, rail, and ports that could constrain growth as the economy recovers in 2010 and beyond.

Key Macroeconomic Variables

	2009	2010	2011	2012	2013	2014
GDP growth, percent	-2.1	1.9	3.8	4.3	4.5	4.5
Inflation (CPI, eop), percent	7.2	6.0	4.7	4.7	4.4	4.6
Current account balance, percent of GDP	-6.0	-6.4	-6.9	-7.0	-7.2	-7.4
Potential GDP growth rate, percent	4.0	3.9	4.0	4.0	4.1	4.1
Output gap, percent of potential output	-2.9	-4.8	-4.9	-4.7	-4.3	-3.9

Source: IMF staff projections.

10. **The risks to the outlook are mainly on the downside:**

- ***The downturn in South Africa's major trading partners*** may prove deeper and more protracted than currently anticipated, resulting in a concomitant decline in exports.

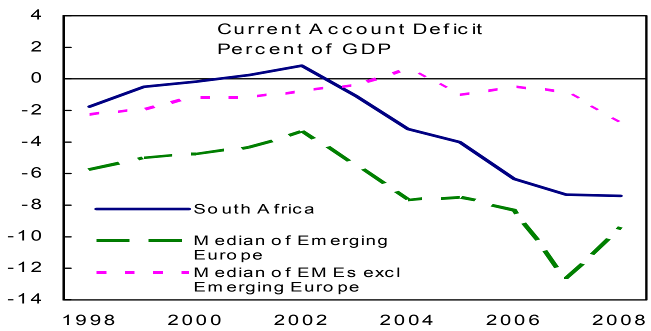
- ***Another bout of global financial market turbulence*** could trigger capital outflows and a sharp, potentially destabilizing exchange rate depreciation.

- ***Deteriorating loan quality*** could prompt banks to further raise lending standards and squeeze credit, worsening the recession.

- ***On the upside, the impact of decisive macroeconomic policy actions*** may provide a larger and quicker-than-expected demand impulse and resumption of growth, particularly if global growth also turns out to be stronger than expected.

Box 1. Current Account Vulnerabilities

South Africa's current account deficit is high relative to that of other EMEs and is financed by relatively volatile capital inflows.[1] Foreign direct investment has typically been smaller than in other emerging markets, averaging just over 1 percent of GDP in the past ten years compared to around 3 percent of GDP for the median of EMEs. Instead, South Africa has been more reliant on portfolio flows, which are volatile in comparison to other EMEs.



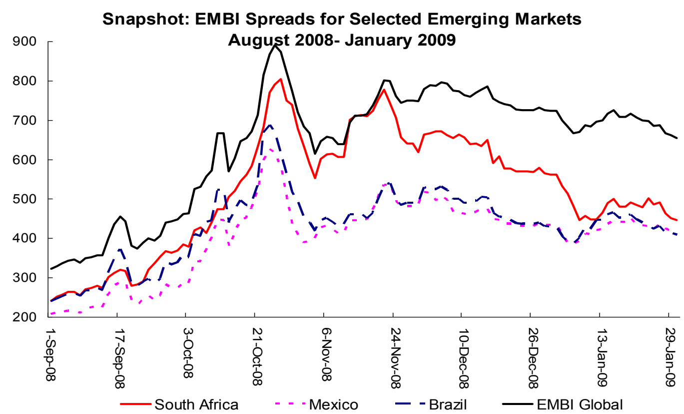
Source: IMF Vulnerabilities Exercise Emerging Economies Database.

Volatility of Capital Account Inflows 1995-2008
As a Percent of GDP
Standard Deviation

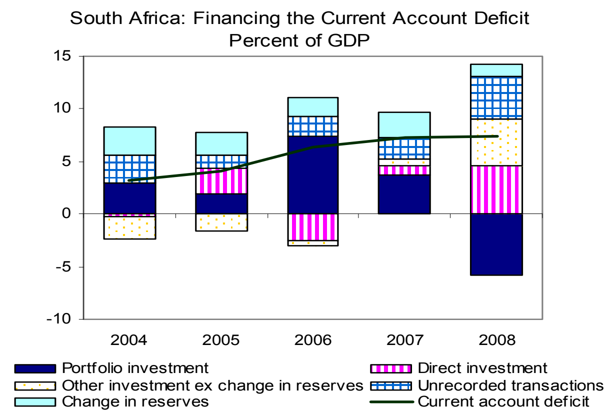
	Total Inflows	Portfolio Inflows	o/w debt securities	o/w equity securities
Thailand	6.71	1.60	0.85	1.18
Hungary	3.86	3.51	3.09	1.46
Chile	3.57	1.03	1.02	0.77
South Africa	***3.43***	***3.92***	***1.73***	***2.72***
Poland	3.11	1.58	1.50	0.44
Turkey	3.07	1.28	1.08	0.36
Brazil	2.01	1.10	0.94	0.52
Colombia	2.89	0.25	…	0.25
Mexico	1.09	1.49	1.36	0.38

Source: IMF World Economic Outlook, April 2009.

The global market turmoil of late 2008 also had a significant, if temporary, impact on South African financial market variables. Spreads widened by 440 basis points in October 2008, more than in some other EMEs with smaller current account deficits. Portfolio outflows accelerated while the rand depreciated by around 30 percent against the U.S. dollar, and the stock market fell by 26 percent. Although spreads have fallen back substantially since then and the exchange rate has appreciated strongly in recent months—more than reversing the earlier depreciation (Figure 3)—the episode is a reminder of the pressures that South Africa can face, as a bellwether for emerging markets, and because of the vulnerabilities arising from its current account deficit.



Source: Bloomberg



Source: South Africa Reserve Bank Quarterly Bulletin, June 2009

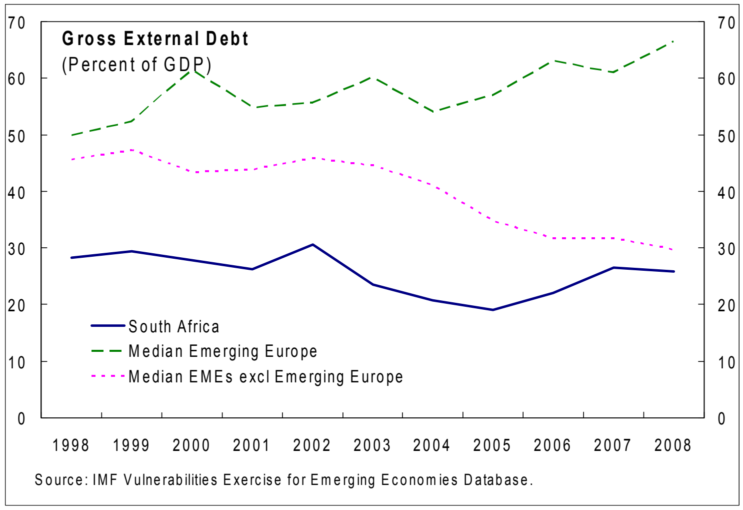
The weak domestic economy is expected to narrow the current account deficit in 2009 and concerns about financing have receded with the recovery of capital inflows since February, but South Africa remains vulnerable to a sudden stop. The current account deficit is expected to remain sizable over the medium term as the recovery in investment would need to be financed externally given the country's low saving rate.[2] With rising inflows, factor income payments will also tend to rise contributing to a wider deficit.

[1] See *Selected Issues* paper, "South Africa and Other Emerging Markets: Response to the Global Financial Crisis."

[2] The factors underlying the low saving rate are discussed in the 2008 Article IV Consultation Report for South Africa (SM/08/267, 8/18/08).

- ***In the medium term, the still large current account deficit***—in part stemming from the large public investment program—makes the recovery vulnerable to investor sentiment (Box 1), even if in the long run the large investment projects could strengthen the economy's export-generating capabilities.

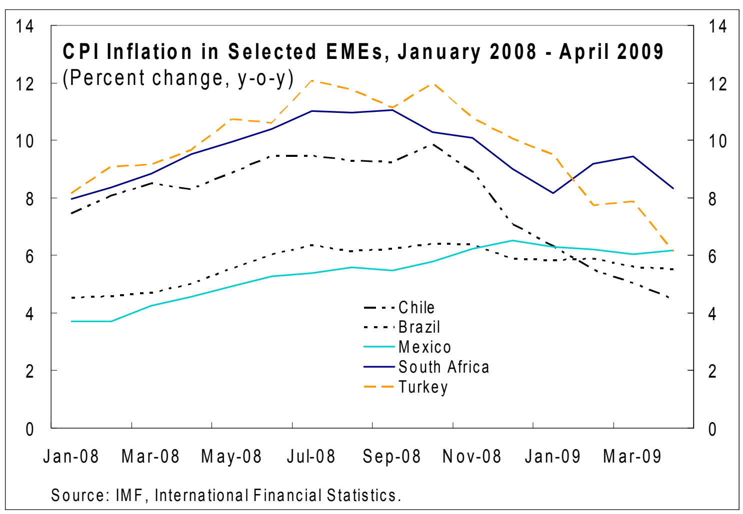
11. **There are, nevertheless, important mitigating factors.** External debt is low (26 percent of GDP at end-2008), over 40 percent of which is denominated in rand. Banks, corporations, and households have limited foreign currency balance sheet exposure. Capital inflows are predominantly in the form of equity, and hence denominated in rand, while the exchange rate floats. Should capital outflows reemerge, foreign investors would share the adjustment burden—as they did in late 2008 when the stock market declined and the rand depreciated sharply.



III. Policy Discussions

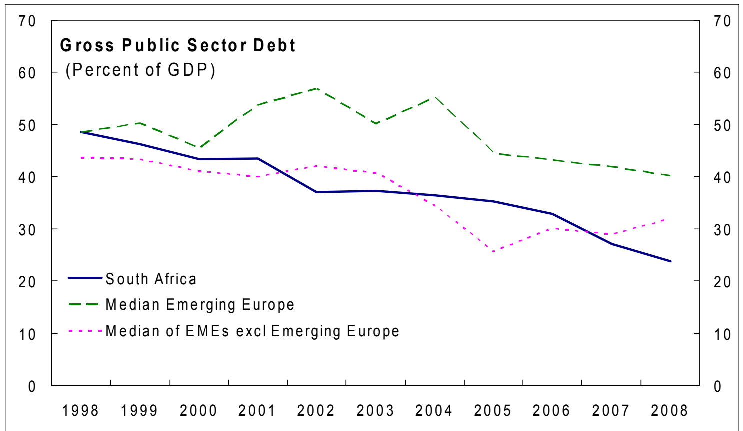
A. Supporting Demand While Maintaining Stability

12. **Macroeconomic policies face the difficult task of supporting domestic demand while maintaining macroeconomic stability.** The widening output gap and declining employment levels warrant countercyclical fiscal and monetary policies. But this policy response needs to be calibrated to preserve external and price stability, given the still unsettled global environment and stubborn domestic inflation. With the external current account deficit expected to remain high over the next several years, maintaining medium-term sustainability will be important to retain foreign investors' confidence in South Africa's growth prospects.



Supportive fiscal policy consistent with medium-term sustainability

13. **Fiscal policy has been strongly countercyclical, but spending growth is expected to moderate over the medium term.** The authorities implemented a large and front-loaded easing (4.5 percent of GDP) in FY 2008/09 delivered through both the government budget and the public enterprise investment program (table below and Figure 4). The increase in the government deficit was partly due to a higher-than-anticipated wage bill reflecting a significant general salary increase.



Source: IMF Vulnerabilities Exercise for Emerging Economies Database.

The FY2009/10 budget provides for a further sizable discretionary fiscal impulse based on a continued increase in infrastructure investment and an expansion of the social safety net (Tables 2 and 3). The cyclically-adjusted public sector borrowing requirement (PSBR) is expected to narrow over the next few years as the growth of public investment and consumption spending slows. The authorities observed that prudent fiscal policies during the previous economic expansion had resulted in a sharp decline in debt and debt service, which created the fiscal space to invest in public infrastructure. They stressed that their investment plans, which had been formulated before the current downturn, would relieve critical bottlenecks in electricity and transportation, and have large long-run fiscal multipliers. With the economic downturn, their budget plans would also support demand in the short run. They indicated that if the downturn were to turn out steeper than anticipated in the budget—as now seems likely—they would continue to allow the operation of the stabilizers while keeping spending broadly on current plans.[2]

Headline and Cyclically Adjusted Fiscal Balances and Public Debt, 2006/7 - 2011/12

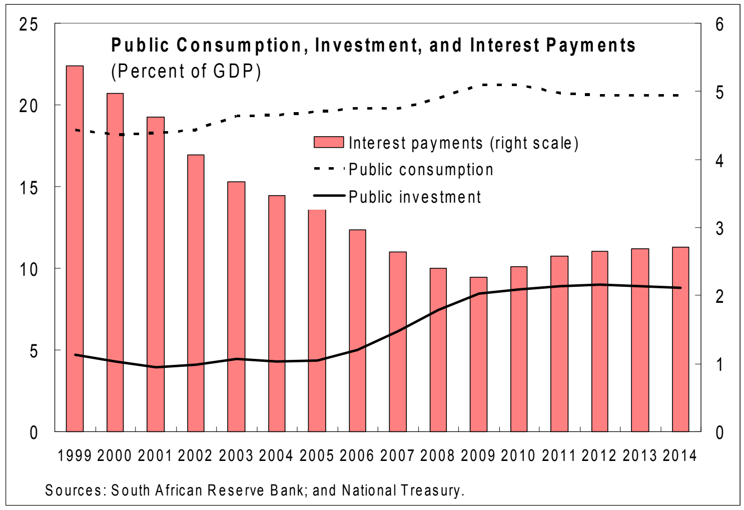
(In percent of GDP)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Headline balances 1/						
National (central) government	0.6	1.0	-1.0	-5.5	-4.6	-3.6
General government	0.9	1.1	-1.6	-5.8	-4.7	-3.6
Public sector borrowing requirement	-0.3	-0.6	4.0	9.6	8.0	6.6
Cyclically adjusted balances 2/						
National (central) government	0.2	0.2	-1.5	-3.9	-2.8	-2.1
General government	0.5	0.3	-2.1	-4.2	-2.8	-2.1
Public sector borrowing requirement	0.1	0.2	4.5	8.0	6.1	5.1
Public debt	38.1	35.4	35.3	42.8	46.5	48.7

Sources: National Treasury and IMF staff estimates.

1/ Staff projections based on the authorities' policy intentions as outlined in *Budget Review 2009*.
2/ Cyclical adjustments use tax-specific elasticities to tax-specific base gaps (see IMF Country Report 06/328).

[2] The budget was based on GDP growth of 1.2 percent in 2009.



14. **Staff agreed that the fiscal easing envisaged for FY2009/10 and medium-term plans were appropriate given the sharp recession and weak economic outlook**. The plans, which envisage a moderation in the growth of government consumption spending beyond FY2010/11, appear to strike the right balance between supporting output in the short term, while retaining the confidence of domestic and external sources of finance needed to fund the still-high headline PSBR.[3] Staff's model simulations (Box 2) indicate that these fiscal policies would play an important role in supporting output and employment in 2009 and 2010. Staff's debt sustainability analysis confirms that the envisaged nominal spending path is consistent with medium-term fiscal sustainability, with public debt (general government and public enterprises) expected to stabilize at about 51 percent of GDP by 2014.[4] In addition, sensitivity of public debt to standard shocks appears low (Appendix I). If the economy turns out weaker than staff's current projections, staff would support the continued full operation of the automatic stabilizers in FY2009/10 and FY2010/11, within a sustainable medium-term fiscal path that would require spending growth to be moderated further as the economy recovers. The burden could be borne mainly by the wage bill—which has grown rapidly in the last two years—and spending on goods and services, while protecting investment and well-targeted social safety net programs. Current spending could also be prioritized more stringently by improving service delivery in key areas through reform, rather than higher spending.

15. **Staff noted, however, that there are significant risks that the structural fiscal deficit could be higher over the medium term than currently anticipated:**

- The public debt service burden is likely to be higher than budget projections, as the assumed yields in the budget appear to be too low. Interest rates on medium- and long-term government bonds have trended up since the beginning of this year despite

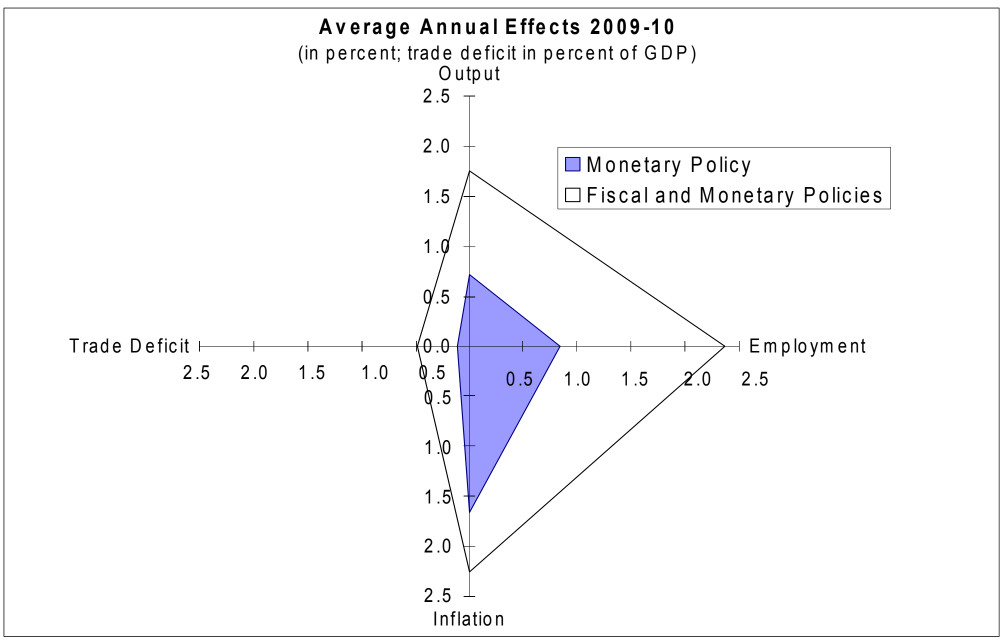
[3] Approximately 70 percent of the PSBR is expected to be financed domestically.

[4] Mendoza and Ostry (2007) find that the ability of emerging market countries to maintain fiscal solvency appears to wane when public debt reaches 50–60 percent of GDP. Given the lack of consistent cross-country data, the study uses different definitions of debt for different countries. If the South African authorities' preferred aggregate—net government and government-guaranteed debt—is used, the medium–term debt would stabilize at about 43 percent of GDP, given current expenditures plans (in nominal terms) and no further net issuance of guarantees.

the sharp decline in short-term rates, signaling rising borrowing costs and a potentially higher-than-projected debt service burden (Figure 5).

Box 2. Quantitative Effects of Macroeconomic Policies

Staff's model simulations find that the authorities' fiscal and monetary policies strike broadly the right balance between supporting demand and maintaining macroeconomic stability. The IMF's Global Integrated Monetary and Fiscal model is used for simulating the dynamics of the economy under a package of already adopted or announced fiscal and monetary policies aimed at countering the negative external demand and commodity price shocks brought on by the global crisis.[1] We find that these policies would raise output and employment by about 2 percentage points, at the expense of higher inflation (by about 2 percentage points), higher trade deficit (by about 0.5 percentage point of GDP), and a mild crowding out of private investment, relative to a counterfactual of no discretionary policies. These results cannot be extrapolated, however, for a larger fiscal expansion than is currently planned, as it would lead to rising real interest rates that would diminish and eventually eliminate output and employment gains.



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[1] See *Selected Issues* paper, "Between Scylla and Charybdis: Demand Management Policies to Support Growth and Maintain Stability in South Africa."

- Slow improvement in public service delivery and rising public pressure could make it difficult to moderate the planned spending growth over the medium term. Also, the limited competition in many of South Africa's product markets and rigidities in its labor market could magnify the employment cost of the current recession, creating pressure for more public employment and government consumption spending.[5]

- Failure to implement accompanying sectoral structural reforms (see paragraph 29) could limit the potential growth impact, and hence the fiscal revenue payoff, from higher public infrastructure investment. Given publicly-owned infrastructure monopolies, it may also force the government to share the cost of the additional infrastructure investment needed to maintain medium-term growth prospects.

16. **Staff also cautioned that higher-than-anticipated medium-term fiscal deficits would exacerbate external current account vulnerabilities.** If the current account deficit continues to widen over the medium term as public investment rises, structural government saving would need to be gradually raised again to reassure investors that the public sector is not adding to the large external imbalance.[6] As noted above, moderating the government wage bill and improving the efficiency of public service provision should yield significant savings.

Box 3. Summary of Previous Consultation Discussions

There has been broad agreement on policies, as the Fund has generally supported the authorities' stance on fiscal policy, inflation targeting, exchange rate policy, and international reserve accumulation. At the 2008 Article IV consultation, Directors suggested that external current account vulnerabilities be addressed by raising government saving over the medium term to balance the structural PSBR. The FY2009/10 budget envisages somewhat higher spending, but the economic outlook has weakened significantly more than anticipated. In past consultations, Directors have also encouraged structural reforms to raise medium-term growth and employment, but progress has lagged. The 2008 Financial Sector Assessment Program (FSAP) Update found South Africa's financial system to be broadly sound and well regulated, but facing some risks. The authorities' follow up on these recommendations is outlined below.

17. **The authorities acknowledged that there are risks to budget plans, but emphasized that they intend to run a disciplined and pragmatic fiscal policy.** They agreed that spending growth will need to be moderated over the medium term. This could be done in part by improving public service delivery and the efficiency of government spending

[5] A recent Organization for Economic Co-Operation and Development (OECD) report links weak product market competition with low labor utilization in South Africa. OECD. *Economic Assessment of South Africa,* July 2008.

[6] This issue was discussed in the 2008 Article IV Consultation Report for South Africa (SM/08/267, 8/18/ 08).

(see paragraph 29). In addition, they noted that much of the infrastructure investment program could be prolonged if deficits became too large or financing risks materialized. Moreover, as noted in the FY2009/2010 budget, they have a debt limit for net government and government guaranteed debt of 50 percent of GDP, which would provide an anchor for fiscal policy, and they intend to take action on spending well before that limit is reached. Staff supported these intentions, while suggesting that the authorities also monitor and publish consolidated gross public sector debt data.

Monetary policy focused on low inflation

18. **Weakening economic activity and falling global commodity prices have lowered inflation, but the pace of disinflation remains slow**. Inflation, which has remained outside the 3–6 percent target band since April 2007, peaked in August 2008 and slowed to 8 percent in May 2009. Consumer price index (CPI) inflation excluding food, petrol, and energy has continued to trend upward.[7] The slower-than-expected disinflation reflects a confluence of factors, including the large exchange rate depreciation in Q4:2008, the strong increase oil prices in the first six months of this year, and backward-looking wage indexation that has resulted in substantial wage demands (annual wages grew by over 10 percent on average in Q1:2009).

19. **The SARB eased monetary policy decisively starting in late 2008, but rising inflation risks led it to leave the policy rate unchanged in June 2009.** As economic activity weakened and the inflation outlook improved, the monetary policy committee (MPC) reduced interest rates by 450 basis points between December 2008 and May 2009. In a move that surprised markets (which had expected a 50 basis point cut), the MPC left the policy rate unchanged at its June meeting, citing upside risks to inflation and the already significant monetary accommodation since end-2008. The Committee noted that the downside risks to inflation from the wider output gap and weaker domestic demand were offset by the deterioration in inflation expectations and rising inflation risks from increases in electricity and other administered prices, and nominal wage increases in excess of inflation.[8] Staff noted that its model simulations also suggested that the policy rate may have bottomed if inflation is to be brought within the 3–6 percent target band by end-2010 as the SARB intends, unless the output slowdown and exchange rate appreciation exert stronger-than-expected downward pressure on inflation.

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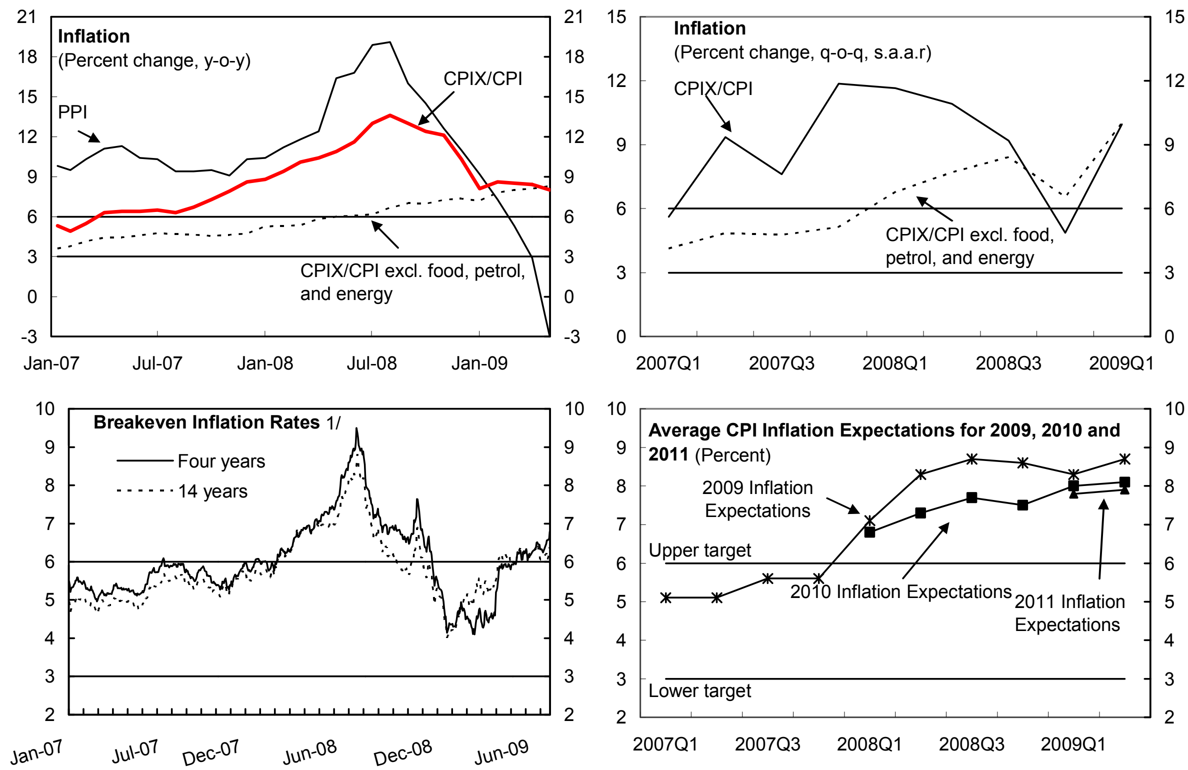
[7] Since January 2009, a reweighted and rebased CPI replaced the CPIX (the consumer price index excluding the interest component of mortgage payments) as the main measure of inflation, targeted by the SARB.

[8] In June 2009, the energy price regulator approved an electricity tariff increase of 31.3 percent.

South Africa: Inflation Developments



Source: Statistics South Africa; Bureau for Economic Research; and Datastream.

1/ Represent the spread between the yields of conventional and CPI-indexed bonds maturing over the indicated horizon.

20. **Given South Africa's large current account deficit and reliance on equity inflows, the effects of monetary policy on capital flows are of interest.** Staff's analytical work suggests that expected policy rate changes have little effect on South Africa's capital flows while unexpected rate cuts are associated with rand depreciation and a small *inflow* of equity, likely due to foreign investors rebalancing their portfolios.[9] Staff estimates suggest, on the other hand, that policy rate cuts have a significant positive effect on real economic activity beginning with a two quarter lag.[10] Taken together, the finding suggest that monetary policy actions in South Africa can have a strong countercyclical impact and entail little risk of destabilizing capital movements, at least over the business cycle.

21. **South Africa's inflation targeting framework has been criticized by some groups in recent months.** Labor unions, for instance, have argued that the SARB's mandate should include growth and employment and that interest rate increases have had harsh effects on

[9] See *Selected Issues* paper, "The Impact of Monetary Policy Shocks on Capital Flows in South Africa."

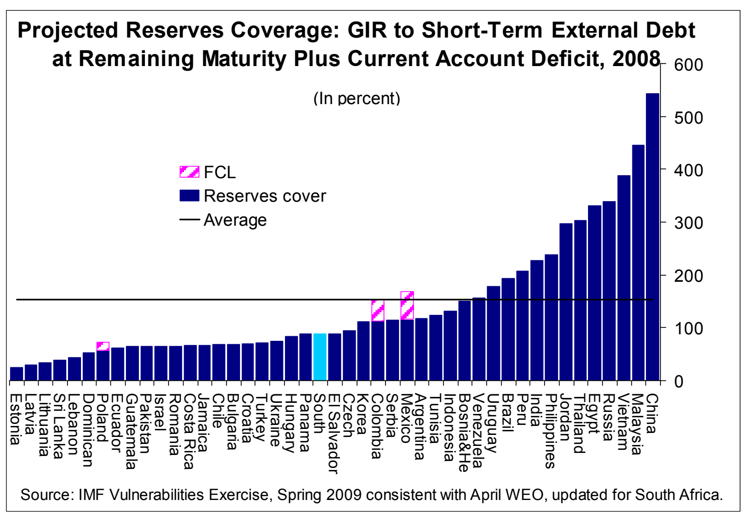
[10] See *Selected Issues* paper, "The Impact of Interest Rates on Real Activity in South Africa."

workers. The authorities indicated that while public debate on the issue was constructive, they did not have plans for any significant changes to the inflation targeting framework. The Minister of Finance and the Governor of the SARB have publicly defended inflation targeting as fully appropriate for South Africa. Financial market analysts also strongly supported inflation targeting and believed that substantive changes to the framework were unlikely. Staff agreed that inflation targeting had served South Africa well and observed that the primacy of inflation in the SARB's mandate is critical for the transparency of monetary policy decisions and the SARB's effectiveness in anchoring inflation expectations.

External policies to mitigate current account vulnerabilities

22. **The authorities reiterated their commitment to a floating exchange regime.** The SARB did not intervene to support the rand during the global market turbulence, in line with previous statements that it would allow the rand to depreciate in the event of capital outflows. Neither did it intervene in the other direction when the rand strengthened sharply in the first six months of 2009. Staff agreed that the flexibility of the rand is an important buffer against external shocks. In particular, it has discouraged the South African private sector from borrowing in foreign currency, despite significant capital inflows, and facilitated foreign investors sharing in the adjustment burden in the event of rand depreciation.

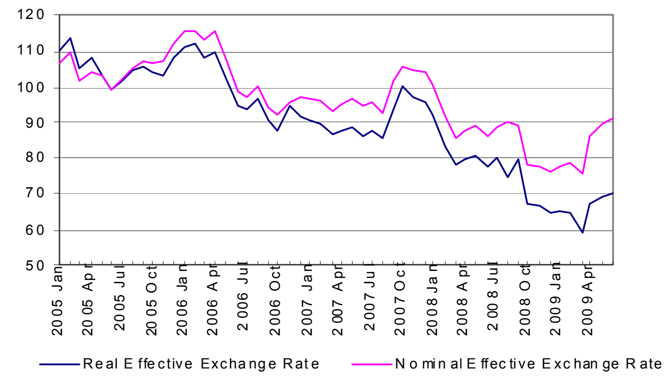
23. **Staff's assessment of the level of the exchange rate suggests that the rand is moderately overvalued, although there is a considerable range of uncertainty around this estimate.** On the basis of projections as of early July and taking into account South Africa's specific circumstances, the IMF's methodology indicates that the rand is overvalued by some 6–16 percent following its recent appreciation (Box 4). The authorities noted this assessment and agreed with staff that efforts to actively manage the exchange rate would be ineffective and costly, given the large scale and volatility of capital flows (Table 4).



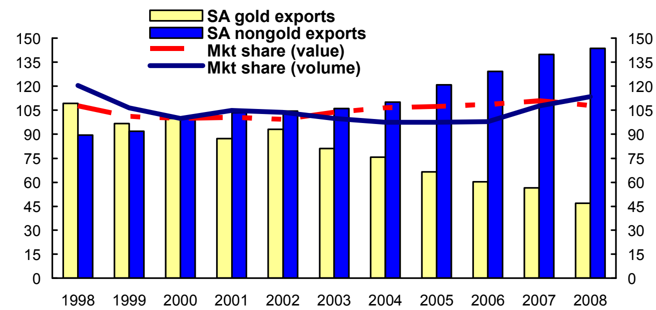
Box 4. The Real Exchange Rate and Competitiveness

The exchange rate assessments based on the IMF's methodology adapted for South Africa's specific circumstances suggest that the rand is moderately overvalued as of early July 2009.[1] The macroeconomic balance approach, which compares South Africa's medium-term current account stripped of temporary factors, to a norm derived from cross-country analysis of other EMEs indicates an overvaluation of about 12 percent as of early July.[2] The external sustainability approach, which compares a projection of South Africa's net foreign assets to an average of other EMEs suggests that the rand is about 16 percent above its equilibrium rate.[3] The equilibrium real effective exchange rate (REER) approach—a single equation method relating the REER to its fundamental determinants—pointed to an overvaluation of 6–8 percent.

South Africa: Nominal and Real Effective Exchange Rates (2000=100)



South Africa: Market Shares in World Exports and Export Volumes 1998-2008 (2000=100)



Sources: IMF, Direction of Trade and World Economic Outlook.

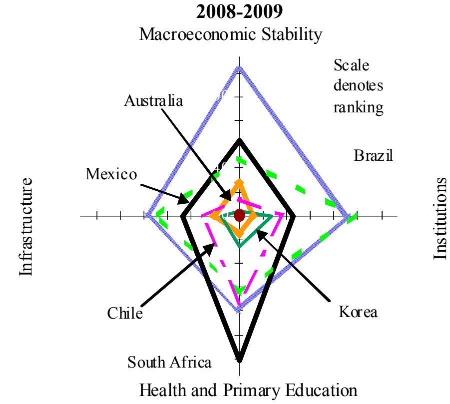
Although South Africa's exports, excluding gold, have grown steadily, market share has remained broadly stable. Specific factors have affected gold exports, including the increasing costs of deep mining as ore is depleted. Survey-based evidence suggests there is scope to improve competitiveness in other exports. South Africa ranked 45th in the World Economic Forum (WEF) Global Competitiveness Report in 2008 and improved its ranking to 48th in the 2009 IMD World Competitiveness rankings. South Africa tends to rank relatively highly on macroeconomic policies and government institutions but scores weakly on health and education and labor market indicators. The ranking for infrastructure is weighed down by the problems in the electricity sector.

World Competitiveness Ranking 1/

	WEF		IMD	
	2007	2008	2008	2009
Australia	19	18	7	7
Brazil	72	64	43	40
Chile	26	28	26	25
China	34	30	17	20
India	48	50	29	30
Korea	11	13	31	27
Mexico	52	60	50	46
South Africa	44	45	53	48
Memorandum items				
Number of countries ranked	131	134	55	57
South Africa's rank infrastructure ranking	49	48	55	54
South Africa's labor market ranking	78	88	45	54

1/ From the World Economic Forum (WEF), the International Institute for Management Development (IMD). The years mentioned refer to the timing of the surveys.

WEF Elements of Competitiveness, Basic Requirements 2008-2009



Source: World Economic Forum Global Competitiveness Report (2008-2009)

1/ The adaptation of the three approaches used by the methodology is described in *IMF Country Report* SM/07/267.

2/ The estimated current account norm based on comparisons with other EMEs is -3.4 percent of GDP. The projected current account deficit for South Africa, excluding the temporary surge in public investment, is 4.9 percent of GDP in 2014. If public investment is included, the estimated overvaluation rises to about 21 percent.

3/Including the surge in public investment, the estimated overvaluation would rise to about 25 percent.

24. **The authorities indicated that they continue to follow their policy of gradually building up international reserves.** As in the past, they noted they did not have a specific timetable or target level of reserves, and would purchase from the market as conditions permit, without seeking to influence the exchange rate. The SARB has not made significant market purchases to accumulate reserves that while reserves have increased over the past several years, they remain below the sum of short-term debt and the current account deficit, a traditional indicator.

South Africa: Indicators of Reserve Adequacy at end-2008

(In percent, unless otherwise indicated)

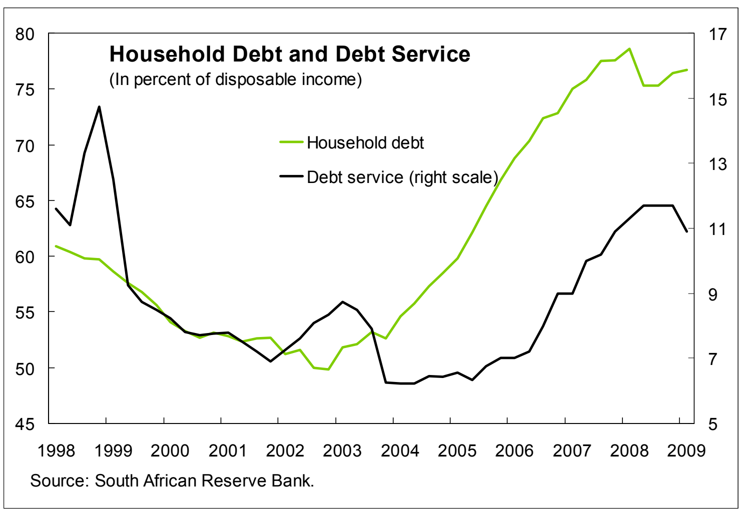
	South Africa	Other emerging markets 1/ All countries	Other emerging markets 1/ Floating Exchange Rate :
Ratio of international reserves to:			
Short-term debt 2/	134.1	155.4	143.0
Short-term debt plus current a	81.3	94.4	111.1
GDP	11.9	17.1	13.9
Imports of goods and service	4.2	5.8	5.9
Broad money	14.3	31.8	30.5

Source: South African authorities and IMF staff estimates.

1/ Median values for a group of 52 emerging market countries.
2/ Short-term debt at remaining maturity.
3/ Countries with floating or freely floating exchange rate regimes as defined by the IMF Annual Report on Exchange Arrangements and Exchange Restrictions (2009, forthcoming).

B. Financial Sector: Remaining Vigilant

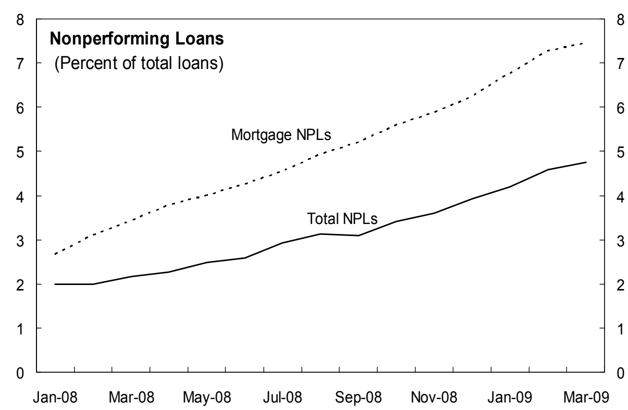
25. **Money markets remained orderly and financial institutions stable when the global financial crisis intensified last year.** Interbank interest rate volatility remained within normal bounds in late 2008 and early 2009, reflecting generally adequate market liquidity. South African banks' low leverage, high profitability, and limited exposure to foreign assets and funding allowed them to remain liquid and well-capitalized, obviating any need for extraordinary liquidity or state support, in contrast with the experience of some other countries. Banks' foreign currency funding represents less than 7 percent of their liabilities and their exposure to foreign assets is low in part due to attractive domestic returns and capital controls.



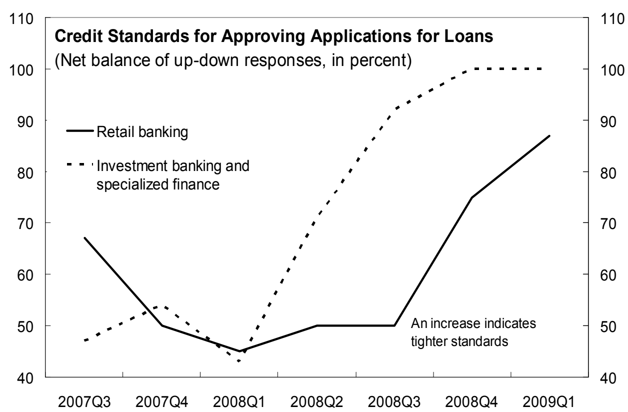
26. **The authorities indicated that the financial system remains stable, although banks are now feeling the effects of declining economic activity and rising unemployment on asset quality and returns.** Household debt remains near historic highs and borrowers have been hit by the unfolding recession and rising interest rates during 2006-2008. Impaired loans as a ratio to total loans have risen to a multi-year high and banks' profits have declined somewhat (Box 5). Nevertheless, staff's analysis of macro financial linkages suggests that the market's overall assessment of solvency risks to South African banks, as well as feedback effects from the real sector, remain small, likely reflecting their strong capital position and generally high profitability (Table 7).

Box 5. Banking Sector Risks

The sharply rising level of impaired loans is a key conjunctural risk faced by the South African banking system. Since 2006, total and mortgage nonperforming loans (NPLs) have accelerated from low levels spurred by rising interest rates (from 2006–2008) and, subsequently, a weakening economy and rising unemployment (in 2009). Total NPLs rose to 5.1 percent in April 2009, more than doubling since January 2008. The rising unemployment rate, deterioration in household's disposable income, and other relevant indicators tracked by the SARB suggest that NPLs could continue to rise over the next few months.



Source: South African Reserve Bank.



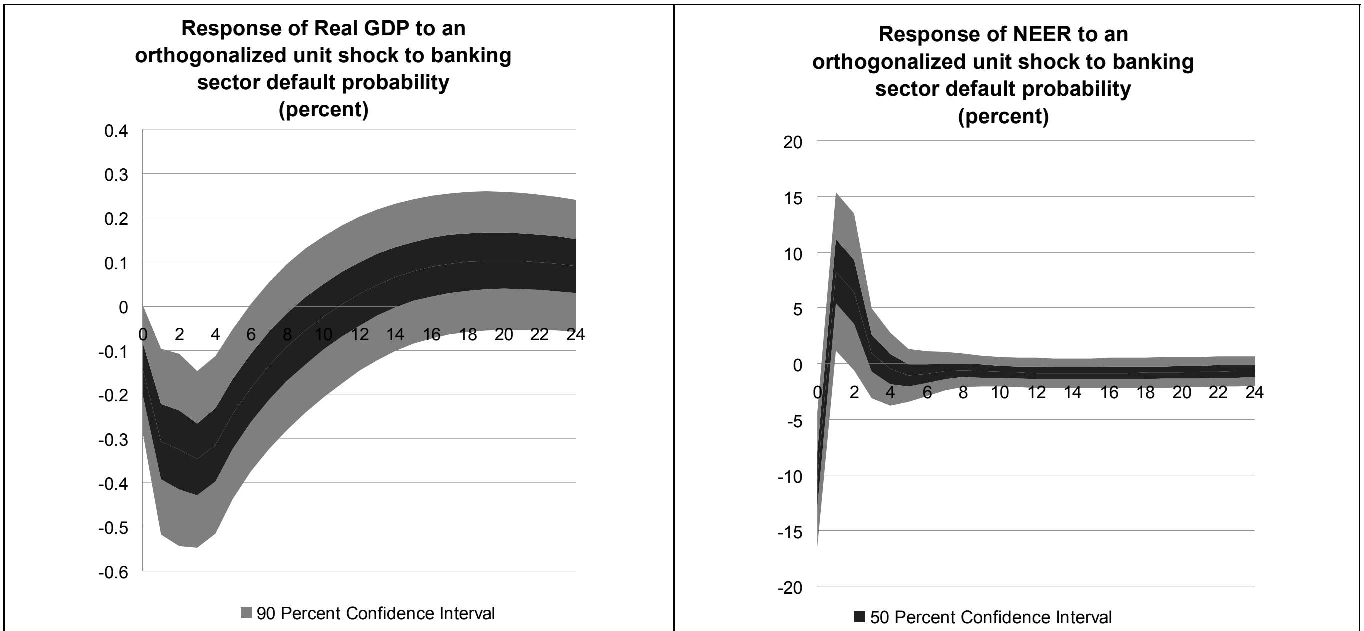
Source: Ernst &Young Financial Services Index, 2009Q1.

Credit risks to the banking system are mitigated by supportive macroeconomic policies coupled with features of the South African financial system. Significant monetary policy easing has lowered lending rates while more stringent bank loan origination standards and a decline in the demand for credit have moderated credit growth (Figure 5). In addition, South African banks hold most of the mortgages they originate, which encourages them to engage in workouts with distressed homeowners. Also, under South African law, banks can claim the pension and other assets of defaulting borrowers, lowering incentives to default, including on foreclosed properties with negative equity.

The South African banking system also faces long-standing structural risks, including the reliance of its funding base on short-term wholesale corporate deposits. Retail deposits represent only about 25 percent of total deposits, while deposits with less than one year maturity represent close to 80 percent of total deposits. The FSAP Update recommended implementing a deposit insurance system to counter such risks. Such a system could also have the added benefit of inducing household saving to migrate from unguaranteed liquid financial instruments to competing bank deposits, thus strengthening the retail base of banks.

The dominance of the financial system by a few large financial conglomerates with cross-border share holdings and cross-sector activities poses another structural risk. These conglomerates combine banking, securities trading, and insurance in a single organization. As the recent global crisis has illustrated, even when banks are well managed—as in the South African case—there is a risk that the sectoral supervisory arrangements could miss potentially systemic linkages. Therefore, in line with FSAP Update recommendations, it would be important to seek to identify potential information and regulatory gaps relating to conglomerate activity.

Staff estimates suggest that, on balance, markets have a positive outlook for South African banks' credit risk. A staff paper estimates probabilities of default for the four largest banks and macro-financial linkages for the 2000-2009 period, based on equity price data. [1] The paper finds that although South African banks' probabilities of default increased recently, they are significantly lower than those of several large international banks based in mature economies. Furthermore, feedback from the real economy to solvency risk in the banking sector is limited, but shocks from the banking sector have significant effects on the exchange rate and GDP growth.



Note: x-axis is over months.

Following a shock representing a 0.25 percent increase in the joint default probability of the largest four banks, real GDP declines by 0.35 percent on the third month after the shock—or 6.5 percent at a seasonally adjusted annualized rate—and the exchange rate depreciates by 10 percent on the same month of the shock.

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[1] See *Selected Issues* paper, "An Analysis of the Macrofinancial Risks in the South African Banking System."

27. **The authorities indicated—and the banks confirmed—that they have stepped up bank supervision since late 2008, in response to rising financial sector risks**. They have intensified on site supervision, including assessing the stress testing, risk models and risk management practices of banks, while also conducting, twice a year, off-site stress testing using supervisory data, in line with the recommendations of the 2008 FSAP Update. They indicated that the end-2008 exercise showed that, even under a severely unfavorable macroeconomic scenario, none of the systemically-important banks would see their capital

ratios fall below the regulatory minimum. Overall, the authorities were of the view that banks were provisioning adequately against rising impaired loans and that banks' capital—which comprised mostly Tier 1 capital—remained at comfortable levels to meet the increasing risks.

28. **Despite its resilience, South Africa's financial system has a number of long-standing structural risks that were also reviewed during the 2008 FSAP Update: the dominance of financial conglomerates, the reliance of banks on short-term wholesale deposits, and the governance framework for pension funds.** In this regard:

- The authorities noted that in line with FSAP Update recommendations, and as a complement to the existing high-level SARB- FSB committee,[11] they have established a working-level joint SARB-FSB committee to help guide the work of supervisory colleges covering individual ***financial conglomerates***. Staff suggested regular reporting of the work of these committees to senior policy makers in order to assess whether further action, including possible changes to legislation, would be needed to minimize regulatory gaps and strengthen consolidated supervision. It also suggested formal analysis of systemic linkages based on a matrix of exposures within and across financial conglomerates.[12]

- It would be useful for the SARB and the FSB jointly to explore ways to reduce the risks associated with ***banks' reliance on short-term wholesale deposits***. Staff also suggested analyzing the extent to which deposit insurance could provide incentives for increasing the scale of retail bank deposits.

- Staff urged the speedy completion of the work of the interministerial task force on ***pension system*** reform, so that the FSAP Update recommendations on strengthening governance and risk management in this sector could be implemented without delay. The authorities noted that pension reform was likely to be lengthy process and that they were looking into measures that could be taken in the meantime to strengthen the governance and supervision of this sector.

C. Structural Policies to Consolidate Gains and Accelerate Growth

29. **The recession and resulting pressures on macroeconomic policies and the policy framework underscore the urgency of pressing ahead with structural reform and improving public services in order to achieve stronger and more inclusive growth.**

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[11] The SARB supervises commercial banks, while the Financial Services Board (FSB) supervises insurance and pensions funds and oversees capital markets.

[12] Staff presented methodologies developed for the April 2009 GFSR and offered to provide the network analysis model to the authorities in order to analyze possible spillover effects of financial conglomerate risks.

Rising job losses and unemployment and falling real disposable incomes, amidst significant income disparities, has renewed pressures for higher government consumption spending and sector-specific support. In this context:

- ***The authorities underscored the commitment of the new government to improving public service delivery—a centerpiece of its election platform.*** They recognized that in education, for instance, South Africa already spends comparatively generously, but student achievement has lagged behind international standards and labor skill levels remain a binding constraint on growth. They noted that the cabinet had been restructured to strengthen the planning and oversight capabilities of the Presidency, lending greater coherence to cross-cutting policy design and implementation. The government was also reviewing ways to improve the quality of public services, including improving capacity at the provincial and local government levels, where key decisions were made.

- ***On trade policy, the authorities noted that they would be reassessing scope to take action, consistent with WTO rules, in specific sectors that have been prioritized in the context of the government's industrial policy*** (e.g., possibly by increasing tariffs up to bound levels). To the extent that some of this reassessment may be driven by protectionist pressures, staff urged the authorities to ensure that the benefits brought to South Africa by international trade—including increased competition in domestic markets—are preserved and pursued further.[13] Moreover, protectionist actions could result in retaliation by other countries, potentially amplifying the costs of the global recession. As in past years, staff suggested proactively increasing the transparency and efficiency of the trade regime by simplifying the tariff structure, without increasing overall protection, for instance by limiting tariffs to four or five bands.

- ***Calls have increased for providing exceptional support to companies and industries in difficulty,*** including through public financial institutions such as the Industrial Development Corporation and the Development Bank of South Africa. Staff cautioned against special support that would create fiscal or quasi-fiscal costs and undermine the balance sheets of these institutions as well as the efficiency of domestic markets. Any support should clearly identify the specific market distortion that would justify government intervention, be explicitly temporary, and include strict conditions for burden sharing with beneficiaries.

- ***Staff noted that productivity growth from increased public investment spending would depend, among other things, on sector-specific regulatory reform and***

[13] Barriers to entry in key sectors have been identified as an important constraint to growth by the previous government's medium-term growth strategy, Accelerated and Shared Growth Initiative for South Africa (ASGISA), and last year's OECD report. OECD, *Economic Assessment of South Africa*, July 2008.

strategies, including with regard to the role of the private sector. Creating the conditions for private sector participation in infrastructure investment and service provision could help relieve fiscal pressures and improve efficiency, particularly in electricity generation, port services, and rail transport. To make best use of public-private partnerships, the government would need to ensure that projects are rigorously evaluated and risks are properly shared between the public and private sectors.

30. **The authorities underscored their commitment to regional integration, but noted recent challenges.** In particular, they voiced concern over the potential inconsistencies between Botswana's, Lesotho's and Swaziland's recent signing of interim economic partnership agreements (EPAs) with the EU and the rules of the Southern Africa Customs Union (SACU), which also includes Namibia. They noted that the interim EPAs contain different rules of origin and tariffs structures and are difficult to harmonize with South Africa's trade regime. The authorities intend to continue negotiating with the other SACU members and the EU to resolve these inconsistencies. They noted that the gradual expansion of SACU was a central pillar of regional integration within the broader South African Development Community.

IV. Staff Appraisal

31. **Until recently, South Africa enjoyed a robust economic expansion that created strong income and employment growth.** While a favorable external environment buoyed the economy, sound macroeconomic policies, underpinned by a consistent and transparent policy framework, contributed importantly to the expansion—an impressive achievement considering the challenges faced following the end of apartheid only 15 years ago. Prudent fiscal policy created fiscal space for a steady increase in public spending to address social needs. The inflation targeting framework—with low inflation as the primary objective—made monetary policy more focused, predictable, and credible. And effective banking supervision allowed a modern banking sector to flourish while keeping risks in check.

32. **The economic outlook has changed sharply as a result of the global financial crisis in late 2008, even though the direct effects of the shock on the domestic financial system were modest.** The economy, now in a recession, is expected to begin recovering later this year, but the pace of growth next year is projected to be below potential. Inflation risks, however, have increased. Over the medium term, the current account deficit is projected to widen again to levels that keep the economy vulnerable to changes in investor sentiment. There are downside risks to the outlook: a deeper or more protracted global downturn than currently anticipated, another bout of global financial market turbulence, or deteriorating domestic credit quality could lower growth. But on the upside, there could be a stronger-than-anticipated economic response to supportive macroeconomic policies. The impact of any shocks, however, would be mitigated by the low external debt, the limited foreign currency exposure on balance sheets, and the floating exchange rate regime.

33. **Fiscal policy is appropriately countercyclical and will support output and employment in 2009 and 2010.** The three-year spending envelope in the FY2009/10 budget, which envisages a moderation of future spending growth, strikes the right balance between supporting output and preserving medium-term sustainability. Given the well-known weaknesses in South Africa's infrastructure, the size and composition of the package is also likely to relieve binding constraints on the country's potential growth rate. The significant discretionary easing planned for this year is appropriate. If the economy turns out weaker than currently projected, the automatic stabilizers should continue to be allowed to operate, but spending growth would need to be moderated further when the economy recovers in order to stabilize public debt at a prudent level over the medium term. Investment and well-targeted social safety net programs would need to be protected at the expense of wages and other current spending.

34. **Nevertheless, it may be difficult to rein in medium-term spending growth as envisaged in budget plans.** The debt service burden may turn out higher than projected, particularly if bond yields are higher, or revenue weaker than expected. Slow improvement in public service delivery, and structural rigidities in product and labor markets that inhibit employment creation, could increase pressure for more government consumption spending. In addition, the growth and revenue payoff from infrastructure projects may be limited by delays in sectoral reforms.

35. **The SARB's decisive easing of monetary policy since December 2008 has been appropriate, and a pause is justified as inflation risks have intensified.** Based on the current assessment of inflation risks, the scope for monetary easing may have reached its limit if inflation is to be brought below 6 percent by end-2010, as the SARB intends—unless downward inflation pressures prove to be stronger than expected because of a sharper recession or stronger rand appreciation than currently projected.

36. **South Africa's floating exchange regime is an important mitigant of external shocks and risks.** The floating currency inhibits the accumulation of foreign currency liabilities by South African residents and, in the event of large outflows, helps ensure that foreign investors share some of the adjustment burden. On the basis of current projections, the exchange rate appears moderately overvalued after its appreciation in recent months, although this estimate is subject to considerable uncertainty. Efforts to actively manage the exchange rate are likely to be ineffective and costly, given the large scale and volatility of capital inflows.

37. **The gradual build up of net international reserves from low levels in the late 1990s has strengthened private sector confidence.** Given that reserves are still below traditional benchmarks of reserve adequacy, there is room for further accumulation. The SARB's policy of gradually building reserves through market purchases without seeking to influence the exchange rate thus remains appropriate.

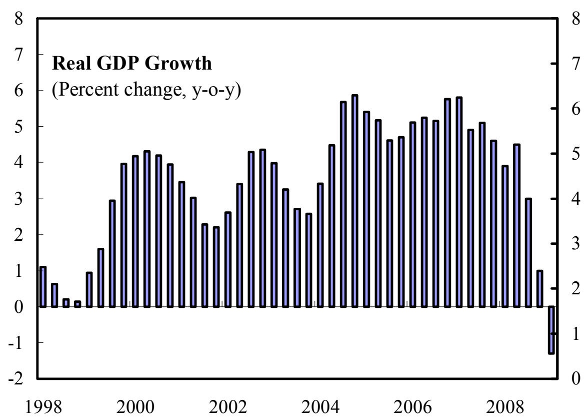
38. **The financial sector has weathered the immediate impact of the global crisis well, but risks have been rising as the economy weakens.** The authorities' assessment that the banking sector remains well-capitalized and adequately provisioned is reassuring. They would need to continue engaging with banks to ensure that provisions and capital buffers remain adequate to meet increasing risks. However, even when banks are well managed there is a risk that the sectoral supervisory arrangements could miss potentially systemic linkages within large financial conglomerates, including across borders. The authorities' welcome efforts to further strengthen consolidated supervision—as recommended in the 2008 FSAP Update—could be enhanced through formal analysis of systemic linkages and regular reporting to senior policy makers, so that any further necessary actions to minimize supervisory gaps could be taken. It would also be useful to explore ways to reduce banks' reliance on short-term wholesale funding, including to analyze the potential effects of introducing deposit insurance on improving the stability of banks' funding bases. Measures to strengthen the governance and supervision of the pension sector should also be expedited.

39. **A strong push on structural reform is critical to accelerate growth and employment creation**. The government's emphasis on improving the quality and efficiency of public services is welcome and would need to be pursued decisively. In this context, it would be useful to evaluate the quality and effectiveness of government spending. Pressures to provide trade protection should be resisted and the transparency and efficiency of the trade regime enhanced by simplifying the tariff structure. It would be important to clearly identify the specific market distortions that would justify any sector-specific support—with any support made explicitly temporary and subject to conditions to protect taxpayers. To enhance the productivity of public infrastructure investment, sectoral reforms could be implemented, including to encourage private participation in the provision of electricity, rail and port services, with appropriate risk sharing between public and private sectors.

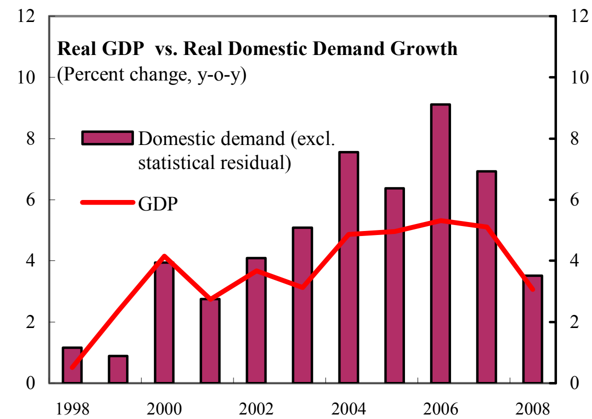
40. **It is expected that the next Article IV consultation will be held on the standard 12-month cycle.**

Figure 1. South Africa: Real Sector Developments

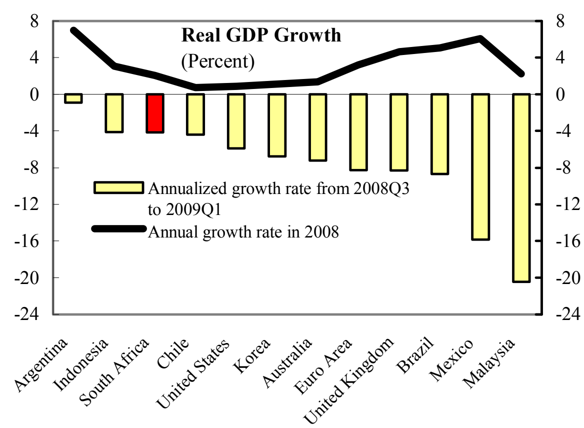
South Africa has seen output decline...



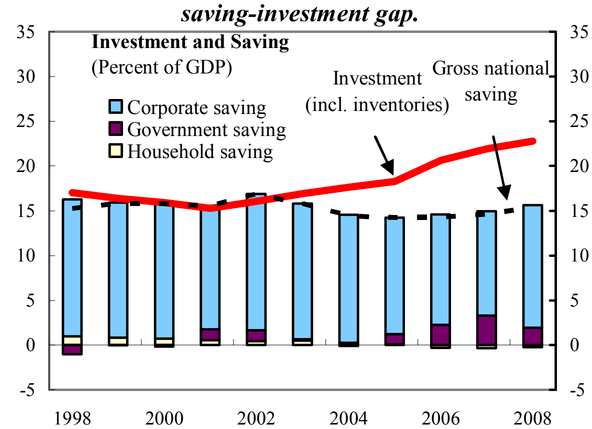
...and domestic demand moderate...



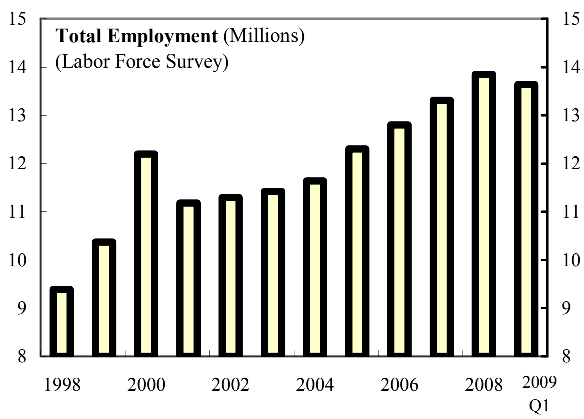
... but not as much as in other emerging markets.



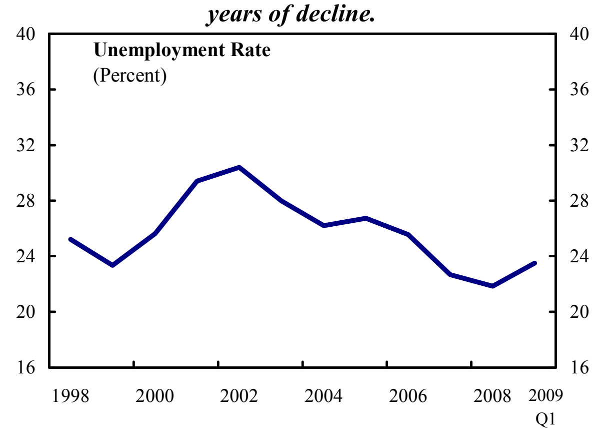
Strong domestic demand opened a persistent saving-investment gap.



Employment has been growing until lately...



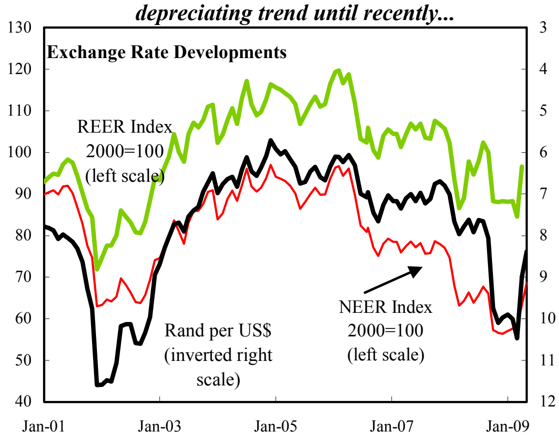
...and unemployment rose in early 2009 after years of decline.



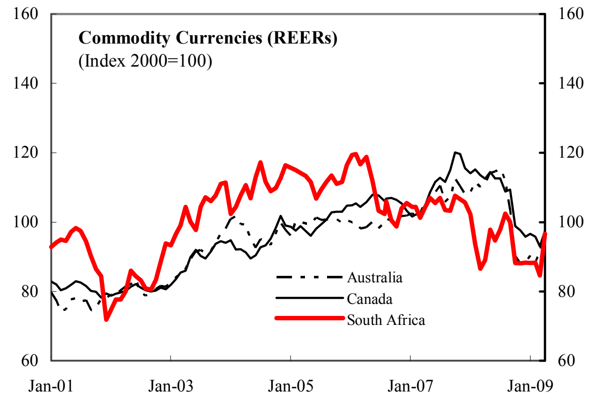
Sources: South African Reserve Bank; and IMF.

Figure 2. South Africa: Exchange Rates, Asset Prices and Spreads

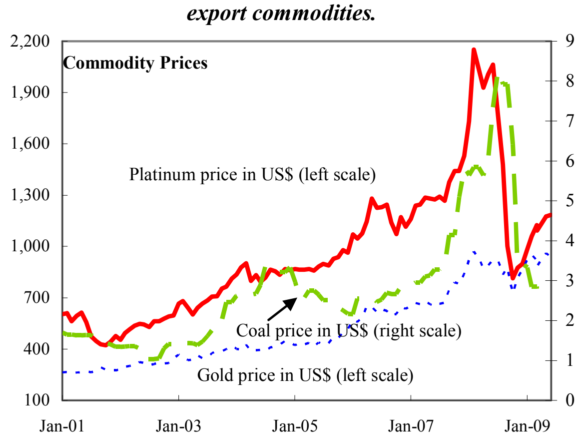
The exchange rate has been volatile around a depreciating trend until recently...



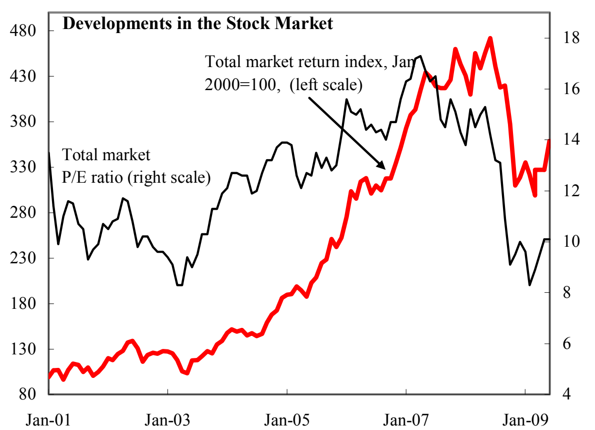
...and the REER has depreciated relative to currencies of other commodity exporters...



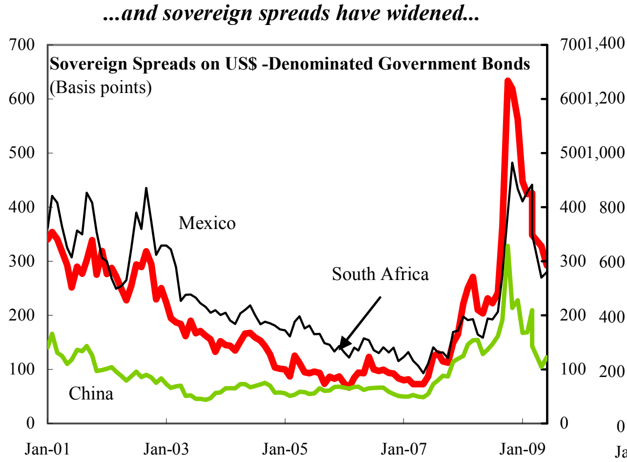
…even before the sharp drop in the price of major export commodities.



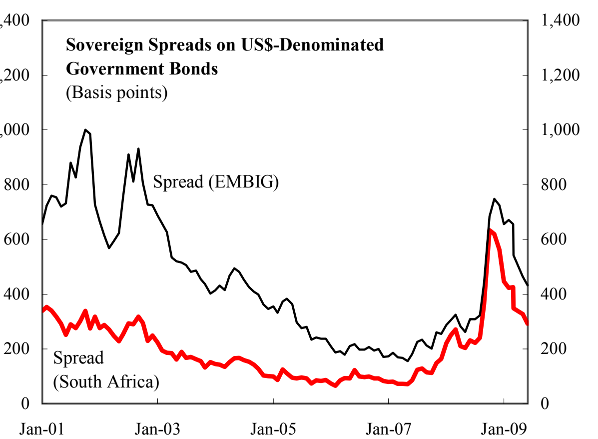
Equities prices have declined in late 2008...



...and sovereign spreads have widened...



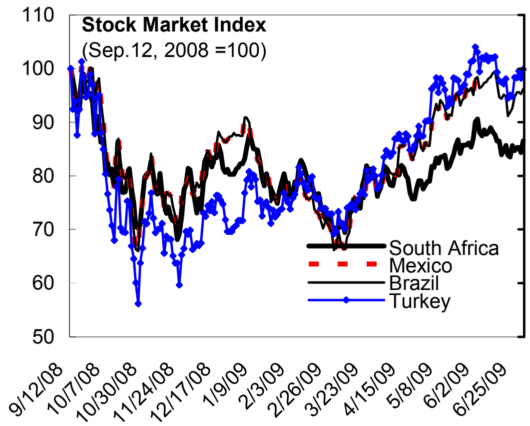
…but less than for other emerging markets.



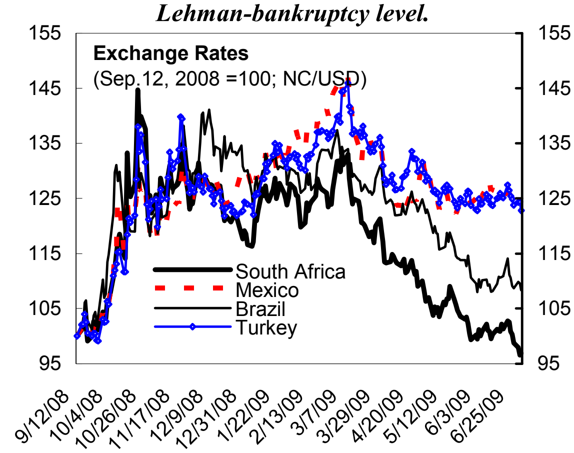
Sources: South African Reserve Bank; Datastream; Amalgamated Bank of South Africa; and IMF.

Figure 3. South Africa and Selected Emerging Market Economies: Recent Developments in Financial Markets

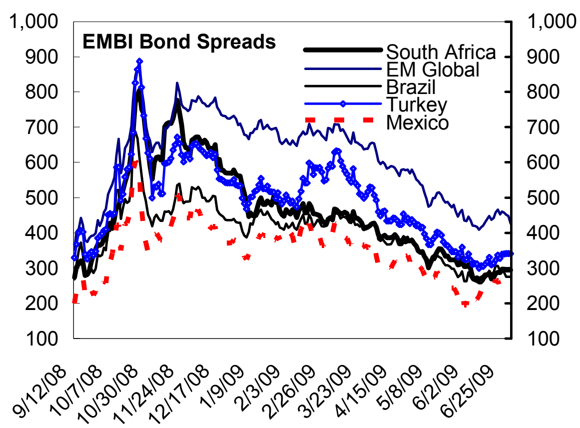
The stock market is gradually rebounding...

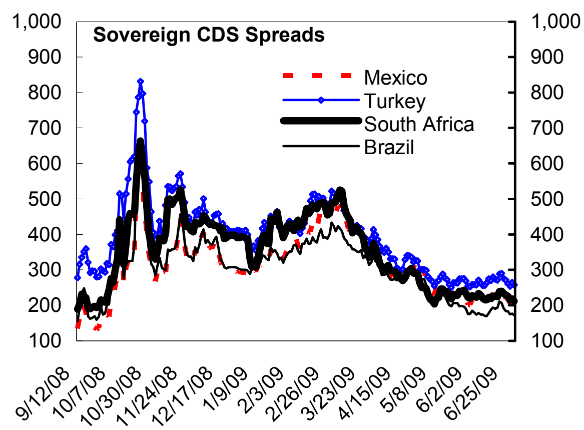


..and the exchange rate has reached its pre-Lehman-bankruptcy level.

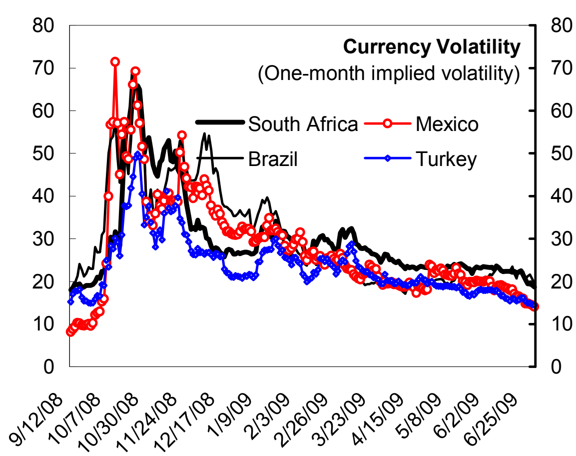


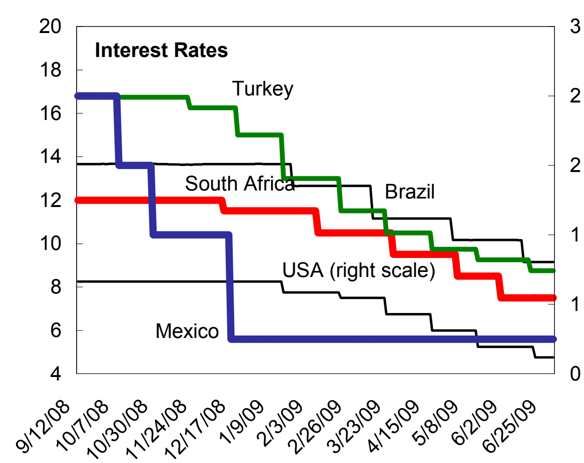
As in other large emerging markets, international measures of sovereign credit risk have fallen...





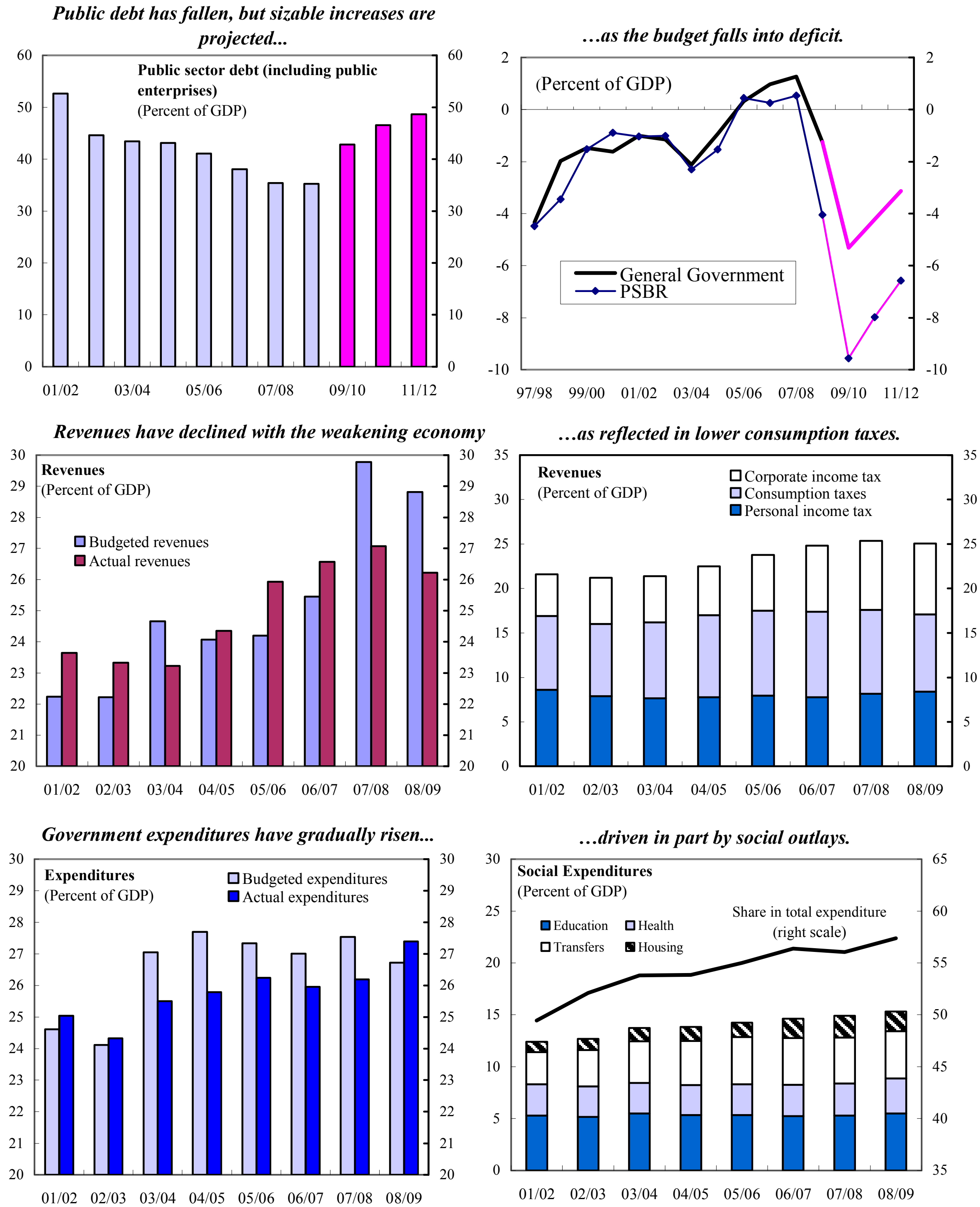
and currency volatility and interest rates have also declined.





Source: Bloomberg.

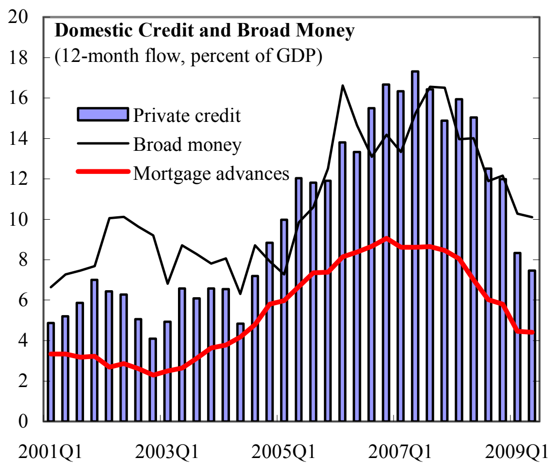
Figure 4. South Africa: Fiscal Developments

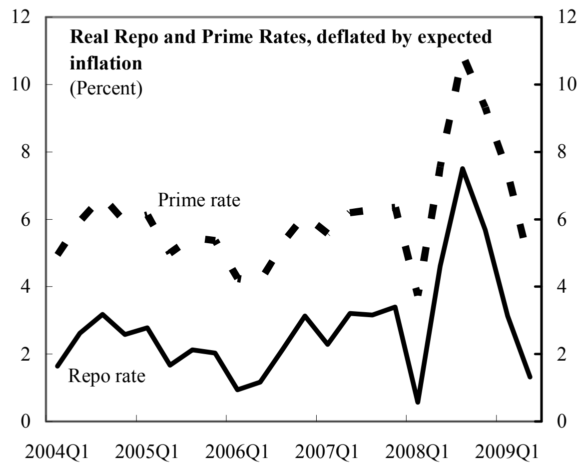


Sources: National Treasury of South Africa; and IMF.

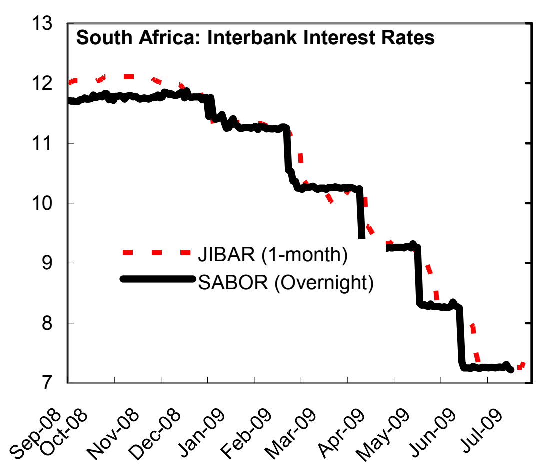
Figure 5. South Africa: Money, Prices, and Interest Rates

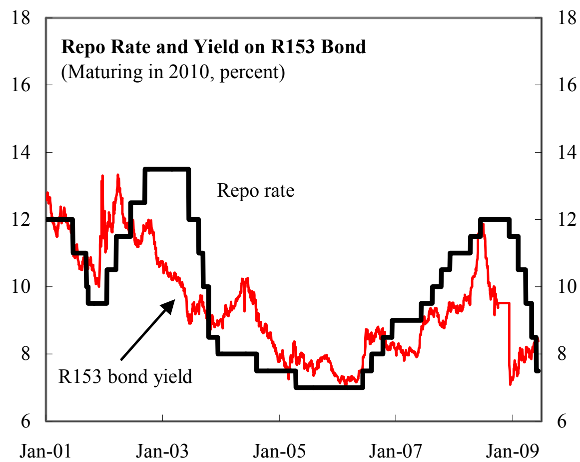
Money and credit flows have moderated ... ...as ex-ante real interest rates rose in late 2008.



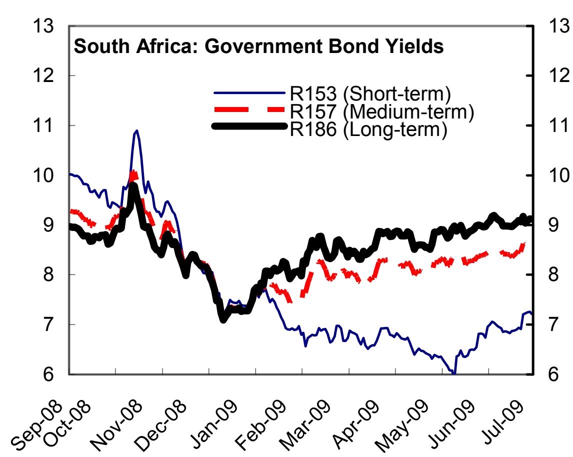


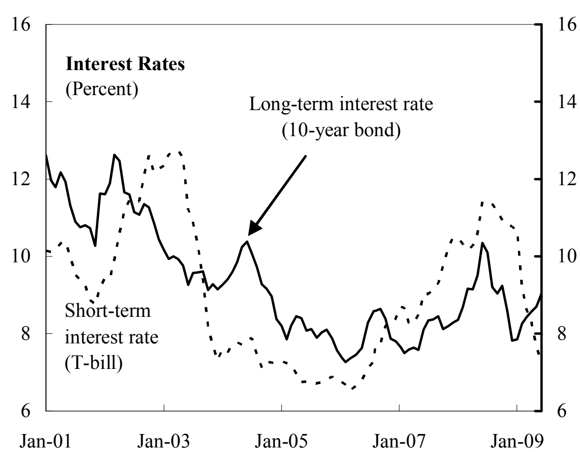
Short-term money market rates and bond yields have caught up with the repo rate...





but medium- and long-term bond yields have diverged from short-term rates.





Sources: South African Reserve Bank; Bureau for Economic Research; Datastream; and IMF.

Table 1. South Africa: Selected Economic and Financial Indicators, 2007–14

Nominal GDP (2008): US$277.2 billion
Population (2008): 48.7 million
GDP per capita (2008): US$5,693

			Projected					
	2007	2008	2009	2010	2011	2012	2013	2014
	(Annual percent change, unless otherwise indicated)							
National income and prices								
Real GDP	5.1	3.1	-2.1	1.9	3.8	4.3	4.5	4.5
Real GDP per capita	4.1	1.3	-3.2	0.8	2.7	3.2	3.4	3.3
Real domestic demand	6.0	3.1	-2.1	2.4	3.7	4.3	4.5	4.4
GDP deflator	9.0	10.8	7.5	8.6	7.1	6.0	5.9	5.8
CPI (annual average)	7.1	11.5	7.4	6.9	5.1	4.5	4.5	4.5
CPIX (end of period) 1/	8.6	10.3	…	…	…	…	…	…
Labor market								
Unemployment rate (percent)	22.7	21.9	24.9	24.3	23.4	22.1	20.7	19.3
Average remuneration (formal nonagricultural sector)	6.7	12.7	9.9	9.5	7.8	7.6	7.6	7.1
Labor productivity (formal nonagricultural sector)	2.4	1.1	0.6	0.9	2.3	2.3	2.5	2.5
Nominal unit labor costs (formal nonagricultural sector)	4.2	11.5	9.2	8.6	5.3	5.2	5.0	4.5
External sector								
Merchandise exports, f.o.b. 2/	17.4	12.8	-16.9	5.4	6.7	6.9	6.8	6.8
Merchandise imports, f.o.b. 2/	15.5	10.1	-15.9	7.8	6.3	6.5	6.6	6.5
Export (goods and services) volume	7.5	1.7	-10.3	2.7	5.0	5.5	5.7	5.8
Import (goods and services) volume	10.0	2.2	-8.5	4.3	4.4	5.0	5.3	5.2
Terms of trade	3.4	1.1	0.7	0.3	-1.0	-0.1	-0.1	-0.3
Nominal effective exchange rate (period average) 3/	-9.7	-18.5	12.6	…	…	…	…	
Real effective exchange rate (period average) 3/	-3.3	-11.6	2.4	…	…	…	…	
Money and credit								
Net domestic assets 4/	21.3	9.6	9.1	10.6	11.6	11.6	11.6	11.6
Broad money (including foreign exchange deposits)	23.6	14.8	7.9	12.6	12.5	12.3	12.3	12.2
Velocity (GDP/average broad money)	1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.1
Bank rate/repurchase rate (end of period, percent) 5/	11.0	11.5	7.5	…	…	…	…	
	(In percent of GDP, unless otherwise indicated)							
Investment and saving								
Investment (including inventories)	21.9	22.8	22.3	22.8	23.3	23.4	23.6	23.6
Of which:								
Public fixed investment (including public enterprises)	6.2	7.5	8.4	8.7	8.9	9.0	8.9	8.8
Private fixed investment	15.0	15.8	15.4	15.4	15.4	15.5	15.6	15.7
Gross national saving	14.6	15.4	16.4	16.4	16.3	16.4	16.4	16.3
Public (including public enterprises)	4.8	3.5	-0.7	-0.7	0.5	0.9	1.1	1.4
Private	9.8	11.9	17.1	17.1	15.8	15.5	15.2	14.8
National government budget 6/								
Revenue, including grants	26.9	26.4	25.0	24.6	24.6	24.8	25.0	25.3
Expenditure and net lending	26.1	27.1	29.4	29.5	28.6	28.4	28.4	28.4
Overall balance	0.8	-0.7	-4.4	-4.8	-3.9	-3.6	-3.4	-3.1
National government debt	28.5	27.3	30.2	32.4	33.0	33.5	33.7	33.6
Borrowing requirement of the nonfinancial public sector	-0.5	2.9	8.1	8.3	7.0	6.2	5.2	4.6
- cyclically adjusted	0.2	3.5	7.1	6.6	5.3	…	…	…
External sector								
Current account balance	-7.3	-7.4	-6.0	-6.4	-6.9	-7.0	-7.2	-7.4
Overall balance of payments	2.4	1.1	0.6	0.0	0.0	0.0	0.0	0.0
Total external debt	26.6	25.9	27.3	30.6	32.5	34.1	35.8	37.6
Gross reserves (SARB, billions of U.S. dollars)	33.0	34.1	35.8	35.8	35.8	35.8	35.8	35.8
(months of next year's total imports)	3.7	4.6	4.5	4.2	3.9	3.7	3.5	3.3

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

1/ Since January 2009, a reweighted 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/ In U.S. dollars; annual percent change.
3/ End-of-period. For 2009, April relative to December 2008.
4/ Contribution (in percentage points) to the growth of broad money.
5/ In 2009, as of July 9.
6/ Calendar-year figures, based on National Treasury data and IMF staff projections.

Table 2. South Africa: National Government Main Budget, 2006/07–2011/12 1/

(In percent of GDP)

			Prelim.	Proj. 2/		
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Total revenue and grants	26.6	27.1	26.2	24.4	24.6	24.7
Tax revenue	26.0	26.5	25.7	23.9	24.1	24.3
Income tax	15.5	16.1	16.5	14.7	14.6	14.9
Of which:						
Personal income tax	7.8	8.2	8.4	8.1	8.3	8.5
Corporate taxes (CIT+STC)	7.4	7.8	8.0	6.5	6.2	6.3
Indirect taxes	9.6	9.4	8.7	8.6	8.8	8.7
Of which:						
Value-added tax	7.4	7.3	6.7	6.2	6.5	6.4
Excises	2.1	2.0	1.9	2.1	2.1	2.0
Trade and other (less SACU payments)	0.9	1.0	0.5	0.6	0.7	0.7
Other tax revenue	0.9	0.9	0.7	0.7	0.7	0.7
Of which: trade taxes	1.3	1.3	1.0	0.9	0.9	0.9
Of which: SACU payments 3/	1.4	1.2	1.2	1.1	1.0	1.0
Nontax revenue	0.6	0.6	0.5	0.5	0.5	0.5
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	26.0	26.2	27.4	30.1	29.2	28.3
Interest	2.9	2.6	2.3	2.3	2.5	2.6
Transfer to subnational governments	11.5	11.9	12.6	13.6	13.2	12.9
Of which:						
Provinces	10.0	10.1	10.7	11.6	11.3	11.0
Municipalities	1.5	1.8	1.9	2.0	1.8	1.9
Other	11.6	11.7	12.5	14.2	13.6	12.8
Budgetary balance	0.6	0.9	-1.2	-5.7	-4.7	-3.6
Extraordinary payments, net 4/	0.0	-0.1	-0.2	-0.2	0.0	0.0
Augmented balance	0.6	1.0	-1.0	-5.5	-4.6	-3.6
Financing	-0.6	-1.0	1.0	5.5	4.6	3.6
Domestic borrowing (net)	0.3	0.2	1.5	5.4	4.1	3.2
Foreign borrowing (net)	0.0	-0.2	-0.2	0.2	0.3	0.3
Change in cash and other items	-0.9	-0.9	-0.3	-0.2	0.3	0.1
Memorandum items:						
GDP (billions of rand)	1,811	2,068	2,320	2,456	2,736	3,041
Real GDP growth, percent	5.5	4.6	1.9	-1.8	2.9	4.1
GDP deflator, percent change	8.1	9.1	10.1	7.9	8.3	6.7
Primary balance, in percent of GDP	3.5	3.4	1.2	-3.4	-2.2	-1.0
Cyclically-adjusted overall balance, in percent of GDP 5/	0.2	0.2	-1.5	-3.9	-2.8	-2.1
National government debt, in percent of GDP	30.6	27.9	27.1	31.3	32.7	33.2
Domestic	26.0	23.3	23.0	27.1	28.4	28.8
Foreign	4.6	4.7	4.1	4.2	4.3	4.4

Sources: South African authorities; and IMF 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 2009 Budget Review, and staff estimates.
3/ SACU payments are based on a revenue-sharing formula.
4/ Mainly related to debt management transactions.
5/ Before extraordinary payments.

Table 3. South Africa: Nonfinancial Public Sector Operations, 2006/07–2011/12 1/

(In percent of GDP)

			Prelim.	Projected 2/		
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Consolidated national and provincial governments						
Total revenue and grants	28.2	28.7	27.7	26.2	26.3	26.3
National government	26.6	27.1	26.2	24.6	24.6	24.7
Provinces (own revenue)	0.4	0.5	0.4	0.4	0.4	0.4
Social security funds (own revenue)	1.1	1.2	1.1	1.3	1.3	1.2
Extrabudgetary and other	0.1	0.0	0.0	0.0	0.0	0.0
Total expenditure	27.3	27.5	29.0	31.4	30.4	29.5
Current	26.0	26.2	27.6	29.8	28.6	27.3
Wages and salaries	8.5	8.6	9.1	9.4	9.2	8.8
Other goods and services	3.8	3.8	4.2	4.3	4.3	4.3
Interest	2.9	2.6	2.3	2.3	2.5	2.6
Transfers 3/	10.8	11.3	12.0	13.8	12.6	11.6
Capital expenditure	1.3	1.3	1.4	1.4	1.4	1.5
Contingency	0.0	0.0	0.0	0.2	0.4	0.4
Primary balance	3.9	3.8	1.1	-2.9	-1.7	-0.6
Overall balance	1.0	1.3	-1.2	-5.1	-4.1	-3.2
Public sector borrowing requirement (PSBR)	-0.3	-0.6	4.0	9.4	7.9	6.7
National government 4/	-0.6	-1.0	1.0	5.3	4.6	3.7
Other government borrowing	-0.3	-0.1	0.6	0.4	0.0	0.0
Provincial governments	0.0	-0.1	0.4	0.1	-0.1	-0.1
Local goverments and local enterprises	0.4	0.7	0.7	0.8	0.7	0.6
Extrabudgetary funds and institutions	-0.7	-0.8	-0.6	-0.5	-0.5	-0.5
Nonfinancial public enterprises	0.6	0.5	2.5	3.7	3.3	3.0
Memorandum items:						
Nonfinancial public sector debt (gross)	38.1	35.4	35.3	42.8	46.5	48.7
SOE investment	2.1	2.8	3.7	4.4	4.7	4.7
Social spending 5/	14.6	14.7	15.7	16.1	16.1	15.7
Defense spending	1.4	1.3	1.2	1.4	1.3	1.2

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

1/ For fiscal year beginning April 1.
2/ Staff projections based on the authorities' policy intentions as outlined in the 2009 Budget Review.
3/ For 2008/9–2010/11, includes a large loan to the electricity provider Eskom (R 60 billion in total).
4/ Includes extraordinary payments less extraordinary receipts.
5/ Health, education, welfare, and community development.

Table 4. South Africa: Balance of Payments, 2007–14

	2007	2008	2009	2010	2011	2012	2013	2014
			Projected					
			(In billions of U.S. dollars)					
Balance on current account	-20.7	-20.5	-16.5	-18.4	-20.8	-22.4	-24.2	-26.3
Balance on goods and services	-8.8	-8.6	-8.2	-10.0	-11.1	-11.4	-11.9	-12.4
Exports of goods and services	89.2	97.9	81.3	86.5	91.5	97.9	104.6	111.7
Exports of goods	75.7	85.4	70.9	74.8	79.8	85.3	91.2	97.4
Nongold	70.0	79.5	65.3	69.2	74.7	80.5	86.6	93.2
Gold	5.7	5.9	5.6	5.5	5.1	4.8	4.5	4.1
Exports of services	13.5	12.5	10.4	11.8	11.7	12.5	13.4	14.3
Imports of goods and services	-97.9	-106.5	-89.5	-96.5	-102.6	-109.3	-116.5	-124.0
Imports of goods	-81.4	-89.7	-75.4	-81.3	-86.4	-92.0	-98.1	-104.5
Imports of services	-16.5	-16.8	-14.1	-15.2	-16.2	-17.2	-18.4	-19.6
Balance on income	-9.0	-8.9	-5.8	-5.9	-7.3	-8.5	-10.0	-11.6
Income receipts	6.9	5.8	5.2	5.6	6.5	6.7	6.8	6.9
Income payments	-15.9	-14.8	-11.0	-11.5	-13.8	-15.2	-16.8	-18.5
Balance on transfers	-2.9	-3.0	-2.5	-2.5	-2.5	-2.4	-2.4	-2.3
Capital flows (including errors and omissions)	27.5	23.7	18.2	18.4	20.8	22.4	24.2	26.3
Balance on capital and financial account	21.8	12.6	13.6	18.4	20.8	22.4	24.2	26.3
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	21.8	12.6	13.6	18.4	20.8	22.3	24.2	26.3
Direct investment	2.7	12.5	2.0	2.0	4.0	4.2	4.4	4.7
Liabilities	5.7	9.0	2.0	2.0	4.0	4.2	4.4	4.6
Assets	-3.0	3.5	0.0	0.0	0.0	0.0	0.0	0.0
Portfolio investment	10.4	-15.9	9.6	12.1	14.6	15.4	15.0	17.0
Liabilities	13.8	-8.3	12.3	14.8	18.1	19.1	19.0	21.2
Assets	-3.4	-7.7	-2.7	-2.8	-3.5	-3.7	-3.9	-4.2
Other investment	8.6	16.0	1.9	4.2	2.2	2.7	4.8	4.6
Liabilities	8.3	6.5	2.3	6.5	4.4	3.3	3.5	3.6
Assets	0.3	9.4	-0.4	-2.3	-2.3	-0.6	1.3	1.0
Errors and omissions	5.7	11.1	4.6	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	6.8	3.2	1.7	0.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) 1/	33.0	34.1	35.8	35.8	35.8	35.8	35.8	35.8
International liquidity position of the SARB 1/ 2/	30.2	31.9	33.6	33.6	33.6	33.6	33.6	33.6
			(In percent of GDP; unless otherwise indicated)					
Balance on current account	-7.3	-7.4	-6.0	-6.4	-6.9	-7.0	-7.2	-7.4
Balance on goods and services	-3.1	-3.1	-3.0	-3.5	-3.7	-3.6	-3.5	-3.5
Exports of goods and services	31.5	35.4	29.4	30.2	30.4	30.8	31.0	31.2
Imports of goods and services	-34.6	-38.5	-32.4	-33.7	-34.1	-34.4	-34.5	-34.7
Capital flows (including errors and omissions)	9.7	8.5	6.6	6.4	6.9	7.0	7.2	7.4
Balance on capital and financial account	7.7	4.5	4.9	6.4	6.9	7.0	7.2	7.4
Errors and omissions	2.0	4.0	1.7	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	2.4	1.1	0.6	0.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) 1/	11.6	12.3	12.9	12.5	11.9	11.3	10.6	10.0
Memorandum items:								
Total external debt	26.6	25.9	27.3	30.6	32.5	34.1	35.8	37.6
Foreign currency debt	15.4	15.2	16.6	19.0	20.3	21.1	22.2	23.4
Of which: Short-term debt (at remaining maturity)	6.6	6.7	7.2	8.0	8.4	8.5	8.8	9.1
Total external debt service (billions of U.S. dollars)	8.7	9.4	9.3	8.8	10.0	15.6	14.6	13.2
Gold price (period average; U.S. dollar per ounce)	697	872	914	986	1,009	1,039	1,075	1,080
Crude oil price (period average; U.S. dollar per barrel)	71	97	61	75	78	80	81	83

Sources: South African Reserve Bank; and IMF 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, 2004–08

(December)

	2004	2005	2006	2007	2008
			(In billions of rand)		
Net foreign assets	141.4	195.2	274.3	304.5	390.5
Gross reserves	229.6	297.8	409.8	561.7	847.4
SARB	82.8	130.5	178.3	224.3	317.0
Other monetary institutions	146.7	167.3	231.5	337.4	530.4
Liabilities	88.2	102.6	135.5	257.2	456.9
SARB	19.8	22.2	19.3	12.0	6.1
Other monetary institutions	68.4	80.4	116.2	245.2	450.8
Net domestic assets	772.8	906.0	1,075.0	1,363.1	1,523.7
Credit to government, net	42.6	0.8	-29.5	-32.5	44.7
Claims on government	116.1	107.4	112.4	116.5	179.5
Government deposits	73.4	106.6	141.8	149.0	134.8
Credit to private sector	954.2	1,140.2	1,434.9	1,743.9	1,981.1
Other items, net	-224.1	-235.0	-330.4	-348.3	-502.1
Broad money (M3)	914.2	1,101.1	1,349.3	1,667.6	1,914.2
Of which: M1	421.5	503.1	605.7	738.3	753.6
			(In annual percentage change)		
Net foreign assets	11.6	38.0	40.5	11.0	28.2
Net domestic assets	13.4	17.2	18.7	26.8	11.8
Credit to private sector	13.8	19.5	25.8	21.5	13.6
Broad money (M3)	13.1	20.5	22.5	23.6	14.8
			(Contribution to growth in M3; unless otherwise specified)		
Net foreign assets	1.8	5.9	7.2	2.2	5.2
Net domestic assets	11.3	14.6	15.4	21.3	9.6
Credit to government, net	-0.4	-4.6	-2.7	-0.2	4.6
Credit to private sector	14.3	20.3	26.8	22.9	14.2
Other items, net	-2.6	-1.2	-8.7	-1.3	-9.2
Memorandum item:					
Income velocity of M3	1.61	1.53	1.40	1.30	1.25

Source: South African Reserve Bank.

Table 6. South Africa: Indicators of Vulnerability, 2004–09

(In percent of GDP; unless otherwise specified)

	2004	2005	2006	2007	2008	2009	*Date*
Financial indicators							
Government debt 1/	36.4	35.2	33.0	28.5	27.3	...	
Broad money (percent change; 12-month basis)	13.1	20.5	22.5	23.6	14.8	7.3	*May*
Private sector credit (percent change; 12-month basis)	13.8	19.5	25.8	21.5	13.6	5.7	*May*
Repurchase rate 2/	7.5	7.0	9.0	11.0	11.5	7.5	*June*
Repurchase rate (real) 2/ 3/	3.1	2.9	3.8	2.2	1.1	0.4	*May*
External indicators							
Exports of goods and services (percent change; US$ value)	23.6	15.1	15.0	16.6	9.8	...	
Imports of goods and services (percent change; US$ value)	36.5	16.9	23.8	15.4	8.7	...	
Terms of trade (percent change)	0.8	0.6	4.2	3.4	1.1	...	
Current account balance	-3.2	-4.0	-6.3	-7.3	-7.4	...	
Capital and financial account balance	3.2	5.0	6.1	7.7	4.5	...	
Gross official reserves (US$ billion) 2/	14.7	20.6	25.6	33.0	34.1	35.8	*May*
Short-term foreign liabilities of SARB (US$ billion) 2/	0.4	0.7	2.6	2.7	2.2	1.3	*May*
International liquidity position of SARB (US$ billion) 2/ 4/	11.4	17.2	23.0	30.2	31.9	34.5	*May*
Short-term external debt plus open forward position (US$ billion)	10.4	14.1	17.0	18.6	18.5	...	
Gross official reserves as a percent of the above	141.2	145.9	150.5	177.5	184.7	...	
Foreign currency-denominated external debt (US$ billion)	27.9	28.1	35.8	43.6	42.0	...	
As a percent of total exports	48.3	42.2	46.8	48.9	42.9	...	
External interest payments (as a percent of total exports)	3.8	3.8	4.6	4.7	4.8	...	
Exchange rate (per U.S. dollar; period average) 5/	6.45	6.36	6.77	7.05	8.25	7.74	*June*
Real effective exchange rate appreciation (period average; percent) 6/	6.7	0.5	-2.5	-3.3	-11.6	...	
Financial market indicators 2/							
Stock market index (1994=100) 5/	213	303	419	487	362	372	*July*
Percent change 5/	21.9	42.6	38.0	16.2	-25.7	6.3	*July*
Foreign currency debt rating–Standard & Poor's	BBB	BBB+	BBB+	BBB+	BBB+	BBB+	*May*
Foreign currency debt rating–Moody's	Baa2	Baa1	Baa1	Baa1	Baa1	A3	*July*
Spread of benchmark bonds (basis points) 7/	101	84	87	166	562	290	*July*

Sources: South African Reserve Bank; and IMF staff estimates.

1/ National government debt, end of period.

2/ End of period.

3/ Deflated by the percent change in end-period CPI.

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 2009, as of July 9; stock market index change with regard to end-2008.

6/ SARB.

7/ Until end-2005: a 2017 US$ denominated bond vs. a comparable synthetic U.S. bond from Merrill Lynch; since 2006: JP Morgan's EMBI+ Global Bond Spread for South Africa. End of period. For 2009, as of July 6.

Table 7. South Africa: Financial Soundness Indicators, 2004–09

(In percent, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009 1/
Capital adequacy:						
Regulatory capital to risk-weighted assets 2/	14.0	12.7	12.3	12.8	13.0	13.5
Regulatory tier 1 capital to risk-weighted assets 3/	10.5	9.7	9.0	9.5	10.2	10.5
Asset quality:						
Nonperforming loans to total gross loans 3/	1.8	1.5	1.1	1.4	3.9	5.1
Nonperforming loans net of provisions to capital 3/	6.2	6.4	5.6	8.2	…	…
Share of mortgage advances in domestic private credit 4/	43.3	46.2	47.7	49.0	48.8	48.9
Earnings and profitability:						
Return on assets (average)	1.3	1.2	1.4	1.4	2.1	1.0
Return on equity (average)	16.2	15.2	18.3	18.1	28.7	17.8
Interest margin to gross income	41.6	38.2	43.8	58.5	44.6	50.6
Noninterest expenses to gross income	68.5	61.5	48.5	48.9	42.2	49.8
Liquidity:						
Liquid assets to total assets	4.7	4.8	4.6	4.6	4.7	5.3
Share of short-term deposits in total deposits	43.7	43.5	42.8	42.4	36.4	35.0
Exposure to foreign exchange (FX) risk:						
Effective net open FX position to capital	0.8	1.9	1.4	0.7	0.5	0.5
Share of foreign currency loans in total lending	10.9	11.1	11.4	9.3	7.7	6.9
Share of foreign currency deposits in total deposits 5/	2.7	2.7	3.3	3.0	3.6	3.6
Share of foreign liabilities in total liabilities 6/	4.0	4.2	5.3	6.0	6.2	6.3

Source: South African Reserve Bank.

1/ As of March/April 2009.
2/ Total (banking and trading book).
3/ The definition of nonperforming loans until end-2007 comprised doubtful and loss loans. Doubtful are loans overdue for 180 days unless well secured, or with a timely realization of the collateral. Since 2008, the indicator reflects the ratio of impaired advances to total advances (in line with Basel II definitions), a more stringent definition.
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: Millennium Development Goals, 1990–2007 1/

	1990	1995	2000	2005	2006	2007
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates					
Population below $1 a day (%)	...	6.3	10.7	...	…	…
Poverty gap at $1 a day (%)	...	0.6	1.7	...	…	…
Percentage share of income or consumption held by poorest 20%	...	3.6	3.1	...	…	…
Prevalence of child malnutrition (% of children under 5)	...	9.2	...	...	…	…
Population below minimum level of dietary energy consumption (%)	…	3.0	...	...	3.0	….
2. Achieve universal primary education	2015 target = net enrollment to 100					
Net primary enrollment ratio (% of relevant age group)	90.0	...	96.0	...	88.0	…
Youth literacy rate (% ages 15-24)	…	93.9	93.5	...	…	…
3. Promote gender equality	2005 target = education ratio to 100					
Ratio of girls to boys in primary and secondary education (%)	104.0	...	103.0	...	101.5	…
Ratio of young literate females to males (% ages 15-24)	...	101.0	99.9	...	…	…
Share of women employed in the nonagricultural sector (%)	42.6	43.6	44.6	...	42.9	42.9
Proportion of seats held by women in national parliament (%)	3.0	25.0	30.0	32.8	32.8	33.0
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds					
Under 5 mortality rate (per 1,000)	60.0	59.0	63.0	68.0	69.0	69.0
Infant mortality rate (per 1,000 live births)	45.0	45.0	50.0	55.0	56.0	56.0
Immunization, measles (% of children under 12 months)	79.0	76.0	77.0	82.0	85.0	84.0
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	…	400.0	400.0
Births attended by skilled health staff (% of total)	…	82.0	84.0	…	…	…
6. Combat HIV/AIDS, malaria and other diseases	2015 target = halt and begin to reverse prevalence of diseases					
Prevalence of HIV (% ages 15-49)	…	…	16.9	15.6	18.8	18.1
Contraceptive prevalence rate (% of women ages 15-24)	57.0	…	…	…	14.8	12.7
Number of children orphaned by HIV/AIDS (thousands)	…	…	660.0	…	…	…
Incidence of tuberculosis (per 100,000 people)	224.0	392.4	465.0	599.9	940.0	940.0
Tuberculosis cases detected under DOTS (%)	…	6.0	58.0	103.1	71.0	71.0
7. Ensure environmental sustainability	2015 target = various '					
Forest area (% of total land area)	7.6	8.0	7.3	8.0	8.0	8.0
Nationally protected areas (% of total land area)	...	6.1	...	…	6.1	…
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	...	...	3.8	…	…	
CO2 emissions (metric tons per capita)	9.4	...	9.0	…	9.4	…
Access to an improved water source (% of population)	83.0	84.0	89.0	…	88.0	93.0
Access to improved sanitation (% of population)	55.0	56.0	57.0	…	…	59.0
8. Develop a Global Partnership for Development	2015 target = various '					
Youth unemployment rate (% of total labor force ages 15-24)	…	…	44.2	...	...	...
Fixed line and mobile telephones (per 1,000 people)	94.3	116.0	302.3	825.1	825.1	889.0
Personal computers (per 1,000 people)	7.1	28.1	66.4	84.6	84.6	…
General indicators						
Adult literacy rate (% of people ages 15 and over)	…	82.4	85.2	...	...	...
Total fertility rate (births per woman) 2/	3.3	3.1	…	2.8	2.8	...
Life expectancy at birth (years) 2/	61.9	58.0	48.5	47.7	47.7	...

Sources: World Bank and Statistics South Africa.

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

1/ For definitions of the goals, see http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do?siteId=2&menuId=LNAV01HOME3.

Table 9. South Africa: Social and Demographic Indicators

(2008, unless otherwise specified)

Area	
1.22 million square kilometers	
Population characteristics	
Population density	39.9 per sq. km.
Urban population (percentage of total, 2005)	60
Proportion in capital city as a percentage of urban population (census 2001)	8
Population age structure (percent)	
0-14 years	32
15-64	64
65 and above	4
Population below $2 a day, PPP basis (percent of population, 2000)	34.1
GDP per capita at current prices	
In U.S. dollars	5,693

Population	
Total	48.7 million
Annual rate of growth	1.7 percent
Health	
Life expectancy at birth Total (years, 2005)	47.7
Infant mortality per thousand live births (2005)	54
Labor force	
Female (percentage of labor force)	46
Percentage of employment	
Agriculture	5.5
Mining	2.3
Industry 1/	23.2
Trade	22.9
Other services	46.1
Education (2007)	
Adult literacy (15+, percentage)	
Male	84
Female	81
Total	82

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

1/ Comprises the manufacturing, construction, and utilities sectors.

APPENDIX I. SOUTH AFRICA—DEBT SUSTAINABILITY ANALYSIS

South Africa's external debt is projected to rise to 37.6 percent of GDP by 2014. The current account deficit widens again to 7–7.5 percent of GDP from 2011–14 reflecting a larger trade deficit as growth recovers, the import-intensive infrastructure investment program progresses, and dividend payments abroad pick up. Given South Africa's deep domestic financial markets, a significant part of the deficit is expected to be financed—as in the past—by nonresident portfolio flows, around 60 percent of which are equities and nondebt creating. Although portfolio flows were disrupted in 2008 Q4, they have recovered strongly since then, with net inflows amounting to almost $6 billion in 2009 H1. Part of the public sector borrowing requirement is also expected to be financed by nonresidents through Eurobond issuance ($1.5 billion was raised in May 2009), purchases of domestic securities, and multilateral loans for infrastructure. The financing of the current account deficit by this mix of non-debt-creating and debt creating capital flows results in an 11 percentage point increase in the external debt ratio to 37.6 percent in 2014.

The rising external debt ratio makes it somewhat more vulnerable to external shocks and rollover risk, although it looks manageable against a range of other shocks (Figure 6). The stress tests indicate that the largest adverse impact is from a further widening of the non-interest current account deficit by 1.7 percentage points on average over the next five years (under the assumption that this is debt-financed); this raises the external debt-GDP ratio to around 45 percent in 2014. By contrast, a large (one standard deviation) permanent adverse shock to real GDP growth has only a minor effect. The standard shocks to real interest rates, the exchange rate, and the combined shock have either only minor or moderate effects. Resilience to the exchange rate shock reflects the significant proportion of rand-denominated debt (41.5 percent of external debt at end-2008). Rollover risk looks relatively comfortable in 2009, with reserves at 81 percent of the current account deficit plus short-term debt at remaining maturity, but the position becomes tighter in the medium term.

South Africa's public debt position appears sustainable. Under the policies outlined in the 2009/10 budget and the medium-term expenditure framework, the ratio of government debt to GDP is expected to rise over the short term, from 27.3 percent in 2008 to a maximum of 33.8 percent in 2013—of which, 4.4 percent of GDP is expected to be denominated in foreign currency—before declining gradually thereafter (Table 12). Gross financing needs should also stabilize at around 6–7 percent of GDP in the medium term, albeit at a level higher than the average of the past five years (Figure 7). Total public debt is also projected to rise in the short term, as public enterprise borrowing increases to help finance the accelerated investment expansion, but total public debt is projected to stabilize at around 51 percent of GDP by 2014 (Table 12).

The ratio of government debt-to-GDP ratio appears broadly robust to a variety of shocks, including weaker GDP growth, a lower primary balance, a 30 percent real depreciation of the exchange rate, and a 10 percent increase in the debt stock (Figure 2). Under most of these scenarios, the government debt ratio rises above the baseline over the projection period, and in the case of the "no policy change" scenario, the debt ratio falls well below the baseline owing to the surpluses in the last four years. However, the government debt ratio does rise sharply in the case of a hypothetical 10 percent contingent liability shock, but remains manageable over the projection horizon.

Table 10. South Africa: External Debt Sustainability Framework, 2004–14

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing noninterest current account 6/**
Baseline: External debt	**20.8**	**19.0**	**22.1**	**26.6**	**25.9**	**27.3**	**30.6**	**32.5**	**34.1**	**35.8**	**37.6**	**-4.2**
Change in external debt	-2.8	-1.8	3.1	4.4	-0.6	1.4	3.2	1.9	1.7	1.7	1.7	
Identified external debt-creating flows (4+8+9)	-3.8	-3.3	2.0	2.3	4.4	3.9	3.3	3.0	2.7	2.0	1.8	
Current account deficit, excluding interest payments	2.2	3.0	4.9	5.8	5.7	4.3	4.7	5.0	4.9	4.9	4.9	
Deficit in balance of goods and services	0.4	0.8	3.2	3.1	3.1	3.0	3.5	3.7	3.6	3.5	3.5	
Exports	26.7	27.4	29.7	31.5	35.4	29.4	30.2	30.4	30.8	31.0	31.2	
Imports	27.1	28.2	32.9	34.6	38.5	32.4	33.7	34.1	34.4	34.5	34.7	
Net nondebt creating capital inflows (negative)	-2.6	-5.2	-2.7	-2.7	-1.8	-2.7	-2.7	-2.8	-3.0	-3.8	-4.0	
Automatic debt dynamics 1/	-3.4	-1.1	-0.2	-0.8	0.6	2.2	1.2	0.8	0.8	0.8	0.9	
Contribution from nominal interest rate	1.0	1.0	1.4	1.5	1.7	1.7	1.7	1.9	2.1	2.3	2.4	
Contribution from real GDP growth	-0.9	-0.9	-1.0	-1.0	-0.8	0.5	-0.5	-1.1	-1.3	-1.4	-1.5	
Contribution from price and exchange rate changes 2/	-3.5	-1.2	-0.6	-1.3	-0.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.0	1.5	1.1	2.1	-5.1	-2.5	0.0	-1.1	-1.0	-0.3	-0.1	
External debt-to-exports ratio (in percent)	77.9	69.4	74.6	84.4	73.4	92.9	101.0	106.7	110.9	115.6	120.3	
Gross external financing need (in billions of U.S. dollars) 4/	18.3	19.3	28.3	38.6	39.3	41.9	44.2	50.8	58.9	55.9	59.9	
In percent of GDP	8.5	8.0	11.0	13.6	14.2	15.2	15.4	16.9	18.5	16.6	16.7	
Scenario with key variables at their historical averages 5/						**27.3**	**25.1**	**22.1**	**19.2**	**17.2**	**15.5**	**-3.9**
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	4.9	5.0	5.3	5.1	3.1	-2.1	1.9	3.8	4.3	4.5	4.5	
GDP deflator in US dollars (change in percent)	23.8	6.9	0.9	4.6	-5.2	2.1	1.5	1.2	1.4	1.5	1.5	
Nominal external interest rate (in percent)	5.6	5.7	7.7	7.4	6.2	6.4	6.5	6.7	6.9	7.0	7.2	
Growth of exports (U.S. dollar terms, in percent)	23.6	15.1	15.0	16.6	9.8	-16.9	6.4	5.8	6.9	6.8	6.8	
Growth of imports (U.S. dollar terms, in percent)	36.5	16.9	23.8	15.4	8.7	-15.9	7.8	6.3	6.5	6.6	6.5	
Current account balance, excluding interest payments	-2.2	-3.0	-4.9	-5.8	-5.7	-4.3	-4.7	-5.0	-4.9	-4.9	-4.9	
Net nondebt creating capital inflows	2.6	5.2	2.7	2.7	1.8	2.7	2.7	2.8	3.0	3.8	4.0	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator ιν Υ.Σ. δολλαρ τερμσ, γ = ρεαλ ΓΔΠ γροωτη ρατε, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in τοταλ εξτερναλ δεβτ.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ 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 noninterest current account and nondebt 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 nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Table 11. South Africa External Sustainability Framework—Gross External Financing Need, 2004–14

	Actual					Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
						I. Baseline Projections					
Gross external financing need in billions of U.S. dollars 1/	18.3	19.3	28.3	38.6	39.3	41.9	44.2	50.8	58.9	55.9	59.9
In percent of GDP	8.5	8.0	11.0	13.6	14.2	15.2	15.4	16.9	18.5	16.6	16.7
						II. Stress Tests					
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative scenarios											
A1. Key variables are at their historical averages in 2009–14 3/						41.9	34.2	34.7	35.5	29.1	28.2
B. Bound tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						41.9	44.6	51.4	59.7	56.9	61.1
B2. Real GDP growth is at baseline minus one-half standard deviations						41.9	44.1	50.4	58.1	54.9	58.3
B3. Noninterest current account is at baseline minus one-half standard deviations						41.9	49.2	58.0	69.1	67.7	73.9
B4. Combination of B1-B3 using 1/4 standard deviation shocks						41.9	46.9	54.6	64.2	62.0	67.1
B5. One time 30 percent real depreciation in 2010						41.9	39.0	39.5	44.2	40.3	41.9
Gross external financing need in percent of GDP 2/											
A. Alternative scenarios											
A1. Key variables are at their historical averages in 2009–14 3/						15.2	11.4	10.6	10.0	7.5	6.7
B. Bound tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						15.2	15.6	17.1	18.8	16.9	17.1
B2. Real GDP growth is at baseline minus one-half standard deviations						15.2	15.6	17.1	18.9	17.0	17.2
B3. Non-interest current account is at baseline minus one-half standard deviations						15.2	17.2	19.3	21.7	20.1	20.7
B4. Combination of B1-B4 using 1/4 standard deviation shocks						15.2	16.4	18.3	20.4	18.6	19.0
B5. One time 30 percent real depreciation in 2010						15.2	20.7	20.0	21.1	18.2	17.8

1/ Defined as noninterest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

4/ The implied change in other key variables under this scenario is discussed in the text.

Table 12. South Africa: Public Sector Debt Sustainability Framework, 2006–14

(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing primary balance 10/**
Baseline: Government debt 1/ 2/	33.0	28.5	27.3	**30.2**	**32.4**	**33.1**	**33.6**	**33.8**	**33.7**	**-0.4**
Of which: Foreign-currency denominated	4.6	3.9	4.2	4.1	4.3	4.3	4.4	4.4	4.3	
Change in public sector debt	-2.2	-4.5	-1.2	2.9	2.2	0.7	0.5	0.2	-0.2	
Identified debt-creating flows (4+7+12)	-4.5	-5.7	-1.6	2.7	1.3	0.1	-0.2	-0.6	-0.9	
Primary deficit	-3.8	-3.8	-1.8	2.0	2.1	0.8	0.3	0.0	-0.4	
Revenue and grants	28.1	28.6	28.0	26.5	26.2	26.4	26.6	27.0	27.3	
Primary (noninterest) expenditure	24.3	24.8	26.2	28.5	28.3	27.2	27.0	27.0	27.0	
Automatic debt dynamics 3/	-0.7	-1.6	0.3	0.9	-0.5	-0.7	-0.5	-0.6	-0.5	
Contribution from interest rate/growth differential 4/	-1.1	-1.6	-1.2	0.9	-0.5	-0.7	-0.5	-0.6	-0.5	
Of which contribution from real interest rate	0.6	-0.1	-0.4	0.4	0.0	0.4	0.8	0.8	0.8	
Of which contribution from real GDP growth	-1.7	-1.5	-0.8	0.5	-0.5	-1.1	-1.3	-1.4	-1.4	
Contribution from exchange rate depreciation 5/	0.4	-0.1	1.5	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	-0.2	-0.1	-0.3	-0.2	-0.1	0.0	0.0	0.0	
Privatization and other extraordinary receipts (negative)	-0.2	-0.2	-0.1	-0.3	-0.2	-0.1	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 6/	2.3	1.2	0.4	0.3	0.8	0.7	0.7	0.8	0.8	
Government debt-to-revenue ratio 1/	117.4	99.7	97.6	114.2	123.6	125.5	126.3	125.4	123.1	
Gross financing need 7/	3.5	2.6	3.5	7.5	7.6	6.5	6.0	5.4	5.6	
In billions of U.S. dollars	9.1	7.3	9.8	20.7	21.7	19.6	18.9	18.3	20.1	
Scenario with key variables at their historical averages 8/				**23.7**	**20.6**	**17.6**	**14.8**	**12.0**	**9.3**	**-0.2**
Scenario with no policy change (constant primary balance) in 2009-2014				**26.3**	**24.5**	**22.8**	**21.2**	**19.8**	**18.4**	**-0.2**
Key macroeconomic and fiscal assumptions underlying baseline										
Real GDP growth (in percent)	5.3	5.1	3.1	-2.1	1.9	3.8	4.3	4.5	4.5	
Average nominal interest rate on public debt (in percent) 9/	9.5	9.2	9.6	8.8	8.9	8.9	8.8	8.9	8.9	
Average real interest rate (nominal rate minus change in GDP deflato	2.2	0.2	-1.2	1.3	0.3	1.8	2.8	2.9	3.0	
Inflation rate (GDP deflator, in percent)	7.3	9.0	10.8	7.5	8.6	7.1	6.0	5.9	5.8	
Growth of real primary spending (deflated by GDP deflator, in percent	6.8	7.0	9.0	6.5	1.1	-0.1	3.3	4.5	4.5	
Primary deficit	-3.8	-3.8	-1.8	2.0	2.1	0.8	0.3	0.0	-0.4	
Memorandum items:										
Debt of nonfinancial public enterprises	6.5	6.0	7.0	10.4	12.8	14.6	15.6	15.8	15.8	
Debt of local governments and local enterprises	1.4	1.5	1.3	1.4	1.4	1.4	1.4	1.4	1.4	
Gross public sector debt	40.9	36.0	35.6	42.0	46.6	49.1	50.6	51.0	50.9	

Sources: South African National Treasury and Fund staff estimates.

1/ Includes the central government, and provincial and local government activities financed with transfers from the central government.

2/ The authorities' monitored debt concept--net government and government-guaranteed debt--is equivalent to government debt plus government contingent liabilities minus government cash reserves. It is projected at about 43 percent of GDP at end-2014 on the assumption that contingent liabilities, which include the large guarantee to Eskom, are kept at their 2008 level.

3/ 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).

4/ 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.

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

6/ For projections, this line includes exchange rate changes.

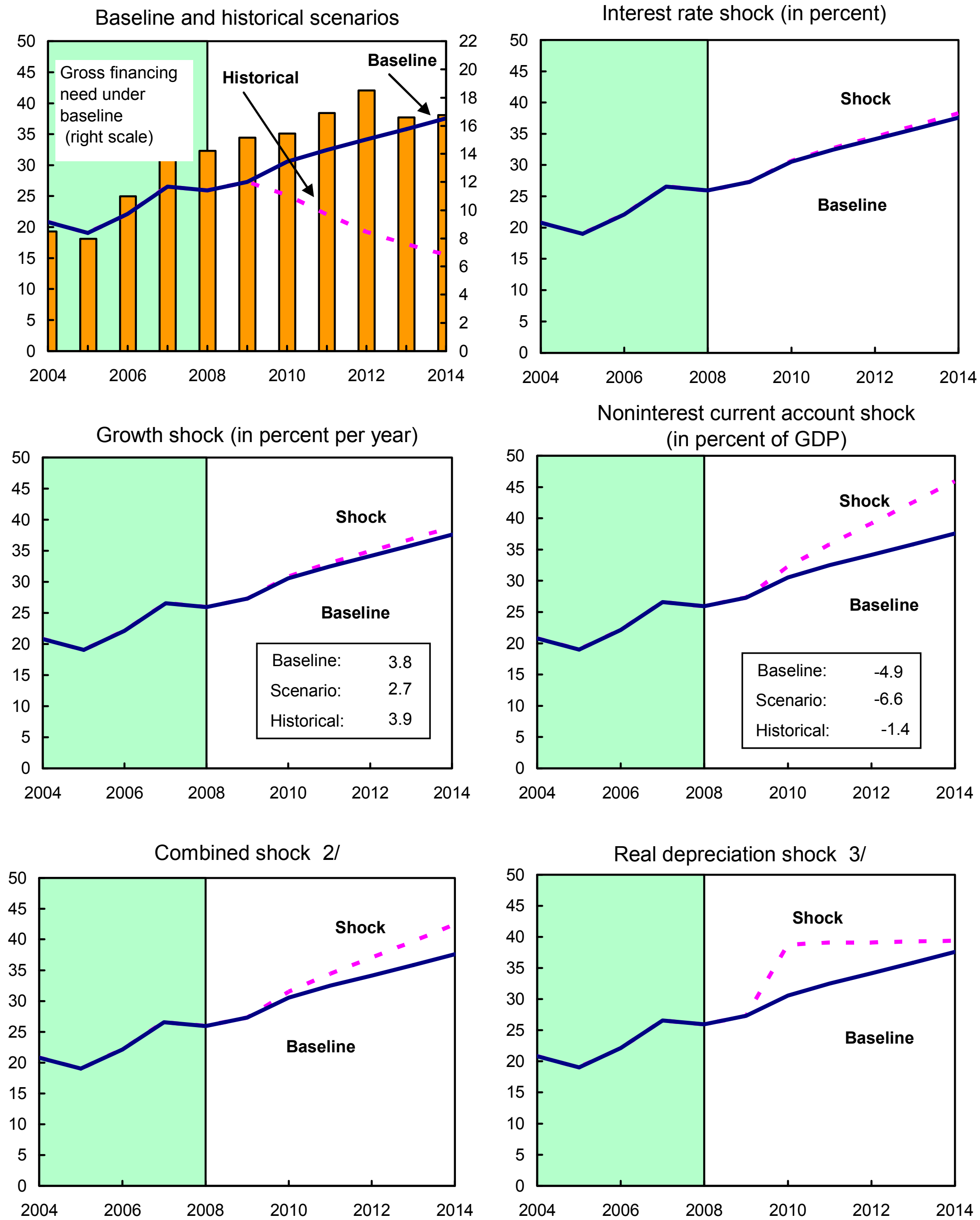
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ Derived as nominal interest expenditure divided by previous period debt stock.

10/ 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 6. South Africa: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



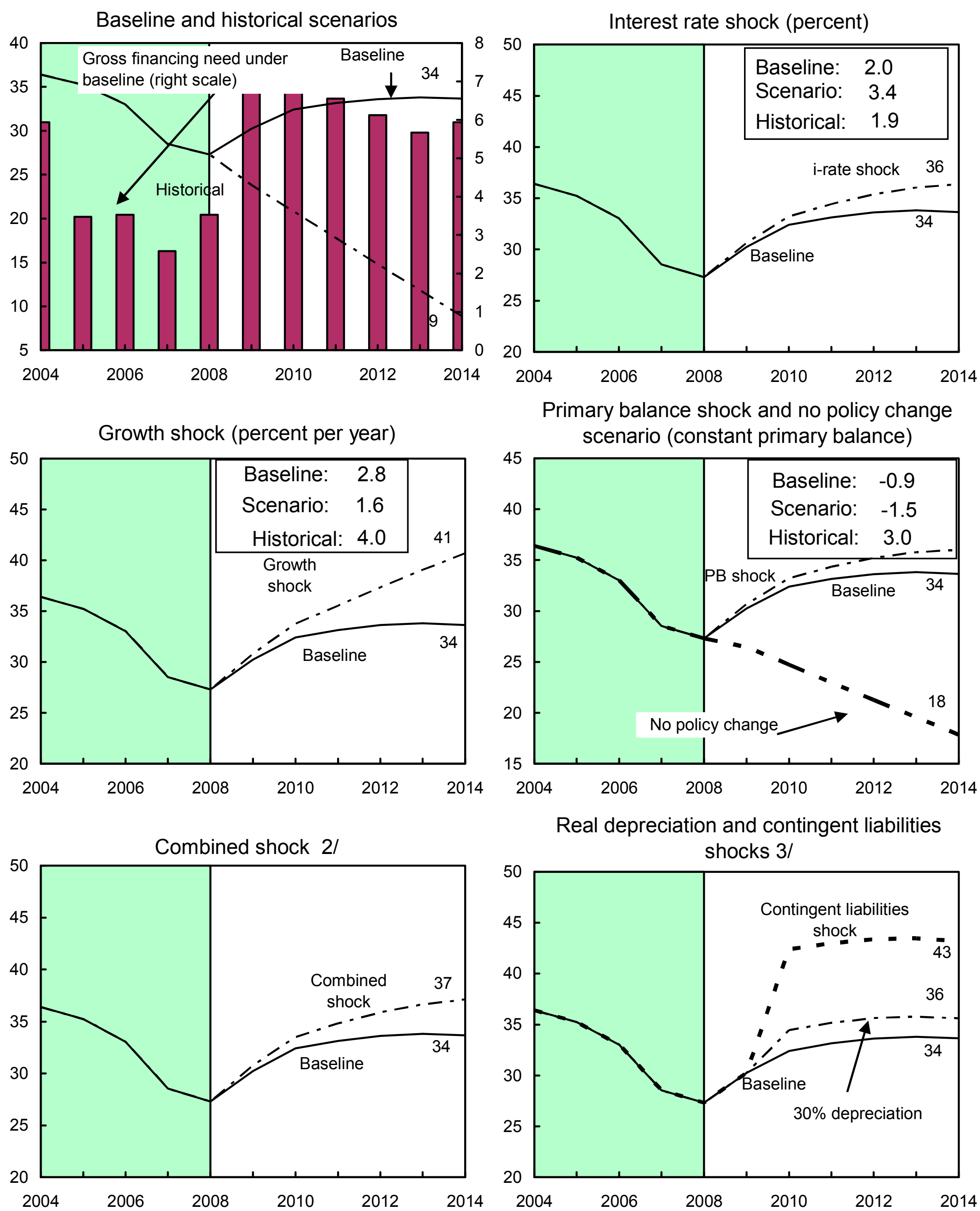
Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except for growth which is a 1 standard deviation shock. 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 2009.

Figure 7. South Africa: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



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

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

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, 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).

INTERNATIONAL MONETARY FUND

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[August ----, 2009]

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700 19th Street, NW
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Appendix II. Draft Public Information Notice

IMF Concludes Article IV Consultation with South Africa

On August 3, 2009 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

South Africa enjoyed a buoyant economy in the mid-2000s. A favorable external environment and strong domestic demand, accommodated by rapid credit expansion, raised growth to 5 percent on average in 2004–07 and lowered the unemployment rate by 5 percentage points. Rising employment, growing personal income, and wealth effects from rising asset prices buoyed household consumption, while strong business confidence and high commodity prices supported private investment. The current account deficit widened sharply and was financed mainly by robust portfolio inflows. However, the domestic demand-led expansion, together with surging international food and fuel prices, also created inflation pressures and led the SARB to embark on a tightening cycle in mid-2006. The slowdown in the global economy, power shortages, and rising interest rates dampened growth starting in mid-2008.

The global financial crisis of late 2008 sharply changed the outlook for an already slowing economy. Large capital outflows triggered by investor withdrawal from emerging market assets lowered stock prices and depreciated the rand. A sharp decline in external demand and a slump in the prices of some major commodity exports weakened the economy. These shocks pushed the economy into a recession: output fell by 1.8 percent (q-o-q, saar) in Q4:2008 and by 6.4 percent in Q1:2009.

[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.

Financial markets have begun to stabilize since early 2009. Portfolio inflows have returned, the rand has retraced its losses, the main stock market index has recovered, and—after widening significantly—credit default swap and EMBI spreads have declined to pre-September 2008 levels.

Weakening economic activity and falling global commodity prices have lowered inflation, but the pace of disinflation remains slow. Inflation, which has remained outside the 3–6 percent target band since April 2007, peaked in August 2008 and slowed to 8 percent in May 2009. Consumer price index (CPI) inflation excluding food, petrol, and energy has continued to trend upward. Large exchange rate depreciation in Q4:2008, the sharp increase in oil prices in the first six months of 2009, substantial wage demands, and high inflation expectations played an important role in slowing the decline in inflation.

Fiscal policy has been strongly countercyclical. The authorities implemented a large and front loaded easing in FY 2008/09 delivered through both the government budget and the public enterprise investment program. The FY2009/10 budget provides for a further sizable discretionary fiscal impulse based on a continued increase in infrastructure investment and an expansion of the social safety net, which would support demand in the short run and could raise the economy's potential growth rate in the long run.

The SARB eased monetary policy decisively starting in late 2008. As economic activity weakened and the inflation outlook improved, the monetary policy committee (MPC) reduced interest rates by 450 basis points between December 2008 and May 2009. However, rising inflation risks led it to keep the policy rate unchanged at its June 2009 meeting.

Money markets remained orderly and financial institutions stable during the global financial crisis in late 2008. However, household debt remains near historic highs and borrowers have been hit by the unfolding recession and rising interest rates during 2006-2008. As a result, impaired loans have risen to a multi-year high relative to total loans. Although banks' profits have declined somewhat, their capital remains well above the regulatory minimum.

South Africa maintains a floating exchange regime. The authorities have been gradually building up international reserves as market conditions permit, without seeking to influence the exchange rate. Gross official reserves stood at US$ 35.8 billion at end-June 2009 or some 134 percent of short-term external debt.

The short-term outlook is for output to begin a gradual recovery in the latter part of 2009, with the pace of growth next year remaining below the economy's potential. Inflation would continue to slow due to weak activity, but is expected to start rising again toward the end of 2009, pushed by rising international energy prices and increases in regulated electricity prices, among other factors. After narrowing temporarily, the external current account deficit is expected to resume widening over the medium term as private demand recovers and the public investment program unfolds.

Executive Board Assessment

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 and Financial Indicators, 2005–09

(Annual percent change; unless otherwise indicated)

	2005	2006	2007	2008	Proj. 2009
Real GDP	5.0	5.3	5.1	3.1	-2.1
CPI (metropolitan areas, annual average)	3.4	4.7	7.1	11.5	7.4
CPIX (end of period) 1/ 2/	4.0	5.0	8.6	10.3	...
Unemployment rate (percent)	26.7	25.5	22.7	21.9	24.9
Broad money 2/	20.5	22.5	23.6	14.8	7.9
National government budget balance (percent of GDP) 3/	-0.6	0.4	0.8	-0.7	-4.4
National government debt (percent of GDP) 3/	35.2	33.0	28.5	27.3	30.2
External current account balance (percent of GDP)	-4.0	-6.3	-7.3	-7.4	-6.0
External debt (percent of GDP)	19.0	22.1	26.6	25.9	27.3
Gross reserves (SARB, in months of next year's total imports)	2.9	3.1	3.7	4.6	4.5
International liquidity position of SARB (in billions of U.S. dollars) 2/	17.2	23.0	30.2	31.9	33.6
U.S. dollar exchange rate (rand per U.S. dollar) 2/	6.33	6.97	6.81	9.53	...

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

1/ Since January 2009, a reweighd 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.