INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/247

SOUTH AFRICA

2012 ARTICLE IV CONSULTATION

August 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 5, 2012, with the officials of South Africa on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 16, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Staff Statement** of August 1, 2012 updating information on recent developments.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board.

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

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SOUTH AFRICA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

July 16, 2012

KEY ISSUES

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

Growth prospects: Reflecting the global slowdown, growth is likely to fall below 3 percent in 2012, and gradually recover ground to close the negative output gap, now two years later than envisaged.

Policy mix: The policy discussions centered on monetary and fiscal policies under the baseline and the proper policy mix under a severe adverse scenario. Staff supported the monetary and fiscal policy stances and emphasized the need for rebalancing the composition of spending away from the wage bill and toward capital spending and, in the medium term, rebuilding fiscal buffers. In the adverse scenario, authorities agreed that monetary policy should provide most of the stimulus given the more limited fiscal space.

Structural reforms: Labor and product market reforms are key to reduce high structural unemployment, improve external competitiveness, and foster inclusive growth.

Financial stability: Banks' capital and liquidity cushions have stabilized at comfortable levels, and credit growth and bank profitability have started to pick up from a low base. The main risks remain banks' dependence on domestic short-term wholesale funding and their heavy exposure to home mortgages. Broad regulatory reforms to further enhance financial sector resiliency are under way.

External vulnerability: Although vulnerabilities are on the low side, risks have increased. Public and external debts are moderate and largely denominated in domestic currency. Rand flexibility and international reserve coverage provide buffers against external risks.

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Discussions took place in Pretoria May 23–June 5, 2012. The staff comprised Messrs. McDonald (head), Canales Kriljenko, Klein, Saxegaard and Ms. Liu (all AFR), and Mr. Gray (SPR). Mr. Cuevas (Resident Representative) assisted the mission. Mr. Todani (OED) also participated in the discussions.

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THE CONTEXT

South Africa needs to build on its many policy successes to expand employment opportunities, secure better education and health outcomes, and build more efficient infrastructure to support inclusive growth, while maintaining macroeconomic and financial stability in a risky global environment.

1. **The South African economic strategy adopted since 1994 has been successful on many dimensions.** It has delivered macroeconomic and financial stability despite a volatile external environment. This has allowed South Africa to retain its ability to borrow abroad in its own currency at interest rates that reflect its investment grade rating. It has also achieved a nontrivial reduction in extreme poverty levels and an improvement in social indicators within a peaceful democratic process.

2. **The challenge ahead is to deliver better outcomes on employment, education, health, and public infrastructure, while preserving macroeconomic stability.** The unemployment rate stands at 25 percent despite one of the lowest participation rates in emerging markets. Educational attainment is low and, reportedly, high school graduates lack marketable and practical skills to work or set up a business.[1] A large share of the population lacks proper access to basic health care, and the degree of HIV infection is among the highest in the world. Shortfalls in public infrastructure have constrained growth opportunities.

3. **If not addressed, the stubbornly high unemployment rate is likely to become politically and socially unsustainable.** Job creation is rightly an urgent national priority. The New Growth Path (NGP) and the draft of the National Development Plan (NDP) have increased public awareness of the urgent need for planting the seeds that foster inclusive labor-intensive growth that reduces poverty and inequality.[2] Achieving the job-creating targets in these documents calls for all key players, including government, business, and labor leaders, to put in place the needed policies and reforms.

4. **The 2012 Article IV discussions centered on** South Africa's policies for maintaining macroeconomic and financial stability under the uncertain and volatile global environment that has prevailed since the 2008–09 global financial crisis, while making firm progress on reforms that promote long-run inclusive growth. The discussions took place in the context of a significant slowdown in the global economy and higher tail risks. The authorities' macroeconomic policies have

[1] The results of the standardized test given for the first time in 2011 to 8-year olds have been poor.

[2] The independent National Planning Commission published a draft National Development Plan (NDP) in November 2011. This document proposes a strategy for reaching ambitious development goals by 2030 and calls for a broad array of deep-rooted reforms, including on labor markets.

generally been consistent with staff's recommendations, although labor and product market policies have been less well aligned (Table 1).

A SLOW RECOVERY

5. **The 2008–09 global financial crisis tested the resiliency of the South African economy.** South Africa's integration in global commercial and financial markets, which provides significant benefits during normal times, exposed the country to adverse spillovers. South Africa's countercyclical fiscal and monetary policy response helped protect the social spending envelope while maintaining stability. This was largely possible thanks to the prudent fiscal policies in the previous years, which provided significant fiscal space. Unlike major advanced economies, South Africa had enough room to lower the nominal policy rates without reaching the zero interest-rate bound. The flexible exchange rate provided a buffer to the economy. Admittedly, South Africa's integration in the world economy also allowed it to benefit from the countercyclical fiscal and monetary policies adopted around the world, and which facilitated a fast recovery in world trade and commodity prices. Although lagging behind peer emerging markets, by mid-2011, South Africa had already surpassed earlier GDP peaks and was on track to close the output gap by mid-2012.

6. **Since the last Article IV consultation, however, renewed distress in Europe—South Africa's main regional trading partner—has delayed South Africa's recovery.** Given the rapid transmission of global shocks, growth turned out to be roughly 1 percentage point lower than envisaged in 2011. Domestic factors contributed to the slowdown, including industrial action in mining and manufacturing. Domestic demand also slowed but continued growing faster than GDP. Consumption and inventory growth slowed; but fixed capital investment started to increase, taking advantage of a reduction in real interest rates. Although policy rates remained on hold, rising inflation and inflation expectations implied further monetary policy stimulus, which reactivated investment demand. Employment started to pick up but did not keep pace with the increase in working age population and labor participation.

7. **The degree of rand overvaluation diminished and real wage growth moderated.** Together with the currencies of peer emerging markets, by April 2012, the rand had depreciated by 10 percent in nominal effective terms and by 7 percent in real effective terms (year on year). Headline inflation briefly exceeded the 3–6 percent target band reflecting high fuel and food prices and rand depreciation early in the year. Core inflation rose but remained within the

target band. Real wage growth slowed significantly and employment rose by about 3 percent, reducing the gap between real wages and labor productivity. The deterioration in the current account deficit ended up roughly as envisaged. Although portfolio flows sharply diminished in 2011, higher foreign direct investment helped fund the deficit.

8. **In 2012, growth is likely to fall below 3 percent, lower than most estimates of potential growth.** The authorities share staff's baseline view that the slowdown is temporary and growth will pick up over the next few years to close the negative output gap. A rebound in private sector demand is expected to take place under the relatively favorable external conditions of the WEO baseline. This would reflect a recovery in investor confidence that leads to higher private sector investment, demand for bank credit, and employment.

9. **Nevertheless, GDP will take longer than envisaged earlier to reach potential.** The change in the external environment has resulted in a downward revision of the feasible growth rates in South Africa during the next few years, taking into account its effect on South African exports and income. Inflation rates and fiscal revenue should also be lower than earlier anticipated. In turn, fiscal deficits and public debt levels would be higher than envisaged earlier (Figures 1 and 2). Rating agencies have lowered South Africa's outlook questioning the government's ability to contain the deficit over the medium term as intended.

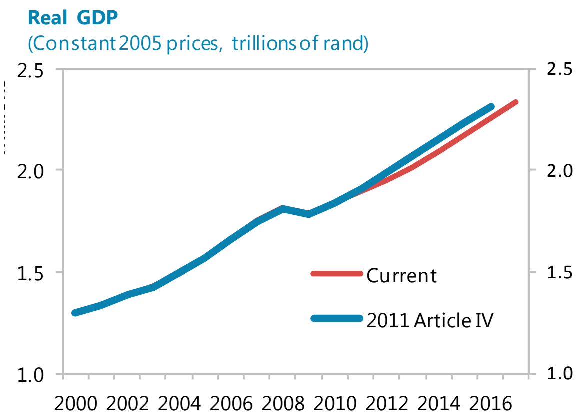
RISING RISKS, STILL MODERATE VULNERABILITIES

10. **Renewed concerns about the euro area and signs of a slowdown in China have recently tilted risks to the downside.** The sources of risks to the outlook are mainly external, although domestic risks also are present (Table 2).

11. **External developments have a strong influence on South Africa.** This partly reflects that export industries generate a significant amount of the wealth and facilitates the generation of value added in supporting industries and the provision of services. In addition, external savings (foreign funding) have helped fund both fiscal and external current account deficits. Although the flexible exchange rate and adequate international reserves help buffer in part the effects of positive and negative shocks on domestic income, changes in external demand have a strong effect on the real sector, and indirectly on the domestic financial sector. Finally, South Africa reliance on mineral exports makes it sensitive to movements in international commodity prices.

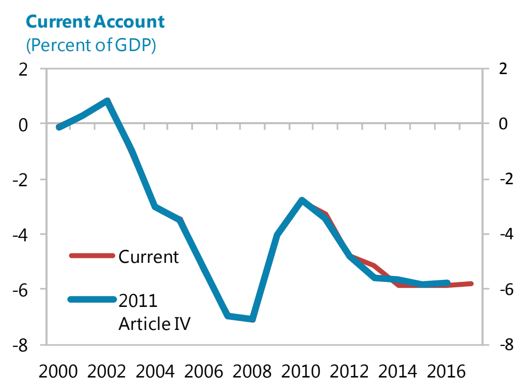
Figure 1. South Africa: Impact of Global Slowdown

The global slowdown has lowered growth prospects,…

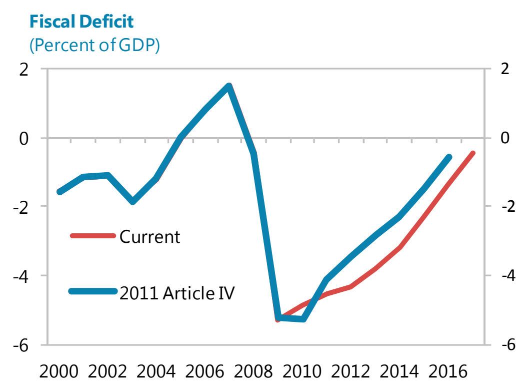


…and prospective export receipts,

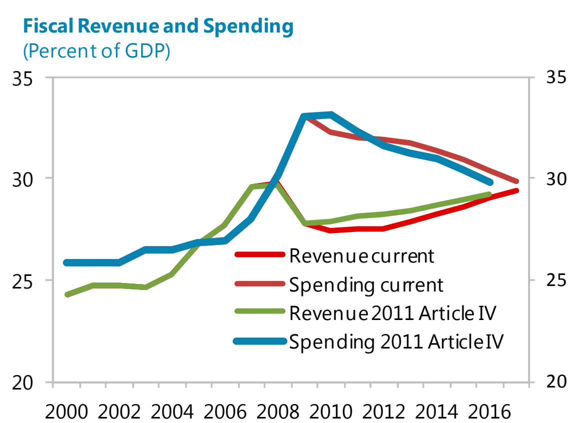
… while the current account is expected to be broadly unchanged.



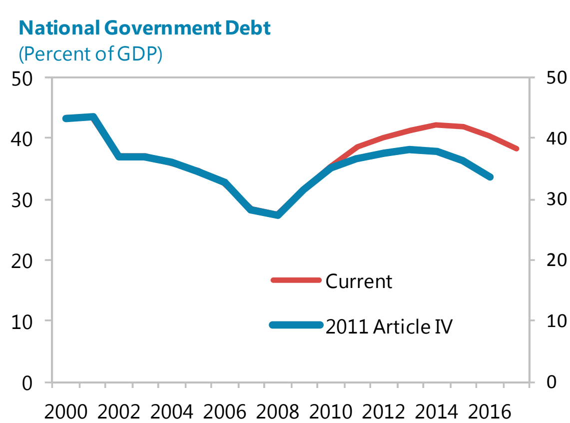
The fiscal policy response has been to slow the pace of fiscal consolidation,…



…reflecting lower than envisaged fiscal revenue and higher spending over the medium term, …



and resulting in a higher government debt-to-GDP ratio than forecasted during the 2011 Article IV consultation.

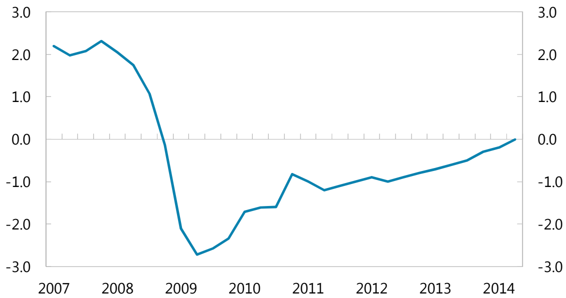


Source: IMF's World Economic Outlook.

Figure 2. South Africa: Slowdown in Economic Activity

The negative output gap widened slightly in 2011,...

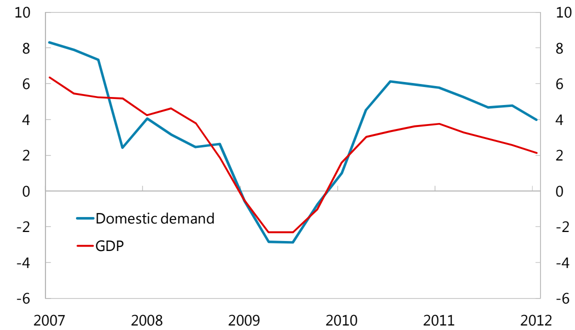
South Africa: Output Gap
(Percent of potential GDP)



Source: IMF staff estimates.

...while real domestic demand kept growing faster than GDP,

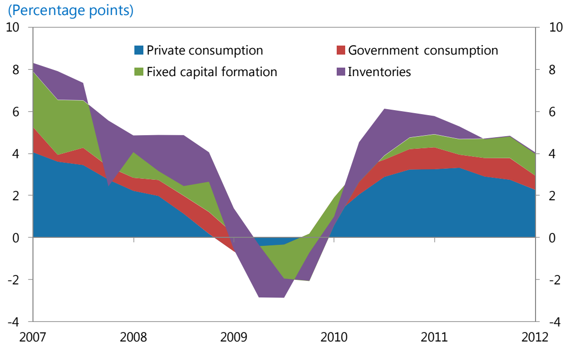
South Africa: Real GDP and Domestic Demand Growth
(In percent, y/y)



Sources: SARB and Haver Analytics, Inc.

... with consumption and inventories slowing while private fixed capital formation recovered slightly...

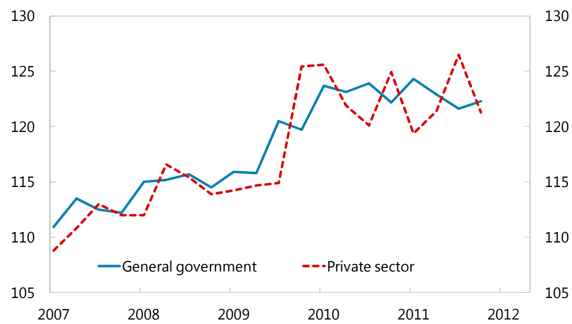
South Africa: Contributions to Domestic Demand Growth
(Percentage points)



Sources: SARB and Haver Analytics, Inc.

...with some real wage moderation, ...

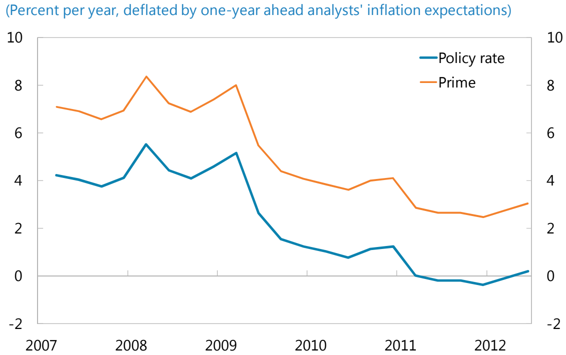
South Africa: Real Wages
(Index, 2000=100, seasonally adjusted)



Sources: SARB and Haver Analytics, Inc.

...amid low real interest rates, ...

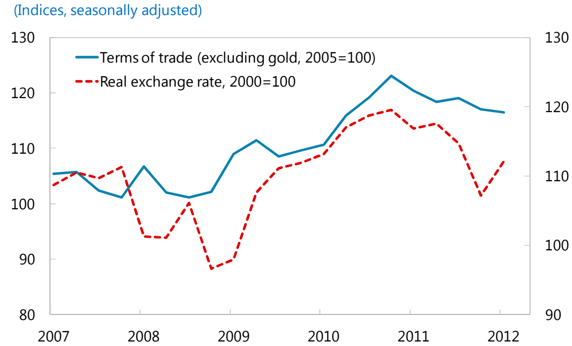
South Africa: Real Interest Rates
(Percent per year, deflated by one-year ahead analysts' inflation expectations)



Sources: SARB and Haver Analytics, Inc.

...with some deterioration in the terms of trade offset by real rand depreciation.

South Africa: Terms of Trade and Rand Appreciation
(Indices, seasonally adjusted)



Sources: SARB and Haver Analytics, Inc.

12. External sources of risk include slower demand for South African exports and a further decline in commodity prices. Although the euro area remains the main regional trading partner, South Africa has been able to diversify its export markets through a significant increase in exports to China, and sub-Saharan Africa. Nevertheless, since the euro area and China are global players, disruption in one economy will likely have significant spillovers on the other and the rest of the world. Although the direct share of China is smaller than that of the euro area, it will likely have a strong indirect effect through its impact on commodity prices and other sub-Saharan African economies (Appendix I).

13. Adverse developments in one of these economies would be particularly damaging if it also gave rise to a sharp increase in risk aversion. Capital outflows, such as those arising from a global reassessment of the riskiness of emerging markets in general or South Africa in particular, could also force a sharp adjustment in fiscal spending and import levels. Large portfolio flows have helped fund the significant external current account and fiscal deficits although in 2011 foreign direct investment played a significant role. The impact on GDP of capital outflows would depend on the net effect of higher risk sensitivity, currency depreciation, and interest rates. The flexible exchange rate regime helps share the adjustment cost with foreign investors holding the mainly rand-denominated public debt.

14. Domestic sources of risk include increased labor unrest in a politically important year. In December 2012, the ANC, the party in power since 1994 and in a tripartite alliance with one of the main labor unions and the communist party, chooses its presidential candidate. Impatience with the high structural unemployment, particularly of the young, could lead to inappropriate responses that might threaten macroeconomic stability. In addition, adverse external developments and domestic shocks could increase further unacceptably high levels of unemployment.

15. On the positive side, a resolution of the uncertainty in Europe could give rise to an unexpectedly sharp expansion in demand on a global scale. This would foster demand for South African exports and would likely give rise to an increase in commodity prices. The prevailing low levels of risk aversion under low global interest rates could result in large flows to emerging markets. Under this environment, South Africa may find it easier to implement its ambitious public investment program and this may result in high growth rates. On the other hand, the inflows and repricing of risk would likely lead to strong rand appreciation.

16. Although low, South Africa's vulnerability to external shocks has increased over the last few years. Balance-sheet effects are likely to be contained because prudential rules and capital controls keep low the exposure to exchange rate risk. Public debt levels are moderate and its composition bears little exchange rate or maturity risk. However, the fiscal position has worsened and lowered significantly the fiscal space available for countercyclical fiscal policy in a significant downward scenario. Although external solvency indicators remain sound, the net external investment position is weaker despite better international reserve coverage. On the other hand, the quality of portfolio investments abroad of the nonbank private sector, of about 30 percent of GDP in 2010, could suffer in a severe adverse scenario. Banks remain well capitalized and liquid, although a sharp change in investor sentiment is likely to further hurt their already low profitability. Moreover, the mortgage portfolio, the largest item in banks' balance sheets, may become vulnerable if the downward scenario gives rise to higher unemployment and house prices decline substantially. The recent sharp increase in unsecured lending, although from a low base, could give rise to additional stress.

Authorities' Views

17. The authorities expressed concern about the mutating nature of a five-year global financial crisis, which has been negatively affecting emerging markets such as South Africa. They were concerned that tail risks in Europe would hit emerging markets hard because policy space in advanced economies, and to a lower degree in emerging markets, had been eroded. In their view, lack of decisive and timely action by key policymakers in advanced countries could severely impair the global economic outlook.

POLICY DISCUSSIONS

18. The temporary deterioration in the external environment under the baseline justifies the authorities' current policy mix. This includes the decision to keep the policy stimulus for longer than initially envisaged, by delaying the pace of fiscal consolidation and keeping interest rates on hold. However, fiscal space will be rebuilt in the medium term.

A. Broadly Adequate Pace of Fiscal Consolidation but Need to Change the Composition of Spending

19. The fiscal stance has provided further stimulus in the face of weak external demand and a negative output gap. In 2011/12, the cyclically adjusted fiscal deficit remained broadly stable at around 4 percent of GDP while the gross national government debt reached just below 40 percent of GDP.

20. The 2012 Budget reaffirms the authorities' consolidation plans. The 2012 Budget review envisages that the fiscal deficit in 2012/13 will fall by 0.2 percent of GDP (0.3 percentage point of GDP in cyclically-adjusted terms), mainly by reducing public spending (as a share of GDP), especially the government's wage bill. Staff is of the view that the budget strikes the appropriate balance between fiscal consolidation and supporting the economy.

21. The pace of fiscal consolidation over the budget horizon is broadly adequate under the baseline external environment (Figures 3 and 4). The cyclically adjusted deficit is projected to narrow gradually to just below 3 percent of GDP by 2014/15, with gross national government debt peaking at about 42 percent of GDP. The strategy is to achieve a gradual decline in the public spending-to-GDP ratio by controlling real spending growth while increasing the revenues-to-GDP ratio, primarily through improvements in tax collection as the economy recovers. Staff advised taking measures as soon as possible to rebuild some of the policy buffers lost in recent years to lower vulnerabilities and reduce the gross national government debt-to-GDP ratio to around 35 percent by 2017.[3, 4] Staff recommended that any revenue overperformance be saved.

22. The 2012 Budget Review recognized that rebalancing the composition of public spending is critical to promoting long-term growth. In recent years, the wage bill has grown to become the single largest component of government spending and one of the largest in peer emerging markets (Figure 5); and capital spending plans have been only partly fulfilled, reflecting to some extent limited implementation capacity in some local governments. Although the 2012 Budget Review clearly recognizes this issue and anticipates a rebalancing over the three-year budget horizon, staff reiterated this point during the discussions because in 2011 the government's wage bill ended up being higher, and capital spending lower, than budgeted, and because the wage bill is set to increase further this year. Raising real public sector wages during the peak of the recession contributed to one of the largest job shedding experiences among emerging markets during the global financial crisis.[5] Staff urged the authorities to bring the wage bill back to pre-crisis levels and cautioned that further slippages could erode the government's credibility at a delicate global juncture when rating agencies are questioning its ability to rein in spending. Lowering the wage bill

[3] Figures do not include the health and social security reforms, which have not yet been budgeted, except for pilot programs.

[4] These measures could include a combination of revenue and spending measures, including increases in the VAT rate and reductions in the real wage bill. Restraint on fiscal spending alone as recommended by staff could reduce the public debt to about 38 percent of GDP.

[5] Klein, N. (2012) "Real Wage, Labor Productivity, and Employment Trends in South Africa: A Closer Look" IMF working paper WP/12/92.

burden would provide greater room for capital spending, which would help improve and expand the delivery and quality of public services, especially in critical areas such as health and education. To increase capital spending, the implementation capacity at lower levels of government should be strengthened.

23. **Over the medium term, greater stability in public real wages would be desirable.** Staff recommend that once the wage bill burden has been lowered as planned, real wage growth in the public sector be limited to 1–2 percent a year in line with estimates of long-term economy-wide average labor productivity growth.

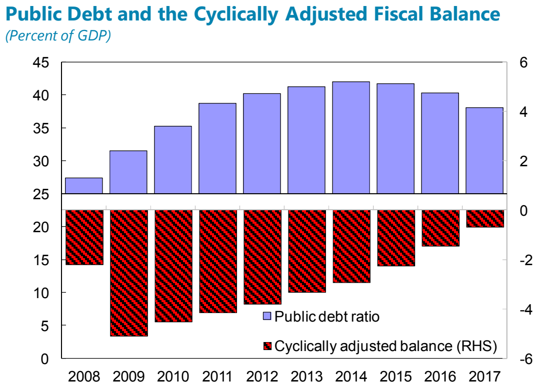
24. **Staff welcomes the renewed drive for building public infrastructure.** Investment in infrastructure has been held back largely due to limited implementation capacity. The resulting bottlenecks in electricity generation, transport, and port infrastructure means South Africa has not benefited as much as other resource intensive emerging market economies from its large terms of trade gains of the last decade. This in turn has discouraged investment in South Africa's natural resource industry, and some key exports have seen substantial volume declines despite high commodity prices. Public enterprises increased their fixed capital formation in the late 2000s and owing to gestation periods a new large power plant will start partial operations only in 2013. In 2012, a presidential commission identified key infrastructure projects to be rolled out over the coming decades. Enhancement of key infrastructures would help remove existing supply-side bottlenecks in important network industries, which have constrained exports and domestic economic activity in recent years.

25. **Large-scale projects, such as those identified by the presidential infrastructure coordinating commission, need to be subject to rigorous but prompt assessment and prioritized to maximize long-term benefits.** To contain fiscal risks, tariffs and user fees should reflect service and investment costs while ensuring efficiency in running these enterprises, which often have a dominant market position. Options to involve the private sector in network industries dominated by state-owned enterprises need to be explored.

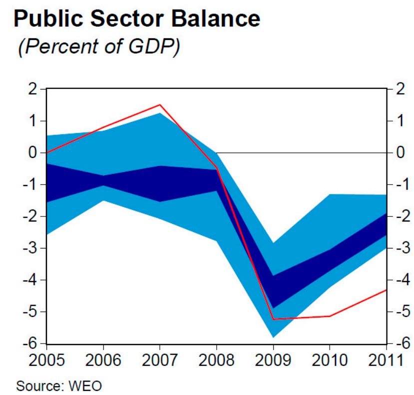
26. **Staff supports the government's intent to introduce a National Health Insurance (NHI) scheme and social security and retirement reforms.** The NHI reform rightly aims to improve access to public health services, while improving its quality and coverage (Box 1). Staff endorses the authorities' gradual and cautious implementation, and stresses that careful attention should be given to design issues, which determine incentives and ultimately the cost of the programs. Although financing options are still under debate, the chosen financing package should keep the fiscal consolidation plan intact and preserve fiscal sustainability.

Figure 3. South Africa: More Gradual Fiscal Consolidation

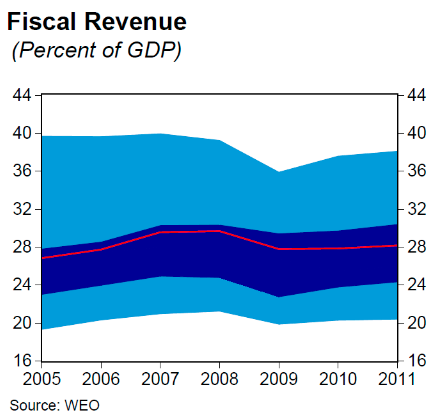
The 2012 budget envisages a more gradual reduction in the cyclically adjusted deficit than anticipated in 2011...



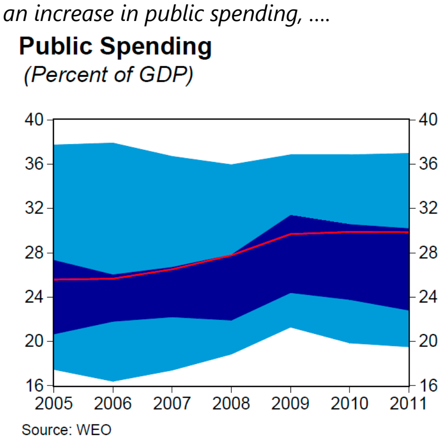
... and more gradual than in many peer emerging markets.



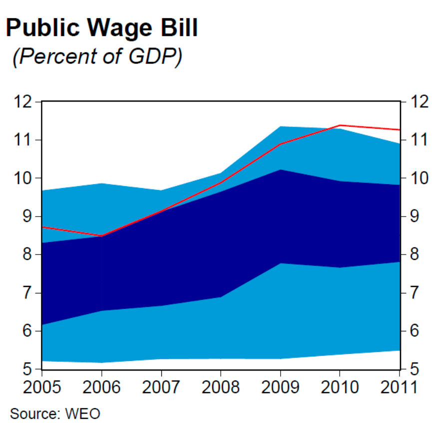
Partly this reflects a slower recovery in fiscal revenue...



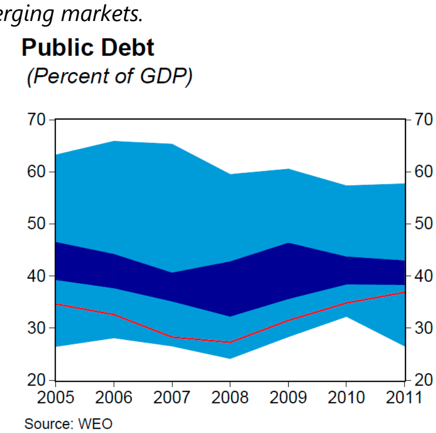
... and an increase in public spending, ...



... especially on the government's wage bill,



... leading to an increase in public debt toward the median of emerging markets.

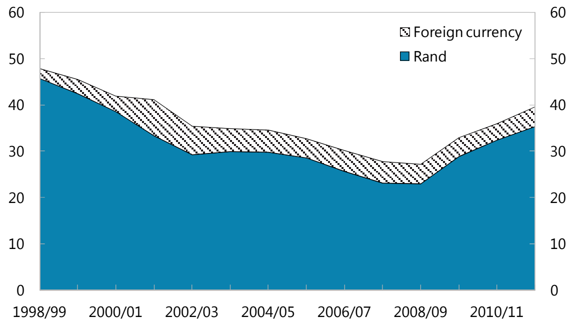


Shaded lines correspond to the central 60 percent of the distribution. The dark blue line represents the center quintile. The red line represents South Africa.

Figure 4. South Africa: Well-Managed Public Debt

Public debt is mostly denominated in rand, …

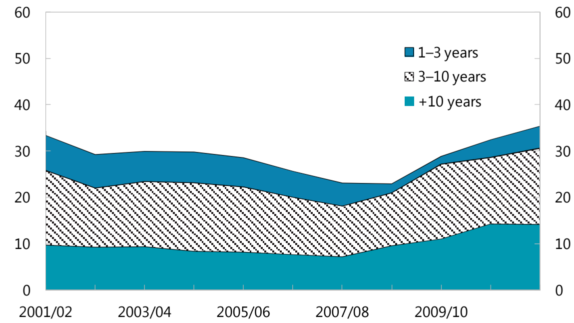
National Government Debt
(Percent of GDP)



Source: National Treasury.

… predominantly long term, …

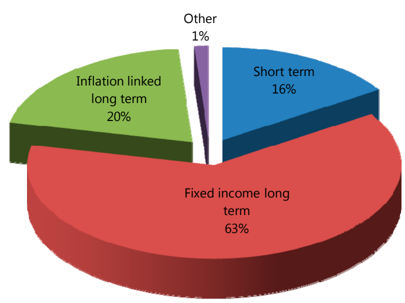
Maturity of Rand Marketable Debt (National Government)
(Percent of GDP)



Source: National Treasury.

…including fixed-income and inflation-linked bonds, …

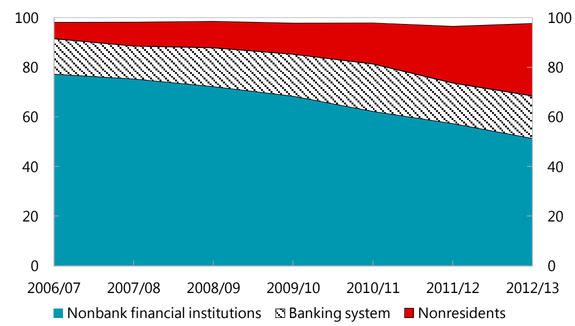
Composition of Public Debt, by Instrument (2011)
(Percent)



Source: National Treasury.

… and held increasingly by nonresidents..

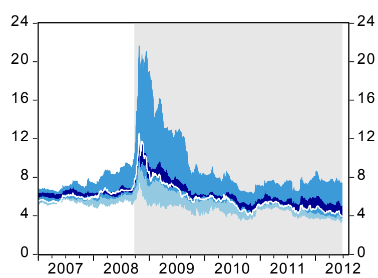
Ownership of Domestic Government Marketable Bonds
(Percent)



Source: National Treasury.

Sovereign spreads are among the lowest in emerging markets (EMs), …

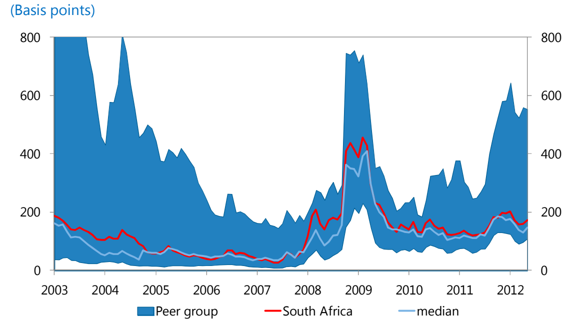
Sovereign yield distribution
(EMBIG, percent a year)



Sources: J.P. Morgan. Updated on 6/26/2012. White line is South Africa

… while credit default swaps (CDS) fluctuate around the median for peer EMs..

CDS Spreads
(Basis points)

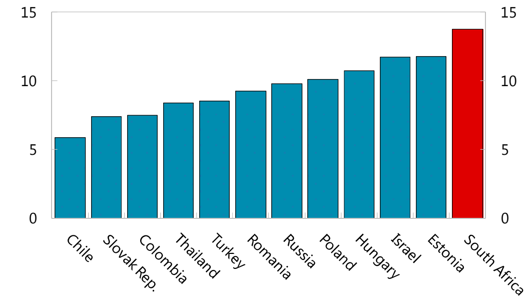


Source: Markit.
Peer countries include Brazil, Chile, China, Colombia, Hungary, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Thailand, and Turkey.

Figure 5. South Africa: High Government Wage Bill

Compared with its emerging market peers, the government's wage bill is large in percent of GDP,,...

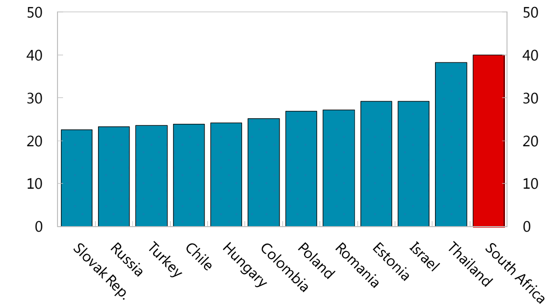
Wage Bill of General Government: 2010
(Percent of GDP)



Source: Government Finance Statistics and WEO.

... and as a share of fiscal revenue,...

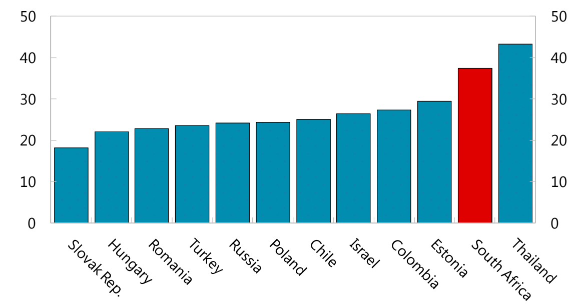
Wage Bill of General Government: 2010
(Percent of Revenues)



Source: Government Finance Statistics.

... and government spending,

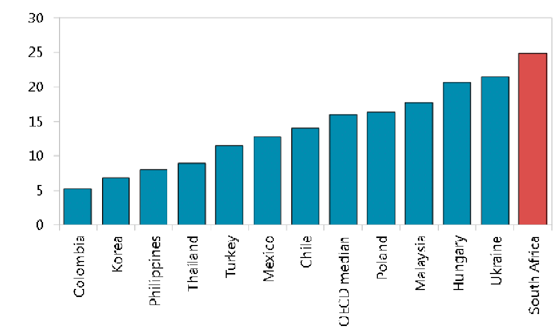
Wage Bill of the General Government: 2010
(Percent of total spending)



Source: Government Finance Statistics.

... reflecting both relatively high wages and public sector employment.

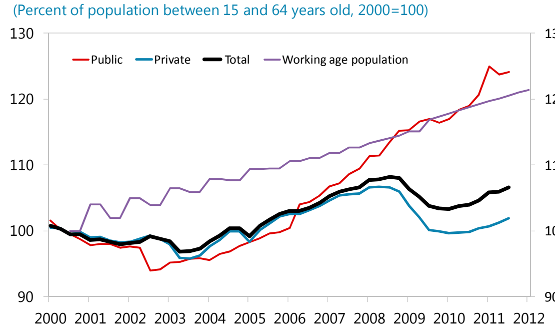
Share of Public Sector Employment
(In percent of total employment)



Sources: ILO, OECD, Stats SA and IMF staff calculations.

Public employment has been growing faster than the working age population since the mid 2000's,...

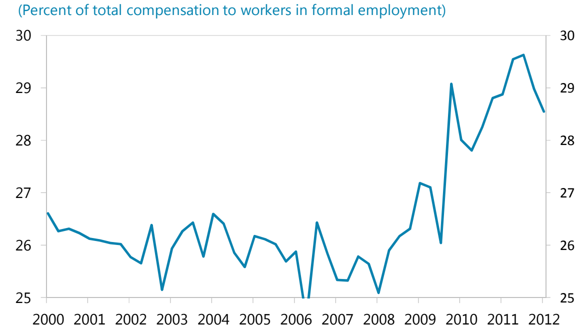
Private and Public Employment
(Percent of population between 15 and 64 years old, 2000=100)



Sources: Haver Analytics, Inc.

with compensation of government employees accounting for about a third of the formal sector wage bill.

Public Sector Workers' Compensation
(Percent of total compensation to workers in formal employment)



Sources: Satistics South Africa.

Box 1. Toward a National Health Insurance System in South Africa

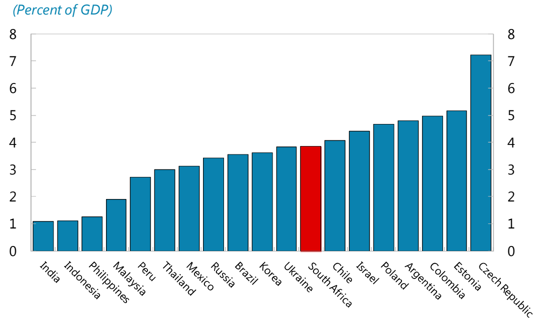
South Africa has one of the largest disease burdens and lowest life expectancies among emerging markets, yet access to health care services is low for a large share of its population. In 2011, the government made the political decision to extend access to health care services to the population as a whole by implementing over time a National Health Insurance (NHI) scheme. Although the details are still being fleshed out, the approach is to pool the risks and the funds so that equity and social solidarity will be achieved through the creation of a single NHI fund.

The NHI is planned to be implemented gradually over 14 years in three phases. The first phase (2011–15) mainly includes organizational changes to build capacity and pilots projects to assess the preliminary design. In the second and third phases (2016–2020 and 2020–24), the NHI will progressively take over the administration for the health functions.

The cost of the NHI is difficult to predict given the large uncertainties regarding the "utilization" levels of the insured population, the disease burden, some possible changes in the coverage of the medical benefits package, and the price evolution of the health care services. Preliminary estimates from the National Treasury suggest that public health spending could increase by 2 percentage points of GDP to reach 6.2 percent of GDP in 2025. This would require new sources of financing, and the authorities are considering various options, including a payroll tax (payable by both employees and employers), a higher value-added tax rate, a surcharge on taxable income, or some combination of these. In choosing among the funding options, care should be taken not to further increase labor costs that could have an adverse effect on employment.

But beyond the need to identify the financing measures, the authorities acknowledge the need to contain public health spending and maintain fiscal sustainability. Lessons from other countries suggest that this would require both macrolevel instruments (such as budget caps and central oversight) and microlevel measures to improve the efficiency of spending. Strengthening market mechanisms, among other things by allowing more competition between health service providers and insurers, and relying on a greater degree of private provision, as well as increasing the level of cost-sharing have been successful in containing spending growth.

Public Health Spending, 2008–09[1]
(Percent of GDP)



Source: FAD database.
[1] Latest available data.

27. The forthcoming report on South Africa's long-term fiscal dynamics will further improve fiscal transparency. It will raise public awareness of longer-term fiscal policy implications and options and the associated fiscal risks. It will also be a useful tool for communicating the medium-term costs involved with the NHI and social security reforms and highlight the fiscal tradeoffs involved in different design options. These trade-offs could be assessed under the fiscal guidelines on intergenerational fairness, countercyclicality, and sustainability. Although financing options have not been finalized, the 2012 Budget Review mentioned as funding options an increase in the VAT rate, a payroll tax on employers, and a surcharge on the taxable income of individuals.

28. There remains some scope for further improving fiscal management. Although South Africa has the most transparent budget process according to the International Budget Parnership's (IBP's) Open Budget Index, the IMF study on budget institutions in G20 countries identified areas for further improvement, including external scrutiny of the treasury's macroeconomic assumptions and forecast and independent evaluation of fiscal policies, beyond the current activities of South Africa's fiscal commission. There was also scope for more systematic monitoring, reporting, and management of fiscal risks.

Authorities' views

29. The authorities are firmly committed to careful fiscal management, which is crucial for maintaining macroeconomic stability. At the same time, they are trying to strike a good balance between providing stimulus and maintaining fiscal sustainability. They are aware that fiscal space for facing any future stress diminishes as the government debts continues to increase. They recognize the merits of wage moderation in the public sector, including for making space for needed public infrastructure.

B. Policy Rates on Hold for Now

30. The inflation targeting framework has been crucial in South Africa's resilience to the large shifts in the global external environment. It has allowed the monetary authorities to provide stimulus while keeping inflation expectations well anchored (Figure 6).

31. Staff supports the decision to keep the policy rate on hold for now. The policy rate has remained unchanged at 5.5 percent since November 2010, and one-year-ahead inflation forecasts suggest the policy rate has become negative in real terms. This accommodative monetary policy stance has appropriately provided stimulus given the negative output gap and well-contained core and inflation expectations. The sharp drop in fuel prices observed by mid-2012 is likely to exert downward pressure on inflation given the full pass through of fuel prices.

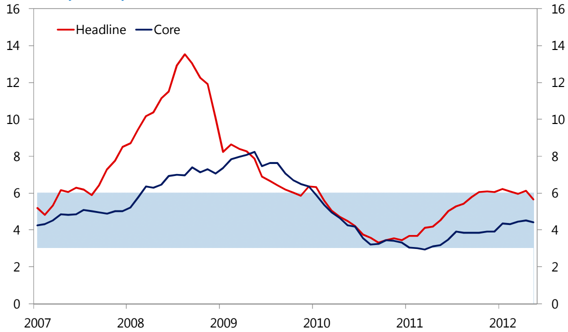
32. But, given the high uncertainty, staff supports the South African Reserve Bank's (SARB's) readiness to move the policy rate in either direction as needed. In principle, the policy rate could remain on hold as long as the one-year-ahead inflation forecast remains within the inflation target range. But, with the balance of risks tilted to the downside, the SARB should be ready to cut the policy rate to support the economy, especially given the limited fiscal space. The target band gives flexibility to provide monetary stimulus (Appendix II). Forward- rate agreements are already pricing this possibility. On the other hand, monetary tightening could be brought forward if inflation forecasts exceed the target range or balance-sheet vulnerabilities build up.

Figure 6. South Africa: Continued Monetary Support

Inflation has remained within the target band,...

Headline and Core Inflation

(Percent, year on year)

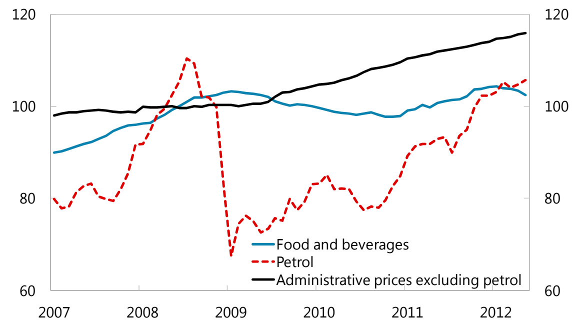


Sources: SARB and Haver Analytics, Inc.

...but relative price changes arising from supply shocks ...

Key Relative Prices

(Percent of CPI excluding food, beverages and petrol, 2008=100)

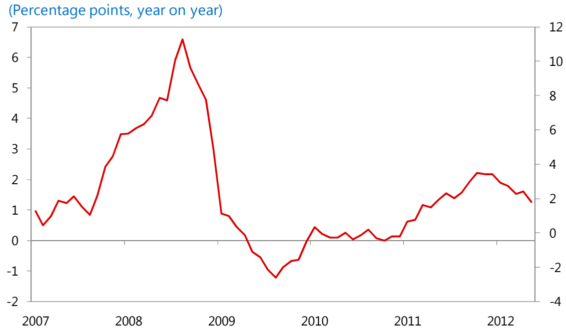


Sources: SARB and Haver Analytics, Inc.

...which pushed headline above core inflation.

Headline Minus Core Inflation

(Percentage points, year on year)

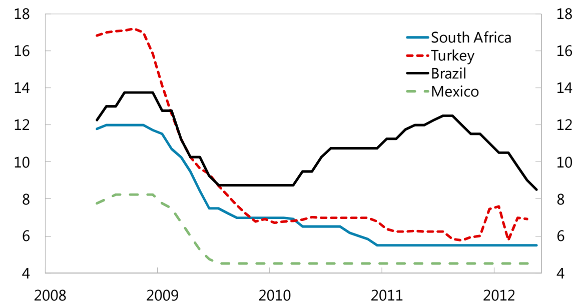


Sources: SARB and Haver Analytics, Inc.

Policy rates have been countercyclical,

Policy Rate

(Percent)

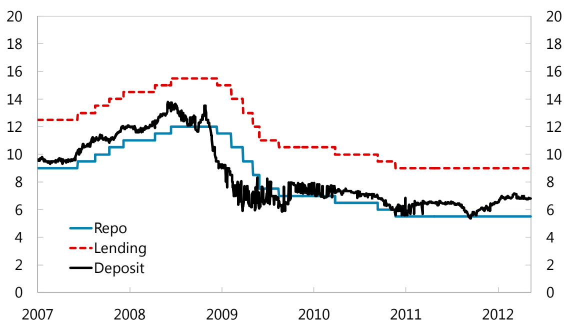


Source: Haver Analytics, Inc.

...having the desired impact on banking rates...

Banking Rates

(Percent per year)

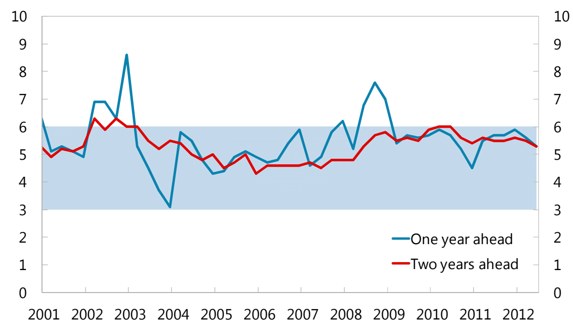


Sources: SARB and Haver Analytics, Inc.

...and keeping inflation expectations well anchored.

Survey Inflation Expectations

(Percent per year, analysts)



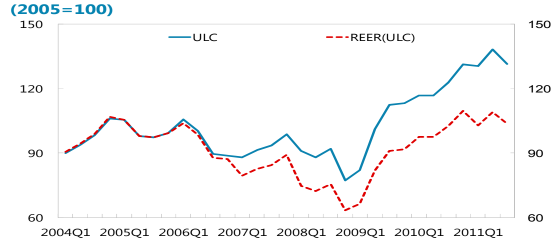
Sources: Bureau of Economic Research South Africa and Haver Analytics, Inc.

C. Flexible Exchange Rate, but Lingering External Competitiveness Problems

33. The highly flexible exchange rate regime has helped smooth external shocks. The exchange rate helps rapidly transmit news about the external environment, but also means high volatility in nominal and real exchange rates. The rand responds rapidly to changes in the VIX, whose surges give rise to shifts away from risky assets and activities (Figure 7).

34. Despite recent rand depreciation, various indicators point to enduring problems with external competitiveness. High wage bargains have contributed to high domestic costs of production, including high unit labor costs. Export volumes remain below their historically high precrisis levels and have continued to recover more slowly than partner demand, although in part they reflect a substantial decline in gold production. South Africa's market share in global export markets has increased modestly since the mid-2000s, in contrast to rapid gains by other emerging markets and commodity producers. Competitiveness problems could intensify if easy external financing conditions lead to a resumption of capital inflows to emerging markets (Figure 8).[6]

Unit Labor Costs in Manufacturing and REER (ULC) (2005=100)



Source: South African Central Bank.

35. Model-based estimates suggest the rand was overvalued in real effective terms by 5–15 percent in March 2012 (Box 2). These models aim to control for changes in fundamentals, including fiscal variables. Low structural savings and substantial investment needs justify large current account deficits but may also require significant real rand depreciation over the medium term to help service the increasing foreign liabilities, even if largely rand denominated.

Authorities' Views

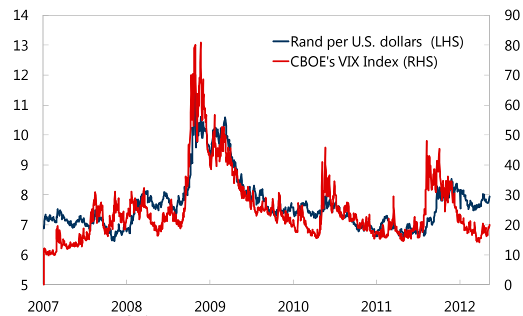
36. The authorities agreed that South African firms faced high domestic costs of production, which negatively affected their external competitiveness. They also acknowledged that low domestic savings requires relying on foreign savings for investment needs. Their models also led them to believe that the rand is somewhat overvalued, but that the precise magnitude was difficult to pin down given the high volatility in fundamentals, which implied large rand volatility. Therefore, assessments may vary by the specific date they were conducted.

[6] South Africa will be included in Citigroup's World Government Bond Index (WGBI) in October, which will increase inflows at the margin.

Figure 7. South Africa: Volatile Asset Prices

South Africa's financial variables have been highly sensitive to changes in global risk aversion, …

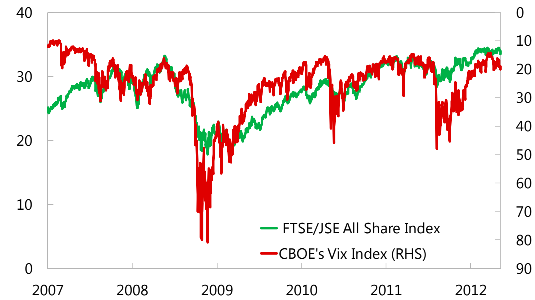
Nominal Exchange Rates and Risk Aversion[1]
(Rand per foreign currency)



Source: Haver Analytics, Inc.

… including exchange rates and stock prices, …

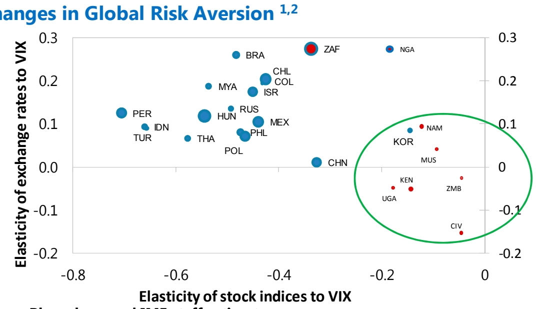
Stock Market Prices and Risk Aversion
(Indices)



Source: Haver Analytics, Inc.

…although South African exchange rates have been more sensitive than stock prices compared to peer emerging markets.

Exchange Rate Flexibility and Stock Market Sensitivity to Changes in Global Risk Aversion [1,2]



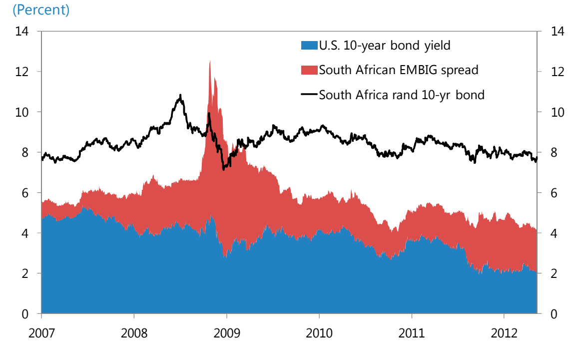
Source: Bloomberg and IMF staff estimates.

[1] A positive exchange rate sensitivity to the VIX index indicates the domestic currency depreciates when the VIX index increases.

[2] Bubble size represents R squared in linear regressions on VIX (logs, daily).

Long-term yields have remained fairly stable, even declining, …

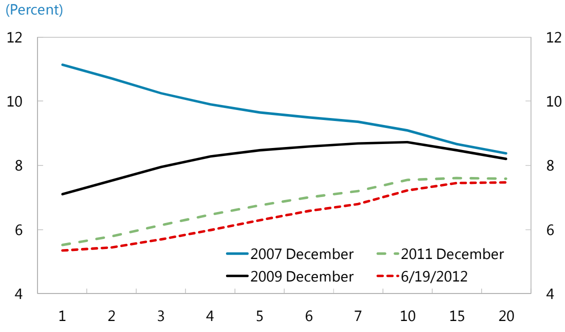
South Africa: 10-year Bond Yields
(Percent)



Source: Haver Analytics, Inc.

…with larger interest rate changes over shorter horizons.

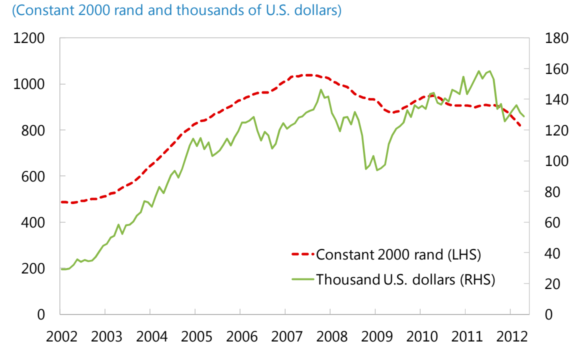
Interest Rates Swap Yield Curve
(Percent)



Source: Haver Analytics, Inc.

House prices have been volatile and lost some value in real terms.

House Prices
(Constant 2000 rand and thousands of U.S. dollars)

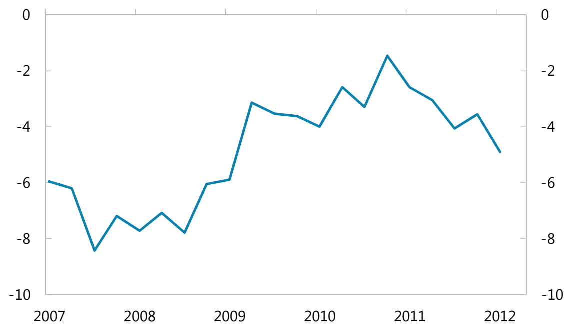


Sources: ABSA Bank and Haver Analytics, Inc.

Figure 8. South Africa: Enduring Problems with External Competitiveness

The current account weakened as softer terms of trade and labor disruptions in mining and manufacturing …

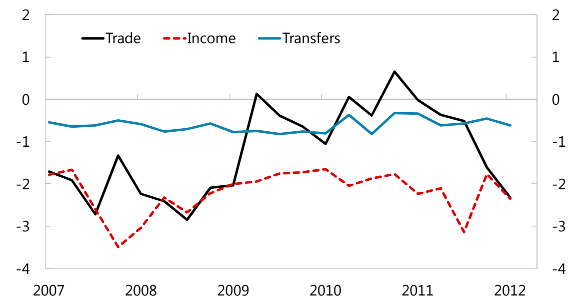
South Africa: Current Account Balance
(Percent of GDP)



Sources: SARB and Haver Analytics, Inc.

… hurt the trade account, and income transfers picked up with global financial stress.

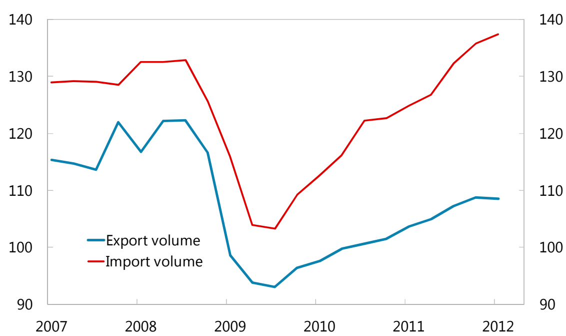
South Africa: Current Account Components
(Percent of GDP)



Sources: SARB and Haver Analytics, Inc.

…Growth in real import volumes outpaced that in real exports …

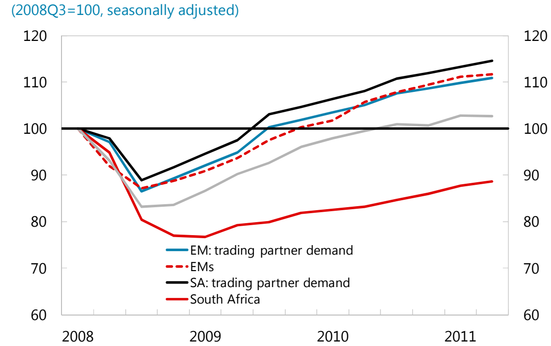
South Africa: Export and Import Volumes
(Index, 2005=100)



Sources: SARB and Haver Analytics, Inc.

… with South African exports losing market share in world markets.

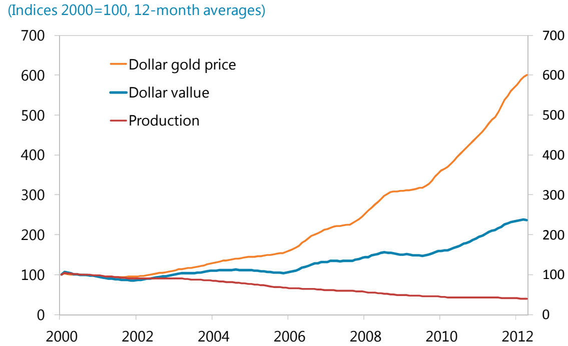
Export Volumes and Trading Partner Demand
(2008Q3=100, seasonally adjusted)



Source: United Nations Commodity Trade Statistics Database (Comtrade).

This partly reflects a secular decline in gold production

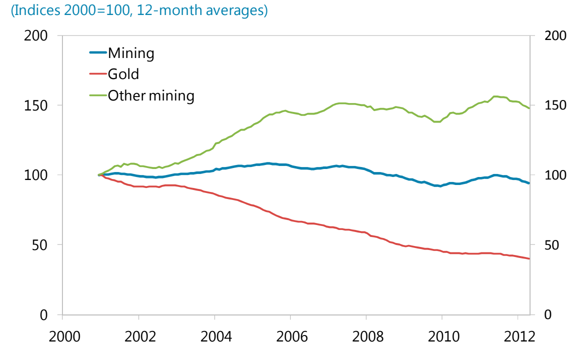
Gold Production
(Indices 2000=100, 12-month averages)



Sources: Statistics South Africa and Haver Analytics, Inc.

… and partly an offset by increased exploitation of other minerals.

Mining Production
(Indices 2000=100, 12-month averages)

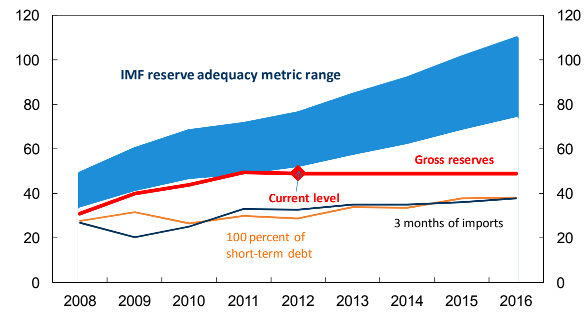


Source: Statistics South Africa.

D. Further Reserve Buildup Needed to Maintain Adequate Coverage for Precautionary Purpose

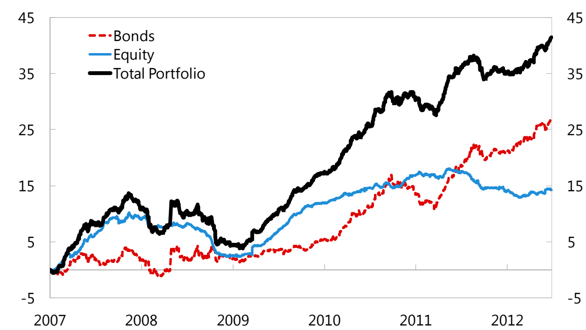
37. Further buildup of gross reserves will likely be required in the coming years to ensure reserves remain adequate for precautionary purposes. The substantial strengthening of South Africa's reserve position in recent years has contributed to investor confidence and dampened the country's vulnerability to tail risks, although at significant fiscal (sterilization) cost, borne in large part directly by the treasury.[7] Maintaining an adequate stock of safe and liquid assets will be especially critical in the current environment. Because the capital inflows needed to fund the structural current account increase financial risks, South Africa would benefit from building up further reserves for precautionary reasons. Although reserves are adequate under traditional metrics, the IMF's risk-weighted metric for reserve adequacy suggests that, under the prevailing macroeconomic outlook, further buildup might be warranted over the medium term just to remain within the adequacy range.

Gross Reserves vs. Measures of Adequacy
(Billions of U.S. dollars)



Sources: IMF and country authorities.

Portfolio Flows
(Billions of U.S. dollars, cummulative since 2007)



Source: Country authorities

Authorities' Views

38. While agreeing in principle, the authorities cautioned that they will seek to further build-up reserves for precautionary reasons as opportunities arise, and that the process will be determined by movements in the rand, and the cost of reserve buildup. They indicated that they see a variety of indicators to decide on their optimal level of reserves each year.

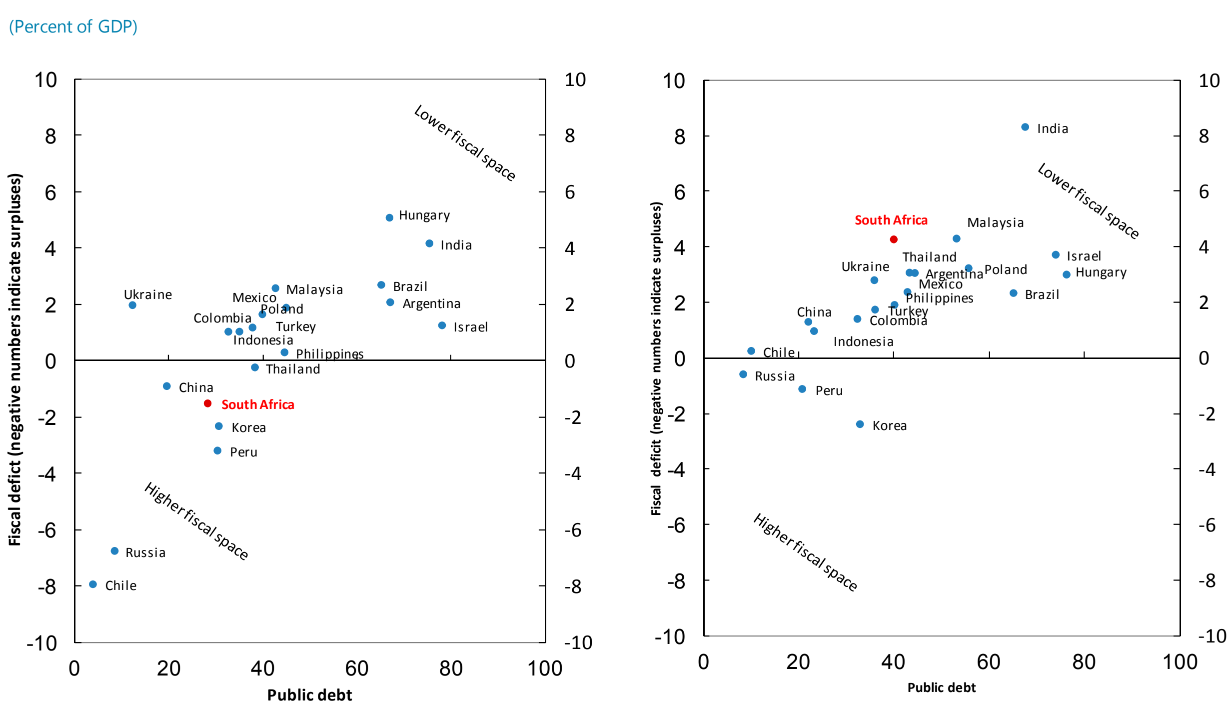
[7] The treasury holds significant deposits at the SARB for sterilization. It also covers the cost of the foreign currency swaps used to sterilize some official foreign exchange intervention, usually associated with lumpy foreign direct investment inflows.

E. Reliance on Monetary Stimulus in Severe Adverse Scenario

39. Global uncertainty and the narrower fiscal space may require difficult decisions. Staff supported the monetary policy stance. However, the SARB would have room to lower nominal policy rates if the outlook worsens given the resulting decline in economic activity and the expected moderation in inflation. The limited fiscal space would likely require policy measures to ensure fiscal sustainability (Figure 9). This could include reassessing spending limits and possible measures on the revenue side to ensure fiscal sustainability in light of the impact of the global stress on fiscal dynamics. It would not be feasible to adhere to a nominal expenditure ceiling while allowing automatic stabilizers to operate through the revenue side. Public spending should be prioritized to protect the envelope for social transfers.

40. Under a severe adverse scenario that could lead to a substantial deceleration in economic activity, the policy mix may need to rely more on monetary policy. The fiscal space would be very limited while, under such circumstances, monetary space would be available.

Figure 9. Fiscal Space South Africa and EM 20 Peer Countries: 2007 and 2012

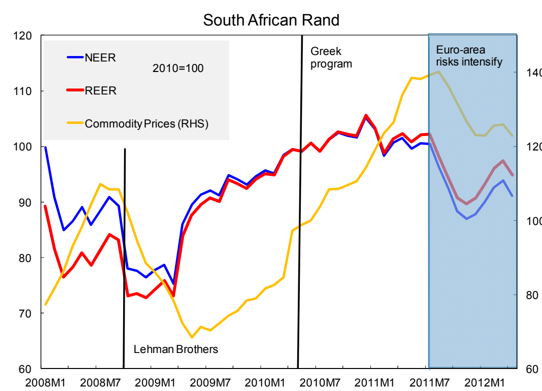


Source: World Economic Outlook.

Box 2. South Africa: External Sector Assessment

External sector risks are relatively contained. South Africa's exchange rate regime is one of the most flexible among emerging markets. The net IIP position at -18 percent of GDP in 2010 is not seen as a major source of risk. Both external debt and the net international investment position are moderate, with a large share of liabilities either in equity and/or denominated in rand. Although portfolio flows have increased, the associated risks they pose are mitigated by the free-floating exchange rate. Reserves are currently adequate according to the IMF metric. In the current environment, the quality of portfolio investments abroad of the nonbank private sector, of about 30 percent of GDP in 2010, is a possible source of vulnerability.

However, competitiveness and the elevated level of the underlying current account deficit have been more enduring sources of concern. The dollar-rand exchange rate has traded in lock-step with risk aversion indicators such as the VIX. The real exchange rate has been marginally less volatile, dampened by offsetting movements in euro-dollar exchange rates. Inflation differentials have also diminished the extent of real depreciation, but the real exchange rate was nevertheless 7 percent below its year-earlier level in April. At the same time, the increase in risk aversion has put downward pressure on commodity prices, partially unwinding the terms of trade improvements of recent years, which if sustained would imply a depreciation of the equilibrium real exchange rate.



To disentangle the relative effects of these two forces on the external assessment, we start by assessing the underlying level of the current account deficit. This involves adjusting the realized level of the current account balance to strip out temporary factors such as output gaps in both South Africa and its trading partners. As a proxy for this, we take our medium-term projection of the current account (a deficit of 5.9 percent of GDP) in 2017, by which time all such transitory factors should have dissipated. The substantial widening expected in the deficit expected over the medium term reflects in large part: (i) the transitory nature of recent terms of trade gains, (ii) higher expected deficits on net income once interest rates normalize, (iii) and transfers to other countries in the South African Customs Union (SACU). More fundamentally, they reflect South Africa's low saving rates for its large investment needs.

Application of a range of techniques, including two based on our estimate of the underlying current account, suggests that real exchange rate remained misaligned in the first quarter of 2012. In particular, CGER approach suggests misalignment of 13 percent in February-March, while preliminary estimates based on the IMF's pilot external balance assessment (EBA) approach imply that the current account deficit in 2011 was 2.5 percent of GDP higher than predicted, which is consistent with misalignment of 11 percent. Taking into account forecast uncertainty, staff assess that the real exchange rate was misaligned by 5-15 percent during this period.

The CGER methodology is based on an average of three complementary methods:

- The first of these approaches, macro-balance, compares the underlying current account with a current account norm (at minus 3 percent of GDP), implying that the underlying current account deviates from the level implied by medium-term fundamentals by around 3 percent of GDP, which is consistent with misalignment of around 17 percent.

Box 2. South Africa: External Sector Assessment (concluded)

- The External Sustainability (ES) approach compares the underlying current account with a level that would stabilize South Africa's external liabilities around the average for all emerging markets (34 percent of GDP).[1] This approach implies an even larger degree of misalignment, slightly exceeding 20 percent.
- Finally, the equilibrium exchange rate approach implies that the real exchange rate is fairly valued. The application of this approach to South Africa is complicated by the extent of structural change after the fall of Apartheid, and the need to assume that the exchange rate is in equilibrium on average over the sample period.

Assessment of Competitiveness, Feb-March 2012

	Current Account Deviation from norm	Misalignment
Equilibrium exchange rate	-2.9	0
Macro balance	-4.3	17
External sustainability		22

- **Other structural indicators, while more backward looking in nature, broadly support the conclusion of a chronic but moderate competitiveness problem.** South Africa's share of global export markets has expanded since the mid-2000s, but less rapidly than that of most large EMs. Export performance has remained weak in volume terms, with export volumes growing at a slower pace than import demand in trading partners, whereas most EMs have seen faster volume growth than trading partner demand during the same period.

[1] As in past Article IVs, the external sustainability for South Africa is based on the EM average for the net international investment, as the current level seems low for its development needs.

JOB CREATING POLICIES

41. **The structure of product and labor markets has contributed to preserving inequality and high unemployment.** South Africa's high unemployment is the result not only of chronic skill and geographical mismatches (legacies of Apartheid), but also of policies, product market structure, and labor market arrangements that end up protecting insiders at the expense of the unemployed. High margins in product markets and wages in labor markets have resulted in uncompetitive domestic costs of production, eroding external competitiveness and excluding part of the population from formal economic activity. This has constrained South Africa's ability to diversify its exports into areas that go beyond its comparative advantage of exploiting its mineral endowment. The relatively high wages and profits for insiders have resulted in higher consumer price levels and unemployment for outsiders. In addition, labor market arrangements have set entry-level wages above the productivity of inexperienced workers with little marketable skills, including through relatively high minimum wages. The struggle for dividing rents between highly concentrated, oligopolistic firms and strong and politically influential labor unions has resulted in large economic losses associated with frequent labor strikes. Although real

wages and labor productivity are cointegrated in the long-run, episodes of large wage increases like those that took place during 2008–10 tend to have long-lasting effects on unemployment and firms' incentives for hiring (Appendix III). The relatively high labor cost discourages labor demand, especially for newcomers to the labor market, and help explain the low share of labor income on GDP, which has declined in South Africa over the last two decades in line with the experience of peer emerging markets.

42. A durable pickup in job creation that reduces mass unemployment seems unattainable without major labor and product market reforms. Reducing the skills shortages of the unemployed is a gradual process that would take time to yield fruit. But, within any given distribution of skills, the ability of individuals to find jobs depends in part on the labor and product market structures. Structural policies of the types discussed below are needed to raise potential growth and make it more labor intensive.

43. Increasing product market competition will help reduce margins in consumer products (Figure 10)**.** Significant progress has been made in recent years in strengthening the antitrust legal framework and its enforcement. Continued efforts to enhance competition in product markets would include strengthening the competition commission to crack down on abuse of market dominance and collusive behavior. Penalties for market misconduct needs to rise and timeframes for due process should be shortened. Product market regulations could also be improved, especially those for setting up new firms.[8] Also, the public sector can contribute in promoting competition in the markets in which its state-owned enterprises have a presence. Where applicable, the authorities could consider opening the sector reserved for public enterprises to private sector competition. Crossborder cooperation between jurisdictions where cartels operate could also help contain anticompetitive practices in South Africa.

44. More flexibility in the wage-setting mechanism, supported by well-designed and targeted active labor market measures, can support employment by better aligning wages with productivity levels at the firm level. A more flexible wage bargaining mechanism, for example for small, and medium enterprises (SMEs) or newly created businesses, as well as more flexible labor laws and regulations are essential to improve the business environment and increase employment opportunities, especially for newcomers with limited skills. In that regard, draft labor law amendments in Parliament may reduce employment as they imply restrictions on the flexible contractual arrangement that led to large increases in employment during 2004–07 (Figure 11).

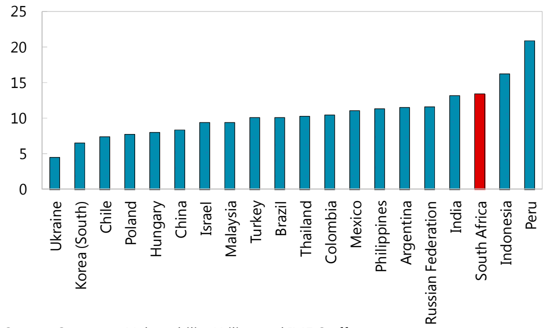
[8] In the OECD's product market regulations index, South Africa ranks poorly compared to the OECD median because regulations remain a substantial entry barrier for new firms.

Figure 10. South Africa: Product Market Highlights

Non-financial firms are highly profitable,...

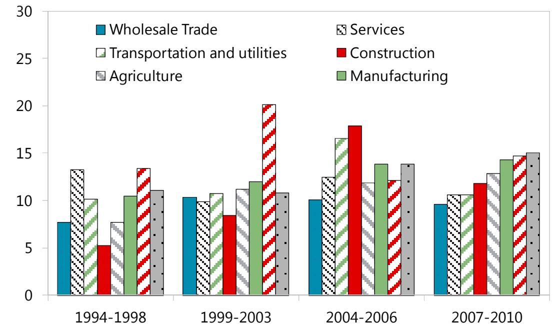
...across sectors and over fairly long periods.

Return on Asset (average of 2007–2010)
(Percent)



Source: Corporate Vulnerability Utility, and IMF Staff.

Return on Assets
(Percent)

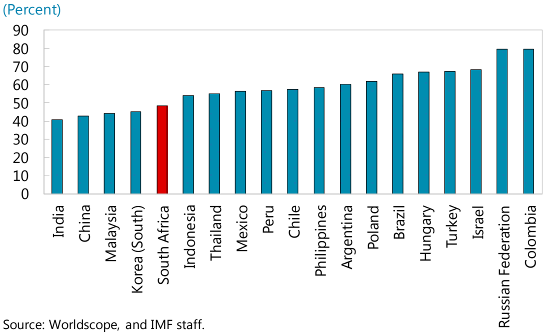


Source: Corporate Vulnerability Utility, and IMF staff estimates.

Although South African industries are not as concentrated as that of emerging market peers, ...

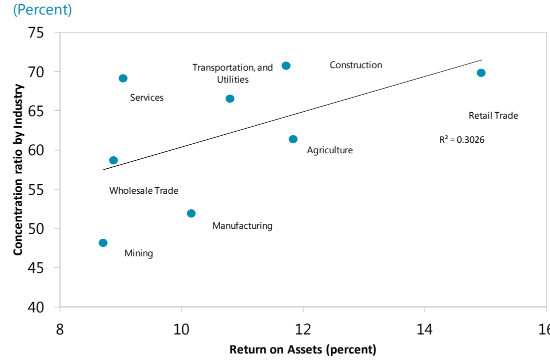
... more concentrated industries have higher returns.

Industry Concentration Ratio
(Percent)



Source: Worldscope, and IMF staff.
Note: The industry concentration ratio is the assets of top two companies by asset as a share of top 15 companies' asset in each industry, aggregated with asset weight across industries.

Industry Concentration and Profitability, 2009
(Percent)

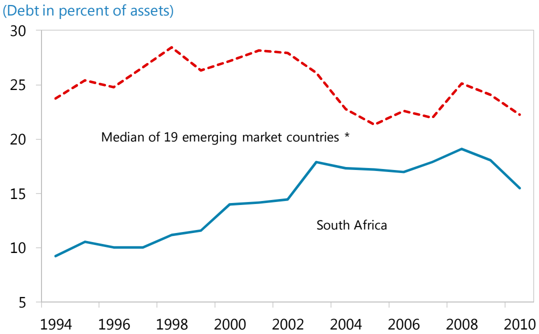


Source: Corporate Vulnearbility Utility, and IMF staff estimates.

Although South African firms have increased their leverage over time, ...

they tend to borrow less than firms in peer emerging markets.

Nonfinancial Corporate Leverage, 1994–2010
(Debt in percent of assets)



Source: Worldscope, and IMF staff calculation
* These countries include Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Philippines, South Korea, Thailand, Hungary, Israel, Poland, Russia, South Africa and Turkey.

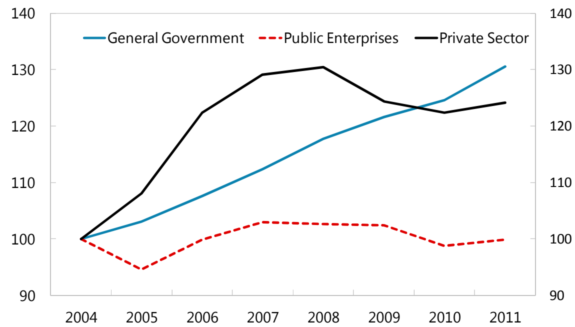
Non Financial Corporate Sector Leverage, 2010
(Debt in percent of assets)

Source: Worldscope, and IMF staff calculations

Figure 11. South Africa: Labor Market Highlights

Private sector employment has not recovered since the crisis, while government employment is picking up.

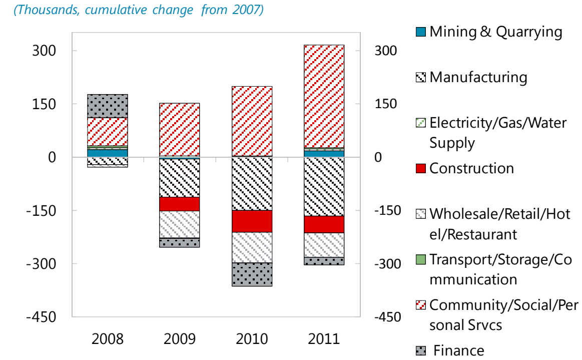
Employment
(SA, 2004=100)



Sources: Haver Analytics, Inc., and IMF staff.

Manufacturing and trade sectors have shed the most jobs since 2007…

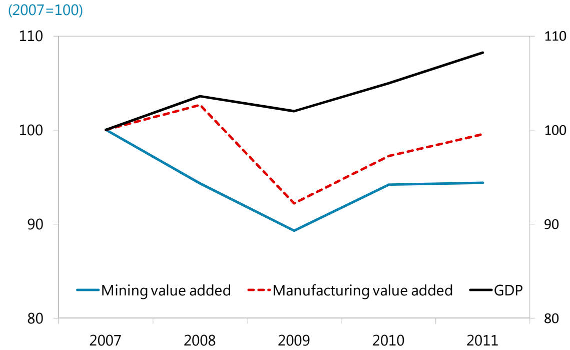
Sectoral Employment
(Thousands, cumulative change from 2007)



Sources: Haver Analytics, Inc. and IMF staff estimates.

… while manufacturing and mining have lagged behind the recovery.

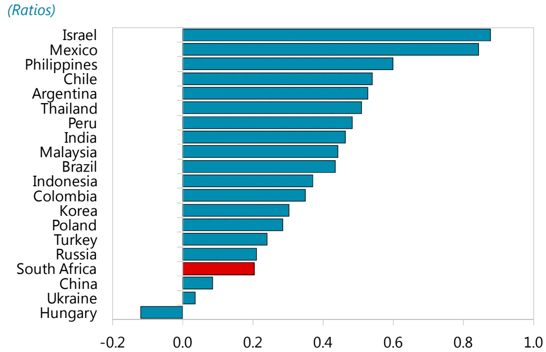
South Africa - Value Added in Mining and Manufacturing
(2007=100)



Source: Statistics South Africa.

South Africa has not created as much jobs out of economic growth as peer emerging markets.

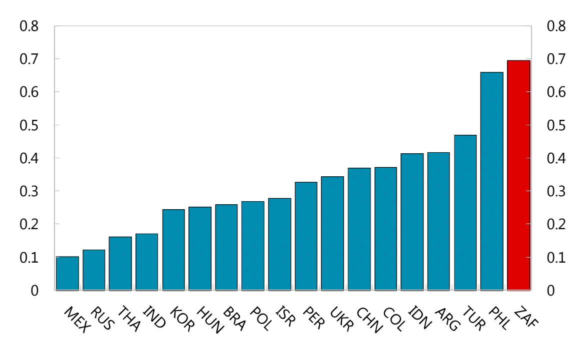
Job Growth (%)/GDP Growth (%): 2000-2011
(Ratios)



Sources: WEO, and IMF Staff

Entry level wages are relatively high …

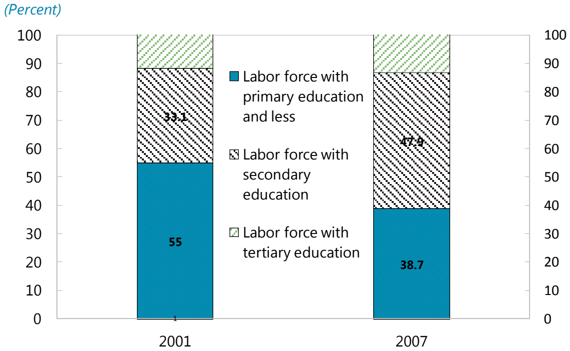
Minimum Wage/Average Value Addition



Source: World Bank, Doing Business Indicators, 2012.

… especially for those with low skills.

Labor Force Education Level
(Percent)



Source: World Bank, World Development Indicators.

45. In the short run, employment can also be supported through active labor market policy (ALMP) measures. These could include temporary youth wage subsidies, transport subsidies for job seekers, and other schemes to provide working experience and on-the-job training. Staff noted such schemes should be carefully designed to prevent abuse and create net employment, with spending in this area tightly controlled given the fiscal cost of such schemes. Temporary public work programs could also provide an important safety net for the unemployed, would be self-selecting if wages are kept low, and would not permanently increase the public wage bill.[9] Staff argued, however, that the recent increase in public sector employment is not a cost effective or efficient way to increase employment. It may crowd out critical health and education spending and tend to put upward pressure on wages in the economy, thereby limiting the impact on aggregate employment.

Authorities' Views

46. The authorities emphasized the need for product market reforms to complement those of the labor market. They felt that greater emphasis should be placed on the former, and cautioned that the political economy of South Africa makes it difficult to carry out radical labor market reforms, given the historically difficult hard-won rights of the labor movement. The largest umbrella labor union, Congress of South African Trade Unions (COSATU), emphasized three main points. First, greater emphasis should be given to temporary public works programs. Second, in its present form, the youth wage subsidy would not lead to a net increase in permanent employment. Third, the current labor protection laws does allow for SMEs to be exempted from certain collective bargaining agreements. With regard to the last point, the authorities clarified that this was, in practice, very difficult to achieve.

[9] According to the Budget Review, the governments' existing ALMP programs include training courses and apprenticeships to enhance skills, 125 labor centers offering job-search and job-matching services, public work programs that provide short-term jobs to the unemployed, a Jobs Fund to support projects with the potential to create a large number of jobs, and training layoff schemes to subsidize the temporary suspension of work in favor of training. Government spending on public work programs has increased from R4.2 billion (0.6 percent of consolidated government expenditure) in 2008/09 to R7.8 billion (0.8 percent of expenditure) in 2011/12.

REGIONAL INTEGRATION

47. South Africa's de facto economic and financial integration with the sub-Saharan Africa (SSA) region has significantly expanded over the last few years. With the large reduction in external demand from Europe, South African firms have further diversified their export markets into SSA. South Africa's exports to the region amounted to about 15 percent of exports in 2011. SSA accounts for a third of South African manufacturing exports. These increased linkages increase the scope for inward and outward spillovers (Appendix I).

48. South Africa has also expanded its foreign direct investment to the region. South African banks already have an important Pan African presence, and, in 2012, some of the largest ones have announced significant expansion plans into SSA. South African firms also have important presence in developing mining projects in the region (Figure 12)).

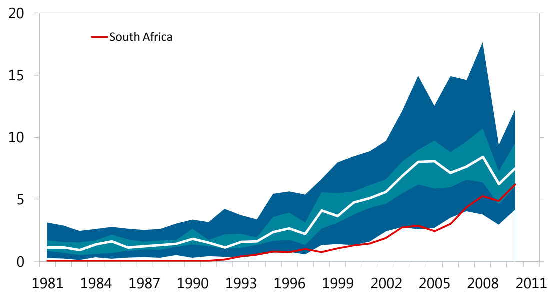
49. Progress in multilateral trading arrangements has continued, with the emphasis on removing nontariff barriers to trade, including red tape and infrastructure shortfalls. With three country exceptions, the free trade agreement under the Southern African Development Community (SADC) should be fully implemented in 2012 with almost all tariff lines traded duty free. In addition, the June 2012 SADC summit highlighted a regional infrastructure development master plan for implementing infrastructure networks in the key sectors such as energy, transport, among others. The negotiations for a free-trade area covering the 26 member countries of SADC, the East African Community (EAC) and the Common Market for East and Southern Africa (COMESA) that started in 2011 have also continued with a view of concluding negotiations by 2014 and implementation by 2015. The work plan on this tripartite arrangement also focuses on building infrastructure for regional trade.

50. In the South African Customs Union (SACU), further integration continues along the five priority areas highlighted in the 2010 summit. The reform of the 2002 revenue sharing formula has identified the principles that would underpin the formula to improve the predictability of these revenues. In addition, SACU countries are working toward promoting industrial development among SACU members, improving trade facilitation, developing common SACU institutions, and engaging in joint trade negotiations with third parties.

Figure 12. South Africa: Regional Integration and Interlinkages

South Africa has been increasing its trade with sub-Saharan countries in the last decade,...

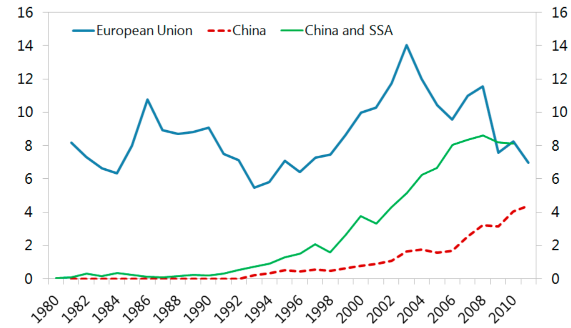
SSA: Intra SSA Trade Distribution: 1980–2010
(Percent of each SSA-country GDP)



Sources: IMF Direction of Trade Statistics
Shaded areas reflect the three center quintiles of the distribution. The white line represents the median.

... and South Africa now exports as much to China and SSA as it does to the European Union.

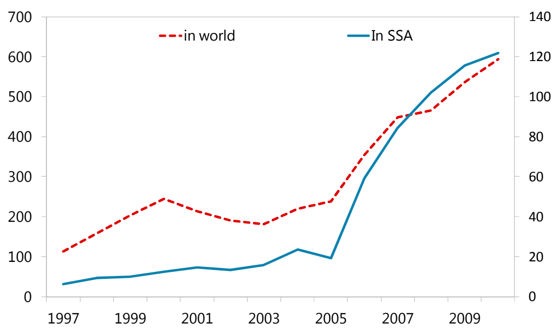
South Africa - Exports to European Union and China
(Percent of GDP)



Sources: IMF Direction of Trade Statistics.

South Africa has also increased its foreign direct investment in the SSA, ...

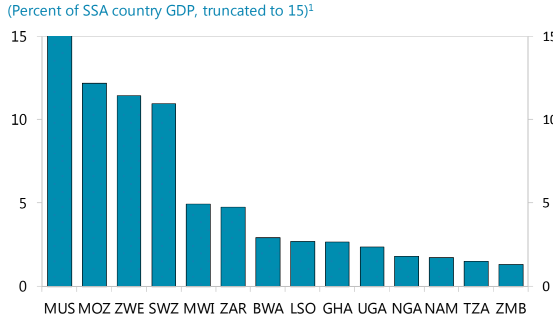
South Africa: Foreign Direct Investment in SSA
(Rand billion)



Source: SARB.

... and is an important source of FDI within SSA.

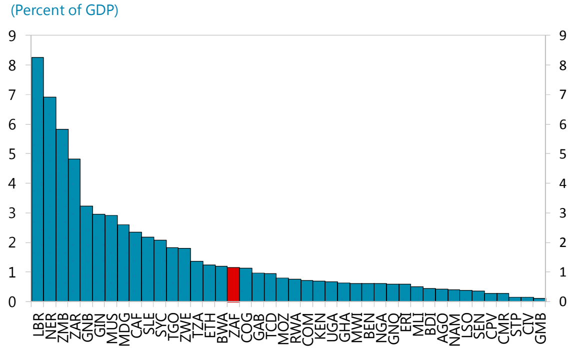
South Africa: FDI in Selected SSA Countries
(Percent of SSA country GDP, truncated to 15)[1]



Sources: Coordinated Direct Investment Survey and IMF's World Economic Outlook.
[1]Observation for Mauritius (MUS) is 82 percent of GDP.

Chinese FDI is important for many countries in SSA, but not yet for South Africa.

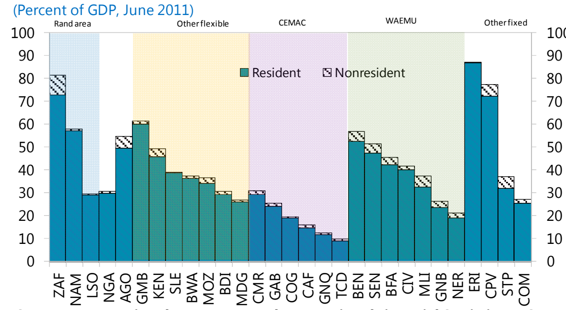
Chinese Investment in Sub-Saharan Africa
(Percent of GDP)



Source: Statistical Bulletin of China's Outward Foreign Direct Investment, 2010.

Cross-border banking exposures are very limited throughout the region.

SSA: Banking System Funding [1]
(Percent of GDP, June 2011)



Sources: International Monetary Fund International Financial Statistics (IFS).
[1] Includes banking system data from disaggregated information submitted to the IMF for the preparation of monetary statistics and the compilation of summary data presented at the IFS. About half the sample is reporting under the new standardized format.

51. The increased integration of South Africa with the region also increases the scope for inward and outward spillovers. Typically, South Africa exports more to SSA countries than vice versa. Although developments in individual SSA countries may be small for South Africa, as a whole the region plays an important role in South Africa's external demand. In practice, because SSA depends crucially on commodity prices, which in turn depend on developments in China, South Africa's intraregional trade essentially increases its exposure to China.

STRENGTHENING FINANCIAL STABILITY

52. South African banks proved resilient to the 2008–09 global financial crisis. Financial soundness indicators remain at comfortable levels and have partially recovered from the effects of the global financial crisis. Banks have increased their capital adequacy ratios and their liquidity buffers, which are currently well above regulatory limits. Profitability has started to increase from a low base as a decline in impaired loans has offset large increases in operational costs (Figure 13).[10]

53. A limited dependence on external funding and low direct exposure to euro area periphery countries have so far allowed South African banks to remain largely unaffected by the recent increase in global financial stress. Although UK financial institutions own two of the largest banks, their subsidiaries fund their operations with local deposits. Nevertheless, banks are likely to be affected through real sector channels, as financial conditions affect real sector developments with a lag (Appendix IV). The large nonbank financial sector—closely linked to the banking sector through cross-ownership structures—also appears to have weathered the crisis well, partly due to high capital levels in the insurance sector, the predominance of defined contribution pension funds, and conservative investment strategies.

54. Some risks remain. Banks are heavily exposed to fluctuations in house prices through the collateral value of their mortgage portfolio, the main asset in their balance sheet.[11] Banks are also subject to risks associated with the business cycle, which would increase impaired loans and compromise profitability, especially if unemployment rises. South African banks are also subject to liquidity risk through their

[10] Loans become impaired when the bank or supervisory authority conclude that the principal or interest of the loan cannot be collected as envisaged in the loan contract.

[11] By May 2012, house prices had declined by 7 percent in nominal terms from their peak in August 2011. On the other hand, household debt and financing costs to disposable income have been steadily declining since 2008.

dependence on short-term domestic wholesale liabilities, although in practice this source of funding has been very stable because it largely corresponds to contractual savings in pension and insurance schemes. The low profitability exposes banks to the temptation of looking for higher yields taking increasing risks. Prolonged period of easy money could eventually lead to high credit growth and a gradual buildup of balance sheet vulnerabilities. The rapid expansion in unsecured lending, albeit from a low base requires close monitoring.

Institutional reforms and Basel III implementation

55. Staff welcomes the ambitious program to strengthen the legal framework for bank supervision and improve crisis management frameworks. These legal reforms (including the twin peaks regulatory structure that consolidates power for prudential regulation and supervision on one end and market conduct on the other) would lead to significant progress in adopting FSAP recommendations and attaining the Basel III liquidity requirements and other G20 initiatives.[12]

56. Progress has been made toward achieving Basel III benchmarks. South African banks already meet the more stringent capital requirements. In addition, the authorities have adopted the alternative treatment to meet the Basel III liquid coverage ratio requirements, and the SARB has created a liquidity facility for this purpose and allowed banks to count their statutory reserves as high quality liquid assets. However, difficulties meeting the net-stable-funding ratio (as currently envisaged by the 2018) implementation date could result in higher interest rates (as banks try to attract longer term deposits) or deleveraging. To avoid this, it will be important to engage in a constructive dialogue with the Basel Committee on the stability of rand wholesale funding while looking for opportunities to extend the duration of bank liabilities.

Macroprudential and capital flow measures

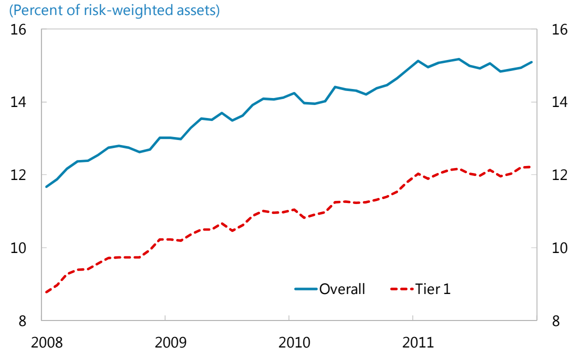
57. Staff supports the gradual and cautious pace in liberalizing capital controls and replacing them with prudential regulations addressing the underlying risks. Staff emphasized that liberalization of limits on foreign investments of domestic nonbank institutional investors should proceed slowly to give time to address the liquidity risk for banks that depend on domestic wholesale funding.

[12] An ongoing peer review by the Financial Stability Board will focus on South Africa's experience with (1) interagency coordination and the introduction of a 'twin peaks' regulatory structure and (2) over-the-counter derivatives market reforms. The report will include a self assessment of progress in implementing FSAP and ROSC recommendations.

Figure 13. South Africa: Resilient Banking System

Financial soundness indicators have stabilized at comfortable capital adequacy levels …

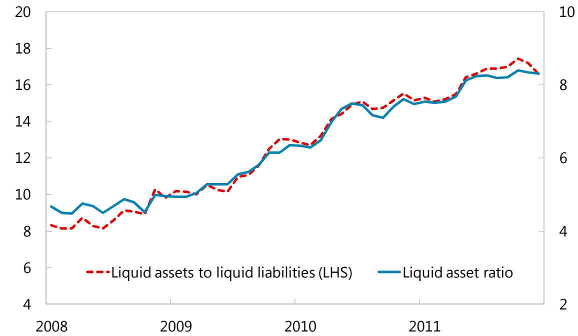
Capital Adequacy Ratios
(Percent of risk-weighted assets)



Source: SARB

…and liquidity,…

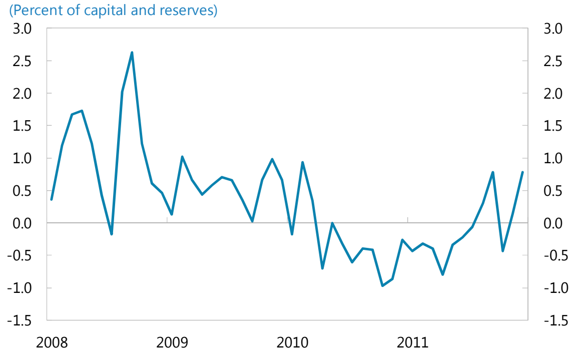
Liquidity Indicators
(Percent of assets and of liabilities)



Source: SARB

…with well contained exchange rate risks.

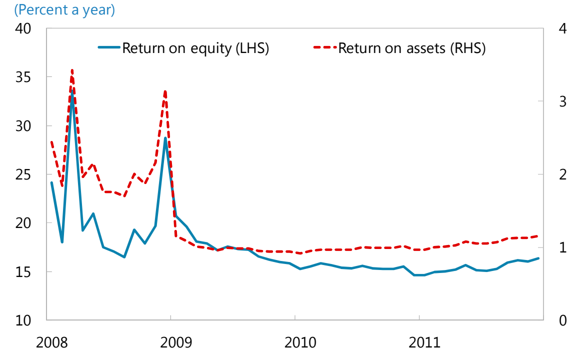
Net Open Foreign Exchange Position
(Percent of capital and reserves)



Source: SARB

However, profitability has remained low,…

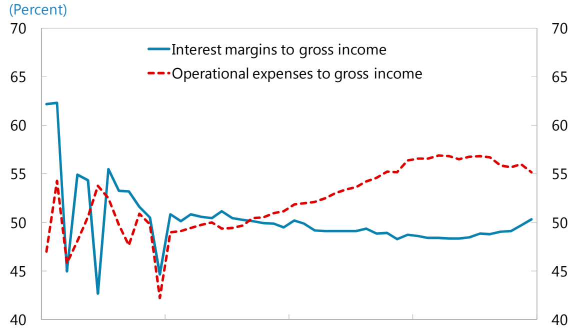
Profitability Indicators
(Percent a year)



Source: SARB

… as interest margins have started to recover and operational expenses to fall relative to gross income, …

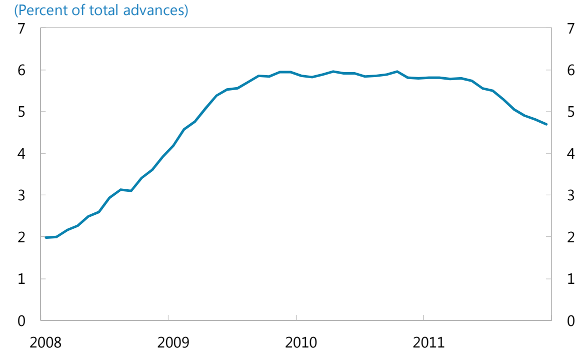
Operational Indicators
(Percent)



Source: SARB

…with an acceleration in the decline of impaired advances.

Impaired Advances
(Percent of total advances)



Source: SARB

58. The authorities have decided not to add capital inflow management measures to their policy toolkit at this time. This follows careful examination of the experiences of other countries, but also reflects that pressures for adopting such measures have subsided with global stress arising from Europe. Various concerns about the use of capital flow measures (CFMs) may have also played a role, including South Africa's large reliance on foreign savings, doubts about the effectiveness of CFMs, and their possible unintended effects, especially if inadequately designed and calibrated. However, if South Africa were to add CFMs to its policy toolkit in the future, staff recommended that they complement rather than substitute macroeconomic policy adjustments. In practice, the authorities' response to earlier capital inflow episodes has been eclectic, including allowing the exchange rate to appreciate, maintaining an accommodative monetary stance, liberalizing capital outflow controls, and building international reserves.

STAFF APPRAISAL

59. South Africa's economic and financial policy frameworks have reliably delivered domestic and external stability. Despite a highly uncertain and volatile external environment, the inflation targeting regime has anchored inflation expectations within the 3–6 percent target range. In turn, the flexible exchange rate regime has helped cushion the large real and financial external spillovers to which a small open economy such as South Africa is exposed. Credibility in the government's ability to pay back its mostly rand-denominated debt has allowed South Africa to maintain its public spending plans despite the decline in its fiscal revenue. This credibility depends not only on the government's ability to generate surpluses to honor its future debt payments, but also on the SARB's ability to maintain a predictable value of the rand.

60. Distress in Europe has delayed South Africa's recovery. Although the slowdown should be temporary before growth picks up over the next few years to close the persistently negative output gap, risks are tilted to the downside. For example, South Africa would be negatively affected, mainly through real sector channels, from a severe intensification of the euro area crisis, especially if it were to affect global risk aversion and investor confidence.

61. The monetary policy stance has appropriately reacted to the slowdown. Although nominal rates have remained unchanged since November 2010, the pickup in inflation expectations toward the upper end of the band have de facto implied additional stimulus from lower real interest rates. The large degree of uncertainty requires close vigilance from the SARB to provide as much stimulus as possible while keeping one-year-ahead inflation expectations within the target.

62. **Although the more gradual fiscal consolidation is broadly appropriate, rebalancing the composition of public spending remains a priority.** Essentially, within the overall spending envelope envisaged, the wage bill needs to fall and capital spending to increase, especially for priority areas such as health and education. The new drive for public infrastructure in network industries should help remove the bottlenecks that have been holding back growth opportunities. Given the large uncertainties in the world economy, any revenue overperformance should be saved to reduce the amount of debt accumulation.

63. **After four years of monetary and fiscal stimulus, the policy space to deal with adverse shocks has significantly diminished.** This is particularly acute on the fiscal side, where this space will further shrink with the global stress, as fiscal revenue is likely to decline. In contrast, monetary space will likely widen under such a deflationary scenario, suggesting that the authorities may need to rely more heavily on countercyclical monetary policy to cushion the effect of the adverse spillovers arising from the global turmoil.

64. **Despite recent currency depreciation, South Africa continues to face an external competitiveness problem.** This reflects, in part, high domestic costs of production arising from inadequate public infrastructure, market power in product and labor markets, and burdensome regulations that inhibit labor and product market entry and flexibility. In addition, the structural imbalance that results from low domestic savings for the large investment needs requires a more depreciated rand in the medium-term to service the foreign liabilities, even if rand denominated.

65. **High unemployment, especially of the young, could eventually become politically and socially unsustainable.** A four-pronged approach is needed to improve external competitiveness and reduce structural unemployment:

- Labor and product markets reforms to increase their flexibility, contestability, and access, which would contribute to reduce domestic costs of production;
- Improved service delivery in health and education to improve human capital, marketable skills, and entrepreneurship of the currently unemployed;
- Short-term active labor interventions to create first-time employment opportunities for the young; and
- Better infrastructure in network industries that remove bottlenecks and support higher growth rates.

66. **Although vulnerabilities remain low, risks have increased.** External debt remains moderate and about half of it rand denominated. International reserves are

currently adequate, but the expected increase in foreign liabilities warrants increasing reserve coverage over the medium term.

67. South African financial institutions remain sound, liquid, and profitable, and impaired loans have started to decline. Although direct crossborder exposures are limited, South African financial institutions would be indirectly affected through real sector channels, which would tend to increase impaired loans.

68. Staff recommends that South Africa remains on the standard 12-month Article IV consultation cycle.

Table 1. Authorities' Response to Past IMF Policy Recommendations
(Scale—fully consistent, broadly consistent, marginally consistent, or inconsistent)

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal policy Tighten fiscal stance over the medium term. Rebalance the composition of public spending Limit annual (primary) real spending growth to around 2 percent. Wage moderation in the public sector.	**Broadly consistent** The 2012 Budget calls for rebalancing public spending and wage moderation. The implicit real annual primary spending growth is 2.7 percent over the 3-year budget horizon. However, in 2011, the wage bill exceeded budgeted levels and capital spending allocations remained unfulfilled. Growth in real public wages did moderate due to higher inflation.
Public enterprises Expand electricity capacity in a timely fashion.	**Fully consistent** Eskom is planning to ramp up its investment plan. In 2013 will start partial operations one of the two power plants that will increase installed capacity by [20] percent by 2018.
Monetary policy Given high uncertainty to the outlook, delay the start of tightening monetary policy.	**Fully consistent** The policy rate was kept unchanged while inflation expectations remained within the target band.
Reserve policy Increase reserve buildup in the near term.	**Marginally consistent** Reserves have fluctuated around a relatively stable level, partly reflecting valuation changes.
Capital flow management Keep exchange rate flexibility and continued building reserves in the near term, and gradually recalibrate the fiscal-monetary policy mix over the medium term.	**Broadly consistent** South Africa has one of the most flexible exchange rate regimes in emerging markets. No capital inflow management measures have been added to the toolkit.
Labor reforms Increase labor and wage flexibility. Endow the wage bargaining framework with sufficient flexibility to exempt smaller firms and reduce unnecessary regulatory burdens facing firms.	**Inconsistent** Labor regulations in South Africa play an important role in protecting worker rights, but may also impose rigidities and contribute to unemployment. Amendments to the labor laws brought to the attention of Parliament would constrain the role of labor brokers, which had given some flexibility to the labor market and accounted for a substantial increase in employment during 2005-2008.
Product market regulation Remove burden of regulation and barriers to entry in key network industries.	**Broadly Consistent** The new Companies Act makes it easier to start, sell, or close a business. The development of standards has enabled growth in new sectors. Tax thresholds to firms have been increased to encourage small businesses.
Financial sector policy Continue progress in adopting FSAP recommendations, adopting Basel III initiatives, and setting the institutional and regulatory infrastructure for the twin-peaks system.	**Fully consistent** Significant overhaul in laws and regulations to reach the objectives.

Table 2. South Africa: Risk Assessment Matrix (RAM)[1]

Source of Risks	Relative Likelihood	Impact if Realized
1. Strong intensification of the euro area crisis	**Medium**	**Medium to High** Such intensification would have global effects, including lower world growth, falling commodity prices, and higher risk aversion that leads to capital outflows and volatility. It would directly affect about ¼th of South African exports, especially of manufactured goods. The indirect effect depends on associated decline in commodity prices and increase in global risk aversion, which would affect confidence and domestic demand.
2. Sharp slowdown in China	**Low**	**Medium to High** A slowdown in China would reduce global commodity prices. It will directly affect about 12 percent of South African exports. Indirectly it would likely affect South Africa's exports to sub-Saharan Africa (about 15 percent of exports), which depends heavily on commodity prices. Low commodity prices would lower domestic income and demand.
3. Idiosyncratic adverse terms of trade shock resulting from lower non-oil commodity prices or a sharp increase in oil prices.	**Medium** Slowdown in economic activity may lead to lower commodity prices. **Low** Oil prices may increase beyond cyclical levels for geopolitical considerations.	**Medium** Adverse terms of trade would have adverse income effects on domestic demand and may on the margin reduce mineral exports. A sharp rise in oil prices would also increase headline inflation and could have second round effects on core inflation. Geopolitical tensions could affect South Africa's cost of refining, which depends heavily on Iranian oil.
4. Sharp fall in nominal house prices.	**Low**	**Medium** Home mortgages account for a significant share of banks' loan portfolio, and a sharp drop may increase bank nonperforming loans, hurt profitability, and erode their capital base.
5. Large capital inflows	**Medium** Easy external financial conditions, characterized by low global interest rates, may result in high inflows into emerging markets once risk aversion subsides.	**Low to Medium** Large inflows would ensure low interest funding of the current account and fiscal deficits, but the resulting real appreciation may affect growth, if not accompanied by booming economic activity abroad.
6. Ratings downgrade	**Medium**	**Low** A possible downgrade has already been priced in, and partly offset by the inclusion of South Africa in Citi's emerging market index.
6. Regulatory deleveraging	**Medium**	**Low** As currently defined, the BIS's net stable funding ratio may require South African banks to replace their domestic wholesale funding with more expensive funding, to increase their liquidity, or to deleverage. These may affect bank profitability and hurt credit growth.

[1] The RAM shows events that could materially alter the baseline path—the scenario most likely to materialize in staff's view.

Table 3. South Africa: Selected Economic and Financial Indicators, 2008–17

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Annual percent change, unless otherwise indicated)									
National income and prices										
Real GDP	3.6	-1.5	2.9	3.1	2.6	3.4	4.0	3.9	3.7	3.7
Real GDP per capita	2.5	-2.6	1.8	1.9	1.4	2.2	2.7	2.7	2.5	2.5
Real domestic demand	3.5	-1.6	4.2	4.3	2.7	2.7	4.2	4.0	3.4	3.6
GDP deflator	8.3	7.7	7.9	8.0	6.9	5.4	5.1	4.9	4.7	4.7
CPI (annual average)	11.5	7.1	4.3	5.0	5.7	5.3	5.0	4.8	4.7	4.7
CPI (end of period)	10.1	6.3	3.5	6.1	5.4	5.3	4.9	4.8	4.7	4.7
CPI (end of period) 1/	10.1	6.3	3.5	6.1	5.4	5.3	4.9	4.8	4.7	4.7
CPIX (period average) 1/	11.3	7.6	4.4							
Labor market										
Unemployment rate (in percent)	22.9	23.9	24.9	24.9	22.7	22.5	22.2	21.7	21.2	20.7
Average remuneration (formal nonagricultural sector) 2/	12.8	11.8	13.5	7.1	8.4	8.0	7.6	7.4	7.3	7.3
Labor productivity (formal nonagricultural)	1.7	1.5	3.6	0.9	3.8	3.6	3.3	3.0	2.8	2.8
Unit labor costs (formal nonagricultural)	10.9	10.1	9.6	6.1	4.4	4.2	4.1	4.3	4.4	4.4
External sector										
Current account balance (percent of GDP)	-7.2	-4.0	-2.8	-3.3	-4.8	-5.2	-5.9	-5.9	-5.9	-5.8
Overall balance of payments (percent of GDP)	1.2	0.7	1.2	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt (percent of GDP)	26.6	27.6	28.7	27.3	32.0	33.8	35.7	37.7	39.8	42.0
Gross reserves (SARB, in billions of U.S. dollars)	34.1	39.7	43.8	48.9	48.9	48.9	48.9	48.9	48.9	48.9
(in months of total imports)	3.8	5.9	5.3	4.9	4.8	4.7	4.4	4.2	4.1	3.9
Merchandise exports, f.o.b. 3/	12.0	-22.7	29.5	20.5	-1.5	2.8	3.1	5.6	5.7	5.7
Merchandise imports, f.o.b. 3/	10.2	-26.7	24.4	23.2	1.7	2.4	5.3	5.4	3.9	4.5
Export (goods and services) volume	1.8	-19.5	4.5	5.6	3.6	5.3	5.2	5.8	6.0	5.8
Import (goods and services) volume	1.5	-17.4	9.6	9.7	3.7	3.2	5.8	5.7	4.5	4.9
Terms of trade	0.5	8.0	7.4	2.4	-3.1	-1.7	-1.4	0.4	0.7	0.6
Nominal effective exchange rate 4/	-26.8	25.5	12.3	-16.9	...	...	...	...	...	...
Real effective exchange rate 4/	-16.3	22.1	10.1	-13.8	...	...	...	...	...	...
Money and credit										
Net domestic assets 5/	9.6	3.7	6.8	0.1	9.5	8.2	9.1	9.1	9.1	9.2
Broad money (including foreign exchange deposits)	14.8	1.8	6.9	8.3	9.9	9.7	9.8	9.8	9.8	9.8
Velocity (GDP/average broad money)	1.2	1.2	1.3	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Bank rate/repurchase rate (period end, in percent)	11.5	7.0	5.5	5.5	...	...	...	...	...	...
Broad money (period average)/GDP (in percent)	81	81	75	72	73	73	73	74	75	75
	(In percent of GDP, unless otherwise indicated)									
Investment and saving										
Investment (including inventories)	22.7	19.6	19.4	19.7	20.9	21.9	22.4	22.6	22.7	23.0
Of which: public fixed investment (incl. public enterprises)	7.8	8.3	7.4	7.1	7.4	7.4	7.2	7.0	6.8	6.6
private fixed investment	15.2	13.5	12.2	11.8	12.0	12.3	12.7	13.1	13.5	13.9
Gross national saving	15.5	15.6	16.6	16.4	16.1	16.7	16.6	16.7	16.9	17.2
Public (incl. public enterprises)	5.1	1.2	-0.5	0.3	0.0	0.5	1.4	2.3	3.3	4.2
Private	10.4	14.4	17.1	16.1	16.2	16.2	15.2	14.4	13.6	13.0
Consolidated budget and other fiscal indicators 6/										
Revenue, including grants	29.8	27.8	27.5	27.5	27.6	27.9	28.2	28.6	29.0	29.4
Expenditure and net lending	30.2	33.1	32.3	32.0	31.9	31.7	31.4	30.9	30.4	29.8
Overall balance	-0.5	-5.3	-4.8	-4.4	-4.4	-3.8	-3.2	-2.3	-1.4	-0.5
National government debt	27.4	31.5	35.3	38.7	40.2	41.3	42.1	41.8	40.4	38.2

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/ At current prices; annual percent change.

3/ U.S. dollars; annual percent change.

4/ End-of-period.

5/ Contribution (in percentage points) to the growth of broad money.

6/ Calendar-year figures are based on National treasury's historical data and staff's projections starting 2012.

Table 4. South Africa: Consolidated Government Operations, 2008/09–2014/15[1]
(In percent of GDP unless otherwise noted)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Proj.			
				Authorities' 2011 Budget			
Total revenue and grants	29.7	27.2	27.5	27.7	27.4	27.8	28.0
Total expenditure	30.8	33.9	31.7	32.5	32.1	31.7	31.0
Current	28.2	30.2	29.0	30.1	29.7	29.3	28.3
Wages and salaries	10.1	11.2	11.2	11.6	11.2	10.9	10.5
Other goods and services	5.2	5.7	5.2	5.5	5.4	5.3	5.1
Interest	2.5	2.6	2.4	2.6	2.7	2.8	2.7
Transfers	10.3	10.8	10.1	10.5	10.3	10.3	10.0
Capital expenditure	2.2	2.3	2.0	2.3	2.2	2.1	2.1
Payment for financial assets	0.5	1.3	0.8	0.0	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.0	0.2	0.3	0.6
Overall balance	-1.2	-6.7	-4.2	-4.8	-4.6	-4.0	-3.0
Memorandum items:							
GDP (billions of rand)	2,304	2,442	2,754	2,996	3,301	3,622	3,997
National government debt (gross)	27.2	33.0	36.0	40.1	41.0	42.2	42.4
Cyclically-adjustment overall balance 2/	-1.5	-5.0	-3.1	-4.6	-4.3	-3.6	-2.6
				Staff estimates			
Total revenue and grants	29.7	27.2	27.5	27.5	27.6	28.0	28.3
Total expenditure	30.8	33.9	31.8	32.1	31.9	31.7	31.3
Current	28.2	30.2	29.0	29.6	29.2	29.0	28.6
Wages and salaries	10.1	11.2	11.3	11.3	11.0	10.7	10.6
Other goods and services	5.2	5.7	5.2	5.4	5.2	5.2	5.2
Interest	2.5	2.6	2.4	2.5	2.7	2.8	2.8
Transfers	10.3	10.8	10.2	10.4	10.3	10.3	10.1
Capital expenditure	2.2	2.3	2.0	2.5	2.4	2.4	2.1
Payment for financial assets	0.5	1.3	0.8	0.0	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.0	0.2	0.3	0.6
Overall balance	-1.2	-6.7	-4.2	-4.6	-4.3	-3.7	-3.0
Memorandum items:							
GDP (billions of rand)	2,304	2,442	2,750	3,031	3,323	3,625	3,961
National government debt (gross)	27.2	33.0	36.0	39.6	40.4	41.6	42.2
Cyclically-adjustment overall balance	-2.6	-6.3	-3.9	-4.1	-3.6	-3.2	-2.8

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

1/ For fiscal year beginning April 1.
2/ For national government main budget only.

Table 5. Statement of Operations—National Government Main Budget 2008/09–2014/15[1]
(GFSM2001 basis; in percent of GDP unless otherwise noted)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
					Proj. 2/		
Revenue	26.4	23.7	24.3	24.3	24.4	24.9	25.2
Taxes	25.9	23.4	23.9	23.8	23.9	24.4	24.7
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	0.5	0.3	0.5	0.5	0.5	0.5	0.5
Expenditure	27.1	29.3	28.5	29.4	29.2	29.1	28.8
Expense	26.8	28.9	28.2	29.0	28.8	28.6	28.3
Interest	2.4	2.3	2.4	2.5	2.7	2.8	2.8
Grants	12.6	14.2	13.8	13.7	13.3	13.0	11.7
Of which : provinces	10.7	12.1	11.7	11.5	11.0	10.7	10.3
local governments	1.9	2.1	2.2	2.2	2.3	2.3	2.4
Other expense	11.8	12.4	11.9	12.7	12.7	12.8	13.9
Net acquisition of nonfinancial assets	0.4	0.4	0.3	0.4	0.4	0.5	0.4
Gross Operating Balance (Revenue - Expense)	-0.4	-5.2	-3.9	-4.7	-4.3	-3.7	-3.1
Budgetary balance (Revenue - Expenditure)	-0.7	-5.6	-4.2	-5.1	-4.8	-4.1	-3.6
Extraordinary payments, net	-0.2	-0.2	-0.1	-0.1	0.0	0.0	0.0
Net lending (+)/borrowing (–)	-0.6	-5.4	-4.1	-5.0	-4.7	-4.1	-3.5
Net acquisition of financial assets							
Domestic	0.8	2.5	2.2	0.6	-1.0	-0.2	-0.2
Currency and deposits	0.4	1.2	1.5	0.6	-1.0	-0.2	-0.2
Loans	0.4	1.3	0.7	0.0	0.0	0.0	0.0
Net incurrence of liabilities	1.4	7.9	6.3	5.5	3.8	3.9	3.4
Domestic	1.5	6.9	6.2	5.2	4.0	4.0	3.4
Foreign	-0.2	1.0	0.1	0.3	-0.2	-0.1	0.0
Memorandum items:							
Fiscal year GDP (billions of rand)	2,304	2,442	2,750	3,031	3,323	3,625	3,961
Real GDP growth (percent)	2.5	-0.8	3.1	2.7	2.9	3.6	4.0
GDP deflator (percent change)	8.3	6.8	9.4	7.3	6.6	5.3	5.0
Gross debt	27.2	33.0	36.0	39.6	40.4	41.6	42.2

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

1/ For fiscal year beginning April 1. National government comprises the central government, including transfer to subnational government financed by the national revenue fund.

2/ Staff projections base on the authorities' policy intentions as outlined in the 2012 budget.

Table 6. South Africa: Balance of Payments, 2009–2017

			Proj.						
	2009	2010	2011	2012	2013	2014	2015	2016	2017
				(In Billion of US dollars)					
Balance on current account	-11.5	-10.2	-13.5	-18.9	-21.2	-25.4	-26.7	-28.2	-29.2
Balance on goods and services	-2.5	-0.7	-2.5	-6.3	-6.1	-9.0	-8.9	-6.3	-4.6
Exports of goods and services	77.9	99.4	117.8	116.1	119.3	123.0	130.0	137.6	145.6
Exports of goods	65.9	85.4	102.9	101.4	104.2	107.5	113.4	120.0	126.8
Nongold	59.7	77.3	92.5	91.1	94.5	98.1	104.4	111.3	118.3
Gold	6.3	8.1	10.4	10.3	9.7	9.3	9.0	8.7	8.4
Exports of services	11.9	14.0	14.9	14.6	15.1	15.5	16.5	17.7	18.9
Imports of goods and services	-80.4	-100.1	-120.3	-122.4	-125.4	-132.0	-138.8	-144.0	-150.2
Imports of goods	-65.7	-81.7	-100.7	-102.4	-104.9	-110.5	-116.4	-120.9	-126.3
Imports of services	-14.7	-18.4	-19.6	-20.0	-20.4	-21.5	-22.4	-23.1	-23.9
Balance on income	-6.3	-7.2	-9.0	-8.9	-11.6	-12.8	-14.1	-17.8	-20.4
Income receipts	4.0	4.7	5.3	6.1	6.9	8.1	10.6	11.6	14.0
Income payments	-10.4	-11.9	-14.3	-15.0	-18.5	-21.0	-24.7	-29.4	-34.4
Balance on transfers	-2.7	-2.3	-2.0	-3.7	-3.6	-3.6	-3.8	-4.1	-4.3
Capital flows (including errors and omissions)	13.6	14.5	19.4	18.9	21.3	25.4	26.7	28.2	29.2
Balance on capital and financial account	13.5	11.1	19.4	18.9	21.3	25.4	26.7	28.2	29.2
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	13.5	11.1	19.4	18.9	21.3	25.4	26.7	28.2	29.2
Direct investment	4.2	1.1	6.4	3.1	5.0	7.3	9.7	10.9	11.7
Liabilities	5.4	1.6	5.8	4.0	6.2	8.7	11.4	12.9	14.1
Assets	-1.2	-0.5	0.6	-0.9	-1.1	-1.4	-1.7	-2.0	-2.4
Portfolio investment	11.1	10.9	0.3	14.5	14.2	16.0	17.7	19.4	21.4
Liabilities	12.7	14.7	6.5	18.5	20.0	22.5	25.0	27.5	30.5
Assets	-1.6	-3.9	-6.1	-4.0	-5.8	-6.5	-7.3	-8.1	-9.1
Other investment	-1.9	-0.9	3.9	1.3	1.9	2.0	-0.7	-2.1	-4.0
Liabilities	-4.7	1.5	4.4	5.2	7.4	8.7	11.4	12.9	15.1
Assets	2.8	-2.4	-0.5	-3.9	-5.5	-6.7	-12.1	-15.1	-19.1
Errors and omissions	0.1	4.9	7.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	2.1	4.3	4.6	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) [1]	39.7	43.8	48.9	48.9	48.9	48.9	48.9	48.9	48.9
International liquidity position of SARB [1 2]	39.0	43.1	48.1	48.2	48.2	48.2	48.2	48.2	48.2
				(In percent of GDP)					
Balance on current account	-4.0	-2.8	-3.3	-4.8	-5.2	-5.8	-5.8	-5.9	-5.8
Balance on goods and services	-0.9	-0.2	-0.6	-1.6	-1.4	-2.0	-1.9	-1.3	-0.9
Exports of goods and services	27.4	27.3	28.8	29.3	29.0	28.4	28.5	28.7	28.9
Imports of goods and services	-28.3	-27.5	-29.4	-30.8	-30.4	-30.4	-30.4	-30.0	-29.8
Capital flows (including errors and omissions)	4.8	4.0	4.4	4.8	5.2	5.8	5.8	5.9	5.8
Balance on capital and financial account	4.7	2.6	2.6	4.8	5.2	5.8	5.8	5.9	5.8
Errors and omissions	0.0	1.4	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	0.7	1.2	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) [1]	14.0	12.1	12.0	12.3	11.9	11.3	10.7	10.2	9.7
Gross reserves (including the banking sector) [1]	14.0	12.1	11.9	12.2	11.8	11.2	10.6	10.1	9.6
International Liquidity Position of SARB [1]	13.7	11.9	11.8	12.1	11.7	11.1	10.6	10.1	9.6
Memorandum items:									
Total external debt	27.6	28.7	27.3	32.0	33.9	35.7	37.7	39.8	42.0
Foreign currency debt	14.8	12.4	12.8	14.7	15.8	16.6	17.7	18.9	20.2
of which: short-term (at remaining maturity)	8.2	6.6	4.3	4.3	4.8	3.8	4.0	4.1	4.0
Medium and Long Term External debt service (in Billion of US dollars)	12.0	13.3	11.8	17.2	21.6	25.7	24.8	28.0	31.6

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

[1] End of period.

[2] Gross reserves minus foreign loans and minus forward position.

Table 7. South Africa: Monetary Survey 2004–2011

	2004 Dec	2005 Dec	2006 Dec	2007 Dec	2008 Dec	2009 Dec	2010 Dec	2011 Dec
				(In billions of rand)				
Net foreign assets	141.4	195.1	274.3	304.5	390.5	354.2	356.8	526.9
Gross reserves	229.6	297.8	409.8	561.7	847.4	670.8	671.5	846.1
SARB	82.8	130.5	178.3	224.3	317.0	292.7	290.6	397.8
Other monetary institutions	146.7	167.3	231.5	337.4	530.4	378.1	380.9	448.3
Liabilities	88.2	102.6	135.5	257.2	456.9	316.7	314.7	319.1
SARB	19.8	22.2	19.3	12.0	6.1	2.7	0.1	0.1
Other monetary institutions	68.4	80.4	116.2	245.2	450.8	314.0	314.6	319.0
Net domestic assets	772.8	906.0	1,075.0	1,363.1	1,523.7	1,594.1	1,726.3	1,728.4
Credit to government, net	42.6	0.8	-29.5	-32.5	44.7	85.6	63.9	37.1
Claims on government	116.1	107.4	112.4	116.5	179.5	223.7	252.1	308.1
Government deposits	73.4	106.6	141.8	149.0	134.8	138.1	188.2	271.0
Credit to private sector	954.2	1,140.2	1,434.9	1,743.9	1,981.0	1,978.4	2,086.8	2,215.0
Other items, net	-224.1	-235.0	-330.4	-348.3	-502.0	-470.0	-424.3	-523.7
Broad money (M3)	914.2	1,101.1	1,349.3	1,667.6	1,914.2	1,948.2	2,083.1	2,255.3
Of which: M1	421.5	503.1	605.7	738.3	753.6	806.3	862.8	946.9
				(Annual percentage change)				
Net foreign assets	11.6	38.0	40.5	11.0	28.2	-9.3	0.7	47.7
Net domestic assets	13.4	17.2	18.7	26.8	11.8	4.6	8.3	0.1
Credit to private sector	13.8	19.5	25.8	21.5	13.6	-0.1	5.5	6.1
Broad money (M3)	13.1	20.5	22.5	23.6	14.8	1.8	6.9	8.3
				(Contribution to growth in M3, unless otherwise specified)				
Net foreign assets	1.8	5.9	7.2	2.2	5.2	-1.9	0.1	8.2
Net domestic assets	11.3	14.6	15.4	21.3	9.6	3.7	6.8	0.1
Credit to government, net	-0.4	-4.6	-2.7	-0.2	4.6	2.1	-1.1	-1.3
Credit to private sector	14.3	20.3	26.8	22.9	14.2	-0.1	5.6	6.2
Other items, net	-2.6	-1.2	-8.7	-1.3	-9.2	1.7	2.3	-4.8
Memorandum item:								
Income velocity of M3 (GDP/average broad money)	1.63	1.55	1.42	1.31	1.24	1.24	1.33	1.38

Sources: South African Reserve Bank (SARB).

Table 8. South Africa: Financial Soundness Indicators 2008–2011

	2007 Dec.	2008 Dec.	2009 Dec.	2010 Dec.	2011 Dec.
	(In percent, unless otherwise indicated)				
Capital adequacy:					
Capital adequacy ratio		13.0	14.1	14.9	15.1
Regulatory tier 1 capital to risk-weighted assets	9.5	10.2	11.0	11.8	12.2
Credit risk					
Impaired advances to gross loans and advances		3.9	5.9	5.8	4.7
Profitability					
Return on assets (smoothed)	1.4	.	0.9	1.0	1.2
Return on equity (smoothed)	18.1	28.7	15.8	14.7	16.4
Interest Margin to gross income (smoothed)	.	44.6	49.5	48.8	50.3
Liquidity:					
Liquid assets to total assets (liquid-asset ratio)	4.6	5.0	6.4	7.5	8.3
Liquid assets to short-term liabilities	8.7	9.8	13.0	15.5	16.6
Effective net open foreign-currency position to qualifying capital and reserve funds	0.7	0.5	0.7	-0.3	0.8

Source: South African Reserve Bank.

Appendix I. South Africa: Inward and Outward Spillovers

South Africa is a prime candidate for studying spillovers. The largest sub-Saharan African (SSA) economy, accounting for over a third of SSA's GDP and about 40 percent of its exports, has strong financial and trade links to the global economy and other SSA countries. It is subject to inward spillovers from shocks to advanced economies and other emerging markets through financial and real sector channels (Canales-Kriljenko, 2011). South Africa has one of the most liquid bond and equity markets among emerging market economies and shocks to global financial conditions rapidly filter into South African domestic financial variables. South African GDP is closely correlated to world GDP, a correlation that has increased over the last few decades. Through trade and financial channels, it could in principle also retransmit some of those shocks to other SSA countries, giving rise to outward spillovers. Arguably, the scope for spillovers within the region has increased with the expansion of intraregional trade over the last decade. South Africa has also expanded its foreign direct investment in the region over the last decade, and South African banks are key players in many countries in the region, although cross-border flows are limited because their subsidiaries essentially manage local deposits.

South Africa is significantly exposed to adverse developments in Europe and China. Adverse developments in one would affect the other and, ultimately, world growth. A slowdown in China could have the additional impact of likely giving rise to a sharper reduction in commodity prices. Such a slowdown would also have an indirect effect on South Africa through its SSA trading partners, which heavily depend on commodity prices. Model simulations suggest that shocks to any of these countries would have a more deleterious effect on South Africa if they also lead to a sharp increase in global risk aversion, which tends to lower business and consumer confidence not only in South Africa, but also in other trading partners (Meyer-Cirkel and Canales-Kriljenko, forthcoming).

Adverse developments in Europe and China would hurt the Southern Africa Customs Union (SACU) members both directly and through spillovers from South Africa. The resulting slowdown in world growth and commodity prices would reduce SACU member's income and external demand, but the impact via South Africa of the crisis would be more likely felt in the smaller countries that trade more with South Africa. South Africa accounts for about 80 percent of exports and an even higher share of imports of Lesotho and Swaziland. Customs revenues heavily depend on South African imports and account for a substantial amount of fiscal revenue in most SACU countries. The formula for sharing custom revenues provides members in the region about two years to adjust their policies in response to the decline in customs revenues associated with a decline in global trade. It exposes the members' fiscal revenue to rand volatility. In addition, most SACU members, except Botswana, peg their currencies to the South African rand, in practice, adopting monetary policy decisions from the South African Reserve Bank. Anecdotal evidence suggests that remittances from South Africa to some SACU members may also be significant. Moreover, South African financial groups are the dominant players in the financial markets of the region, spanning banking, pension, insurance, and wealth management services, whose treasury and risk management decisions tend to be centralized in Johannesburg. These institutions may help channel the substantial foreign direct investment from South Africa into the rest of the region. Despite all spillovers on different dimensions, output correlation among SACU members is low and South African GDP does not enter into a panel explaining GDP fluctuations in the region after controlling for world variables and fiscal policies (Canales-Kriljenko, Gwenhamo, and Thomas, forthcoming).

Other countries with strong trade and investment links to South Africa that would suffer from outward spillovers include Congo Malawi, Mozambique, Zambia, and Zimbabwe.

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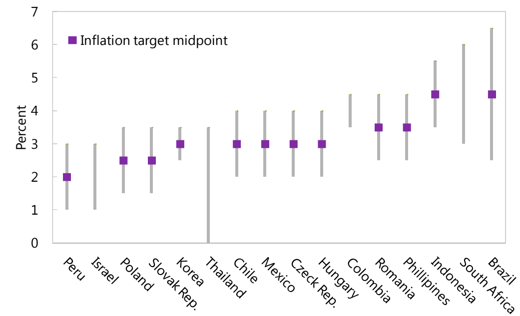
* Canales-Kriljenko, J. I., 2011, "South Africa: Macro Policy Mix and Its Effects on Growth and the Real Exchange Rate--Empirical Evidence and GIMF Simulations," IMF African Departmental Paper No. 11/04.
** Canales-Kriljenko, Gwenhamo, and Thomas, "Spillovers into the SACU Region," IMF Working Paper (forth.).
*** Meyer-Cirkel, A. and J. I. Canales-Kriljenko, "Global Financial Stress Transmission into sub-Saharan Africa—A GVAR approach," IMF Working Paper (forthcoming).

Appendix II. Estimating the Implicit Inflation Target[1]

South Africa adopted inflation targeting (IT) as a formal framework for monetary policy in 2000, with an inflation target band of between 3 and 6 percent. The adoption of the IT framework has clearly strengthened the South African Reserve Bank's (SARB's) mandate to focus on price stability and increased the SARB's accountability toward its main objective. However, unlike many reserve banks with an inflation targeting framework, the SARB has refrained from announcing an official mid-point (Figure 1). While this provided the SARB with greater flexibility in implementing monetary policy in an environment of volatile inflation, it may have undermined monetary policy's efforts to anchor medium- and long-term inflation expectations and may have complicated market participants' projections regarding the future path of the SARB's policy rate and monetary policy stance more generally.

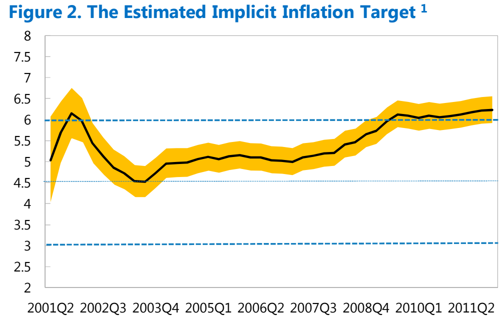
Figure 1. Inflation Targets in Selected Emerging Markets



Sources: Habermeier and others (2009) and central bank websites.

The analysis aims to reveal the SARB's implicit inflation target by estimating a simple Taylor rule in a state space approach where the coefficients of the SARB reaction function are estimated alongside the inflation target.[2] The results should be treated with caution given the large uncertainties regarding the "true" output gap level and natural real rate as well as the possibility that the SARB may have looked at a longer forecast horizon for inflation and output gap when it set its policy rate. With this caveat in mind, the estimation results indicate that the SARB aimed for the upper segment of the band (4.5–6 percent) for most of the period, despite the substantial variation of the output gap (Figure 2). Moreover, the estimation results show that the implicit inflation target varied over time, and in recent years it has shifted toward the upper limit of the inflation target range. This perhaps implies that since the outbreak of the financial crisis in 2008 the SARB has become more tolerant toward higher levels of inflation to better support economic activity in the face of an extremely challenging global environment.

Figure 2. The Estimated Implicit Inflation Target [1]



[1] Band indicates +/-1 standard error.
Sources: Author's estimation.

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[1] Based on Klein, N., "Estimating the Implicit Inflation Target of the South African Reserve Bank," IMF Working Paper (forthcoming).

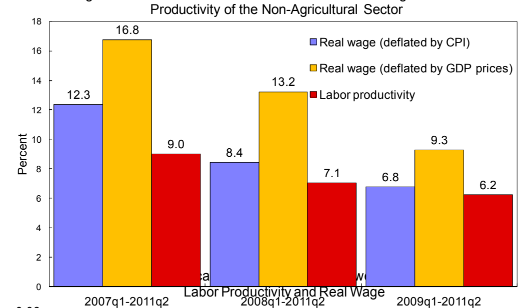
[2] The analysis builds on Leigh, D., 2008, "Estimating the Federal Reserve's Implicit Inflation Target: A State Space Approach," *Journal of Economics and Control*, Vol. 32 pp. 2013–30.

Appendix III. South Africa: Real Wage, Labor Productivity, and Employment[1]

The recent financial crisis hit South Africa's labor market severely. In 2009–10, South Africa lost about three-quarters of a million jobs—equivalent to about 5 percent of total employment at end-2008, and unemployment, which already hovered above 20 percent during the precrisis period, increased further to about 25 percent. In 2011, this trend was partially reversed; however job creation continued to be rather weak and insufficient to make a substantial dent in unemployment.

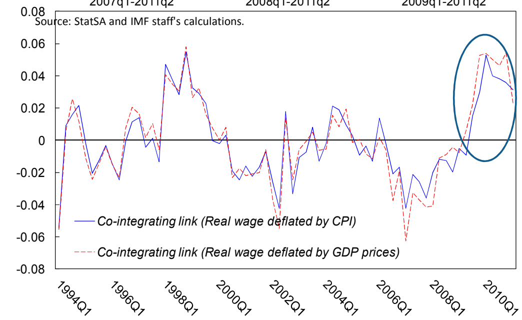
The massive employment loss in 2009–10 and the relatively weak job creation in 2011 may reflect several factors, including the weak employment protection of the large share of informal workers and the sluggish recovery in South Africa's traditional trading partners, particularly the United States and Europe. It may also represent the rapid increase in real wages, which outpaced the growth of labor productivity in recent years (Figure 1). Although empirical findings point to a clear long-term link between the real wage and labor productivity, the deviations from "equilibrium" are persistent and take about 10–12 quarters on average, with potentially negative repercussion on employment creation (Figure 2). And indeed, a sectoral panel analysis that focused on 2008–11 in South Africa, confirms that higher excess real wage growth (real wage growth above labor productivity growth) significantly contributed to the decline in the formal employment. The persistent deviation from equilibrium was also reflected in a high increase in the nominal unit labor cost, which increased during the 2009-2010 by about 20 percent on a cumulative basis. The back-of-the-envelope calculations suggest that the excess real wage growth accounts for at least 25 percent of the employment loss in 2008–2010.

Figure 1. South Africa: Cumulative Growth of Real Wage and Labor Productivity of the Non-Agricultural Sector



Source: StatSA and IMF staff's calculations.

Labor Productivity and Real Wage



Source: IMF staff's estimations.

The analysis also examines the link between real wage growth and labor productivity growth from an international perspective. It confirms that labor productivity growth has, on average, a positive and significant impact on real wage growth; however, in South Africa, the link between the two is substantially weaker than in other emerging markets, even after controlling for labor market tightness indicators such as unemployment and labor absorption rate.

[1] Based on Klein, N., 2012, "Real Wage, Labor Productivity, and Employment Trends in South Africa: A Closer Look," IMF Working Paper (WP/12/92).

Appendix IV. A Financial Conditions Index for South Africa[1]

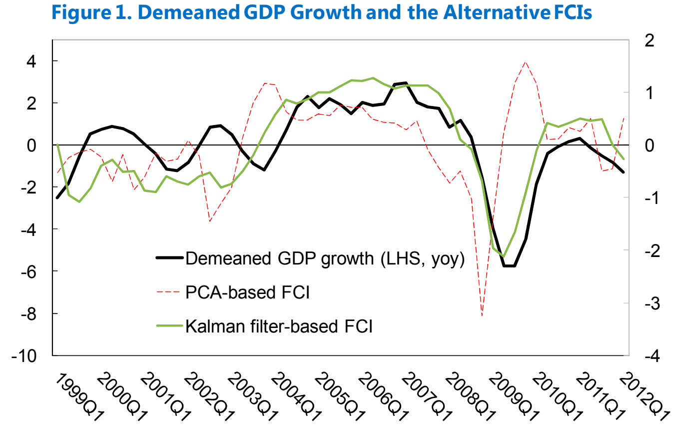
Financial conditions are known to have an important influence on business cycles because they reflect not only the feedback of current and past economic conditions but also the markets' expectations about the economic outlook. The construction of financial conditions indices (FCIs) has become critical not only to better understand the macrofinancial linkages, but also to obtain some indications about the direction of the near-term economic activity.

Although there is wide range of methodologies to construct a financial conditions index, the application for South Africa involves two alternative approaches: a principal component analysis (PCA), which uses the methodology proposed by Hatzius and others (2010),[2] and a Kalman filter, which allows for a smoother, auto-correlated statistical process. Both approaches aim to identify an unobservable common factor from a group of global financial indicators (the global risk aversion, the TED spread, S&P500 index, the emerging market bond index), as well as South Africa-related financial variables (sovereign spread, credit to the private sector, non-performing loans, the rate of negotiated certificates of deposits, JSE index, house prices, NEER).

The estimated FCIs were found to have predictive power for near-term GDP growth (up to 4 quarters), pointing to strong macro-financial linkages in the economy. And indeed, the economic boom in 2005–08, the contraction in economic activity in 2009 and the recovery in 2010–11 are well captured by the FCIs' trajectories (Figure 1).

In recent months, however, there has been some deterioration, on the back of the elevated stress triggered by the sovereign and banking crisis in the euro area. Based on the historical link between FCIs and GDP growth, this may suggest economic activity is likely to moderate in the period ahead.

Figure 1. Demeaned GDP Growth and the Alternative FCIs



Source: Authors' calculations

[1] Based on Gumata, N., N. Klein, and E. Ndou, "A Financial Conditions Index for South Africa," IMF Working Paper (forthcoming).

[2] Hatzius, J., P. Hooper, F. S. Mishkin, K. L. Schoenholtz, and M. W. Watson, 2010, "Financial Conditions Indexes: A Fresh Look after the Financial Crisis," NBER Working Paper No. 16150 (Cambridge, Massachusetts: MIT Press).

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 16, 2012

Prepared By

The African Department
(In collaboration with other departments)

CONTENTS

RELATIONS WITH THE IMF

As of May 31, 2012

Membership Status

Joined: December 27, 1945

Accepted the obligations of Article VII Sections 2, 3, and 4 of the IMF's Articles of Agreement on September 15, 1973.

General Resources Account	**SDR Million**	**%Quota**
Quota	1,868.50	100.00
IMF holdings of currency	1,866.70	99.90
Reserve position	1.82	0.10

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,785.42	100.00
Holdings	1,788.12	100.15

Outstanding Purchases and Loans None

Latest Financial Arrangements None

Projected Payments to the IMF

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/interest		0.02	0.02	0.02	0.02
Total		0.02	0.02	0.02	0.02

South Africa has consented to its quota increase under the 14th General Review of Quotas which will essentially double the IMF's quota resources, once effective. South Africa also accepted the proposed amendment to reform the Executive Board. The quota increases will become effective once members having not less than 70 percent of total quotas (as of November 5, 2010) have consented to the increase in their quotas, and once the proposed amendment to reform the Executive Board entered into force which occurs once the Fund certifies that three-fifths of the IMF members (i.e., out of currently 188, i.e., 113 members) having 85 percent of the total voting power have accepted the proposed amendment. South Africa's quota under the 14th General Review will increase to SDR 3,051.2 million (R 38.6 billion).

In September 2010 South Africa also agreed to lend the IMF up to SDR 340 million (R 4.3 billion) under the New Arrangements to Borrow (NAB). The NAB is a set of credit arrangements the IMF has with 40 member countries and/or its institutions. Currently 37 of these arrangements are active and thus can be drawn by the IMF to supplement its quota resources for lending purposes. South Africa is paid interest on its loans to the IMF under the NAB based on the SDR interest rate. As of end-May, South Africa had lent SDR 34.7 million (R 435 million) to the IMF under the NAB.

On June 19, 2012, The South African Presidency issued a statement noting that it intends to pledge an additional $2 billion (R 16.8 billion) to IMF resources, as part of a global drive to increase the IMF's resources by more than US$430 billion. Once available, these resources will be used for crisis prevention and resolution. They will be drawn only if they are needed, and if drawn, they will earn interest based on the SDR interest rate.

Exchange Rate Arrangement

The rand floats against other currencies, and South Africa maintains an exchange system consistent with South Africa's obligations under Article VIII of IMF Statutes.[1] In particular, its exchange system is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions. South Africa has continued to gradually liberalize the system of capital controls in place during the Apartheid regime.

With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated. Nonresidents are free to purchase shares, bonds, and other assets and to repatriate dividends, interest receipts, and current and capital profits, as well as the

[1] South Africa accepted its Article VIII, Section 2(a), 3, and 4 obligations in 1973.

original investment capital. Foreign companies, African governments, and institutions may inward list on South Africa's equity and debt instruments on South Africa's securities exchanges.

Box 1. Liberalization of Capital Controls on Residents

October 2009 – The authorities (i) raised the lifetime limit on individuals investment offshore to R4 million from R2 million a year and (ii) increased the single discretionary allowance to R750,000 from R500,000.

March 2010 – Authorised dealers were allowed to acquire direct and indirect foreign exposure up to a macroprudential limit of 25 percent of their total liabilities, excluding total shareholder's equity.

October 2010 – Authorities (i) eliminated the 10 percent levy on the capital South Africans can transfer upon emigration, (ii) raised the limit on offshore investments by individuals to R4 million a year from R4 million in a lifetime, and (iii) raised the single discretionary allowance to R1 million from R750,000.

December 2010 – Limits that resident institutional investors can invest offshore were raised by 5 percentage points, and now range from 25 to 35 percent depending on the type of institutional investor.

January 2011 – Authorities allowed qualifying international headquarter companies, subject to approved registration with the Financial Surveillance Department of the South African Reserve Bank, to raise and deploy capital offshore without exchange control approval.

October 2011 – Authorities (i) removed the restriction on foreign participation in the ownership of money remittance businesses and the requirement to partner with an existing authorised dealer to conduct money remittance business; (ii) approved criteria for consideration of individual foreign investments above R4 million; (iii) announced that all inward-listed shares traded and settled in rand on the Johannesburg Stock Exchange will be regarded as domestic assets; (iv) allowed South African companies to raise and deploy offshore capital of up to R500 million without any restrictions on investing in any business; (v) withdrew the prohibition on the transfer of additional working capital for investments below R500 million per applicant campany, per calendar year; (vi) permitted South African companies to acquire 10 percent of equity or 20 percent of voting rights, whichever is higher, in a foreign entity that holds investments or makes loans into any Common Monetary Area (CMA) country.

Exchange controls on capital transactions by residents have been gradually relaxed. The authorities' main objective has been to move toward a system based on prudential limits and supervision, and away from a rigid system of quantitative controls. Box 1 summarizes recent measures consistent with the overall liberalization strategy that have helped offset some of the pressure on the exchange rate coming from strong portfolio flows since 2010.

Article IV Consultation

The 2011 Article IV consultation was concluded by the Executive Board on July 25, 2011. South Africa is on the standard 12-month Article IV consultation cycle.

Technical Assistance

An IMF Fiscal Affairs Department (FAD) mission took place in December 2010 to support capacity for fiscal policy analysis in the treasury's Fiscal Policy Unit (FPU). In July 2011 senior FPU staff visited the IMF's headquarters to discuss international experience with fiscal rules. In March 2012, an FAD team visited Pretoria to discuss room for further improvement in South Africa's strong budget institutions.

In March 2011, an STA mission took place to conduct the training on the Coordinated Direct Investment Survey for Anglophone Africa in Pretoria.

A number of IMF Legal Department (LEG) missions in 2007–09 assisted the authorities in the ongoing process of rewriting the Income Tax Act and drafting a new Tax Administration Act. The most recent LEG mission took place in November 2008, and a report on this mission was completed in late 2009. LEG has submitted comments on the Tax Administration Act to the authorities by email.

THE JMAP BANK IMF MATRIX

The IMF South Africa team led by Mr. McDonald (mission chief) met with the World Bank South Africa team led by Mr. Sandeep Mahajan (Acting Country Manager and Lead Economist) on June 1, 2012, to identify macrocritical structural issues and to coordinate the two teams' work for June 2012–May 2013.

The teams agreed that South Africa's macroeconomic challenges include promoting job creation and improving the long-run inclusive growth needed for maintaining social cohesion. Prudent fiscal policies—including improving the composition of public spending—and structural labor and product market reforms will be needed to meet these challenges.

Based on this shared assessment, the IMF and the World Bank agreed to support the authorities efforts on the following macrocritical fronts:

- Long-term fiscal policy planning: The South African authorities are preparing a report on long-term fiscal dynamics. Key challenges include (i) modeling the fiscal implications of South Africa's demographic changes; and (ii) modeling the implications of the proposed NHI and social security reforms and highlighting the tradeoffs involved in different design options. The long-term fiscal report provides a tool for signaling South Africa's long-term fiscal stance and will help raise public awareness of longer-term fiscal challenges, as well as the associated fiscal risks.

- Improvements in the composition of public spending: In recent years, the wage bill has grown to become the largest component of government spending, reducing space for capital spending and eroding the credibility of the government's fiscal policy. An agreement to limit real wage growth in the public sector would support the government's fiscal consolidation plans while leaving space for public spending in areas critical for long-term growth, and promote job creation by limiting overall wage growth in the economy.

- Strengthened public infrastructure: Improving South Africa's public infrastructure would help remove existing supply-side bottlenecks in key network industries such as electricity and transport, which have constrained exports and domestic economic activity in recent years. Key issues include (i) ensuring that large-scale infrastructure projects are subject to rigorous assessment and prioritized to maximize long-term benefits; (ii) making sure that tariffs and user fees fully reflect service and investment costs to contain fiscal risks; and (iii) ensuring efficiency in running these enterprises which often have a dominant market position.

- Labor market reforms: Key reform objectives include (i) increasing the flexibility of the wage bargaining mechanism, especially for small and medium-size enterprises (SMEs) and newly created businesses; (ii) increasing the flexibility of labor laws and regulations to improve the business environment and increase employment opportunities; and (iii) introducing well-designed active labor market measures to encourage youth employment and providing working experience or on-the-job training.

- Product market reforms: Increasing product market competition is an integral component of the authorities' job creation strategy. Key objectives include (i) strengthening the competition authorities to crack down on abuse of market dominance and collusive behavior; (ii) ensuring state-owned enterprises are run on a competitive basis; (iii) encouraging the involvement of the private sector in key network industries dominated by state-owned enterprises; and (iv) increasing crossborder cooperation to crack down on non-competitive behavior.

In terms of specific actions, the teams agreed on the following work program:

- Long-term fiscal policy: The IMF will elaborate on the long-term fiscal challenges and risks facing South Africa in the 2013 Article IV. It will draw on recent work by FAD on health care reform and seek opportunities, such as workshops with the authorities, to discuss options for the design of reforms in this area and will continue to inform the authorities of best practices from other countries in terms of modeling the implications of health and social security reforms. It has offered technical cooperation and discussions for the preparation of the report.

- Improvements in the composition of public spending: The IMF has called for containing the public sector wage bill and increasing capital spending during the 2012 Article IV consultation. The World Bank is providing technical assistance for ongoing efforts to strengthen government-wide monitoring and evaluation systems and is carrying out a public expenditure tracking survey for health-related spending in the province of Kwa-Zulu Natal.

- Strengthened public infrastructure: The Eskom Investment Support Project ($3.75 billion) and the Eskom Renewable Energy Support Project, both being implemented by the Bank, support the expansion of electricity supply and help South Africa accelerate development of renewable energy generation capacity.

- Labor market reforms: The IMF has highlighted the urgency of making progress on this area to reduce structural unemployment during the 2012 Article IV consultation.

- Product market reforms: The IMF conducted some preliminary analysis of product market competition in the 2012 Article IV, and intends to elaborate further proposals in the context of the 2013 Article IV. The Bank identified competition as a key impediment to faster and more inclusive growth in its July 2012 Economic Update and is considering more indepth analysis in one of its upcoming economic updates.

- Tackling high inequality: Recognizing South Africa's exceptionally high inequality, the Bank's July 2013 Economic Update puts the spotlight on extraneous individual circumstances that constrain children's access to basic opportunities (inequality of opportunity) and thereby their chances to succeed in life. The Bank is also developing a systematic analytical understanding of the structure of the township economy, to grasp its full economic potential for policy action. A Bank study on the potential of and constraints to private sector development in less developed regions is ongoing.

- Financial sector stability and inclusion: At the request of the National Treasury and SARB, the Bank is reviewing South Africa's contingency planning and crisis management framework, assessing the institutional set-up of financial sector supervision, and carrying out a Review of Standards and Codes (RoSC) on Insolvency and Creditor Rights. The Bank is also working with an interministerial working group that is assessing strategic priorities for financial inclusion.

The teams have the following requests for information from their counterparts:

- The IMF team asks to be kept informed of progress in the macrocritical structural reform areas under the Bank's purview. Timing: when milestones are reached (and at least semiannually).
- The Bank team asks to be kept informed of progress in the macrocritical structural reform areas under the IMF's purview. Timing: when milestones are reached (and at least semiannually).

Table 1 lists the teams' separate and joint work programs during June 2012–May 2013.

STATISTICAL ISSUES

Data provided to the IMF are adequate for surveillance. South Africa subscribed to the Special Data Dissemination Standard (SDDS) on August 2, 1996, and is in observance of specifications for coverage, periodicity, and timeliness of data, although using a flexibility option on the timeliness and periodicity of unemployment data. A Report on Observance of Standards and Codes—Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) was published on October 16, 2001.

Real sector

The national accounts are compiled according to the SNA 1993. In 2009, the base year of the national accounts was changed from 2000 to 2005. At the same time, benchmarking was undertaken to reflect more accurately the structure of the economy and to introduce other methodological changes to the compilation of data. Reporting of real sector data for International Financial Statistics (IFS) is timely.

Labor market statistics are published with lags of three months. Given the seriousness of the unemployment problem, labor market analysis and policy design would benefit from better, more frequent and timely labor market data. A new quarterly Labor Force Survey has been conducted in January 2008.

The consumer price index (CPI) covers all households living in metropolitan and urban areas, which represent approximately 56 percent of the total number of households and 75 percent of private consumption expenditure. The CPI weights were rebased in January 2009 according to the new weights published in July 2008. Current price indices, which were rebased to 2008=100, are calculated according to these weights. These indices form the basis for calculating the year-on-year changes in the CPI for 2009 and the month-on-month change between December

2008 and January 2009. New weights for the CPI will be introduced in January 2013 based on the 2010/11 Income and Expenditure Survey. The CPI indices will be rebased to 2012, and the historical rates of inflation will not be revised backward.

Government finance

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

Monetary statistics

Monetary statistics compiled by the SARB are consistent with the methodology recommended in the Monetary and Financial Statistics Manual. South Africa regularly reports good quality monetary statistics for publication in the IFS and the IFS Supplement, although there is room for improving the timeliness of the data on nondepository financial institutions.

Balance of payments

Balance of payments data are broadly consistent with the fifth edition of the Balance of Payments Manual (BPM5). The authorities are also working with their partners in the Southern African Customs Union (SACU) to improve the coverage of intra-SACU trade flows. Data reported for Direction of Trade Statistics differ substantially from external trade data reported for IFS, particularly exports, because of balance of payments adjustments.

Data on international reserves position are disseminated in line with the requirements of the IMF's template on international reserves and foreign currency liquidity.

Work is ongoing to improve the reliability and accuracy of balance of payments data, with the aim of reducing the number of errors and omissions. Export and import price deflators are expected to be revised in 2013.

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, June 2012–May 2013

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	$3.75b Eskom operation	*Note: missions are ad hoc but generally occur twice a year.*	Ongoing
	Ongoing $500m renewable (solar and wind) operation		Ongoing
	Possible urban sector fee-based TA program		Ongoing
	ROSC accounting and auditing report		November 2012
	PFM dialogue		Ongoing
	PETS on HIV/AIDS in KZN province		December 2012
	National Health Insurance dialogue		Ongoing
	Economics of Township Report		February 2012
	Economic updates		Semiannual
	Financial sector stability, including financial inclusion dialogue		Ongoing
	Economic Diversification and MSME Development		Ongoing
	Study on potential of and constraints to private sector development in less developed regions in South Africa		November 2012
	Monitoring and Evaluation technical assistance		Ongoing
	Rural development and land reform fee-based program (Phase II)		2013
2. IMF Work Program	Staff visit	November 2011.	n.a.
	2013 Article IV Consultation.	May 2013.	July 2013.
3. Joint products in the next 12 months	No joint products planned at this time		

Table 2. South Africa: Table of Common Indicators Required for Surveillance
(as of June 25, 2012)

	Date of Latest Observation	Date Received[10]	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange rates	6/25/12	6/25/12	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[1]	5/12	6/7/12	M	M	M		
Reserve/base money	5/12	6/17/12	M	M	M	O, O, LO, O	LO, O, O, O
Broad money	4/12	5/30/12	M	M	M		
Central bank balance sheet	5/12	6/17/12	M	M	M		
Consolidated balance sheet of the banking system	4/12	5/01/12	M	M	M		
Interest rates[2]	6/25/2012	6/125/12	D	D	D		
Consumer Price Index	5/12	6/20/12	M	M	M	O, LO, O, O	LO, LO, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	4/12	5/31/12	M	M	M	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of cinancing[3]– central covernment	(4/12)	6/10/12	M	Q	Q		
Stocks of central government and central government-guaranteed debt[5]	5/12	6/29/12	Q	Q	Q		
External current account balance	Q1 2012	6/21/12	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and imports of goods and services [6]	4/12	5/31/12	M	M	M		
GDP/GNP	Q1 2012	5/29/12	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross external debt	Q1 2012	Q2 2012	Q	Q	Q		
International investment position	2010	11/2011	A	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Monthly data for goods. Goods and services are published quarterly on the same schedule as the rest of the balance of payments.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC (October 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.
[10] Reflects the latest information released by the IMF Statistics Department by 06/30/2011.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS

July 16, 2012

Approved By
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Prepared by the Staff Representatives for the 2012 Consultation with South Africa

DEBT SUSTAINABILITY ANALYSIS

1. **South Africa's external debt is projected to reach 42 percent of GDP by 2017.** The 15 percentage point increase in the external/GDP ratio reflects a widening of the current account deficit to around 6 percent of GDP in 2014-17 as strengthening growth buoys import demand, recent gains in the terms of trade unwind, while rising profits and global interest rates spur dividend and interest outflows. The deficit is expected to be financed to a large extent by non-resident portfolio investment. This includes portfolio equity (which does not add to the debt stock), and local-currency bonds, with only a small share expected to come from foreign-currency denominated debt. The public-sector borrowing requirement is expected to be financed partly by nonresidents through international bond issues, purchases of domestic bonds, and multilateral loans for infrastructure projects.

2. **The rising external debt ratio only slightly increases South Africa's vulnerability to external shocks and rollover risk, and risks look manageable against a range of other shocks.** The large share of debt denominated in local currency, and at fixed rates of interest significantly lowers risks. Stress tests indicate that the largest adverse impact would arise from a 30 percent exchange rate depreciation, or from a further widening of the non-interest current account deficit. These shocks would push the external debt ratio to 54 percent and 48 percent respectively by 2017. But these are likely to represent upper bound estimates, since the standard DSA does not capture the likelihood of exchange rate weakening if those shocks were to materialize, and therefore narrower trade deficit. By contrast, a large (one standard deviation) permanent shock to real GDP growth and the standard shock to interest rates have only minor

effects, and the combined shock has a moderate effect on external debt levels.

3. **South Africa's public debt position appears sustainable.** Under the policies the medium-term expenditure framework outlined in the 2012/13 budget, the ratio of government debt to GDP is expected to rise over the short term, from 39 percent in 2011 to a maximum of 42 percent in 2014—of which, some 2.5 percent of GDP is expected to be denominated in foreign currency— before declining gradually thereafter (Table 2). Gross financing needs peaked at some 8 percent of in 2009, and steadily decline afterwards to below 3 percent in the medium term (Figure 2). Total public debt is also projected to rise in the short term, as public enterprise borrow to help finance the accelerated investment expansion, but total public debt is projected to peak at close to 55 percent of GDP by 2015 (Table 2).

4. **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 by only modest margins. One noticeable exception is in the case of the "no policy change" scenario where the debt ratio rises sharply and reaches 49 percent of GDP at the end of projection period, mainly owing to the recent sharp deterioration in fiscal balance.

Table 1. South Africa: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
Baseline: External debt	26.4	26.6	27.6	28.7	27.3			**32.0**	**33.8**	**35.7**	**37.7**	**39.8**	**42.0**	**-7.6**
Change in external debt	4.5	0.2	1.1	1.1	-1.4			4.7	1.8	1.8	2.0	2.1	2.2	
Identified external debt-creating flows (4+8+9)	1.1	6.1	-2.2	-3.8	-2.7			0.0	-1.6	-1.7	-2.2	-2.4	-2.6	
Current account deficit, excluding interest payments	5.5	5.4	3.0	2.0	2.2			3.5	3.6	4.1	4.0	3.9	3.7	
Deficit in balance of goods and services	2.7	3.1	0.9	0.2	0.6			1.6	1.5	2.1	1.9	1.3	0.9	
Exports	31.5	35.8	27.4	27.3	28.8			29.3	29.0	28.4	28.5	28.7	28.9	
Imports	34.2	38.8	28.3	27.5	29.4			30.8	30.5	30.4	30.4	30.0	29.8	
Net non-debt creating capital inflows (negative)	-3.7	-0.5	-5.1	-2.2	-3.0			-4.0	-5.7	-6.3	-6.8	-7.0	-7.0	
Automatic debt dynamics 1/	-0.7	1.1	-0.1	-3.6	-1.9			0.5	0.5	0.5	0.5	0.6	0.7	
Contribution from nominal interest rate	1.5	1.7	1.1	0.8	1.1			1.2	1.5	1.8	1.9	2.0	2.1	
Contribution from real GDP growth	-1.1	-1.0	0.4	-0.6	-0.8			-0.7	-1.0	-1.3	-1.3	-1.3	-1.4	
Contribution from price and exchange rate changes 2/	-1.1	0.4	-1.6	-3.8	-2.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.4	-5.8	3.2	4.9	1.3			4.7	3.4	3.6	4.3	4.5	4.8	
External debt-to-exports ratio (in percent)	83.7	74.3	100.9	105.0	94.6			109.4	116.7	125.8	132.4	138.5	145.1	
Gross external financing need (in billions of US dollars) 4/	68.1	93.9	74.3	56.8	65.6			69.9	76.0	83.9	85.6	91.6	97.0	
in percent of GDP	23.8	34.3	26.2	15.6	16.1	10-Year	10-Year	17.6	18.5	19.4	18.8	19.1	19.3	
Scenario with key variables at their historical averages 5/								**32.0**	**32.3**	**32.6**	**33.2**	**33.6**	**34.0**	**-6.0**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	5.5	3.6	-1.5	2.9	3.1	3.6	2.1	2.6	3.4	4.0	3.9	3.7	3.7	
GDP deflator in US dollars (change in percent)	3.7	-7.4	5.3	24.3	9.0	10.4	17.1	-5.4	0.3	1.3	1.3	1.3	1.3	
Nominal external interest rate (in percent)	7.4	6.2	4.2	3.9	4.3	5.7	1.3	4.4	5.0	5.5	5.5	5.5	5.5	
Growth of exports (US dollar terms, in percent)	14.8	9.1	-20.6	27.6	18.5	13.6	14.3	-1.5	2.8	3.1	5.7	5.9	5.8	
Growth of imports (US dollar terms, in percent)	15.4	8.9	-24.5	24.5	20.1	15.9	17.2	1.7	2.4	5.3	5.2	3.7	4.3	
Current account balance, excluding interest payments	-5.5	-5.4	-3.0	-2.0	-2.2	-2.4	2.4	-3.5	-3.6	-4.1	-4.0	-3.9	-3.7	
Net non-debt creating capital inflows	3.7	0.5	5.1	2.2	3.0	2.9	2.0	4.0	5.7	6.3	6.8	7.0	7.0	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

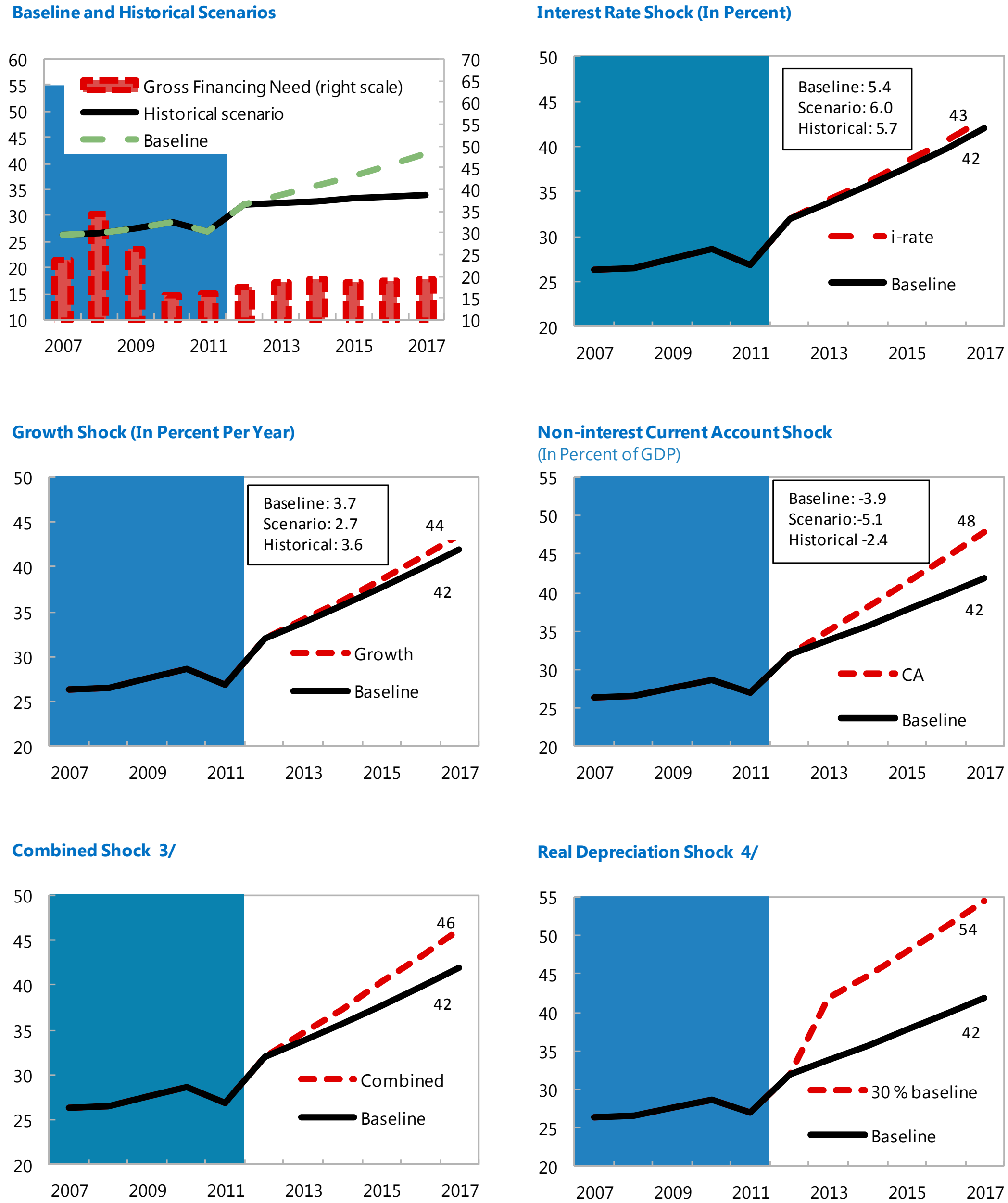
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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



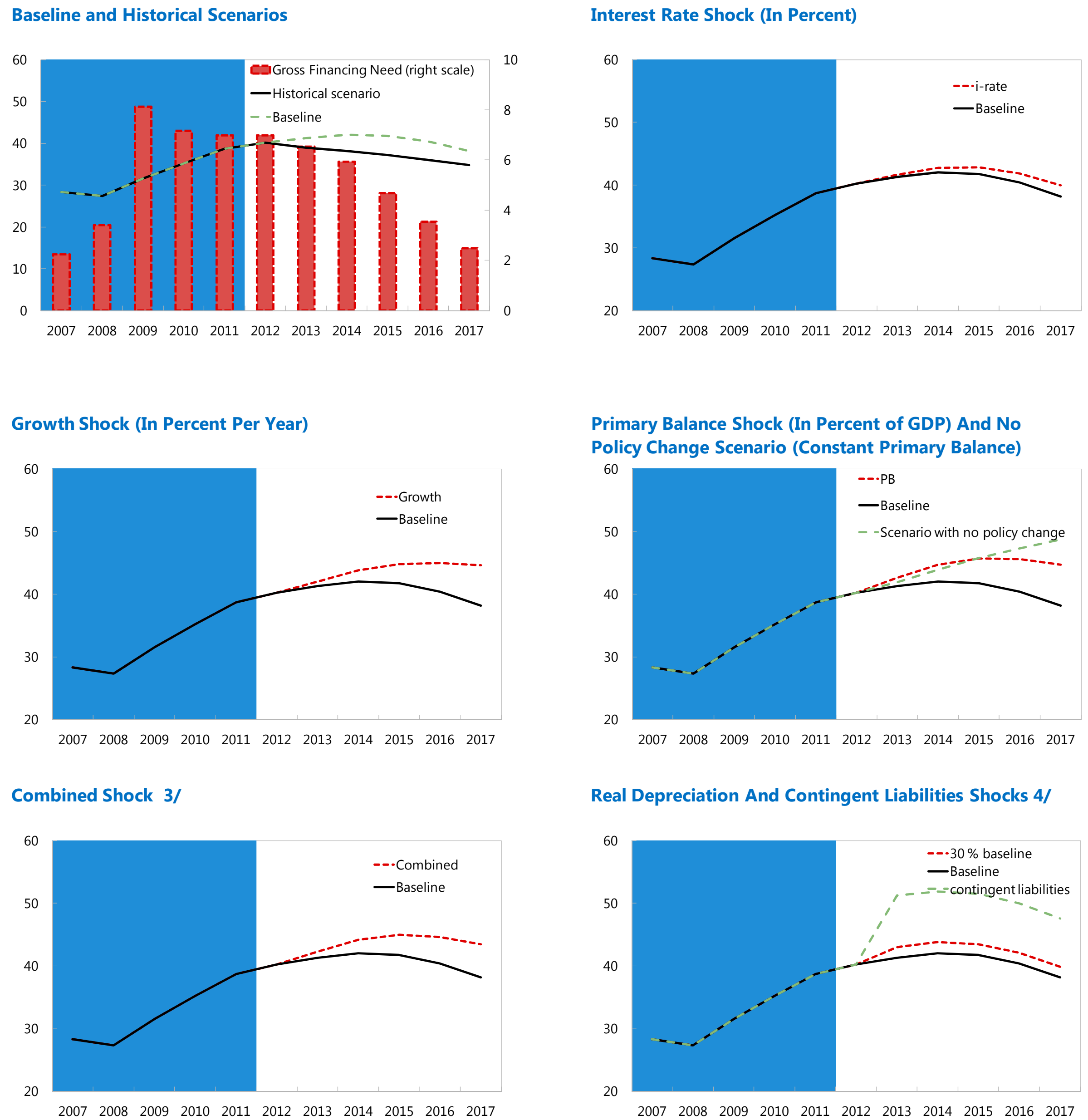
Source: Fund Staff Estimates and Forecast.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2011.

Table 2. South Africa: Public Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	28.3	27.4	31.5	35.3	38.7	**40.2**	**41.2**	**42.0**	**41.7**	**40.3**	**38.1**	**-0.6**
o/w foreign-currency denominated	3.8	4.3	4.1	3.7	4.1	3.5	2.8	2.6	2.3	2.1	1.9	
2 Change in public sector debt	-4.3	-0.9	4.2	3.7	3.4	1.5	1.0	0.7	-0.3	-1.4	-2.2	
3 Identified debt-creating flows (4+7+12)	-5.6	-1.3	2.9	1.3	1.7	0.9	0.5	-0.3	-1.2	-2.0	-2.8	
4 Primary deficit	-4.3	-2.1	2.7	2.4	2.0	1.7	1.1	0.4	-0.4	-1.3	-2.1	
5 Revenue and grants	29.6	29.8	27.8	27.5	27.5	27.6	27.9	28.2	28.6	29.0	29.4	
6 Primary (noninterest) expenditure	25.3	27.7	30.5	29.9	29.5	29.2	29.0	28.6	28.2	27.7	27.3	
7 Automatic debt dynamics 2/	-1.4	0.9	0.1	-1.1	-0.3	-0.8	-0.6	-0.7	-0.7	-0.7	-0.7	
8 Contribution from interest rate/growth differential 3/	-1.3	-0.5	1.0	-0.7	-1.1	-0.8	-0.6	-0.7	-0.7	-0.7	-0.7	
9 Of which contribution from real interest rate	0.3	0.4	0.6	0.1	-0.1	0.1	0.7	0.7	0.8	0.8	0.7	
10 Of which contribution from real GDP growth	-1.6	-0.9	0.4	-0.8	-1.0	-0.9	-1.3	-1.5	-1.5	-1.4	-1.4	
11 Contribution from exchange rate depreciation 4/	-0.1	1.3	-0.9	-0.4	0.8	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.3	0.3	1.3	2.4	1.7	0.6	0.6	1.1	0.9	0.6	0.6	
Public sector debt-to-revenue ratio 1/	95.6	91.8	113.4	128.4	140.7	145.8	147.7	148.8	145.7	138.8	129.6	
Gross financing need 6/	2.2	3.4	8.1	6.0	5.6	5.7	5.5	5.1	3.4	2.5	1.5	
in billions of U.S. dollars	6.4	9.3	23.1	21.8	22.7	24.0	23.9	23.4	16.3	12.6	8.1	
Scenario with key variables at their historical averages 7/						**40.2**	**38.9**	**38.1**	**37.2**	**36.0**	**34.7**	**-0.5**
Scenario with no policy change (constant primary balance) in 2012-2017						**40.2**	**41.9**	**43.9**	**45.7**	**47.2**	**48.7**	**-0.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.5	3.6	-1.5	2.9	3.1	2.7	3.4	4.0	3.9	3.7	3.7	
Average nominal interest rate on public debt (in percent) 8/	9.7	10.3	9.9	8.6	7.9	7.5	7.5	7.3	7.1	6.9	6.7	
Average real interest rate (nominal rate minus change in GDP deflator, in p	1.6	2.0	2.3	0.8	-0.1	0.6	2.1	2.2	2.2	2.2	2.0	
Nominal appreciation (increase in US dollar value of local currency, in perc	2.3	-26.8	26.1	11.3	-18.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.1	8.3	7.7	7.9	8.0	6.9	5.4	5.1	4.9	4.7	4.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	11.3	13.2	8.7	0.6	1.9	1.8	2.4	2.7	2.3	2.1	2.2	
Primary deficit	-4.3	-2.1	2.7	2.4	2.0	1.7	1.1	0.4	-0.4	-1.3	-2.1	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi$ (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. South Africa: Public Debt Sustainability: Bound Tests 1/ 2/
(Public 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. 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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND
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Public Information Notice (PIN) No. 12/98
FOR IMMEDIATE RELEASE
August 23, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with South Africa

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

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

Background

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

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

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

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

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

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

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

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

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

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

Executive Board Assessment

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

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

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

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

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

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

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with South Africa is also available.

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

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

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

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