September 2010
IMF Country Report No. 10/296

South Africa: 2010 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for South Africa

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 18, 2010, 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 June 23, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement on the Debt Sustainability Analysis.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 7, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for South Africa.

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

Copies of this report are available to the public from

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

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with South Africa

Approved by Sharmini Coorey and Aasim Husain

June 23, 2010

- ***Discussions:*** May 5–18, 2010, with Ministers Gordhan (Finance), Manuel (Planning) and Patel (Economic Development), Governor Marcus, other senior government officials as well as labor and private sector representatives.

- ***Staff***: Messrs. Selassie (Head), Ramcharan and Zhan and Mmes. Aydin and Stuart (SPR). Mr. Cuevas, the Senior Resident Representative, also took part in the discussions.

- ***Focus:*** The macroeconomic policy mix to sustain the on-going recovery and structural reforms needed to raise potential growth.

- ***Previous Article IV***: Directors found South Africa to be weathering the immediate effects of the global financial crisis well on account of its sound macroeconomic framework, underpinned by consistent and transparent frameworks, the floating exchange rate regime, and a well supervised financial system.

- ***Exchange system***: The South African rand floats against other currencies. The exchange rate system is free of restrictions on the making of payments and transfers for current international transactions.

Contents Page

EXECUTIVE SUMMARY

Background: Along some key dimensions, the global financial crisis had a much more pronounced impact on South Africa relative to some other large emerging markets. Notably, the contraction in South African economic activity in 2009, while smaller than those advanced countries at the epicenter of the crisis, was still larger than in much of emerging Asia, and Latin America. The scale of job shedding in South Africa was also among the highest in the G20. Playing off strongly counter-cyclical policies and the global recovery, economic activity is now rebounding. Recent events in the Euro Area have caused portfolio inflows to abate, the local stock market to wobble, and the rand to weaken somewhat against the U.S. dollar.

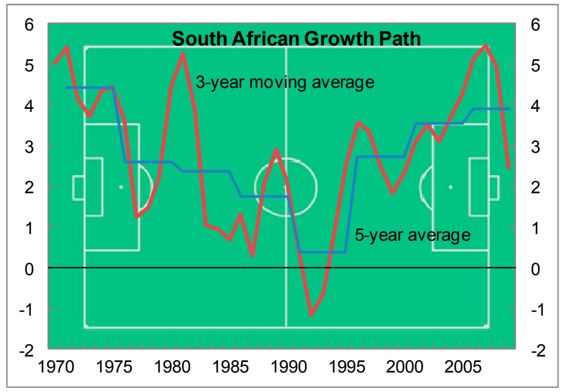
Challenges: The overriding economic policy challenge is reducing unemployment and inequality through higher economic growth. On the macroeconomic front, this requires fiscal and monetary policies that will sustain the ongoing recovery while gradually shifting to a more neutral stance so as economic recovery takes hold. Second, because the likely growth path under current policies is only going to have a limited impact on unemployment, there is a need for reforms to improve the efficiency of labor and product markets.

Authorities' views: Fiscal policy has been cast with an eye to supporting the recovery while gradually rebuilding policy buffers. If revenues over perform on account of higher growth in 2010 and beyond, they might use some of the additional resources on priority spending areas. Monetary policy has been eased fairly aggressively, and with the recovery taking hold and inflation expectations on the high side the room for further rate cuts has likely narrowed. The authorities feel that greater reserves accumulation would be useful in addressing the challenges from large capital flows, but also emphasized that these challenges are best dealt within a multilateral context. Unemployment is a key policy focus, and a wage subsidy aimed at younger unskilled workers, as well as other policy options are under discussion.

Staff views: Staff broadly concur with the authorities' approach, and believe that the current fiscal plan strikes the right balance between supporting the recovery through sustained infrastructure investment while ensuring fiscal sustainability. To avoid any procyclical bias in fiscal policy however, recurrent spending growth should adhere to the 2–3 percent real growth target outlined in the budget. Spending growth, particularly on wages, which has accounted for much of the recent growth in recurrent spending, should be benchmarked to productivity gains. The monetary policy stance has been appropriate, and with risks evenly poised, the scope for further rate cuts seems limited. There is more scope to increase international reserves further. More pressing still are policies to engender higher economic growth. The various government initiatives to enhance the competitiveness of selected industries can be usefully complemented with reforms to improve the effectiveness and efficiency of labor and product markets.

I. Introduction

1. **South Africa's economic performance since the mid-1990s has been strong**. Economic growth picked-up quite perceptibly during this period against the backdrop of vastly improved macroeconomic policy management. Tax collections improved allowing the fiscal deficit to decline and fiscal policy to be managed in a relatively counter-cyclical manner during the upswing. This in turn allowed public debt to be reduced from 48 percent of GDP in 1995 to 28 percent in 2007. International reserves have been increased from a mere US$8 billion in 2003 to close to US$42 billion in May 2010.



Source: South Africa Reserve Bank

2. **The result was a fairly robust macroeconomic position on the eve of the global financial crisis**. And while the economy slipped into recession in the wake of the crisis, there was ample room to ease monetary and fiscal policy aggressively and avoid an even deeper contraction.

3. **But this strong overall performance is blemished by the difficulty encountered in reducing the high unemployment level**. Moreover, the recession worsened the unemployment picture considerably, with close to 1 million jobs lost since end–2008. As of March 2010, unemployment stood at some 25 percent. This contributes to the rather high level of income inequality.

4. **Now as South Africa navigates its way out of its first recession since 1992 it faces two challenges.**

- **Sustaining the incipient recovery**. After contracting by 1¾ percent in 2009, South Africa's economy has turned the corner and is expected to expand by around 3¼ percent in 2010 (Table 1). The focus in the coming months accordingly needs to be on sustaining the recovery while recalibrating policies amidst the ebb and flow of portfolio flows and uncertain global economic prospects

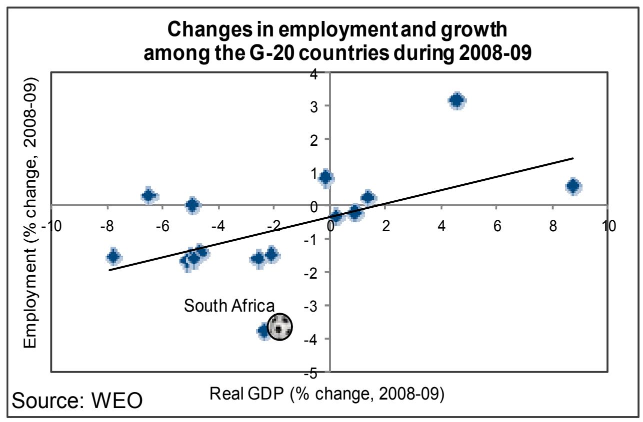
- **Raising potential growth.** The growth rates considered most probable under a baseline scenario (4–4½ percent over the medium-term) are highly unlikely to quickly reverse the sharp cyclical increase in unemployment much less make in-roads into reducing the high structural unemployment level. That would instead require growth rates in the range of 6 percent. And this in turn would require major changes to the incentives facing firms and employees.

II. Navigating The Near-Term Policy Challenges

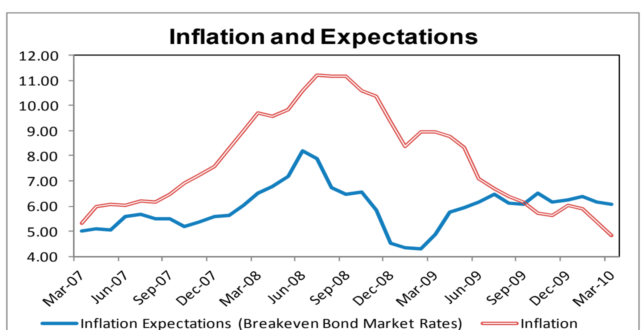
A. Recent Developments and Outlook

5. **Playing off strongly counter-cyclical policies and the global recovery, economic activity is rebounding**. The economy contracted for three consecutive quarters beginning in 2008Q4, a period during which close to 1 million jobs was lost. Economic activity has since expanded by 0.9 and, 3.2 percent in 2009Q3 and 2009Q4 respectively. And growth accelerated further still to 4.6 percent in the first quarter of 2010 (Figure 1). The recovery most recently has been led by a rebound in activity in the export-oriented and interest-sensitive sectors—mining, manufacturing, and financial services. From the demand side, private consumption growth remains anemic, reflecting high levels of indebtedness, and with ample unutilized capacity, investment growth is also weak. Still, the recovery looks self-sustaining providing the global recovery continues apace.

6. **Along some key dimensions, the global financial crisis had a much more pronounced impact on South Africa relative to some other large emerging markets**. Notably, the contraction in South African economic activity in 2009, while smaller than those advanced countries at the epicenter of the crisis, was still larger than in much of emerging Asia, and Latin America—Brazil's economy declined by -0.2 percent in 2009—and indeed much of sub-Saharan Africa. In addition, by some measures, the scale of job shedding in South Africa was among the highest in the G20, many of which also experienced banking crises. One explanation for this seemingly disproportionate impact of the crisis on South Africa is the sensitivity of the country's main exports (diamonds, platinum, cars, etc.) to credit conditions in the advanced countries.



7. **Reflecting the subdued domestic demand conditions inflation has declined steadily**. After peaking at some 12 percent in late 2008, inflation as of April 2010 stood at 4¾ percent. The deceleration has been somewhat sluggish reflecting the extensive reliance on backward-looking wage awards and administrative price increases. Inflation expectations derived from the bond market have also declined,



Source: Datastream

and the inflation rate is expected to remain within the 3–6 percent target band over the next 2 quarters. Survey based measures of inflation expectation for 2011, however, remain above the target band.

8. **Through April, the stock market and the rand strengthened significantly from last year's lows amid large capital inflows**. The rebound in the rand is one of the strongest among emerging markets, and has been largely driven by capital inflows (Figure 2). In particular, portfolio flows in the first 4 months of 2010 have totaled some \$6 billion, above the \$5 billion observed in during the same period in 2007 at the height of the global liquidity glut. Price-to-earnings ratios on the Johannesburg Stock Exchange are now slightly above their pre crisis average. Yields on government bonds have also drifted lower in the last year, but have remained attractive enough to elicit substantial flows particularly in recent months. Changes in global sentiment triggered by recent events in the Euro area, however, caused portfolio inflows to abate, the local stock market to wobble, and the rand to weaken somewhat in May, illustrating the high level of sensitivity of South Africa to developments in the rest of the world.

9. **Looking ahead, the staff expects the recovery to be sustained, albeit in an environment of heightened risks**. Under the central scenario, output growth is projected to be 3¼ percent in 2010, gradually rising to 4½ percent over the medium term with the output gap expected to close by around 2014, driven in part by exports and a gradual recovery of private investment and, to a lesser extent, household consumption. Inflation is also expected to remain within the target band over the forecast horizon. There are, however, some mainly downside risks to this scenario:

- A hiatus in the global economic recovery would almost certainly stifle South Africa's on-going recovery. In particular, the elasticity of South African exports to the economic performance of the Euro area, South Africa's largest trading partner, is relatively high, and any persistent weakness there can spill over onto the South African economy. The risk of spillovers from any strains in the Euro area financial sector to South Africa is mainly indirect through possible effects on the UK and the significant level of nonresident activity in South Africa's foreign exchange market (nonresident transactions account for nearly three quarters of turnover).

- A more marked differentiation in the speed of recovery of South Africa's various trading partners may also affect the sectoral composition of growth in South Africa, with potential implications for job creation. South Africa's exports to the Euro area are dominated by manufacturing exports while its exports to, for example, China mainly comprise of commodities.

- The impact of ongoing global financial market uncertainty is a bit less clear. If it heads in the direction of generalized risk aversion, then there may well be a sell-off of rand assets, translating into tighter financing conditions for both corporates and the government. On the other hand, if markets were to become more discriminating, South Africa's relatively sound macroeconomic situation may lead to more portfolio inflows, with attendant pressure on the rand to appreciate.

10. **Over the medium term, the pick-up in growth, and the continuation of the infrastructure investment program are expected to widen the current account deficit**. Continued rand strength and the country's apparent structural savings-investment imbalance are also likely to add to the current account deficit. These sustained deficits are a source of vulnerability, especially given that volatile portfolio flows are projected to be the chief source of funding for the current account over the medium term. However, there are some important mitigating factors. Equity flows are an important source of financing of the current account deficit, providing an important countercyclical impulse during downturns (as demonstrated in 2009). The floating exchange rate acts as a shock absorber with foreign investors sharing in the adjustment burden on occasions when capital flows out. External debt is also low (28 percent of GDP at end-2009), though it is projected to increase, and households and corporates have limited foreign currency exposure.

B. Ensuring Fiscal Sustainability

11. **The sizeable fiscal easing has helped ameliorate the impact of the crisis, albeit at some cost**. According to staff estimates, the structural fiscal deficit widened from 2¼ to 6 percent of GDP between 2008/09 and 2009/10 (text table), almost entirely on account of discretionary spending increases. Part of it (about ¾ percentage points of GDP) was due to lending to the state-owned electricity company (Eskom) and is thus expected to be a one-off. Another 2 percentage points of GDP however went towards public sector salary increases as well as increased coverage of social transfer programs and is thus of a more permanent nature. On the revenue side, the staff's work suggests that the decline in collections is mainly due to the output gap, and should reverse as the gap gradually closes.[1]

12. **The government plans to reduce the fiscal deficit through lower spending growth**. Specifically, the 2010/11 budget documents noted that spending growth would be curbed ambitiously from the 9 percent or so growth rate of the past three years to 2–3 percent going forward. Under the authorities' lower economic growth assumptions this would permit

[1] See Aydin (2010, forthcoming) "*Cyclicality of Revenue and Structural Balances in South Africa*" shows that tax revenue cycle is mainly explained by changes in the output gap and to a lesser degree by the credit cycle. Asset and commodity prices do not have any explanatory power. Aydin (2010, forthcoming) "*Performance of Fiscal Accounts in South Africa in a Cross-Country Setting*" shows that elasticity of revenues with respect to growth in South Africa is quite high during the business cycle upturns.

Headline and Cyclically Adjusted Fiscal Balances and Public Debt, 2007/08-2012/13
(In percent of GDP)

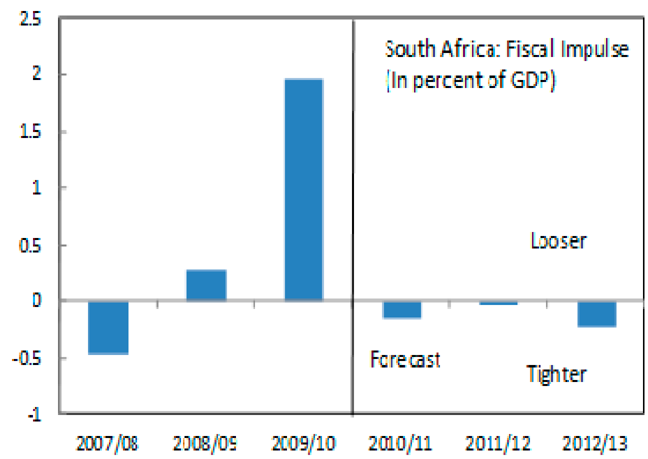
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Headline balances						
Consolidated government	1.3	-1.0	-6.7	-5.6	-4.1	-2.6
Public sector borrowing requirement	-0.6	3.8	11.1	10.4	7.8	5.7
Cyclically adjusted balances						
Consolidated government	-0.2	-2.3	-6.0	-5.0	-3.5	-2.3
Public sector borrowing requirement	0.9	5.1	10.4	9.8	7.2	5.4
Fiscal impulse	-0.5	0.3	2.0	-0.2	0.0	-0.2
Government debt 1/	27.7	27.0	32.1	35.8	38.4	39.4
Public debt 2/	33.8	33.7	39.1	42.6	45.1	45.9

1/ Includes the central government, and provincial and local government activities financed with transfers from the central government.
2/ Includes government debt, debt of local governments and local enterprises, and debt of nonfinancial public enterprises.

a gradual reduction in the fiscal deficit.[2] But with more evidence now that economic growth—at least, in 2010—is likely to be higher than earlier envisaged, staff pointed to the feasibility of a lower deficit path, provided that the government sticks to its announced spending growth path (Table 2). In particular staff argued that such a spending path would help:

- prevent a pro-cyclical bias in fiscal policy. The team's estimates suggest that a 2-3 percent real growth path would be consistent with a broadly neutral fiscal impulse following the 2009/10 impulse of more than 2 percent of GDP.

- rebuild public savings quicker, including with a view to containing the current account deficit and alleviating the burden on monetary and exchange rate policy.



Source: National Treasury and IMF staff projections

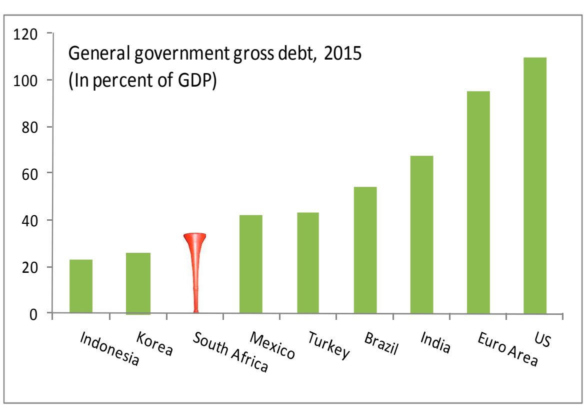
- avoid allocating still more resources to the public sector wage bill, in particular before the effectiveness of the last round of large increases in improving public service delivery have been ascertained.

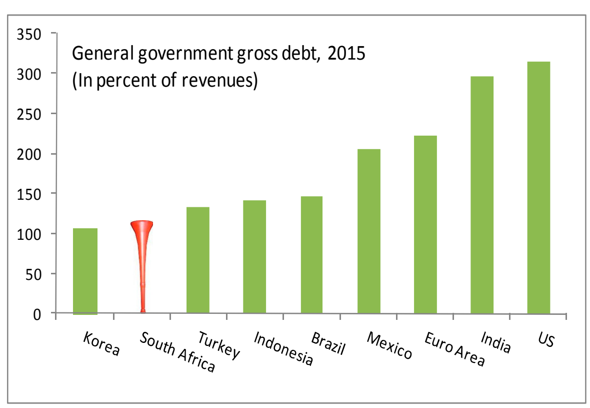
[2] The authorities' 2010/11 budget envisages output to grow by 2¼ percent in 2010, and by 3¼–3½ percent in outer years.

13. **The authorities affirmed their strong commitment to reducing the fiscal deficit as quickly as practicable**. They were guarded about the prospects for a quick a recovery in revenue collections, preferring to be surprised on the upside. And should revenue collections be higher than they currently envisage, they noted that they might use some of these additional resources to fund urgent development priorities.

14. **A somewhat higher rate of spending growth can be accommodated, but staff pointed out that longer-term fiscal needs warrant sticking to the announced spending path**. There are a number of reforms being contemplated that could entail significant budgetary outlays in the near future—including social security and health care reforms. And staff argued that if any of the additional fiscal room is to be exploited, it could more productively be directed towards the unanticipated cost of these and related reforms and/or, for example, to defray the cost of increasing international reserves further. Also, the impressive increase in the revenue-to-GDP ratio in recent years looks mainly to have been on account of an expansion in the tax base and significant improvement in tax administration. But the tax buoyancy also reflects the strong credit boom since the mid-2000s. And with rapid credit growth unlikely to be repeated in the near future, there is an outside possibility that tax collections may underperform.

15. **Overall, under most plausible growth scenarios it should be possible to contain public debt at reasonable levels**. The consolidated government debt stock is now expected to rise from 28 percent in 2007 and peak just under 40 percent in 2012 before declining steadily in the outer years under the staff's projections (Appendix 1). While this increase in indebtedness is nontrivial, it would still leave both the debt-to-GDP and debt to tax revenue ratios well below the averages of either the advanced countries or that of most of the large G-20 emerging markets. Including the debt of public enterprises and local governments, the debt-to-GDP ratio would peak at some 46 percent 2012—a still manageable debt level (Table 3). Borrowing by public enterprises is expected to remain at elevated levels over the medium-term as they finance the much-needed infrastructure investment program. But to contain fiscal risk, part of the resources required are being generated through higher tariffs—with, for example, electricity prices set to increase by 25 percent a year for the next three years, moving them closer to full cost recovery.





Source: WEO

C. Monetary Policy: Staying Ahead of the Curve

16. **Monetary policy considerations are now finely balanced**. In particular, there was agreement between the authorities and staff that the risks to the inflation outlook seem broadly balanced. On the one hand, militating against a further cut in the policy rate is the fact that economic recovery is now nicely in-train with the full impact of past monetary easing yet to be realized (Figure 3). There are also nontrivial risks posed by on-going wage settlements at well above the current inflation rate. In addition, the authorities saw some upside risks to the inflation path from any adjustments to domestic administered prices beyond anticipated electricity tariffs. These risks are however counter balanced by the fact that households balance sheets remain under strain, credit growth remains anemic and the output gap is not expected to close for another few years. Staff and the authorities agreed that the focus of monetary policy should be to avoid falling behind the curve and, with risks evenly balanced, that there might be a need to move fast in either direction in response to new developments.

17. **The authorities feel that developments in the Euro areas pose considerable risk to South Africa**. Weaker-than-envisaged global growth could threaten the ongoing recovery. And should this also lead to higher risk premia on South African assets, the related depreciation of the rand could induce an unwelcome combination of higher inflationary pressures alongside weak growth prospects. This could be particularly challenging for the SARB, which might face a difficult policy dilemma requiring judgment on the relative threat from those two risks.

18. **Staff noted that the inflation targeting regime has served South Africa well**. The framework has been flexible enough to allow a sharp reduction in interest rates as the economy slowed down, and the policy rate is now at its lowest level in over a decade. Still, this has not prevented criticism of the monetary policy framework. The Minister of Finance has sought to remove any ambiguity by making it clear in a public letter that the inflation targeting framework would continue to be implemented flexibly. The 3–6 percent target range for headline inflation was affirmed. And the letter also outlined the need to continue to pursue this objective with due regard to balanced and sustainable growth.

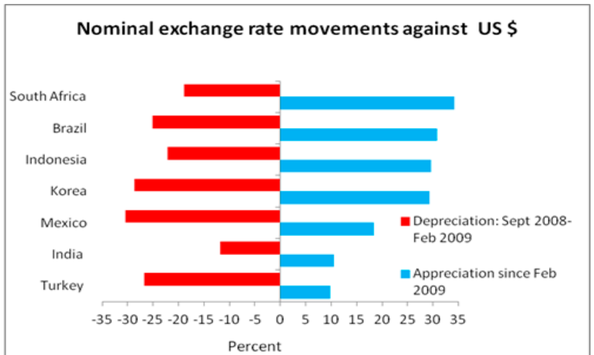
19. **The mission also welcomed the authorities enhanced communication efforts on the monetary policy decisions**. The staff's work shows that agents are backward looking, and expectations of next year's inflation is shaped by inflation outcomes some three to four quarters in the past. Staff estimates also show that these backward looking expectations in turn play a prominent role in determining wage settlements, creating a relatively sticky inflation series. A focused communication strategy on the part of the SARB that induces agents to look forward when forming their inflation expectations, and perhaps place greater

weight on the SARB's own forecasts, could help dampen the real cost of disinflation on the domestic economy.[3]

20. **The recent steps to integrate banking and financial sector stability issues within the monetary policy decision making framework are an important advance**. South Africa's financial system is comprised of large complex firms providing banking, insurance and other financial services. And shocks to any segment of these business operations can spill over within the firm, and more broadly to the financial sector as whole, given its interlocking nature. The government has strengthened macro prudential analyses, and there is further work planned on monitoring how shocks, such as sharp swings in domestic stock prices induced by external turbulence, might affect the overall financial system.

Managing Capital Inflows

21. **The recent debate over the appropriate monetary policy framework has partly been driven by the rand's volatility**. In the wake of the collapse of Lehman Brothers in the fall of 2008, the rand was among the largest movers depreciating by some 30 percent in the immediate aftermath of the crisis and by 19 percent through February 2009. In the 12-months since, the rand appreciated strongly—again among the currencies with the largest appreciation in the emerging market universe. These movements were mainly driven by the ebb and flow of portfolio flows (Table 4). And the appreciation, in particular, has been the source of strong concern lest it hampers the recovery. Since April, the rand has weakened somewhat in the wake of the heightened uncertainties on global financial markets. At its most recent valuation level, the staff's estimates suggest that the real exchange rate could be around 5–15 percent overvalued, although there is a large degree of uncertainty around these estimates (Box 1).

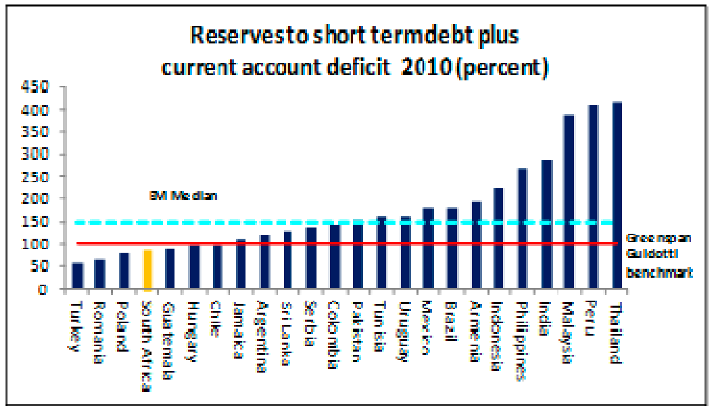


Source: Bloomberg

22. **Against this backdrop, there was discussion of the appropriate policy response**. There was broad agreement that the flexible exchange rate regime had served South Africa well and should be retained, but also recognition that exchange rate volatility had at times been very high. Staff argued that there seems greater scope to use the opportunity provided

[3] Rodney Ramcharan "Monetary Policy and Economic Fluctuations in Emerging Markets: Evidence from the "Forecast Approach" in South Africa."

by strong inflows to build reserves than has perhaps been the case in the recent past—especially as they are on the low side compared to several standard metrics (Table 5). While a modestly higher reserves buffer may not have much effect on the level of the exchange rate, it could be helpful in absorbing large shocks. The authorities did not disagree. They noted that reserve accumulation in recent months had been rather more than suggested by changes in the level of gross reserves, which have remained broadly unchanged in US dollar terms on account of valuation changes in nondollar assets. However, they also pointed to the fiscal cost that is associated with the accumulation of reserves. Lastly, they noted that the scale and depth of South Africa's foreign exchange markets—with a daily transaction volume of the order of $10-12 billion—means that the government's ability to influence the level of the rand is limited. The pros and cons of other policy options being discussed in the public domain were also considered:



Source: WEO

- *Relaxing controls on outflows*. As part of their gradual approach to the liberalization of foreign exchange controls on residents, the authorities made some changes in October 2009 and March 2010.[4] The staff's sense was that further removal of controls should continue to be part of this gradual approach and should not be accelerated given the heightened uncertainties at the moment.

- *Controls on inflows*. A small tax on inflows might help slow the volume of inflows or change its composition. However, the international experience is that these tools might be easily circumvented, with their effectiveness eroding overtime. Further, given South Africa's reliance on foreign savings to finance investment the adoption of such an instrument would not be as straight forward.

[4] The authorities announced a relaxation of capital controls on residents by increasing the limit on outward investment by corporates from R 50 million to R 250 million, removing the 180 day rule for conversion of foreign currencies into rand and by increasing the foreign capital allowance for individuals from R 2 million to R 4 million.

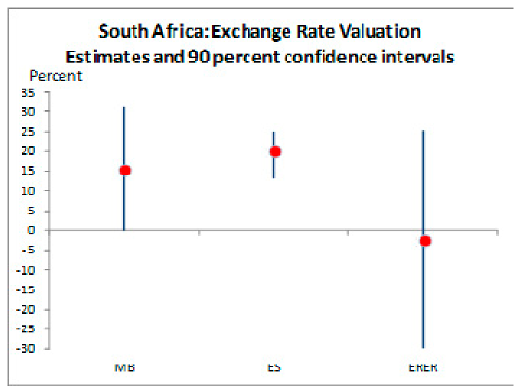
Box 1. South Africa: Exchange Rate Assessment

South Africa's floating exchange rate regime has been an important absorber of shocks, enabling the economy to adjust in the face of the global financial crisis. The floating exchange rate has discouraged private sector borrowing in foreign currency, preventing a buildup of foreign currency mismatches on household and corporate sector balance sheets, and ensuring that foreign investors share in the adjustment burden in the event of rand depreciation. However, the rand has appreciated strongly through 2009-10, likely driven by portfolio inflows and a search for yield. Even following a period of volatility and depreciation in response to market turbulence in Europe, the rand looks to be somewhat overvalued on a range of measures. The deterioration in export market performance in 2009 with South Africa's export volumes contracting much more sharply than import demand of major trading partners (-20 percent versus -11 percent respectively) could also possibly point towards exchange rate overvaluation, although specialization in credit-sensitive goods also likely played a role.

Staff estimates based on the IMF's methodology, adapted for South Africa specific circumstances, suggest the exchange rate could be around 5-15 percent overvalued—but with a wide range of uncertainty as illustrated by the wide range of the confidence intervals.

Using CGER approaches:

- The macroeconomic balance approach suggests the current account norm is around -3 percent – somewhat less negative than the level reached in 2009—and so this approach points to an overvaluation of around 15 percent.[1/]
- The external sustainability approach—based on stabilizing the NFA at around -30 percent of GDP (similar to the average of other emerging markets)—points to an even bigger overvaluation of around 20 percent.
- By contrast, the equilibrium real exchange rate approach suggests that the exchange rate is close to balance. But this approach hinges on the assumption that commodity prices in the medium term will remain at their current elevated levels, thus yielding little difference between the estimated equilibrium and actual real exchange rates.



Source: IMF staff estimates

Discussions with private sector and other commentators also point to overvaluation estimates ranging from around 5-15 percent. Analysts responding to a Reuters survey also typically expect a nominal depreciation of the rand against the dollar of between 5 and 25 percent by the end of 2012.

1/ In both the macroeconomic balance and external sustainability approaches the projected current account deficit excludes the temporary but persistent surge in public investment which would otherwise add 1.5 percentage points to the current account deficit. If the public investment program is assumed to be permanent this would raise the estimate of current account overvaluation to around 24 percent and 28 percent respectively.

- *Interest rate cuts*. There was broad agreement that interest rate decisions should remain fully embedded in monetary policy considerations. Staff also argued that rate cuts for the sole purpose of countering capital flows might well be counterproductive, as lower interest rates might elicit more inflows into equities, and strengthen the exchange rate.

- *Policy mix*. The current fiscal policy stance has been calibrated with a view to supporting the recovery while alleviating infrastructure bottlenecks. Changing the mix towards a much tighter fiscal stance would however require revisiting current fiscal objectives—which are appropriately cast from a sustainability point of view.

- *Targeted interventions.* Capital market imperfections can make it difficult, especially for smaller firms to borrow against future profits and elevate hedging costs. The authorities and staff thus saw some merit in temporary targeted intervention to help the enterprises that are being most adversely affected by the strength of the rand. For instance, increases in the investment tax allowance for small and medium-sized companies engaged in labor-intensive nontraditional activities could be considered. By tying the benefit to investment, this could help elicit more investment in plant and machinery as well as creating more jobs. However, care would need to be taken to ensure that such measures are easily reversible. Other options included finding ways to make it less costly for affected companies to hedge exchange rate risk. There was though agreement that any such schemes would need to be carefully designed to focus its coverage and with some degree of automaticity so it expires when the degree of overvaluation diminishes.

Financial Sector

23. **The authorities noted that the banking sector has remained essentially sound, although its activity was affected by the recession** (Box 2). Banks remained profitable despite the increase in impaired loans to 6 percent of gross loans and advances in January 2010 from 2 percent two years earlier—some of this increase may have been due to the switch to Basel II accounting standards. In any event, no public support was extended during the recession and capital adequacy ratios remained above their regulatory minima throughout the crisis period (Figure 4). This in part reflected the banking sector's moderate exposure to foreign risk and the conservative regulatory environment. Nevertheless, the rise in idle capacity and the sizable jobs losses have seen a contraction in credit extended to the private sector thus far in 2010.

24. **South Africa has a strong bank supervisory framework**. In following up on the 2009 FSAP update recommendations, staff welcomed ongoing actions by the bank and nonbank regulators to exchange information on a regular basis. These include regular supervisory meetings between the FSB and the BSD for the three largest banking and insurance groups. And in 2010, there are plans to host a college of supervisors from those African countries in which South African banks have a presence. In addition, the SARB is

developing a framework for the analysis of macro-prudential risks, and there has also been liquidity risk reviews and simulation exercises involving the country's major banks.

25. **However, staff also highlighted a number of challenges that require careful monitoring.** This included the potential implications of a sudden reversal of the recent sharp increase in domestic stock prices and the transmission of external shocks (Table 6). The interlocking nature of the financial system means that such a shock could have much wider implications for financial stability, especially against the backdrop of weakened household and enterprise balance sheets (Table 7). Also, the weak employment environment in conjunction with large share of mortgages on the balance sheet of banks presents another challenge that require monitoring. The authorities acknowledged these risks and stressed that they are keeping a watchful eye on such risks. A joint IMF/World Bank team is finalizing an assessment of the regulatory framework's compliance with internationally accepted standards and codes (Basel II, IOSCO and IAIS). This assessment was requested by the authorities in response to an observation made by the Financial Stability Board. The preliminary assessments are broadly positive; the assessors are making some recommendations to ensure fuller compliance with the standards.

26. **The authorities and the banks are following the discussion on regulatory reform taking place in global fora**. They are of the view that many of the measures being proposed are in fact already in effect in South Africa. However, they expressed reservations in connection with special levies and taxes, arguing that the South African government had not been called upon to support banks, and with stronger liquidity requirements, which would be difficult to implement given the banks' reliance on wholesale funding.

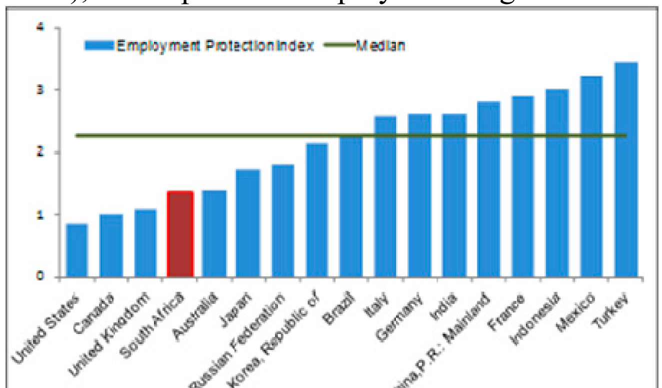
III. Raising Potential Growth

A. Unemployment

27. **South Africa's labor market has been characterized by persistently high unemployment and low labor force participation**. The country's official unemployment rate has stayed above 20 percent since the launch of the Labor Force Survey in 2000, and remains the highest among G-20 countries. South Africa's labor force participation rate, at around 55 percent, is almost 20 percentage points below the median for G-20 countries.

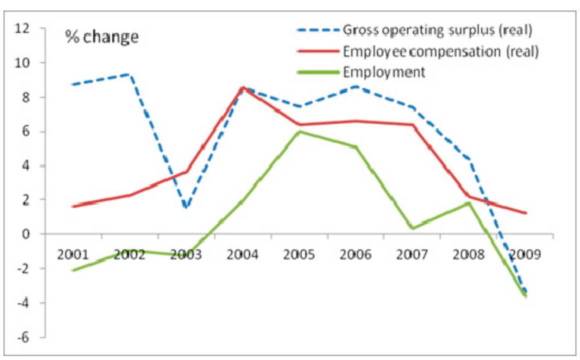
28. **The recession has exacerbated this problem**. In the first three quarters of 2009, close to 1 million jobs were lost, which is almost equivalent to 7.3 percent of the total employed workers at end-2008. After briefly stabilizing in the last quarter of 2009, job shedding continued in the first quarter of this year. As of March 2010, the unemployment rate in South Africa stands at some 25 percent based on the official narrow measure, which excludes discouraged workers. If discouraged workers are included, close to 36 percent of the labor force is unemployed.

29. **One feature of the labor market is its flexibility in the volume dimension**. This is evident from the fairly elastic response of employment to growth. Both during the upswing (2000-07) and now the downswing (2008-09), the response of employment to growth in South Africa was the highest among the G-20. A look at measures of employment protection legislation, such as that compiled by the OECD, also does not point too much by way of policy-induced obstacles to hiring and firing. South Africa has the fourth lowest score among G-20 countries and the lowest score among G-20 emerging markets.

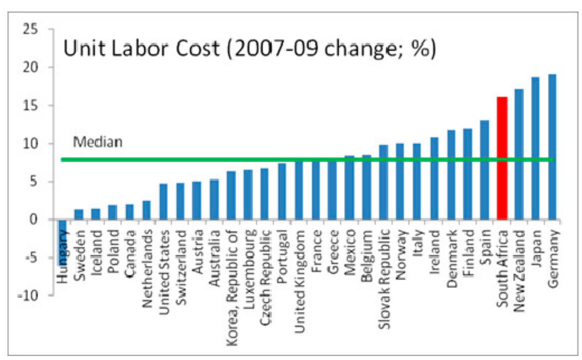


Source: OECD

30. **But wages have proved much stickier.** As economic growth slowed and eventually turned negative during the period 2007-09, wage growth remained strong. The average wage settlement between unions and the business in 2009 reached 9.3 percent, led by the public sector wage increase of 11.2 percent, significantly outstripping inflation and productivity gains. Consequently, unit labor costs increased by around 16 percent in the last two years, one of the highest among a wide range of countries. But unlike the boom years when firms could more easily pass-through higher labor costs onto final goods prices, the recession and associated disinflation significantly limited firms' pricing power. Thus, the strong wage growth that continued during the recession looks to have contributed to the substantial job losses. In the staff's view, this suggests that the wage bargaining framework is not sufficiently flexible.



Source: Stats SA



Source: WEO

31. **Most worrisome still, staff estimates that unemployment is likely to remain high for a considerable period**. Even allowing for the customary high elasticity of employment with respect to output growth and assuming a constant labor participation rate, the projections suggest that employment as a share of the total labor force would not return to its recent 2008 peak until 2015 or so. It is only with growth in the region of 5½–6 percent that

employment levels would revert to the level last seen in 2008 by 2013. Thus, raising potential growth to around 6 percent, and making such growth more labor intensive, is paramount to large scale job creation.

32. **To address unemployment, the authorities are focused on orienting economic policy to raise potential growth and increase its labor intensity**. To this end, the government has emphasized that its infrastructure construction program, intended to relieve bottlenecks in electricity and transport, would raise potential growth over the medium term and foster more job creation. Electricity remains a key constraint on economic activity, and lower transport costs, would not only reduce the cost of business, but make it easier for workers to commute to jobs, helping to overcome the legacy of spatial separation. The authorities have also noted that elements of this infrastructure program have been designed to be labor intensive, helping to facilitate faster job growth in the short run.

33. **The government is also contemplating more direct interventions in the labor market, such as a wage subsidy aimed at younger workers.** Current labor market institutions do not allow for the productivity gap between young and older workers to be reflected fully in wage differentials and so unemployment among young labor force entrants is phenomenally high at some 50 percent (Table 8). The wage subsidy, if introduced, would make it cheaper for firms to employ young unskilled workers, helping to build skills and enhance the productivity of these workers over their careers. The authorities however noted that there is no single measure available to address unemployment, and only a combination of carefully designed initiatives as well as faster growth are likely to make significant inroads in unemployment.

B. Other Structural Policies

34. **Enhancing product market competitiveness is also essential for raising potential growth.** In aggregate, the OECD has found that product market indicators for South Africa to be more restrictive than any of its member countries other than Poland. While the degree of product market restrictiveness in South Africa is not too dissimilar from that found in some large non-OECD countries such as China, India and Russia, in South Africa it is coupled with a dearth of significant informal sector activity, resulting in a relative lack of dynamism and competition in product markets.

35. **In the main, the authorities are tackling this problem by strengthening the enforcement of competition policy**. To this end, for example, the activities of the Competition Commission have been stepped-up considerably. Over the past year, the Commission has undertaken a number of investigations and indentified cartel-like practices in a range of input industries such as milling, imposing fines on those found guilty. The Commission has also identified anti-competitive practices in the financial services sector, and in response, the government has encouraged banks to lower fees and widen credit access for

consumers and small and medium sized firms. More generally, there have also been steps to enhance private sector participation and lower costs in some sectors that are natural monopolies, like transport.

36. **Staff welcomed these steps but also inquired if a broader and more market based-impetus is not called for to enhance competition.** Staff has in the past suggested—and reiterated—that further liberalization of trade could be important in aiding product market competition and that simplifying and making the tariff structure more transparent would be helpful. The authorities however pointed to the generally low level of tariff and non tariff barriers compared to other middle income countries. But in 2009 some steps were taken to selectively raise tariff levels in favored industries.

37. **South Africa also remains committed to regional integration but economic partnership agreements (EPA) with the EU by some SACU members poses challenges for the customs union.** The South African authorities remain concerned that there are potential inconsistencies between Botswana's, Lesotho's and Swaziland's interim economic partnership agreements (EPAs) with the EU and the rules of the Southern Africa Customs Union (SACU), which also includes Namibia. They noted that the interim EPAs contain different rules of origin and tariffs structures and are difficult to harmonize with South Africa's trade regime. Thus there may be a need to accommodate different tariff structures at the port of entry, complicating the operation of the customs union. The authorities noted that the gradual expansion of SACU, which celebrated its centenary this year, remains a central pillar of regional integration within the broader South African Development Community. Further discussions with SACU will take place over the summer.

IV. Staff Appraisal

38. ***Crisis and policy response***. Building on over a decade of prudent macroeconomic management, the South African government was able to orchestrate a timely and effective countercyclical policy response to the recession. The economy appears to be recovering, and staff strongly supports the easing of monetary and fiscal policies that was undertaken as the economy slowed. It was timed well and of broadly the right magnitude.

39. ***Challenges***. Like the government, staff sees the overriding economic policy challenge as reducing unemployment and inequality through higher economic growth. Fostering growth in turn requires fiscal and monetary policies that will sustain the ongoing recovery while gradually shifting to a more neutral stance so as to rebuild policy space.

40. ***Context***. As if this challenge was not demanding enough, it has to be pursued in a much more complex and uncertain global environment—one where the threat from exogenous shocks has heightened. This highlights the importance of preserving residual

policy space, especially as prolonged market volatility could depress growth in the European Union, and dampen South African export demand.

41. ***Approach***. A useful starting principle is to sustain those policies that have been reasonably effective and to change the policies in the areas which have been most problematic. In the broadest of terms, this calls for sustaining the current macro policies and framework, but bolder measures are needed to improve the effectiveness of labor and product markets, where outcomes have been poor, through structural reforms. Against this backdrop, the following policies would help consolidate the recovery while raising potential growth.

42. ***Fiscal policy***. The government's current fiscal plan strikes the right balance between supporting the ongoing recovery through sustained infrastructure investment while rebuilding fiscal space. There is strong merit in adhering to the 2–3 percent real spending growth targeted in the 2010/11 budget—particularly in the case of recurrent spending. Spending growth, particularly on wages, should be benchmarked to productivity gains. Another round of public sector wage settlements that exceed inflation and productivity gains would likely distort wage negotiations in other sectors—and indeed hinder the ability of the SARB to anchor inflation expectations.

43. ***Monetary policy***. The inflation targeting framework has served South Africa well and the SARB's series of interest rate cuts have significantly moderated the impact of the recession. However, risks at this point are evenly poised, and the scope for further rate cuts looks limited if the recovery proceeds as expected. But in the current highly uncertain environment, the SARB should remain ready to move quickly in either direction—a tightening (if there is an upward shift in inflation expectations) or a loosening (in response to, say, a deterioration in external conditions) of the stance as needed to keep inflation expectation anchored within the band. The backward looking nature of inflation expectations and its significant role in determining wage settlements engender significant inflation inertia, elevating the cost of disinflation. There is thus considerable scope for the SARB to continue its communication and outreach to help make inflation expectations more forward looking and enhance the effectiveness of monetary policy.

44. ***The rand***. Staff's central estimates suggest that the rand is somewhat overvalued, although the range of uncertainty accompanying these estimates is wide. At this juncture, perhaps the most effective step that can be taken would be to use the opportunities provided by large capital inflows to increase the level of international reserves so as to further increase South Africa's policy buffers in the event of large shocks. Easing monetary policy on its own without the support of a tighter fiscal stance (or incomes policy to limit wage increases) would simply lead to higher inflation and an unchanged real exchange rate.

45. ***Interventions***. Given capital market imperfections and the potentially high cost of hedging currency movements, especially for smaller firms, targeted interventions to help the

enterprises that are being most adversely affected by the strength of the rand could mitigate the negative output effects of the overvaluation. But given the pitfalls associated with such approaches, South Africa's foray into this area should be disciplined (time bound and with performance-based criteria), transparent (on budget) and with a high degree of automaticity.

46. ***Growth.*** The greater challenge in South Africa is to raise the country's growth potential. The government has put in-train a number of initiatives to this end—from increased investment in infrastructure to more support to industry to improvements in the provision of key public services such as education and health. These should contribute to higher growth in the medium- to long-term. But the severity of the unemployment problem, in particular, calls for bolder action to enhance the efficacy of labor and product markets. And in terms of timing, there is a strong case for undertaking these reforms now during the upswing of a business cycle, as more jobs are being created and profitability is improving.

47. ***Labor market***. As the government well recognizes, South Africa's growth potential cannot be unleashed without tapping into the large reservoir of unemployed people. The wage subsidy proposal being considered for young workers would be a useful starting point, although any such scheme would need to be carefully designed to minimize the displacement of existing workers, and the substitution away from older workers. This is one area where significant fiscal resources would be well-worth allocating. But perhaps of more importance changes to the wage bargaining framework seem imperative. South Africa's labor legislation provides important and necessary protections for workers, but the large decline in employment during the recession suggests that some hard choices must now be confronted. Accordingly, a closer look at the bargaining framework so that it encourages employers and employees to conclude more flexible wage contracts could help. Such provisions should allow companies to adjust more easily to economic fluctuations in a way that preserves jobs.

48. ***Product markets***. Perhaps of equal importance, product markets in key economic sectors such as finance and infrastructure services need to be made more competitive. Taking into account stability considerations, greater competition in the financial sector should help lower fees and reduce the cost of capital for businesses. Similarly, lower input costs stemming from increased competition in the intermediate industrial products market can help the external competitiveness of the manufacturing and other tradable sectors. Providing the Competition Commission with greater resources and legal authority to identify and address anticompetitive behavior would thus be useful. Continued trade liberalization, including by reducing nontariff barriers, could also be an impetus for greater competition and innovation. There is also scope for creating an enabling environment for private sector participation in infrastructure projects. While it may not be necessary nor politically feasible to consider wholesale private sector involvement in some areas, experimenting with private sector partners on a project by project basis might help reduce infrastructure bottlenecks more quickly.

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

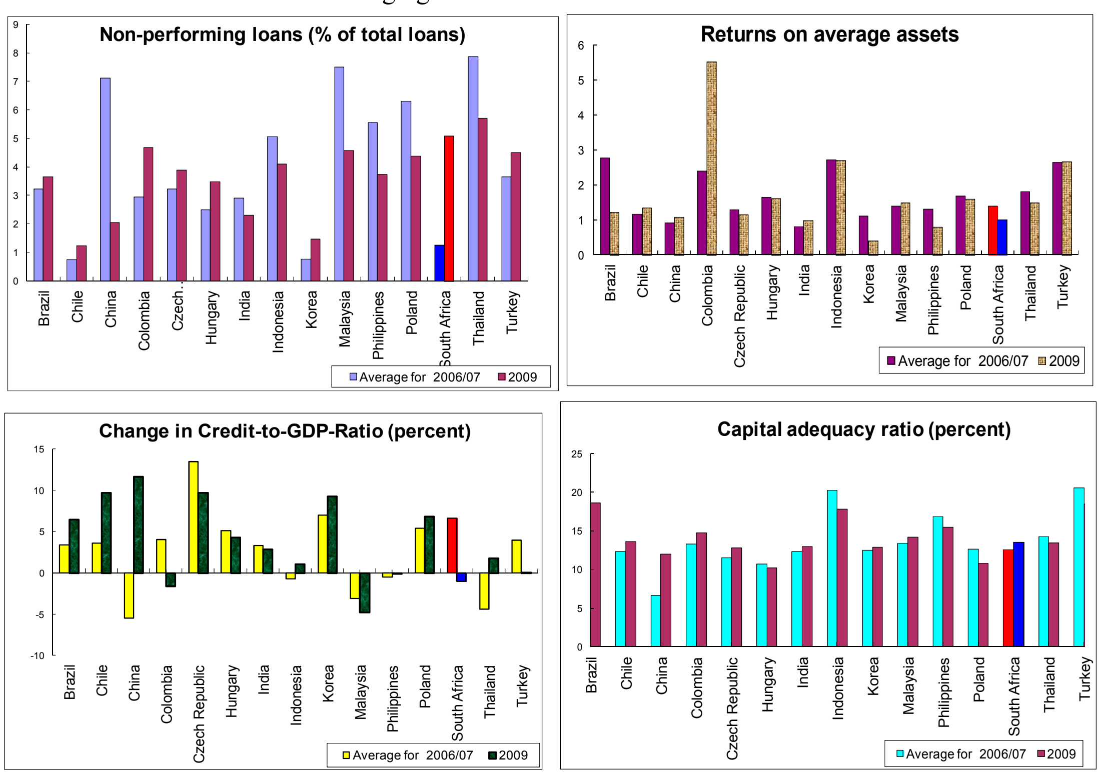
Box 2. The South African Financial Sector After the Crisis

The South African financial sector weathered the global financial and economic crisis without major problems. There was no need for public support, and capital adequacy ratios remained above their regulatory minima throughout the crisis period. This was in part the result of financial sector firms' moderate exposure to foreign risk and reliance on traditional lending frameworks, and of the proactive approach pursued by regulators (e.g., the bank supervisor spearheaded the early adoption of Basel II, concluded in 2008, with capitalization requirements above those recommended by the Basel Committee).

Nevertheless, the recession had a significant impact on the financial sector. Private sector credit growth has been mildly negative in recent months, compared to growth of 20 percent or so during 2005-2008. The recession has also led to a pronounced increase in impaired loans in the banking system, which rose to 6 percent of gross loans and advances in January 2010, from 2 percent two years earlier.[5] As a result, banks' profitability declined, but remains positive, at 0.9 percent of assets and 15.8 percent of equity as of December 2009. The combined effect of these and other trends has been a shrinking of the balance sheets of banks (text table). This is expected to be reversed as the recovery takes hold and businesses expand again, although a return to high rates of growth of credit aggregates is unlikely, given that many firms and households are still highly geared.

The impact of the recession on the South African banking system appears to have been broadly similar to that observed in other emerging market economies (text figure). By and large, the effects in this group of countries have been moderately adverse. One area where developments in South Africa were somewhat atypical is the evolution of credit, which in most other countries only decelerated, but remained positive.

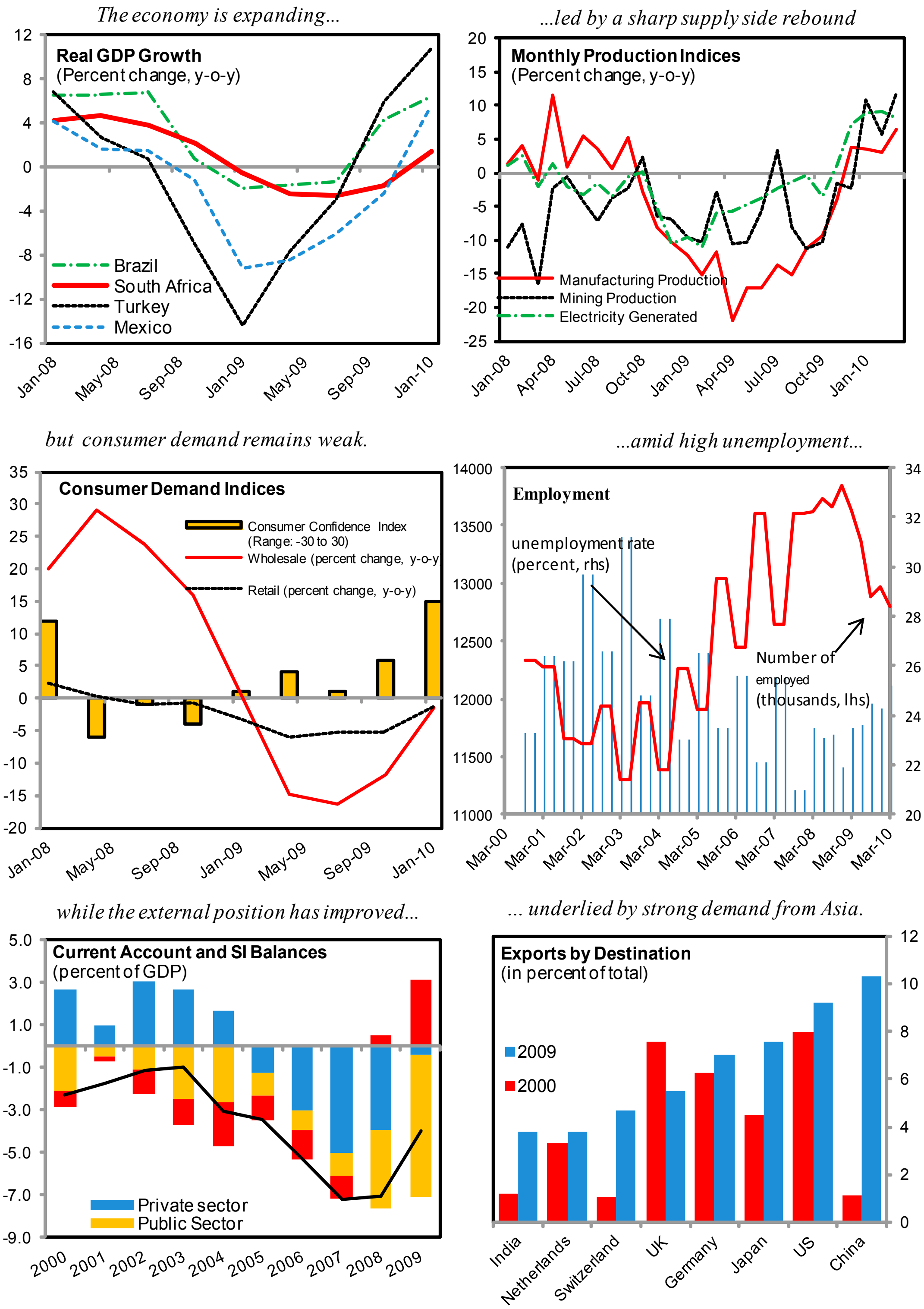
Selected Emerging Markets: Financial Soundness Indicators



Source: VEE Database.

[5] In South Africa, with the implementation of Basel II in January 2008, the concept of 'non-performing loans' was replaced with that of 'impaired advances', which is broader, making comparisons over time difficult.

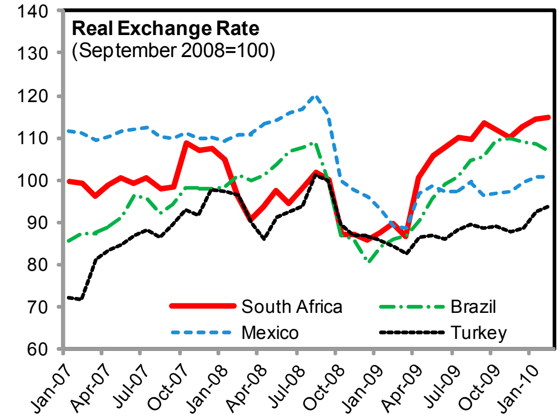
Figure 1. South Africa: Real Sector Developments



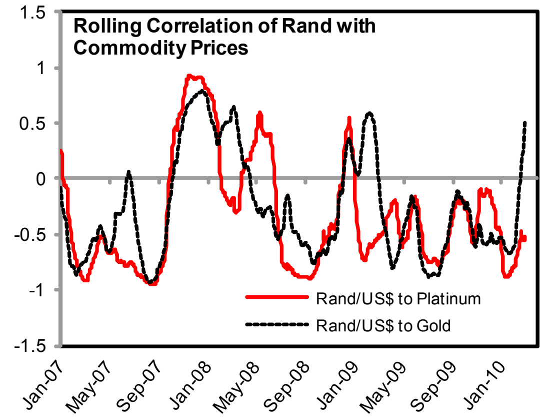
Sources: SARB, Statistics South Africa, and IMF.

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

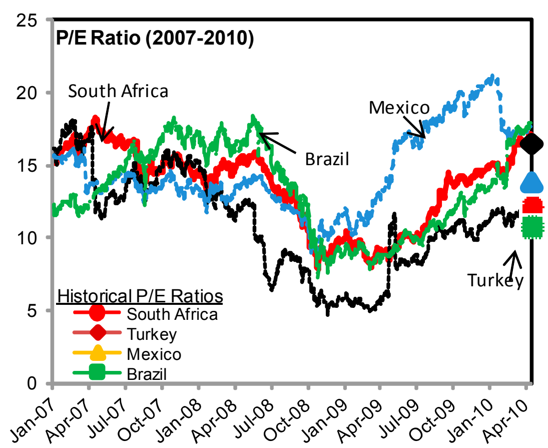
The real exchange rate appreciated sharply in 2009 ...



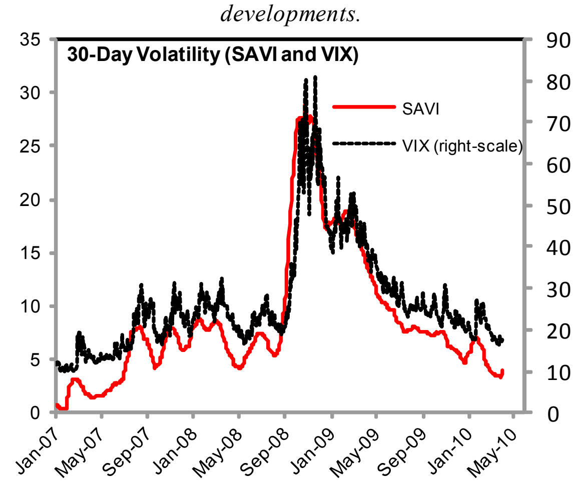
...in line with the recovery in commodity prices...



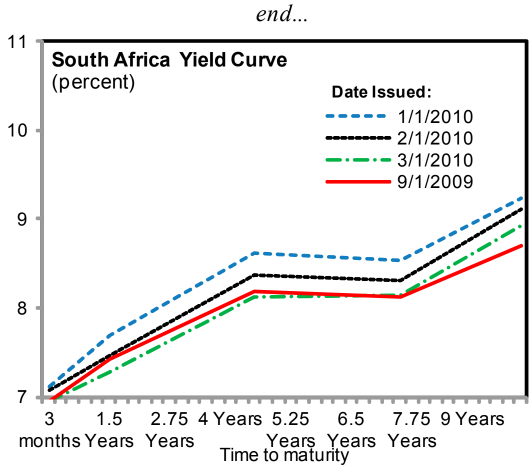
Equity prices have also risen...



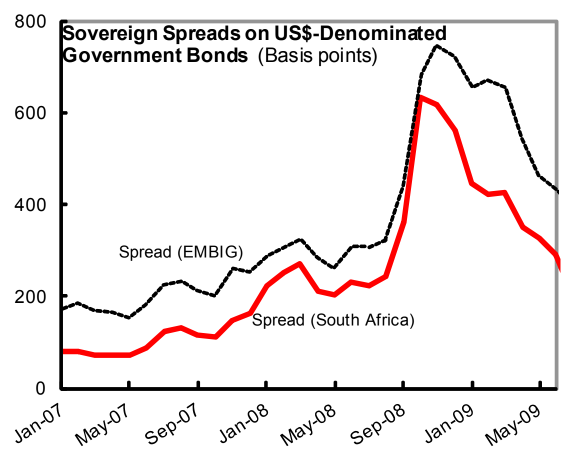
...with volatility reflecting international developments.



Yields have also fallen, especially on the short end...



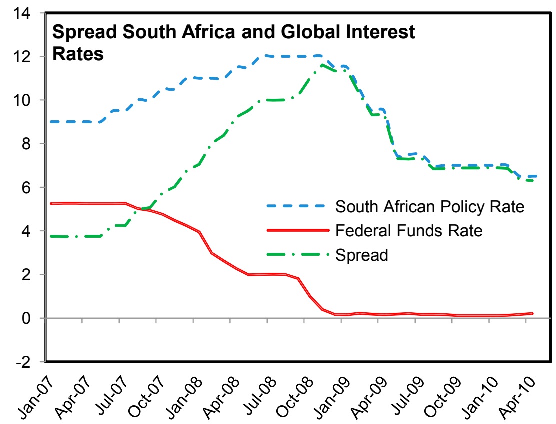
...again following international trends.



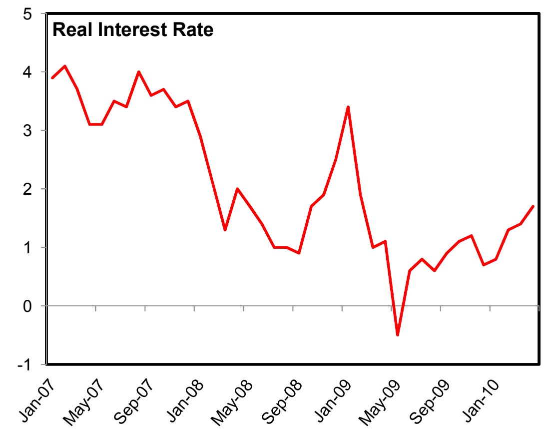
Sources: South African Reserve Bank; Datastream; Amalgamated Bank of South Africa; and IMF.

Figure 3. South Africa: Monetary Developments and Interest Rates

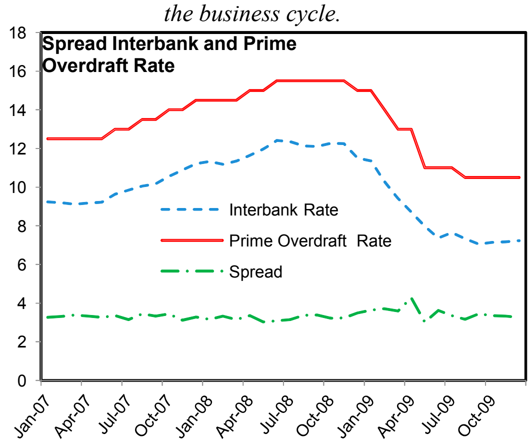
After responding to idiosyncratic supply side shocks, South African interest rates have fallen in tandem with



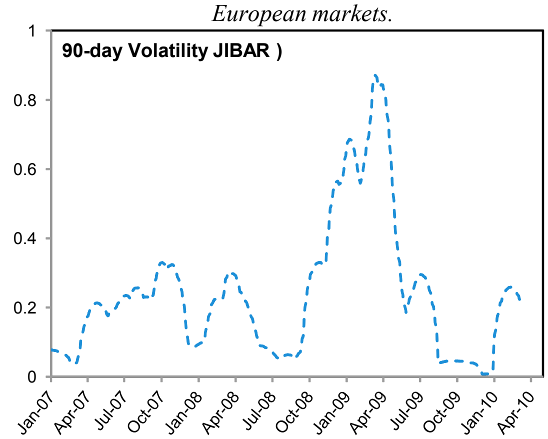
Real interest rates have also fallen, albeit more slowly...



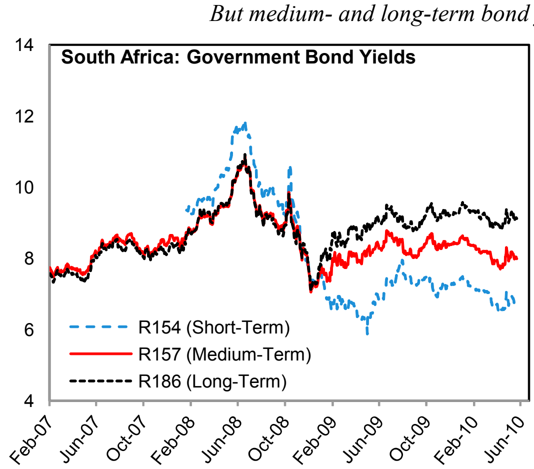
The interbank and benchmark consumer rates have also fallen, but the spread has remained stable over the business cycle.

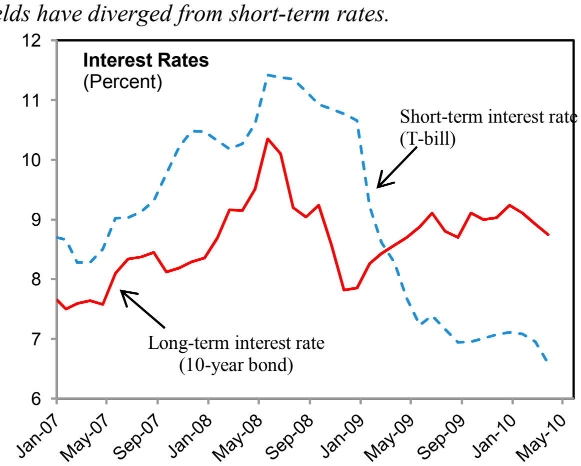


Stability in the interbank market was achieved despite the recent spike due to the volatility in the European markets.



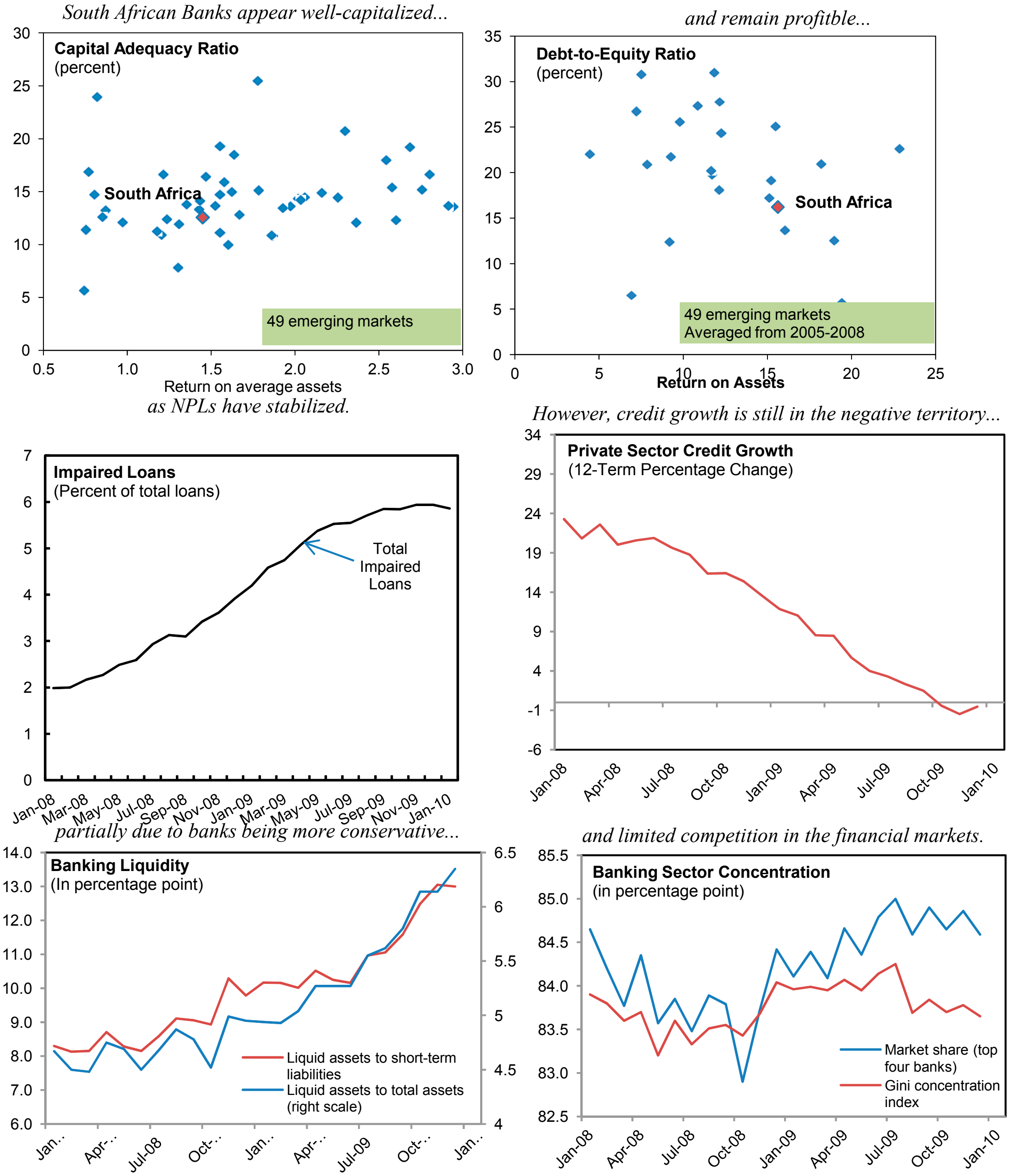
But medium- and long-term bond yields have diverged from short-term rates.





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

Figure 4. South Africa: Financial Sector Developments



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

Table 1. South Africa: Selected Economic and Financial Indicators, 2008–15

Nominal GDP (2009): US$287.2 billion
Population (2009): 49.3 million
GDP per capita (2009): US$5,825

				Projected				
	2008	2009	2010	2011	2012	2013	2014	2015
	(Annual percent change, unless otherwise indicated)							
National income and prices								
Real GDP	3.7	-1.8	3.2	3.6	3.9	4.2	4.4	4.5
Real GDP per capita	1.9	-3.0	2.0	2.4	2.7	3.0	3.2	3.3
Real domestic demand	3.3	-1.8	5.5	4.5	3.9	4.1	4.3	4.4
Output Gap 1/	3.0	-1.2	-0.4	0.4	0.9	1.3	0.0	0.0
GDP deflator	9.2	8.0	7.2	7.2	7.0	6.8	6.5	6.2
CPI (annual average)	11.5	7.1	5.6	5.8	5.6	5.2	5.0	4.5
CPIX (end of period) 2/	10.3	…	…	…	…	…	…	…
Labor market								
Unemployment rate (percent)	21.9	24.3	24.8	24.4	23.7	23.5	23.2	22.7
Average remuneration (formal nonagricultural sector)	12.8	8.5	7.1	7.9	8.2	7.9	7.7	7.2
Labor productivity (formal nonagricultural sector)	1.0	4.5	3.7	3.7	5.0	4.5	3.8	3.6
Nominal unit labor costs (formal nonagricultural sector)	11.7	3.9	3.3	4.1	3.0	3.3	3.8	3.5
External sector								
Current account balance	-7.1	-4.0	-4.5	-6.4	-6.7	-7.1	-7.3	-7.5
Overall balance of payments	1.1	0.7	1.0	0.0	0.0	0.0	0.0	0.0
Total external debt	25.9	27.5	26.5	28.2	29.9	31.8	33.6	35.2
Gross reserves (SARB, billions of U.S. dollars)	34.1	39.7	43.0	43.0	43.0	43.0	43.0	43.0
(months of next year's total imports)	5.1	5.2	5.0	4.8	4.5	4.2	3.9	3.7
Merchandise exports, f.o.b. 3/	12.8	-22.7	10.8	4.4	5.7	6.5	6.6	6.7
Merchandise imports, f.o.b. 3/	10.1	-26.7	15.1	10.6	5.8	6.6	6.7	6.8
Export (goods and services) volume	2.4	-18.7	3.1	3.2	4.7	5.5	5.6	5.7
Import (goods and services) volume	1.4	-17.4	11.9	6.5	4.5	4.8	4.8	4.9
Terms of trade	0.7	6.9	5.5	-3.4	-0.3	-0.9	-0.8	-0.7
Nominal effective exchange rate 4/	-18.5	25.6	…	…	…	…		
Real effective exchange rate 4/	-12.9	23.5	…	…	…	…		
Money and credit								
Net domestic assets 5/	9.6	3.7	16.1	11.6	12.0	12.1	12.2	12.2
Broad money (including foreign exchange deposits)	14.8	1.6	19.2	12.8	12.9	12.9	12.9	12.9
Velocity (GDP/average broad money)	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.1
Bank rate/repurchase rate (end of period, percent) 6/	11.5	7.0	…	…	…	…		
	(In percent of GDP, unless otherwise indicated)							
Investment and saving								
Investment (including inventories)	22.0	19.3	22.1	21.7	21.3	21.1	21.0	20.9
Of which:								
Public fixed investment (including public enterprises)	7.9	9.1	9.9	9.4	8.9	8.6	8.4	8.2
Private fixed investment	14.6	13.3	13.7	13.7	13.9	14.0	14.1	14.2
Gross national saving	14.9	15.3	17.5	15.2	14.6	14.1	13.7	13.4
Public (including public enterprises)	4.2	2.4	-0.3	0.5	1.9	3.5	4.5	5.7
Private	10.7	12.9	17.9	14.7	12.7	10.6	9.1	7.7
General government budget 7/								
Revenue, including grants	29.4	27.5	27.2	27.8	28.3	28.9	29.5	30.1
Expenditure and net lending	29.9	32.8	33.1	32.2	31.3	30.3	29.7	29.2
Overall balance	-0.5	-5.3	-5.9	-4.4	-3.0	-1.3	-0.2	0.9
General government debt	27.2	30.8	34.8	37.7	39.1	38.8	37.8	34.8
Borrowing requirement of the nonfinancial public sector	2.7	9.3	10.6	8.4	6.2	5.1	4.4	2.8
- cyclically adjusted	3.1	8.1	8.8	7.8	6.8	…	…	…

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

1/ Percentage deviation of RGDP from Potential.
2/ 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.
3/ In U.S. dollars; annual percent change.
4/ End-of-period. For 2009, September relative to December 2008.
5/ Contribution (in percentage points) to the growth of broad money.
6/ In 2009, as of July 9.
7/ Calendar-year figures, based on National Treasury data and IMF staff projections.

Table 2. South Africa: National Government Main Budget, 2007/08–2012/13 1/

(In percent of GDP)

				Proj. 2/		
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Total revenue and grants	26.9	26.2	23.4	23.8	24.3	24.8
Tax revenue	26.3	25.7	23.0	23.4	23.9	24.4
Income tax	16.0	16.5	14.3	14.0	14.4	14.7
Of which:						
Personal income tax	8.1	8.4	8.3	8.3	8.9	9.1
Corporate taxes (CIT+STC)	7.7	8.0	6.1	5.6	5.4	5.5
Indirect taxes	9.4	8.7	8.0	8.6	8.4	8.6
Of which:						
Value-added tax	7.2	6.6	6.0	6.1	6.0	6.2
Excises	2.0	1.9	2.0	2.2	2.1	2.1
Trade and other (less SACU payments)	1.0	0.5	0.7	0.9	1.1	1.1
Other tax revenue	0.9	0.7	1.0	0.7	0.7	0.7
Of which : trade taxes	1.3	1.0	0.8	0.8	0.8	0.8
Of which : SACU payments 3/	1.2	1.2	1.1	0.6	0.4	0.4
Nontax revenue	0.6	0.5	0.4	0.4	0.4	0.4
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	26.0	27.4	30.0	29.7	29.1	28.3
Interest	2.5	2.3	2.2	2.6	2.8	3.0
Transfer to subnational governments	11.8	12.6	13.9	13.5	12.8	13.0
Of which:						
Provinces	10.0	10.7	11.9	11.7	11.0	10.8
Municipalities	1.8	1.9	2.0	1.8	1.8	2.2
Other	11.7	12.4	13.9	13.6	13.4	12.3
Budgetary balance	0.9	-1.2	-6.6	-5.9	-4.7	-3.5
Extraordinary payments, net 4/	-0.1	-0.2	-0.2	0.0	0.0	0.0
Augmented balance	1.0	-1.0	-6.4	-5.9	-4.7	-3.5
Financing	-1.0	1.0	6.4	5.9	4.7	3.5
Domestic borrowing (net)	0.2	1.5	6.1	5.4	4.2	3.1
Foreign borrowing (net)	-0.2	-0.2	0.3	0.4	0.4	0.4
Change in cash and other items	-0.9	-0.4	-0.1	0.1	0.1	0.1
Memorandum items:						
GDP (billions of rand)	2,082	2,322	2,479	2755.2	3057.8	3404.3
Real GDP growth, percent	5.0	2.5	-1.3	3.9	3.5	4.1
GDP deflator, percent change	8.1	8.8	8.2	7.0	7.2	7.0
Primary balance, in percent of GDP	3.4	1.2	-4.4	-3.2	-1.9	-0.5

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

1/ For fiscal year beginning April 1. National government comprises the central government and subnational spending financed by transfers from the national revenue fund.

2/ Staff projections based on the 2010 Budget Review , and staff estimates.

3/ SACU payments are based on a revenue-sharing formula.

4/ Mainly related to debt management transactions.

Table 3. South Africa: Nonfinancial Public Sector Operations, 2007/08-2012/13 1/

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
					Proj. 2/	
			(In percent of GDP)			
Consolidated national and provincial governments						
Total revenue and grants	28.6	29.7	26.8	27.3	27.9	28.5
National government	26.9	26.2	23.4	23.8	24.3	24.8
Provinces (own revenue)	0.4	0.0	0.0	0.0	0.0	0.0
Social security funds (own revenue)	1.2	0.0	0.0	0.0	0.0	0.0
Extrabudgetary and other	0.0	3.5	3.4	3.5	3.6	3.6
Total expenditure	27.3	30.7	33.5	32.9	32.0	31.1
Current	26.0	28.1	30.0	29.5	29.3	28.2
Wages and salaries	8.5	10.0	10.9	10.7	10.3	9.8
Other goods and services	3.7	5.4	5.8	5.7	5.5	5.3
Interest	2.5	2.5	2.5	2.8	3.1	3.3
Transfers [3]	11.2	10.2	10.8	10.3	10.3	9.9
Capital expenditure	1.3	2.1	2.2	2.5	2.3	2.2
Contingency	0.0	0.0	0.0	0.2	0.4	0.7
Overall balance	1.3	-1.0	-6.7	-5.6	-4.1	-2.6
Public sector borrowing requirement (PSBR)	-0.6	3.8	11.1	10.4	7.8	5.7
National government 4/	-1.0	1.0	6.4	5.9	4.7	3.5
Other government borrowing	-0.1	0.6	0.5	0.3	0.0	0.0
Provincial governments	-0.1	0.4	0.1	-0.1	-0.1	-0.2
Local govts. and local enterprises	0.7	0.7	0.5	0.5	0.5	0.5
Extrabudgetary funds and institutions	-0.8	-0.6	-0.1	-0.1	-0.4	-0.4
Nonfinancial public enterprises	0.5	2.3	4.2	4.3	3.1	2.3
Memorandum items:						
Non-financial public sector debt (gross)	33.8	33.7	39.1	42.6	45.1	45.9
SOE investment	2.8	3.7	4.8	5.1	4.8	5.0
Social spending 5/	14.6	15.8	16.9	16.8	16.6	16.0
Defense spending	1.3	1.3	1.3	1.2	1.2	1.2

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

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

Table 4. South Africa: Balance of Payments, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
			Projected					
	(US $ billions)							
Balance on current account	-19.6	-11.4	-15.7	-22.8	-25.0	-28.1	-30.5	-33.2
Balance on goods and services	-8.3	-2.4	-5.3	-12.1	-13.0	-14.0	-15.0	-15.9
Exports of goods and services	98.1	77.9	87.1	90.1	95.2	101.4	108.1	115.3
Exports of goods	85.4	65.9	73.1	76.3	80.6	85.8	91.5	97.6
Nongold	79.5	59.7	66.0	69.5	74.2	79.7	85.6	91.9
Gold	5.9	6.3	7.1	6.8	6.4	6.2	5.9	5.7
Exports of services	12.8	11.9	14.0	13.8	14.6	15.5	16.6	17.7
Imports of goods and services	-106.5	-80.3	-92.4	-102.2	-108.2	-115.4	-123.0	-131.2
Imports of goods	-89.7	-65.7	-75.6	-83.6	-88.5	-94.3	-100.6	-107.5
Imports of services	-16.8	-14.6	-16.9	-18.6	-19.7	-21.0	-22.4	-24.0
Balance on income	-9.0	-6.3	-7.6	-8.0	-9.4	-11.4	-12.9	-14.7
Income receipts	5.8	4.0	5.5	6.6	6.8	7.0	7.2	7.3
Income payments	-14.8	-10.4	-13.1	-14.6	-16.2	-18.4	-20.0	-22.0
Balance on transfers	-2.3	-2.7	-2.7	-2.7	-2.7	-2.7	-2.6	-2.6
Capital flows (including errors and omissions)	22.8	13.5	19.0	22.8	25.0	28.1	30.5	33.2
Balance on capital and financial account	11.7	12.6	19.0	22.8	25.0	28.1	30.5	33.2
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	11.7	12.6	18.9	22.8	25.0	28.0	30.5	33.2
Direct investment	12.2	4.1	1.6	3.6	3.8	4.0	4.2	4.4
Liabilities	9.0	5.7	2.0	4.0	4.2	4.4	4.6	4.9
Assets	3.1	-1.6	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Portfolio investment	-16.3	11.0	16.3	18.5	20.2	22.1	23.5	25.8
Liabilities	-8.7	12.7	19.1	21.9	23.8	25.9	27.5	30.1
Assets	-7.7	-1.7	-2.7	-3.4	-3.6	-3.8	-4.0	-4.3
Other investment	15.8	-2.6	1.0	0.8	1.0	2.0	2.8	3.0
Liabilities	5.8	-5.0	4.6	3.5	3.0	3.2	3.4	3.5
Assets	10.1	2.5	-3.6	-2.7	-2.0	-1.2	-0.6	-0.5
Errors and omissions	11.1	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	3.2	2.1	3.3	0.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) 1/	34.1	39.7	43.0	43.0	43.0	43.0	43.0	43.0
International Liquidity Position of the SARB 1/ 2/	31.9	39.0	42.3	42.3	42.3	42.3	42.3	42.3
	(Percent of GDP)							
Balance on current account	-7.1	-4.0	-4.5	-6.4	-6.7	-7.1	-7.3	-7.5
Balance on goods and services	-3.0	-0.9	-1.5	-3.4	-3.5	-3.6	-3.6	-3.6
Exports of goods and services	35.5	27.1	25.2	25.4	25.5	25.8	26.0	26.1
Imports of goods and services	-38.5	-28.0	-26.8	-28.8	-29.0	-29.3	-29.5	-29.7
Capital flows (including errors and omissions)	8.2	4.7	5.5	6.4	6.7	7.1	7.3	7.5
Balance on capital and financial account	4.2	4.4	5.5	6.4	6.7	7.1	7.3	7.5
Errors and omissions	4.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	1.1	0.7	1.0	0.0	0.0	0.0	0.0	0.0
Gross Reserves (SARB)	12.3	13.8	12.5	12.1	11.5	10.9	10.3	9.7
Memorandum items:								
Total external debt	25.9	27.5	26.5	28.2	29.9	31.8	33.6	35.2
Foreign currency debt	15.2	15.3	13.8	15.1	16.1	17.4	18.6	19.7
Of which: Short-term debt (at remaining maturity)	6.7	6.6	5.8	6.3	6.5	6.9	7.2	7.5
Total external debt service (billions of U.S. dollars)	9.4	9.1	17.3	10.3	15.9	14.9	13.5	14.9
Gold price (period average; U.S. dollar per ounce)	872	973	1,183	1,221	1,245	1,281	1,329	1,380
Crude oil price (period average; U.S. dollar per barrel)	97	62	75	78	80	82	84	86

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

1/ End of period.
2/ Gross reserves minus foreign loans and minus forward position.

Table 5. South Africa: Monetary Survey, 2005–09

(December)

	2005	2006	2007	2008	2009
			(In billions of rand)		
Net foreign assets	195.1	274.3	304.5	390.5	384.2
Gross reserves	297.8	409.8	561.7	847.4	714.1
SARB	130.5	178.3	224.3	317.0	292.7
Other monetary institutions	167.3	231.5	337.4	530.4	421.4
Liabilities	102.6	135.5	257.2	456.9	329.9
SARB	22.2	19.3	12.0	6.1	2.7
Other monetary institutions	80.4	116.2	245.2	450.8	327.3
Net domestic assets	906.0	1,075.0	1,363.1	1,523.7	1,560.7
Credit to government, net	0.8	-29.5	-32.5	44.7	85.7
Claims on government	107.4	112.4	116.5	179.5	223.8
Government deposits	106.6	141.8	149.0	134.8	138.1
Credit to private sector	1,140.2	1,434.9	1,743.9	1,981.1	1,970.1
Other items, net	-235.0	-330.4	-348.3	-502.1	-495.2
Broad money (M3)	1,101.1	1,349.3	1,667.6	1,914.2	1,944.8
Of which: M1	503.1	605.7	738.3	753.6	805.5
			(In annual percentage change)		
Net foreign assets	38.0	40.5	11.0	28.2	-1.6
Net domestic assets	17.2	18.7	26.8	11.8	2.4
Credit to private sector	19.5	25.8	21.5	13.6	-0.6
Broad money (M3)	20.5	22.5	23.6	14.8	1.6
			(Contribution to growth in M3, unless otherwise specified)		
Net foreign assets	5.9	7.2	2.2	5.2	-0.3
Net domestic assets	14.6	15.4	21.3	9.6	1.9
Credit to government, net	-4.6	-2.7	-0.2	4.6	2.1
Credit to private sector	20.3	26.8	22.9	14.2	-0.6
Other items, net	-1.2	-8.7	-1.3	-9.2	0.4
Memorandum item:					
Income velocity of M3	1.55	1.42	1.32	1.25	1.25

Source: South African Reserve Bank.

Table 6. South Africa: Indicators of Vulnerability, 2005–09

(In percent of GDP, unless otherwise specified)

	2005	2006	2007	2008	2009
Financial indicators					
Government debt 1/	34.6	32.6	28.3	27.2	30.8
Broad money (percent change; 12-month basis)	20.5	22.5	23.6	14.8	1.6
Private sector credit (percent change; 12-month basis)	19.5	25.8	21.5	13.6	-0.6
Repurchase rate 2/	7.0	9.0	11.0	11.5	7.0
Repurchase rate (real) 2/ 3/	2.9	3.8	2.2	1.1	0.6
External indicators					
Exports of goods and services (percent change; US$ value)	16.6	15.9	14.1	9.7	-20.6
Imports of goods and services (percent change; US$ value)	17.3	23.2	15.4	8.8	-24.6
Terms of trade (percent change)	1.5	3.5	1.8	0.7	6.9
Current account balance	-3.5	-5.3	-7.2	-7.1	-4.0
Capital and financial account balance	4.9	6.1	7.6	4.2	4.4
Gross official reserves (US$ billion) 2/	20.6	25.6	33.0	34.1	39.7
Short-term foreign liabilities of SARB (US$ billion) 2/	0.7	2.6	2.7	2.2	2.2
International liquidity position of SARB (US$ billion) 2/ 4/	17.2	23.0	30.2	31.9	37.5
Short-term external debt plus open forward position (US$ billion)	14.1	17.0	18.6	18.5	19.0
Gross official reserves as a percent of the above	145.9	150.5	177.5	184.7	209.0
Foreign currency-denominated external debt (US$ billion)	28.1	35.8	43.6	42.0	44.1
As a percent of total exports	41.5	45.6	48.8	42.8	56.6
External interest payments (as a percent of total exports)	3.8	4.5	4.7	4.8	5.9
Exchange rate (per U.S. dollar; period average) 5/	6.36	6.77	7.05	8.25	8.44
Real effective exchange rate appreciation (period average; percent) 6/	0.5	-2.5	-3.3	-12.9	8.5
Financial market indicators 2/					
Stock market index (1994=100) 5/	303	419	487	362	465
Percent change 5/	42.6	38.0	16.2	-25.7	28.6
Foreign currency debt rating–Standard & Poor's	BBB+	BBB+	BBB+	BBB+	BBB+
Foreign currency debt rating–Moody's	Baa1	Baa1	Baa1	Baa1	A3
Spread of benchmark bonds (basis points) 7/	84	87	166	562	290

Sources: South African Reserve Bank and IMF staff estimates.

1/ National government debt, end of period.
2/ End of period.
3/ Deflated by the percent change in end-period CPI.
4/ Gross reserves minus foreign loans and minus forward position. The SARB's open position in the forward market was closed in February 2004.
5/ For 2009, as of July 9; stock market index change with regard to end-2008.
6/ SARB.
7/ Until end-2005: a 2017 US$ denominated bond vs. a comparable synthetic U.S. bond from Merrill Lynch; since 2006: JP Morgan's EMBI+ Global Bond Spread for South Africa. End of period. For 2009, as of July 6.

Table 7. South Africa: Financial Soundness Indicators, 2005–10

(In percent, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 1/
Capital adequacy:						
Regulatory capital to risk-weighted assets	12.7	12.3	12.8	13.0	14.12	14.26
Regulatory tier 1 capital to risk-weighted assets 2/	9.7	9.0	9.5	10.2	10.97	11.06
Asset quality:						
Nonperforming loans to total gross loans 3/	1.5	1.1	1.4	3.9	5.94	5.86
Nonperforming loans net of provisions to capital 3/	6.4	5.6	8.2	…	…	
Share of mortgage advances in domestic private credit 3/	46.2	47.7	49.0	48.8	50.5	
Earnings and profitability:						
Return on assets (average)	1.2	1.4	1.4	2.1	0.9	0.9
Return on equity (average)	15.2	18.3	18.1	28.7	15.9	15.2
Interest margin to gross income	38.2	43.8	58.5	44.6	51.2	
Noninterest expenses to gross income	61.5	48.5	48.9	42.2	51.1	51.8
Liquidity:						
Liquid assets to total assets	4.8	4.6	4.6	4.7	6.4	
Share of short-term deposits in total deposits	43.5	42.8	42.4	36.4	38.2	
Exposure to foreign exchange (FX) risk:						
Effective net open FX position to capital	1.9	1.4	0.7	0.5	0.7	
Share of foreign currency loans in total lending	11.1	11.4	9.3	7.7	6.9	
Share of foreign currency deposits in total deposits 4/	2.7	3.3	3.0	3.6	2.6	
Share of foreign liabilities in total liabilities 5/	4.2	5.3	6.0	6.2	4.9	

Source: South African Reserve Bank.

1/ As of March 2010.
2/ Total (banking and trading book).
3/ The definition of nonperforming loans until end-2007 comprised doubtful and loss loans. Doubtful are loans overd 180 days unless well secured, or with a timely realization of the collateral. Since 2008, the indicator reflects the rat impaired advances to total advances (in line with Basel II definitions), a more stringent definition.
4/ Domestic private credit not seasonally adjusted.
5/ Foreign funding to total funding.

Table 8. South Africa: Millennium Development Goals, 1990–2008 1/

	1990	1995	2000	2005	2007	2008
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates					
Population below $1 a day (%)	...	6.3	10.7	...	…	…
Poverty gap at $1 a day (%)	...	0.6	1.7	...	…	…
Percentage share of income or consumption held by poorest 20%	...	3.6	3.1	...	…	…
Prevalence of child malnutrition (% of children under 5)	...	9.2	...	...	…	…
Population below minimum level of dietary energy consumption (%)	…	3.0	...	...	…	…
2. Achieve universal primary education	2015 target = net enrollment to 100					
Net primary enrollment ratio (% of relevant age group)	90.0	...	96.0	...	…	…
Youth literacy rate (% ages 15-24)	…	93.9	93.5	...	…	…
3. Promote gender equality	2005 target = education ratio to 100					
Ratio of girls to boys in primary and secondary education (%)	104.0	...	103.0	...	…	…
Ratio of young literate females to males (% ages 15-24)	...	101.0	99.9	...	…	…
Share of women employed in the nonagricultural sector (%)	42.6	43.6	44.6	...	42.9	
Proportion of seats held by women in national parliament (%)	3.0	25.0	30.0	32.8	33.0	33.0
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds					
Under 5 mortality rate (per 1,000)	60.0	59.0	63.0	68.0	69.0	…
Infant mortality rate (per 1,000 live births)	45.0	45.0	50.0	55.0	56.0	…
Immunization, measles (% of children under 12 months)	79.0	76.0	77.0	82.0	84.0	…
5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	…	…	230.0	…	400.0	…
Births attended by skilled health staff (% of total)	…	82.0	84.0	…	…	…
6. Combat HIV/AIDS, malaria and other diseases	2015 target = halt and begin to reverse prevalence of diseases					
Prevalence of HIV (% ages 15-49)	…	…	16.9	15.6	18.1	…
Contraceptive prevalence rate (% of women ages 15-24)	57.0	…	…	…	12.7	…
Number of children orphaned by HIV/AIDS (thousands)	…	…	660.0	…	…	…
Incidence of tuberculosis (per 100,000 people)	224.0	392.4	465.0	599.9	940.0	960.0
Tuberculosis cases detected under DOTS (%)	…	6.0	58.0	103.1	71.0	68.0
7. Ensure environmental sustainability	2015 target = various '					
Forest area (% of total land area)	7.6	8.0	7.3	8.0	8.0	…
Nationally protected areas (% of total land area)	...	6.1	...	…	…	…
GDP per unit of energy use (2000 PPP $ per kg oil equivalent)	...	...	3.8	…	…	…
CO2 emissions (metric tons per capita)	9.4	...	9.0	…	…	…
Access to an improved water source (% of population)	83.0	84.0	89.0	…	93.0	…
Access to improved sanitation (% of population)	55.0	56.0	57.0	…	59.0	…
8. Develop a Global Partnership for Development	2015 target = various '					
Youth unemployment rate (% of total labor force ages 15-24)	…	…	44.2	...	...	45.0
Fixed line and mobile telephones (per 1,000 people)	94.3	116.0	302.3	825.1	889.0	...
Personal computers (per 1,000 people)	7.1	28.1	66.4	84.6	…	...
General indicators						
Adult literacy rate (% of people ages 15 and over)	…	82.4	85.2	...	...	89.0
Total fertility rate (births per woman) 2/	3.3	3.1	…	2.8	...	3.0
Life expectancy at birth (years) 2/	61.9	58.0	48.5	47.7	...	51.0

Sources: World Bank and Statistics South Africa.

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

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

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by Staff Representatives for the
2010 Consultation with South Africa

Approved by Sharmini Coorey and Aasim Husain

June 23, 2010

- **Relations with the Fund.** Describes financial and technical assistance by the IMF and provides information on the safeguards assessment and exchange system. South Africa has no outstanding purchases and loans from the Fund.

- **The JMAP Bank-Fund Matrix**. Describes the priorities and main activities of the World Bank Group and the IMF and areas of cooperation in their work with the South African authorities.

- **Statistical Issues.** Assesses the quality of statistical data. Economic data for South Africa are generally of good quality and are provided to the Fund and the public in a timely manner. South Africa subscribes to the SDDS and publishes all data on the reserves template.

Contents Page

I. Relations with the Fund

(As of May 31, 2009)

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

II. **General Resources Account:**	SDR Million	Percent Quota
Quota	1,868.50	100.00
Fund holdings of currency	1,867.10	99.92
Reserve position in Fund	1.48	0.08

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	1,785.42	100.00
Holdings	1,788.15	100.15

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

V. **Latest Financial Arrangements:** None

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

	Forthcoming				
	2010	2011	2012	2012	2014
Principal					
Charges/Interest		0.01	0.01	0.01	0.01
Total		0.01	0.01	0.01	0.01

VII. **Exchange Rate Arrangement:**

The South African rand floats against other currencies. South Africa maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

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 without restriction and to repatriate dividends, interest receipts, and current and capital profits, as well as the original investment capital. Foreign companies, governments and institutions may list on South Africa's bond and securities exchanges.

Since 1995, exchange controls on capital transactions by residents have also been relaxed. Rather than completely liberalizing particular types of capital transactions, the authorities have pursued a strategy of allowing an increasing array of transactions, with quantitative caps applied to individuals and institutional investors which have been increased over time—most recently in October 2009 and March 2010[1]. Regarding outward foreign direct investment by South African corporates, application to the South African Reserve Bank's Exchange Control Department is still required but the transactions limit was raised in 2009 from transactions above R50 million a year to transactions above R500 million.

Prudential limits were introduced in 2003, and in 2008 the authorities initiated a process of replacing direct exchange controls on local institutional investors with foreign exposure prudential regulations and relaxing their foreign exposure limits.

Under the new system, the SARB monitors these investors' foreign exposure through quarterly reports, abolishing the previous pre-transaction authorization requests; however, substantial changes in foreign exposure will still require pre-notification. Institutional investors are permitted to invest in foreign securities, subject to an overall prudential limit of 20 percent of their total retail assets for retirement funds and the non-linked policies of long-term insurers. Investment managers registered as institutional investors for exchange control purposes, linked policies of long-term insurers and collective investment schemes management companies are restricted to 30 percent of total retail assets under management. There is an additional allowance of 5 percent of assets for portfolio investment in Africa for all institutional investors. In March 2010 the government finalized reporting measures for macro-prudential foreign exposure limits on banks. South African banks will be able to acquire direct and indirect foreign exposure up to 25 percent of their total liabilities (excluding equity), covering all foreign exposure but excluding FDI. The initial limit of 40 percent was adjusted downwards in light of recent global financial market turbulence.

Corporates are not allowed to undertake foreign portfolio investment at present using locally sourced capital. Corporates may, upon application, establish Dual Listed Company Structures provided certain conditions are met. Their currency proceeds from exports must be repatriated to South Africa but the 180-day rule was abolished in 2009. All local entities are now allowed to participate in the rand futures market, enabling them to hedge and diversify their portfolios.

[1] Other quantitative arrangements are on applications which can be processed by banks R0 – R499 million or the SARB at R500 million. These are not caps as there are no quantitative limits in investments abroad by corporates only approval is necessary.

Private individuals are allowed to invest up to R4 million offshore. In addition to the above, they can take out a further R750,000 a year as a documented discretionary allowance (gifts, donations, travel, etc.). There are restrictions on the transfer of funds abroad by emigrants (blocked funds). The transfer of blocked funds in excess of R4 million for individuals and R 48 million for families is allowed, provided a 10 percent exit levy is paid. Large amounts may be staggered to manage any impact on the foreign exchange market. Dividends and interest payments on the blocked funds are freely transferable abroad.

VIII. **Article IV Consultations**

The 2009 Article IV consultation was concluded by the Executive Board on August 5, 2009. South Africa is on the standard 12-month Article IV consultation cycle.

IX. **Technical Assistance**

An FAD mission took place in 2003 to discuss with the National Treasury their draft royalty bill. A monetary and financial statistics mission took place in 2003, followed up by a visit during May–June, 2004.

In 2009, two STA missions took place to attend the meetings on the 57th ISI Conference and the training on Coordinated Direct Investment Survey Seminar for Anglophone Africa. Further two DFIDs took place in South Africa: (i) Management of Statistical Systems, Agriculture, Health, and (ii) 57th Bi-Annual Session of the International Statistical Institute.

A number of 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.

II. The JMAP Bank-Fund Matrix

Title	Products	Provisional timing of missions	Expected delivery date
A. Mutual information on relevant work programs			
The World Bank work program in the next 12 months (to be confirmed with GOSA in FY11 business plan)	**Lending** ESKOM Renewable ($1.250b) **Ongoing Supervision** ESKOM Investment-SIL CF Durban Landfill (FY04) GEF Renewable Energy Market Transform (FY07) GEF Great Addo SIL (FY04) GEF Isimangaliso Wetland Park GEF Richtersveld MSP SIL (FY01) **ESW** Analysis of Invest Climate/PSD Policy Notes Closing Skills and Technology Gap ESMAP Low Carbon **TA** Rural Development and Land Reform Post Crisis SME Finance Basel 2 (FSAP Follow-up) Labor Intensive Industrial Development TB and HIV/AIDS Program Water and Transport Sector Dialogue Urban Policy Dialogue Climate change dialogue and Macro Modeling Economic Development Dialogue		FY11 Q3 Ongoing Ongoing Ongoing Ongoing Ongoing Ongoing 7/30/2010 2/28/2011 9/30/2010 6/10/2010 2/1/2011 FY11 QTBD FY11 QTBD FY11 QTBD Ongoing Ongoing Ongoing Ongoing
The Fund work program in the next 12 months	1. 2010 Article IV consultation report - Background papers on a) quantitative effects of monetary policy, b) labor markets and recent job shedding, c) cyclicality of fiscal accounts and revenue performance, and d) a summary of vulnerabilities of South Africa and other emerging market economies to external developments. 2. Staff visit – preparatory work for the 2011 Article IV consultation 3. 2011 Article IV consultation 4. LEG TA in rewriting the Income Tax Act and drafting a new Tax Administration Act	May 2010 Q4 2010 Q2 2011	Board meeting in July 2010 Board meeting in July-August 2011 Ongoing
Title	**Products**	**Provisional timing of missions**	**Expected delivery date**
B. Requests for work program inputs			
Fund request to Bank	Periodic update on progress on analytical work		
Bank request to Fund	Periodic updates on macroeconomic developments and analytical work		

III. STATISTICAL ISSUES

Data provided to the Fund are adequate for surveillance purposes. South Africa subscribed to the Special Data Dissemination Standard (SDDS) on August 2, 1996 and 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 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 expenditures. The CPI weights are re-based in January 2009 according to the new weights published in July 2008. New price indices, which are re-based to 2008=100, are calculated according to these weights published in July 2008. 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 At the same time, Statistics South Africa changed the way of measuring housing costs. The concept of owners' equivalent rent are used to more accurately reflect the cost of the accommodation services derived by owner occupiers from their own homes.

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 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 non-depository 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, due to balance of payments adjustments.

The banking sector holdings of foreign-currency assets have been removed from the official measure of reserves, in accordance with international practice. Data on international reserves position are disseminated in line with the requirements of the IMF's template on international reserves and foreign currency liquidity.

Net errors and omissions in the balance of payments are large, averaging 2 percent of GDP during 2003–07. Work is ongoing to improve the reliability and accuracy of balance of payments data.

SOUTH AFRICA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(as of June 2, 2010)

	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]	Data Quality – Accuracy and reliability[9]
Exchange Rates	5/13/10	4/21/10	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/10	2/10	M	M	M		
Reserve/Base Money	4/10	2/10	M	M	M	O, O, LO, O	LO, O, O, O
Broad Money	3/10	1/10	M	M	M		
Central Bank Balance Sheet	4/10	5/13/10	M	M	M		
Consolidated Balance Sheet of the Banking System	3/10	5/17/10	M	M	M		
Interest Rates[2]	4/10	5/11/10	D	D	D		
Consumer Price Index	4/10	5/13/10	M	M	M	O, LO, O, O	LO, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	FY 2008/09	4/30/08	A	S	S	O, O, O, O	O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2/10	4/14/10	M	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2009	5/13/08	Q	Q	Q		
External Current Account Balance	Q4 2009	3/29/10	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and Imports of Goods and Services [6]	Q4/09	3/29/10	M	M	M		
GDP/GNP	Q4 2009	3/26/10	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross External Debt	Q1 2009	Q4 2008	Q	Q	Q		
International Investment Position	2009	2010	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 Statistics Department on 06/02/2010.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Debt Sustainability Analysis

Prepared by the Staff Representatives for the 2010 Consultation with South Africa

Approved by Sharmini Coorey and Aasim Husain

June 23, 2010

1. **South Africa's external debt is projected to rise to 35 percent of GDP by 2015.** The increase in external debt by around 7 percentage points of GDP reflects the widening of the current account deficit to above 7 percent of GDP from 2013–15 as growth recovers, the import-intensive infrastructure investment program progresses, and dividend payments abroad pick up again. The real effective exchange rate is also currently on the strong side which, if sustained, is likely to contribute to a widening current account deficit. Although the external debt level is rising it is increasing from a low level and given South Africa's deep domestic financial markets, a significant part of the deficit is expected to be financed—as in the past—by nonresident portfolio flows, around 60 percent of which are equities and nondebt creating. Portfolio inflows have been strong over the past twelve months with net inflows amounting to around $15 billion, and recent turbulence in markets has been accompanied by only small capital outflows from South Africa thus far. Part of the public sector borrowing requirement is expected to be financed by nonresidents through Eurobond issuance ($2 billion was raised in March 2010 and similar amounts are expected in the next two years), purchases of domestic securities, and multilateral loans for infrastructure.

2. **The rising external debt ratio makes it somewhat more vulnerable to external shocks and rollover risk, although it looks manageable against a range of other shocks** (Figure 1). The stress tests indicate that the largest adverse impact is from a 30 percent exchange rate depreciations or from a further widening of the non-interest current account deficit by 1.5 percentage points on average over the next five years. These shocks could respectively raise external debt to 47 percent and 43 percent by 2015. But these are likely to be upper bound estimates, since, for example, the exchange rate is likely to have a positive effect on export volumes which is not taken into account in the standard DSA. By contrast, a large (one standard deviation) permanent adverse shock to real GDP growth and the standard shock to interest rates have only a minor effect, while the combined shock has a moderate effect on external debt levels. Rollover risk was relatively comfortable in 2009,

with reserves at 89 percent of the current account deficit plus short-term debt at remaining maturity, but the position becomes tighter in the medium term.

3. **South Africa's public debt position appears sustainable.** Under the policies the medium-term expenditure framework outlined in the 2010/11 budget, the ratio of government debt to GDP is expected to rise over the short term, from 31 percent in 2009 to a maximum of 39 percent in 2012—of which, close to 4 percent of GDP is expected to be denominated in foreign currency—before declining gradually thereafter (Table 3). Gross financing needs surge to close to 9 percent of GDP in 2010, but will gradually decline afterwards to below 4 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 stabilize at close to 46 percent of GDP by 2012 (Table 3).

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. The only exception is in the case of the "no policy change" scenario where the debt ratio rises sharply and exceeds 50 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, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009	10-Year Historical Average	10-Year Standard Deviation	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	18.7	21.8	26.3	25.9	27.5			**26.5**	**28.2**	**29.9**	**31.8**	**33.6**	**35.2**	**-6.0**
Change in external debt	-1.8	3.2	4.5	-0.4	1.6			-1.0	1.7	1.7	1.9	1.8	1.7	
Identified external debt-creating flows (4+8+9)	-3.8	1.2	2.3	4.6	-1.2			0.4	1.6	1.4	0.4	0.4	0.3	
Current account deficit, excluding interest payments	2.4	3.9	5.7	5.4	2.4			3.0	4.7	4.9	5.1	5.2	5.2	
Deficit in balance of goods and services	0.5	2.4	2.9	3.0	0.9			1.5	3.4	3.5	3.6	3.6	3.7	
Exports	27.4	30.0	31.3	35.5	27.1			25.2	25.4	25.5	25.8	26.0	26.1	
Imports	27.9	32.5	34.2	38.5	28.0			26.8	28.8	29.0	29.3	29.5	29.8	
Net non-debt creating capital inflows (negative)	-5.1	-2.7	-2.7	-1.6	-4.0			-3.4	-3.9	-4.3	-5.5	-5.6	-5.8	
Automatic debt dynamics 1/	-1.2	-0.1	-0.7	0.8	0.4			0.8	0.8	0.8	0.8	0.8	0.9	
Contribution from nominal interest rate	1.0	1.4	1.5	1.7	1.6			1.5	1.7	1.8	2.0	2.2	2.3	
Contribution from real GDP growth	-1.0	-1.0	-1.1	-1.0	0.4			-0.7	-0.9	-1.0	-1.2	-1.3	-1.4	
Contribution from price and exchange rate changes 2/	-1.2	-0.5	-1.1	0.1	-1.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.0	2.0	2.2	-4.9	2.8			-1.4	0.1	0.3	1.4	1.3	1.3	
External debt-to-exports ratio (in percent)	68.3	72.8	84.2	73.2	101.5			105.0	111.2	117.2	123.4	129.3	134.9	
Gross external financing need (in billions of US dollars) 4/	24.5	33.8	41.6	51.7	36.6			49.2	41.7	58.7	56.9	61.5	69.7	
in percent of GDP	9.9	12.9	14.5	18.7	12.8			14.2	11.8	15.7	14.5	14.8	15.8	
Scenario with key variables at their historical averages 5/								**26.5**	**24.2**	**22.6**	**22.2**	**21.7**	**21.2**	**-4.0**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	5.3	5.6	5.5	3.7	-1.8	3.6	2.2	3.2	3.6	3.9	4.2	4.4	4.5	
GDP deflator in US dollars (change in percent)	6.9	0.2	3.8	-6.6	5.7	5.5	18.0	16.4	-0.7	1.1	1.2	1.4	1.4	
Nominal external interest rate (in percent)	5.7	7.7	7.4	6.2	6.4	6.3	0.8	6.5	6.7	6.9	7.0	7.2	7.4	
Growth of exports (US dollar terms, in percent)	16.6	15.9	14.1	9.7	-20.6	9.6	14.1	11.8	3.5	5.7	6.5	6.6	6.7	
Growth of imports (US dollar terms, in percent)	17.3	23.2	15.4	8.8	-24.6	11.7	18.1	15.1	10.6	5.8	6.6	6.7	6.8	
Current account balance, excluding interest payments	-2.4	-3.9	-5.7	-5.4	-2.4	-1.6	3.0	-3.0	-4.7	-4.9	-5.1	-5.2	-5.2	
Net non-debt creating capital inflows	5.1	2.7	2.7	1.6	4.0	3.0	2.1	3.4	3.9	4.3	5.5	5.6	5.8	

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).

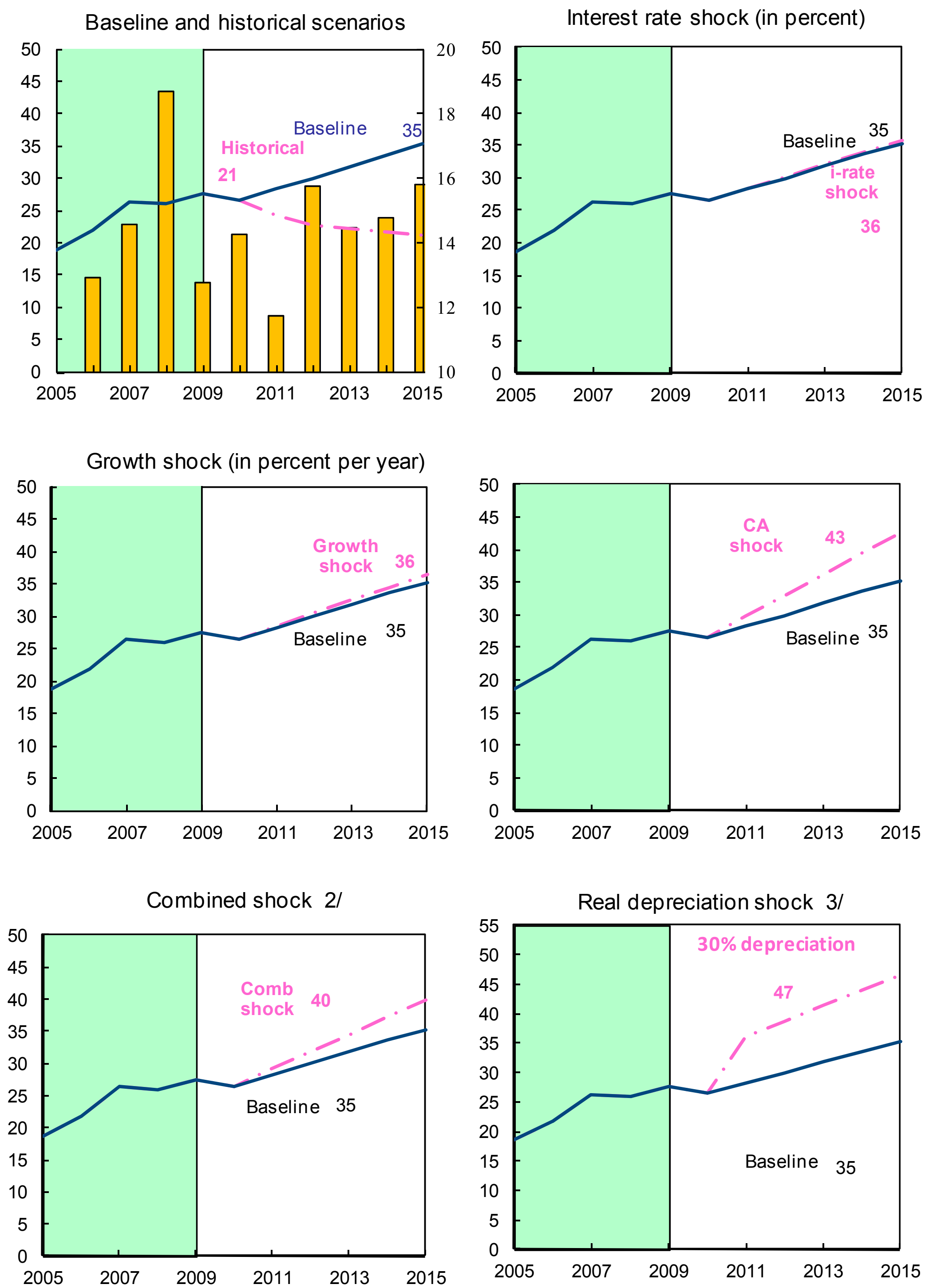
3/ For projection, line includes the impact of price and exchange rate changes.

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

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Table 2. South Africa: External Sustainability Framework--Gross External Financing Need, 2005-2015

	Actual					Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
						I. Baseline Projections					
Gross external financing need in billions of U.S. dollars 1/	24.5	33.8	41.6	51.7	36.6	49.2	41.7	58.7	56.9	61.5	69.7
in percent of GDP	9.9	12.9	14.5	18.7	12.8	14.2	11.8	15.7	14.5	14.8	15.8
						II. Stress Tests					
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2010-2015 3/						49.2	30.1	42.1	36.6	38.5	42.8
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						49.2	42.1	59.2	57.5	62.3	70.8
B2. Real GDP growth is at baseline minus one-half standard deviations						49.2	41.5	58.2	56.0	60.2	67.8
B3. Non-interest current account is at baseline minus one-half standard deviations						49.2	47.3	66.9	66.7	73.5	84.8
B4. Combination of B1-B3 using 1/4 standard deviation shocks						49.2	44.6	62.8	61.7	67.2	76.7
B5. One time 30 percent real depreciation in 2011						49.2	41.2	53.3	52.3	56.8	64.6
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2010-2015 3/						14.2	8.0	10.2	8.1	7.8	7.9
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						14.2	11.9	15.9	14.6	15.0	16.0
B2. Real GDP growth is at baseline minus one-half standard deviations						14.2	11.8	15.9	14.7	15.1	16.2
B3. Non-interest current account is at baseline minus one-half standard deviations						14.2	13.3	17.9	17.0	17.7	19.2
B4. Combination of B1-B4 using 1/4 standard deviation shocks						14.2	12.6	17.0	15.9	16.5	17.8
B5. One time 30 percent real depreciation in 2011						14.2	17.1	21.1	19.6	20.1	21.6

1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
4/ The implied change in other key variables under this scenario is discussed in the text.

Table 3. South Africa: Public Sector Debt Sustainability Framework, 2007-15
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	**28.3**	**27.2**	**30.8**	**34.8**	**37.7**	**39.1**	**38.8**	**37.8**	**34.8**	**-0.6**
o/w foreign-currency denominated	3.8	4.3	3.9	3.8	3.8	3.8	3.9	3.9	3.1	
Change in public sector debt	-4.3	-1.1	3.7	4.0	2.9	1.4	-0.3	-1.1	-3.0	
Identified debt-creating flows (4+7+12)	-6.6	-3.8	-0.4	-0.6	-1.9	-3.6	-5.4	-6.4	-7.3	
Primary deficit	-5.1	-4.3	-0.5	-0.3	-1.5	-3.1	-4.6	-5.6	-6.5	
Revenue and grants	28.4	29.4	27.5	27.2	27.8	28.3	28.9	29.5	30.1	
Primary (noninterest) expenditure	23.3	25.1	27.0	26.9	26.3	25.2	24.3	24.0	23.6	
Automatic debt dynamics 2/	-1.5	0.6	0.0	-0.2	-0.4	-0.5	-0.8	-0.8	-0.8	
Contribution from interest rate/growth differential 3/	-1.4	-0.8	0.9	-0.2	-0.4	-0.5	-0.8	-0.8	-0.8	
Of which contribution from real interest rate	0.2	0.1	0.5	0.7	0.7	0.8	0.7	0.7	0.7	
Of which contribution from real GDP growth	-1.6	-0.9	0.5	-0.9	-1.1	-1.3	-1.5	-1.5	-1.5	
Contribution from exchange rate depreciation 4/	-0.1	1.3	-0.9	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.2	2.7	4.1	4.6	4.8	5.0	5.1	5.3	4.3	
Public sector debt-to-revenue ratio 1/	99.6	92.4	112.1	128.1	136.0	138.2	134.3	128.0	115.5	
Gross financing need 6/	2.5	3.5	8.3	8.7	7.3	5.8	4.1	3.5	3.2	
in billions of U.S. dollars	7.0	9.7	23.9	29.9	25.9	21.8	16.1	14.7	14.2	
Scenario with key variables at their historical averages 7/				**34.8**	**35.3**	**36.0**	**36.7**	**37.7**	**37.8**	-0.2
Scenario with no policy change (constant primary balance) in 2010-2015				**34.8**	**38.3**	**42.4**	**46.3**	**50.3**	**53.3**	-0.9
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	5.5	3.7	-1.8	3.2	3.6	3.9	4.2	4.4	4.5	
Average nominal interest rate on public debt (in percent) 8/	9.2	10.1	9.8	9.8	9.7	9.6	9.0	8.8	8.6	
Average real interest rate (nominal rate minus change in GDP deflator, in p	1.0	0.9	1.7	2.6	2.6	2.6	2.2	2.3	2.4	
Nominal appreciation (increase in US dollar value of local currency, in perc	2.3	-26.8	26.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.2	9.2	8.0	7.2	7.2	7.0	6.8	6.5	6.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	8.1	11.5	5.9	2.6	1.3	-0.2	0.5	2.8	2.8	
Primary deficit	-5.1	-4.3	-0.5	-0.3	-1.5	-3.1	-4.6	-5.6	-6.5	
Memorandum items:										
Debt of nonfinancial public enterprises	**1.5**	**1.3**	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**	
Debt of local governments and local enterprises	**4.9**	**5.5**	**5.7**	**5.6**	**5.5**	**5.3**	**5.1**	**4.9**	**4.7**	
Gross public sector debt	34.6	34.0	37.9	41.9	44.6	45.8	45.3	44.0	40.8	

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

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

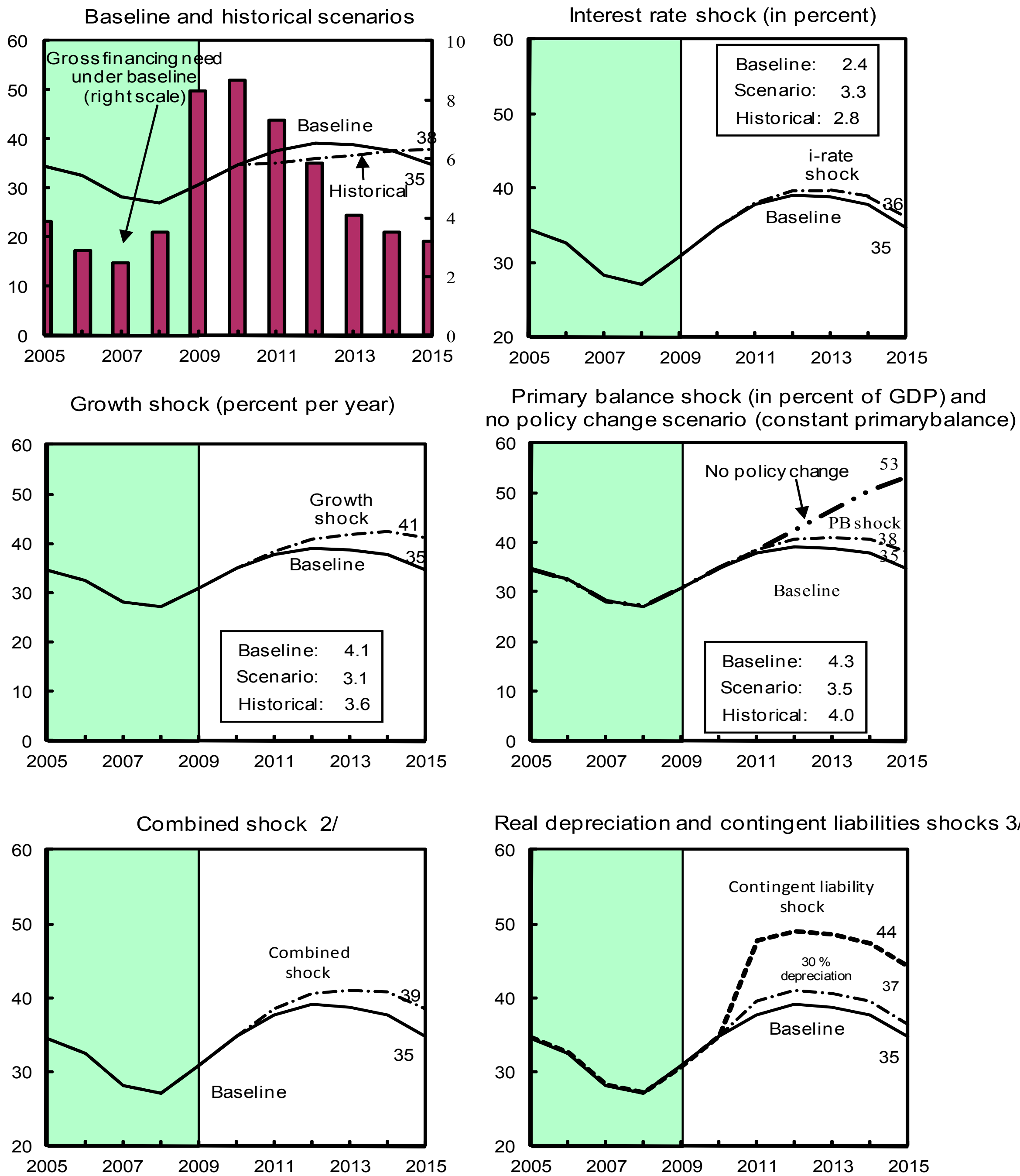
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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/
(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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 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
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/132
FOR IMMEDIATE RELEASE
September 21, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with South Africa

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

Background

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

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

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

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

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

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

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

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

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

Executive Board Assessment

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

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

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

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

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

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with South Africa is also available.

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

(Annual percent change; unless otherwise indicated)

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

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

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

Statement by Mr. Itam on South Africa
July 5, 2010

Introduction

My South African authorities would like to thank staff for the useful discussions held for the 2010 Article IV Consultation. The staff report provides a well-balanced assessment of the South African economy. Like many emerging economies, South Africa faces challenging times in the aftermath of the crisis, and my authorities value the continued close dialogue with the Fund in their efforts to address these challenges.

The impact of the crisis and recent economic developments

South Africa's economy has been affected more severely by the global financial crisis than a number of other emerging markets. The global contraction has adversely affected the mining, manufacturing and trade sectors through lower commodity prices, falling exports and slowing domestic demand. The resulting recession has caused a huge setback on the employment numbers, with the unemployment rate rising sharply.

The recovery in economic activity, however, has not yet materialized in generating net employment and the unemployment rate in the first quarter of 2010 rose further to 25.2 percent. Conditions in the labour market remain subdued owing mainly to the uncertainties surrounding the recovery in economic activity.

Consumption expenditure by households also picked up strongly facilitated by acceleration in the growth rate of real disposable income, relatively low interest rates and inflation, positive wealth effects, and an improvement in household confidence. The rising demand for exports and generally buoyant commodity prices have resulted in a notable acceleration in economic activity generating growth rate of 4.6 percent. This growth was widespread among the major economic sectors, with manufacturing playing a strong role alongside mining and commerce. Capacity utilisation nevertheless remained at low levels.

Private investment growth, edged lower, although at a slower pace than the contractions observed during 2009. Capital expenditure increases by the private sector in areas such as construction, telecommunications and accommodation, partly related to the expected influx of tourists during the 2010 FIFA World Cup tournament, was offset by lower capital outlays in agriculture, mining and manufacturing. However, public corporate investment in the areas of transport, electricity and telecommunications infrastructure helped to more than offset the declines recorded by the general government and private sectors.

The recession and sluggish recovery of domestic demand helped narrow the current account deficit, which was easily financed by ample portfolio capital inflows in late 2009. However, as improvement in the domestic economy and stronger rand boosted import demand and weakness in the Euro zone slowed exports, the external current account deficit widened significantly. The stable economic environment in the country, alongside well-developed and liquid financial markets, facilitated a further strong net inflow of portfolio capital in the first quarter of 2010, mainly in the form of debt securities. However, this inflow started to weaken in the wake of concerns regarding fiscal sustainability in Greece and a number of other European countries. In contrast, flows of direct and other investment capital remained fairly subdued over the period.

My authorities remain concerned about the current account deficit, and acknowledge the case made in the staff paper that there are vulnerabilities from the volatile portfolio flows and strengthening rand. But the mitigating factors, such as equity flows, as investor interest in emerging markets returns, the floating exchange rate and the low external debt should limit the impact.

Fiscal policy response

Prudent fiscal management, maintained over the last l0 years, created fiscal space which enabled the authorities to mitigate the impact of the crisis with a strong counter-cyclical policy. In the ensuing crisis, expenditure levels were maintained, allowing the budget deficit to widen further in fiscal 2009/10 as tax revenue receded on account of the comparatively subdued levels of economic activity. The policy was aimed at guarding against a reversal of the hard won improvements in living standards achieved during the past decade; cushioning the impact of slower growth and job losses on the poor; and sustaining the public infrastructure investment program, particularly those related to easing electricity supply constraints and transport bottlenecks.

The current fiscal plan remains to strike a balance between supporting the ongoing recovery through sustained infrastructure investment, which should strengthen the long-term growth potential of the economy and lower the cost of economic activity, and building fiscal space. Most recently there were signs of a moderate increase in tax collections as the economic recovery gains traction, which should help narrow the fiscal deficit.

The recent increase in the public sector wages should be ascribed to one-off pay adjustments, made in accordance with the occupation-specific dispensation and including an element of back pay. The intention of this dispensation is to improve government's ability to attract and retain appropriately skilled employees through improved remuneration by recognising improved skills and accumulated work experience.

Monetary developments

Low global inflation, the appreciation in the external value of the rand and progress made in containing production costs helped to restrain inflationary pressures in the domestic economy in the first quarter of 2010. Furthermore, the consistent implementation of monetary policy played a role in suppressing the high level of inflation. As a result, inflation fell within the target range. The lower inflation outcome also contributed to a moderation in inflation expectations.

Since the first reduction in the policy rate in December 2008, the repurchase rate has been lowered by a cumulative 550 basis points. Among other factors, a large output gap, modest pace of growth in domestic expenditure, and relatively stable international oil prices have contributed to the improved inflation outlook. These developments have created monetary policy space for the SARB to support the domestic economy through interest rate cuts. Since the inflation outlook had remained broadly unchanged, SARB in its May 2010 Monetary Policy Committee meeting decided to keep the policy rate unchanged at 6.5 percent. My authorities consider that inflation targeting remains the operational framework for conducting monetary policy and they stand ready to move quickly to use the instruments at their disposal to ensure that inflation expectation remain within the band.

Labor market

The high and persistent unemployment level remains a key challenge. This problem has been exacerbated by the recent financial and economic crisis. To address this issue, economic policies are focusing on raising the long-term growth potential of the economy and the labour intensity of economic activities. To this end, the authorities are making a concerted effort to reduce joblessness among young people through carefully designed initiatives. These include support for labour-intensive industries through industrial policy interventions, skills development, public employment programmes, information services and a rural development strategy.

Conclusion

The key challenges remain creating jobs and reducing poverty. The strength of present policy response in the face of deterioration in economic activity and higher uncertainties in the global economy underline the authorities' continued commitment to put South Africa on a path to sustained economic growth.