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Research:
South Africa (Republic of)

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	Local Currency	Foreign Currency
Credit Rating	A-/Stable/A-2	BBB-/Stable/A-3

Rationale

The ratings on the Republic of South Africa are supported by:

- Prudent fiscal policies and reforms that have brought spending under control and put deficits on a downward trend. National government deficits are projected to decline to about 2.0% of GDP by 2003-2004 from a budgeted 2.5% in 2001, which is a substantial improvement from more than 5.0% in the mid-1990s. Reductions in the Reserve Bank's forward foreign exchange book should also reduce future budgetary risks stemming from potential losses, which are ultimately a government liability. General government debt is forecast to fall to about 45% of GDP, and should decline further with the planned sale of state assets.
- A relatively manageable external debt burden. South Africa's external position has strengthened on the back of low current account deficits. Net external debt is projected to fall to about 38% of exports, and net public external debt to about 36% of exports in 2001. With privatization underpinning foreign direct investment (FDI) inflows, these ratios should improve further, while the term structure of external debt should lengthen to levels broadly in line with those of similarly rated sovereigns.
- An independent central bank committed to low inflation. The Reserve Bank's new inflation targeting strategy is working well, and achieving the government's inflation target of 3%-6% for 2002 has become a realistic prospect.
- Liquid domestic capital markets and a robust and well-regulated banking sector. The banking system's external obligor position (estimated at 10% of exports in 2001) is trending down, and the sector's credit risk profile is below the average for emerging market countries.

South Africa's ratings are constrained by:

- Modest, although slowly improving, external liquidity. Official reserves cover only about 60% of the annual external financing requirements, but the position will improve with the forward book now well below $10 billion and declining, and because reserves should also benefit from the government's privatization program. The ongoing relaxation of exchange controls, however, makes South Africa more vulnerable to volatile capital flows. This underscores the need for South Africa to improve its ability to attract FDI and for the Reserve Bank to maintain its floating exchange rate regime and rely primarily on its interest rate policy to safeguard reserves.
- Persistent structural economic weaknesses and social inequality. Although South Africa's growth performance is improving gradually, it will only slowly begin to ameliorate the country's chronic unemployment and social problems. Factors still constraining growth include low levels of savings and investment, and labor market rigidities. The rising incidence of HIV among the population will also impose a substantial burden in the coming decade, straining the health system and financial resources.

Outlook

Cautious fiscal and monetary policies, coupled with microeconomic reforms, should underpin South Africa's investment-grade ratings in the coming years. With a sound macroeconomic framework now firmly established, the government can turn to microeconomic reforms and a prudent progrowth fiscal policy. Real GDP should increase by 3.0%-4.0% per year this decade--significantly faster than the average of just 1.3% in the 1990s. The government's credit standing would come under downward pressure if fiscal discipline were substantially relaxed or political backing for economic restructuring stalled.

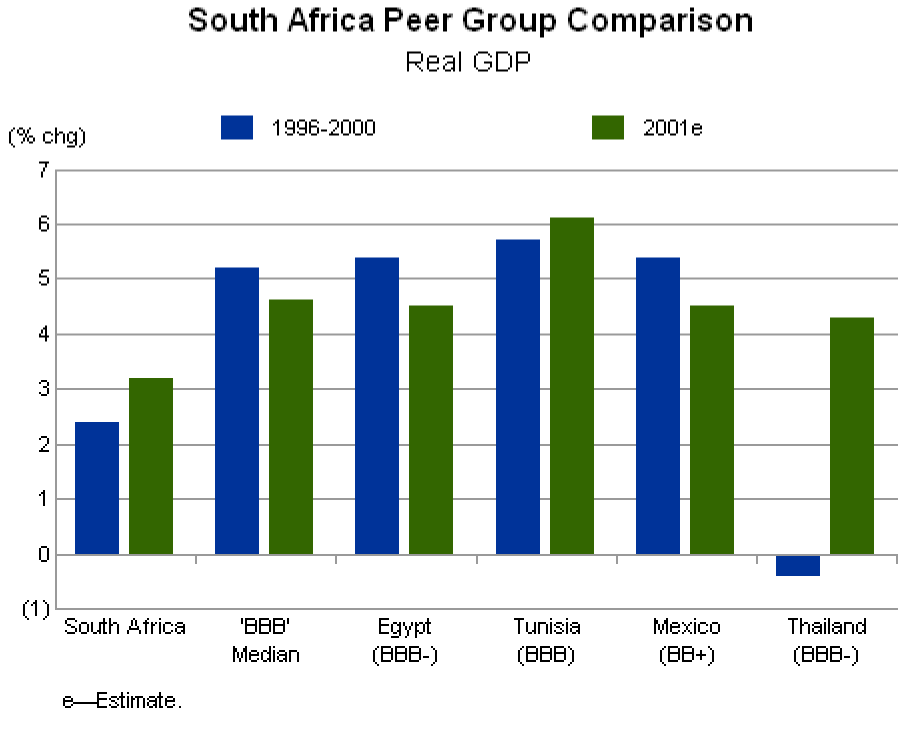
Comparative Analysis

- A credible economic policy framework, as mirrored by good progress in fiscal consolidation and structural reforms, and a smooth democratic election and transfer of government have established South Africa firmly in the investment-grade category.
- Social inequality, as well as low growth, savings, and investment rates in the context of a vulnerable external position continue to be more challenging in South Africa than in most of its peer countries.

Post-apartheid policy credibility.

A credible economic policy framework and a smooth democratic transition have established South Africa firmly as an investment-grade country, roughly seven years after the end of the apartheid regime. Given its problems of poverty, inequality, and racial polarization, the policy environment of post-apartheid South Africa will continue to be challenging and at times unsettling. In these respects, however, South Africa is not alone and all of its key peer countries (Mexico, Egypt, Tunisia, and Thailand) at times face significant opposition to their economic policies and reform processes.

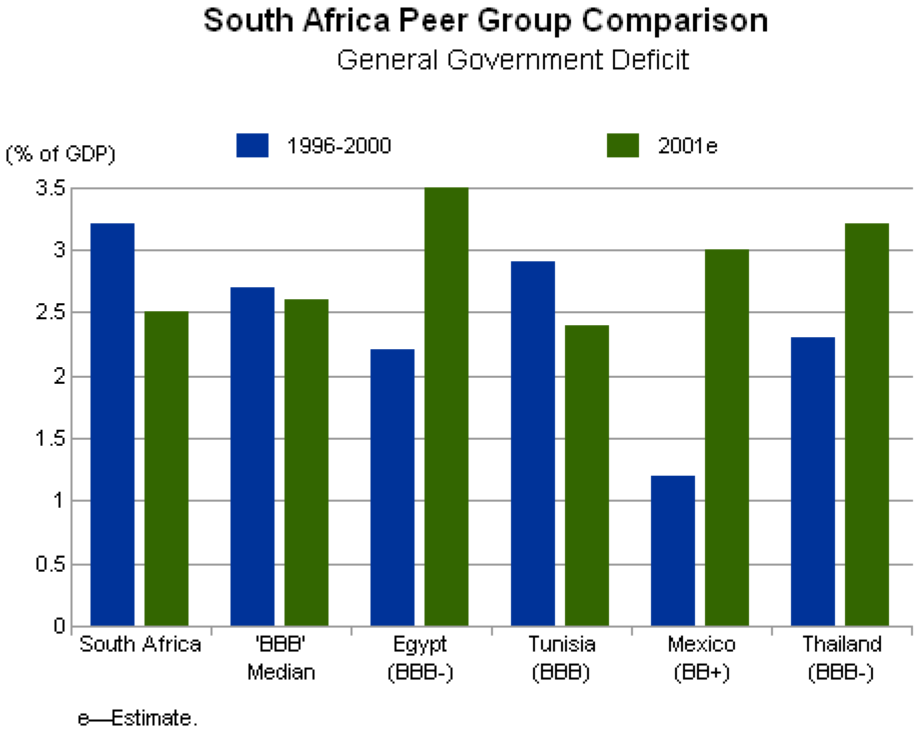
South Africa stands out among its peers regarding its sound and transparent economic policy framework and healthy financial system: fiscal consolidation and disinflation are well-recognized and widely supported policy objectives. Budgetary reforms and structural changes to the monetary policy framework have created a transparency and predictability that is outstanding by emerging market standards.



Continuing fiscal prudence.

Post-apartheid governments have not succumbed to a policy of rapid redistribution at the cost of sustainable fiscal policies. Instead, policymakers have demonstrated at critical stages their ability to follow orthodox economic policies or to correct policies where needed, highlighting their commitment to South Africa's global integration and their willingness to subject government policies to the rigor of market forces.

Prudent fiscal and monetary policies, accompanied by structural reforms, have reduced the high imbalances and deep-seated inflation expectations that plagued South Africa's economy in the past. General government deficits are well in line with the 'BBB' median and lower than those in Tunisia (BBB/Stable/A-3), Egypt (BBB-/Negative/A-3), or Thailand (BBB-/Stable/A-3). General government debt is on a firm downward trend and nearing the 'BBB' median.



Structural reform and external liquidity.

Mexico (BB+/Positive/B) and Thailand have significantly lower leverage ratios than South Africa, but have struggled with implementing structural reforms. Egypt, on the other hand, is significantly more leveraged, but this is balanced by a relatively strong external position. South Africa's improving external debt ratios are moderate and well in line with the 'BBB' median. Nevertheless, South Africa still compares unfavorably with its peers with regard to external liquidity and its relatively high share of short-term external debt.

Improvements to South Africa's external liquidity and higher growth (that would ameliorate South Africa's socio-economic inequalities) will be key to the sovereign's rating prospects.

Socio-economic challenges.

With regard to socio-economic indicators, South Africa's peer group provides a mixed picture. Tunisia, Egypt, and Thailand register per capita incomes that are well below that in South Africa. Social indicators put South Africa behind its Latin American or Eastern European peers, but in many respects ahead of rated North African sovereigns (Egypt, Tunisia, and Morocco [BB/Stable/B]), although South Africa's pronounced economic inequality along racial lines is not nearly as prevalent in peer countries. In addition, among peers, South Africa will have to bear by far the heaviest burden in terms of economic and social costs as a result of the growing AIDS epidemic.

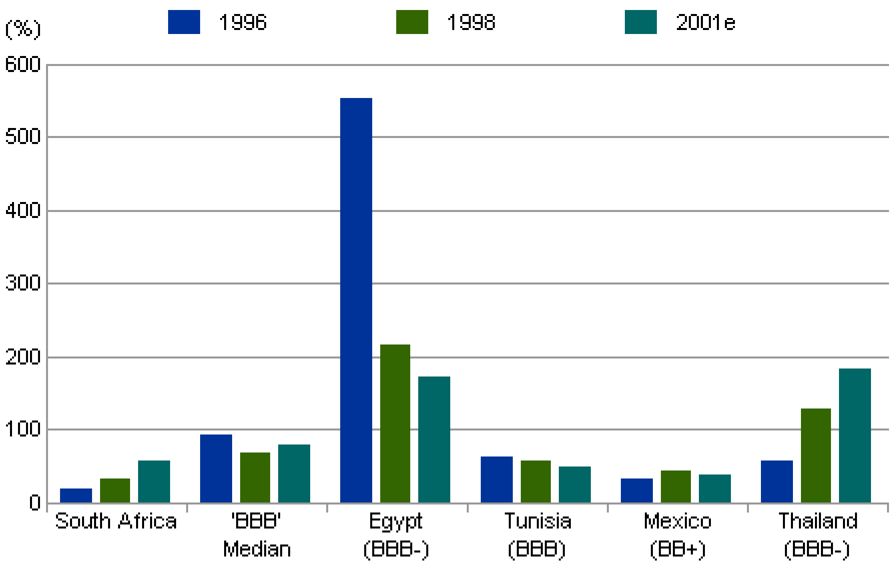
The structural problems of financing growth

The structural problems of financing growth.

South Africa's moderate (albeit improving) growth prospects are the result of continued low savings and investment rates, which are well below the rates of all its peers and the 'BBB' median. More rapid growth in South Africa tends to quickly reveal a growing structural savings/investment gap, which forces South Africa to rely on foreign savings to support investment and growth. Unlike its Latin American, Eastern European, or Asian peers, however, where the gap is often entirely filled by FDI, South Africa continues to be only moderately successful in attracting FDI, but instead has relied on more volatile portfolio inflows. As demonstrated by a number of Eastern European transition economies, privatization involving strategic foreign investors offers a way out of this dilemma: at least for a few years, it would ensure substantial, nondebt creating capital inflows, allowing for a period of higher current account deficits, during which economic restructuring can be safely undertaken.

South Africa Peer Group Comparison

Reserves/Financing Gap



e—Estimate.

Political Environment

- The government is stable and democracy is firmly established. Failure to bridge the wealth gap, however, still poses a challenge to South Africa's long-term stability.
- Notwithstanding the criticism of President Thabo Mbeki's leadership, South Africa's government remains committed to macroeconomic stability and an orthodox policy mix.
- Room to maneuver created by the successful fiscal consolidation in recent years will be used for social and labor-intensive public infrastructure spending.

Roughly seven years after the end of the apartheid regime, South Africa's democracy is well entrenched, and the macroeconomic environment is relatively robust. During the first seven years of post-apartheid rule, government policy has focused on achieving macroeconomic stability, implementing prudent orthodox economic management, and liberalizing the economy. Overall, government policies have been relatively successful in providing electricity, safe water, and housing to the townships and rural areas, but have failed elsewhere in creating jobs and reducing poverty. Growth, domestic savings, and FDI inflows have remained well behind expectations, while the government has continued to struggle with the serious challenges posed by crime, the skills shortage, and the growing AIDS epidemic. Nevertheless, despite disappointment in some quarters, there is no reason to fear a general political or land crisis in South Africa of the kind experienced in Zimbabwe.

Party politics, dominated by the ANC.

The African National Congress (ANC), which scored a landslide victory in the 1999 general elections, remains well positioned as the premier post-apartheid party. In local elections held in December 2000 it won about 60% of the popular vote, slightly less than the percentage in the 1999 general election. The outcome confirmed the movement's dominance at all levels of politics in South Africa, pointing to a broad-based and fiercely loyal ANC constituency. Subsequently, there seems to be little doubt about the outcome of the next general election in 2004, despite the debate over President Mbeki's leadership--one that is unlikely to completely disappear until next year's ANC national conference.

The good performance of the newly formed, opposition Democratic Alliance (comprising the Democratic Party, the New National Party, and the Federal Alliance) in the local elections, during which it won more than 20% of the vote, indicates that some changes are occurring to South Africa's political landscape. Although the alliance is by no means a threat to the ANC in the short term (because it still mainly relies on White constituency support and some from the mixed-race community), its success at the local level suggests that it might establish itself as a second force in an evolving two-party system, and act as a counterbalance to the ANC.

Speculation over deepening rifts between the ANC and two of its alliance partners--the Congress of South African Trade Unions (COSATU) and the South African Communist Party (SACP)--has not ceased, and tensions among the alliance partners are likely to increase from time to time, particularly as the government will be pushing ahead with its agenda of prudent economic policies and privatization. A near-term break-up of the coalition is highly unlikely, however, as both these organizations would be substantially weakened without ties to the ANC.

South Africa's image problem and the challenges ahead.

The challenges for the government in the coming years are manifold: maintaining higher growth, creating more jobs, reducing poverty, pushing through structural reforms, preventing crime, weeding out corruption, redressing pronounced skill shortages (which continues to be exacerbated by the brain drain of scarce skills through unabated White emigration), and controlling the AIDS epidemic. While these challenges are nothing new, the increasingly negative perception of the country by investors has severely compounded these challenges since last year. This growing image problem came as somewhat of a surprise, given that Mr. Mbeki had started his presidency determined to promote private sector investment and higher economic growth--a policy stance that received a warm welcome by the international investor community. South Africa's growing image problems are partly the result of political and/or economic crises elsewhere in Africa--Zimbabwe, Democratic Republic of Congo, Sierra Leone, and others--highlighting that South Africa's image and economic potential are inextricably linked to the performance of the rest of the African continent.

The growing perception problem also reflects some shortcomings in South African politics, however, and a resurgence of publicly expressed racial bitterness. The government's credibility both at home and abroad have been dented by its defensive style, allegations of corruption, the ill-considered handling of the HIV/AIDS debate, the controversial investigations into alleged plots against President Mbeki, and the government's "quiet diplomacy" and reluctance to publicly condemn illegal land invasion in Zimbabwe (albeit with belated assurances from President Mbeki that illegal land invasion would not be tolerated in South Africa).

The policy focus is changing.

All in all, pressure on the government to meet targets and expectations is growing, particularly from the ordinary South Africans who have not seen their living standards and incomes rise since apartheid ended. In this context, promising free basic services as the ANC local government election manifesto did, has unnecessarily raised expectations in the electorate. Despite the growing pressure, however, a lasting populist economic policy approach is not in the least likely: the government remains fully committed to its economic and development strategy, which was laid out in the 1996 Growth, Employment, and Redistribution Plan (GEAR)--a blueprint of orthodox economic and financial management.

With a stable macroeconomic framework now firmly established, however, the government is adopting a progrowth fiscal stance. The ongoing shift in policy was indicated in last November's Medium Term Budget Policy Statement (MTBPS), and is mainly reflected in increasing infrastructure spending and reformed public service delivery by putting local governments at the forefront of delivering basic services--a shift that is politically compelling and economically affordable given the improvement in the fiscal position. In addition, reforms over recent years have created a strong framework of increased fiscal position. In addition, reforms over recent years have created a strong framework of increased transparency, predictability, and accountability, ensuring that hard-won room for maneuver will be used wisely.

Economic Prospects

- Notwithstanding the difficult external environment, South Africa's economy has remained in relatively good shape, with real growth increasing to 3.0% in 2000, and estimated at 3.2% in 2001.
- Combating very high unemployment remains a key policy challenge. The failure to create jobs despite moderate real wage increases suggests that more emphasis has to be given to education and upgrading skills.

South Africa Economic/Financial Indicators

	--Year ended Dec. 31--				
(% chg.)	**2003f**	**2002f**	**2001f**	**2000**	**1999**
Real GDP	3.1	3.3	3.2	3.0	1.9
Real gross fixed investment	6.5	7.5	6.5	1.5	(6.0)
Real private consumption	3.2	3.8	3.6	3.1	1.1
Real domestic	3.0	3.5	3.0	2.0	(0.1)
Real exports	6.1	6.3	6.5	7.5	1.3
Gross domestic savings/GDP (%)	15.0	15.0	14.9	15.0	14.5
Gross domestic investment/GDP (%)	16.8	17.0	16.0	15.4	15.0
Employment in the formal sector (excluding agriculture) (%)	0.5	0.2	0.0	(1.0)	(2.5)
Nominal unit labor costs	2.0	1.8	1.5	1.5	2.8
Headline inflation (period average)	5.3	5.9	6.5	5.2	5.2
CPIX (period average)	5.4	5.8	6.7	7.7	6.9
Domestic credit to private sector and NFPEs	10.0	11.0	12.5	11.7	8.7
Long-term government bond yield, (eop %)	11.2	11.6	12.0	13.0	13.3
Money supply (% chg in M3)	8.0	9.0	8.5	7.5	10.2
Exchange rate, eop (Rand/$)	8.70	8.35	8.00	7.65	6.15
f--Forecast. NFPEs--Nonfinancial public enterprises. eop--End of period.					

The economy weathers shocks.

Real growth reached 3% in 2000--the highest rate since 1996. The latest GDP figures suggest that the economy is in healthier shape than previously thought, after external shocks (high oil prices, the crisis in Zimbabwe, and severe flooding) and decreasing confidence hit South Africa's economy.

Agriculture recovered completely from the flood damage in the first quarter of 2000, with bumper crops harvested later in the year. Manufacturing also gained momentum thanks to robust domestic and foreign demand, with real output growing by 3.5% after being virtually flat in 1999. Services, particularly telecommunications and financial services, also increased steadily over the course of last year. Mining, however, continued its perennial decline, with gold production reaching the lowest level in 46 years.

Real domestic demand was up by 2%. Private consumption benefited from increasing disposable incomes and a slight increase in household debt. Public consumption remained weak against the background of the ongoing fiscal retrenchement. Importantly, gross fixed investment recovered from its 6% slump in 1999, growing by 1.5%. Against this background, South Africa's investment-to-GDP ratio, which had fallen steadily in recent years, picked up slightly, but at only about 15% it remains well below ratios in South Africa's peer countries. Investment continues to be constrained by similarly low domestic savings. Household savings have remained very muted, while the government only last year began to make a positive contribution to national savings.

began to make a positive contribution to national savings.

Growth should remain robust in 2001 and 2002 within a range of 3.0%-3.5% on the back of a further strengthening of domestic demand and good export earnings, assuming no severe external shocks nor a dramatic contraction in global demand. Public investment will also regain momentum with increased public spending on infrastructure. In addition, falling long-term interest rates, tax cuts, and healthier corporate and household balance sheets provide a solid base for growth.

Employment creation is of vital importance.

Although expected faster growth will begin to ameliorate South Africa's socio-economic inequalities, they will remain formidable for many years. The challenge remains to raise growth to the level required to make a serious impact on South Africa's chronic unemployment; more than 5% GDP growth per year. Only in 1996 did real GDP growth approach that level, however.

Formal employment in the private sector outside agriculture has yet to stabilize, after a continuous fall since the mid-1990s, brought about by productivity-enhancing industrial restructuring and substantial lay-offs in the mining and construction sector. Public sector employment has maintained its slow downward trend, reflecting the government's efforts to "right-size" at all levels of government. Unemployment still remains very high, with an official unemployment rate of 23%. Estimates according to broader, survey-based methods put unemployment between 35% and 40%, also masking substantial regional and racial/ethnic disparities. Although a sharp rise in informal sector activity mitigates the situation slightly, there can be little doubt that job creation is one of the most pressing problems in South Africa.

The poor record of job creation, and continued substitution of labor through capital in South Africa's agro sector and capital-intensive manufacturing has pushed the government to review the raft of labor legislation that has been introduced gradually since the mid-1990s. The proposed amendments, however, fall short of expectations and mainly aim at enhancing employment creation, supporting small and midsize enterprises (SMEs), and improving workers' protection in case of insolvency.

Employment creation is undoubtedly constrained by the country's capital-intensive production structure and onerous labor laws. After several years of very moderate real wage increases and waning trade union influence, however, the long-used argument that South Africa's labor force is too expensive and strike prone has lost resonance. South Africa's labor market problems are more complex: higher growth of the sort needed to create more jobs very quickly reveals severe bottlenecks, suggesting that there is a severe skills shortage that is being compounded by the structural changes in the economy. These ongoing structural changes have substantially altered South Africa's economy: the primary sector's share in total output fell about 10% in 1999; the secondary sector's to 24%; while the tertiary sector increased its share to about 65%. The problem is exacerbated by continued emigration of Whites and administrative problems for firms wanting to fill the gap with expatriate labor. Government policies are increasingly focusing on the problem, with the budget placing greater emphasis on investing in and raising standards for academic and vocational training. Raising education standards will take time, however, given the legacy of the apartheid years that has left the majority of the population with low standards of literacy, numeracy, and technical competency.

Wage growth remained relatively moderate in 2000. Private and public sector wage growth was held closely to the key inflation rate, CPIX (headline inflation excluding mortgage interest rates), which stood at 7.8% in 2000. A public sector wage agreement, which puts annual average wage increases at about 6.5% for 2000/2001 bodes well for continued wage moderation. Private sector wage growth is also likely to be kept reasonably well in check in a less hostile wage bargaining environment, as demonstrated by the continued decrease in man-days lost to strikes. Moderate wage increases, combined with rapid productivity growth, has resulted in a further slowdown in the growth of nominal unit labor costs (to 1.5%)--an encouraging sign for future underlying inflationary pressure.

The threat of HIV/AIDS to growth.

Beyond the immediate constraints on growth, HIV/AIDS, which affects an estimated 4.2 million of the total population of 44 million in 1999, poses the most severe threat to growth and social stability in South Africa. Currently available research paints a rather bleak picture: South Africa's economy could be 17% smaller in 2010 than it would have been without AIDS; six to 10 million people could die of AIDS in South Africa by 2010 and about 16 million by 2021; and one-third of all semi-skilled and unskilled workers could be HIV-positive by 2005. Although prevention efforts are being stepped up, HIV infection rates and AIDS cases will remain high for some time to come, straining society, the health system, and financial resources.

Fiscal Flexibility

- There has been good progress on fiscal consolidation and reform, creating room for a shift to a progrowth policy.
- The progrowth policy shift is happening within a framework of further gradual deficit reduction, and therefore should not undermine macroeconomic stability.
- Although the speed at which the deficit is reduced will slow down, privatization proceeds should cut the borrowing requirement and keep the debt-to-GDP ratio on a downward trend.

South Africa Fiscal Indicators

	--Year ended Mar. 31-- *)						
(as a % of nominal GDP)	**2003/2004f**	**2002/2003f**	**2001/2002f**	**2000/2001p**	**1999/2000**	**1998/1999**	**1997/1998**
PSBR	2.0	2.0	2.4	2.0	1.1	3.3	4.6
Total public sector balance	(2.9)	(2.9)	(3.0)	(2.1)	(1.8)	(3.7)	(4.6)
General government balance	(2.5)	(2.6)	(2.6)	(2.0)	(1.5)	(2.5)	(4.3)
National government balance	(2.1)	(2.3)	(2.5)	(1.9)	(2.0)	(2.3)	(3.8)
National government revenues	23.6	23.7	23.8	24.0	24.3	24.4	23.5
National government expenditures	25.7	25.9	26.3	26.0	26.2	26.3	27.3
National government interest payments	4.5	4.7	5.0	5.2	5.5	5.8	5.7
National and provincial expenditure							
Education	5.3	5.5	5.6	5.7	5.7	6.0	6.4
Health	2.9	2.9	3.0	3.1	3.0	3.1	3.3
Welfare	2.3	2.3	2.3	2.4	2.4	2.4	2.6
Justice	2.6	2.7	2.7	2.8	2.8	2.8	2.7
Infrastructure	2.8	2.8	2.8	2.7	2.6	2.6	
as a % of national government revenues							
National government balance	9.0	9.5	10.7	10.2	11.7	10.6	16.2
National government interest payments	19.0	19.9	21.0	21.5	23.2	23.2	23.8
Memo item: Nominal GDP (Bil. LC at fiscal year-end)	1148.7	1063.3	976.7	892.5	816.7	750	695.7
	--Year ended Dec. 31--						
(as a % of nominal GDP)	**2003f**	**2002f**	**2001e**	**2000**	**1999**	**1998**	**1997**
General government gross debt	41.6	43.4	45.6	47.7	49.6	50.0	50.2
General government net debt	28.0	30.5	32.5	35.2	38.4	40.1	40.1
National government debt	40.6	42.8	44.9	47.1	48.9	48.8	49.2
Debt in local currency (%)	91.0	91.0	91.5	92.0	94.0	98.9	95.6
Debt in foreign currency (%)	9.0	9.0	8.5	7.0	6.0	1.1	4.4
Public sector gross debt	49.0	51.0	54.0	56.0	57.9	58.3	59.8

f--Forecast. e—-Estimate. p-Preliminary. PSBR--Public sector borrowing requirement. Sources: Government plan and S&P estimates

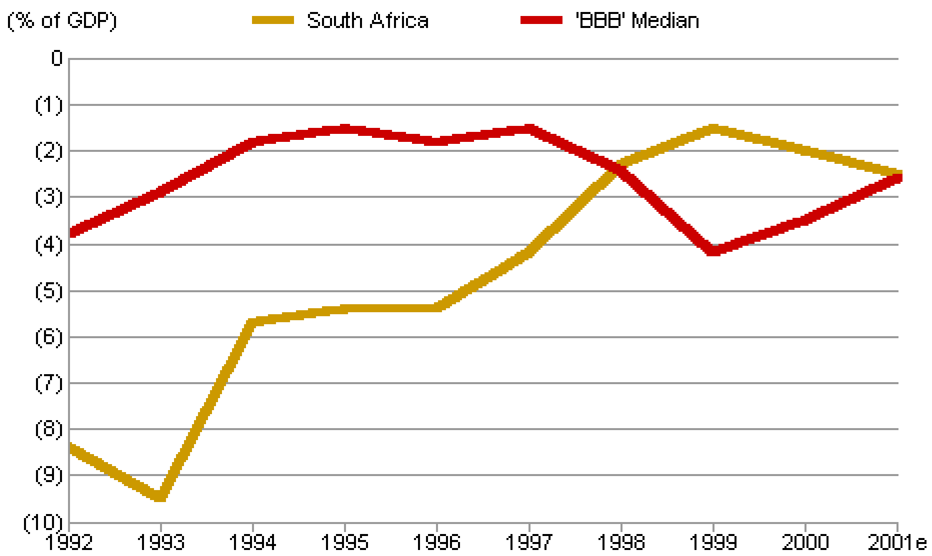
Tax broadening and efficiency leads to fiscal improvements.

Fiscal results have remained better than expectations and the government remains committed to its strategy of gradually reducing budget deficits through a widening of the tax base and improving tax collection and administration, while expenditures are better managed and controlled. At the same time, expenditure priorities have been focused on most pressing issues (infrastructure, education, health care, and crime prevention), while any growth dividend is used to cut household taxes (particular for lower- and middle-income groups).

The momentum behind fiscal administrative reforms has also been sustained with the Public Finance Management Act coming into effect on April 1, 2000. This Act increases accountability at all levels of government and tightens internal controls through better reporting and auditing, while adjustments to budgets are only allowed under certain conditions.

The fiscal year 2000-2001 is estimated to have ended with a national government deficit of 1.9% of GDP (compared with a target of 2.6%) and a general government deficit of a similar order (due to broadly balanced provincial and local government books). National government revenues in 2000-2001 were again above expectations due to further improvements in collection and administration. This allowed for some extra spending (for infrastructure repairs following the spring floods and a slightly higher-than-expected public sector wage increase) without jeopardizing the overall deficit target. Lower-than-expected GDP growth (by about 0.5 percentage points) was broadly balanced by higher-than-expected inflation.

General Government Balance



e—Estimate.

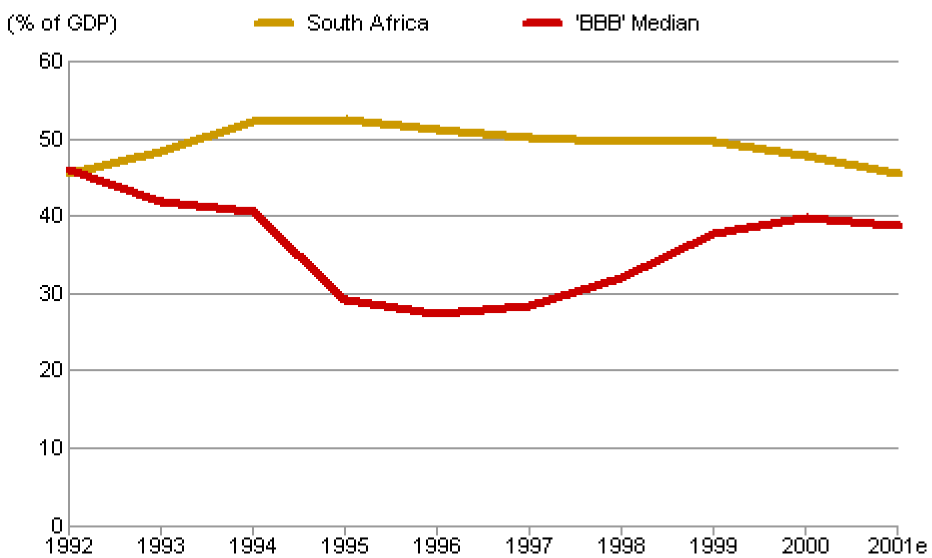
The 2001-2002 national government budget aims at a deficit of R22 billion ($2.8 billion), or 2.5% of GDP. Significant allocations are made to education, health, welfare, and the criminal justice system. The budget also confirms the policy of real increases in infrastructure spending as announced in last year's Medium Term Budget Policy Statement (MTBPS). In addition, key measures include tax relief for lower- and middle-income earners, tax incentives for job creation and investment, and a further gradual relaxation of exchange controls. On the funding side, the greater part of the deficit is expected to be covered by privatization proceeds (R18 billion), primarily from the Telkom IPO and the sale of the government's remaining 24.5% in mobile phone company M-Cell. Net foreign borrowing of R11.3 billion is also proposed to allow for the retirement of some R7.5 billion of long-term domestic debt.

For the medium term, the October 2000 MTBPS maps out a continued path of fiscal consolidation, albeit more slowly than during the past five years. In its macroeconomic assumptions the MTBPS assumes a pick-up in real GDP growth of 3.7% in 2001-2002 (which is at the upper end of current market forecasts), while inflation is projected to fall to 5% in 2002, which is well within the range of the official inflation target. The national government deficit is put at 2.1% of GDP and the general government deficit at 2.4% of GDP by 2003-2004. Owing to the deficit reduction and substantial privatization proceeds, the general government borrowing requirement is projected to fall to 1.6% of GDP, and the public sector borrowing requirement (including public corporations) to 2.0% in 2003-2004.

Real noninterest spending to rise.

More importantly, however, within the context of steady deficit reduction and expenditure control, real noninterest spending is projected to rise 3.7% per year. This is made possible due to buoyant revenues, lower interest outlays (due to falling rates and a lower debt burden), and a steady reduction in personnel spending (as a percentage of noninterest expenditures). At the same time, the policy of reprioritizing government spending continues. In contrast to past years, when social services received priority (raising their share in total spending to nearly 55%), infrastructure and economic services (training and skills development) have clearly become priority areas, with infrastructure spending increasing by an average 17% per year between 2000-2001 and 2003-2004. Spending on education, health, and welfare will rise only moderately in real terms over the coming few years, with average growth rates of between 6% and 8%. Pressures on welfare spending, however, are unlikely to ease in the foreseeable future. The lack of a social safety net puts the burden of supporting the elderly, families, and children entirely on grant support programs and therefore on the budget. In addition, over the next 10 years or more, the AIDS epidemic will put huge demands on social services.

General Government Debt



e—Estimate.

The current MTBPS spells out the growing emphasis on service delivery through the local government sector, following the completion of the reorganization of the local government sector, which has substantially reduced the number of local governments. The national government appears to be acutely aware of the risks decentralization represents to spending controls. Local government are expected to step up their borrowing gradually. In the medium term, legislation prohibiting provinces from long-term borrowing might also be revised. Within the framework of the Public Finance Management Act, checks and balances are relatively strong, however. Also, if the firm manner in which the national government dealt with provinces in 1997/1998 is anything go by, the expected decentralization is unlikely to result in a loss of spending control.

The successful fiscal consolidation of recent years, together with privatization proceeds, has put the government debt on a declining trend. Against the background of a pickup in growth, falling interest rates and rising privatization proceeds, the favorable trend in government debt should persist over the coming years, taking the general government debt-to-GDP ratio to well below 50% of GDP toward the end of the MTBPS.

A timetable for privatization.

An even sharper reduction in debt could well be on the cards if the government's plans for privatization are successful. Privatization, which has proceeded relatively slowly over recent years, is now likely to be intensified. The government has tabled a policy document outlining the framework for the restructuring/privatization of the key state-owned enterprises (Transnet, Telkom, Eskom, and Denel). These four, accounting for the bulk of state-owned assets, are reported to be worth R140 billion; however, the government's policy document is short on details concerning the timetable for the sale of these assets and the expected level of privatization proceeds.

Monetary Policy

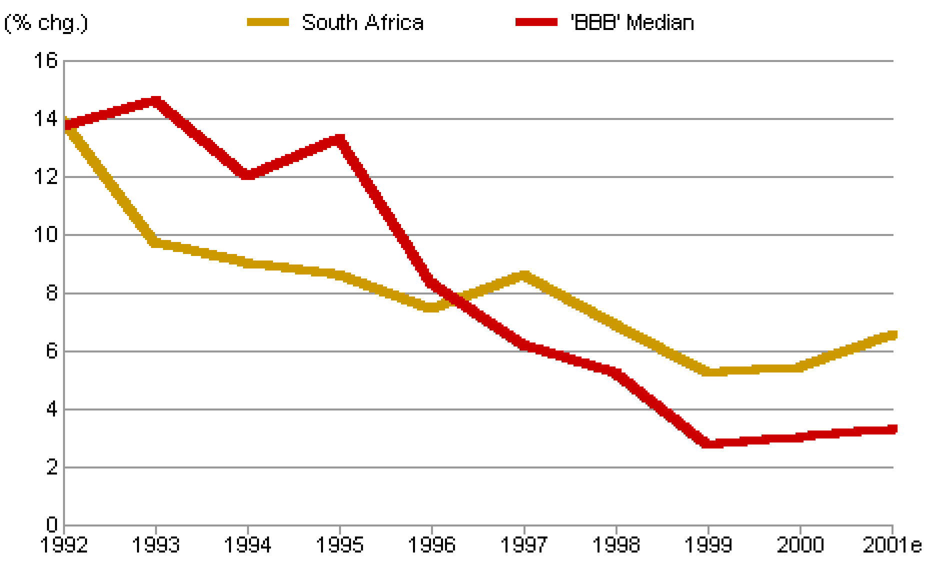
- South Africa's robust monetary policy framework remains a key factor in the country's creditworthiness.
- Despite periodic pressure on the rand, the Reserve Bank has not intervened in foreign exchange markets. Instead, it has maintained its floating exchange rate regime and relied primarily on interest rates to safeguard reserves.

South Africa's monetary policy framework, which has experienced substantial enhancements over recent years and now includes inflation targeting and a Monetary Policy Committee, responsible for policy decisions, remains an important pillar to South Africa's credit rating. Prudent monetary policies, together with fiscal consolidation over the past five years, have ensured that macroeconomic stability is now largely achieved.

Inflation trending down.

The rise in 2000 in consumer price inflation and producer price inflation to 7.8% and 9.2%, respectively, was largely the result of higher oil and food prices and the depreciation of the rand. Looking ahead, inflation is likely to have peaked. Assuming no further oil price shocks, and the impact of rand depreciation wearing off, while wage, money, and credit growth remain relatively contained, all-inclusive headline inflation should be at about 6.5% on average in 2001 and trend down below 6.0% in 2002 and thereafter. CPI-X (which is used by the Reserve Bank as its inflation target) should fall in line with headline inflation. With underlying inflationary pressures remaining relatively weak, the Reserve Bank should be able to achieve its inflation target of bringing CPI-X to within 3%-6% by 2002.

Consumer Prices



e—Estimate.

In its pursuit of the inflation target, the Reserve Bank takes guidance from a number of economic and financial indicators, particularly with money supply and credit extension. Growth in M3 and private sector credit were boosted in the fourth quarter of 2000 on the back of accelerating overall economic activity and the steady decline in interest rates between October 1998 and January 2000, which took prime lending rates to their lowest levels in more than a decade. Compared with the breakneck pace of credit expansion in 1998, trends continue to be relatively benign and support the view that underlying inflationary pressures are well under control. In addition, current credit growth is occurring against a background of healthier corporate and household balance sheets.

Government sticks to its policy of not intervening in foreign exchange market.

Wary of the costs of its past forays into the spot and forward exchange markets, the Reserve Bank has remained committed to its foreign exchange policy of not intervening to support the rand, which is also in line with its inflation targeting policy. After relative stability in 1999, the rand has been under significant pressure since early 2000, and fell by about 30% between January 2000 and May 2001 against the U.S. dollar. In trade-weighted terms, however, the decline was more modest because of a smaller decline against the euro (South Africa's main trading partner currency), the U.K. pound sterling, and the yen.

South Africa's currency has been buffeted since early 2000 by a combination of external and domestic factors. Looking ahead, despite South Africa's sound policy mix, relatively robust economic fundamentals, and good balance of payments performance, the rand is expected to remain volatile. Nervousness in both foreign exchange and bond markets still tends to translate quickly into exchange rate pressures, highlighting the need for policymakers to move more decisively on reform issues. In particular, privatization (coupled with an acceleration of restructuring in the large corporate sector) could generate substantial capital inflows, which in turn would help to improve South Africa's still vulnerable international liquidity position and reduce the rand's volatility.

Foreign exchange reserves and the net open forward position.

Although the Reserve Bank's foreign exchange reserve have grown steadily since late 1998, external liquidity is unlikely to strengthen substantially in the near term, as the bank continues--whenever market conditions allow it--to mop up inflows to reduce the forward book. Owing to this policy, good progress has been made in reducing the Reserve Bank's net open forward position. From a peak of $23 billion in September 1998, the net open forward position had fallen to $9 billion by end of April 2001. With the rand weakening and capital inflows subsiding last year, reductions in the forward book, however, slowed during the course of the year. The weakness of the rand in 2000 also meant that the currency's spot value worsened by more than that implied by the forward contracts, leaving the bank with a substantial loss on the book (compared with a profit in 1999), when the rand was relatively stable). Ultimately, the government covers the losses on the forward book. Looking ahead, the Reserve Bank will continue its stated policy of gradually reducing its net open forward position. At the same time, the authorities are expected to continue their strategy of gradually eliminating remaining exchange controls.

The banking system continues to perform well.

The banking system continues to be an important factor supporting South Africa's credit rating. South African banks are--by emerging market standards--relatively healthy and well regulated. The banking system's external obligor position (an estimated 10% of exports in 2001) is trending down, and nonperforming loans have remained low. Standard & Poor's puts the banking sector's potential peak of problematic assets at a moderate 8%-16% of GDP. The banking sector therefore poses a relatively manageable risk to the sovereign as a contingent liability.

External Finances

- The current account deficit (0.3% of GDP in 2000) has been well contained over the past few years and is not a major credit concern.
- South Africa's inability to attract more significant FDI, however, continues to be a constraint on

- South Africa's inability to attract more significant FDI, however, continues to be a constraint on growth and a concern in the context of South Africa's vulnerable international liquidity position.

South Africa External Indicators							
	--Year ended 31 Dec.--						
(as a % of exports of goods and services plus net transfers)	2002f	2001e	2000p	1999	1998	1997	1996
Trade balance	5.1	7.5	9.5	10.8	5.9	6.1	7.4
Current account balance	(5.4)	(3.1)	(1.2)	(1.3)	(5.1)	(6.0)	(5.2)
Net external liabilities	33.7	30.7	29.1	30.3	31.5	52.3	68.2
Gross external debt	95.4	101.0	103.6	109.9	99.2	100.0	91.8
Net external debt							
Net of liquid external assets	53.9	61.3	65.4	69.3	73.5	75.0	75.0
Net of all external assets	31.3	37.9	44.0	50.3	59.9	64.0	68.9
Gross public sector external debt	60.5	63.3	64.3	68.0	62.6	61.8	51.8
Net public sector external debt	30.8	36.1	39.2	42.0	42.8	41.2	38.9
Net private nonfinancial sector external debt	(8.4	(8.4)	(5.9	(2.3)	2.1	3.9	8.1
Net financial sector external debt	9.1	10.2	10.7	10.6	21.4	20.9	22.8
Net external investment payments	7.8	7.8	7.9	8.2	8.4	8.4	8.6
Net external interest payments	3.5	3.7	4.1	6.6	6.6	6.5	6.3
Scheduled external principal repayments	3.7	6.8	7.8	7.9	8.9	8.2	7.8
External debt service							
Excluding STD	9.0	12.5	13.9	16.6	17.2	16.1	14.9
Including STD	37.3	40.7	42.8	47.7	49.0	44.9	33.9
Reserves/imports (months)	2.9	2.7	2.5	2.5	1.8	1.8	0.7
Reserves/financing gap (%)	67.7	58.8	53.5	51.3	33.5	36.5	20.1
(as a % of GDP)							
BOP exports	34.8	33.9	30.5	26.5	27.0	25.2	25.1
Current account balance	(1.9)	(1.1)	(0.4)	(0.4)	(1.4)	(1.5)	(1.3)
Net FDI	1.6	1.3	0.6	0.2	(0.8)	1.0	(0.2)
Total external debt	33.2	34.2	31.6	29.2	26.8	25.1	23.1
Memo item: BOP exports (Bil. US$)	44.2	40.7	38.2	34.8	36.0	37.9	36.4
f--Forecast. e—-Estimate. p--Preliminary. STD—-Short-term debt. BoP--Balance of Payments. FDI--Foreign direct investments.							

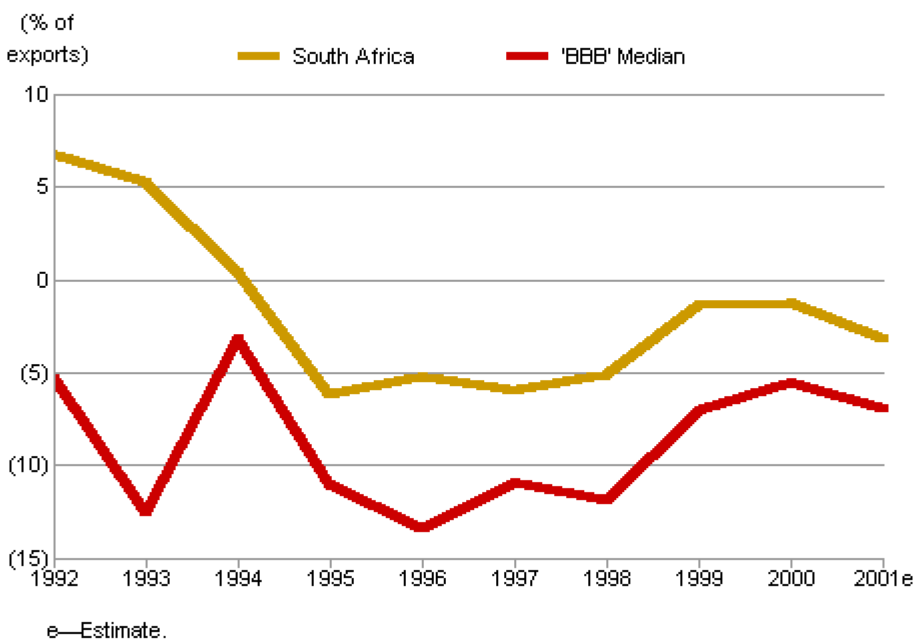
Modest current account deficits bolster external position.

Moderate current account deficits over the past few years have contributed to strengthening of South Africa's external position. In 2000, the current account remained near balance. Although the robust export performance was partially offset by a rebound in imports during course of the year, South Africa's trade performance remained strong in 2000, with a trade surplus of almost 3% of GDP. Nongold exports increased by more than 10% in 2000, benefiting from both the rand depreciation as well as strong global demand. Within manufacturing, the motor vehicle industry has become a mainstay. In mining, platinum exports have gained as much importance to South Africa's mining exports as gold, which continued to decline in volume terms. Import growth surged in the second half of the year, particularly high-tech products, reflecting stronger investment activity in South Africa's economy. The traditional deficit on the services account widened significantly in 2000, not least due to higher dividend payment outflows following the primary listing of various South African companies abroad.

In the medium term, the current deficit should remain at readily supportable levels. Stronger import growth, mainly as a result of the expected rise in private and public investment, is likely to result in a widening of the current account deficit to about 2% of GDP by 2002, despite robust export growth. Exports of manufactured goods should remain relatively robust, with competitiveness gains (due to the rand depreciation) offsetting slower demand particular from the U.S. and neighboring African markets. European and Asian exports should continue to grow steadily, and exports to Europe in particular should benefit from the free-trade agreement with EU that came into force in early 2000. Relatively stable commodity prices (particularly platinum prices) should underpin mining exports.

Although financing the small current account deficit for 2000 did not pose a challenge at all, South Africa's continued reliance on perception-sensitive portfolio capital flows remains a concern. Changing investor sentiment in 2000 resulted in a sharp fall in net capital inflows on the financial account to R8.5 billion from nearly R30.0 billion in 1999.

Current Account Balance

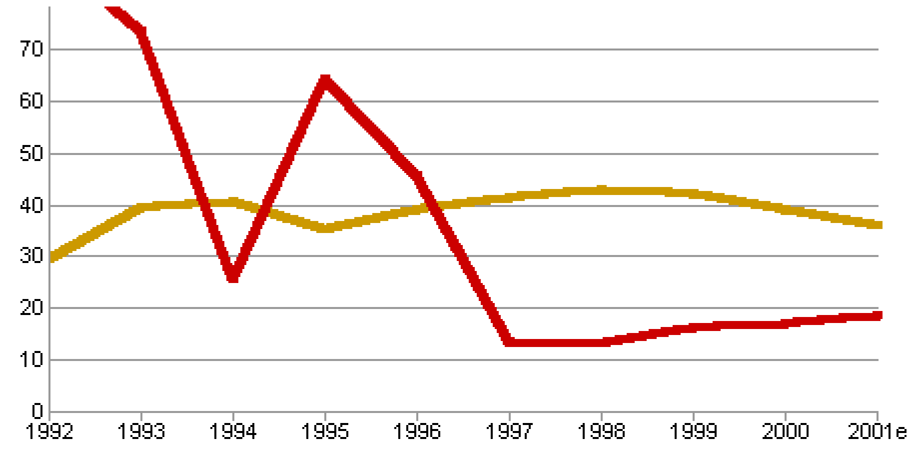


Capital flows.

A smaller inflow of equity capital, together with a net outflow of fixed-income capital (as nonresidents became net sellers of rand-denominated bonds), resulted in substantial lower inflow in portfolio investment last year (R11.8 billion compared with R83.9 billion in 1999).

Net FDI turned around in 2000, generating about R2.2 billion of net inflows after net outflows in 1999, but when compared with other emerging markets remain disappointingly low. Capital flows in general are not likely to change significantly this year. So far, nonresidents have remained net equity buyers and net bond sellers. The expected buyout of De Beers and the government's budgeted $1 billion foreign borrowing program for this year should underpin capital inflows into South Africa in the coming months, notwithstanding current weaknesses of other emerging markets. Over the medium term, the envisaged acceleration in privatization should boost FDI inflows, and thereby remove one of the key constraints to higher growth in South Africa. This is also important against the background of the expected further gradual relaxation of remaining foreign exchange controls, which is likely to lead to higher outflows as South African residents continue to diversify their investments, and as blocked rand accounts of South African émigrés estimated to be worth about $2.5 billion still wait to be released one day.

Net Public External Debt



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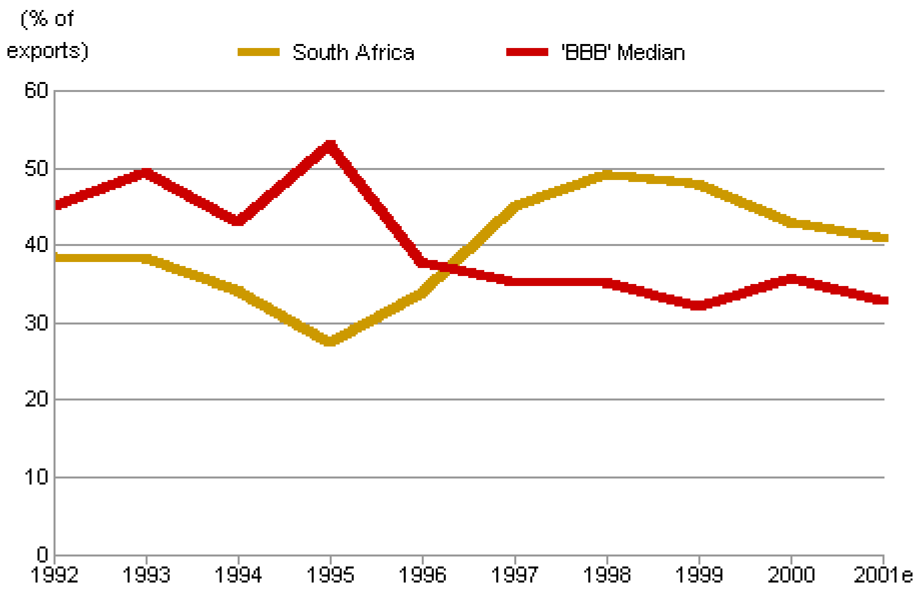
Short-Term Debt Service



e—Estimate.

The favorable current and capital account trends over the past few years have somewhat strengthened South Africa's external financial indicators--a trend that should be maintained with ongoing fiscal consolidation and privatization-related FDI inflows. Net external debt is estimated to fall below 40% of exports this year. Net public external debt is also expected to maintain its downward trend, reaching about 30% of exports by 2002. South Africa's gross financing requirement remains high at about 170% of reserves this year, but substantially lower than its peak of nearly 300% in 1998. Short-term debt also still accounts for nearly one-third of gross external debt--a significantly higher share than in South Africa's peer countries. Barring any unforeseen shocks or market turbulence, refinancing $2.8 billion this year and $1.6 billion next year in foreign currency debt maturing in 2001 and 2002 does not present a problem.

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