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IMF Executive Board Concludes Article IV Consultation with South Africa

On September 2, 2005 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

South Africa's macroeconomic performance was strong in 2004 and early 2005. Growth was supported by a continuation of sound policies and a favorable external environment. Real GDP grew by 3.7 percent in 2004, and 3.5 percent in the first quarter of 2005. The fairly broad-based expansion was mainly driven by strong final domestic demand, fueled by growing disposable income, a large reduction in interest rates, and wealth effects arising from rising housing and stock prices. The rapid expansion in economic activity led to some increase in employment, contributing to reduce the unemployment rate to 26.2 percent in September 2004, some 4 percentage points lower than two years earlier. Subsequently, employment continued to grow but not sufficiently to offset the impact of a growing labor force, and the unemployment rate rose marginally to 26.5 percent by March 2005.

CPIX inflation has remained within the official 3–6 percent target band since September 2003; it fell to the lower end of the target in February 2005, before edging up to 3.5 percent in

[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.

June 2005.[2] During 2004, the continued strengthening of the rand helped contain inflationary pressures and softened the impact of higher oil prices. Expected CPIX inflation for 2005 and 2006 has been within the target band since late 2004. Growth in broad money and bank credit to the private sector has remained robust.

The South African Reserve Bank (SARB) has maintained its flexible exchange rate policy while building up international reserves. Gross international reserves increased from the equivalent of 70 percent of short-term external debt at end-2003 to an estimated 178 percent as of end-June 2005. The higher level of reserves and sound macroeconomic policies have contributed to a further decline in sovereign risk spreads.

The rand continued to strengthen in 2004, a process that started in 2002. This appreciation—as that of other commodity-currencies, such as the Australian dollar—was associated with a rise in commodity prices. Also, large capital inflows resulting from strong global appetite for emerging assets, helped support the rand. This pattern was reversed during 2005, however, with the rand depreciating moderately.

The external current account deficit widened to 3.2 percent of GDP in 2004, from 1.5 percent of GDP in 2003, owing to the rapid growth in domestic demand and the strength of the rand. Import volumes grew strongly, exceeding the growth in export volumes, while the terms of trade remained broadly unchanged. The current account deficit was easily financed by capital inflows.

The fiscal deficit fell to 1.5 percent of GDP in FY2004/05, from 2.3 percent of GDP a year earlier, reflecting strong tax revenue performance. Tax revenue rose significantly owing to buoyant domestic demand and greater efficiency in tax collection. An increase in social spending, mainly in the form of targeted grants, was partially offset by the impact of lower domestic interest rates on debt-service payments.

Asset prices rose strongly in 2004 and early 2005. Low domestic interest rates, favorable growth prospects, and improved business confidence pushed the Johannesburg Stock Exchange (JSE) all-share index up by 18 percent in real terms during 2004, and a further 10 percent in the first half of 2005. Also, boosted by falling interest rates and new demand by an emerging black middle class, residential property prices rose by 28 percent in real terms in 2004, and at a lower rate in recent months.

Executive Board Assessment

Executive Directors commended the South African authorities for the remarkable economic progress achieved since democratization through sound macroeconomic policies and structural reforms. The economy is now growing strongly, inflation has been lowered and has become more predictable, public finances have been strengthened, and the external position has improved markedly. The expansion in economic activity has created additional jobs.

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[2] The CPIX—the measure targeted by the SARB under its inflation-targeting framework—is equal to the CPI excluding interest payments on mortgage bonds.

Given South Africa's position in the region, the country's strong economic performance has benefited the rest of Africa.

Directors saw South Africa's near-term economic outlook as favorable. Growth was expected to remain robust owing to low interest rates, a moderately expansionary fiscal policy, and healthy growth in the world economy.

Directors noted that serious economic challenges remain, including persistent high unemployment, widespread poverty, large wealth disparities, and a high incidence of HIV/AIDS. They supported the authorities' approach to deal with these problems through policies aimed at raising economic growth within a stable macroeconomic environment, combined with targeted initiatives to reduce unemployment and improve social conditions. Directors felt that this strategy could be bolstered by including substantial labor market reforms and further trade liberalization.

Directors agreed that sound fiscal management over the past years had created space for a moderate increase in government expenditure in the period ahead. They supported well-targeted additional spending in the social areas and on infrastructure to help address pressing social needs and enhance the productive capacity of the economy. At the same time, they felt it was important to keep the fiscal deficit at levels that would prevent an undesirable increase in the debt to GDP ratio that would put upward pressure on interest rates. Directors considered that budget documents could usefully expand the coverage of fiscal indicators to include public enterprises that carry potentially significant fiscal risk.

Directors welcomed the authorities' skillful implementation of monetary policy, which had kept inflation within the target band for about two years. They noted that the inflation targeting regime had gained credibility, as evidenced by the decline in inflation expectations, and thought that continued clear communication with the public, emphasizing inflation as the overriding objective of monetary policy, would further enhance credibility. Directors also considered that targeting inflation at the mid-point of the band over the medium-term would help anchor inflation expectations and increase monetary policy effectiveness. They noted some risks to the inflation outlook, including higher oil prices, a weakening of the rand and a pickup in unit labor costs, and encouraged the authorities to stand ready to adjust interest rates, if needed, to keep inflation within the target band.

Directors noted that the flexible exchange rate system had benefited the country, being an integral element of its inflation targeting regime and facilitating the adjustment of the economy to external shocks. They shared the authorities' view of seeking competitiveness gains through measures that raise productivity and reduce costs. Directors also supported additional accumulation of international reserves, but noted that reserves could be approaching levels that would make the case for further accumulation less compelling. Looking forward, they observed that further analysis of this issue would be useful. Directors agreed with the gradual relaxation of capital controls, welcomed the advances made in this area in the past year, and felt that further progress in this direction would be beneficial.

Directors regarded the banking system as fundamentally sound. They noted that most of the Financial Sector Assessment Program's (FSAP's) recommendations were being implemented,

which together with other initiatives to enhance the regulatory and supervisory framework would further strengthen the financial sector's resilience to adverse shocks. They commended the authorities on progress so far in facilitating access of previously disadvantaged groups to banking services. Further advances in implementing the Financial Services Charter and the introduction of a regulatory framework for institutions specialized in basic banking services should help accelerate this process.

Directors stressed that success in reducing unemployment was critical for bolstering support for ongoing reform initiatives. They supported the government's approach that includes programs to enhance skills and to provide temporary jobs in infrastructure and other projects, as well as measures to foster small business development. They noted, however, that this approach could benefit substantially from a relaxation of restrictive labor market regulations, and encouraged the authorities to consider reducing the scope of centralized collective bargaining, simplifying the minimum-wage structure and moderating minimum-wage adjustments, and further streamlining dismissal procedures.

Directors considered that further trade liberalization and a simplification of the tariff regime would increase productivity and support growth. Efforts could focus on lowering the overall level of protection, harmonizing protection across sectors, reducing the number of tariff bands, and applying ad valorem duties for most items. It would also be important that preferential trade agreements being negotiated be broad-based and non-discriminatory so as to complement multilateral liberalization and limit the potential for trade diversion.

Directors supported the government's objective of enhancing the efficiency of state-owned enterprises, as this would increase productivity, support infrastructure investment, and reduce the cost of doing business in South Africa. They also consider it useful to keep open the possibility of future privatization under an effective regulatory framework.

Directors agreed that further reducing social and wealth disparities was key for improving the living standards of the entire population, and ensuring a favorable environment for further social and economic progress. They welcomed the advances made with the Broad Based Black Economic Empowerment program. Directors noted that progress with land reform had been more limited, and felt is was important to address the obstacles to faster progress, while keeping the program grounded on well-defined legal principles. They also noted that continued and firm action against the HIV/AIDS epidemic will help contain the serious social impact of the disease.

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 for the Article IV consultation with South Africa may be made available at a later stage if the authorities consent.

South Africa: Selected Economic Indicators, 2001-05
(Annual change in percent, unless otherwise indicated)

	2001	2002	2003	2004	2005 Proj.
Real GDP	2.7	3.6	2.8	3.7	4.3
CPI (metropolitan areas, annual average)	5.7	9.2	5.8	1.4	3.9
CPIX (annual average) 1/	6.6	9.3	6.8	4.3	4.3
Broad money 2/	16.5	18.1	12.9	13.1	13.5
Unemployment rate (in percent)	29.5	30.5	28.2	26.2	25.3
National government budget balance (in percent of GDP) 3/	-1.5	-1.2	-2.0	-1.7	-1.9
National government debt (in percent of GDP)	41.4	37.1	35.7	35.8	35.1
External current account balance (in percent of GDP)	0.1	0.7	-1.5	-3.2	-3.7
External debt (in percent of GDP)	26.0	29.5	22.4	19.8	19.1
Gross reserves (SARB, in months of total imports)	2.9	2.8	2.2	3.1	3.7
International liquidity position of SARB (in billions of U.S. dollars) 2/	-4.8	-1.6	4.8	11.4	19.8
U.S. dollar exchange rate (rand per U.S. dollar) 2/	12.13	8.64	6.64	5.64	...

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

1/ The CPIX is equal to the CPI excluding interest payments on mortgage bonds.
2/ End of period.
3/ Calendar year.