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IMF Concludes Article IV Consultation with South Africa

On August 5, 2009 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

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

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

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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

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

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

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

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

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

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

Executive Board Assessment

Executive directors noted that the economy has weathered the immediate effects of the global crisis well mainly due to sound macroeconomic policies underpinned by consistent and transparent policy frameworks, the floating exchange rate regime, and a well supervised financial system. Nonetheless, the global crisis has pushed the economy into a recession in 2009, and below potential growth is projected for 2010. Downside risks to this outlook prevail, and the economy remains vulnerable to changes in investor sentiment, particularly in light of the projected current account deficits. Directors observed that South Africa continues to face challenges in addressing high levels of unemployment and income inequality. They saw the immediate challenge as supporting domestic demand with well-calibrated counter cyclical macroeconomic policies, while preserving price and external stability.

Directors noted that fiscal policy is appropriately countercyclical in 2009 and 2010, striking the proper balance between supporting output and preserving medium-term sustainability. They supported higher spending on public investment, given its large multiplier and the need to boost South Africa's potential growth rate. Directors observed that if the economy turns out weaker than currently projected, automatic stabilizers should continue to be allowed to operate, although to ensure fiscal sustainability, spending growth would need to be moderated further when the economy recovers.

Directors welcomed the authorities' intention to keep public debt at prudent levels. They cautioned against a large public sector wage bill that would raise spending beyond budgeted levels and limit scope for future spending moderation. They also noted that public debt service may turn out higher than expected. Directors stressed that improvements in public service delivery and progress in structural reforms are needed to ease pressures on government spending.

Directors considered that the inflation-targeting framework has served South Africa well. They welcomed the decisive easing of monetary policy since December 2008, agreeing that a pause is justified and the scope for further easing may be limited—unless downward inflation pressures prove to be more pronounced than expected.

Directors supported South Africa's floating exchange-rate regime, which is an important buffer against external shocks. They noted staff's assessment that the exchange rate may be moderately overvalued and the uncertainty surrounding this assessment. Directors recommended that steps be taken to improve competitiveness, particularly through reforms of labor and product markets. They supported the authorities' policy of gradually building up international reserves without seeking to target an exchange rate level.

Directors found reassuring the authorities' assessment that the banking sector remains well capitalized and adequately provisioned. Nonetheless, to meet increasing risks, they recommended that the authorities continue engaging with banks to ensure that provisions and capital buffers remain adequate. Directors welcomed efforts to follow up on the 2008 FSAP Update recommendations, and encouraged further strengthening consolidated supervision and exploring ways to reduce banks' reliance on short-term wholesale funding. They also recommended measures to strengthen the governance

and supervision of the pension sector.

Directors encouraged strong action on structural reform to accelerate growth and employment creation and reduce poverty. They noted that public investment aimed at eliminating infrastructure bottlenecks could be complemented by more private sector involvement in infrastructure investment and service delivery, with appropriate risk sharing. Directors also encouraged the authorities to strengthen product market competition, including by resisting trade protectionism and limiting sector-specific support to identified market distortions.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

South Africa: Selected Economic and Financial Indicators, 2005–09

(Annual percent change; unless otherwise indicated)

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

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

1/ Since January 2009, a reweighd and rebased CPI replaced the previously used CPIX (the consumer price index excluding the interest on mortgage loans) as the targeted measure of inflation.

2/ End of period.

3/ calendar year.