IMF Country Report No. 11/258

South Africa

2011 ARTICLE IV CONSULTATION

South Africa: 2011 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 2011 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 7, 2011, with the officials of South Africa on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2011. 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 25, 2011discussion 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.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

July 7, 2011

KEY ISSUES

Context: The authorities face the dual challenge of sustaining the ongoing recovery while rebuilding policy space, and raising potential growth and labor intensity of growth to help reduce the extremely high levels of unemployment and inequality.

Growth prospects: Growth should rise to 4 percent a year in 2011 and 2012, underpinned by solid domestic demand.

Focus: The discussions centered on the timing and strength of the required exit from supportive policies in the context of large capital inflows. There was broad agreement that barring a pronounced increase in core inflation or inflation expectations policy rate increases could be put off given the still uneven nature of the recovery and the uncertain global environment. Staff recommended stronger fiscal consolidation beyond the current fiscal year than currently being considered, and rebalancing the composition of public spending to help support higher potential growth.

Structural reforms: Policies to moderate real wage growth and increase product market competition will be critical to reverse the large job losses of recent years and make inroads into reducing high structural unemployment.

Financial stability: Banks have rebuilt their capital and liquidity cushions, but low credit demand has lowered profitability. The main risks remain banks' dependence on domestic short-term wholesale deposits and high household indebtedness.

External vulnerability: Relatively low public and external debts, mainly denominated in domestic currency, and adequate international reserve coverage offset risks from currency overvaluation and current account deficits funded by portfolio flows.

Approved By
Sharmini Coorey and Aasim Husain

Discussions took place in Pretoria May 25–June 7, 2011. The staff comprised Messrs. Selassie (head), Cuevas, Canales Kriljenko, Zhan, Klein, Asonuma (all AFR), and Mr. Gray (SPR). Mr. Todani (OED) also participated in the discussions.

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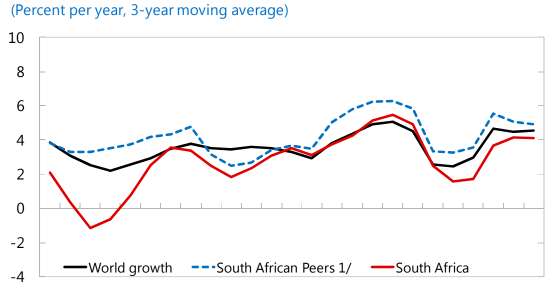
BACKGROUND

1. **Since 1994, South Africa has become increasingly integrated into the global economy.** This has allowed output growth to converge to the world average level and foreign savings have helped finance domestic investment beyond the country's low savings rate. But this integration has also exposed South Africa to global business cycles—most recently, the severe stress imparted by the global financial crisis and ensuing global downturn. Prudent countercyclical monetary and fiscal policies, together with a flexible exchange rate, have helped dampen the adverse effects of those global cycles; and sound financial supervision has guided financial institutions in managing the associated risks. And while transfer programs have lifted the most vulnerable from extreme poverty, progress in social indicators has lagged behind macroeconomic achievements. Unemployment and inequality have remained stubbornly high, and the recent recession has only exacerbated this further.

South Africa: Growth, Relative Performance
(Percent per year, 3-year moving average)



Sources: WEO and IMF staff estimates.

1/ Unless otherwise indicated and depending on data availability, South Africa's peer group in this report includes Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Thailand, Turkey, and Ukraine.

2. **Against this backdrop, the government has developed an ambitious development strategy, the New Growth Path (NGP), whose objectives include:**

- the creation of five million jobs over the next 10 years by raising economic growth to 6–7 percent;
- increasing domestic savings to reduce the economy's reliance on portfolio inflows; and
- attenuating the deep cleavages that characterize the South African economy, particularly between big businesses and those in formal sector employment and smaller enterprises, the unemployed, and discouraged work seekers.

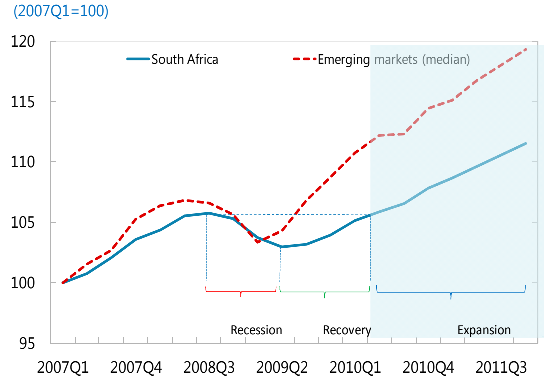
3. **The 2011 Article IV discussions centered on the policies needed to move the country toward these strategic objectives**. In the near term, this includes the policy refinements needed to ensure that the lopsided, private-consumption-led growth currently underway is more balanced. And for the medium term, on the reforms needed to raise potential growth. In particular, the consultation focused on the following issues and questions:

- What is the fiscal deficit path that would balance the country's development objectives while rebuilding fiscal buffers?
- How quickly does monetary policy tightening need to begin?
- How should policies respond to a sustained period of capital inflows?
- What measures are needed to sustain the financial sector's stability?
- What are the reforms needed to make growth more labor intensive?

AN UNEVEN RECOVERY

4. **South Africa's recovery from the 2008–09 recession has been uneven and hesitant.** The recovery has been largely led by private and public consumption growth, while export volumes and private investment have remained markedly below precrisis levels (unlike in most other large emerging markets). Moreover, quarterly growth rates (in seasonally adjusted annualized terms) have wavered between robust and more mediocre rates. Still, while lagging behind other large emerging markets in the business cycle, GDP is now above the precrisis peak, and although output remains below potential this gap is expected to close by early 2012 (Appendix I and Klein, 2011, a).

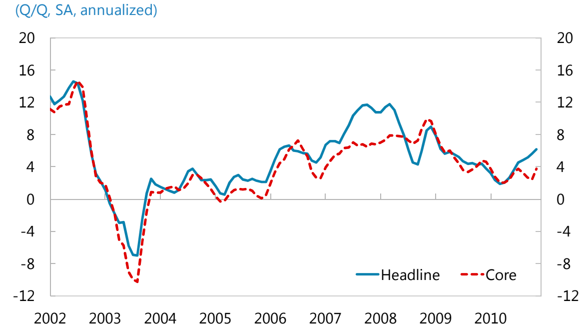
From Recovery to Expansion
(2007Q1=100)



Source: IMF's World Economic Outlook.

5. **Inflation has remained contained.** Headline inflation reached its lowest level since 2004 late in 2010 (3.2 percent y-o-y). Besides the negative output gap, the fall in inflation reflected currency appreciation and moderate domestic food prices. These developments offset the sharp increases in electricity tariffs and other administrative prices engineered to increase power generation capacity and improve public services. Inflation expectations, however, have declined more gradually and remain slightly below the upper limit of the 3 to 6 percent target range. And since early 2011, high food and fuel prices have increased headline inflation. Even though core inflation has seen some upward movement in recent months, it remains low.

South Africa: Headline and Core Inflation
(Q/Q, SA, annualized)

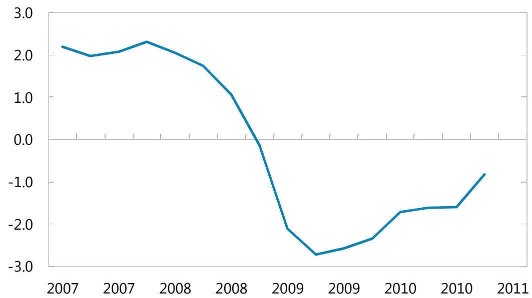


Sources: Country authorities and Haver Analytics, Inc.

Figure 1. South Africa: Consumption Led Recovery

The negative output gap is closing,...

South Africa - Output gap
(Percent of potential GDP)

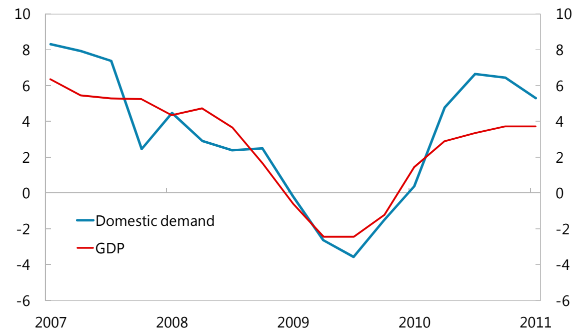


Sources: IMF staff estimates.

...with the recovery in real domestic demand,

*

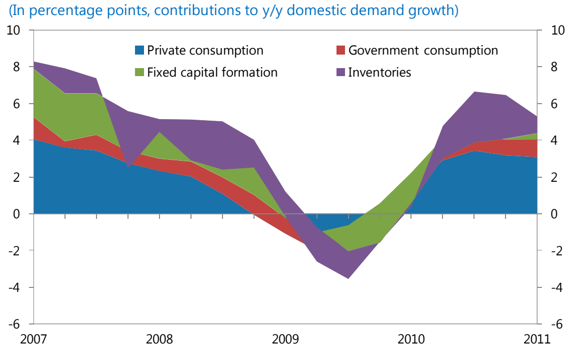
South Africa: Real GDP and Domestic Demand Growth
(In percent, y/y, seasonally adjusted)



Sources: SARB and Haver Analytics, Inc.

... reflecting solid consumption growth...

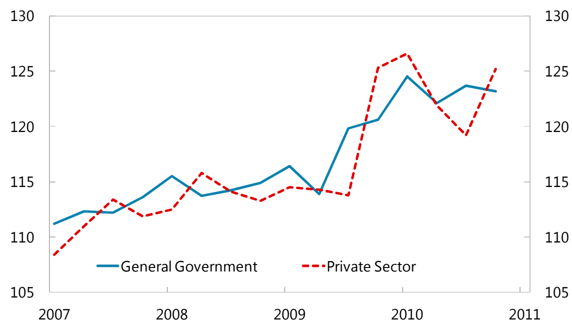
South Africa: Domestic Demand Growth Contributions
(In percentage points, contributions to y/y domestic demand growth)



Sources: SARB and Haver Analytics, Inc.

...underpinned by strong real wages, ...

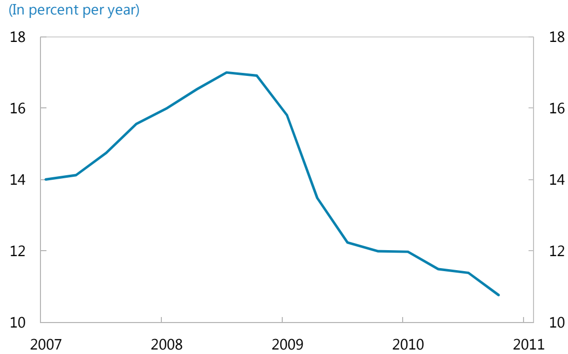
South Africa: Real Wages
(Index, 2000=100, seasonally adjusted)



Sources: SARB and Haver Analytics, Inc.

...lower interest rates that cut mortgage servicing costs, ...

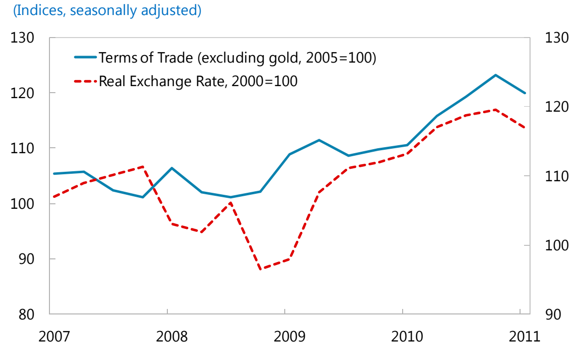
South Africa: Marginal Lending Interest Rates
(In percent per year)



Sources: SARB and Haver Analytics, Inc.

...positive terms of trade and rand appreciation.

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

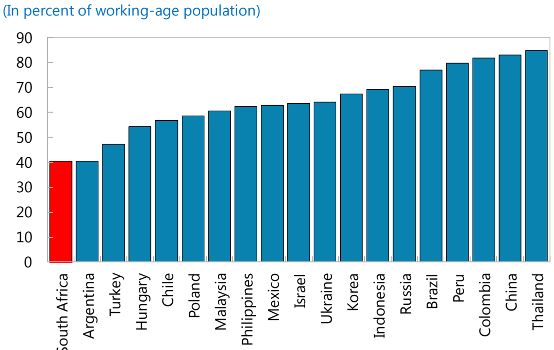


Sources: SARB and Haver Analytics, Inc.

6. **The still weak economic conditions and large real wage increases have stymied recovery in employment.** During 2008–09 as the economy slumped into recession, South Africa lost close to 1 million jobs—proportionately, this is as many jobs as countries at the epicenter of the global financial crisis lost. And despite these poor labor market conditions and moderation in inflation, wage awards remained high (averaging some 8 percent) in 2010. In addition, over the last year hiring may have been discouraged by uncertainty about proposed changes in legislation governing temporary employment. The ratio of employment to the working-age population has declined from around 45 percent in 2008 to 40 percent in early 2011, implying that employment remains some 0.9 million (or 6½ percent) below the precrisis level. Besides low employment opportunities, it also reflects a worrisome reduction in the participation rate.

Employment, 2010

(In percent of working-age population)

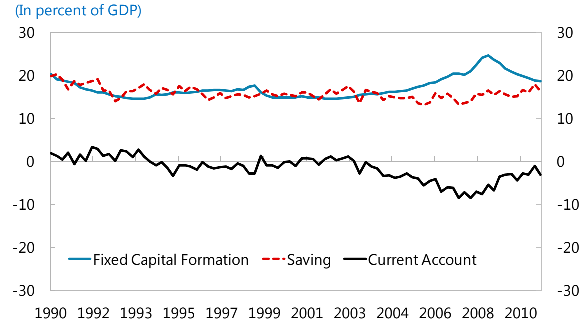


Sources: WEO, WDI, and IMF staff calculations.

7. **The current account balance strengthened significantly in 2010, mainly reflecting improvement in the terms of trade and reduced import demand**. The current account deficit narrowed to 2¾ percent of GDP in 2010 from 4 percent of GDP in 2009. High export prices helped offset low export volumes, while weak investment demand limited import volumes. The composition of South African exports has shifted toward commodities from manufacturing products. And the geographic distribution is also changing with Asian markets gaining share at the expense of those in Europe. The increase in commodity trade and favorable commodity prices, have made China South Africa's main individual trading partner. Net portfolio flows funded most of the current account deficit.

Current Account, Saving and Fixed Capital Formation

(In percent of GDP)

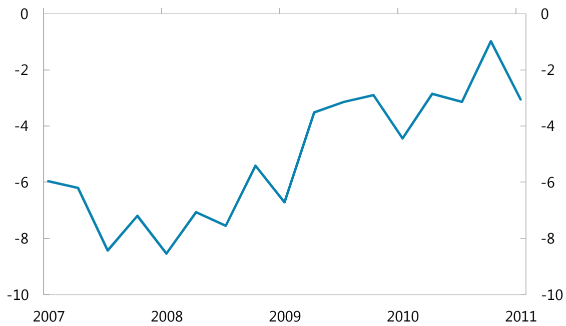


Sources: SARB and STATS SA.

Figure 2. South Africa: Stronger Current Account Balance

The current account strengthened in 2010…

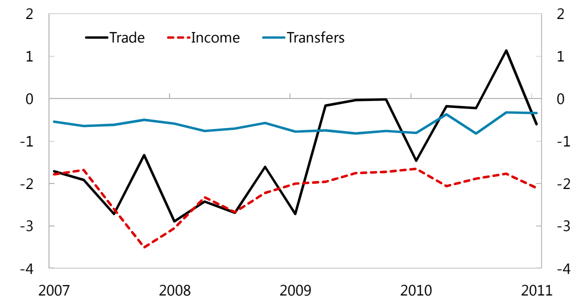
South Africa: Current Account Balance
(In percent of GDP)



Sources: SARB and Haver Analytics, Inc.

…as terms of trade helped improve the trade balance,…

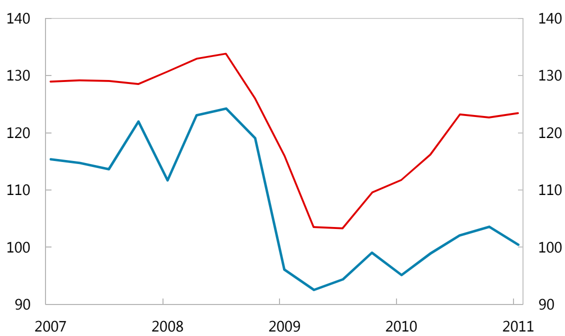
South Africa: Current Account Components
(In percent of GDP)



Sources: SARB and Haver Analytics, Inc.

…despite a slower recovery in export volumes than in real imports.

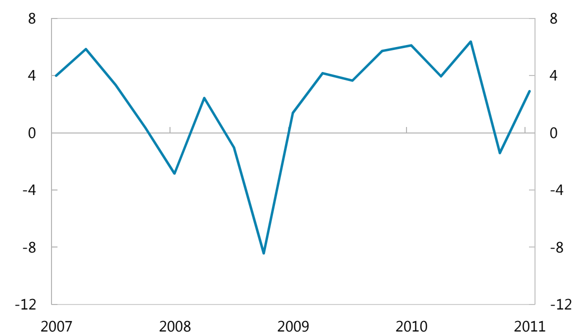
South Africa: Export and Import Volumes
(Index, 2005=100)



Sources: SARB and Haver Analytics, Inc.

Strong portfolio inflows helped fund the external current account deficit …

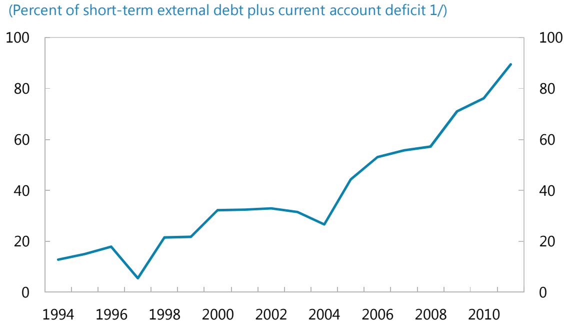
South Africa: Portfolio Inflows
(In percent of GDP, seasonally adjusted GDP, annual rate)



Sources: SARB and Haver Analytics, Inc.

…and strengthen reserve adequacy under a variety of indicators,…

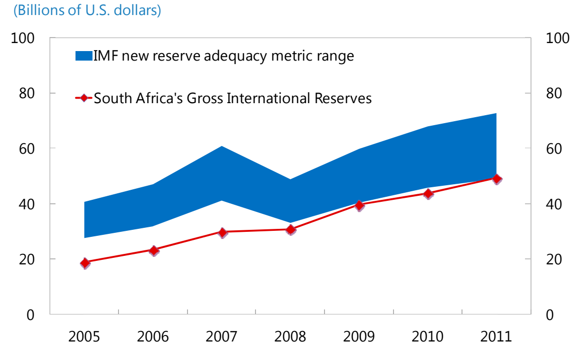
Gross International Reserves
(Percent of short-term external debt plus current account deficit 1/)



Sources: Country authorities and IMF staff estimates.
1/ Short-term debt on a remaining maturity basis

…reaching levels considered appropriate under the new IMF's reserve adequacy metric.

South Africa and IMF's New Reserve Adequacy Metric
(Billions of U.S. dollars)



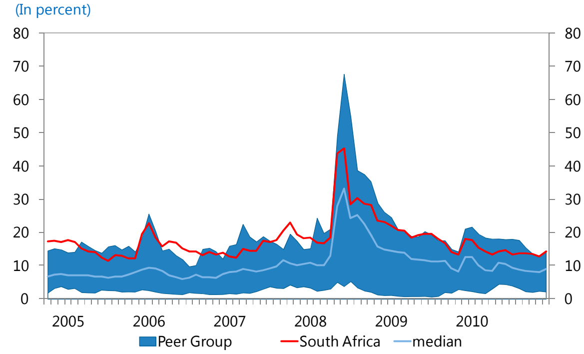
Sources: Country authorities and IMF staff estimates.

8. Fiscal policy has remained supportive relative to the precrisis structural position. In cyclically adjusted terms, the overall deficit of consolidated government swung from surplus in fiscal year 2007/08 to a deficit of 5¾ percent in 2009/10, and staff estimates the deficit at some 4 percent in 2010/11. This improvement owed to moderation in primary spending growth—from an average of some 9 percent between 2004/05 and 2009/10 to ¼ percent in 2010/11—coupled with a modest recovery in tax revenues. Although the government's borrowing requirements remained large, they were easily met through the issuance of rand denominated bonds and bills at low interest rates against the backdrop of large capital inflows. The composition of fiscal spending has tilted more toward current spending, mainly reflecting above budgeted increases in wages.

9. Monetary policy provided additional stimulus, with a 150-basis-points cut in the policy rate in 2010. These cuts have brought the policy rate to 5.5 percent, its lowest level in more than 30 years. With inflation and inflation expectations on the rise since early 2011, the scope for further policy cuts is limited. In its communication to the market, the South African Reserve Bank (SARB) has clearly explained the cost-push nature of the recent rise in inflation, and its readiness to raise policy rates as needed to prevent second-round effects.

10. The external environment and domestic policy settings have resulted in real appreciation pressure. Reflecting the accommodative monetary stance in many advanced countries and the large domestic public sector borrowing requirement, capital inflows, particularly into the bond market over the last year were significant. And the ebb and flow of capital has contributed to the volatility of the rand. But exchange rate flexibility has likely also attenuated inflows by discouraging carry trades. More importantly still, it has helped insulate the real economy. The government also stepped up reserve accumulation (which increased from US$40 billion at end-December 2009 to US$50 billion at end May, 2011) and relaxed controls on capital outflows by residents (as part of a gradual shift from a system based on exchange controls to one based on prudential considerations) (Table 1).

Implied FX Volatility
(In percent)



Source: Datastream.

11. Having come through the recession in reasonable shape, the financial sector is now contending with a period of low credit demand and rising costs. Proactive bank supervision, low dependency on external funding, and conservative risk management have contributed to banks' resilience in recent years. Impaired advances to gross loans and advances have stabilized at under 6 percent of the loan portfolio, but have displayed unusual stickiness partly as a result of a slow debt workout process. The limited impact of the recession on impairments likely reflects the limited access to credit of low-skilled workers among whom most of the job losses were concentrated. Moreover, those who kept their jobs experienced a significant increase in their disposable income arising from high real wages. Growth in credit declined with the fall in private investment and as banks sought to increase liquidity. But more recently, credit growth has resumed at a moderate pace.

OUTLOOK AND RISKS

12. Staff expects the economy to expand by about 4 percent in 2011–12, underpinned by solid domestic demand. Private consumption growth should remain robust, supported by high real wages and the low interest rate environment. Private investment growth, too, should accelerate, with the pickup in overall activity and the lifting of the moratorium on the issuance and renewal of mining licenses. The import intensity of investment and, more broadly, growth, will likely cause the current account deficit to increase to 3½ percent of GDP in 2011 and gradually further widen to about 5–6 percent over the medium term. The closing output gap and the ongoing cost-push pressure, together with the continued administrative price increases, will likely push headline inflation to the top end of the 3–6 percent target range later this year.

13. The main downside risks to this scenario are external. South Africa's close links to advanced economies, especially in the core euro area, exposes it to possible sluggishness in their recovery as monetary and fiscal stimuli are rolled back and to any fallout from the sovereign debt crisis in peripheral euro area countries. South Africa's exposure to developments in China, both as a direct trading partner and through its effect on commodity prices, has also increased. Cost-push pressure arising from global food and fuel prices may also result in higher inflation expectations and wage settlements given the backward-looking nature of these agreements. On the domestic side, high household debt may constrain consumption growth as interest rates become less supportive in the coming months.

Authorities' Views

14. The authorities have a similar view on the outlook and risks. Their baseline projections are that the output gap would be larger and that the pace of growth in the near term somewhat more moderate than staff's. They also emphasized the high degree of uncertainty surrounding these assessments. They agreed with staff that the main source of risk to the outlook is external. They expressed concern about the quality and sustainability of the global recovery. They see the recovery in advanced economies relying on the monetary and fiscal stimuli in place, and that these look set to be withdrawn before domestic demand has recovered sufficiently. They saw a case for more gradual fiscal adjustment in those advanced countries where borrowing costs remain low. The authorities noted the spillover effects of monetary easing in the advanced economies, including their impact on global commodity prices and capital flows.

MANAGING THE UPSWING

A. Fiscal Policy

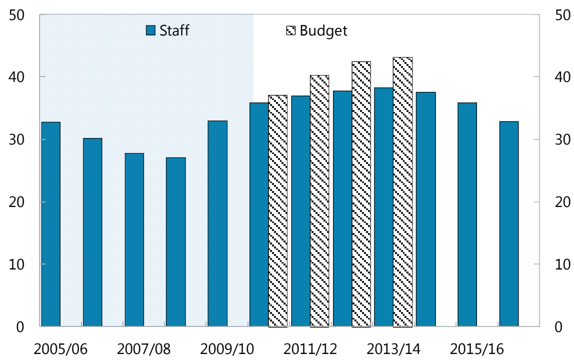
15. With public debt at manageable levels and little sign of domestic demand pressure, the authorities' fiscal plans call for fairly gradual fiscal consolidation. The consolidated government deficit would decline from 5¼ percent in 2011/12 to 3¾ percent in 2013/14. According to staff's estimates for potential output, the plan would leave the structural deficit at some 3½ percent of GDP in 2013/14—five years after the trough of the recession. The 2011 budget envisages this policy would result in gross national government debt peaking at around 43 percent of GDP in 2013/14. This compares with a precrisis level of government debt at some 27 percent of GDP.

16. Although this path would not pose immediate risks to fiscal sustainability, staff felt that it could constrain fiscal space to deal with future shocks. Without straying too far from current policies, staff sees scope for fiscal policy to be more countercyclical in the outer years while avoiding contractionary impulse in 2011/12 when output is expected to remain below potential. Specifically, by adhering to previously stated intentions to keep real spending growth to 2 percent and ensuring that tax revenues gradually recover to precrisis peaks, fiscal policy would become much more counter-cyclical than currently envisaged. Operationally, this would entail the following:

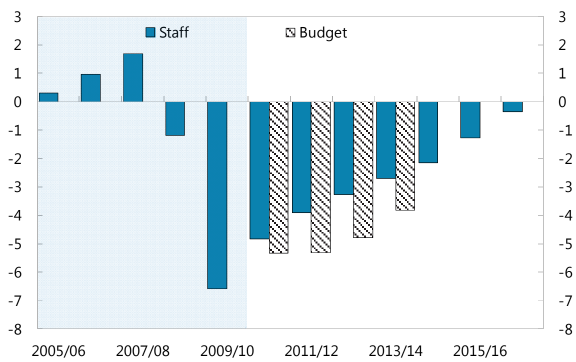
- On the spending side, the government would need to maintain the nominal spending levels over the next 3 years as indicated in the 2011 budget review, and increase real spending by 2-3 percent annually thereafter.
- On the revenue side, staff advocated ensuring that the revenue-to-GDP ratio increased by a ¼ percentage point on average each year so it can approach the precrisis peak of some 29 percent of GDP by 2016/17.
- Such policies would deliver a cyclically adjusted fiscal deficit that is 1–1½ percentage points of GDP tighter than currently envisaged by 2013/14 and close to balance by 2016/17.
- Just as important, it would contain debt at around 35 percent of GDP. This would rebuild some of the buffers that helped protect South Africa from the worst of the

global crisis, while recognizing that addressing South Africa's many development needs justifies a moderate increase in the public debt ratio relative to the pre-crisis level.

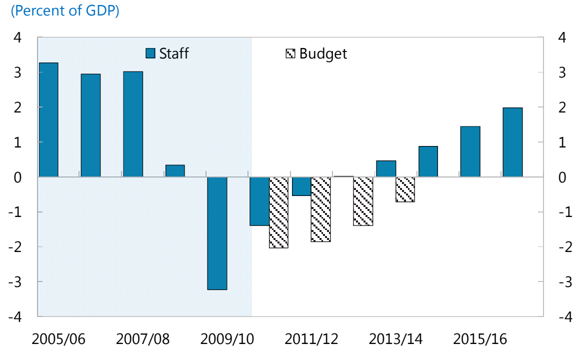
National Government Debt
(Percent of GDP)



Consolidated Government Balance
(Percent of GDP)



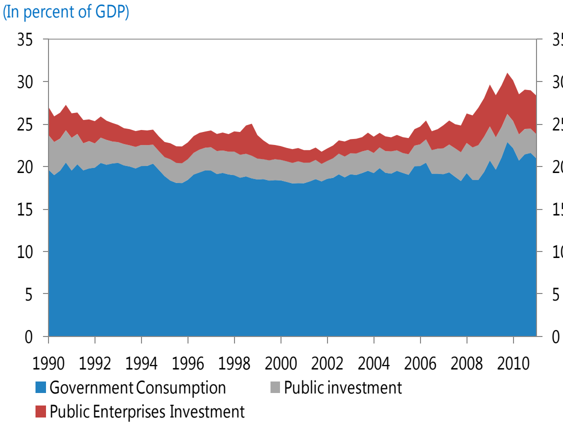
Cyclically Adjusted Primary Balance
(Percent of GDP)



Sources: South African National Treasury and IMF staff estimates.

17. **Within the overall spending envelope, staff also saw a need to rebalance the composition of public spending to help support higher potential growth and enhance public service delivery**. In recent years, the government wage bill has increased markedly—to 11½ percent of GDP in 2010/11 from 9½ percent of GDP in 2007/08. Thus, at its current level, the public sector wage bill is well above the average for other emerging markets in the G-20 (8¾ percent of GDP). Given the influence that the public sector wage agreement round seems to be having on private sector wage adjustments, staff also underscored the need for public sector wage increases to be kept to levels that can be justified by productivity improvements. Capital spending at the consolidated government level has increased only marginally—by just ½ percentage points of GDP to 2¼ percent of GDP over the last three years—and remains well below the levels that the country's overstretched infrastructure necessitate.

Public Spending
(In percent of GDP)

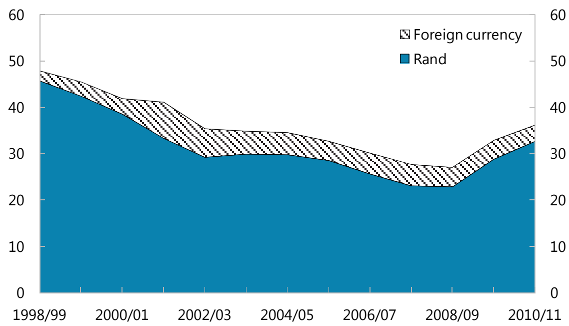


Sources: SARB and STATS SA.

Figure 3. South Africa: Well Managed Public Debt

Public debt has been managed countercyclically and is mostly denominated in domestic currency.

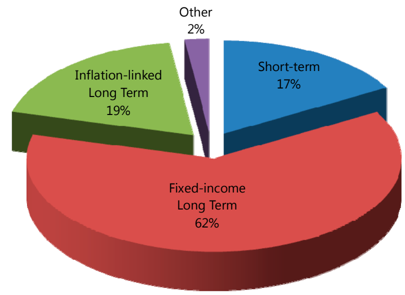
National Government Debt
(In percent of GDP)



Source: National Treasury.

It is mostly long term …

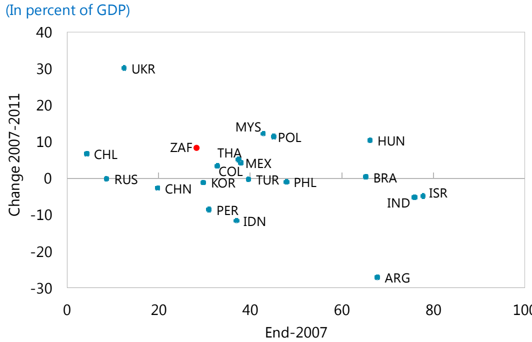
Composition of Public Debt, by Instrument (2010)
(In percent)



Source: National Treasury.

…and relatively modest compared to that of other emerging market countries.

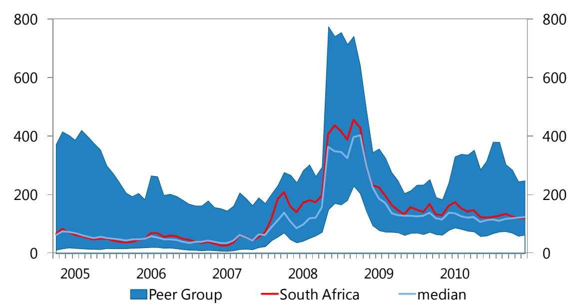
Gross Government Debt, 2007 and 2011
(In percent of GDP)



Sources: WEO and IMF staff calculations.

The market estimates a low default risk, which, like those of its peers, varies with global risk aversion.

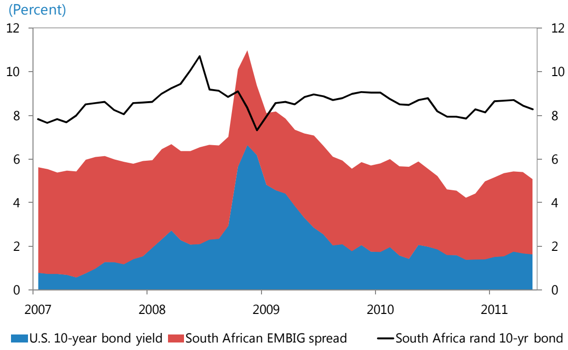
CDS Spreads
(Basis points)



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

Yields on foreign currency debt are lower than those on domestic currency debt,…

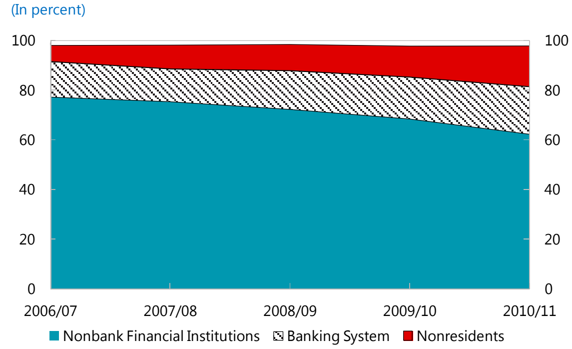
South Africa: 10-year Bond Yields
(Percent)



Source: Haver Analytics, Inc.

… which has attracted nonresident interest despite the exchange rate risk.

Ownership of Domestic Government Marketable Bonds
(In percent)



Source: National Treasury.

18. Staff welcomed the explicit fiscal guidelines expected to inform fiscal policy formulation going forward. The 2011 Budget proposed that fiscal policy be guided by three principles: long-term public debt sustainability, countercyclicality, and intergenerational equity. These principles have been applied to the design and implementation of fiscal policy in South Africa since 1994. In the staff's view, they would also be consistent with a faster consolidation over the medium term than is implied in the trajectory for government deficits presented in the 2011 budget review.

Authorities' Views

19. The authorities affirmed their intention to ensure that fiscal policy is countercyclical during the upswing. With regard to the staff's proposals, they highlighted two concerns. First, the staff's growth outlook is a bit more bullish than theirs (particularly in the near term). This argues for a somewhat more gradual start to the fiscal consolidation process. Second, revenue buoyancy in the coming years may not be as high the staff presumes. Once private investment recovers, corporate tax collection could remain subdued as firms use depreciation allowances and write-off profits against recent losses. More broadly, they felt that a debt-to-GDP ratio of 40 percent or lower would be reasonable for South Africa to maintain, given its development needs and ability to finance its deficit relatively easily in domestic currency and at long-term maturities.

20. The authorities also pointed to a number of reforms underway to enhance the effectiveness and efficiency of public spending. In particular, they noted that before public investment could be increased decisively, the absorption capacity of municipalities and provinces needed to be addressed. At the provincial level, increasing capital spending to budgeted amounts would require better planning for health, education, and housing infrastructure, improved risk management, and improved project management skills, among others. At the municipal level, it requires better financial management, more efficient supply-chain management, and improved capacity to meet requirements for conditional grants. The authorities saw scope for improving service delivery by reallocating savings from low-priority spending.

B. Monetary Policy

21. The case for commencing the tightening cycle soon is finely balanced. Arguments in favor of an early start to the tightening cycle include the following:

- during the next 12 months, the output gap is set to close and there is a possibility that headline inflation will breach the top of the target range.

- with inflation accelerating, an unchanged policy rate implies declining real interest rates and thus a strong impulse on activity 18 to 24 months from now given the lags with which monetary policy operates; and

- inflation in South Africa tends to be persistent. Early monetary policy reaction may help to stabilize expectations before they start rising.

All the same, there are solid reasons for waiting for more signals before initiating the tightening cycle:

- core inflation remains subdued at around 3¼ percent (in seasonally adjusted annualized terms) for the most recent three-month period. The increase in headline inflation largely reflects the surge in international food and fuel prices and is in any event likely to fall back within the target range sooner than when monetary policy would be able to influence it.

- although overall growth prospects have improved, key economic indicators—employment, investment, and exports—are still well below precrisis levels.

- the strength of the rand should continue to moderate inflationary pressure.

- barring slippages, fiscal policy both in the near and medium term should be tighter than currently envisaged.

22. On balance, staff favored waiting for clear evidence of a more pronounced increase in core inflation or inflation expectations before raising the policy rate. An indicator that would tilt the decision in favor of starting the interest rate normalization cycle sooner would be development in wages. Particularly now that the output gap is closing, high wage increases could raise core inflation; it will be important to watch their evolution closely.

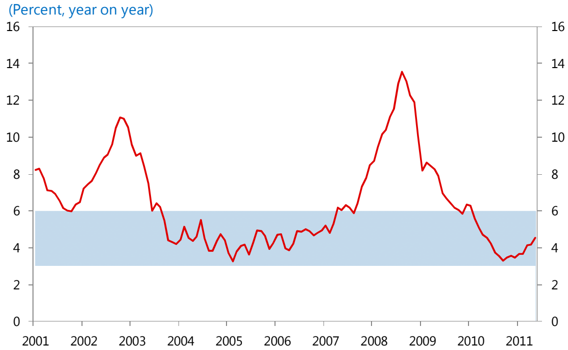
Authorities' Views

23. The authorities argued that the timing for the first hike was unclear given the prevailing uncertainty. They still perceived slack in the economy, and saw no evidence of demand pressure on inflation. Moreover, they were concerned about the global recovery and its implications for South Africa. They did not rule out the possibility of a disorderly adjustment in the medium term, particularly in Europe given its unresolved sovereign debt problems, which would likely have an adverse effect on economic activity in South Africa. They were concerned that under these circumstances an early tightening of monetary policy may prove premature. At the same time, oil and food price shocks are in progress, and thus the SARB must be on the lookout for signs of supply-side pressure spreading to the general price level.

Figure 4. South Africa: Inflation Targeting under Supply Shocks

Inflation has remained within the target band,...

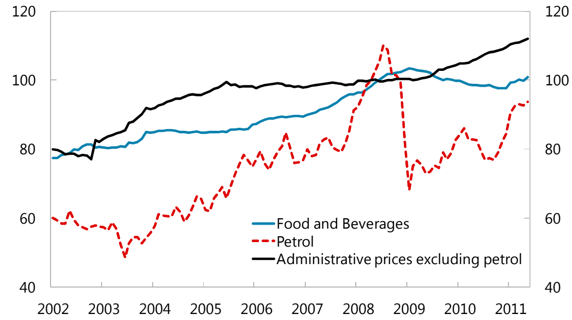
Headline Inflation
(Percent, year on year)



Sources: SARB and Haver Analytics, Inc.

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

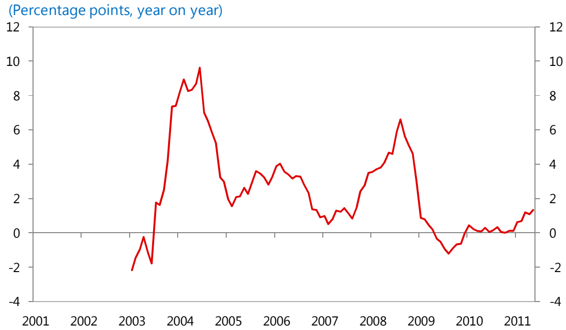
Key Relative Prices
(Percent of CPI excluding Food, Beverages and Petrol, 2008=100)



Sources: SARB and Haver Analytics, Inc.

...have started to push headline above core inflation.

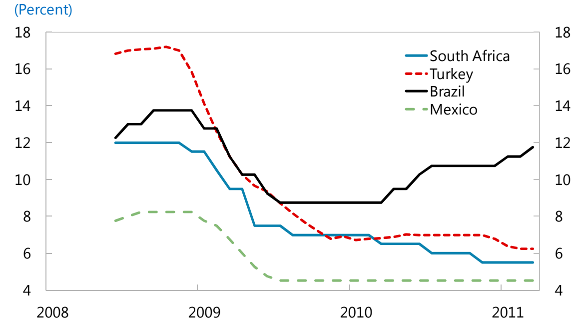
Headline Minus Core Inflation
(Percentage points, year on year)



Sources: SARB and Haver Analytics, Inc.

Policy rates have been countercyclical

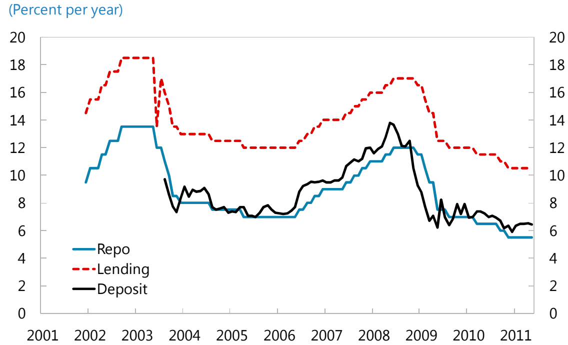
Policy Rate
(Percent)



Source: Haver Analytics, Inc.

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

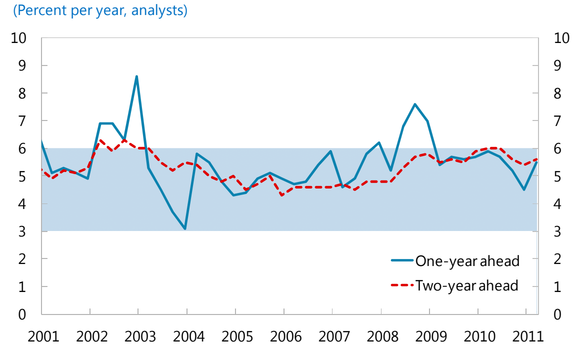
Monetary Transmission
(Percent per year)



Sources: SARB and Haver Analytics, Inc.

...and keeping inflation expectations well anchored.

Survey Inflation Expectations
(Percent per year, analysts)

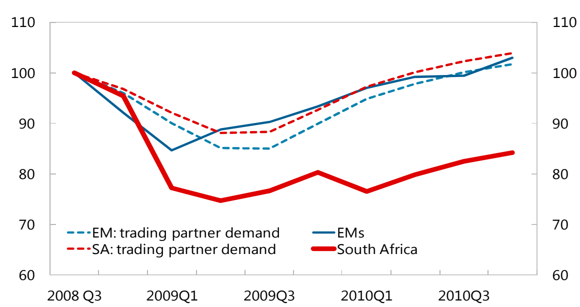


Sources: Bureau of Economic Research South Africa and Haver Analytics, Inc.

C. Dealing with Capital Flows

24. Both direct and indirect measures point to competitiveness problems. On average, three quantitative approaches for gauging the strength of currencies relative to economic fundamentals point to the rand being overvalued by 10 to 15 percent—much the same as last year.[1] And this competitiveness problem is borne out by the recent weak export performance. Notwithstanding the recovery in trading partner country import demand to precrisis levels, South Africa's exports in volume terms are estimated to remain around 15 percent below their precrisis peaks—in sharp contrast to the performance of most other emerging market economies. South Africa's share of global exports has stagnated since 2005, despite strong terms of trade gains, whereas other comparable countries have seen market share increases (Appendix II).

Export Volumes and Trading Partner Demand
(Seasonally Adjusted levels, 2008 Q3=100)



Sources: SARB and IMF's World Economic Outlook.

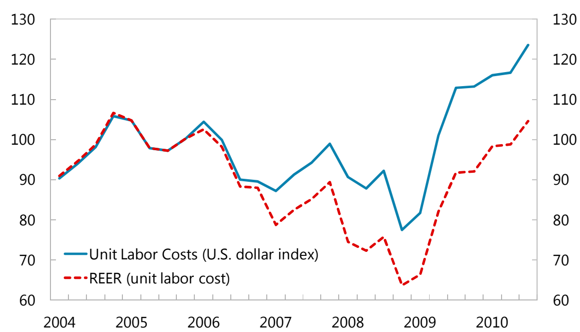
[1] Although the real exchange rate has appreciated during the past year, so has the estimated equilibrium because, among other things, recent sizable terms of trade gains are expected to persist.

25. And as one of the main recipients of portfolio flows over the last year, there is concern that these inflows exacerbate the competitiveness problem. The flows have waxed and waned: there were high inflows between July and November 2010, outflows through March 2011, and a new episode of inflows since then. In total, since end-December 2009 the country has received some R116 billion (US$17 billion) of flows.

26. Still, while they have certainly accentuated the rand's strength at times, the inflows are partly also responding to the country's need for foreign savings. In 2010, for example, net nonresident flows into the bond market are estimated at about US$7 billion, equivalent to roughly 40 percent of the government's financing need. Staff argued, as an asset price, the rand also tends to be influenced by commodity price developments or changing perceptions of risk in emerging markets (Appendix IV and Asonuma and Gray, 2011). Beyond capital account flows, the rand also responds to current account flows. Thus, the rand strengthened last December despite significant intervention and capital account outflows, most likely reflecting that month's trade surplus.

27. Moreover, the competitiveness problem also reflects recent sharp increases in the domestic cost of production. South Africa's manufacturing unit labor costs (ULC) have increased markedly in recent years; and the ULC real effective exchange rate suggests these costs, expressed in dollars and compared to those in trading partner countries, are now some 35 percent higher than they were in 2007–08. When one compares the rate of increase in prices and wages domestically between the tradable and nontradable sectors, increases in the latter have been much more pronounced. Beyond wages, production costs have also risen on account of rising utility tariff and other administrative price adjustments.

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



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

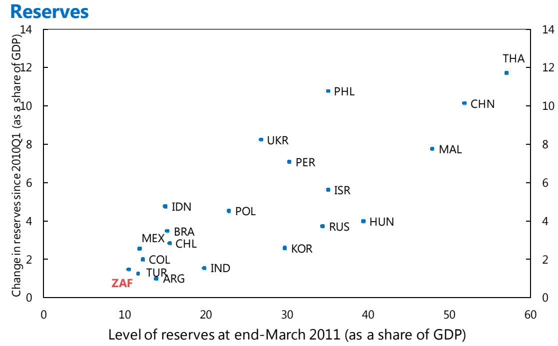
28. Against this backdrop, there was extensive discussion on the pros and cons of the available measures to deal with sustained episodes of capital inflows:

- *Continued reserve accumulation*. While accumulation has been stepped up considerably over the last year, the degree of intervention remains moderate relative to what comparable countries have been doing recently. And reserves are at the lower end of alternative measures of adequacy metrics (Figure 2).

- *Altering the policy mix*. This is not practicable in the very near term when the current broadly supportive stance is more appropriate. However, beyond the current fiscal year, smaller fiscal deficits at least along the lines suggested by staff should help restrain domestic demand and allow more room for monetary easing (Appendix V and Canales Kriljenko, 2011).

- *Capital Flow Measures*. With limited scope for modifying the monetary and fiscal settings in the near term and the rand on the strong side of fundamentals, there is arguably a case for using either an unremunerated reserve requirement or a small tax on inflows to try to curtail inflows or at least change their composition. However, staff pointed to two significant drawbacks that this would pose. First, it likely would raise the government's financing costs. Second, even if this were to help engender nominal rand depreciation, absent wage restraint it is unlikely this would enhance competitiveness.

Selected Economies: Acumulation and Level of International Reserves

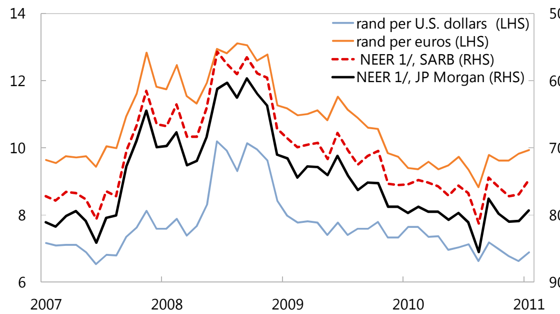


Sources: WEO and Haver Analytics, Inc.

Figure 5. South Africa: Easy Financial Conditions and Rising Asset Prices

Like in many emerging markets, financial conditions are characterized by currency appreciation, ...

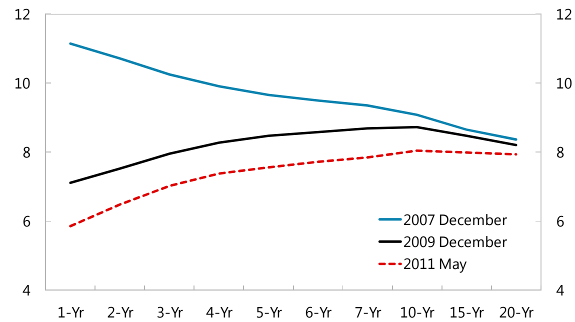
Nominal Exchange Rates
(Rand per foreign currency and Indices, 2000=100)



Source: Haver Analytics, Inc.
1/ NEER stands for nominal effective exchange rate (increase means appreciation).

... low short-term interest rates, ...

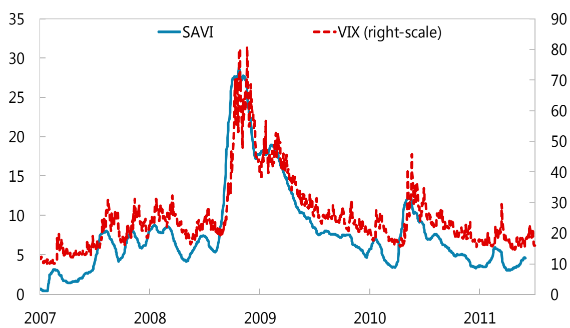
Interest Rates Swap Yield Curve
(Percent)



Source: Haver Analytics, Inc.

...low but volatile risk aversion,...

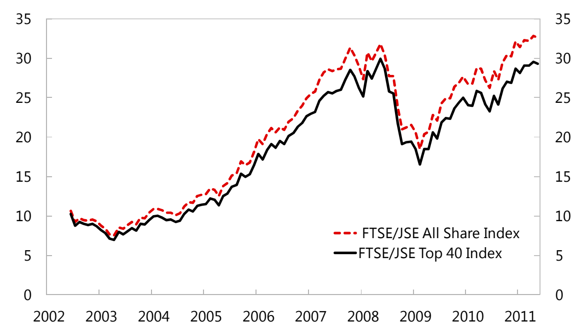
30-Day Volatility (SAVI and VIX)



Sources: Datastream

...and recovering equity prices...

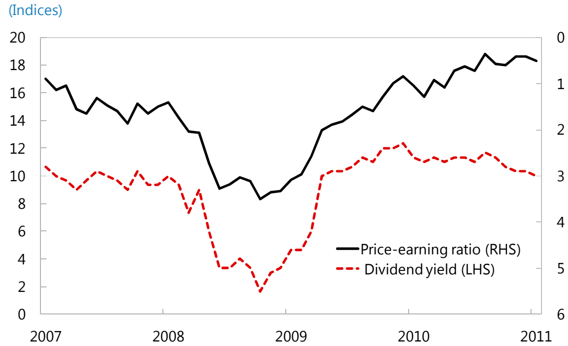
Stock Market Prices
(Indices)



Source: Haver Analytics, Inc.

...that have risen faster than corporate earnings,...

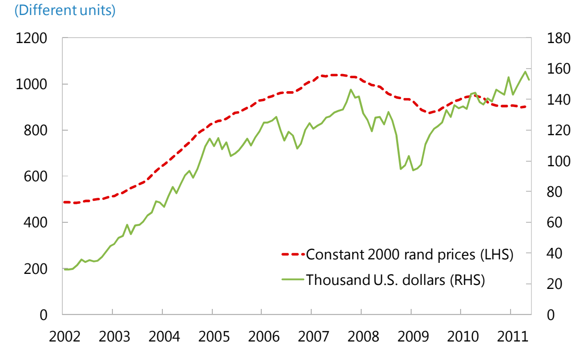
Stock Market Indicators
(Indices)



Source: Haver Analytics, Inc.

...while high household indebtedness has kept housing prices contained in real terms.

House Prices
(Different units)



Sources: ABSA Bank and Haver Analytics, Inc.

Authorities' Views

29. The authorities argued that a range of measures need to be used to deal with inflows and that this has very much been the approach followed over the last year. Reserve accumulation over the last year was significantly more than ever undertaken before and measures to restrict resident's ability to move funds abroad were eased as part of a strategy of gradually moving from administrative exchange controls to prudential measures for addressing crossborder risks. Going forward, further reserve accumulation would continue. But they stressed that reserves were adequate from a prudential perspective: cross-country comparisons focusing on reserves as a ratio to GDP were unfair to South Africa because the lion's share of external liabilities are denominated in local currency. In addition, accumulation entails considerable costs—according to staff estimates, around an interest-only cost of 0.18 percent of GDP for each US$10 billion increase in reserves. They also pointed to their intention to gradually alter the fiscal-monetary mix. The monetary authorities noted that providing fiscal policy is made sufficiently countercyclical and the wage restraint and better alignment between productivity and wages called for in the NGP takes place, there would be more scope for lower interest rates than would otherwise be the case. As for CFMs, the authorities agreed with staff that their effectiveness is questionable. Moreover, they stressed the need to take a close look at each country's circumstances in deciding on the adoption of CFMs. In South Africa, curtailing inflows while the country is also relying on them to finance domestic consumption and investment would be problematic.

REFORMING PRODUCT AND LABOR MARKETS

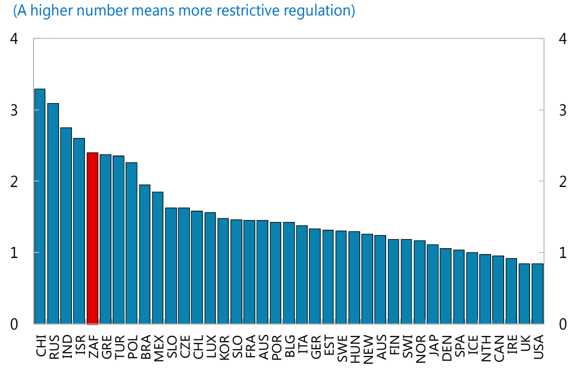
30. Job creation dominates the economic and political agenda. The core objective of the New Growth Path (NGP), launched in November 2010, is the ambitious target of creating five million jobs and reducing the unemployment rate by 10 percentage points in the next decade. If successful, it would raise the employment to working-age population ratio to 50 percent.

31. Staff endorsed the focus on job creation, and stressed that reforming both product and labor markets would be key to raising potential growth and increasing the labor intensity of growth. There was broad agreement that meeting the jobs creation target would require either higher economic growth or more labor-intensive growth. Staff work suggests that with sustained economic growth of 6–7 percent, the ½ million jobs per year should be manageable even with current levels of job-intensity. But with growth rates of about 4 percent, which are more likely in the next few years, reforms to improve the labor intensity of growth are essential (Appendix III).

32. A more forceful approach to strengthen competition in product markets is called for to create new employment opportunities and increase the purchasing power of earnings. There is a high degree of concentration and limited competition in many of South Africa's goods and service markets (Aghion, 2008 and Klein, 2011, b). This reflects not only natural barriers to entry, but also regulatory entry barriers, and the legacy from past attempts at encouraging the emergence of national champions. OECD data suggest that product market regulation in South Africa is the fifth most onerous among the 39 advanced and developing countries for which the measure is calculated (OECD, 2010). Beyond the current industry-by-industry approach to addressing market conduct issues, staff made the case for more broad-based reforms to improve competition and competitiveness—such as further trade liberalization. More aggressive efforts to attract new entrants into key network industries like telecoms, rail and road haulage, and energy generation could also help improve efficiency and the cost of production.

OECD's Product Market Regulation Index

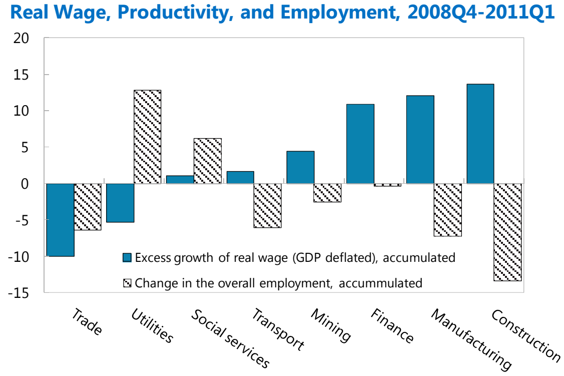
(A higher number means more restrictive regulation)



Source: OECD.

33. Unemployment's complex roots should inform the efforts to increase labor intensity. South Africa's high level of unemployment reflects a host of structural factors, such as the geographic mismatch between population centers and economic activity created by apartheid, and the gap between real wages and the productivity of the unskilled, who bear the brunt of unemployment. While such cross-country comparisons are always difficult, it does seem that the wages in manufacturing and the ratio of the minimum wage to average output are comparatively high in South Africa (Appendix III and Zhan, 2011). In addition, wage revisions during the recession revealed a tendency of bargaining outcomes to prioritize wage growth over job growth. And indeed, in many of the sectors that experienced a sharp decline in employment, real wage growth outpaced productivity gains.[2]

Real Wage, Productivity, and Employment, 2008Q4-2011Q1



Source: Stats SA and IMF staff calculations.

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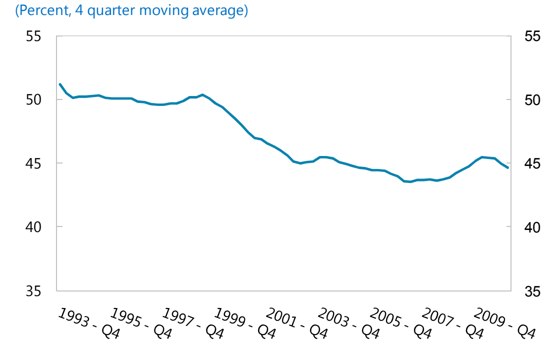
[2] Empirical analysis identifies a negative relationship between "excess" real wage growth and employment, even controlling for output and exogenous factors.

34. Staff saw merit in the proposal in the NGP to moderate economy-wide wage growth. One way to operationalize this would be through an accord between government, employers and trade unions to limit real wage increases to 1 to 2 percent for the next several years. And if this is not feasible, an alternative approach is to introduce changes to the sector-wide wage bargaining system so that it takes more account of the limited ability of small and medium size enterprises to abide by the sector-wide wage agreements to which the more productive and deeper-pocketed large firms agree. Over time, other structural factors behind unemployment would need to be addressed.

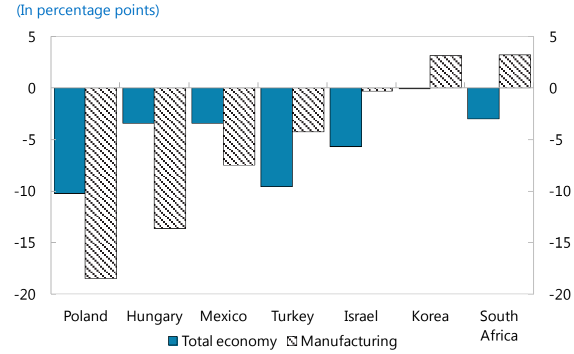
35. To be sure, the view that high real wages have contributed to the country's unemployment problem is not universally accepted. In particular, trade unions point out that the labor share in national income has declined over time—from 50 percent of income in 1999 to around 43 percent in 2007. They argue that the recent partial reversal of this trend—on account of both real wage growth and the contraction of GDP in 2009—needs to be seen against this backdrop. And overall it implies that the lion's share of the returns to economy-wide productivity improvement has not accrued to workers. Staff however thinks that the declining labor share can be interpreted in different ways and that it is important to also look at a range of other indicators. In particular, the declining share of labor in total income could in part reflect a substitution in favor of capital induced by the increase in the relative cost of labor. Relatedly, it may indirectly also reflect the impact of the trend rise in commodity prices in the last decade that is accruing to sectors that have relatively low and declining labor intensity, including for technological reasons. And from a cross-country perspective, the decline in the labor share since 2000 is not unique to South Africa, and in sectors subject to international competition, such as manufacturing, the labor share in South Africa has actually increased markedly.

South Africa's Labor Income Share
(Percent, 4 quarter moving average)



Source: Haver Analytics, Inc.

Change in Labor Income Share since 2000
(In percentage points)

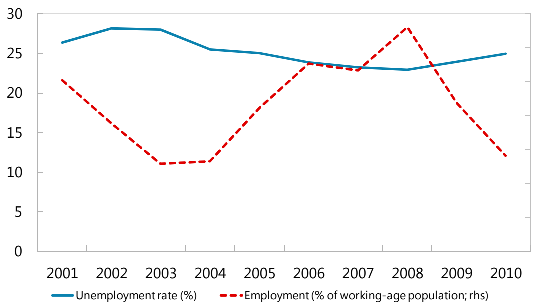


Sources: OECD, Stats SA, and IMF staff calculations.

Figure 6. South Africa: The Unemployment Challenge

A large fraction of the population does not have jobs,...

Unemployment Rate and Absorption Rate

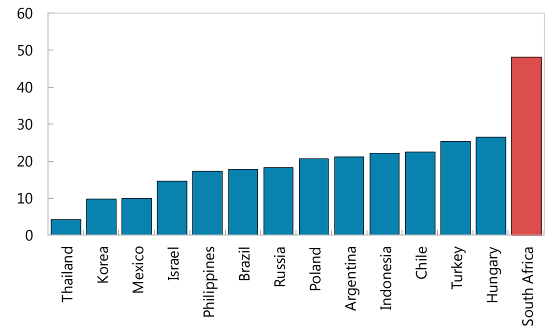


Source: Stats SA.

...especially the young,

Unemployment Rate of the Youth, 2009

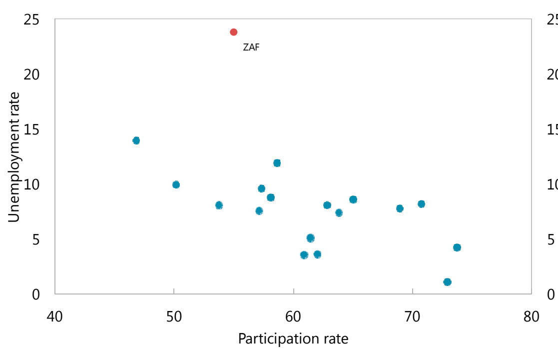
(Percent of total labor force ages 15-24)



Sources: World Bank, WDI.

... and unemployment is significantly higher than in other EMs', despite a rather low labor participation rate,....

Unemployment Rate and Participation Rate, 2009

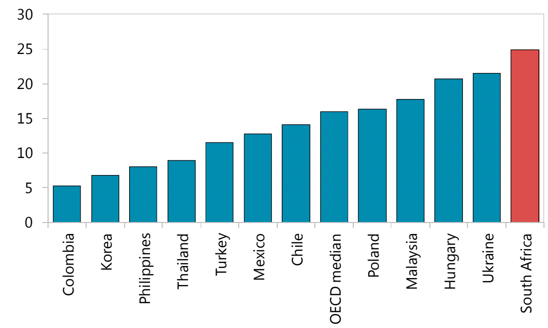


Sources: World Bank, WDI.

... and the direct participation of the public sector as an employer.

Share of Public Sector Employment

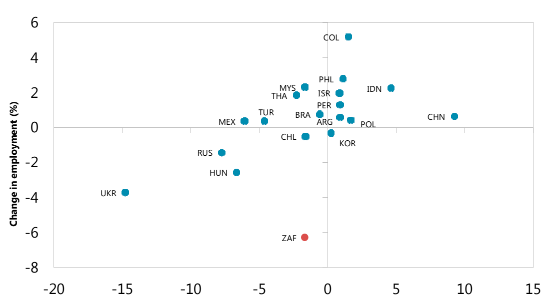
(In percent of total employment)



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

During the global financial crisis, South Africa experienced large job losses compared to its modest output decline ...

Output and Employment, 2008-09

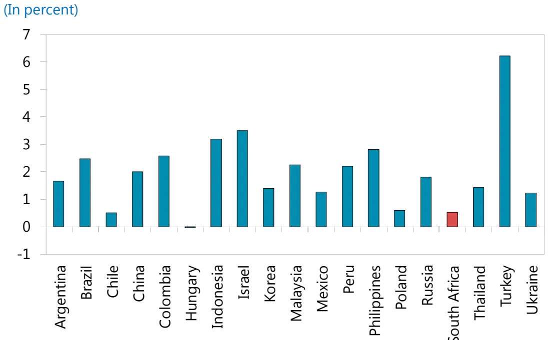


Sources: WEO and Stats SA.

...and the ongoing recovery has so far created less jobs than in other emerging market economies.

Change in Employment, 2009-10

(In percent)



Sources: WEO and Stats SA.

Authorities' Views

36. The authorities pointed to the many initiatives underway to raise potential growth, including in the labor and product markets. They also argued that the cost of hastily designed structural reforms can be high. A lot of emphasis thus needs to be placed on ensuring that the reforms will deliver the desired results. Beyond careful design of reforms, there is often a need to build consensus around reforms and this too takes time. They pointed to the range of reforms currently underway. The competition commission is aggressively tackling anti-competitive practices in key industries. They however saw little scope for further trade liberalization, noting that the average tariff level at the moment is fairly low reflecting the aggressive liberalization that took place under the Uruguay Round, where South Africa participated as a developed country. The need to better align productivity and wage increases is also recognized, and is an objective outlined in the New Growth Path. Initiatives such as the youth wage subsidy outlined in the 2011 budget would help better align pay and productivity for new job market entrants. In addition, the budget also provides support for private initiatives with a strong job-creating component.

MAINTAINING FINANCIAL STABILITY

37. Macroprudential risks in South Africa are moderate. A large reversal in portfolio flows is likely to have small balance sheet effects, because firms, households, and financial institutions bear little exchange rate risk. The flexible exchange rate would pass part of the adjustment cost to foreign investors holding the mainly rand-denominated public debt. Public and external debt levels are relatively low and the public debt composition bears little exchange rate or maturity risk.

38. The financial system concentration and interconnectedness requires continuous vigilance. Areas of vulnerability include (i) the impaired advances on bank balance sheets, which while slowly declining as a share of loans, remain largely unchanged in nominal terms; (ii) the banks' traditional reliance on short-term funding from a relatively few large corporations; and (iii) some financial entities' direct and indirect exposure abroad.

39. Easy external financial conditions call for continued strong supervision of crossborder risks. South Africa's position in the cycle has not so far exposed the banking system to the risks associated with periods of easy external financial conditions. Still, with the external financial conditions set to remain easy for the next few years, it will be important for regulators to continue refining the tools in place to prevent excessive credit growth and risk taking.

40. Staff welcomed improvements in financial regulation and supervision. The authorities have implemented many FSAP/ROSC recommendations, started preparing for the eventual introduction of the Basel III capital and liquidity requirements, and expanded the perimeter of regulation, including initiatives in the insurance and credit rating sectors. The authorities have put in place a new framework for assessing solvency and management of insurance companies similar to Europe's Solvency II. The authorities have also set an interagency financial stability oversight committee that could in the future adjust prudential rules to contain cyclical systemic risk.

41. Staff strongly supported the authorities' intention to move toward a "twin peaks" regulatory and supervisory framework over the next few years. This initiative, which strives to concentrate prudential authority at one peak and market conduct authority at another, bodes well for further improving the consolidated supervision of financial groups. It also rightfully elevates the status of market conduct regulation and supervision given the high concentration and interconnectedness of the financial industry. Prudent management of the transition would be required to minimize regulatory uncertainty while keeping the focus on surveillance and risk management.

42. Staff suggested caution in further liberalizing controls on capital outflows from resident nonbank financial institutions. Banks have granted mortgage loans to customers with funds from corporates and nonbank financial institutions, whose ability to invest abroad has been gradually increased with the liberalization of controls. Although the authorities recognized the risk, in principle, they noted that the limits have not been binding because of a clear home bias. The ongoing implementation of Basel III liquidity requirements, which include a thorough review of incentives embedded in the legal and regulatory framework, taxation, and market practices, will mitigate the potential risks. Further steps in the gradual liberalization of controls on resident financial institutions will need to factor in the capacity of the financial system to manage crossborder risks.

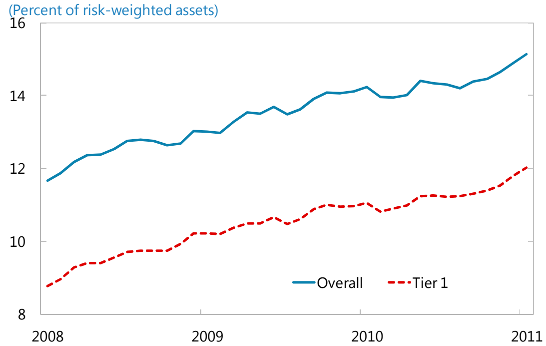
Authorities' Views

43. The authorities agreed that the easy external financial conditions and the uncertainty about the strength of external demand warranted continued vigilance in the financial sector. They noted that South Africa closely follows best practices and standards on financial regulation, supervision and market conduct as set forth by international standard-setting bodies, such as the G-20 Forum, the Financial Stability Board, and the Basel Committee. They pointed out, however, that the ongoing significant change in these international standards and best practices has created some regulatory uncertainty and will take some time to incorporate fully. Nothwithstanding the recent strong performance of the financial sector, they stressed the need to avoid complacency and that they would remain focused on identifying and promptly addressed emerging vulnerabilities.

Figure 7. South Africa: Resilient Banking System

Banks remain well capitalized …

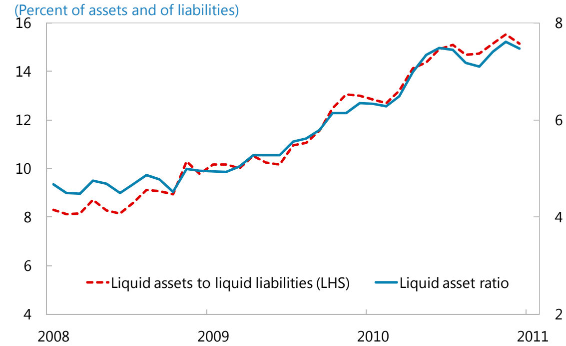
Capital Adequacy Ratios
(Percent of risk-weighted assets)



Source: SARB.

…and liquid,…

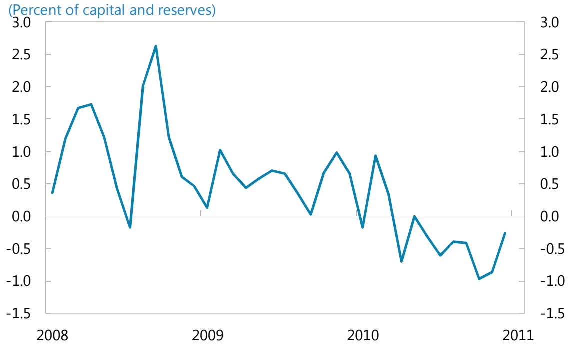
Liquidity Indicators
(Percent of assets and of liabilities)



Source: SARB.

…with well contained exchange rate risks.

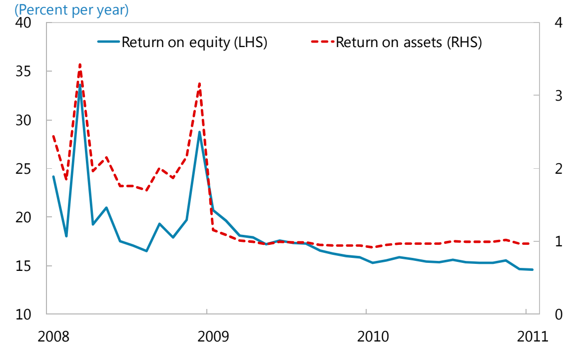
Net Open Foreign Exchange Position
(Percent of capital and reserves)



Source: SARB.

However, profitability has declined,…

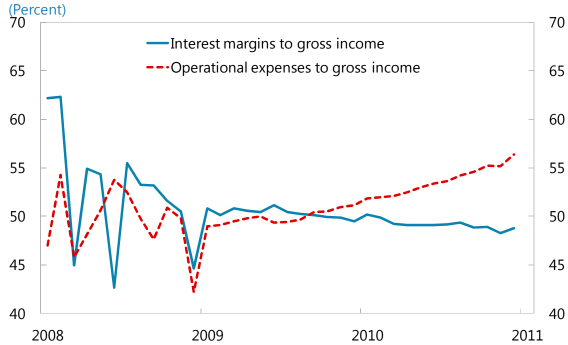
Profitability Indicators
(Percent per year)



Source: SARB.

… with falling interest margins, rising expenses relative to income, …

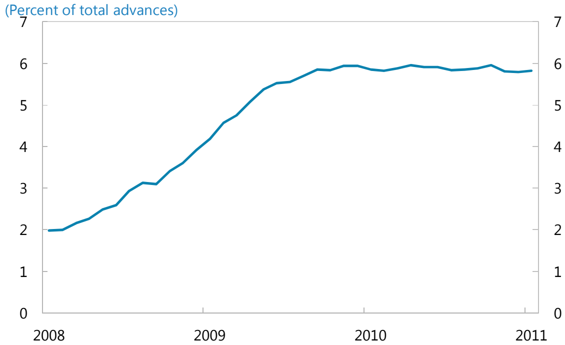
Operational Indicators
(Percent)



Source: SARB.

…and stubbornly stable impaired advances.

Impaired Advances
(Percent of total advances)



Source: SARB.

REGIONAL ISSUES

44. **South Africa remains intent on furthering regional integration.** Within the Southern African Development Community (SADC), the current priority is the consolidation of the free trade agreement through work on harmonizing standards and trade facilitation strategies. Beyond SADC, the authorities are taking an active role in the recently launched negotiations on a free-trade area covering the 26 member countries of SADC, EAC and COMESA, which is expected to take some three years to complete.

45. **The Southern African Customs Union (SACU) should play a crucial role in further advancing regional integration.** In the past year, three heads of state SACU summits have reenergized the group. Discussions are ongoing on strengthening the secretariat, establishing a framework for joint negotiations with third parties, and looking for opportunities to integrate value chains across borders.

46. **The revenue sharing system has generated significant spillovers within SACU.** The shock from the recession to South African customs collections (a main element in the common revenue pool) has, after some technical delay, led to public revenue declines in Botswana, Namibia, Lesotho, and Swaziland. In Swaziland in particular, this has contributed to a fiscal crisis which is taking a heavy toll on the economy. While the Swaziland crisis may in turn generate some negative spillovers for South Africa, these are small given the difference in size between these countries. A reform of the revenue sharing formula is under discussion; but convergence on a new formula could take some time. Staff has recommended that new ways be identified to mitigate the volatility in transfers from the common revenue pool.

STAFF APPRAISAL

47. **Macroeconomic policies in place over the last decade have supported economic and financial stability.** Countercyclical monetary and fiscal policies, together with exchange rate flexibility, have been effective in smoothing the cyclical fluctuations, while maintaining financial soundness. The buffers built during the 2003–08 upswing were used effectively to support domestic demand when the global financial crisis hit. And the flexible exchange rate regime has contributed to insulating the real economy from large swings in the terms of trade and indeed the ebb and flow of investor appetite towards South Africa.[3]

[3] South Africa maintains an exchange arrangement that is free from restrictions and multiple currency practices and is fully consistent with its obligations under the Fund Articles of Agreement.

48. **We expect the recovery to be sustained, but there are significant downside risks to this outlook**. The recovery to date has been uneven, relying mainly on consumption growth supported by fiscal and monetary stimulus. In contrast, investment, employment, and exports remain well below their precrisis peaks. With the help of the current supportive policies and continued global recovery, growth rates of about 4 percent should be feasible this year and next. But this will require an element of good fortune. Domestically, it will be important for electricity capacity, in particular, to be managed effectively and expanded in a timely fashion to facilitate a recovery in investment. Externally, partner country demand needs to remain as robust as it has in recent months.

49. **The high degree of uncertainty to the outlook, on balance, calls for delaying the start of tightening monetary policy.** Headline inflation is set to increase in the coming months but this largely reflects the pass through of higher international food and fuel prices to the domestic market. Core measures continue to point the presence of significant slack in the economy and at this juncture offer better guidance for monetary policy. As in recent months, the SARB needs to continue monitoring closely available information for clear evidence of a pronounced increase in inflation expectations and/or wages before raising the policy rate. The government can also help influence this year's wage agreement round by limiting public sector wages increases to productivity gains.

50. **The broadly neutral fiscal stance for this year is appropriate, but a tighter stance than currently envisaged would be important over the medium term.** Three reasons for this. First, it would help contain public debt at around 35 percent of GDP—a level that would leave adequate fiscal room to maneuver in the event of new shocks. Second, this target can be achieved without a departure from current policies and without endangering the recovery—by ensuring that annual spending growth is limited to 2 percent in real terms with very gradual recovery to the precrisis tax-to-GDP ratio. Third, with deficit paths along these lines, there is scope for the rebalancing of the fiscal/monetary mix that the government is aiming at.

51. **Weak export performance and loss of export market share signal persistent competitiveness problems.** Staff assessment of the real exchange rate points to the rand being 10 to 15 percent overvalued in real terms. The low-interest rate environment in the advanced countries has certainly led to appreciation pressure. But the competiveness problems are as much due to rising labor and other domestic costs of production. Reforms to enhance the product and labor market flexibility will thus be critical to improve competitiveness.

52. **And with competitiveness rather than overheating the main concern, CFMs are unlikely to help much**. Rather, exchange rate flexibility and continued reserve accumulation in the near term, and a gradual recalibration in the fiscal-monetary policy mix over the medium term, constitute the most practical policy

response to capital inflows in South Africa. There is in particular scope to significantly increase the pace of reserve accumulation in the near term. And although CFMs are an option, their drawbacks, including their implications for the financing cost of the government, will likely be nontrivial. Moreover, any benefits that CFMs provide are likely to be transitory. Lasting competitiveness gains can only stem from reforms that control the domestic cost of production.

53. With only modest economic growth rates on the cards in the near term and competitiveness a major problem, bold structural reforms are needed if South Africa is to fulfill its tremendous potential. In particular:

- **The labor market is clearly broken and failing the unemployed**. This is evident from both the high structural level of unemployment that prevailed before the crisis and the excessive job shedding during the recent recession. While, there are a myriad of reasons behind the high level of unemployment, one factor that has certainly not helped in recent years is the high rates of real wage growth. And absent decisive steps to better align wages to productivity levels going forward, competitiveness is unlikely to improve and only a fraction of the 500,000 new jobs a year being targeted are likely to materialize. In this context, one measure that should be considered is endowing the wage bargaining framework with sufficient flexibility to exempt smaller firms.
- **Competition in product markets also needs to be enhanced considerably**. Much more aggressive attempts to remove barriers to entry in key network industries are needed. Further, a systematic effort to identify and reduce unnecessary regulatory burdens facing firms would also enhance competition and entrepreneurship. By reducing the wide margins that firms in many industries and services currently enjoy, it should also be possible to strengthen the purchasing power of earnings.

54. South African banks seem to have weathered the stresses associated with the global financial crisis and the domestic recession well. Banks remain liquid and well capitalized, although a moderate level of impaired advances calls for continued vigilance. The envisaged "twin peaks" regulatory and supervisory framework should help strengthen financial institutions. It bodes well for further improving the consolidated supervision of financial groups. It also rightfully lifts the status of market conduct regulation and supervision given the high concentration and interconnectedness of the financial industry. Prudent management of the transition will be needed to minimize regulatory uncertainty.

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

Table 1. South Africa: Selected Economic and Financial Indicators, 2008–16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
National income and prices									
Real GDP	3.6	-1.7	2.8	4.0	4.2	4.2	4.0	3.8	3.7
Real GDP per capita	2.4	-2.8	1.8	2.8	2.9	3.0	2.7	2.6	2.5
Real domestic demand	3.4	-1.7	4.2	5.5	4.9	3.9	3.4	3.6	3.5
GDP deflator	8.9	7.2	8.1	7.9	6.2	5.4	5.0	4.9	4.7
CPI (annual average)	11.5	7.1	4.3	6.1	5.2	5.0	4.9	4.8	4.7
CPI (end of period) [1]	10.1	6.3	3.5	6.1	5.0	5.0	4.9	4.8	4.7
Labor market									
Unemployment rate (in percent)	22.9	23.9	24.9	24.5	23.8	23.6	23.3	22.8	22.3
Average remuneration (formal nonagricultural sector) [2]	12.9	11.3	11.8	8.5	7.8	7.6	7.5	7.4	7.3
Labor productivity (formal nonagricultural)	1.6	1.5	3.6	4.1	5.3	4.4	3.3	2.9	2.8
Unit labor costs (formal nonagricultural)	11.0	10.0	9.6	4.3	2.4	3.1	4.1	4.4	4.4
External sector									
Current account balance (% of GDP)	-7.1	-4.1	-2.8	-3.4	-4.8	-5.6	-5.7	-5.8	-5.8
Overall balance of payments (percent of GDP)	1.1	0.7	1.2	2.8	0.9	0.0	0.0	0.0	0.0
Total external debt (% of GDP)	26.4	27.7	27.1	24.4	26.2	28.1	29.8	31.2	32.4
Gross reserves (SARB, in billions of U.S. dollars)	34.1	39.7	43.8	55.8	59.8	59.8	59.8	59.8	59.8
(in months of total imports)	3.8	5.9	5.3	5.6	5.5	5.3	5.1	4.8	4.5
Merchandise exports, f.o.b. [3]	12.0	-22.7	29.7	16.3	3.3	4.7	4.4	6.4	7.6
Merchandise imports, f.o.b. [3]	10.2	-26.7	24.4	20.6	7.6	4.7	3.7	5.7	6.1
Export (goods and services) volume	6.6	1.8	-19.5	4.7	4.3	6.1	6.1	6.5	6.3
Import (goods and services) volume	9.0	1.5	-17.4	10.0	6.9	4.8	3.6	5.3	5.2
Terms of trade	0.4	4.9	5.3	1.1	-1.6	-1.2	-1.6	-0.5	0.2
Nominal effective exchange rate [4]	-26.8	25.5	8.8	...	...	...	...	...	...
Real effective exchange rate [4]	-16.3	22.1	8.9	...	...	...	...	...	...
Money and credit									
Net domestic assets [5]	9.6	3.7	6.8	11.1	9.8	10.3	10.0	10.0	10.1
Broad money (including foreign exchange deposits)	14.8	1.8	6.9	16.6	11.9	11.1	10.7	10.7	10.7
Velocity (GDP/average broad money)	1.2	1.2	1.3	1.3	1.3	1.3	1.2	1.2	1.2
Bank rate/repurchase rate (period end, in percent)	11.5	7.0	5.5	...	...	...	...	...	...
Broad money (period average)/GDP, percent	80	81	75	77	78	79	80	81	83
Investment and saving									
Investment (including inventories)	22.5	19.6	19.3	19.9	21.4	22.1	22.2	22.4	22.4
Of which: public fixed investment (incl. public enterprises)	8.0	8.6	7.7	7.7	6.8	6.0	5.9	5.7	5.5
private fixed investment	15.1	13.6	11.9	13.8	16.1	17.7	17.9	18.3	18.4
Gross national saving	15.4	15.6	16.5	16.5	16.6	16.5	16.6	16.6	16.6
Public (incl. public enterprises)	4.6	0.9	-0.9	0.5	1.1	1.9	2.5	3.3	4.2
Private	10.8	14.7	17.4	16.0	15.5	14.6	14.1	13.3	12.4
National government budget and other fiscal indicators [6]									
Revenue, including grants	26.5	24.4	24.6	25.0	25.2	25.4	25.6	25.9	26.1
Expenditure and net lending	27.1	29.8	29.9	29.3	28.8	28.6	28.7	28.0	26.8
Overall balance	-0.6	-5.4	-5.4	-4.3	-3.7	-3.2	-3.1	-2.1	-0.7
Cyclically-adjusted primary balance (FY basis)	0.3	-3.2	-1.4	-0.5	0.0	0.5	0.9	1.5	2.0
National government debt	27.3	31.5	35.1	36.6	37.5	38.1	37.7	36.3	33.6
Borrowing requirement of the nonfinancial public sector	3.2	7.7	9.7	8.4	6.8	5.4	4.5	2.8	1.2

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

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

[2] At current prices; annual percent change.

[3] In U.S. dollars; annual percent change.

[4] End-of-period. 2010 estimate corresponds to change from December 2009 to September 2010.

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

[6] Calendar-year figures are based on National treasury's historical data and staff's projections starting 2011.

Table 2. South Africa: Consolidated Government Operations, 2008/09–2013/14[1]
(In percent of GDP unless otherwise noted)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
					Proj.	
			Authorities' 2011 Budget			
Total revenue and grants	29.5	27.2	28.3	28.3	28.4	28.8
Total expenditure	30.7	33.8	33.6	33.6	33.2	32.6
Current	28.1	30.2	30.6	31.0	30.5	29.6
Wages and salaries	10.1	11.2	11.8	11.6	11.2	10.8
Other goods and services	5.2	5.7	5.6	5.6	5.6	5.4
Interest	2.5	2.6	2.7	2.9	3.1	3.2
Transfers	10.3	10.8	10.6	10.8	10.6	10.3
Capital expenditure	2.1	2.3	2.2	2.5	2.3	2.3
Payment for financial assets	0.5	1.3	0.8	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.1	0.4	0.7
Overall balance	-1.2	-6.6	-5.3	-5.3	-4.8	-3.8
Memorandum items:						
GDP (billions of rand)	2,313	2,443	2,667	2,915	3,201	3,536
National government debt (gross)	27.1	32.9	37.1	40.2	42.4	43.1
Cyclically-adjustment overall balance 2/	-1.5	-5.0	-3.1	-4.6	-4.3	-3.6
			Staff Recommended Fiscal Policy			
Total revenue and grants	29.5	27.2	28.1	28.2	28.2	28.5
Total expenditure	30.7	33.8	32.9	32.1	31.5	31.2
Current	28.1	30.2	29.9	29.4	28.7	28.1
Wages and salaries	10.1	11.2	11.5	11.0	10.5	10.1
Other goods and services	5.2	5.7	5.4	5.3	5.1	5.1
Interest	2.5	2.6	2.6	2.8	3.0	3.1
Transfers	10.3	10.8	10.3	10.3	10.1	9.8
Capital expenditure	2.1	2.3	2.2	2.5	2.5	2.5
Payment for financial assets	0.5	1.3	0.8	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.1	0.3	0.6
Overall balance	-1.2	-6.6	-4.8	-3.9	-3.3	-2.7
Memorandum items:						
GDP (billions of rand)	2,313	2,443	2,728	3,048	3,372	3,693
National government debt (gross)	27.1	32.9	35.8	36.9	37.8	38.2
Cyclically-adjustment overall balance	-2.3	-5.7	-4.0	-3.3	-2.9	-2.6

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

1/ For fiscal year beginning April 1.

2/ For national government main budget only.

Table 3. Statement of Operations—National Government Main Budget 2008/09–2013/14[1]
(GFSM2001 basis; in percent of GDP unless otherwise noted)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
					Proj. 2/	
Revenue	26.3	23.7	24.8	25.1	25.2	25.4
Taxes	25.8	23.4	24.4	24.6	24.7	25.0
Social contributions	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	0.5	0.3	0.4	0.4	0.5	0.5
Expenditure	27.0	29.3	28.9	29.1	28.7	28.5
Expense	26.7	28.9	28.6	28.8	28.3	28.0
Interest	2.4	2.3	2.4	2.5	2.7	2.8
Grants	12.6	14.2	14.0	13.7	13.1	12.7
Of which : provinces	10.6	12.1	11.8	11.4	10.9	10.5
local governments	1.9	2.1	2.2	2.2	2.2	2.3
Other expense	11.8	12.4	12.2	12.6	12.5	12.5
Net acquisition of nonfinancial assets	0.4	0.4	0.3	0.4	0.4	0.5
Gross Operating Balance (Revenue - Expense)	-0.4	-5.2	-3.8	-3.7	-3.1	-2.6
Budgetary balance (Revenue - Expenditure)	-0.7	-5.6	-4.1	-4.1	-3.5	-3.1
Extraordinary payments, net	-0.2	-0.2	-0.1	0.0	0.0	0.0
Net lending (+)/borrowing (–)	-0.6	-5.3	-4.1	-4.0	-3.5	-3.1
Net acquisition of financial assets						
Domestic	0.6	2.5	1.3	0.1	-0.4	-0.5
Currency and deposits	0.1	1.3	0.6	0.1	-0.4	-0.5
Loans	0.4	1.3	0.7	0.0	0.0	0.0
Net incurrence of liabilities	1.1	7.9	5.3	4.1	3.1	2.6
Domestic	1.3	6.9	5.4	4.0	3.2	2.8
Foreign	-0.2	1.0	-0.1	0.1	-0.1	-0.2
Memorandum items:						
Fiscal year GDP (billions of rand)	2,313	2,443	2,728	3,048	3,372	3,693
Real GDP growth (percent)	2.3	-1.2	3.4	4.1	4.3	4.1
GDP deflator (percent change)	8.7	6.9	8.0	7.4	6.1	5.2
Gross debt	27.1	32.9	35.8	36.9	37.8	38.2

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

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

2/ Staff projections base on the authorities' policy intentions as outlined in the 2011 budget.

Table 4. South Africa: Balance of Payments, 2009–2016

	2009	2010	2011	2012	2013	2014	2015	2016
			Proj.					
			(In Billion of US dollars)					
Balance on current account	-11.5	-10.1	-14.6	-21.9	-26.6	-28.4	-30.6	-31.8
Balance on goods and services	-2.5	-0.6	-5.2	-10.5	-11.0	-10.5	-10.3	-8.9
Exports of goods and services	77.9	99.5	115.5	119.3	124.9	130.4	138.7	149.2
Exports of goods	65.9	85.5	99.5	102.7	107.5	112.3	119.4	128.5
Nongold	59.7	77.4	89.7	93.1	98.1	102.9	110.1	119.1
Gold	6.3	8.1	9.7	9.6	9.4	9.4	9.4	9.4
Exports of services	11.9	14.0	16.0	16.6	17.3	18.1	19.2	20.7
Imports of goods and services	-80.4	-100.1	-120.7	-129.8	-135.9	-140.9	-148.9	-158.1
Imports of goods	-65.7	-81.7	-98.5	-106.0	-110.9	-115.0	-121.5	-129.0
Imports of services	-14.7	-18.4	-22.2	-23.9	-25.0	-25.9	-27.4	-29.1
Balance on income	-6.3	-7.2	-7.8	-8.7	-12.4	-14.6	-16.8	-19.1
Income receipts	4.0	4.7	5.1	6.1	7.2	8.2	9.9	10.6
Income payments	-10.4	-11.9	-12.9	-14.8	-19.7	-22.8	-26.8	-29.6
Balance on transfers	-2.7	-2.3	-1.6	-2.6	-3.1	-3.3	-3.5	-3.8
Capital flows (including errors and omissions)	13.6	14.4	26.6	25.9	26.6	28.4	30.6	31.8
Balance on capital and financial account	13.5	11.1	26.6	25.9	26.6	28.4	30.6	31.8
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	13.5	11.1	26.6	25.9	26.5	28.4	30.6	31.7
Direct investment	4.2	1.1	6.5	4.9	4.9	5.9	7.5	8.7
Liabilities	5.4	1.6	7.3	5.9	6.2	7.5	9.4	11.0
Assets	-1.2	-0.5	-0.7	-1.0	-1.3	-1.6	-2.0	-2.3
Portfolio investment	11.1	10.9	10.6	18.9	25.2	27.7	28.2	28.3
Liabilities	12.7	14.7	13.6	23.5	31.8	35.2	36.6	37.7
Assets	-1.6	-3.9	-3.0	-4.5	-6.7	-7.5	-8.4	-9.4
Other investment	-1.9	-0.9	9.4	2.1	-3.5	-5.2	-5.1	-5.3
Liabilities	-4.7	1.5	3.5	3.8	3.6	3.8	3.6	3.7
Assets	2.8	-2.4	5.9	-1.7	-7.2	-9.0	-8.7	-9.0
Errors and omissions	0.1	3.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	2.1	4.3	12.0	4.0	0.0	0.0	0.0	0.0
Gross reserves (SARB) [1]	39.7	43.8	55.8	59.8	59.8	59.8	59.8	59.8
Gross reserves (including the banking sector) [1]	39.7	43.8	55.8	59.8	59.8	59.8	59.8	59.8
International liquidity position of SARB [1 2]	39.0	43.1	55.1	59.1	59.1	59.1	59.1	59.1
			(In percent of GDP)					
Balance on current account	-4.1	-2.8	-3.4	-4.8	-5.6	-5.7	-5.8	-5.8
Balance on goods and services	-0.9	-0.2	-1.2	-2.3	-2.3	-2.1	-2.0	-1.6
Exports of goods and services	27.4	27.4	27.0	26.4	26.3	26.1	26.4	27.1
Imports of goods and services	-28.3	-27.5	-28.3	-28.7	-28.6	-28.2	-28.4	-28.7
Balance on income	-2.2	-2.0						
Balance on transfers	-0.9	-0.6						
Capital flows (including errors and omissions)	4.8	4.0	6.2	5.7	5.6	5.7	5.8	5.8
Balance on capital and financial account	4.8	3.1	6.2	5.7	5.6	5.7	5.8	5.8
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	4.7	3.0	6.2	5.7	5.6	5.7	5.8	5.8
Direct investment	1.5	0.3	1.5	1.1	1.0	1.2	1.4	1.6
Portfolio investment	3.9	3.0	2.5	4.2	5.3	5.5	5.4	5.1
Other investment	-0.7	-0.3	2.2	0.5	-0.7	-1.0	-1.0	-1.0
Errors and omissions	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	0.7	1.2	2.8	0.9	0.0	0.0	0.0	0.0
Gross reserves (SARB) [1]	14.0	12.1	13.1	13.2	12.6	12.0	11.4	10.9
Gross reserves (including the banking sector) [1]	14.0	12.1	13.1	13.2	12.6	12.0	11.4	10.9
International Liqudity Position of SARB [1 2]	13.7	11.8	12.9	13.1	12.4	11.8	11.3	10.7
Net foreign assets								
Memorandum items:								
Total external debt	27.7	27.1	24.4	26.2	28.1	29.8	31.2	32.4
Foreign currency debt	14.8	12.4	11.8	12.8	14.1	15.5	16.7	17.8
of which: short-term (at remaining maturity)	8.0	5.0	6.1	6.5	7.0	7.6	8.0	8.4
Medium and Long Term External debt service (in Billion of US dollars)	12.0	13.3	13.2	12.6	13.1	12.4	13.4	14.2

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

1/ End of period.

2/ Gross reserves minus foreign loans and minus forward position.

Table 5. South Africa: Monetary Survey 2004–2010

	2004 Dec	2005 Dec	2006 Dec	2007 Dec	2008 Dec	2009 Dec	2010 Dec
				(In billions of rand)			
Net foreign assets	141.4	195.1	274.3	304.5	390.5	354.2	357.4
Gross reserves	229.6	297.8	409.8	561.7	847.4	670.8	672.1
SARB	82.8	130.5	178.3	224.3	317.0	292.7	290.6
Other monetary institutions	146.7	167.3	231.5	337.4	530.4	378.1	381.5
Liabilities	88.2	102.6	135.5	257.2	456.9	316.7	314.7
SARB	19.8	22.2	19.3	12.0	6.1	2.7	0.1
Other monetary institutions	68.4	80.4	116.2	245.2	450.8	314.0	314.6
Net domestic assets	772.8	906.0	1,075.0	1,363.1	1,523.7	1,594.1	1,725.6
Credit to government, net	42.6	0.8	-29.5	-32.5	44.7	85.6	63.8
Claims on government	116.1	107.4	112.4	116.5	179.5	223.7	252.1
Government deposits	73.4	106.6	141.8	149.0	134.8	138.1	188.2
Credit to private sector	954.2	1,140.2	1,434.9	1,743.9	1,981.0	1,978.4	2,086.7
Other items, net	-224.1	-235.0	-330.4	-348.3	-502.0	-470.0	-425.0
Broad money (M3)	914.2	1,101.1	1,349.3	1,667.6	1,914.2	1,948.2	2,083.0
Of which: M1	421.5	503.1	605.7	738.3	753.6	806.3	862.4
				(Annual percentage change)			
Net foreign assets	11.6	38.0	40.5	11.0	28.2	-9.3	0.9
Net domestic assets	13.4	17.2	18.7	26.8	11.8	4.6	8.2
Credit to private sector	13.8	19.5	25.8	21.5	13.6	-0.1	5.5
Broad money (M3)	13.1	20.5	22.5	23.6	14.8	1.8	6.9
				(Contribution to growth in M3, unless otherwise specified)			
Net foreign assets	1.8	5.9	7.2	2.2	5.2	-1.9	0.2
Net domestic assets	11.3	14.6	15.4	21.3	9.6	3.7	6.8
Credit to government, net	-0.4	-4.6	-2.7	-0.2	4.6	2.1	-1.1
Credit to private sector	14.3	20.3	26.8	22.9	14.2	-0.1	5.6
Other items, net	-2.6	-1.2	-8.7	-1.3	-9.2	1.7	2.3
Memorandum item:							
Income velocity of M3 (GDP/average broad money)	1.63	1.55	1.42	1.31	1.25	1.24	1.19

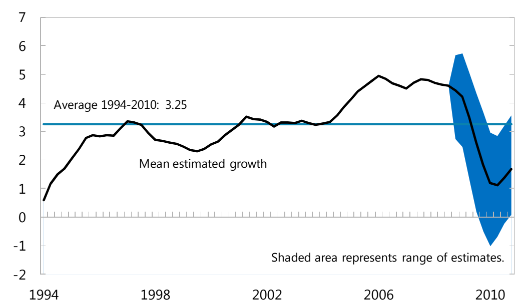
Sources: South African Reserve Bank (SARB).

Appendix I. Measuring South Africa's Potential Output

The analysis, which applies a wide range of estimation techniques to measure potential output, suggests that, while potential output growth steadily accelerated in the post-apartheid era to about 3.5 percent (1994–2008), it decelerated considerably following the outbreak of the financial crisis, as it did in other advanced and emerging economies. While this indicates that, at around -1.5 percent, the estimated 2010 output gap is lower than previously thought, there is a fair amount of uncertainty regarding its "true" magnitude, reflecting in part the backward looking nature of the estimation methods. Going forward, staff is thinks potential growth is likely to revert gradually to its precrisis pace, and the output gap will close by early 2012.

One source of uncertainty surrounding the potential output measurement relates to the massive job shedding that took place in the past two years and the timely pace of recovery over the medium term. While the analysis suggests that part of the employment loss is cyclical in nature, stemming from a shift in the size of output gap from a positive 2 to 3 percent in the precrisis period to negative terrain in 2009–10, some of the employment loss may be more protracted, partly reflecting a marked deterioration of external competitiveness, owing to the sharp appreciation of the real effective exchange rate and the rising unit labor cost. And indeed, a breakdown of employment confirms that the sizeable employment loss is exclusively concentrated in the exporting sectors, most notably manufacturing. The deterioration of competitiveness and the related weak export volumes may also explain the considerable contraction in fixed domestic investment in the past two years.

South Africa: Estimated Potential Growth, 1994-2010
(Percent per year, moving average)



Source: IMF staff estimates.

The analysis explores the extent in which the output gap is sensitive to domestic and external variables. The estimation shows that, although the output gap is significantly affected by policy instruments such as the short-term interest rate and the change in public consumption (as a share of GDP), its sensitivity to the global economic cycles has increased steadily in the past decade. This finding points to South Africa's increasing economic integration into the global economy in recent years, and as corollary, the growing sensitivity of the economy to global economic shocks.

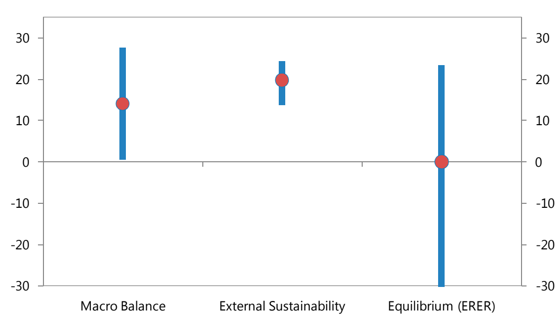
Appendix II. Does South Africa Have a Competitiveness Problem?

The poor performance of exports since the crisis raises concerns about possible competitiveness problems. Exports are 15 percent below their precrisis levels, even though partner demand has fully recovered, whereas most other emerging markets (EMs) have already regained precrisis levels of export volumes. This appendix presents the findings of work done by staff looking at both direct and indirect measures of competitiveness.

On average, the three staff (CGER) approaches point to the real effective exchange rate being misaligned by 10 to 15 percent:

- The macrobalance approach, which compares the medium-term current account projection (-5.8 percent of GDP) with a norm of -3.5 percent of GDP, yields a misalignment estimate of 14 percent.

South Africa: Exchange Rate Variation Estimates and 90 Percent Confidence Intervals
(Percent)



- The external sustainability approach, based on stabilizing South Africa's net external liabilities at the EM average, produces a higher estimate of misalignment (20 percent).

- By contrast, the equilibrium real exchange rate (ERER) approach suggests that the real exchange rate is broadly aligned with its determinants. This result reflects an appreciation in the equilibrium exchange rate driven in part by terms of trade gains as well as rising government consumption. However, the ERER results are very sensitive to specification, as well as estimation period.

Indirect indicators corroborate these concerns:

- South Africa's share of global exports has stagnated since 2005, falling sharply in the crisis, but recovering somewhat in 2010. During the same period comparable EMs have, by contrast, expanded their global market shares by 16 percent on average (or 0.25 percentage points).

- Moreover, the export performance appears even more disappointing once the composition of South Africa's exports is controlled for: while commodity producers have done well, there have been declines in the market share of manufactured exports.

- The weakness of non-commodity exports could reflect structural factors, including weak skills, poor transportation infrastructure and weak take-up of technology.

Appendix III. What Can South Africa Learn from Jobs Champions?

The New Growth Path has set an ambitious goal of creating five million jobs in the next decade. Against this backdrop, staff examined the job creation performance in 20 large emerging market countries, including South Africa, during 2000–09. The findings are as follows:

- Average annual employment increases in the sample ranges from 3 percent (in India) to -0.2 percent (in Hungary). South Africa is at the lower end of this spectrum, ranking seventeenth out of the 20 countries in the sample. Had South Africa performed as well as the median country, it would have had 1.3 million more jobs during this period. Many countries create more jobs than required to keep pace with working-age population growth, but South Africa has failed to do this. The labor intensity of growth in South Africa is also well below the median for the group.

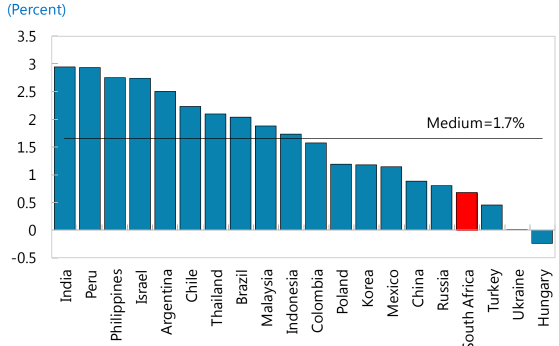
- Fast job creators tend to have slightly higher output growth, lower inflation, more depreciated REER, tend to be more export oriented, and have lower tax-to-GDP ratios. South Africa's growth and inflation performance were worse than that of the median for slow job creators.

- Perception and survey-based labor market rankings present an overall mixed picture, but point to a more cooperative labor relationship in high job creators. South Africa is ranked reasonably well in volume adjustment, but does poorly on dimensions of wage flexibility and how well employers and employees cooperate.

- Fast job creators tend to have lower U.S. dollar wage levels and fewer restrictions on working hours. South Africa does poorly on all these dimensions. Hourly pay in the manufacturing sectors is markedly higher than is the case among high jobs creators. The ratio of the minimum wage to average output in South Africa is also twice the median for slow job creators.

- Social and human capital indicators do not point to noticeable differences between slow and fast job creators. South Africa does not seem to be different from other countries in the sample, with the exception of income distribution which is much more skewed in South Africa.

Average Employment Growth, 2000-09
(Percent)



Sources: WEO, country authorities, and IMF staff calculations.

Appendix IV. Drivers of Portfolio Flows

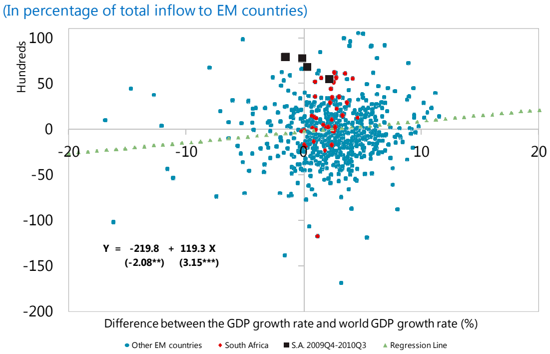
South Africa has been privy to a large volume of capital inflows over the last year. These flows helped supplement domestic savings and thus helped sustain a higher level of consumption and investment than would have otherwise been the case. All the same, the inflows have likely engendered a stronger rand, exacerbating competitiveness concerns. In an effort to disentangle pull from push factors, an empirical model of the drivers of portfolio flows was estimated using a panel regression approach:

- The panel confirms the generally held view that macroeconomic variables help explain portfolio flows in emerging markets. For bond flows, the key macro variables, or "pull factors", are the fiscal balance, excess growth over the world average, and an indicator of external vulnerability. For equity flows, the key variables seem to be excess growth over the world average and lagged exchange rate volatility.

- External variables and domestic institutional factors also play an important role. These include external financial conditions like global interest rates, global risk aversion (as proxied by the VIX), and trends in global stock market prices. Domestic institutional factors include stock market capitalization and population size, among others.

- But South Africa seems to have received more inflows than these factors would suggest. On local bond markets, regression residuals have been positive for most of the sample period (2000Q1–2010Q3). But they were especially high during 2009Q4–2010Q3 (text figure).

Residuals from Regressing Bond Share with Explanatory Variables Except Diff. in GDP Growth Rate
(In percentage of total inflow to EM countries)



- Equity flows into South Africa also appear to be higher than can be justified by domestic variables. This said, factors related to the size of South Africa's equity market (that is, factors beyond macro variables) have contributed to high volumes of equity inflows. This has been evident for the entire period (2000–10), but especially before the global financial crisis (2000–08).

- In short, South Africa appears to have received more portfolio inflows, especially bond flows, during 2009Q4–10Q3 than what systematic pull and push factors can explain.

Appendix V. Macro Policy Mix: Effect on Growth and Real Appreciation

In the globalized economy, external developments significantly influence macroeconomic outcomes in emerging markets. But macroeconomic policies, and how they interact with each other, matter. That is the experience of 20 emerging economies in South Africa's peer group and of South Africa itself. Simulations from the IMF's Global Integrated Monetary and Fiscal Model (GIMF), calibrated to South Africa, show how different policy designs yield markedly different outcomes.

Would a tighter fiscal, looser monetary, and greater reserve buildup increase growth and depreciate the rand in real terms? The existing empirical and theoretical literature would say "maybe." Such a policy mix would reduce macroeconomic vulnerabilities and help prevent financial crises that set back macroeconomic progress. But such a policy mix does not guarantee higher growth or competitiveness even under steady external conditions.

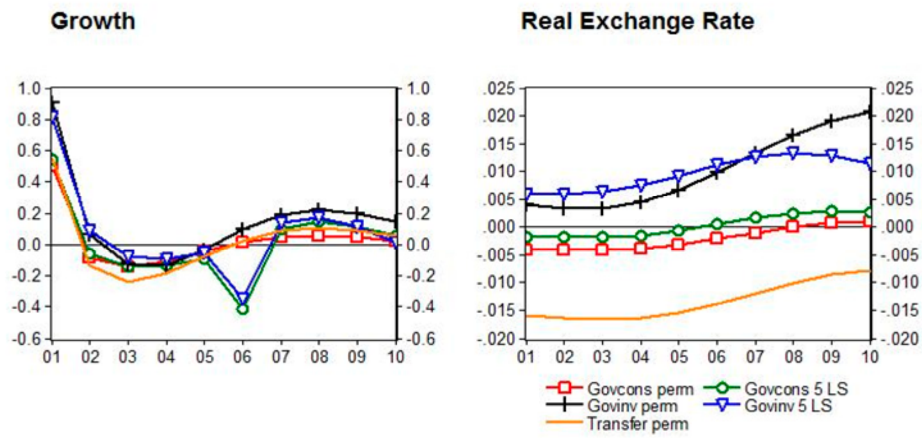
A fresh look at the experience of South Africa and its peers over the last twenty years, through the lens of several econometric techniques, concludes the same. These techniques range from cross-section regressions to panel and South-Africa specific dynamic systems. They suggest that higher public spending contributed to growth, but this effect was partly offset by the adverse effect of higher public revenue and public debt. Taking the cross-country parameters at face value, a country that increased public spending and revenue in the same amount lowered its growth potential. Those that funded the expanding fiscal spending with debt grew more. Nevertheless, this effect will be partly offset when they need to raise taxes to pay back or stabilize the debt.

These results suggest that the proposed shift in the policy mix will raise growth only if the expansionary effect of monetary and reserve policies offset tighter fiscal policies. The effect of fiscal policies on exchange rates is ambiguous. A looser monetary policy characterized by lower real interest rates tends to increase growth in the medium run and depreciate the domestic currency in real terms. Finally, reserve accumulation seems to have contributed to higher growth, even if it is associated with stronger domestic currencies in real terms. A South Africa specific dynamic system, however, suggest that at least during 2003–2010, such a change in the policy mix would have delivered a more depreciated rand in real terms.

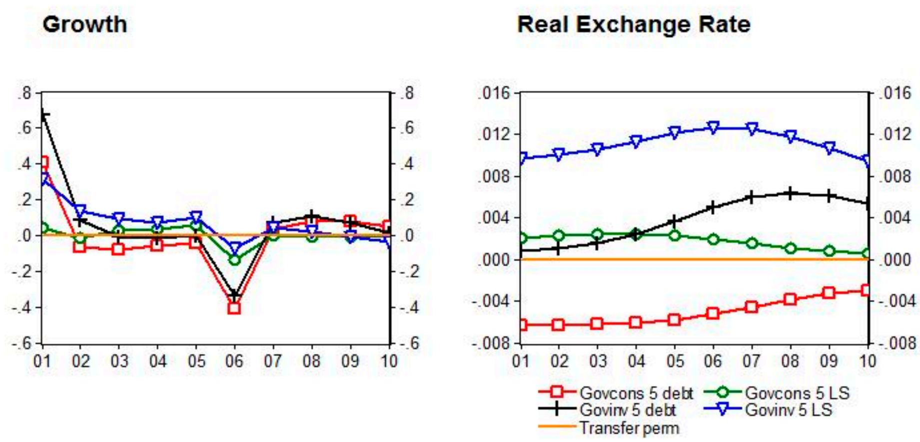
The Global Integrated Monetary and Fiscal Model (GIMF) simulations support the conclusions that fiscal tightening tends to contract economic activity and has ambiguous effects on the real exchange rate. It also shows that funding and the composition of fiscal spending matters for growth, with cuts in public investment hurting growth the most. It also shows that the monetary policy reaction is crucial for determining the macroeconomic impact of fiscal measures. The model does illustrate that a fiscal tightening may be expansionary if it reduces the risk premium, lowering policy rates.

Figure 1: Global Integrated Monetary and Fiscal Model, Calibrated to South Africa
Simulations of Higher Fiscal Spending under Alternative Funding Assumptions

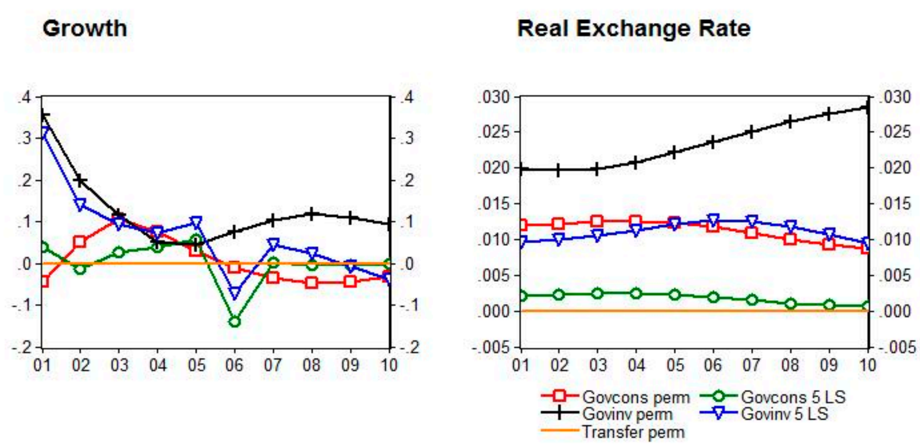
Letting policy reaction functions operate



Funding higher fiscal spending with debt



Funding higher fiscal spending with lump sum taxes



An increase in the real exchange rate means rand depreciation.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 7, 2011

Prepared By

The African Department
(In collaboration with other departments)

CONTENTS

RELATIONS WITH THE FUND

As of May 31, 2011

Membership Status

Joined: December 27, 1945

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

General Resources Account:	**SDR Million**	**%Quota**
Quota	1,868.50	100.00
Fund holdings of currency	1,866.85	99.91
Reserve position	1.65	0.09

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,785.42	100.00
Holdings	1,788.13	100.15

Outstanding Purchases and Loans: None

Latest Financial Arrangements None

Projected Payments to Fund

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

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

Exchange Rate Arrangement:

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

With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated. Nonresidents are free to purchase shares, bonds, and other assets and to repatriate dividends, interest receipts, and current and capital profits, as well as the original investment capital. Foreign companies, African governments and institutions may inward list on South Africa's equity and debt instruments on South Africa's securities exchanges.

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

Table 1. Liberalization of Capital Controls on Residents

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

March 2010 – Authorized Dealers were allowed to acquire direct and indirect foreign exposure up to a macro-prudential limit of 25 per cent of their total liabilities, excluding total shareholder's equity.

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

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

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

Article IV Consultation

The 2010 Article IV consultation was concluded by the Executive Board on July 7, 2010. South Africa is on the standard 12 month Article IV consultation cycle.

Technical Assistance

An FAD mission took place in December 2010 to support capacity for fiscal policy analysis in the Treasury's Fiscal Policy Unit (FPU), followed up by a visit during April 2011. This visit also followed a study tour by FPU senior staff to the IMF's headquarters in July to discuss international experience with fiscal rules.

In March 2011, a STA missions took place to conduct the training on Coordinated Direct Investment Survey Seminar for Anglophone Africa in Pretoria, South Africa. Further a DFID took place in South Africa on organize South African Customs Union Module Regional Workshop.

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.

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	**New Lending** ESKOM Renewable ($250m) **Ongoing Supervision as of June 2011** ESKOM Investment-SIL ($3,750b) GEF Renewable Energy Market Transform (FY07) GEF Isimangaliso Wetland Park **ESW for FY11** Closing Skills and Technology Gap ESMAP Low Carbon **TA for FY11-12** Rural Development and Land Reform Post Crisis SME Finance Support to Financial Stability Investment Climate Follow up/PSD Policy Notes Flood response Urban Policy Dialogue TB and HIV/AIDS Program Carbon Capture Storage		 FY11 Q4 Ongoing Ongoing Ongoing Ongoing 10/12/10 6/10/11 3/07/11 4/01/11 3/16/11 5/18/11 Ongoing Ongoing Ongoing
The Fund work program in the next 12 months	1. 2011 Article IV consultation report - Background papers on a) measuring South Africa's potential output, b) South Africa's competitiveness problem, c) what South Africa can learn from fast job creators, d) South Africa's share of portfolio flows, and e) macro policy mix –effect of growth and real appreciation. 2. Staff visit – preparatory work for the 2012 Article IV consultation 3. 2012 Article IV consultation 4. LEG TA in rewriting the Income Tax Act and drafting a new Tax Administration Act	May-June 2011 Q4 2011 Q2 2012	Board meeting in July 2011 Board meeting in July-August 2012 Ongoing
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		

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 in January 2008.

The consumer price index (CPI) covers all households living in metropolitan and urban areas, which represent approximately 56 percent of the total number of households and 75 percent of private consumption expenditures. The CPI weights are rebased in January 2009 according to the new weights published in July 2008. New price indices, which are rebased to 2008=100, are calculated according to these weights. These indices form the basis for calculating the year-on-year changes in the CPI for 2009 and the month-on-month change between December 2008 and January 2009. 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 the SARB are consistent with the methodology recommended in the Monetary and Financial Statistics Manual. South Africa regularly reports good quality monetary statistics for publication in the IFS and the IFS Supplement, although there is room for improving the timeliness of the data on nondepository financial institutions.

Balance of payments

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

Work is ongoing to improve the reliability and accuracy of balance of payments data, with the aim of reducing the level of errors and omissions.

<table>
<tr><th colspan="8">Table 2. South Africa: Table of Common Indicators Required for Surveillance
(as of June 30, 2011)</th></tr>
<tr><th rowspan="2"></th><th rowspan="2">Date of latest observation</th><th rowspan="2">Date received[10]</th><th rowspan="2">Frequency of Data[7]</th><th rowspan="2">Frequency of Reporting[7]</th><th rowspan="2">Frequency of publication[7]</th><th colspan="2">Memo Items:</th></tr>
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<tr><td>Broad Money</td><td>4/11</td><td>6/17/11</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Central Bank Balance Sheet</td><td>5/11</td><td>6/17/11</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Consolidated Balance Sheet of the Banking System</td><td>4/11</td><td>5/01/11</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>Interest Rates[2]</td><td>5/31/2011</td><td>6/14/11</td><td>D</td><td>D</td><td>D</td><td></td><td></td></tr>
<tr><td>Consumer Price Index</td><td>5/11</td><td>6/23/11</td><td>M</td><td>M</td><td>M</td><td>O, LO, O, O</td><td>LO, LO, O, O</td></tr>
<tr><td>Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]</td><td>Q1 2011</td><td>6/15/11</td><td>A</td><td>S</td><td>S</td><td rowspan="2">O, O, O, O</td><td rowspan="2">O, O, O, O</td></tr>
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<tr><td>External Current Account Balance</td><td>Q1 2011</td><td>6/27/11</td><td>Q</td><td>Q</td><td>Q</td><td rowspan="2">LO, LO, LO, LO</td><td rowspan="2">LO, LO, LO, LO</td></tr>
<tr><td>Exports and Imports of Goods and Services [6]</td><td>Q1 2011</td><td>6/27/11</td><td>M</td><td>M</td><td>M</td></tr>
<tr><td>GDP/GNP</td><td>Q1 2011</td><td>6/21/11</td><td>Q</td><td>Q</td><td>Q</td><td>O, LO, LO, LO</td><td>LO, O, O, O</td></tr>
<tr><td>Gross External Debt</td><td>Q1 2011</td><td>Q2 2011</td><td>Q</td><td>Q</td><td>Q</td><td></td><td></td></tr>
<tr><td>International Investment Position</td><td>2009</td><td>11/2010</td><td>A</td><td>A</td><td>A</td><td></td><td></td></tr>
</table>

[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 interna standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not obs 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 by 06/30/2011.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS

July 7, 2011

Approved By
Sharmini Coorey and Aasim Husain

Prepared by the Staff Representatives for the 2011 Consultation with South Africa

DEBT SUSTAINABILITY ANALYSIS

56. South Africa's external debt is projected to reach 32 percent of GDP by 2016. The 8½ percentage point increase in the external-debt-to-GDP ratio reflects a widening of the current account deficit to around 6 percent of GDP in 2014-16. The current account balance should weaken as growth buoys import demand, recent gains in the terms of trade partly unwind, and rising profits and interest rates spur dividend and interest outflows. A large share of the deficit will be financed by nonresident portfolio investment (around three-quarter of the total over the medium term). This includes portfolio equity (which do not add to the debt stock), and local-currency bonds, with only a small share expected to come from foreign-currency denominated debt. The public-sector borrowing requirement is expected to be financed partly by nonresidents through international bond issues, purchases of domestic bonds, and multilateral loans for infrastructure projects.

57. The rising external-debt ratio increases South Africa's vulnerability to external shocks and rollover risk, although risks look manageable. Stress tests indicate that the largest adverse impacts would arise from a 30 percent rand depreciation, or from a further widening of the noninterest current account deficit. These shocks would push the external-debt ratio to 43 percent and 39 percent respectively by 2016. But these are likely to represent upper bound estimates, since the standard DSA does not capture the effect of a likely exchange rate weakening if those shocks were to materialize, which could lead to a narrower trade deficit. By contrast, a large (one standard deviation) permanent shock to real GDP growth and the standard shock to interest rates have only minor effects, while the combined shock has a moderate effect on external debt levels.

58. South Africa's public debt position appears sustainable. Under the policies the medium-term expenditure framework outlined in the 2011/12 budget, the ratio of government debt to GDP is expected to rise over the short term, to a maximum of 38 percent in 2013 from 35 percent in 2010—of which, some 3 percent of GDP is expected to be denominated in foreign currency—before declining gradually thereafter (Table 2). Gross financing needs peaked at some 8 percent of in 2009, and steadily decline afterwards to below 2 percent into the medium term (Figure 2). Total public debt is also projected to rise in the short term, as public enterprises borrow to help finance the accelerated investment expansion, but total public debt is projected to peak at close to 53 percent of GDP by 2014 (Table 2).

59. The government debt-to-GDP ratio appears broadly robust to a variety of

shocks, including weaker GDP growth, a lower primary balance, a 30 percent real depreciation of the exchange rate, and a 10 percent increase in the debt stock (Figure 2)**.** Under most of these scenarios, the government-debt ratio rises above the baseline over the projection period by only modest margins. One noticeable exception is in the case of the "no policy change" scenario where the debt ratio rises sharply and approaches 45 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, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2006	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016	Debt-stabilizing non-interest current account 6/
Baseline: External debt	21.8	26.3	26.1	27.7	27.1			**24.4**	**26.2**	**28.1**	**29.8**	**31.2**	**32.4**	**-6.6**
Change in external debt	3.2	4.5	-0.3	1.6	-0.6			-2.7	1.8	1.9	1.7	1.4	1.2	
Identified external debt-creating flows (4+8+9)	-0.7	1.4	7.6	-1.8	-5.5			-0.7	-0.4	-1.0	-1.2	-1.3	-1.6	
Current account deficit, excluding interest payments	3.9	5.5	5.4	3.0	1.9			2.4	3.8	4.3	4.2	4.3	4.1	
Deficit in balance of goods and services	2.4	2.7	3.0	0.9	0.2			1.2	2.3	2.3	2.1	2.0	1.6	
Exports	30.0	31.5	35.6	27.4	27.4			27.0	26.4	26.3	26.1	26.4	27.1	
Imports	32.5	34.2	38.6	28.3	27.5			28.3	28.7	28.6	28.2	28.4	28.7	
Net non-debt creating capital inflows (negative)	-5.0	-3.7	-0.5	-5.1	-2.2			-3.1	-4.3	-5.5	-5.8	-6.1	-6.3	
Automatic debt dynamics 1/	0.3	-0.4	2.7	0.3	-5.2			0.1	0.1	0.2	0.4	0.5	0.5	
Contribution from nominal interest rate	1.4	1.5	1.7	1.1	0.8			1.0	1.0	1.2	1.5	1.6	1.6	
Contribution from real GDP growth	-1.0	-1.1	-1.0	0.4	-0.6			-0.9	-1.0	-1.0	-1.1	-1.1	-1.1	
Contribution from price and exchange rate changes 2/	0.0	-0.8	2.0	-1.2	-5.4			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.9	3.1	-7.9	3.4	4.9			-2.0	2.2	2.8	2.9	2.7	2.8	
External debt-to-exports ratio (in percent)	72.8	83.7	73.2	100.9	99.0			90.3	99.3	106.9	114.0	117.9	119.5	
Gross external financing need (in billions of US dollars) 4/	60.9	68.1	93.9	75.7	84.0			74.6	96.5	106.7	114.2	124.9	134.1	
in percent of GDP	23.3	23.8	34.1	26.7	23.1	10-Year	10-Year	17.5	21.4	22.4	22.9	23.8	24.4	
Scenario with key variables at their historical averages 5/								**24.4**	**24.4**	**24.7**	**24.8**	**24.8**	**24.6**	**-4.8**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	5.6	5.6	3.6	-1.7	2.8	3.5	2.1	4.0	4.2	4.2	4.0	3.8	3.7	
GDP deflator in US dollars (change in percent)	0.1	3.7	-6.9	4.8	24.5	8.2	18.6	12.9	1.6	1.0	1.0	1.1	1.1	
Nominal external interest rate (in percent)	7.7	7.4	6.2	4.3	3.9	5.8	1.2	4.3	4.5	5.0	5.5	5.5	5.5	
Growth of exports (US dollar terms, in percent)	15.9	14.8	9.1	-20.6	27.8	11.4	15.2	16.1	3.3	4.7	4.4	6.4	7.6	
Growth of imports (US dollar terms, in percent)	23.2	15.4	8.9	-24.5	24.5	13.2	18.5	20.6	7.6	4.6	3.7	5.7	6.2	
Current account balance, excluding interest payments	-3.9	-5.5	-5.4	-3.0	-1.9	-2.0	2.8	-2.4	-3.8	-4.3	-4.2	-4.3	-4.1	
Net non-debt creating capital inflows	5.0	3.7	0.5	5.1	2.2	3.1	2.1	3.1	4.3	5.5	5.8	6.1	6.3	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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/ 2/
(External debt in percent of GDP)

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

Table 2. South Africa: Public Sector Debt Sustainability Framework, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	32.6	28.3	27.3	31.5	35.1	**36.6**	**37.5**	**38.1**	**37.7**	**36.3**	**33.6**	**0.0**
o/w foreign-currency denominated	4.5	3.8	4.3	4.1	3.6	3.3	3.2	3.1	2.6	2.2	1.6	
Change in public sector debt	-2.0	-4.3	-1.0	4.2	3.6	1.5	0.9	0.5	-0.4	-1.4	-2.7	
Identified debt-creating flows (4+7+12)	-4.2	-5.6	-1.4	3.0	1.7	0.3	-0.1	-0.5	-0.9	-1.6	-2.3	
Primary deficit	-3.7	-4.3	-2.1	2.7	2.7	1.4	0.5	-0.2	-0.8	-1.5	-2.3	
Revenue and grants	27.7	29.6	29.7	27.8	27.9	28.2	28.2	28.4	28.7	29.0	29.3	
Primary (noninterest) expenditure	24.0	25.3	27.6	30.5	30.5	29.6	28.7	28.2	27.9	27.4	27.0	
Automatic debt dynamics 2/	-0.5	-1.4	0.7	0.3	-0.9	-1.1	-0.6	-0.3	-0.1	0.0	0.0	
Contribution from interest rate/growth differential 3/	-0.9	-1.3	-0.6	1.2	-0.5	-1.1	-0.6	-0.3	-0.1	0.0	0.0	
Of which contribution from real interest rate	0.8	0.3	0.3	0.7	0.3	0.2	0.8	1.1	1.3	1.3	1.2	
Of which contribution from real GDP growth	-1.7	-1.6	-0.9	0.4	-0.8	-1.3	-1.4	-1.4	-1.4	-1.3	-1.2	
Contribution from exchange rate depreciation 4/	0.4	-0.1	1.3	-0.9	-0.4	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.2	1.3	0.4	1.3	1.9	1.2	1.0	1.1	0.5	0.2	-0.4	
Public sector debt-to-revenue ratio 1/	117.6	95.7	91.9	113.3	126.0	130.0	133.1	134.1	131.4	125.3	114.7	
Gross financing need 6/	3.5	2.2	3.4	8.1	6.4	5.2	4.8	4.5	4.2	2.6	1.7	
in billions of U.S. dollars	9.1	6.4	9.4	22.9	23.4	22.1	21.8	21.4	21.0	13.5	9.5	
Scenario with key variables at their historical averages 7/						**36.6**	**35.5**	**34.4**	**32.8**	**30.8**	**28.3**	**-0.2**
Scenario with no policy change (constant primary balance) in 2011-2016						**36.6**	**38.0**	**40.2**	**42.1**	**43.6**	**44.5**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.6	5.6	3.6	-1.7	2.8	4.0	4.2	4.2	4.0	3.8	3.7	
Average nominal interest rate on public debt (in percent) 8/	9.5	9.7	10.3	9.9	9.2	8.7	8.8	8.9	8.9	8.8	8.5	
Average real interest rate (nominal rate minus change in GDP deflator, in	3.0	1.6	1.4	2.7	1.1	0.8	2.6	3.5	4.0	3.9	3.8	
Nominal appreciation (increase in US dollar value of local currency, in per	-9.3	2.3	-26.8	26.1	11.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.5	8.1	8.9	7.2	8.1	7.9	6.2	5.4	5.0	4.9	4.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.3	11.2	12.9	8.7	3.0	0.9	1.1	2.3	2.7	2.2	2.1	
Primary deficit	-3.7	-4.3	-2.1	2.7	2.7	1.4	0.5	-0.2	-0.8	-1.5	-2.3	
Memorandum items:												
Debt of nonfinancial public enterprises	**4.5**	**4.9**	**5.6**	**6.3**	**5.7**	**9.1**	**11.4**	**12.7**	**13.2**	**13.2**	**12.9**	
Debt of local governments and local enterprises	**2.3**	**1.4**	**1.3**	**1.5**	**1.8**	**1.9**	**2.0**	**2.0**	**2.1**	**2.2**	**2.2**	
Gross public sector debt	39.4	34.6	34.2	39.2	42.6	47.6	50.9	52.8	53.1	51.6	48.7	

1/ Includes the national government, and provincial and local government activities financed with transfers from the national 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 ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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FOR IMMEDIATE RELEASE
August 25, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with South Africa

On July 25, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

Over the last two decades, South Africa has become increasingly integrated into the global economy, which has allowed output growth to converge to the world average level. But this integration has also exposed South Africa to global business cycles. Prudent countercyclical monetary and fiscal policies, together with a flexible exchange rate, have helped dampen the adverse effects of those global cycles; and sound financial supervision has guided financial institutions in managing the associated risks. And although transfer programs have lifted the most vulnerable from extreme poverty, progress in social indicators has lagged behind macroeconomic achievements.

Over the last year, South Africa's has continued to recover from the 2008–09 recession led by solid consumption growth. Although its gross domestic product (GDP) now exceeds the pre-crisis peak, output remains below potential. Inflation has remained contained, partly reflecting the negative output gap, rand appreciation, and, until recently, moderate domestic food prices.

[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.

The current account has strengthened on account of favorable terms of trade, which offset a faster recovery in import than in export volumes.

Fiscal and monetary policies have remained supportive. In cyclically adjusted terms, the deficit swung from a surplus in fiscal year 2007/08 (April-March) to a deficit in 2009/10, and staff estimates the deficit at some 4 percent in 2010/11. Spending growth moderated in 2010, and became more tilted toward current spending, mainly reflecting above-budgeted increases in wages. Monetary policy provided additional stimulus, with a 150-basis-point cut in the policy rate in 2010. These cuts have brought the policy rate to 5.5 percent, its lowest level in more than 30 years.

With public debt at manageable levels and contained demand pressure, the authorities' fiscal plans call for fairly gradual fiscal consolidation. This would result in gross national government debt peaking at around 43 percent of GDP in 2013/14. Although this path would not pose immediate risks to fiscal sustainability, it could constrain fiscal space to deal with future shocks. On monetary policy, although further interest rate cuts are no longer on the horizon and headline inflation has been picking up, the timing for starting the tightening cycle remains unclear because most of the increase in headline inflation reflects cost-push factors and uncertainty in the external environment is high.

Having come through the recession in reasonable shape, the financial sector is now contending with a period of low credit demand and rising costs. Banks have remained well capitalized and liquid, with well contained market risks. The move toward a "twin peaks" regulatory and supervisory framework over the next few years, which strives to concentrate prudential authority at one peak and market conduct authority at another, bodes well for further improving the consolidated supervision of financial groups.

The medium-term outlook envisages South Africa growing on par with the world economy. Growth should rise to 4 percent a year in 2011 and 2012, underpinned by solid domestic demand. Over the next 12 months, the output gap is set to close and there is a possibility that headline inflation will breach the top of the target range. The expected recovery in investment will likely cause the current account deficit to gradually further widen to about 5–6 percent over the medium term.

Executive Board Assessment

Executive Directors commended the authorities for the prudent macroeconomic policies which, together with a flexible exchange rate and sound financial sector, have mitigated the output drop during the global recession. Directors noted that the key challenges ahead are to support the ongoing recovery and raise growth to reduce high unemployment and inequality. In this regard, Directors welcomed the authorities' New Growth Path which focuses on these priorities.

Directors supported a broadly neutral fiscal stance for 2011/12 and welcomed the prudent fiscal policy guidelines included in the 2011 budget. They agreed that, over the medium term, a tighter fiscal stance than currently contemplated would be useful to rebuild policy buffers and contain public debt at moderate levels. Directors encouraged the authorities to rebalance the composition of public spending to help support higher potential growth, and called for moderation in public wage growth.

Directors endorsed South Africa's inflation targeting framework, noting that it has kept inflation expectations well anchored. While recognizing the difficulties in determining the precise timing for starting the tightening cycle in light of the uncertain global environment, Directors encouraged the authorities to remain vigilant about the pass through of high international food and fuel prices. In this context, they noted that a pronounced increase in wages or inflation expectations would call for policy tightening sooner than currently envisaged.

As a policy response to capital inflows, Directors supported continued exchange rate flexibility and further accumulation of international reserves, and a gradual recalibration in the fiscal-monetary policy mix over the medium term. Directors noted that, while capital flow management measures are an option, their costs and effectiveness should be carefully considered.

Directors stressed that increased product and labor market flexibility is critical to improve competitiveness and inequality. They encouraged the authorities to take decisive steps to improve the wage-bargaining framework to better align wages to productivity levels, and to contain public sector wage increases to avoid distortions in the private sector wage setting. They also supported more ambitious efforts to remove barriers to entry in key industries to facilitate greater product market competition.

Directors noted that the banking system remains sound, with banks being liquid and well capitalized. Nevertheless, continued vigilance would be important in light of the moderate impaired advances on bank balance sheets, the banks' dependence on domestic short-term wholesale deposits, high household indebtedness, and the renewed tensions in the international financial markets. Directors agreed that the shift toward a "twin peaks" regulatory and supervisory framework envisaged over the next few years would further improve the consolidated supervision of financial groups and lift the status of market conduct regulation and supervision.

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 2011 Article IV Consultation with South Africa is also available.

South Africa: Selected Economic and Financial Indicators, 2007–11

(Annual percent change; unless otherwise indicated)

	2007	2008	2009	2010	2011 Proj.
Real GDP	5.6	3.6	-1.7	2.8	4.0
CPI (end of period) 1/,2/	9.0	10.1	6.3	3.5	6.1
Unemployment rate (percent)	22.7	21.9	24.3	24.8	24.4
Broad money 2/	23.6	14.8	1.8	6.9	16.6
National government budget balance (percent of GDP) 3/	0.8	-0.6	-5.4	-5.4	-4.3
National government debt (percent of GDP) 3/	28.3	27.3	31.5	35.1	36.6
External current account balance (percent of GDP)	-7.0	-7.1	-4.1	-2.8	-3.4
External debt (percent of GDP)	26.4	26.4	27.7	27.1	24.4
Gross reserves (SARB, in months of next year's total imports)	4.0	3.8	5.9	5.3	5.6
International liquidity position of SARB (in billions of U.S. dollars) 2/	31.3	33.5	39.0	43.4	45.9
U.S. dollar exchange rate (rand per U.S. dollar) 2/	6.8	9.3	7.4	6.6	7.2

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

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

2/ End of period.

3/ Calendar year.

Statement by Mr. Majoro on South Africa
July 25, 2011

The South African economic recovery is progressing well with both monetary and fiscal policies remaining supportive. The key challenge remains employment creation and this is the main policy priority going forward. Given limited scope in both fiscal and monetary policy, the focus is on microeconomic policies and reforms that will stimulate job creation. These include reforming the product and labor markets with the objective of raising potential growth and increasing the labor intensity of growth.

Economic Developments and Outlook

The South African economy continues to recover. Following an average growth rate of 2.8 percent in 2010, the economy gained further traction in the first quarter of 2011 with real GDP expanding at an annualized rate of 4.8 percent. This higher-than-expected growth was mainly attributable to a rebound in manufacturing output. Notwithstanding this rebound, aggregate production in manufacturing remained well below pre-crisis levels and capacity utilization rose only marginally, suggesting room for improvement. Going forward, the authorities expect GDP to rise by about 3.9 percent in 2011—roughly in line with staff forecast.

Strong increases in real consumption expenditure by the household sector continue to provide the main impetus to domestic final demand. On the back of rising disposable incomes, declining household indebtedness ratio and accommodative monetary policy stance, consumption should continue to be the major driving force in the recovery. Exports and investment continue to perform below authorities' expectations, but are expected to accelerate as overall growth in global activity picks up. The current-account deficit of 3.1 per cent of GDP was recorded in the first quarter of 2011.

Headline consumer price inflation remained relatively well contained and has averaged 4.3 percent in 2010. The authorities expect inflation to average 5.1 percent in 2011, well within the inflation target range of 3 to 6 per cent. The main risks to the inflation outlook continue to emanate from cost push pressures, including administered, food and fuel prices.

Fiscal Policy

Due to a robust fiscal policy framework and sound management of public finances, the South African economy entered the 2008-2009 recession with healthy public finances and comparatively low debt levels. This allowed for a flexible counter-cyclical response to deteriorating economic conditions. Going forward, the authorities will continue to ensure that fiscal policy remains counter cyclical. The projected budget deficit in 2010/11 is 5.3 per cent of GDP, but as economic growth strengthens and tax revenue recovers, government will reduce the budget deficit gradually to 3.8 per cent of GDP by 2013/14. The authorities are comfortable with the debt-to-GDP ratio of 40 percent or lower given the country' development needs.

The 2011 Budget underscored that fiscal policy continues to be guided by three principles: a moderate public debt, counter cyclicality, and inter-temporal fairness. In addition, there are a number of reforms underway to enhance the effectiveness and efficiency of public spending. As detailed in the staff report, these include increasing the absorption capacity of municipalities and provinces. In particular, efforts are under way to enhance planning for health, education, and housing infrastructure, to improve risk and financial management as well as capacity at both provincial and municipal government levels.

Monetary Policy

Anchored on an inflation targeting framework, monetary policy's objective remains price stability. In response to the financial crises the Monetary Policy Committee (MPC) reduced the policy rate by a cumulative 150 basis points during 2010, thereby bringing the nominal and real policy rates to their lowest levels in over 30 years. At the time of the Article IV consultation, the authorities discerned no evidence of demand pressures on inflation, given the slow pace of recovery. However, the average level of wage settlements, which stood at 8.2 per cent in 2010, is set to continue. These settlements are far above inflation rates and together with rising food and fuel prices pose an upward risk to the inflation outlook. Given these risks, the MPC will continue monitoring closely any indications of inflationary pressures, particularly those emanating from second round effects of food and fuel prices increases. The MPC will not hesitate to respond timeously to signs that threaten to move inflation out of the target range on a sustained basis.

Reforming the product and labor markets

The South African authorities have declared job creation as the top priority for economic policy. In this regard, the government has launched, in November 2010, the New Growth Path (NGP), whose core objective is to create five million jobs and reduce the unemployment rate by 10 percentage points in the next decade. Meeting the jobs creation target would require either higher economic growth or more labor-intensive growth. The authorities agree with staff that with sustained economic growth of 6 – 7 percent, the target should be achievable even with current levels of job-intensity. The challenge is to increase growth rate from the expected 4 percent to the required 6 – 7 percent. While the authorities recognize that views differ on the achievability of these goals, there are, nonetheless, a variety of initiatives currently under way to increase potential output, which would enable economic growth to increase without undue impact on inflation.

The NGP calls for wage moderation although details still have to be worked out. Staff has proposed ways of achieving moderation in wage growth including, through an accord between government, employers and trade unions to limit real wage increases to 1 to 2 percent for the next several years and to introduce changes to the sector wide wage bargaining system. The authorities appreciate these inputs although they recognize that the tendency of bargaining objectives to prioritize wage increases has complex historical roots and thus would be cautious in immediately proposing measures that would infringe on labor rights of collective bargaining.

The youth wage subsidy outlined in the 2011 budget should help better align pay and productivity for new job market entrants. In addition, the budget also provides support for private initiatives with a strong job-creating component. In the product markets, the competition commission is aggressively tackling anticompetitive practices in key industries and more still need to be done. The authorities concur with the staff proposal that a more forceful approach to strengthen competition in product markets is called for to create new employment opportunities and increase the purchasing power of earnings. As suggested by staff, the authorities continue to look for ways to attract new entrants into key network industries like telecoms, rail and road haulage, and energy generation which could also help improve efficiency and reduce the cost of production.

Financial Stability

The macro prudential risks in South Africa are moderate, although the financial system concentration and interconnectedness requires continuous vigilance. In this regard, the authorities have implemented many FSAP/ROSC recommendations and have started preparing for the eventual implementation of Basel III. A new risk-based solvency regime for short- and long-term insurers is being developed by the Financial Services Board (FSB) to enhance the soundness of the insurance sector. Other regulatory initiatives include regulating systemically important financial institutions (SIFIs), expanding the scope of financial regulation and improving the financial crisis resolution framework.

The South African Reserve Bank (SARB) has also enhanced and elevated the Financial Stability Committee (FSC) and it now consists of all the members of the MPC and other members with financial stability responsibilities at the SARB.

Additionally, as mentioned in the staff report, over the next few years, the authorities intend to move toward a "twin peaks" regulatory and supervisory framework, i.e. the concentration of prudential authority at one peak and market conduct authority at another. All these measures should enhance the robustness of the South African financial sector going forward. The authorities recognize that given the uncertainty in global financial developments there is little room for complacency.

Capital flows

South Africa has been one of the main recipients of portfolio flows over the last year. So far the authorities have mainly used reserve accumulation to manage these flows and this will continue. The authorities consider other Capital Flow Management (CFM) measures as potentially useful tools that are at their disposal, although they currently see no need to utilize them. The authorities understand that these tools are country specific and thus deciding on their adoption requires a close look at each country's economic circumstances. As the staff report pointed out, curtailing inflows while the country is also relying on them to finance domestic consumption and investment may not always be appropriate.

The recent exchange rate appreciation in South Africa is partly attributable to capital inflows. The authorities consider this an essential part of a flexible exchange rate regime which has, so far, provided a useful shock absorber for South Africa. At the same time the appreciated exchange rate may have negatively affected the country's competitiveness and thus exports. The authorities agree with staff that the cost of production is also an important factor influencing competitiveness. In this regard, the labor and product market reforms, as the staff report pointed out, should help improve South Africa's competiveness. The authorities also believe that weak export performance in South Africa is also attributable to weak export demand by major trading partners, and as growth picks up in major trading partners, export demand should rise.

A variety of export incentive schemes, such as the Export Marketing & Investment Assistance Scheme, administered by the Department of Trade and Industry are also in place to improve export performance. Going forward, the South African authorities will continue looking for ways to improve export performance, including engaging in efforts to establish a free trade zone between the East African Community, the Common Market for East and Southern Africa and the SADC.