January 2003
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South Africa: 2002 Article IV Consultation—Staff Report; Staff Statement; 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 2002 Article IV consultation with **South Africa**, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 11, 2002,** with the officials of South Africa on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 6, 2002.** 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 statement of **July 1, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 1, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for South Africa.

The document(s) listed below will be separately released.

Selected Issues

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 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with South Africa

Approved by José Fajgenbaum and Masood Ahmed

June 6, 2002

- The 2002 Article IV consultation discussions were held in Pretoria and Cape Town during March 27–April 11, 2002. The staff team met with the Ministers of Finance and Agriculture; the Governor of the South African Reserve Bank; senior officials in the Ministries of Trade and Industry, Public Service, Education, Health, and Labour; and representatives of the private sector, the trade union movement, community organizations, and the academic community.

- The staff team comprised Mr. Nowak (head-AFR), Mr. Arora (AFR), Mr. Arvanitis (PDR), Mr. Barnett (FAD), Mr. Ricci (AFR), Mr. Vocke (AFR), and Mr. Bhundia (AFR). Mr. Ibrahim, the Fund's Resident Representative in Pretoria, and Mr. Milton, Advisor to the Executive Director for South Africa, also participated in the discussions. Prior to the discussions, members of the mission met with market analysts in London. The mission overlapped with an FAD team conducting a Report on the Observance of Standards and Codes (ROSC) (Fiscal Transparency Module).

- At the conclusion of the previous Article IV consultation on March 16, 2001, Directors commended the authorities for a continued improvement in economic performance and the reduced vulnerability of the economy to external shocks. They emphasized, however, a need to step up efforts to combat poverty and the AIDS pandemic, and to raise investment and growth on a sustained basis to lower unemployment. They saw structural reforms in the labor market, privatization, and trade liberalization as being crucial for meeting these challenges.

- South Africa accepted the obligations of Article VIII in 1973 and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- South Africa's relations with the IMF, including recent technical assistance, are summarized in Appendix I, and its relations with the World Bank Group in Appendix II. Statistical issues, including social and demographic indicators, are discussed in Appendix III. The quality and timeliness of South Africa's reporting of economic and financial data is generally satisfactory for conducting surveillance, but weaknesses remain in the reporting of key labor market statistics.

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Executive summary

- **South Africa felt the impact of the slowdown in global economic activity in 2001.** A contraction in overseas demand contributed to a fall in real GDP growth to 2.2 percent. However, a modest economic recovery is now underway, fueled by a sustained real depreciation of the rand and increases in commodity prices. Real GDP growth is expected to rise to 2½ percent in 2002 and 3 percent in 2003.

- **Fiscal policy continues to be sound.** The fiscal deficit in 2001/02 was 1.5 percent of GDP, which is much lower than originally targeted. The budget for 2002/03 appropriately foresees an expansion in the deficit to 2.1 percent of GDP, reflecting tax relief for low- and middle-income earners and higher spending on poverty reduction and HIV/AIDS.

- **The rand depreciated sharply during the final quarter of 2001.** This reflected a range of factors, including looser monetary conditions and delays in the privatization program, and occurred despite continued fiscal restraint and a reduction in the central bank's short-term foreign currency exposure. Some exchange rate overshooting appears to have occurred, and the rand has since recovered much of its value.

- **Higher monetary growth and the currency depreciation have been feeding through to prices.** Inflation appears likely to exceed the official target of 3-6 percent in 2002, but the authorities are committed to meeting the targets for 2003 and beyond, and have raised interest rates in response. Credit conditions may need to be tightened further to dampen inflationary expectations and sustain credibility in the inflation-targeting framework.

- **The stabilization effort alone will not be sufficient to raise economic growth and reduce poverty.** Structural factors that have held down growth performance include chronic skills shortages and labor market rigidities that contribute to high unemployment; the slow pace of privatization, which has inhibited foreign investment; and the impact of HIV/AIDS.

- **The government is making a determined effort to address South Africa's acute unemployment problem**. In particular, a comprehensive program for raising educational standards and providing job training is being implemented, although the reliance on a payroll tax for financing the program may have a negative impact on job creation. The government is about to pass a number of amendments to the labor laws that are aimed at reducing labor costs while protecting workers' rights. The staff welcomes the amendments as an important first step, but encourages the government to continue to keep labor legislation under review and allow for greater decentralization of the collective bargaining system.

- **The authorities have indicated that they are taking steps to bring the privatization program back on track.** Telkom, the state telecommunications company, is expected to be divested by March 2003 and efforts are under way to finalize needed regulatory changes in the telecommunications and power sectors. Good progress is now being made in divesting, or preparing for sale, a number of noncore public assets.

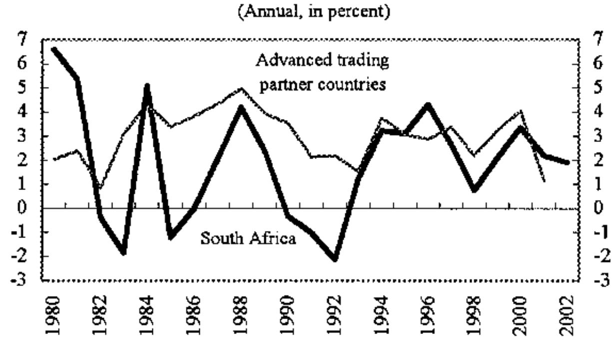
- **The spread of HIV/AIDS and its macroeconomic impact are hard to predict, but it is likely that both life expectancy and economic growth will be significantly reduced.** The government has adopted a multisectoral approach for combating the disease, and it is treating the epidemic as a fiscal priority while ensuring that budgetary funds are well spent.

I. Recent Developments

> - *The pace of economic activity in South Africa slowed during 2001 in response to the global downturn. A modest recovery now appears to be under way.*
> - *A tightening of fiscal policy, accompanied by an easing in credit conditions, contributed to lower real interest rates in 2001. This policy mix has been reversed in 2002.*
> - *The rand depreciated sharply during the final quarter of 2001, but it has since regained much of its value. The depreciation is now feeding through into higher inflation.*
> - *Further progress has been made in reducing the central bank's short-term foreign currency exposure.*

1. **The South African economy felt the impact of the slowdown in global economic activity during 2001**. Driven primarily by a contraction in overseas demand that lowered both export prices and volumes, real GDP growth fell to 2.2 percent in 2001 from 3.4 percent in 2000 (Table 1). Activity reached a trough in the third quarter, with growth slowing to just over 1 percent at an annualized rate. The downturn during this business cycle, however, has been far less severe than in previous cycles, and compares quite favorably with that of most other emerging markets (Figure 1).

Figure 1. Real GDP Growth, 1980-2002Q1
(Annual, in percent)



2. **A number of factors have helped strengthen the resilience of the South African economy to external shocks.** Most notably, extensive trade liberalization undertaken in the 1990s, supported by a depreciated exchange rate, has rendered the economy more competitive and the export base more diversified.[1] Consequently, South Africa's trade performance, helped by some improvement in the terms of trade, was relatively strong during this downturn, and the current account deficit narrowed to

[1] The share of manufacturing in total exports rose each year between 1994 and 2001 from 24 percent to 38 percent.

0.1 percent of GDP in 2001 (Figure 2 and Table 2). At the same time, industrial profitability has been boosted by lower borrowing and input costs. In particular, both real interest rates and real unit labor costs have declined markedly since 1998 (Figure 3).[2] As a result, domestic demand held up relatively well in 2001, and both fixed investment and household consumption grew by around 3 percent. Employment conditions appear to have worsened, however, and the unemployment rate rose to 29 percent in September 2001, from 26 percent in February 2001.[3]

Figure 2. External Current Account, Trade Balance, and Real Effective Exchange Rate (REER), 1994-2001

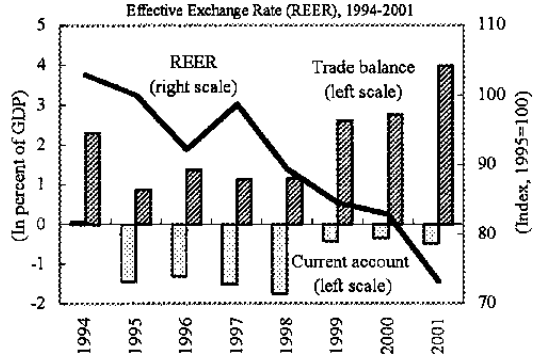
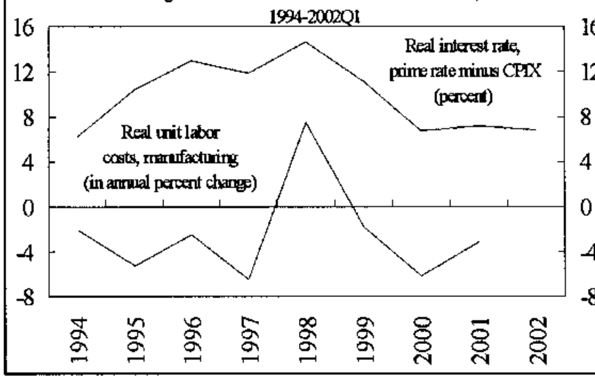
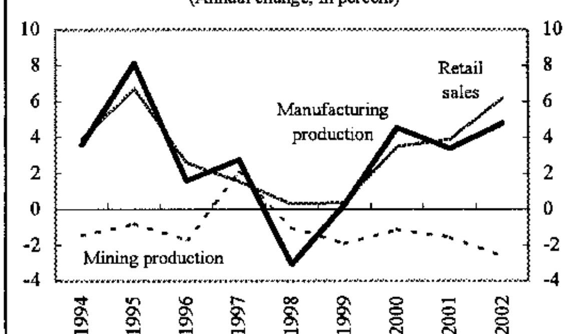


Figure 3. Real Interest Rate and Unit Labor Costs, 1994-2002Q1



3. **A modest economic recovery is under way**. The upturn has been fueled in large part by the sustained real depreciation of the rand and, more recently, by the prospect of an expansion in overseas activity and a firming of gold and other commodity prices. Real GDP grew at well over 2 percent at an annualized rate during the past two quarters, while the most recent data on manufacturing, retail sales, and trade also suggest a relatively buoyant demand picture (Figure 4). The stock

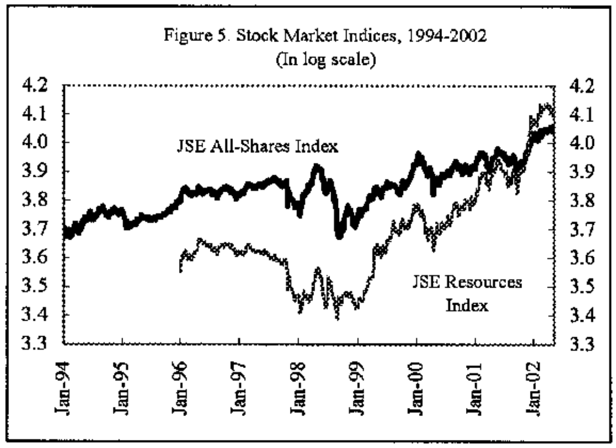
Figure 4. Manufacturing and Mining Production, and Retail Sales, 1994-2002Q1
(Annual change, in percent)



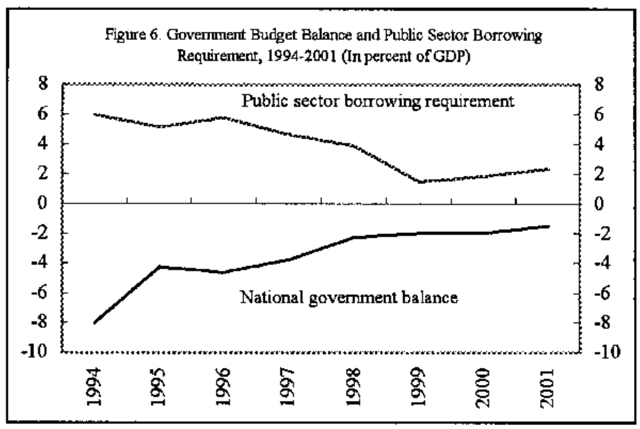
[2] The fall in real unit labor costs reflects wage moderation and large productivity gains that appear to stem largely from the shedding of labor.

[3] These data are based on semi-annual surveys and are subject to considerable measurement errors. They also exclude "discouraged" workers; when such workers are included, the unemployment rate rose from 37 percent to 41 percent over the period.

market has been at or close to record levels (Figure 5), and business confidence indices reached a six-year high in March 2002. This year's grain harvest was very good. Real GDP growth in 2002-03 is, therefore, expected to rise to South Africa's trend growth rate of around 3 percent.



4. **Fiscal discipline has been maintained over the past year**. The national budget deficit shrank to 1.5 percent of GDP in 2001/02 (April-March), from 2.0 percent in 2000/01 (Figure 6 and Table 3). This outturn, which compares with an original target for the deficit of 2.5 percent of GDP, was attributable to strong revenue growth backed by steps taken to strengthen expenditure monitoring and control. The provincial budgets also overperformed, and the consolidated deficit narrowed to an estimated 1.3 percent of GDP from 1.7 percent in 2000/01 (Table 4). The budget for 2002/03, which was presented to parliament in February, targets an increase in the national deficit to 2.1 percent of GDP; the provincial budgets are expected to be broadly in balance. Public debt as a share of GDP is projected to decline to around 40 percent in 2002/03, from 43 percent in 2001/02, and South Africa's medium-term debt dynamics remain comfortable.[4]



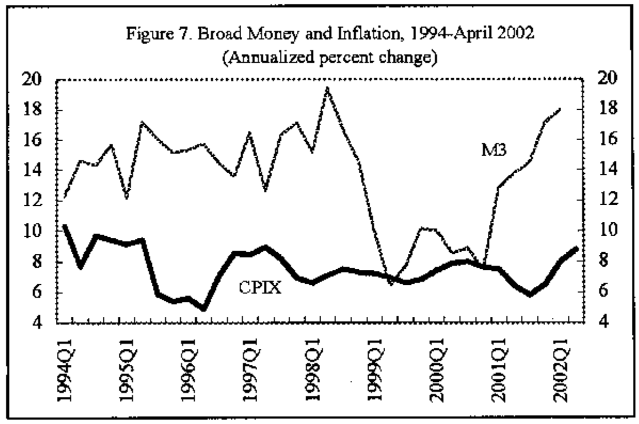
5. **South Africa adopted an inflation-targeting strategy in February 2000.** CPIX[5] inflation is targeted at 3-6 percent (on a period-average basis) for 2002 and 2003, and at 3-5 percent for 2004 and 2005.[6] Under the strategy, inflation was lowered to 5.8 percent (year-on-year) in September 2001 from 7.6 percent at the end of 2000. In response to the improved inflation outlook, a slowdown in

[4] The forthcoming selected issues paper provides an analysis of the debt outlook in South Africa.

[5] CPIX is the CPI less the interest on mortgage bonds.

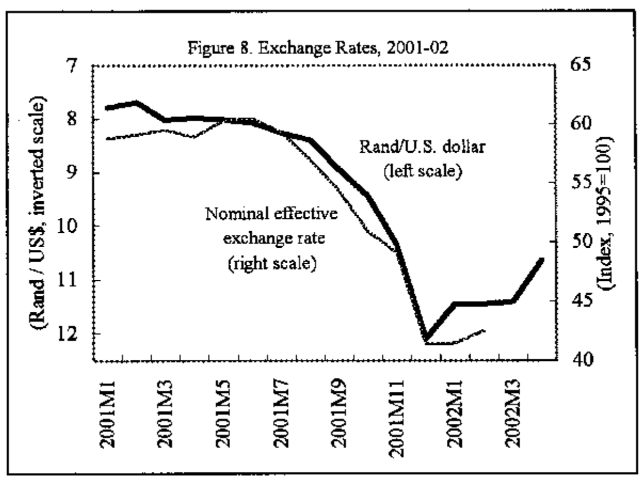
[6] Presently, the Monetary Policy Committee of the SARB meets quarterly to discuss progress in implementing inflation-targeting and to assess the inflation outlook. The Committee's reports are published.

domestic activity, and cuts in overseas interest rates, short-term policy interest rates were lowered by 100 basis points in June 2001 and by a further 50 points in September. The easing in credit conditions was reflected in a jump in M3 growth from 7.5 percent at the end of 2000 to 17 percent at the end of 2001 (Figure 7 and Table 5). To improve the SARB's control over short-term interest rates, a number of changes were made to the refinancing system in September 2001.[7]



6. **The effort to lower inflation suffered a severe setback during the final quarter of 2001 when the value of the rand dropped sharply (Figure 8)**. The currency had steadily lost value between January and August 2001, but the pace of depreciation picked up sharply toward the end of September. By mid-December, the rand was some 40 percent weaker in nominal effective terms than at the end of August. The currency subsequently regained much of its value, however, and at end-May 2002 was estimated to be around 15 percent weaker than at end-August 2001.

7. **In addition to the cuts in interest rates and associated increase in monetary growth, several other factors contributed to the currency depreciation:**



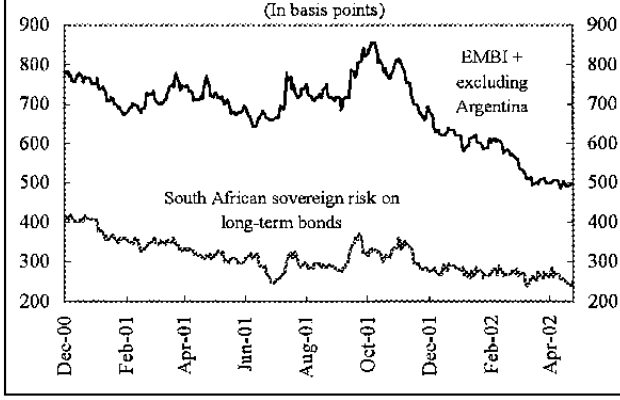
- The value of public assets that were to be sold under the privatization program fell sharply because of the depressed state of international telecommunications stocks. Delays were also experienced in putting the telecommunications regulatory framework in place.

[7] These changes included the replacement of daily repurchase auctions with weekly repurchase tenders and the introduction of intervention points to prevent unduly large fluctuations in interbank rates. They also involved a one-off "technical" reduction in the repurchase rate, which is the central bank's key policy instrument, of 100 basis points to bring it more in line with prevailing market rates; other short-term money market rates were not affected.

- Uncertainties emerged surrounding exchange control policy; initially there was speculation that all controls would be removed, but subsequently in October 2001 the SARB announced that it would tighten the enforcement of existing controls.[8]
- Overseas dividend payments increased markedly in the second and third quarters of 2001.
- Sentiment in the rand weakened as a result of the deterioration in the economic and political situation in Zimbabwe.

8. **The rapid slide in the rand occurred despite a number of positive macroeconomic developments.** In addition to the improved fiscal position, inflationary expectations softened as indicated by inflation surveys and falling long-term bond yields. Moreover, sovereign risk spreads on South African external debt fell during 2001 by 130 basis points, of which around 40 points occurred during the final quarter (Figure 9).[9] South Africa also earned a credit rating upgrade on its external debt from Moody's in November 2001 in recognition of its progress in achieving macroeconomic stability.[10]

Figure 9. Emerging Market Spreads, 2000-02
(In basis points)



9. **Consistent with the freely floating exchange rate regime, and in contrast to its strategy during the rand crisis of 1998, the SARB did not intervene in the foreign exchange market to support the rand in 2001** (Box 2). Since mid-December 2001 a number of policy steps have been taken that have helped strengthen the rand. The Minister of Finance and the Governor of the SARB announced that they were prepared to take whatever corrective action was necessary to contain the inflationary impact of the depreciation. Subsequently, short-term

[8] Some analysts have argued that this announcement lowered turnover in the foreign exchange market, which created the potential for volatile movements in the exchange rate. The link between turnover and the depreciation, however, is far from clear (see Box 1).

[9] The lower spreads reflected an increase in global risk appetite, leading to a decline in the spreads across emerging market economies, and the impact of a reduction in the SARB's net foreign currency exposure (see below).

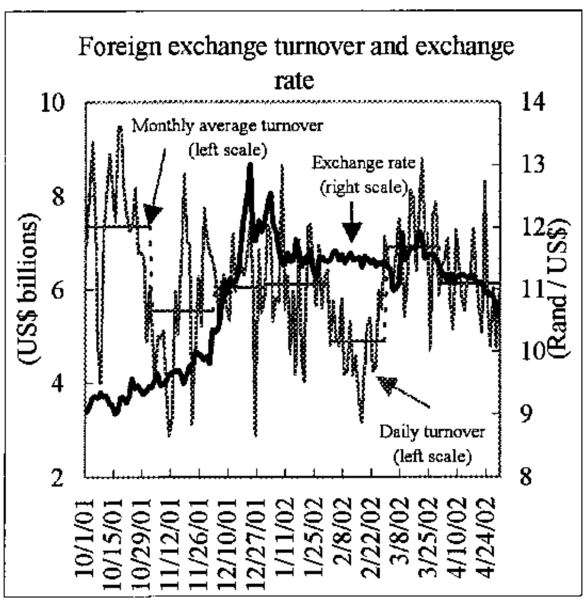
[10] The rating was raised from Baa3 to Baa2. Standard and Poor's and Fitch awarded South Africa an investment grade status of BBB- in 2000.

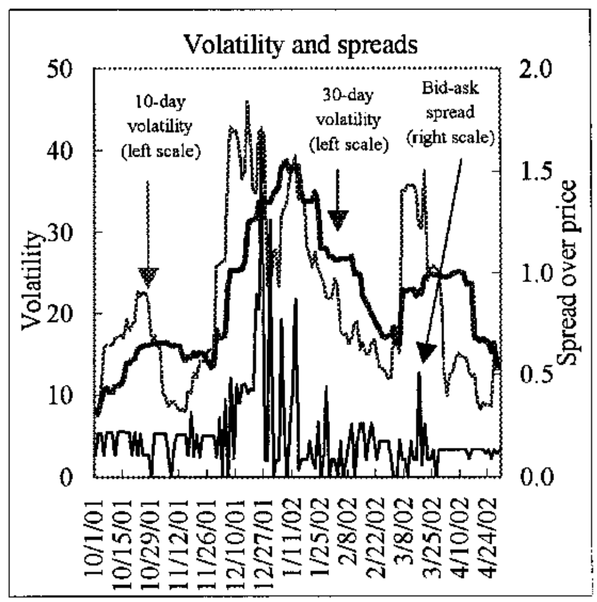
Box 1. Trading Volumes, Volatility, and Spreads in the Foreign Exchange Market

A number of observers, including some who testified before the Myburgh Commission, have argued that the SARB's announcement on October 14, 2001, that it would tighten the enforcement of exchange controls resulted in a marked reduction in market liquidity and higher bid-ask spreads, and thereby contributed to the sharp currency depreciation.

The data indicate that, while periods of sharp depreciation were accompanied by increased volatility and spreads, there appears to have been no clear link between market turnover and the pace of depreciation:

- While turnover fell sharply after the October announcement, there seems to have been little discernible impact on spreads and the rate of depreciation (see figure below).
- Average turnover recovered somewhat in December, although it remained lower than during the preannouncement period. However, the rate of depreciation increased sharply. The volatility of the exchange rate jumped markedly in December and this was accompanied by a rise in bid-ask spreads, consistent with the view that higher exchange rate volatility raises risk and pushes up spreads (see figure below).
- Market turnover declined to very low levels in February 2002, but the rand remained broadly stable. Spreads returned to the relatively low levels that prevailed before December.



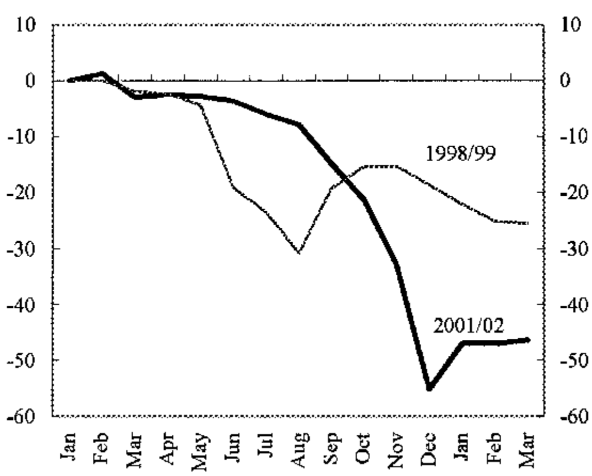


Box 2. The Currency Depreciation of 2001—A Comparison with the 1998 Episode

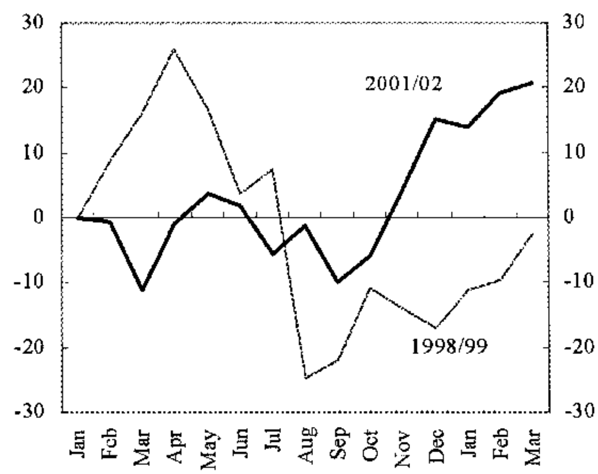
The currency depreciation in 2001 was different in many respects from the episode in 1998. In 1998, the rand depreciated by 28 percent in nominal terms against the U.S. dollar between end-April and end-August, accompanied by increases of around 700 basis points in short-term interest rates and long-term bond yields and of almost 400 basis points in sovereign U.S. dollar-denominated bond spreads. At the same time, share prices fell by 40 percent and output contracted during the third quarter of 1998 (quarter-on-quarter). In 2001, the rand depreciated by 26 percent in nominal terms against the U.S. dollar between end-September and end-December, but short-term rates remained stable; meanwhile long-term bond yields increased by less than 100 basis points and sovereign U.S. dollar-denominated bond spreads narrowed about 40 basis points. Share prices rose by 28 percent, and real GDP increased.

The varying macroeconomic outcomes during the two episodes partly reflect different economic policy responses. In 1998, the SARB initially relied heavily on intervention to support the currency. Consequently, between April and August 1998, the NOFP increased from US$12.8 billion to US$23.1 billion. Only once it became clear that this approach was not succeeding was greater reliance placed on the use of interest rates. The 2001 depreciation took place in a context of lower external vulnerability and the SARB did not intervene in the foreign exchange market nor did it raise interest rates, thereby allowing export-led growth to pick up during the fourth quarter of 2001 and into early 2002. Foreign capital moved out of the bond market into resource-based stocks as commodity prices were rising, leading to stronger stock prices. Furthermore, in 2001, the macroeconomic policy framework was more credible, reflecting a longer period of fiscal consolidation and the establishment of an inflation-targeting regime.

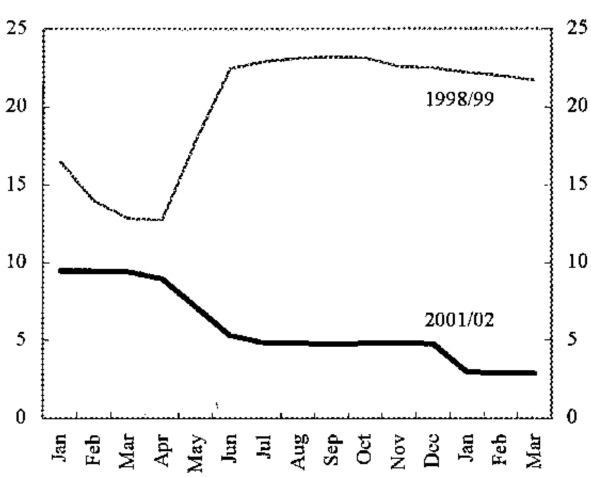
Exchange Rate
(In percent change from beginning of year)



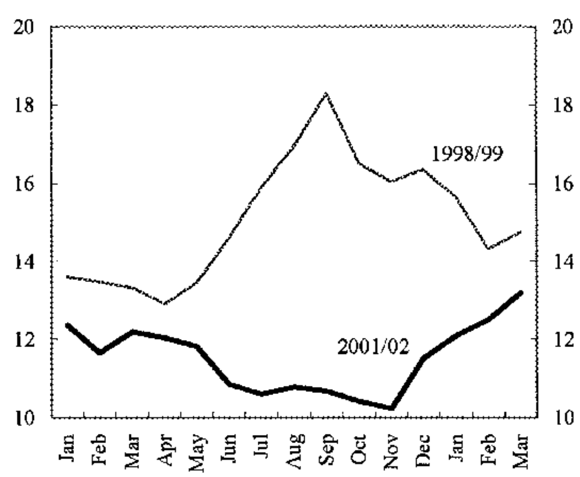
Johannesburg All-Shares Index
(In percent change from beginning of year)



Net Open Forward Position
(In billions of U.S. dollars)



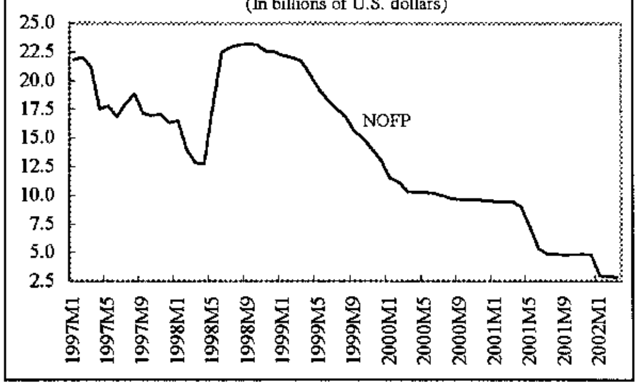
Long-Term Bond Yields
(In percent)



interest rates were raised by 100 basis points in January 2002 and again in March. The government also jump-started its privatization program by bringing forward the sale of a cell phone company and set up an inquiry to look into the reasons for the fall in the rand.[11] The rand received further support from increases in gold and platinum prices. The relatively strong recovery of the rand since the beginning of the year suggests that some exchange rate overshooting appears to have occurred.[12]

10. **The monetary expansion and currency depreciation have been feeding through to higher prices.** By April 2002, annual CPIX inflation had risen to 8.8 percent, driven by price increases for both imported and domestically produced goods, particularly food. The interest rate adjustments appear to have had some effect on tightening liquidity conditions; although the annual rate of money supply growth remained relatively high at 18 percent at the end of April, the monthly rate of increase slowed sharply.

Figure 10. Net Open Forward Position (NOFP), 1997-2002
(In billions of U.S. dollars)



11. **Despite the foreign exchange pressures, the SARB significantly reduced its net foreign currency exposure, which had in the past represented a major source of external vulnerability.** By end-May 2002, the NOFP had been lowered to less than US$2 billion from a peak of over US$23 billion in October 1998 (Figure 10).[13] The reduction during 2001 and 2002 had been made possible by the retention of proceeds from the sale of the De Beers mining company, privatization, and external official borrowing.[14]

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[11] Specifically, in February 2002 President Mbeki established a commission of inquiry, headed by Judge Myburgh, to investigate whether exchange control violations had contributed to the depreciation of the rand during 2001. A final report is expected to be completed by the end of June 2002.

[12] Boxes 3 and 4 discuss alternative, but mutually consistent, reasons why the rand has been reverting to a more appreciated real level.

[13] The NOFP (net open forward position) is the SARB's open position in the forward market less its net international reserves.

[14] Because of the one-off nature of these proceeds, it is unlikely that their purchase by the SARB significantly contributed to the depreciation of the rand. Moreover, had the proceeds been sold in the market, the relief provided to the rand would probably have been temporary.

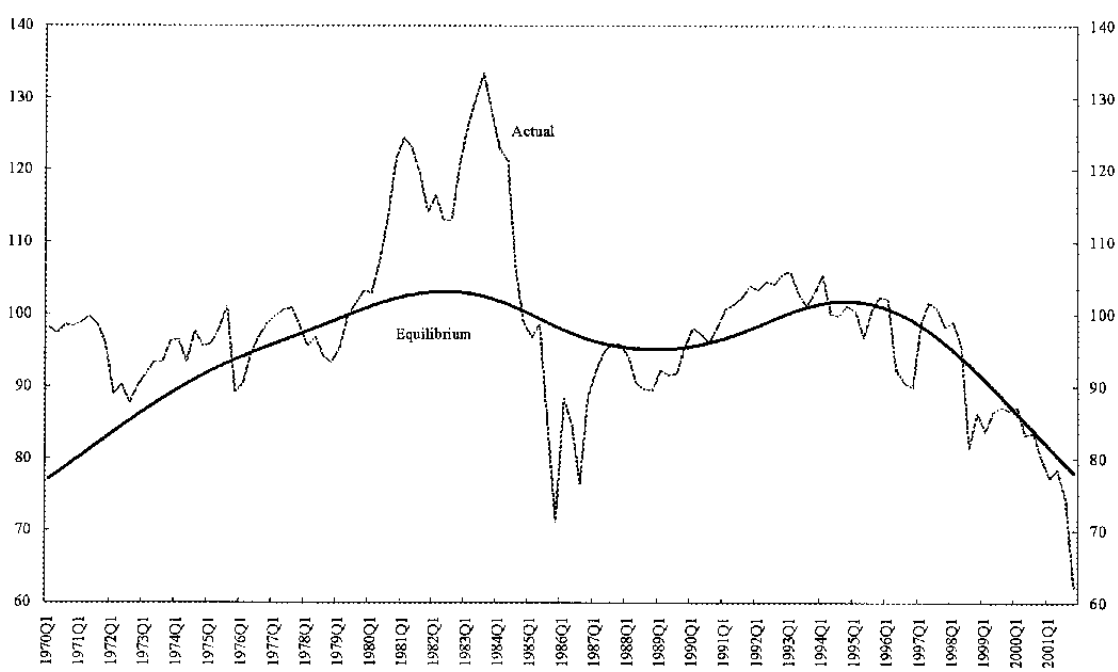
Box 3. Real Exchange Rate Developments

When assessed on the basis of objective economic indicators, a staff study suggests that the substantial depreciation of the real effective exchange rate in South Africa during 1995-2001 (about 40 percent) may have driven the real exchange rate below its equilibrium level.[1] These indicators include commodity price movements, productivity and real interest rate differentials vis-à-vis trading partner countries, measures of openness, and the size of the fiscal balance.

In 1995, the real exchange rate appears to have been close to its equilibrium level, and about half of its depreciation since then can be accounted for by the indicators mentioned above (see figure below). In the fourth quarter of 2001, the average level of the rand (R 10.1 per U.S. dollar) was some 15 to 25 percent more depreciated than a level consistent with the equilibrium of the real exchange rate, the range depending upon different ways of distinguishing between permanent and temporary movements in the explanatory variables.[2] These calculations may, however, overestimate the equilibrium exchange rate to the extent that they do not account for structural factors, such as high unemployment and the HIV/AIDS pandemic, in which case the gap would be correspondingly smaller.

If the real exchange rate is deviating from its equilibrium level due to temporary financial factors, one would expect the real exchange rate to revert to equilibrium over time. Staff estimates suggest that, in the absence of further shocks, around half of the gap could be eliminated within two to three years.

Real Effective Exchange Rate: Actual vs. Equilibrium Level, 1970-2001



[1] See "Estimating the Equilibrium Real Exchange Rate for South Africa" in the forthcoming selected issues paper.

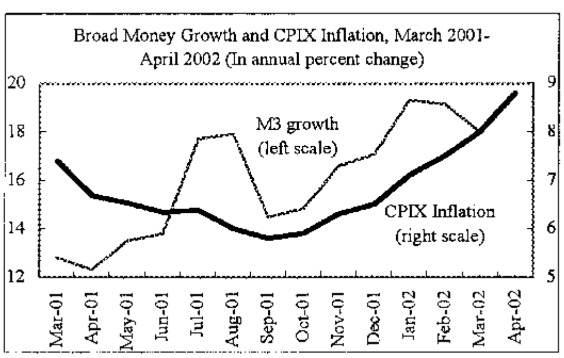
[2] In May 2002, when the rand averaged R 10.2 per U.S. dollar, the real exchange rate (and its equilibrium gap) was close to its level in the last quarter of 2001.

Box 4. Monetary Shocks and Exchange Rate Overshooting

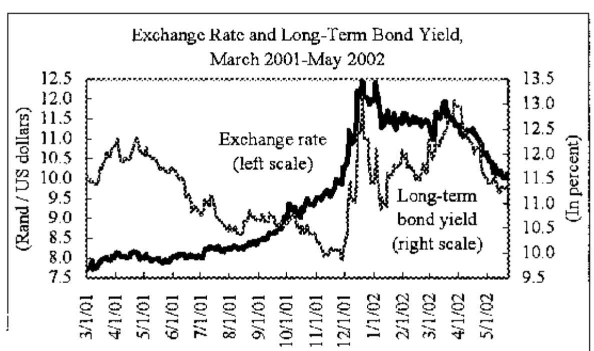
Recent monetary and exchange rate developments bear some striking similarities to the predictions presented in Dornbusch's seminal paper on exchange rate dynamics.[1] The paper argues that an increase in the money supply could lead to an overshooting of the exchange rate in a world of sticky goods prices, high capital mobility, and rational expectations. The hypothesis is that a decline in interest rates associated with the increase in real money balances would, via the interest parity condition, need to be accompanied by the expectation of a currency appreciation. Since in the long run the currency must depreciate in response to the monetary expansion, the only way the appreciation could occur was if the currency were initially to overshoot. Interest rates would increase as the currency recovered, and prices would eventually rise in response to the favorable impact of the real currency depreciation on growth.

Dornbusch's model appears to explain certain of the recent developments in South Africa. A pickup in the rate of monetary expansion from around midyear was followed by a sharp depreciation of the currency during the final quarter. Moreover, bond yields continued to fall until around the time the currency was at its weakest and, according to surveys, inflationary expectations began to harden. (The coexistence of a rapid depreciation and falling bond yields puzzled most market analysts at the time). After the currency "overshot" and began to recover in value, bond yields rose, the pace of economic activity picked up, and inflation increased. The reversion of the exchange rate to its long-run equilibrium level is discussed in Box 3.

However, some of the assumptions in Dornbusch's model may not entirely apply to the South African case (for example, there are capital controls on residents). Moreover, at no time while the currency appreciated after its trough in December 2001 was the rand at a premium in the forward market, as the model would have predicted. This can perhaps be explained by the joint Treasury/SARB announcement made toward the end of December that gave rise to the expectation of a tightening in monetary policy, thereby setting up a process of overshooting in the opposite direction.



Broad Money Growth and CPIX Inflation, March 2001-April 2002 (In annual percent change)



Exchange Rate and Long-Term Bond Yield, March 2001-May 2002

[1] R. Dornbusch, 1976, "Expectations and Exchange Rate Dynamics," *Journal of Political Economy*, Vol. 84, No.6, pp1161-1176.

II. Report on The Discussions

A. Economic and Social Policy Framework

12. **The task of elevating economic growth to a higher plateau in a manner that raises living standards across the board constitutes the central policy challenge facing South Africa.** It therefore formed the core of the policy discussions. Since 1994, when the present government came to power, South Africa's growth rate has averaged 2.7 percent per year, which compares with an average rate of 1 percent during 1980–93 (see table below). This increase in growth, which reflects gains in total factor productivity, is welcome, but it will not be sufficient to make appreciable inroads into reducing unemployment or poverty.

South Africa: Sources of Growth
(contributions, in percentage points; unless otherwise indicated)

	1980-93	1994-2001
Annual real GDP growth (percent)	1.0	2.7
Labor	0.1	-0.9
Capital	0.9	0.6
Total factor productivity	0.0	3.0

Sources: Statistics South Africa; and staff estimates.

13. **The government has made major strides in reducing macroeconomic imbalances since 1994.** An inflation-targeting framework is in place, and a marked strengthening in government finances has contributed to an improved external current account. South Africa's international reserve position has improved considerably, and its medium- and long-term external debt exposure is low by emerging market standards. Financial institutions are adequately capitalized and well regulated. These elements provide the necessary foundation for achieving the sound and stable economic environment that is essential for higher growth.

14. **Relatively high real interest rates and the prospect of rising inflation, however, pose risks to growth in the near term.** Maintaining a prudent fiscal stance and persevering with the effort to reduce inflation will help preserve gains in external competitiveness, stabilize the exchange rate, and ease pressure on interest rates. In addition, a continued buildup in international reserves should contribute to a further lowering of risk spreads and long-term borrowing costs.

15. **Investment has been inhibited by a number of factors.** In the virtual absence of saving by the household sector, investment has remained anchored at around 15 percent of GDP, and is only likely to rise if South Africa can attract more foreign investment. So far, this investment has failed to materialize in any significant amount; indeed, outward foreign

investment has been considerable.[15] Investor confidence has been unsettled by delays and uncertainties in implementing the privatization program, the incidence of urban crime, and the HIV/AIDS pandemic. Moreover, although considerable progress has been made in promoting industrial development, uncompetitive corporate tax rates and relatively high protection for some sectors, such as textiles, have discouraged investment. Investor sentiment has also been adversely affected by developments in Zimbabwe and concerns that South Africa's land reform program, which is market based and respectful of property rights, may be moving too slowly.

16. **Higher investment alone, however, will not necessarily lead to an alleviation of South Africa's chronic unemployment problem.** To make labor more competitive and to reverse a secular increase in the capital-labor ratio, worker productivity needs to be raised and labor costs reduced so that new investment absorbs rather than displaces labor. Enhancing job skills among the unemployed and easing labor market rigidities should be an integral part of this effort.

17. **The government has increased budgetary allocations for the social sectors and taken steps to improve the quality of social services** (Box 5). These efforts are reflected in a marked improvement in social indicators relating to education and access to basic amenities. Life expectancy, however, has declined significantly because of the HIV/AIDS pandemic (Box 6).

B. Macroeconomic Stabilization

Inflation-targeting and interest rate policy

18. **On the basis of a number of objective indicators, such as movements in real commodity prices, the rand presently appears to be undervalued.**[16] If pressures for some real exchange rate appreciation persist, the monetary authorities will need to ensure that it takes the form of a nominal currency appreciation, rather than a resurgence in inflation. The appreciation of the rand since the beginning of the year indicates some success in this regard.

19. **The mission argued that, if inflation were allowed to rise significantly above target for any appreciable period of time, the inflation-targeting strategy could lose credibility and the effort to bring inflation back down could be prolonged and costly in terms of output losses.** It was critical, therefore, that the SARB make every effort to contain

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[15] Excluding inflows associated with the takeover of De Beers, foreign direct investment amounted to only 0.5 percent of GDP in 2001. Outward investment, on the other hand, amounted to nearly 2 percent of GDP.

[16] As indicated in Box 3, however, these indicators do not capture the possible impact on South Africa's long-term growth prospects of factors such as high unemployment, HIV/AIDS, and social inequalities.

Box 5. Trends in Social Development Indicators

In recent years, the reduction in the budget deficit has been accompanied by a reorientation of expenditure aimed at reducing poverty and creating conditions that are more conducive to economic growth. Spending on welfare, crime prevention, health, and education all have grown in relation to GDP, while defense outlays have declined (see table below). At the same time, the government has also worked to increase the efficiency of its spending.

Functional Classification of Consolidated National and Provincial Noninterest Expenditures, 1993/94-2001/02

	1993/94 [1/]	2001/2002	Change in Percentage
	(In percent of GDP)		Points of GDP
Social security and welfare	2.3	3.4	1.1
Crime prevention (police, prisons, courts)	2.3	3.0	0.7
Health	2.9	3.2	0.3
Education	5.5	5.6	0.1
Housing and other social services	1.0	0.9	-0.1
Defense and intelligence	2.4	1.8	-0.6

Source: National Treasury.
[1/] Excludes the unemployment insurance fund and some work compensation funds.

The reorientation of spending has contributed to an improvement in a range of social development indicators (see table below). Both the adult literacy rate and the primary-to-tertiary enrollment ratio have increased, approaching or surpassing the averages for middle-income countries. Access to improved water sources and sanitation coverage have shown similar improvements, thereby raising South Africa's indicators above global averages. However, a significant rise in the HIV prevalence rate, from below 8 percent of the working-age population in 1994 to nearly 20 percent in 1999, led to a marked decline in life expectancy from 64 years to 54 years, which is well below the average of low-income countries; this resulted in a modest deterioration in the human development index.

Human Development Indicators

	South Africa		Low-Income Countries	Middle-Income Countries
	1994	1999	1999	1999
Adult literacy rate (in percent)	82	85	62	86
Combined primary, secondary, and tertiary enrollment ratio (in percent)	81	93	51	74
Access to improved water source (in percent of population)	70	86	82 [1/]	82 [1/]
Sanitation coverage (in percent of population)	46	86	60 [1/]	60 [1/]
Life expectancy at birth (years)	63.7	53.9	59.4	69.5
HIV prevalence rate (in percent of working-age population)	7.6	19.9	< 2 [2/]	< 2 [2/]
Human development index [3/]	0.72	0.70	0.55	0.74

[1/] Global WHO estimate across all country income groups.
[2/] UNAIDS estimate.
[3/] UNDP composite index to quantify the level of human development across different dimensions.
Sources: UNDP, *Human Development Report*, 1997 and 2001; UNAIDS database, 2002; and World Health Organization (WHO), *Global Water Supply and Sanitation Assessment*, 2000.

Box 6. The Economic Impact of HIV/AIDS

HIV/AIDS in South Africa is now at pandemic proportions and is likely to have a significant economic impact in the next decade.[1] HIV currently infects around 5 million of people (or 11 percent of the population), up from fewer than 200,000 people (less than 1 percent of the population) in 1990. Prevalence rates are higher among the working-age population (20 percent), and concentrated among the unemployed, unskilled workers, and pregnant women. They are also higher in the central provinces than in other regions.

Without drastic policy measures and changes in social behavior, HIV/AIDS can be expected to continue spreading and to take a heavy toll on the population and the labor force. Between now and 2010, around 10-15 percent of the population could die from AIDS-related diseases; population and labor force growth could slow to zero (compared with a non-HIV/AIDS baseline projection of 1.5 percent); life expectancy could drop to 38 years from the current level of close to 54 years; and the HIV infection rate could reach 15 percent of the population and 25 percent of the labor force.

The economic impact of HIV/AIDS can be expected to occur gradually over the next decade or so. Different studies have produced a wide range of estimates for the impact on output and income per capita, depending on the projected developments in labor force, unemployment, productivity, and population. The decline in the labor force could have a large negative impact on output growth, partly offset by a possible reduction in unemployment as firms replace disabled workers. On the other hand, productivity could rise because of an increase in the average skills of labor induced by the disproportionate effect of HIV/AIDS on unskilled workers; on the other hand, productivity could fall due to absenteeism and sickness. As a result, the decline in output growth relative to a non-AIDS baseline scenario could range between 0.5 and 2.5 percentage points annually, while per capita income growth could be up to 1 percentage point per year above or below the baseline scenario.

HIV/AIDS could also have a significant impact on the public finances. Public expenditure will probably rise as the government bears part of the costs of HIV/AIDS and increases the provision of health services and welfare grants. Revenues could decline relative to a baseline because of lower growth in economic activity. As a consequence, by 2010 the impact on the budget might exceed 3 percentage points of GDP which would require a combination of cuts in nonhealth-related expenditure and increases in taxes to correct.

The government has stepped up its policy response to slow the spread of HIV/AIDS. The government strategy for dealing with HIV/AIDS encompasses prevention, treatment, legal assistance, and monitoring. The 2002/03 budget foresees an increase in direct HIV/AIDS-related expenditure from 0.1 percent of GDP in 2002/03 to nearly 0.2 percent of GDP in 2004/05. However, the indirect expenditure is much larger, though very difficult to estimate; it could be as high as 40 percent of the health budget or nearly 1½ percent of GDP. In mid-April 2002, the government initiated a major policy shift by announcing that antiretroviral drugs would be made generally available.

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[1]This box draws on the Bureau of Economic Research, 2001, "The Macro-Economic Impact of HIV/AIDS in South Africa;" M. Haacker (2002) "The Economic Consequences of HIV/AIDS in Southern Africa," IMF/WP/02/38; and C. Arndt and J. Lewis, 2001, "The HIV/AIDS pandemic in South Africa: Sectoral Impacts and Unemployment," Journal of International Development, Vol. 13, pp. 427-49.

inflationary pressures. Although the inflation target for 2002 could not likely be met without unduly jeopardizing growth performance, the mission suggested that credit conditions may need to be tightened in order to meet the targets for 2003 and beyond. In stating the case, it noted that short-term interest rates were still lower in real terms than before the rate cut of June 2001 and that money supply growth remained high. Moreover, the recovery in economic activity appeared sufficiently strong to weather the impact of temporarily higher real rates. A determined stand on inflation would also help dampen inflationary expectations and contain the second-round inflation effects arising from higher wage demands.

External vulnerability

20. **The SARB has, as a matter of policy, avoided intervening in the foreign exchange market to support the rand.** The mission considered this strategy appropriate in light of South Africa's relatively weak reserve position and associated vulnerabilities, and of the limitations inherent in sterilized intervention (Table 6). The mission also welcomed the authorities' goal of reducing the NOFP to zero by March 2003 as a means of helping boost confidence in the currency and lowering sovereign risk spreads and long-term interest rates. However, even at a zero NOFP balance, the ratio of South Africa's reserves to short-term debt, including forward market exposure, would still only be around 50 percent, which is well below that of other emerging market economies. The SARB was, therefore, encouraged to continue to strengthen its foreign reserve position by buying privatization and external borrowing proceeds from the government. In particular, the mission argued that, at a minimum, the SARB might seek to close its exposure in the forward market, which would imply a negative NOFP of around US$5 billion. Closing the forward book would also eliminate the risk of the SARB making losses in the forward market.[17]

21. **South Africa has pursued a sound and cautious approach to debt management.** As a consequence, official external debt presently stands at only around 8 percent of GDP. It would have been tempting, as a number of analysts had advised, for the authorities to have reduced the NOFP more quickly through greater recourse to foreign borrowing. Quite appropriately, however, the authorities recognized that a significant increase in borrowing could raise the cost of borrowing and create another source of external vulnerability.

22. **The government has followed a policy of gradually removing capital controls.** The mission expressed strong support for this strategy. Many of the controls, such as restrictions on overseas investment by resident institutional investors, are binding, and their removal could lead to large capital outflows. While it is possible that the removal of capital controls could bolster confidence and trigger capital inflows, on balance the mission agreed that any further significant relaxation of the controls should proceed only once a period of stability had been restored to the foreign exchange market and international reserves had

[17] These losses are estimated to have been equivalent to 30 percent of reserve money (nearly 2 percent of GDP) in 2001/02.

been rebuilt to comfortable levels. Thereafter, liberalization should include such steps as replacing restrictions on capital outflows by institutional investors with prudential limits.

Fiscal policy

23. **The mission commended the government on its impressive record of fiscal management over the past several years.** It also expressed support for the overall policy thrust contained in the budget for 2002/03. The budget will provide a mild expansionary impulse, while attempting to address the country's social problems in an affordable and sustained manner. It includes lower income tax rates, which will provide tax relief mainly to low- and middle-income earners and bring personal and company tax rates closer together. The budget also devotes additional resources to targeted social welfare services, HIV/AIDS prevention and treatment, and the development of economic infrastructure (see table below).

South Africa: National Government Main Budget, 2000/01-2002/03 1/

(In percent of GDP)

	2000/01	2001/02		2002/03
		Original budget	Staff estimate	Budget
Total revenue and grants	23.6	23.6	24.8	24.5
Total expenditure	25.7	26.2	26.3	26.6
Of which: Social services 2/	12.8	12.8	13.1	13.3
Education	5.6	5.9	5.6	5.5
Health	3.1	3.0	3.2	3.1
Social security and welfare	3.2	3.2	3.4	3.8
Other	0.8	0.7	0.8	0.9
Protection services 2/	4.5	4.6	4.7	4.8
Interest	5.1	4.9	4.8	4.4
Balance	-2.0	-2.5	-1.5	-2.1
Primary balance	3.1	2.4	3.3	2.3

Sources: South African authorities; and staff estimates

1/ Fiscal year begins April 1.
2/ Consolidated national and provincial government.

24. **The revenue projections for 2002/03 appear quite ambitious**. After taking into account the impact of the tax policy changes (which involve a net revenue loss of 1½ percent of GDP), the revenue projections imply an additional tax effort of around 1 percent of GDP.

Moreover, the strong revenue performance of last year may not necessarily be sustained.[18] The authorities nevertheless indicated to the mission that, in light of the improvements made in tax collection procedures and the impact of the recent increases in commodity prices on corporate profitability, the revenue targets were feasible.

25. **Looking ahead, the authorities explained that, on the grounds of efficiency, equity, and competitiveness, efforts would continue to be made to lower income tax rates.**[19] Lower rates would be funded by measures to broaden the revenue base, like the shift to a residency-based income tax effective January 2001, and the imposition of a capital gains tax in October 2001. Various steps to further strengthen tax collection would also be taken, such as the introduction of a unified tax identification number.

26. **The government also set out its medium-term expenditure strategy.** It is based on channeling the savings from lower interest payments to poverty reduction, developing social and economic infrastructure, addressing the HIV/AIDS problem, and combating crime. The authorities are acutely aware of the demands placed on the budget by South Africa's pressing social problems, but they explained that spending on social services remained constrained by the need to ensure that funds were efficiently spent (Box 7). Moreover, shortages of trained personnel had hindered the effort to improve the delivery of social services.

C. Structural Policies

Privatization

27. **In August 2000, the authorities launched a comprehensive program for restructuring public enterprises that sought to accelerate the pace of privatization.**[20] Until recently, however, implementation has been slow. The sale of the government's controlling interest in Telkom, the state telecommunications company, was originally

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[18] While most of the revenue overperformance in 2001/02 was in the area of corporate income taxes, it is not clear to what extent revenue growth reflects permanent improvements in tax administration or policy (such as the shift to a residency-based income tax) or one-off events (such as a bringing forward of tax payments). The fiscal ROSC mission made several recommendations to improve revenue analysis and forecasting.

[19] Despite reductions in previous budgets, the company tax burden remains uncompetitive, consisting of a corporate tax rate of 30 percent plus a "secondary" tax of 12½ percent on dividends.

[20] The main state enterprises are Telkom (telecommunications), Eskom (electricity), Denel (defense), and Transnet (transport). For a summary of the authorities' restructuring program, see Box 7 in *South Africa—Staff Report for the 2000 Article IV Consultation,* SM/01/65.

Box 7. Measures to Improve the Quality of Public Expenditure

The government has achieved a substantial consolidation of its fiscal position since the mid-1990s. The overall budget deficit (main budget) was reduced from a peak of over 9 percent of GDP in 1993/94 to 1½ percent of GDP in 2001/02. Of this reduction, around 5 percentage points of GDP reflected lower noninterest expenditure and the rest higher revenue.

A further increase in the revenue-to-GDP ratio is not planned. The Growth, Employment, and Redistribution (GEAR) strategy includes the objective of keeping this ratio below 25 percent. It also indicates that improvements in revenue collection would be used to lower corporate and personal income tax rates. Consistent with this strategy, the last two budgets have included significant personal income tax cuts.

Given the revenue strategy, and a commitment to maintain fiscal discipline, there is little scope for increasing the noninterest expenditure-to-GDP ratio, other than through lower interest costs. The challenge for the government is thus to prioritize and re-orient expenditure so as to meet its key social and economic objectives, including economic growth, job creation, equity and social development, and strengthening the safety and justice sector.

Toward this end, measures have been implemented to promote sound expenditure management, transparency and accountability, and efficiency.[1] Since 1994, there has been an overhaul of public financial management at all levels of government, including a substantial consolidation in the number of municipal governments, passage of the Public Finance Management Act (PFMA), and extension of the PFMA to provincial governments.[2] The PFMA is being implemented over a number of years, coinciding with programs to boost financial and managerial capacity. Key features of public financial management include:

- **Tight restrictions on increasing expenditure during a fiscal year.** The conditions for increasing expenditure are mainly restricted to (1) expenditures that are related to significant and unforeseeable economic developments; and (2) emergency situations, for which prior approval of the National Assembly is not needed, but for which the increase must be less than 2 percent of spending.

- **Requirements for managing and reporting expenditures.** Departments and provinces must provide the National Treasury (NT) with monthly reports on their performance.[3] The NT must publish monthly reports on its operations and quarterly reports on provincial operations. The Auditor General must audit each department annually and present a report to parliament that is made public.

- **Performance indicators and medium-term expenditure framework.** A system is being introduced whereby budget documentation must list the objective of each program, the expected outputs, and performance relative to the outputs. In addition, budgets include a 3-year rolling framework that helps promote prioritization and efficiency in spending.

- **Spending efficiency.** Emphasis is placed on improving value for money, such as through use of public-private partnerships, increases in nonpersonnel expenditure, and adoption of innovative health programs, including step-down and community-based care for HIV/AIDS patients.

- **Contingency reserve.** The budget, as well as the medium-term expenditure framework, includes a contingency reserve. In 2002/03, the contingency reserve, which is 0.3 percent of GDP, could be used to finance some or all of the higher costs associated with recent changes in HIV/AIDS policy and additional personnel costs relating to the multiyear wage agreement.[4]

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[1] These are described in the forthcoming fiscal ROSC, which also provides more details on institutional arrangements, including the intergovernmental fiscal system.

[2] A draft Municipal Finance Management Bill, the municipal equivalent of the PFMA, has been prepared.

[3] Provincial governments undertake a substantial amount of spending but are funded almost entirely from national government transfers. For example, in the 2002/03 budget around 50 percent of national expenditure represents transfers to subnational governments (mainly provinces), 15 percent represents interest payments, and the remaining 35 percent is spent directly by the national government. It is important, therefore, to look at consolidated national and provincial expenditure when analyzing expenditure developments.

[4] Public sector salaries are linked to the CPIX inflation rate, with the growth rate set at CPIX inflation plus a markup equal to ½ percent and 1 percent in 2002 and 2003, respectively. In addition, a clause allows wage negotiations to be reopened if CPIX inflation exceeds 7½ percent in May 2002.

scheduled for the second half of 2001 but was held up because of weak international market conditions and delays in formulating an appropriate regulatory framework. Moreover, a number of other public companies originally identified for divestiture still remain in state hands.

28. **The authorities indicated they were taking steps to bring the privatization program back on track.** A decision has been made to divest Telkom, if possible before the end of the financial year, rather than await an upturn in market conditions; efforts are also being intensified to finalize the necessary regulatory changes. Key steps in modifying the regulatory framework in the power sector have also been completed. In addition, plans to bring in a strategic equity partner for Denel, the state defense corporation, have been finalized (this is well ahead of the original schedule) and good progress is now being made in divesting, or preparing for sale, a number of noncore public assets.

29. **The authorities acknowledged that there had been difficulties in communicating to the public important policy positions and the status of the restructuring program.** Consequently, the Department of Public Enterprises has been working to strengthen its communications capacity by issuing quarterly restructuring reports. In addition to providing a comprehensive review of performance and a regular update of future plans, the mission suggested that these reports include performance benchmarks wherever possible.[21]

Labor market

30. **Relatively low economic growth has impeded job creation in South Africa, but growth performance itself has been held back by a range of factors that have contributed to persistently high unemployment.** These factors include chronic skill deficiencies, the legacy of apartheid labor practices, and various labor market impediments. The government recognizes these factors and has adopted a number of initiatives to tackle the problem.

31. **An integrated human resource development strategy is being implemented to address skill deficiencies in South Africa**. The strategy involves raising educational standards, supporting employment growth through industrial policies, and enhancing job skills.[22] With regard to the latter, a skills development program has been launched that is funded by a payroll tax (levied at a rate of 1 percent), of which 60 percent is to be refunded

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[21] To promote standards, in early May the Department also issued the first draft of a protocol on corporate governance in the public sector; comments are being sought from the public.

[22] These initiatives will be complemented by new immigration legislation making it easier to recruit foreign skilled labor to South Africa.

to employers who provide training to staff.[23] To date, however, the take-up rate of grants under the scheme has been rather low, although the authorities expressed confidence that the first set of performance indicators, which were for 2005, would still be met.[24]

32. **The mission shared the authorities' view that the skills program was a valuable initiative aimed at tackling a root cause of unemployment in South Africa**. It noted, however, that most of the training was directed at those already with jobs rather than the unemployed and that the payroll tax might have a counterproductive impact on employment. The mission suggested that alternative sources of funding be found so that employers were provided with a stronger incentive to recruit and train jobless workers.

33. **Amendments to South Africa's labor legislation are about to become law** (Box 8).[25] They were prompted by a desire to "improve the efficiency of the labor market and promote employment creation" and follow up on a review of the "unintended consequences of labor legislation." A number of the amendments will go some way toward increasing the flexibility of work practices and lowering labor costs by streamlining arbitration and conciliation procedures. Others will provide additional protection to retrenched workers but are not likely to lead to significant job creation.

34. **On balance, the amendments represent an important move in the right direction, but they should be considered as a first step only.** The mission recognized that pushing through these amendments had been a lengthy and arduous process for all concerned, but nevertheless urged that the legislation continue to be reviewed at frequent intervals. In particular, it suggested that consideration be given to relaxing the "extension principle" in collective bargaining procedures, whereby centrally agreed wage agreements were extended by law to nonparticipating parties.[26] Granting small and medium-sized enterprises greater autonomy in setting wages would significantly expand job opportunities and encourage the opening up of new businesses.[27]

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[23] A tax allowance will be introduced to provide a further incentive for training once the necessary legislation has been passed.

[24] These performance indicators include such targets as the number of enterprises that provide, and the number of people that receive, training.

[25] This legislation was introduced between 1995 and 1998 with the aim of providing better protection for workers' rights and improving the conditions and benefits of employment.

[26] Although the extension can be waived, in practice the actual number of waivers granted is very small.

[27] Small and medium-sized enterprises contribute about one-third of total output, but account for over one-half of formal private sector employment.

Box 8. Amendments to the Labor Legislation: An Update

In July 2000, the Minister of Labor announced a number of proposed amendments to existing labor legislation that sought to "improve the efficiency of the labor market and improve employment creation."[1] A revised version of the amendments was passed by Parliament in February 2002 and is expected to be signed into law later this year. The amended legislation includes the following elements (unless noted otherwise they are the same as the 2000 proposals):

Collective bargaining and bargaining councils

- Bargaining councils must continue to consult with nonparties of bargaining agreements before they can extend the agreements to nonparties, and they must report these consultations to the Department of Labour.
- In order to increase the effectiveness of bargaining councils, designated agents are given greater power to monitor compliance with collective bargaining agreements and the Registrar is given greater oversight authority regarding councils' compliance with the Labor Relations Act.
- Steps are to be taken to speed up establishment of a rational framework for bargaining in the public service.

Dispute resolution

- Action is to be taken to enable the Court for Conciliation, Mediation and Arbitration (CCMA) to improve its service to employers and vulnerable workers; this includes a speedier "one-stop" process of conciliation and arbitration for unfair dismissals and unfair labor practices.
- A probationary period of six months is to be introduced during which less strict dismissal procedures would apply in cases of unfair dismissals.

Workers' rights in the event of retrenchment, transfer of businesses, and insolvency

- Parties to a retrenchment dispute are obliged to engage in a mutual consultation, which could involve the services of a facilitator from the CCMA.
- In companies with more than 50 employees, if no consensus is reached after 60 days on dismissals above a specified size (which depends on the size of the company) workers can decide whether to strike or to take their dispute to the Labour Court.
- A legal basis is provided for the transfer of employees' contracts when a business is transferred as a going concern.
- A package of amendments has been introduced to clarify the situation for workers in insolvent companies, including amendments that require severance pay and that present contributions for benefit funds from becoming part of the insolvent estate. (This is an addition to the original 2000 proposals.)
- Workers will be informed on a timely basis about possible liquidations.

Conditions of employment

- The July 2000 proposal to normalize work on Sundays was withdrawn; it will continue to be a legal requirement to pay a premium for work on Sundays.
- The notice period for those employed for less than six months will be reduced to one week.
- Bargaining councils will be able, by collective agreement, to increase the number of regular working hours in a week to more than 45 hours and the number of overtime hours to 15 hours (for up to two months in any twelve-month period).

Independent labor contractors

- The coverage of labor laws will be extended to de facto workers who may presently be legally regarded as independent contractors.

[1] See Box 6 in *South Africa—Staff Report for the 2000 Article IV Consultation,* SM/01/65.

Trade and industrial policies

35. **South Africa has undertaken extensive trade reform since the early 1990s.**[28] Empirical evidence suggests that trade liberalization was the major source of total factor productivity growth in the 1990s, which in turn has accounted for virtually all of South Africa's economic growth since 1994.[29] Free trade agreements implemented with the European Union (January 2001) and with other Southern African Development Community (SADC) members (September 2000) are helping sustain the momentum of reform, and the authorities are examining the scope for further liberalization. The mission suggested that the relatively high rates of protection for certain labor-intensive sectors, most notably textiles, be lowered, ideally in conjunction with labor market reform. South Africa's complex structure of tariffs, moreover, should be streamlined and nontrade barriers removed.[30] The depreciated value of the rand provides an excellent opportunity to move ahead with tariff reform.

36. **Agreement has been reached with South Africa's partners in SACU to establish a regional Tariff Board.**[31] This would replace the South African Board of Trade, which has formulated tariff policy with relatively little consultation with other members of the union. The authorities explained that, while the new arrangement would permit a more consensual approach to trade reform, it could slow down the pace of liberalization.

37. **The government recently announced the outline of a comprehensive industrial strategy**. Some of the initiatives, like the integrated human resource strategy, are already being implemented, but details of other elements still need to be formulated. The strategy envisages the government contributing to industrial development through deregulation, corporate law reform, improving the access of small enterprises to finance, and developing the information technology sector.

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[28] The average (unweighted) tariff rate was lowered from 30 percent in 1990 to its present level of 7 percent, implying a rating of 4 in the Fund's trade restrictiveness index (a zero rating corresponds to no restrictions). This compares very favorably with other emerging market economies.

[29] See "Trade Liberalization and Productivity in South Africa" in IMF Staff Country Report No. 00/42.

[30] These nontrade barriers are relatively minor and relate to restrictions, such as quotas on textiles from certain countries in the region.

[31] SACU (Southern African Customs Union) consists of South Africa, Botswana, Namibia, Lesotho, and Swaziland.

Financial sector

38. **South Africa's financial system is sound and well regulated.** The key macro-prudential indicators remain at healthy levels and the foreign exchange exposure of the banking system is quite small.[32] The robust state of the banks helped the financial system successfully weather the impact of the currency depreciation.

39. **Several relatively small banks have recently experienced difficulties as a result of either direct or indirect involvement in microfinancing operations.**[33] One of these banks has been closed, while another, considered to be of systemic importance, was placed under curatorship and has been sold.[34] A third is also being sold and, in the meantime, its smaller depositors have been provided with deposit guarantees by the authorities. These developments have been accompanied by a significant shift in deposits to the largest banks, which has in turn placed some, although so far manageable, strain on some of the smaller institutions.

40. **Good progress has generally been made in following up on the recommendations of a Financial Sector Assessment Program (FSAP) report.**[35] In particular, steps have been taken to move into full compliance with the Basel Core Principles.[36] Regarding the planned establishment of a unified supervisory agency, the mission reiterated the conclusion of the FSAP report that, prior to such a step, issues relating to the availability of skilled personnel would need to be carefully assessed.[37] A compulsory deposit insurance scheme is being prepared and will likely be included in next year's legislative program.

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[32] At end-March 2002, the capital adequacy ratio of the banks was 12 percent, while nonperforming loans represented less than 4 percent of total loans and advances. Foreign currency loans make up less than 10 percent of total bank loans, and the banks are observing limits on their overall net foreign positions.

[33] These operations appear to have been affected by legal restrictions placed on access to government payrolls by financial institutions for use as collateral.

[34] The systemic institution, Saambou Bank, is the seventh-largest bank in South Africa, although its assets accounted for less than 2 percent of total bank assets at end-2000.

[35] The main report was discussed by the Executive Board of the Fund in February 2000 and the follow-up report in March 2001.

[36] For example, anti-money-laundering legislation has been passed, and the SARB now has the authority to remove the management of troubled banks.

[37] Presently, the Banking Supervision Division of the SARB licenses and supervises banks, while the Financial Services Board regulates and supervises the financial markets and nonbank financial institutions.

Land reform

41. **South Africa is pursuing a market-based land reform program within the framework of the constitution.** The aim is to redress the consequences of land policies pursued under the apartheid era and to contribute to growth and poverty alleviation. In contrast to most other developing countries, unemployment in South Africa is higher in rural than urban areas, and successful land reform has the potential to make a significant impact on job opportunities in the agricultural sector.

42. **The land reform program is primarily based on two components—restitution and redistribution.** Land restitution, which seeks to compensate and restore land to dispossessed people, is now proceeding well, and the exercise should be completed by 2005. In contrast, land redistribution, which is based on a willing buyer/willing seller principle with financial support from the government, is moving slowly. This reflects the limited supply of land coming onto the market and a much smaller number of restitution claims than had initially been expected. Consequently, only 3 percent of agricultural land has been redistributed, which is well short of the original target of 30 percent over a 15-year period.

III. Staff Appraisal

43. **South Africa felt the impact of the downturn in global economic activity during 2001.** The slowdown in growth, however, was much less pronounced than during previous business cycles. This greater resilience of the economy is largely attributable to an improved policy environment that has helped realize gains in international competitiveness, diversify the export base, and enhance corporate profitability by lowering borrowing and labor costs in real terms. The economy now appears poised for a recovery, although growth is unlikely to rise much beyond 3 percent over the medium term in the absence of structural policy reforms.

44. **The value of the rand has undergone significant swings over the past year**. The weakness of the rand during the final quarter of 2001 was partly attributable to a confluence of factors, including an easing in monetary policy, delays in the privatization program, and contagion from developments in Zimbabwe. The rapidity and magnitude of the depreciation, however, is difficult to reconcile with a number of favorable macroeconomic developments, such as the strong fiscal position, waning inflationary expectations, and the narrowing of sovereign risk spreads. Indeed, recent currency movements would appear to suggest that there has been significant overshooting of the exchange rate. On the basis of various objective indicators, such as movements in real commodity prices, the rand still appears to be undervalued, although these indicators do not capture concerns about the structural health of the economy relating to the high rate of unemployment, the prevalence of HIV/AIDS, and social inequalities.

45. **The central policy challenge facing South Africa remains the quest for higher growth and lower unemployment**. Success in meeting these goals hinges on maintaining a sound and stable financial environment, which will require implementing the

inflation-targeting strategy, maintaining fiscal restraint, and rebuilding international reserves. But growth performance is also dependent on attracting foreign investment, which in turn is dependent on undertaking further structural reforms in the areas of privatization and trade liberalization. In addition, more ambitious labor market reforms would help to ensure that investment absorbs rather than displaces labor.

46. **The depreciation of the rand is providing a major competitive boost to the economy, but it is also undermining the effort to bring inflation under control**. It is most unlikely that the SARB's inflation target for 2002 will be met, but the targets for 2003 and beyond remain feasible. To this end, interest rates were raised earlier this year and a further tightening in credit seems warranted, particularly in light of relatively high money supply growth and an intensification of inflationary expectations.

47. **The government is to be commended for maintaining strict fiscal discipline in the face of budgetary pressures.** The budget significantly overperformed in 2001/02 owing to very strong revenue growth; this fiscal stance was not intended and has now been relaxed somewhat. While still helping to maintain macroeconomic stability, the budget provides room for cuts in income tax rates and spending increases in areas such as social services and HIV/AIDS. The revenue projections for 2002/03, however, appear quite ambitious. Efforts to strengthen tax administration will, therefore, need to continue.

48. **The authorities have made excellent progress in lowering the NOFP**. This had been a major source of external vulnerability in the past, and the staff welcomes the authorities' goal of reducing the NOFP to zero by March 2003. Even then, however, South Africa's international reserve position would still be relatively weak, and the SARB should use every opportunity to further build up its reserves with the proceeds from privatization and, to a lesser extent, external borrowing. Nonetheless, the staff would agree that the SARB should not actively purchase foreign exchange in the market so as to prevent a potentially destabilizing impact on the exchange rate and inflation. To avoid unleashing strong foreign exchange pressures, the staff also supports the government's gradualist approach to the liberalization of capital controls.

49. **South Africa's financial system remains sound and well regulated.** In particular, it has proven itself readily capable of withstanding the impact of a large currency depreciation. Some relatively small banks have experienced some difficulties arising from microfinancing operations, but these problems have been satisfactorily resolved with appropriate action by the authorities.

50. **The staff welcomes the authorities' efforts to pick up the pace of privatization.** This will help to increase productive efficiency, attract foreign investment, and transfer technology. Proceeds from privatization will also help generate foreign exchange inflows and reduce government indebtedness. The decision by the government to proceed quickly with the offer for sale of Telkom by March 2003 is, therefore, appropriate. The staff also welcomes the authorities' efforts to communicate the privatization strategy and achievements

more clearly to the public, which will enhance the transparency and credibility of the program.

51. **The government is making a determined effort to address South Africa's acute unemployment problem**. It has identified, quite correctly, chronic and widespread skills shortages as the root cause of unemployment and is implementing a comprehensive program to raise educational standards and provide job training. This has been an important initiative, but the staff would suggest that alternative sources of financing the skills development program be found; the present reliance on a payroll tax is likely to have a negative impact on job creation. The government also recognizes that existing labor laws may have contributed to unemployment and is about to pass a number of amendments into law. These amendments will go some way toward reducing the "statutory" costs of doing business, while protecting workers' basic rights. However, the staff would urge that the process of legislative review be continued at frequent intervals, and that consideration be given to decentralizing the collective bargaining system by granting small and medium-sized enterprises greater latitude in setting wages at the plant level.

52. **The depreciation of the rand provides an opportunity to push further ahead with trade liberalization, which has been the major source of economic growth in recent years**. To maximize the potential employment benefits, it would be important that liberalization be accompanied by the labor market reforms mentioned above. At the same time, every effort needs to be made to ensure that the new institutional arrangements for setting tariffs do not retard the reform process.

53. **South Africa is facing a serious HIV/AIDS pandemic**. The spread of the disease and its macroeconomic impact are difficult to project, but it will in all likelihood significantly lower both average life expectancy and economic growth. The government has adopted a multisectoral approach for combating the pandemic and is, appropriately, treating the disease as a fiscal priority, while ensuring that budgetary funds are well spent.

54. **The fiscal ROSC mission found that fiscal management and transparency in South Africa are high by international standards**. In most important respects, the country meets or exceeds the standards in the IMF's Code of Good Practices. The staff encourages the authorities to address the major outstanding issues identified in the ROSC, notably those related to budget forecasting, information on fiscal risks, and the independent auditing of privatizations.

55. **South Africa's economic data are of high quality**. They are provided to the Fund and generally the public with detail, frequency, and timeliness that are fully adequate for surveillance. South Africa also subscribes to the Special Data Dissemination Standard (SDDS) and is publishing all data on the reserve template. In May 2001, the IMF's Statistics Department assessed the data quality of key macroeconomic data categories in the context of a ROSC (Data Module); the authorities are to be commended on the publication of this report. In the meantime, they are encouraged to implement the recommendations of the report, most notably those relating to government finance and monetary statistics. The

authorities are addressing the weaknesses identified in labor market data by improving source data through the introduction of a new household labor force survey and a new employment survey, based on a better business register.

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

Table 1. South Africa: Selected Economic and Financial Indicators, 1998-2003

	1998	1999	2000	2001 Est.	2002 Proj.	2003 Proj.
	(Annual percent change, unless otherwise indicated)					
National income and prices						
Real GDP	0.8	2.1	3.4	2.2	2.5	3.0
Real GDP per capita	-1.4	-0.1	1.2	0.2	0.5	1.0
Nominal GDP (billions of rand)	740	803	888	975	1,079	1,179
Nominal GDP per capita (U.S. dollars; at PPP)	7,509	7,591	7,838	8,031	...	...
CPI (annual average)	6.9	5.2	5.4	5.7	7.9	6.0
CPI (end of period)	9.1	2.2	2.3	4.6	7.0	5.5
CPIX (period average) 1/	7.1	7.5	8.3	6.9	8.0	6.0
Labor market						
Unemployment rate (official definition; in percent) 2/	25.2	23.3	26.3	28.8	29.6	30.2
Average remuneration (formal nonagricultural private sector)	16.5	9.3	9.2	9.5	9.5	8.5
Labor productivity (formal nonagricultural)	5.0	4.1	6.1	3.6	3.0	3.5
Nominal unit labor costs (formal nonagricultural)	8.6	2.8	2.9	5.9	6.5	5.0
External sector						
Merchandise exports, f.o.b. 3/	-6.7	-1.8	10.9	-3.4	1.9	2.4
Merchandise imports, f.o.b. 3/	-5.7	-9.9	11.5	-6.2	-1.4	2.3
Export (goods and services) volume	2.5	1.4	8.3	2.4	2.2	0.8
Import (goods and services) volume	1.5	-7.5	7.2	0.4	-0.3	1.2
Terms of trade	-1.1	-3.0	-1.7	1.2	0.2	0.1
Nominal effective exchange rate 4/	-11.7	-8.5	-5.1	-14.6	...	...
Real effective exchange rate 4/	-8.9	-5.2	-3.0	-17.0	...	...
Money and credit						
Net domestic assets 5/	19.2	2.9	8.7	18.7	...	...
Credit to the government 5/	3.0	-0.5	0.2	-1.9	...	...
Credit to the rest of the economy 5/	16.2	3.4	8.6	20.5	...	...
Broad money (including foreign exchange deposits)	14.6	10.1	7.5	17.0	10.1	8.8
Velocity (GDP/average broad money)	1.8	1.8	1.8	1.8	1.7	1.7
Investment and saving	(In percent of GDP, unless otherwise indicated)					
Investment (including inventories)	16.7	15.9	15.9	15.3	15.1	15.1
Public fixed investment	2.7	2.6	2.4	2.3	2.3	2.3
Private fixed investment	14.4	12.9	12.5	12.5	12.3	12.4
Gross national saving	14.9	15.4	15.5	15.2	15.8	15.5
Public	-1.1	-0.2	-0.2	1.6	-0.1	0.2
Private	16.0	15.7	15.7	13.6	15.9	15.3
National government budget 6/						
Revenue, including grants	24.4	24.2	23.6	24.8	23.9	23.9
Expenditure and net lending	26.7	26.1	25.7	26.3	25.9	25.7
Overall balance	-2.3	-2.0	-2.0	-1.5	-2.0	-1.9
Primary balance	3.4	3.4	3.1	3.3	2.2	2.3
National government debt	48.2	46.5	43.8	43.3	39.7	38.9
General government balance 7/	-2.0	-1.5	-1.7	-1.3	-2.1	-1.9
Public sector borrowing requirement of the nonfinancial public sector 6/	3.5	0.6	0.9	0.2	1.3	1.6
External sector						
Current account balance (in billions of US$)	-2.3	-0.6	-0.5	-0.2	0.6	0.4
Current account balance	-1.7	-0.5	-0.4	-0.1	0.6	0.4
Overall balance of payments	-0.5	3.2	0.6	0.6	0.0	0.0
Foreign currency-denominated debt (in billions of US$)	25.0	23.9	24.9	23.0	23.9	23.9
Of which: short term (in billions of US$)	14.5	13.5	12.9	11.2	11.7	11.4
Total external debt / exports of goods and services (in percent) 8/	109.0	115.4	100.7	96.4	98.2	96.1
Total external debt service (in billions of US$) 8/ 9/	6.2	6.0	5.1	5.6	4.5	5.6
Total external debt service / exports (in percent) 8/ 9/	18.0	17.9	14.0	15.8	12.5	15.3
Gross official reserves (in billions of US$)	5.4	7.4	7.5	7.5	...	...
(in months of total imports)	2.0	2.9	2.7	2.9	...	...
Net open forward position of SARB (in billions of US$) 10/	22.5	13.0	9.5	4.8	...	...
U.S. dollar exchange rate (end of period)	5.86	6.15	7.57	12.09	...	...

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

1/ CPIX is the CPI less the interest on mortgage bonds.
2/ Excludes individuals who have not taken active steps to look for work or start self-employment in the four weeks prior to the interview.
3/ In U.S. dollars, annual percent change.
4/ Annual average; Information Notice System (INS) definition.
5/ Contribution (in percentage points) to the growth of broad money.
6/ Data refer to fiscal years beginning April 1. The ratios for 2002-03 are based on the staff's GDP projections.
7/ Excluding sales of state assets and profit/losses from forward market operations of the Reserve Bank.
8/ Excluding sales of state assets but including the profit/losses from forward market operations of the Reserve Bank.
9/ Excluding rand-demoninated debt held by nonresidents; end of period.
10/ Defined as net forward liabilities less net international reserves.

Table 2. South Africa: Balance of Payments, 1998-2003

	1998	1999	2000	Est. 2001	Proj. 2002	2003
	(In billions of U.S. dollars)					
Balance on current account	-2.3	-0.6	-0.5	-0.2	0.6	0.4
Balance on goods and services	1.5	3.4	3.5	4.4	5.3	5.2
Exports of goods and services	34.4	33.7	36.6	35.3	36.0	36.8
Exports of goods	29.1	28.6	31.7	30.7	31.2	32.0
Nongold	24.4	24.6	27.9	27.2	27.8	28.7
Gold	4.7	4.0	3.9	3.4	3.4	3.3
Exports of services	5.3	5.1	4.9	4.7	4.7	4.8
Imports of goods and services	-32.8	-30.2	-33.1	-30.9	-30.7	-31.5
Imports of goods	-27.2	-24.5	-27.4	-25.7	-25.3	-25.9
Imports of services	-5.6	-5.7	-5.7	-5.2	-5.4	-5.6
Balance on income	-3.1	-3.2	-3.1	-3.8	-3.7	-3.8
Income receipts	1.3	1.6	2.3	2.2	2.2	2.3
Income payments	-4.4	-4.7	-5.4	-6.0	-5.9	-6.1
Balance on transfers	-0.7	-0.9	-0.9	-0.7	-0.9	-0.9
Capital flows (including unrecorded transactions)	1.6	4.9	1.3	0.9	-0.6	-0.4
Balance on capital and financial account	3.1	5.3	0.3	-1.1	-0.6	-0.4
Balance on capital account	-0.1	-0.1	-0.1	0.0	0.0	0.0
Balance on financial account	3.1	5.3	0.3	-1.1	-0.6	-0.4
Direct investment	-1.2	-0.1	0.6	10.8	1.4	-0.1
Liabilities	0.6	1.5	0.9	7.2	2.4	0.9
Assets	-1.8	-1.6	-0.3	3.7	-1.0	-1.0
Portfolio investment	3.7	8.6	-2.0	-8.3	-0.8	-1.0
Liabilities	9.1	13.7	1.7	-3.0	1.6	1.7
Assets	-5.4	-5.2	-3.7	-5.3	-2.5	-2.7
Other investment	0.7	-3.2	1.7	-3.6	-1.2	0.8
Liabilities	1.2	-1.5	1.6	-2.2	0.5	0.6
Assets	-0.5	-1.6	0.1	-1.4	-1.7	0.2
Unrecorded transactions	-1.5	-0.4	1.0	2.0	0.0	0.0
Overall balance of payments	-0.7	4.2	0.7	0.7	0.0	0.0
Gross reserves (central government and Reserve Bank)	5.4	7.4	7.5	7.5	...	...
Gross reserves (including the banking sector)	7.2	11.2	11.1	12.5	...	...
Net open forward position of the Reserve Bank 1/	22.5	13.0	9.5	4.8	...	...
	(In percent of GDP)					
Balance on current account	-1.7	-0.5	-0.4	-0.1	0.6	0.4
Balance on goods and services	1.2	2.6	2.8	3.9	5.2	5.0
Exports of goods and services	25.7	25.6	28.6	31.2	35.8	34.8
Imports of goods and services	-24.6	-23.0	-25.8	-27.3	-30.6	-29.8
Balance on income	-2.3	-2.4	-2.4	-3.4	-3.7	-3.6
Balance on transfers	-0.6	-0.7	-0.7	-0.7	-0.9	-0.9
Capital flows (including unrecorded transactions)	1.2	3.7	1.0	0.8	-0.6	-0.4
Balance on capital and financial account	2.3	4.0	0.2	-1.0	-0.6	-0.4
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	2.3	4.0	0.3	-1.0	-0.6	-0.4
Direct investment	-0.9	-0.1	0.5	9.6	1.4	-0.1
Portfolio investment	2.8	6.5	-1.6	-7.3	-0.8	-1.0
Other investment	0.5	-2.4	1.3	-3.2	-1.2	0.7
Unrecorded transactions	-1.1	-0.3	0.8	1.8	0.0	0.0
Overall balance of payments	-0.5	3.2	0.6	0.6	0.0	0.0
Gross reserves (central government and Reserve Bank)	4.3	5.7	5.9	6.6	...	...
Gross reserves (including the banking sector)	5.7	8.6	8.7	11.0	...	...
Net open forward position of Reserve Bank	16.8	9.9	7.4	4.2	...	...

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

1/ Defined as net forward liabilities less net international reserves.

Table 3. South Africa: National Government Main Budget, 1998/99-2002/03 1/

	1998/99	1999/00	2000/01	2001/02 Original budget	2001/02 Staff estimate	2002/03 Budget
			(Billions of rand)			
Total revenue and grants	184.3	198.6	215.6	233.4	247.7	265.2
Tax revenue	179.9	193.8	211.9	228.6	243.9	260.2
Income tax	108.4	116.5	126.1	131.6	147.3	155.7
Indirect	66.1	72.2	79.1	86.7	86.4	92.8
Of which : value-added tax (VAT)	43.7	48.3	54.5	60.4	61.1	66.2
Trade and other (less SACU payments) 2/	5.4	5.0	6.6	10.3	10.3	11.7
Trade taxes	6.2	6.8	8.2	9.4	9.0	10.6
Other tax revenue	4.3	5.4	6.8	9.1	9.5	9.3
Less: SACU payments 2/	5.1	7.2	8.4	8.2	8.2	8.3
Nontax revenue	4.0	4.8	3.7	4.8	3.8	5.0
Grants	0.5	0.0	0.0	0.0	0.0	0.0
Total expenditure	201.4	214.8	233.9	258.3	262.7	287.9
Interest	42.7	44.3	46.3	48.1	47.6	47.5
Transfer to subnational governments	97.8	103.5	114.5	123.9	...	141.0
Of which : provinces	93.3	99.0	108.9	117.4	...	132.4
Other	60.9	67.0	73.1	86.3	...	99.4
Balance	-17.1	-16.2	-18.4	-24.9	-14.9	-22.7
Financing	17.1	16.2	18.4	24.9	14.9	22.7
Domestic loans (net)	19.6	4.9	11.4	-3.9	-17.8	-7.0
Foreign loans (net)	-0.7	8.5	1.9	11.3	33.1	16.3
Privatization, cash, and other	-1.8	2.7	5.1	17.4	-0.3	13.4
			(Percent of GDP, unless otherwise specified)			
Total revenue and grants	24.4	24.2	23.6	23.6	24.8	24.5
Tax revenue	23.9	23.6	23.2	23.2	24.4	24.0
Income tax	14.4	14.2	13.8	13.3	14.7	14.4
Indirect	8.8	8.8	8.7	8.8	8.6	8.6
Trade and other (less SACU payments) 2/	0.7	0.6	0.7	1.0	1.0	1.1
Nontax revenue	0.5	0.6	0.4	0.5	0.4	0.5
Grants	0.1	0.0	0.0	0.0	0.0	0.0
Total expenditure	26.7	26.1	25.7	26.2	26.3	26.6
Interest	5.7	5.4	5.1	4.9	4.8	4.4
Transfer to subnational governments	13.0	12.6	12.6	12.5	...	13.0
Other	8.1	8.2	8.0	8.7	...	9.2
Balance	-2.3	-2.0	-2.0	-2.5	-1.5	-2.1
Financing	2.3	2.0	2.0	2.5	1.5	2.1
Domestic loans (net)	2.6	0.6	1.2	-0.4	-1.8	-0.6
Foreign loans (net)	-0.1	1.0	0.2	1.1	3.3	1.5
Privatization, cash, and other	-0.2	0.3	0.6	1.8	0.0	1.2
Memorandum items:						
Fiscal year GDP (Billions of rand)	754	821	912	987	999	1,083
Primary balance (percent of GDP)	3.4	3.4	3.1	2.4	3.3	2.3
Debt (percent of GDP)	48.2	46.5	43.8	41.6	43.3	39.7
Domestic	46.0	43.3	40.3	37.0	35.1	31.0
Foreign	2.2	3.1	3.5	4.6	8.1	8.7
NOFP-related debt (stock) 3/	1.9	1.1	2.0	...	2.8	2.5
NOFP-related balances (- deficit) 3/	-1.9	0.6	-1.0	...	-1.0	0.0

Sources: South African authorities; and staff estimates.

1/ Fiscal year begins April 1.

2/ Southern African Customs Union (SACU) payments are based on a revenue-sharing formula.

3/ Refers to the gold and foreign exchange contingency reserve account, which is excluded from the debt stock.

Table 4. South Africa: Nonfinancial Public Sector Operations, 1998/99-2002/03 1/

	1998/99	1999/00	2000/01	2001/02 Original budget	2001/02 Staff estimate	2002/03 Budget
	(Billions of rand)					
I. General govt. (excl. locals)						
Total revenue and grants	195.3	211.2	228.2	246.6	261.5	279.3
National government	184.3	198.6	215.6	233.4	247.7	265.2
Provinces (own revenue)	3.4	4.0	4.5	4.0	4.6	4.1
Social security funds (own revenue)	7.0	7.8	7.1	8.4	8.4	9.2
Extrabudgetary and other	0.5	0.9	1.0	0.8	0.8	0.8
Total expenditure	210.2	223.6	243.5	270.4	274.8	303.2
Current	196.7	211.3	230.6	248.4	255.8	280.3
Wages and salaries	82.3	86.5	91.8	98.9	98.9	106.8
Other goods and services	23.3	28.2	32.5	39.2	44.2	43.8
Interest	42.7	44.3	46.3	48.1	47.5	47.5
Transfers	48.4	52.3	60.0	65.2	65.2	82.3
Capital expenditure	13.5	12.3	13.0	19.0	19.0	22.8
Net lending	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-14.9	-12.4	-15.4	-23.8	-13.2	-23.8
II. Public sector borrowing requirement (PSBR)	26.1	5.0	8.5	12.4	2.1	14.9
National government	15.3	10.5	17.7	7.5	-2.5	12.3
Local govts. and local enterprises	1.0	-2.1	-2.3	2.0	2.0	1.0
Nonfinancial public enterprises	8.8	-2.2	-5.6	3.0	3.0	-0.5
Other	1.0	-1.2	-1.3	0.0	-0.4	2.1
	(Percent of GDP)					
I. General govt. (excl. locals)						
Total revenue and grants	25.9	25.7	25.0	25.0	26.2	25.8
National government	24.4	24.2	23.6	23.6	24.8	24.5
Provinces (own revenue)	0.5	0.5	0.5	0.4	0.5	0.4
Social security funds (own revenue)	0.9	0.9	0.8	0.9	0.8	0.9
Extrabudgetary and other	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	27.9	27.2	26.7	27.4	27.5	28.0
Current	26.1	25.7	25.3	25.2	25.6	25.9
Wages and salaries	10.9	10.5	10.1	10.0	9.9	9.9
Other goods and services	3.1	3.4	3.6	4.0	4.4	4.0
Interest	5.7	5.4	5.1	4.9	4.8	4.4
Transfers	6.4	6.4	6.6	6.6	6.5	7.6
Capital expenditure	1.8	1.5	1.4	1.9	1.9	2.1
Net lending	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-2.0	-1.5	-1.7	-2.4	-1.3	-2.2
II. Public sector borrowing requirement (PSBR)	3.5	0.6	0.9	1.3	0.2	1.4
National government	2.0	1.3	1.9	0.8	-0.2	1.1
Local govts. and local enterprises	0.1	-0.3	-0.3	0.2	0.2	0.1
Nonfinancial public enterprises	1.2	-0.3	-0.6	0.3	0.3	0.0
Other	0.1	-0.2	-0.1	0.0	0.0	0.2

Sources: South African authorities; and staff estimates.

1/ Fiscal year begins April 1.

Table 5. South Africa: Monetary Survey, 1997-2001

	1997 Dec.	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec.
	(In billions of rand)				
Net foreign assets	-19.9	-28.9	5.7	14.7	37.1
Gross reserves	37.8	50.7	79.9	102.3	183.4
Reserve Bank	28.5	31.6	45.4	57.0	90.6
Other monetary institutions	9.3	19.1	34.5	45.3	92.9
Liabilities	57.6	79.6	74.1	87.6	146.4
Reserve Bank	9.8	18.1	18.8	19.7	48.3
Other monetary institutions	47.8	61.5	55.3	67.9	98.1
Net domestic assets	394.1	457.6	466.4	492.9	556.7
Credit to government, net	20.0	31.3	29.2	30.0	20.6
Claims on government	48.2	59.1	61.3	64.2	66.2
Government deposits	28.2	27.8	32.2	34.2	45.6
Credit to private sector	420.1	490.1	532.7	590.1	661.7
Other items, net	-46.0	-63.8	-95.5	-127.2	-125.6
Broad money (M3)	374.2	428.7	472.2	507.6	593.8
Of which: M1	173.1	213.9	258.3	266.9	316.7
	(Annual percentage change)				
Net foreign assets	23.9	-45.4	119.9	156.3	152.1
Net domestic assets	14.1	16.1	1.9	5.7	13.0
Credit to government, net	96.2	56.4	-6.6	2.8	-31.3
Credit to private sector	14.4	16.7	8.7	10.8	12.1
Other items, net	-44.2	-38.7	-49.6	-33.2	1.2
Broad money (M3)	17.2	14.6	10.1	7.5	17.0
	(Contribution to growth in M3, unless otherwise specified)				
Net foreign assets	1.9	-2.4	8.1	1.9	4.4
Net domestic assets	15.2	17.0	2.1	5.6	12.6
Credit to government, net	3.1	3.0	-0.5	0.2	-1.9
Credit to private sector	16.6	18.7	9.9	12.1	14.1
Other items, net	-4.4	-4.8	-7.4	-6.7	0.3
Memorandum item:					
Income velocity of M3	1.92	1.77	1.76	1.84	1.74
	(In percent, unless otherwise specified)				
Official risk indicators 1/					
Share of nonperforming loans in total lending	3.3	4.1	4.9	4.5	...
Risk-based capital adequacy ratio	9.9	10.6	11.8	12.3	...
Financial sector risk factors					
Share of foreign currency loans in total lending 2/	3.8	4.1	5.9	8.4	13.6
Share of foreign currency deposits in total deposits	2.3	3.5	3.5	4.2	6.2
Share of foreign liabilities in total liabilities 2/ 3/	7.3	7.1	6.1	7.3	9.7
Share of short-term deposits in total deposits 4/	41.6	45.6	49.9	47.9	49.1
Share of mortgage advances in private credit	42.3	39.9	38.2	38.3	39.2
Annual increase in value per real estate transaction 5/	4.8	0.6	9.9	8.8	...
Market assessment					
Financial index of Johannesburg Stock Exchange (index, 2000=100) 6/	94.3	78.2	99.5	100.0	87.8

Sources: South African Reserve Bank; and Fund staff estimates.

1/ Banks are audited using generally accepted international standards; capital adequacy requirements are also imposed on securities trading. The figure for 2000 refers to September.

2/ Including foreign financing in banks' own name on-lent to clients.

3/ Including foreign currency deposits and other foreign loans and advances.

4/ Short-term deposits include check and demand deposits.

5/ For 2000, the annual increase is calculated as at November.

6/ Includes banks and financial services; insurance services; and investment trusts and private equity funds. Data for 2001 refers to December.

Table 6. South Africa: Indicators of External Vulnerability, 1997-2001
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001 Est.
Financial indicators					
Public sector debt 1/	48.0	48.2	46.5	43.8	43.3
Broad money (percent change; 12-month basis)	17.2	14.6	10.1	7.5	17.0
Private sector credit (percent change; 12-month basis)	14.4	16.7	8.7	10.8	12.1
Repurchase rate (in percent) 2/	16.0	19.3	12.0	12.0	9.5
Repurchase rate (in percent; real) 2/ 3/	8.1	10.7	3.8	3.1	3.5
External indicators					
Exports (percent change; US$ value)	3.5	-5.9	-2.0	8.7	-3.5
Imports (percent change; US$ value)	4.6	-5.9	-7.9	9.4	-6.6
Terms of trade (percent change)	-1.2	-1.1	-3.0	-1.7	1.2
Current account balance	-1.5	-1.7	-0.5	-0.4	-0.1
Capital and financial account balance	3.8	2.3	4.0	0.2	-1.0
Gross official reserves (in billions of US$) 2/	5.8	5.4	7.4	7.5	7.5
Short-term official foreign liabilities (in billions of US$) 2/	2.0	3.1	3.0	2.6	3.9
Net official reserves (in billions of US$) 4/	3.8	2.3	4.3	4.9	3.6
Open forward position of SARB (in billions of US$) 2/	20.1	24.8	17.4	14.4	8.4
Net open forward position of SARB (in billions of US$) 2/ 4/	16.3	22.5	13.0	9.5	4.8
Short-term external debt by remaining maturity (in billions of US$)	14.1	14.5	13.5	12.9	11.2
Short-term external debt plus open forward position (in billions of US$)	34.3	39.3	30.9	27.3	19.6
Gross official reserves as a percent of the above	17.1	13.7	23.9	27.6	38.2
Foreign currency-denominated external debt (in billions of US$)	25.2	25.0	23.9	24.9	23.0
As a percent of total exports	69.0	72.6	71.0	67.9	65.1
External interest payments (as a percent of total exports)	8.3	8.7	8.9	6.6	6.4
Exchange rate (per U.S. dollar; period average)	4.61	5.53	6.11	6.94	8.60
Real effective exchange rate appreciation (period average; in percent) 5/	6.5	-8.9	-5.2	-3.0	-17.0
Financial market indicators 2/					
Stock market index (1994=100)	104.3	91.3	143.6	140.0	175.5
Percent change in U.S. dollar terms	-10.4	-27.3	49.8	-20.7	-21.5
Foreign currency debt rating–Standard & Poor's	BB+ (+)	BB+	BB+	BBB-	BBB-
Foreign currency debt rating–Moody's 6/	BBB-	BBB-	Baa3	Baa3	Baa2
Spread of benchmark bonds (basis points; end of period) 7/	270	572	308	411	281

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

1/ National government debt.
2/ End of period.
3/ Deflated by the percent change in end-period core consumer price index.
4/ Defined as net forward liabilities less net international reserves.
5/ Based on IMF's Information Notice System.
6/ In November 2001, Moody's upgraded South African sovereign foreign currency debt to Baa2.
7/ Spread on 15-20-year dollar-denominated bond relative to comparable U.S. treasury bond.

Table 7. South Africa: Social and Demographic Indicators
(2000, unless otherwise specified)

Area		**Population**	
1.22 million square kilometers			44.4 million
		Annual rate of growth	1.7 percent
Population characteristics		**Health (1999)**	
Population density	36 per sq. km.	Life expectancy at birth	
		Total	54
Urban population (percentage of total)	55		
Proportion in capital city (1995) (as a percentage of urban population)	13	Infant mortality (per thousand live births)	62
Population age structure (percent)		**Labor force**	
0-14 years	35		
15-64	61	Female (percentage of labor force)	47
65 and above	4		
GDP per capita at current prices		**Percentage of employment**	
In U.S. dollars	2,912	Agriculture	12
		Mining	4
		Industry	20
		Government	17
		Trade	25
		Other	22
Nutrition (1999)		**Education (1999)**	
Per capita calorie intake per day		Adult literacy (15+, percentage)	
Mean	2,424	Male	86
Median	2,358	Female	84
		Total	85

Sources: World Bank, *World Development Indicators*; UNDP, *Human Development Report*; Statistics South Africa; and Fund staff estimates.

South Africa: Relations with the Fund
(As of April 30, 2002)

I. Membership Status: Joined: 12/27/1945; Article VIII

II. General Resources Account:	SDR Million	Percent Quota
Quota	1,868.50	100.00
Fund holdings of currency	1,868.13	99.98
Reserve position in Fund	0.37	0.02

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	220.36	100.00
Holdings	222.55	100.99

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By Arrangement	11/03/1982	12/31/1983	364.00	159.00
CCFF	12/22/1993	--	614.43	614.43

VI. Projected Obligations to Fund: None.

VII. Exchange Rate Arrangement:

The South African rand floats against other currencies. South Africa formally accepted the obligations of Article VIII, Section 2, 3, and 4 of the Fund's Articles of Agreement, as from September 15, 1973. On April 30, 2002 the exchange rate of the rand was US$0.0935=R 1.

South Africa has followed a strategy of progressively easing exchange controls on capital transactions since 1994, reflecting the government's commitment to the eventual abolition of these controls, and has made considerable progress in this regard in recent years. With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated. They are free to purchase shares, bonds, and other assets without restriction and to repatriate dividends, interest receipts, and current and capital profits, as well as the original investment capital. Nonresidents are also free to hold rand accounts in the banking system, but they are constrained on the amount they may borrow domestically. This constraint has also been relaxed, and only organizations with more than 75 percent nonresident ownership are subject to limits on their domestic borrowing.

Since 1995, exchange controls on capital transaction by residents have also been relaxed considerably. Rather than allowing complete liberalization of a particular type of current or capital transaction, the authorities have pursued a strategy of allowing an increasing array of transactions, with each subject to a quantitative cap that has been progressively raised over time. The limit on foreign exchange holdings by authorized dealers has been eliminated, although they continue to be subject to prudential regulations. There are no controls on the transfer of funds arising from the import or export of goods and services, although the foreign currency proceeds from exports must be repatriated to South Africa within 180 days. South African corporates are allowed to invest up to R 500 million abroad, except for investments in Southern African Development Community (SADC) countries where the cap is R 750 million. In 2001, the mechanism for asset swaps by institutional investors (insurance companies, unit trusts, and pension funds) was terminated. Institutional investors are permitted to invest in foreign securities up to 10 percent of the net inflow of funds during 2000, subject to an overall limit of 15 (20) percent of their total assets for insurance companies and pension funds (unit trusts). Private individuals are allowed to invest up to R 750,000 offshore. Corporates may, upon application, be permitted to establish primary listings offshore under certain conditions. In 2001, the travel allowance for tourism and business was raised to R 140,000 per calendar year.

VIII. Article IV Consultations

The 2000 Article IV consultation was concluded by the Executive Board on March 19, 2001 (SM/01/65). South Africa is on the standard 12-month Article IV consultation cycle.

IX. Technical Assistance

No technical assistance has been provided to South Africa in the last 12 months. (A FAD mission on capital gains taxation took place during the period from November 30 to December 14, 2000).

South Africa: Relations with the World Bank Group

Between 1951 and 1966, the Bank made 11 loans to South Africa, totaling US$ 241.8 million, largely for expanding the country's rail and harbor systems, and for generating and transmitting electricity. The Bank ceased lending operations to South Africa in 1966 and the loans from that earlier period have been fully repaid.

Between 1990 and 1994, the Bank resumed activities in South Africa through a comprehensive program of economic policy advice and capacity building. There was open participation between the Bank and relevant sectors of the South African society, such as government, the Reserve Bank, (then) opposition parties, universities, labor unions, industrialists, and nongovernmental organizations. Several discussion papers and reports resulted on all the key sectors: the macroeconomy, education, health, agriculture, fiscal decentralization, labor markets, trade policy, and microfinance.

Since 1994, the emphasis has shifted slightly toward the provision of policy advice to government, particularly in the areas of municipal services and welfare financing, macroeconomic strategy, poverty, medium-term expenditure framework, economic impact of HIV/AIDS, and business environment. The Bank's non-lending involvement has ranged from traditional economic and sector work, focusing on sectoral analysis and policy recommendations, to more formal research outputs, including numerous policy support exercises that provided the government with advice on strategic policy options.

In addition, the Bank Group has provided financial and technical support through a number of different channels. The Bank began limited project lending leading to the Industrial Competitiveness and Job Creation Project (for US$46 million in 1997, of which US$21.5 million was subsequently cancelled at the government's request and US$7.4 million has so far been disbursed), and the Cape Peninsula Biodiversity Conservation Project (GEF grant of US$12.3 million in 1998) that was prepared under the auspices of the Global Environment Facility. A World Bank team visited Pretoria during December 2001 to appraise the Municipal Financial Management Support Project (MFMSP), and negotiations took place at the end of January 2002. A request for the Bank's assistance on hospital rehabilitation (the project was appraised in 2001) is also being reviewed by the authorities.

The International Finance Corporation (IFC) has been operating in South Africa for only the last four years. The total disbursement of loans amounts to US$62.3 million, and an additional US$21.2 million in loans has been committed. The IFC's strategy focuses on efforts to benefit previously disadvantaged groups directly with project funding for small and medium-sized enterprises and indirectly through job creation, financing of infrastructure, and diversification of business ownership. The Multilateral Investment Guarantee Agency (MIGA) has issued three guarantees for US$13 million in the banking and manufacturing sectors.

South Africa: Statistical Issues

Real sector

In June 1999, Statistics South Africa released a major revision of the national income accounts based on the United Nations System of National Accounts (1993). The revision raised nominal GDP by some 13 percent for the 1993-98 period and raised the average annual rate of growth of real GDP from 2.2 percent to 2.7 percent for the period 1994-98.

Reporting of real sector data for *International Financial Statistics (IFS)* is timely. Data reported for *Direction of Trade Statistics (DOTS)*, however, show substantial inconsistencies with external trade data reported for *IFS*, in particular concerning exports.

Labor market statistics are published with long lags (usually six months), and unemployment data are available only at an annual frequency. Given the seriousness of the unemployment problem, labor market analysis and policy design need to be based on better, more frequent, and timely labor market data.

Government finance

South Africa currently reports data for the consolidated central government and for regional and local governments for publication in the *Government Finance Statistics Yearbook*. It also reports monthly data covering the operations of the budgetary central government for publication in *IFS*.

Balance of payments

South Africa is a regular reporter of balance of payments data. It has recently revised its balance of payments data to be consistent with the fifth edition of the *Balance of Payments Manual*. However, there are deficiencies in the coverage, valuation, and classification of reserve asset components, in the coverage of trade with Southern African Customs Union (SACU) countries, and the coverage of some service transactions, mainly travel and construction service components. Only partial data are compiled on communication services, and the coverage of reinvested earnings on direct investment is limited to foreign branches of domestic banks.

Although South Africa disseminates its international reserve position in line with the requirements of the IMF's template on international reserves and foreign currency liquidity, the reporting of its international reserve position could be brought closer to best practices in a number of ways, including separating monetary from nonmonetary holdings of gold, applying a consistent formula for the valuation of gold, and excluding regional currency holdings from reserves. In addition, the continued inclusion of reserve holdings of the commercial banks rests on earlier interpretations of the application of exchange controls and could usefully be discontinued.

Technical assistance missions in statistics (1994-present)

Subject	Staff Member	Date
Data standards	Peter L. Joyce Ruth Lituma	11/06/95
ROSC mission	Charles Enoch (head) Wipada Soonthornsima Teresa Villacres Nataliya Ivanyk Ana Ansmits	5/7-5/18/01

South Africa: Reporting of Main Statistical Indicators
(As of May 28, 2002)

	Exports/Imports	Current Account Balance	Overall Government Balance	GDP/GNP	Debt Service	Debt
Date of latest observation	3/02	Q4 2001	Q4 2001	Q1 2002	Q2 2001	Q2 2001
Date received	4/30/02	3/18/02	3/18/02	5/28/02	3/18/02	3/18/02
Frequency of data 1/	M	Q	Q	Q	S	S
Frequency of reporting 1/	M	Q	Q	Q	Q	Q
Source of data 2/	P, C	P, C	P, C	P, C	P, C	P, C
Mode of reporting 3/	E	R	R	R	R	R
Confidentiality 4/	C	C	C	C	C	C
Frequency of publication 1/	M	Q	Q	Q	Q	Q

1/ M - Monthly; Q - Quarterly; S – Semiannual.
2/ P - Commercial publication; C - Commercial electronic data provider; A - Direct reporting by authorities.
3/ E - Electronic data transfer; C - Cable or facsimile; R - *Reserve Bank Quarterly Bulletin.*
4/ C - Unrestricted use.

South Africa: Reporting of Main Statistical Indicators (concluded)
(As of May 28, 2002)

	Exchange Rates	International Reserves	Reserve/Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index
Date of latest observation	5/28/02	3/02	3/02	3/02	3/02	5/28/02	4/02
Date received	5/28/02	4/8/02	4/8/02	4/8/02	4/8/02	5/28/02	5/21/02
Frequency of data 1/	D	M	M	M	M	D	M
Frequency of reporting 1/	D	M	M	M	M	D	M
Source of data 2/	P, C	P, C	P, C	P, C	P, C	P, C	P, C
Mode of reporting 3/	E, C	E, C	E, C	E, C	E, C	E, C	E, C
Confidentiality 4/	C	C	C	C	C	C	C
Frequency of publication 1/	D	M	M	M	M	D	M

1/ D - Daily; M – Monthly.
2/ P - Commercial publication; C - Commercial electronic data provider.
3/ E - Electronic data transfer; C - Cable or facsimile.
4/ C - Unrestricted use.

South Africa: Medium-Term Scenario

The staff's medium-term scenario through 2007 assumes the continued implementation of current policies, including a sound fiscal policy, an inflation-targeting strategy, and steady but modest progress with structural reforms, as well as a recovery in the global macroeconomic environment. Specifically, the scenario assumes:

- implementation of the authorities' medium-term budget framework (MTBF), in which the national budget deficit averages around 2 percent of GDP;
- achievement of the CPIX inflation target starting in 2003;
- elimination of the net open forward position of the Reserve Bank in 2002/03, followed by a further strengthening of the net reserve position;
- continued trade liberalization under the commitments to the World Trade Organization (WTO) and in the free trade agreements with the European Union and the Southern African Development Community;
- continued restructuring and privatization of public enterprises along the lines of the announced policy framework;
- gradual progress in removing rigidities in the labor market; and
- annual world real GDP growth of close to 3 percent in 2002 and 4–4½ percent through the medium term, consistent with the assumptions in the most recent *World Economic Outlook.*

Under these assumptions, real output growth is expected to rise to 3 percent in 2003 and remain at that level through the medium term. Achieving a trend decline in unemployment, however, remains uncertain as firms may continue to rely on labor-saving technologies as long as skill levels remain low and rigidities persist in the labor market.

The national government's medium-term fiscal program is consistent with a steadily declining ratio of debt to GDP, reflecting a primary surplus of around 2½ percent of GDP annually and the sale of state assets under the privatization program. Provincial finances should remain strong, and the resulting decline in the public sector borrowing requirement would help sustain lower real interest rates.

Fiscal restraint should help preserve much of the gains in external competitiveness stemming from the exchange rate depreciation in 2001 over the medium term. Consequently, the share of South African exports in other countries' markets is expected to rise, reversing the declining trend in recent years. However, a pick up in private investment and the recovery in GDP growth are expected to contribute to import demand and turn the external current account from a surplus in 2002 into a small deficit by 2006. The import cover of net reserves is projected to remain at a little under three months over the medium term.

Table. South Africa: Selected Economic and Financial Indicators, 2000-07

	2000	2001 Est.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
	(Annual percentage change, unless otherwise specified)							
National income and prices								
Real GDP	3.4	2.2	2.5	3.0	3.0	3.0	3.0	3.0
Real GDP per capita	1.2	0.2	0.5	1.0	1.1	1.1	1.1	1.1
Nominal GDP (in billions of rand)	887.8	975.2	1,079.3	1,179.0	1,273.3	1,367.8	1,461.7	1,562.1
Nominal GDP per capita (in U.S. dollars; at PPP)	7,838	8,031	...	...	...	...	...	...
CPI (annual average)	5.4	5.7	7.9	6.0	4.9	4.3	3.8	3.9
CPI (end of period)	2.3	4.6	7.0	5.5	4.6	4.1	3.9	3.5
CPIX (period average) 1/	8.3	6.9	8.0	6.0	5.0	4.5	4.0	4.0
Labor market								
Labor force	-1.5	2.0	2.0	2.0	1.9	1.9	1.9	1.9
Unemployment rate (official definition; in percent) 2/	26.3	28.8	29.6	30.2	30.2	30.2	30.2	30.2
Labor productivity (formal nonagricultural)	6.1	3.6	3.0	3.5	3.7	3.1	3.1	2.6
Nominal unit labor costs (formal nonagricultural)	2.9	5.9	6.5	5.0	3.9	3.3	2.7	2.8
External sector								
Exports (goods and services), f.o.b. 3/	8.7	-3.5	1.8	2.3	2.2	2.1	1.9	1.9
Imports (goods and services), f.o.b. 3/	9.4	-6.6	-0.7	2.7	3.4	3.0	2.7	2.8
Exports (goods and services) volume	8.3	2.4	2.2	0.8	0.9	0.8	0.6	0.6
Imports (goods and services) volume	7.2	0.4	-0.3	1.2	2.4	1.8	1.5	1.4
Terms of trade	-1.7	1.2	0.2	0.1	-0.1	-0.2	-0.4	-0.6
	(In percent of GDP, unless otherwise specified)							
Investment and saving								
Investment (including inventories)	15.9	15.3	15.1	15.1	15.1	15.2	15.5	15.8
Public fixed investment	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Private fixed investment	12.5	12.5	12.3	12.4	12.7	13.0	13.3	13.6
Gross national saving	15.5	15.2	15.8	15.5	15.2	15.1	15.2	15.2
Public	-0.2	1.6	-0.1	0.2	0.4	0.5	0.7	0.8
Private	15.7	13.6	15.9	15.3	14.8	14.6	14.5	14.5
National government budget 4/								
Revenue, including grants	23.6	24.8	23.9	23.9	24.0	24.0	24.0	24.0
Expenditure and net lending	25.7	26.3	25.9	25.7	25.7	25.6	25.4	25.3
Overall balance	-2.0	-1.5	-2.0	-1.9	-1.6	-1.5	-1.4	-1.3
Primary balance	3.1	3.3	2.2	2.3	2.4	2.4	2.4	2.4
National government debt	43.8	43.3	39.7	38.9	37.0	35.4	34.2	33.0
General government balance 5/	-1.7	-1.3	-2.1	-1.9	-1.6	-1.5	-1.4	-1.2
Public sector borrowing requirement of the nonfinancial public sector 5/	0.9	0.2	1.3	1.6	1.6	1.6	1.6	1.6
External sector								
Current external balance (in billions of US$)	-0.5	-0.2	0.6	0.4	0.1	-0.1	-0.4	-0.7
Current external balance	-0.4	-0.1	0.6	0.4	0.1	-0.1	-0.3	-0.6
Overall balance of payments	0.6	0.6	0.0	0.0	0.0	0.4	0.4	0.4
Foreign currency-denominated debt (in billions of US$)	24.9	23.0	23.9	23.9	23.2	23.3	23.2	23.2
Total external debt / exports of goods and services (in percent) 6/	100.7	96.4	98.2	96.1	91.4	90.0	87.8	86.1
Total external debt service (in billions of US$) 6/ 7/	5.1	5.6	4.5	5.6	6.4	4.6	5.2	5.2
Total external debt service / exports (in percent) 6/ 7/	14.0	15.8	12.5	15.3	17.1	12.1	13.3	13.1
Gross official reserves (in months of total imports)	2.7	2.9	2.9	2.9	2.8	2.9	3.0	3.0

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

1/ CPIX is the CPI less the interest on mortgage bonds.
2/ Excludes individuals who have not taken active steps to look for work or start self-employment in the four weeks prior to the interview.
3/ In U.S. dollars, annual percent change.
4/ Fiscal year beginning April 1. 2001 data are from revised budget.
5/ Excluding sales of state assets and profit/losses from forward market operations of the Reserve Bank.
6/ Excluding sales of state assets but including the profit/losses from forward market operations of the Reserve Bank.
7/ Excluding rand-demoninated debt held by nonresidents; end of period.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/75
FOR IMMEDIATE RELEASE
July 19, 2002

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

IMF Concludes 2002 Article IV Consultation with South Africa

On July 1, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

In 2001, the South African economy felt the impact of a slowdown in global economic activity, which interrupted the modest upturn that started late in 1998. Driven mainly by a contraction in overseas demand that lowered export prices and volumes, real GDP growth fell to 2.2 percent in 2001 from 3.4 percent in 2000. Activity reached a trough in the third quarter of the year, with GDP growth slowing to around 1 percent at an annualized rate and unemployment rising further from already very high levels. A modest recovery now appears to be under way, fueled in large part by a sharp depreciation of the exchange rate in late 2001 and a more recent firming in world commodity prices.

The slowdown in South Africa during 2001 was milder than in previous cycles. The greater resilience of the economy to external shocks reflected in part the extensive trade liberalization undertaken in the 1990s, which together with a depreciated currency has helped to increase competitiveness and diversify the export base, contributing to a relatively strong trade

[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.

performance and a narrowing of the current account deficit to 0.1 percent of GDP in 2001. In addition, industrial profitability has been boosted by lower borrowing and input costs. In particular, real interest rates fell during 2001, and wage moderation and substantial productivity gains led to a decline in real unit labor costs. As a result, domestic demand held up well, with both fixed investment and private consumption remaining relatively strong.

Economic performance has been underpinned by sound fiscal policy. The national budget deficit was reduced from 2.0 percent of GDP in 2000/01 (April-March) to 1.5 percent in 2001/02 (well under the original target of 2.5 percent) as a result of strong tax revenue growth and steps taken to improve expenditure monitoring and control. Provincial governments' budgets also overperformed, contributing to a narrowing in the consolidated government deficit from 1.7 percent of GDP in 2000/01 to an estimated 1.3 percent in 2001/02. The budget for 2002/03 that was presented in February 2002 targets an increase in the national deficit to 2.1 percent of GDP, in part reflecting some tax relief for lower- and middle-income people and higher spending on priority areas such as poverty reduction, social and economic infrastructure, and HIV/AIDS and crime. The provincial budgets are expected to be broadly in balance.

Monetary policy was eased during 2001 in the context of the inflation-targeting strategy that South Africa adopted in 2000. With inflation expectations falling through the third quarter of 2001—to within the official target range of 3-6 percent—and overseas interest rates coming down, short-term policy interest rates were lowered by 150 basis points between June and September. The monetary easing was reflected in an increase in broad money growth from 7.5 percent at end-2000 to 17 percent at end-2001.

The effort to lower inflation suffered a setback during the final quarter of 2001 when the value of the rand dropped sharply. The currency had depreciated steadily during January–August, but the pace of depreciation picked up sharply toward end-September. By mid-December, the rand was weaker by 40 percent in nominal effective terms than at end-August. With inflation rising during the first quarter of 2002, policy interest rates were raised by 100 basis points each in January, March, and June 2002. The tightening provided support for the rand, which at end-June 2002 was around 23 percent more depreciated than at end-August 2001.

The Reserve Bank continued to make steady progress in reducing its short-term foreign currency exposure—a key source of external vulnerability in the past—by retaining some of the proceeds of foreign direct investment, privatization, and external official borrowing. By end-April 2002, its net open forward position (NOFP) had been lowered to less than US$2 billion from nearly US$10 billion at end-2000 and a peak of US$23 billion in October 1998.

After some delays, structural reforms appear to be picking up pace. Implementation of the program for restructuring public enterprises that was launched in 2000 has been slow, but Telkom, the state telecommunications company, is now expected to be divested by March 2003 and the restructuring of Denel, the state defense corporation, is well ahead of schedule. An integrated human resource development strategy is being implemented to address skill deficiencies after a lengthy process of consultation with stakeholders. Amendments to South Africa's labor legislation are about to come into law and include more flexible work practices, steps to protect the interests of retrenched workers, and streamlined arbitration and conciliation procedures.

Executive Board Assessment

Executive Directors welcomed the increased resilience of the economy to external shocks, which has helped South Africa weather the impact of the recent global economic downturn. This resilience reflects an improved macroeconomic policy environment, gains in international competitiveness and export diversification, and a further reduction in the central bank's short-term foreign currency exposure.

Directors agreed that the central policy challenge for South Africa is to achieve higher, broad-based and job-creating economic growth. This will require a continued sound and stable financial environment, including a sufficiently tight monetary policy in the context of the inflation-targeting strategy, maintaining fiscal discipline, and rebuilding international reserves. Structural reforms aimed at promoting private sector activity and attracting foreign investment will remain critical, and should focus on further progress with privatization and trade liberalization, continued labor market reforms, and a sustained effort to address the HIV/AIDS pandemic.

Directors noted that the value of the rand has undergone large swings over the past year, resulting in what has appeared to be a significant overshooting of the exchange rate, which at present appears to be undervalued. While a confluence of factors, including an easing of monetary policy, delays in the privatization program, and contagion from developments in Zimbabwe, appear to have contributed to the weakness of the rand in late 2001, the rapidity and magnitude of the depreciation were difficult to reconcile with the otherwise sound macroeconomic environment.

Directors commended the authorities for their skillful handling of currency developments. They observed, however, that the sharp depreciation of the rand had undermined the effort to lower inflation, making it unlikely that the inflation target of the South African Reserve Bank for 2002 will be met. In light of this, firm commitment to the targets for 2003 and beyond will reinforce the credibility of the inflation-targeting strategy. Directors supported, in this respect, the increases in short-term policy interest rates so far this year to dampen inflationary expectations and contain wage increases, and they welcomed the authorities' determination to take all necessary steps to achieve the 2003 inflation target.

Directors commended the government for maintaining strict fiscal discipline in the face of budgetary pressures. Following a tighter than intended fiscal stance last year, they considered the modest relaxation in fiscal policy announced in the budget for 2002/03 to be appropriate. This will provide welcome room for income tax cuts and higher spending on key social services, HIV/AIDS, and efforts to address the high rate of crime. Directors highlighted the importance of continued improvements in tax administration to ensure that the ambitious revenue projections are met. They commented favorably on the comprehensive framework for improved fiscal management embedded in the Public Finance Management Act.

Directors welcomed the good progress made by the central bank in reducing its net open forward position (NOFP), which had been a major source of external vulnerability, and they supported the goal of eliminating the NOFP by March 2003. However, South Africa's international reserve position would still remain relatively weak, and Directors encouraged the central bank to continue to build up its net reserves with the proceeds from privatization and from prudent external borrowing. Directors commended the authorities' sound debt management policies, and supported the government's gradual approach to removing capital controls.

South Africa's financial system is sound and well regulated, and Directors noted that it had proven itself capable of withstanding the impact of a substantial currency depreciation. The difficulties relating to microfinancing operations, experienced by a few small banks, have been satisfactorily resolved.

Directors encouraged the authorities to persevere with structural reform efforts that are essential for higher sustained growth and employment. They welcomed the authorities' efforts to pick up the pace of privatization, including in the telecommunications sector, which will help increase productive efficiency, attract foreign investment and technology, and reduce government indebtedness. Directors also welcomed the steps taken to communicate the privatization strategy more clearly to the public.

Directors strongly supported the government's efforts to address South Africa's acute unemployment problem through programs to raise educational standards and provide job training. Noting, however, that the use of a payroll tax to finance the skills development program might have a counterproductive impact on job creation, they suggested identifying alternative sources of financing for the program. Directors welcomed recent legislation which will reduce the "statutory" costs of doing business, while protecting workers' basic rights, but they urged the authorities to continue reviewing labor laws at frequent intervals. This should include consideration of a more decentralized collective bargaining system by granting small and medium-sized enterprises greater latitude in setting wages. Directors also encouraged the authorities to continue with their land reform program, which they saw as key to improving rural employment prospects.

South Africa is facing a serious HIV/AIDS pandemic, which could significantly reduce average life expectancy and dampen future economic growth. Directors welcomed the importance that the government is attaching to combating HIV/AIDS by implementing a multisectoral approach and treating the disease as a fiscal priority, while ensuring that budgetary funds are properly targeted and well spent.

Directors encouraged the authorities to push further ahead with trade liberalization, which has been a major source of economic growth in recent years. They hoped that the new institutional arrangements for setting tariffs within the Southern African Customs Union would not slow down the process of trade reform.

Directors welcomed the recent Report on the Observance of Standards and Codes (ROSC) on Fiscal Transparency, which concluded that the quality of fiscal management and transparency in South Africa are high by international standards. They encouraged the authorities to tackle the few areas where further improvements are needed. Similarly, they welcomed the conclusion of a recent Data ROSC, which considered South Africa's economic data to be generally of high quality and adequate for surveillance purposes, although there is scope to improve the reliability and timeliness of labor market data.

Directors commended South Africa's leadership role in contributing to conflict resolution and poverty reduction in Africa, including through continued grant support for the PRGF-HIPC Trust.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

South Africa: Selected Economic Indicators

	1998	1999	2000	2001
	(In percent)			
Domestic economy				
Change in real GDP	0.8	2.1	3.4	2.2
Unemployment rate 1/	25.2	23.3	26.3	28.8
Change in consumer prices (end of period)	9.1	2.2	2.3	4.6
	(In billions of U.S. dollars, unless otherwise noted)			
External economy				
Exports, f.o.b.	29.1	28.6	31.7	30.7
Imports, f.o.b.	27.2	24.5	27.4	25.7
Current account balance (deficit -)	-2.3	-0.6	-0.5	-0.2
Direct investment	-1.2	-0.1	0.6	10.8
Portfolio investment	3.7	8.6	-2.0	-8.3
Financial account balance (deficit -)	3.1	5.3	0.3	-1.1
Gross official reserves	5.4	7.4	7.5	7.5
Current account balance (in percent of GDP, deficit -)	-1.7	-0.5	-0.4	-0.1
Change in real effective exchange rate (in percent) 2/	-8.9	-5.2	-3.0	-17.0
Net open forward position of the Reserve Bank 3/	22.5	13.0	9.5	4.8
External debt (in percent of GDP) 4/	28.0	29.6	28.8	30.0
Exchange rate, rand per U.S. dollar (end of period)	5.86	6.15	7.57	12.09
	(In percent, unless otherwise noted)			
Financial variables				
National government balance (in percent of GDP, deficit -) 5/	-2.3	-2.0	-2.0	-1.5
Change in broad money	14.6	10.1	7.5	17.0
Interest rate 6/	19.32	12.00	12.00	9.50

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

1/ Official definition.
2/ (+)=appreciation (period average).
3/ Defined as net forward foreign exchange liabilities less net spot reserves.
4/ Includes rand denominated external debt.
5/ Fiscal year starting on April 1.
6/ Bank/repo rate (end of period).

Statement by the IMF Staff Representative
July 1, 2002

1. Information that has become available since the staff report was issued provides further evidence that a recovery in economic activity is under way. Domestic demand conditions remained buoyant in the first quarter of 2002 as a result of healthy growth in fixed investment and consumption, while the current account moved into a small surplus, reflecting firmer commodity prices and a competitive exchange rate. Output in the industrial and mining sectors has risen very strongly in recent months.

2. Although the rand has strengthened by around 10 percent in nominal effective terms since the beginning of the year, the inflationary impact of the sharp depreciation in the final quarter of 2001 is still being felt. Annual CPIX inflation rose further to just over 9 percent in May, which is well above the Reserve Bank's target of an average of 3–6 percent for 2002. Moreover, surveys indicate a pronounced hardening of inflationary expectations, and the higher inflation has triggered an upward adjustment in civil service wage rates to 9 percent.

3. In response to these developments, and notwithstanding a marked slowdown in monetary expansion in April, on June 14 the Reserve Bank raised short-term interest rates, for the third time this year, by 100 basis points. This action is consistent with the policy advice given by the staff during the Article IV consultation discussions. The adjustment in interest rates has been accompanied by a significant reflow of portfolio investment into South Africa, and sovereign risk spreads have been in the region of 230–250 basis points, which is close to historic lows.

Statement by Cyrus D. R. Rustomjee, Executive Director for South Africa
July 1, 2002

Key Points

- *The South African authorities continued to implement sound macroeconomic policies during the period under review.*
- *Government finances continued to be strong particularly at the levels of the central and provincial governments. During the year under review revenue collections over-performed, expenditure management was enhanced by new legislation, and a lower-than-budgeted deficit were recorded.*
- *Sound monetary policy continued to be implemented.*
- *The exchange rate depreciated sharply toward the end of 2001, but has regained much of its lost ground.*
- *The Net Open Forward Position (NOFP) was further reduced as the authorities continue to pursue their policy of closing out the position.*
- *Conditions in the labor market improved with the introduction of legislation to streamline the arbitration process, and allow for more flexibility in employment. Better regulation of wage bargaining process resulted in a substantial decline in person-hours lost emanating from labor disputes.*
- *The government is pursuing the process of restructuring of state assets vigorously.*
- *Social Development Indicators show an increase in the living conditions of South Africans. While HIV/AIDS is still prevalent in the country, the rate of increase has stabilized.*
- *South Africa continued to play a leadership role on the African continent, through various initiatives including NEPAD and through contributing to the peace process in conflict countries.*

Introduction

1. We thank the staff for the set of high quality documents, including the selected issues paper and the fiscal ROSC report, regarding economic developments in South Africa for the period under review. My authorities are in broad agreement with the staff's analysis.

2. In the period since the last Article IV consultation, South Africa has continued to make progress across a range of both macroeconomic and social policy objectives. A real growth rate of 2 percent was recorded notwithstanding the global economic downturn; significant further progress was made in reducing the Net Open Forward Position (NOFP); fiscal policy conduct remained sound, with the outcome of the consolidated fiscal deficit for

the period of 1.5 percent, well below budget. Progress also continued with regard to financial soundness of provincial governments with the latter's bank indebtedness decreasing from R1.6 billion at the end of march 2001 to R0.5 billion at the and of March 2002, and with their deposits with the banking sector increasing from R7.9 billion to R9.6 over the same period.

3. Significant progress also continued to be made in the provision of social services, including in the provision of education, preventative health care, water and sanitation, and the extension of electricity to the peri-urban and rural poor. Fiscal consolidation, sound macroeconomic policies and consistent structural reforms since 1994 are enabling the authorities to systematically rectify the appalling social and economic legacy of apartheid.

4. South Africa's status as a stable emerging market economy further strengthened during the year under review. The authorities continued to maintain a prudent external debt management strategy and during the period under review acquired investment grade credit ratings as recognition of many years of progressive and consistent policy improvements.

Recent Economic Developments

5. The South African economy responded with remarkable resilience to the recent global economic slowdown. Several factors contributed to the country's ability to weather external shocks including the country's strong and well managed financial sector, the continued sound implementation of fiscal policy, a substantially lower-than-average external burden in comparison with most emerging markets, and consistency in implementing prudent monetary and exchange rate policy.

6. GDP growth performance was broad based. Manufacturing production increased; and retail sales, trade, and the activities in the financial sector expanded. Sound agricultural production was also recorded during 2001, including a good grain harvest. The growth level of 2001 was sustained during the first quarter of 2002, making this the fourteenth consecutive quarter of economic growth, commencing from the fourth quarter of 1998. My authorities project a 3 percent growth rate for 2002, as the global economic environment itself improves.

Fiscal Policy

7. The authorities remain committed to prudent fiscal policy. At the same time they will continue to seek to address through the national budget the challenges of development and poverty alleviation. To this effect, the most recent budget provides for a strong orientation towards spending on alleviating poverty through increases in old age pension, child support grants and HIV/AIDS projects; and investment in infrastructure in support of urban renewal and rural development. The budget has also focused on substantially strengthening infrastructure and on addressing crime by increasing resources available to the safety and security sector.

8. Revenue collections at the level of the central government continued to improve during the period under review, as a result of the consistent efforts by my authorities to

improve the administrative capacity of the South African Revenue Service (SARS). These efforts resulted in an over-performance of tax collections. My authorities have projected a further increase in revenues for the current fiscal year. Fiscal policy at the level of the central government was further strengthened through a series of further initiatives to control expenditures; and to ensure that spending objectives are met. In this regard, after detailed discussion with all the major stakeholders, my authorities adopted the Public Finance Management Act. The Act provides a comprehensive framework for improved fiscal management at central and provincial government levels, and similar legislation is contemplated for the local governments. Key features of the Act include tight restrictions on increasing expenditures during the fiscal year; detailed requirements on managing and reporting expenditures; performance indicators and a medium-term expenditure framework; and a contingency revenue fund to provide for unexpected expenditures.

9. As a result of the improved fiscal performance, the recorded deficit of the central government declined to 1.5 percent of GDP, lower that the budgeted deficit of 2.2 percent. My authorities used the improved fiscal environment to reduce the public debt as percentage of GDP to 40 percent of GDP; by comparison in 1994/95 public debt as percent of GDP reached at 55 percent. As a consequence of the progressive lowering of public debt, the interest cost to the fiscus has declined steadily over the last few years, from 5.5 percent of GDP in 1999/2000 to 4.7 percent in 2001/02. Similarly, as a result of consolidated strengthened financial management by the general government, the borrowing requirement of the consolidated general government shrank from R17.2 billion in fiscal 2000/01 to R9.7 billion in fiscal 2001/02.

10. The South African authorities also used the more favorable fiscal environment to ease the tax burden of individuals and to make the environment for businesses, particularly small businesses more friendly. In this regard, substantial reductions in the rates of individual income taxes have been introduced across all income categories. The authorities have also introduced tax incentives to encourage investment, and a more generous tax regime for small businesses.

Monetary Policy Developments

11. Monetary policy in South Africa is conducted under the inflation-targeting framework adopted in February 2000. In the period under review, the authorities remained committed to the policy framework, and implemented monetary policy with the aim of achieving the inflation targets. As a result inflation declined from 7.6 percent in 2000, to 5.8 percent in September 2001, well within the initial target range of 3-6 percent. Following the decline in the inflation rate, my authorities adjusted their monetary policy stance with successive cuts in interest rates during the second half of 2001. However, inflationary pressures increased sharply in the first few months of 2002 largely as a result of the depreciation in the external value of the rand in the second half of 2001 and rising expectations of price increases. As the depreciated rand impacted on prices, the year-on-year increase in consumer prices rose from 5.8 percent in September 2001 to 8.8 percent in April 2002.

12. Apart from the weaker currency, food price increases contributed to the acceleration in inflation. These increases were partly related to the depreciated value of the rand because domestic prices are charged at levels approximating those determined internationally and partly due to shortages of certain types of food produced in the Southern African region. Higher international oil prices also contributed further to the acceleration in inflation.

Prospects for Meeting the 2003 Inflation Target

13. The authorities are determined to take all the necessary steps to achieve the 2003 inflation target. Positive factors expected to contribute to a moderation in inflation include surplus production capacity, continuing fiscal discipline, a considerable strengthening of the value of the Rand, which has already brought about some reductions in the price of fuel and some foodstuffs, and a substantial further strengthening in the current account of the balance of payments, which has already changed from a deficit of R2.7 billion in the fourth quarter of 2001 to a surplus of R4.2 billion in the first quarter of 2002.

14. That said, my authorities nevertheless consider that there remain risks that may prevent the attainment of the inflation target for 2003. These include particularly the continued high level of growth in money supply and bank credit extension, and high inflationary expectations. Nevertheless, econometric projections based on a number of different scenarios show that the average inflation rate in the 2003 will be close to the upper level of the inflation target. In view of these risks, the Monetary Policy Committee of the South African Reserve Bank most recently decided to increase the repo rate in June 2002, in order to contain inflationary pressures.

Exchange Rate Developments

15. The South African foreign exchange market, which had been characterized by turbulent conditions in the second half of 2001, consolidated in the first five months of 2002. After having declined by 24 per cent from the end of September 2001 to the end of December, the nominal effective exchange rate of the rand strengthened in the first quarter of 2002. A healthy overall surplus on the balance of payments led to a marked improvement in international sentiment towards South Africa, which bolstered the external value of the rand against a broad range of foreign currencies. On a trade-weighted basis the exchange rate of the rand increased by 6.9 per cent from the end of December 2001 to the end of March 2002.

16. In addition, in the first quarter of 2002 non-residents became keen buyers of South African bonds and equities on a net basis. Several factors suggest that this substantial positive shift could endure. These include the continued reduction in the net oversold position in foreign currency of the Reserve Bank, and the prospect that the net oversold position will be eliminated in due course; a rise in international commodity prices in the first quarter of 2002, and an expectation that any synchronized global upswing in economic activity in the second half of 2002 could boost South Africa's export performance.

Financial Sector Issues

17. The soundness of the South African financial system has contributed significantly to the economy's resilience in the context of the global downturn in 2001, as well as the recent exchange rate shock. These achievements are the result of consistent efforts to progressively strengthen the supervisory and regulatory environment in the financial sector. The authorities have also benefited considerably from, and wish to record their appreciation to the staff team that conducted the FSAP exercise in South Africa. The recommendations in the FSAP report are systematically being applied. Further efforts to strengthen the financial sector include steps being taken toward full compliance with the Basel principles. There has also been significant progress with the authorities intention to introduce a compulsory deposit insurance scheme.

18. The NOFP was for many years a significant source of external vulnerability to the South African economy. My authorities have steadily reduced this level of exposure from a peak level of US$24 billion in 1997. Over the last two years, the NOFP declined from US$4.8 billion at the end of December 2001 to US$1.9 billion at the end of April 2002. My authorities envisage that the NOFP will be completely closed out by March 2003.

19. As regards further efforts toward capital account liberalization, my authorities are determined to pursue the process, which was started since 1994. Gradualism, however, remains the cornerstone of the government's policy and the authorities will pursue further liberalization efforts as exchange rate conditions stabilize and the reserves position improves.

Labor Market Developments

20. Addressing the high level of unemployment remains a substantial challenge and a major concern of the authorities. The high level of unemployment in South Africa is the legacy of years of low economic growth, acute skills shortage, and the displacement of capital for labor. The authorities have taken a series of steps to address these issues, in order to create an enabling environment for job creation. A Skills Development Act was legislated in 1996, as the framework to increase the general skills level of both the employed and the unemployed South Africa. The Act makes provision for training through Sectoral Education and Training Authorities (SETAs) to both the employed and the unemployed, the latter particularly including school leavers and graduates. Several enterprises, particularly in the financial sector provide on-the-job training to graduates, with the option of providing them with full time employment once the training program has been completed. My authorities are confident, that the process of skills enhancement as envisaged by the Act will gather momentum and the performance indicators set for 2005, will be achieved.

21. In addition to the Skills Development Act, my authorities have also adopted the Employment Equity Act inter alia to address the historical segmentation by occupation among the racial groups in South Africa. The government's skills developments strategy recognizes that structural changes are required to ensure that the skills requirements for the economy are met, while at the same time addressing the social and gender imbalances

prevailing in the market. It is envisaged that the present set of labor legislation, especially the Skills Development Act and the Employment Equity Act, will assist in rectifying these structural and social imbalances in the medium term.

22. My authorities have also adopted several amendments to the labor legislation in order to increase the flexibility of work practices, and streamline arbitration and conciliation procedures. These amendments are the result of extensive negotiations between government, business and labor within the National Economic Development and Labor Council (NEDLAC). The Amendments to the legislation provide among other changes, for the establishment for a framework for bargaining in the public service, a speedier "one-stop" process of conciliation and arbitration for unfair dismissals and unfair labor practices, a probationary period of six months to be introduced during which less strict dismissal procedures would apply in cases of unfair dismissals, and the ability of bargaining councils be able, by collective agreement, to increase the number of regular working hours in a week to more than 45 hours and the number of overtime hours to 15 hours.

23. As a result of the more regulated and stable wage-bargaining regime, recent labor relations in South Africa have been more peaceful. This is evident by the declining duration of strikes. In 1993, 3.1 million person-days were lost because of labor disputes, but in 2000, the number fell to 0.5 million or by almost 84 percent - the lowest level in almost two decades.

Restructuring of State Assets

24. The authorities embarked on a comprehensive program of restructuring of public enterprises in August 2000, and they remain fully committed to implementing this policy. The program includes the further divestiture of a broad range of public enterprises including in the transport, electricity, telecommunications and defense sectors. The program also includes the divestiture of smaller enterprises particularly in the leisure industry. Following a brief pause due to the global economic environment downturn in 2001, and in particular the consequences of this in weakening international market conditions for the sale of the telecommunication enterprise Telkom, as well as the authorities efforts to formulate an appropriate regulatory environment for divestiture, the divestiture program is now being applied vigorously. It is the authorities intention to divest Telkom before the end of 2002; to create the regulatory framework to divest Eskom, the electricity utility; to formalize plans to attract a strategic partner for Denel, the defense enterprise; to proceed with finalization of plans to divest non-core public assets; and to formalize a framework for improved communication of the privatization strategy.

25. Revenues from privatization made a significant contribution towards reducing the net borrowing requirement of national government in fiscal 2001/02. Receipts from the restructuring of government assets consisted of a special dividend of R2.2 billion received from the South African Special Risks Insurance Association (Sasria) and a dividend of R1.4 billion declared by the transport utility Transnet. This dividend followed from the

monetization of Transnet's interest of 20 percent in M-Cell, an information and telecommunications company.

Progress with Combating HIV/AIDS

26. A second very significant challenge for the authorities is to address the high prevalence of HIV/AIDS among the South African population. This remains a major source of concern to my South African authorities, since it could impact the country's growth prospects, per capita income, and supply of labor. It could also become a major source of expenditure to the fiscus. To address these concerns my authorities have adopted a multi-sectoral approach to combat the pandemic. A recent survey suggests that the steady progress in stabilizing the spread of the disease has been made, and indicates that while the prevalence of HIV/AIDS remains unacceptably high at 24.8 percent of the adult population, the spreading of the disease has stabilized since 1998. The survey also shows that the prevalence of the disease among teenagers has dropped for the third consecutive year.

27. Budgetary allocations to combat the disease are being increased substantially for the next three years. Both the direct budgetary outlays and the indirect expenditure will increase during for the period 2002/03-2004/05. Direct expenditures are expected to double as share of GDP between 2002/03 and 004/05, while indirect expenditures are currently estimated to be as high as 1.5 percent of GDP, or 40 percent of the health budget. Further efforts to combat the disease have been introduced by making antiretroviral drugs generally available, as a complement to the prevention-centered approach of the authorities.

Trends in Social Development Indicators

28. Since 1994, major efforts have been made to reduce poverty, by improving the quality of expenditure and improved planning and where appropriate, through increased social spending. Increased allocations have been made in the areas of social security, crime prevention, health, and education since 1994. These increased allocations have been accompanied by a significant decline in defense related expenditure. These efforts have resulted in a significant shift in the expenditure priorities of the authorities towards social spending, and in turn has resulted in a substantial improvement in human development indicators in South Africa, particularly in adult literacy, increased enrollment in primary, secondary and tertiary education, and access to water and sanitation. However, as a result of the spreading of HIV/AIDS, the life expectancy of South Africans has decreased significantly, a trend which my authorities believe will be reversed as they continue with their program of combating HIV/AIDS.

Other Recent Developments

Trade and Industrial Policy

29. My authorities have been actively pursuing policies to promote trade liberalization since 1994. These efforts have resulted in free trade agreements with the European Union in

January 1999 and with the SADC region in 2000. Extensive trade negotiations are also underway with other major trading regions, including MERCOSUR, and active trading relations currently exist with many other industrial, emerging market and developing countries. All of these efforts have proved to be a major contributor to the country's growth performance, and these efforts have been boosted by the increased competitiveness as a result of the decline of the value of the currency. My authorities remain committed to further trade liberalization, within a framework that ensures the stability of the macroeconomic environment.

Land Reform

30. South Africa has made very significant progress with land reform since 1994. Land reform is being pursued in the context of market based principles and is taking place according to the law and as guided by the Constitution. The policy is based on restitution for land dispossessed in the past, and redistribution of agricultural land. The authorities have made major strides with the restitution for dispossessed land. The process will be completed in 2005. Thus far, almost a half of all the claims for restitution have been settled. As regards land redistribution, the authorities are also keen to accelerate the process, which is important both to enhance social stability, and to address unemployment in the rural areas. One of the biggest challenges is to provide security of tenure to the one third of South Africans that live on rural land, as stipulated by the Constitution.

Regional Role

31. In the period under review, South Africa's role in the region and continent further strengthened, with the extension of significant foreign direct investment by South African corporates in all parts of Africa, the significant expansion of trade, and the substantial contributions to securing peace in the Democratic Republic of the Congo (DRC) and in Burundi, as well as the provision of peace-keeping personnel in these and other parts of the continent. South Africa has also been an influential contributor to the development of the New Partnership for African Development (NEPAD). In the period under review, the authorities continued to support the PRGF-HIPC Trust, by providing substantial grant contributions to the PRGF Trust. South Africa was also pleased to have been able to make a substantial recent contribution to the bridge loan facility needed to clear the protracted arrears of the DRC.

Conclusion

32. The authorities are making solid progress across a wide range of macroeconomic and social policy fronts. They continue to strongly benefit from the advice of staff and wish to record their appreciation for the quality and professionalism of staff advice in the last few years. The authorities remain committed to pursuing sound monetary, fiscal and exchange rate policies and systematically addressing the economy's structural challenges.

33. The authorities also wish to record their appreciation for the professional manner in which the fiscal ROSC exercise was conducted in South Africa during April 2002. The authorities place a high value on the very candid and positive report following the ROSC exercise, and intend to progressively implement the staff's recommendations.