INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/303

SOUTH AFRICA

2013 ARTICLE IV CONSULTATION

October 2013

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 2013 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF for Executive Board's consideration on July 31, 2013, following discussions that ended on June 4, 2013, with the officials of South Africa on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 19, 2013.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 31, 2013 consideration of the staff report that concluded the Article IV Consultation with South Africa.
- **Statement by the Executive Director** for South Africa.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 19, 2013

KEY ISSUES

Context: South Africa has made impressive strides in economic development over the past two decades. But in recent years, lower growth has exacerbated high unemployment, inequality, and vulnerabilities. Although weak trading partner growth contributed, domestic factors were an important reason why South Africa's growth has been below that of other emerging markets. Large current account and fiscal deficits, so far easily financed by global liquidity, have raised vulnerabilities.

Outlook and Risks: The outlook is for continued sluggish growth and elevated current account deficits, reflecting global developments and important domestic factors. Absent structural reforms, growth will be insufficient to reduce unacceptably high unemployment. Risks are tilted firmly to the downside, especially from lower capital inflows, though stronger implementation of National Development Plan (NDP) would improve the outlook.

Structural Reforms: Advancing structural reforms—by implementing the NDP and increasing competition and flexibility in labor and product markets—is imperative to achieve faster growth and job creation. Prompt progress on NDP implementation could build reform momentum and reduce policy uncertainty. Limited reform progress leads to an inexorable buildup of vulnerabilities.

Demand-Management Policies can only play a limited role in supporting growth. Automatic stabilizers should be allowed to play this year if growth is lower than assumed in the budget, but should growth continue to disappoint, offsetting measures will be required. Greater clarity on a medium-term debt benchmark could bolster credibility. Measures to improve spending efficiency and composition are critical for growth. The monetary policy stance is finely balanced and the inflation targeting framework remains appropriate. Rand flexibility has helped South Africa absorb shocks, and higher reserves would also help manage vulnerabilities.

Financial Stability: Financial soundness indicators remains strong, though rising risks from unsecured lending and high household indebtedness suggest additional macro-prudential and consumer protection measures, as well as improved regulator coordination, may be warranted. The adoption of Basel III will further strengthen the financial architecture, but meeting the net stable funding ratio will be challenging.

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Discussions took place in Pretoria, Johannesburg, and Cape Town, May 22–June 4, 2013. The staff comprised Ms. Papi (head), Messrs. Canales-Kriljenko, Mu, Saxegaard, and Ms. Liu (all AFR), and Mr. Perrelli (SPR). Mr. Schimmelpfennig (Senior Resident Representative) assisted the mission. Mr. Todani (OED) also participated in the discussions.

CONTENTS

TABLES

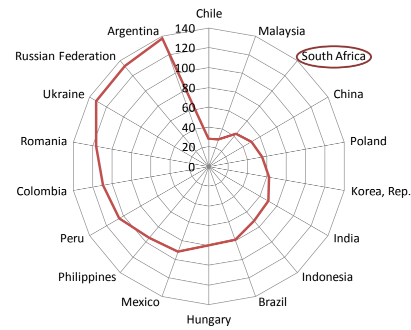
ANNEXES

CONTEXT

1. **South Africa has made strides in economic and social development since its first democratic elections, almost two decades ago.** Growth averaging 3.3 percent since 1994 and social assistance that now reaches more than half of all households have resulted in a 40 percent increase in real per capita GDP and a 10 percentage point drop in the poverty rate (Figure 1). A significant strengthening of South Africa's policy frameworks and institutions, as well as robust balance sheets, have delivered macroeconomic stability and a globally integrated and diversified economy built around the country's natural resource wealth.

South Africa has Strong Institutions

(ranking 2012-13, lower number implies better institutional quality)

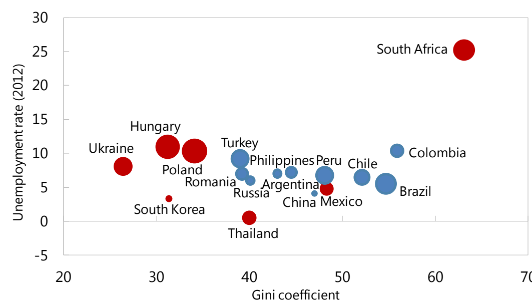


Source: World Economic Forum Database

2. **Yet South Africa's economy faces important structural challenges, primarily one of the world's highest unemployment rates and inequality.** The Gini coefficient, at 63, is in the top 5 percent of the global distribution. Differences in labor income and high unemployment, as well as property income, are the main drivers of income inequality. The unemployment rate is 25 percent (34 percent including discouraged workers), with the youth unemployment rate at 50 percent despite one of the lowest participation rates in the world. Notwithstanding the rising black middle class, wealth, land, education, and health outcomes remain unequally distributed along racial lines. Inequality within races has also increased since 1994.

High Unemployment and Inequality 1/

(latest available observation)



Sources: WEO; and World Bank World Development Indicators.
1/ Blue represents a decrease and red an increase in unemployment between 2008 and 2012. The size of the bubble illustrates the magnitude of the change in unemployment.

3. **In recent years, South Africa's subdued growth has exacerbated unaddressed structural problems and exposed new vulnerabilities.** Since the global financial crisis, South Africa's growth has lagged other emerging markets (EMs) and commodity exporters, aggravating its long-standing high unemployment.[1] Further, though public and external debt remains manageable, after five years of elevated fiscal deficits, fiscal vulnerabilities have increased and the current account deficit has widened. Abundant global liquidity has provided easy financing so far, but the pull back of capital flows from EMs in May 2013 showed how South Africa's domestic vulnerabilities amplify external shocks.

[1] In this report, the peer EM group consists of Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, Thailand, Turkey, and Ukraine. The peer group of commodity exporters includes Australia, Brazil, Canada, Peru and Russia. Policy recommendations draw on a broader set of country experiences.

4. These challenges came to a head in 2012. Dissatisfied with wages and working conditions many workers in the mining sector have changed union membership, leading to inter-union rivalries. In August 2012, a strike turned into a tragedy when over 40 people were killed at the Marikana mine, owned by the world's third-largest platinum producer. Tense industrial relations, especially in the mining sector, persist in 2013, as initial wage demands do not reflect the outlook for growth and commodity prices, or productivity growth. However, a framework agreement to normalize industrial relations in the mining sector and address historical challenges such as spatial patterns, migrant labor, and vulnerabilities brought about by volatility in commodity prices, has been signed. Inequality and unemployment, combined with localized expression of discontent with corruption and poor public service delivery are affecting investor perceptions and macroeconomic outcomes. Since September 2012, citing the lackluster growth, rising vulnerabilities, and structural and social problems, all three major credit rating agencies have downgraded South Africa's sovereign rating—two maintain a negative outlook.

5. Recent statements suggest a renewed commitment to structural reform, but past implementation dampens expectations. The African National Congress' (ANC's) and the government's endorsement of the National Development Plan (NDP) in 2012 raised hopes for structural reforms. Since then the government has reprioritized spending in line with the NDP within the fiscal envelope. However, parts of the tripartite alliance have opposed the NDP, which together with the implementation record of structural reforms leaves many investors skeptical about prospects for major structural change. At the same time, the political debate over the direction of economic policy has resulted in policy uncertainty. Also, various factors (including apparent population dissatisfaction) are contributing to the emergence of other political formations seeking to contest the 2014 elections.

6. The authorities' macroeconomic policies and past Fund advice have been broadly aligned, but progress on structural reforms has been limited. In the 2013 budget, fiscal expenditure growth was lowered. Monetary policy has continued to anchor inflation expectations. In the face of a depreciating currency, the authorities chose not to increase reserves. As for structural reforms, the 2013 budget takes the NDP as its starting point, and the Department of Performance Monitoring and Evaluation has started to develop a medium-term strategic framework that will guide NDP implementation over the next five years. On product market reforms, the Competition Commission's powers have been strengthened. Industrial relations remain tense, and progress on labor market reforms has been elusive.

DEVELOPMENTS

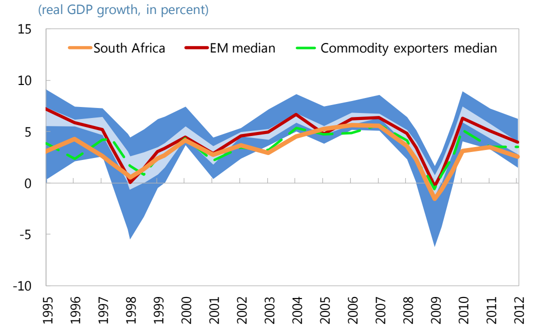
A. South Africa's Economy Underperforms Peer Emerging Markets

7. In recent years growth has been lower than in other EMs and commodity exporters, despite supportive macroeconomic policies.

- Since 2009, South Africa's real GDP growth averaged 3 percent (1.9 percent per capita) compared to 5 percent for EMs and 3.7 percent for commodity exporters (Figure 2). Although weak trading partner growth contributed, domestic factors were an important cause, including labor disruptions. Export growth was lower than expected, reflecting competitiveness problems and power and transportation bottlenecks.

Growth Since 2010 has been Disappointing 1/

(real GDP growth, in percent)

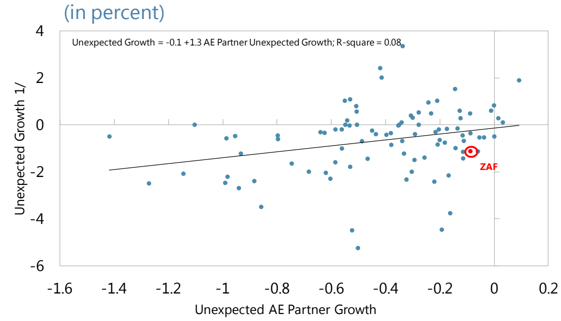


Sources: WEO and Fund staff estimates.
1/ The light blue area represents the center quintile of the EMs' distribution, while the dark blue areas represent the other two center quintiles.

- Domestic demand has grown consistently faster than GDP. Public consumption, and to a lesser extent public investment in large infrastructure projects, supported the economy, accounting for nearly 40 percent of growth since 2009. The South Africa Reserve Bank (SARB) repo rate turned negative in real terms and interest rates have been at historical lows. Solid disposable income growth and rising unsecured credit to households buoyed private consumption. In contrast, despite strong corporate health and favorable financing conditions, private investment has remained anemic since the global financial crisis partly due to low business confidence and policy uncertainty.

The 2013 Slowdown: More than External Spillovers

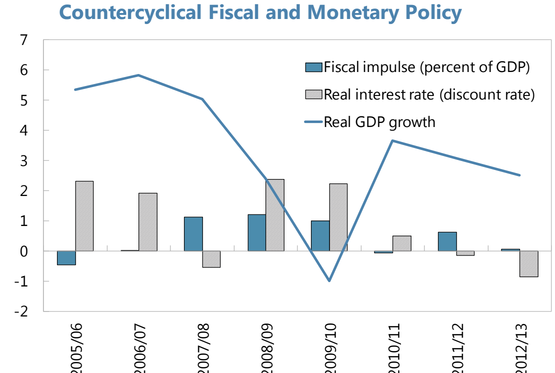
(in percent)



Sources: IMF RES, WEO; and Fund staff estimates.
1/ Unexpected growth denotes real GDP growth in 2013 minus the forecast in 2011 WEO. Partners growth is export weighted average.

- In 2012, growth dipped to 2.5 percent, with mining strikes estimated to have shaved 2 percentage points off exports and ½ a percentage point off GDP growth. The SARB cut the repo rate by 50 basis points (bps) despite inflation hovering at the top of the 3–6 percent target range. But softer private consumption due to slowing income growth and weak consumer confidence took its toll on overall growth. These trends continued in the first quarter of 2013, when GDP growth fell to 0.9 percent, the lowest since

Countercyclical Fiscal and Monetary Policy

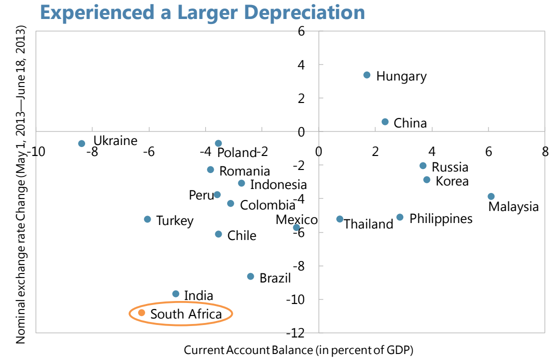


Sources: SARB; and Fund staff estimates.

2009. PMIs and leading indicators continue to point to sluggish growth.

8. South Africa benefited from abundant global liquidity, but its financial market performance has been among the weakest in EMs, including during the recent turmoil. Strong inflows into the local currency bond market have been driven by yield differentials, South Africa's large weight in major EM indices, and its inclusion in Citi's World Global Bond Index in 2012 (Figure 3). The rand has typically been viewed as a global barometer for risky assets, but its correlations with risk on-risk off indicators dropped substantially since last August before picking up again in the May-June turmoil. Since the beginning of 2012, the rand's depreciation (23 percent) and volatility have been among the highest for main EM currencies. During August 2012–April 2013, the yield on the 10-year South African government bond rose by 40 bps, while those of most of EMs declined. In May and June 2013, South Africa's currency and bond sell-offs have been among the largest in EMs, accompanied by sharply higher volatility. In addition, commodity prices, especially gold and platinum, have seen substantial declines.

Countries with a High Current Account Deficit Experienced a Larger Depreciation

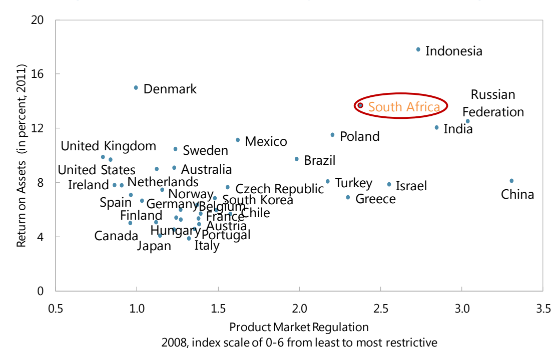


Sources: Bloomberg, WEO; and Fund staff estimates.

B. Structural Problems to the Fore

9. Insider-outsider dynamics characterize product and labor markets and are the root cause of poor labor market outcomes, combined with low education attainment. Collective bargaining between large incumbent firms and labor unions is contributing to above-market-clearing wage settlements that are binding on the entire sector (Annex I and II). Large incumbent firms result partly from apartheid-era policies of promoting national champions and limited progress in reducing barriers to entry. Poor education attainment and skill mismatches contribute to unemployment. Spatial divides and limited opportunities for entrepreneurship during apartheid have left a legacy that continues to hinder employment and small and medium enterprise (SME) development. Burdensome regulations, and to a lesser extent access to finance, are also factors that explain why barriers to entry are high and the creation and survival rates of SMEs in South Africa are among the lowest in the world.[2] Finally, a World Bank study on the economy of townships

High Corporate Profitability and Onerous Regulation



Sources: Corporate Vulnerability Utility; and OECD.

[2] Herrington M. J. Kew, and P. Kew (2009). Global Entrepreneurship Monitor, South African Report.

finds that crime is an important deterrent to economic activity.[3] The result is a large number of people excluded from the labor market, increasing capital intensity, too few SMEs, and stifled innovation and competitiveness.

10. Meager employment growth has highlighted unaddressed structural problems. Employment grew an average of 0.8 percent annually in 2010–12 compared to 1.6 percent in 2002–08, leading to an increase in the unemployment rate from a trough of 21 percent to 25 percent. All net job creation post 2009 has taken place in the public sector, while the private sector has only recovered two-thirds of the jobs lost during the global financial crisis. With inflation at 5½–6 percent and wage settlements averaging 10 percent since 2008, the gap between real wages and productivity growth has widened. Wage demands so far in 2013 exceed inflation by large amounts.

C. Vulnerabilities on the Rise, though Balance Sheets Remain Robust

External position

11. Despite subdued growth and still-robust terms of trade, South Africa's current account deficit in 2012 was one of the largest among EMs.

- After averaging 3½ percent of GDP in the previous three years, the current account deficit deteriorated to 6.3 percent of GDP in 2012, reflecting a wider trade deficit and a 2 percent fall in the terms of trade (Figure 4). Savings fell while investment was broadly constant. Export volumes stagnated despite a re-orientation away from Europe and towards Sub-Saharan Africa and Asia. Import volumes grew rapidly, partly owing to the high import intensity of infrastructure projects. In the first quarter of 2013, the current account deficit improved marginally to 5.8 percent of GDP.

- South Africa's current account deficit reflects competitiveness problems, which remain significant despite the recent depreciation and have contributed to a declining share of global exports (Box 1). Before 2008, improving terms of trade masked weak export performance—had the terms of trade remained at the 2005 level, the 2012 current account deficit would have reached 11 percent of GDP. The share of manufacturing exports has fallen to just below 40 percent from above 50 percent in 2002, while commodities account for almost all the rest.

- The IMF external balance assessment suggests that South Africa's current account deficit exceeded the current account deficit consistent with fundamentals and policies at desired levels by 2–4 percentage points of GDP (Annex III). Applying mechanically trade elasticities, this would imply a 10–15 percent exchange rate overvaluation. Although the rand depreciation since the first quarter of 2013 should help reduce the current account gap,

[3] World Bank (2013, forthcoming) "The Economics of South African Townships," Africa Poverty Reduction and Economic Management.

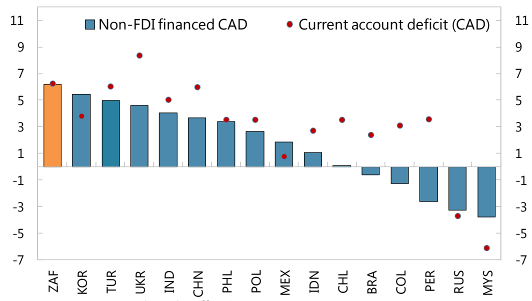
structural factors, such as low household savings, will likely keep the external position weaker than justified by fundamentals.

12. External vulnerabilities are exacerbated by a worsening funding mix and relatively low reserves.

- South Africa's current account deficit is increasingly financed by non-FDI flows, particularly debt. Net portfolio and other investment liabilities accounted for 5.1 percent of GDP in 2012, boosted especially by inflows into the bond market and short-term bank loans. Outward FDI, notably to Sub-Saharan Africa, is rising, while inward FDI has declined in sync with deteriorating investor confidence. Nonresidents hold 34 percent of the shares of the top 100 listed firms and about 36 percent of local government bonds (from 13 percent in 2008) are now held by nonresidents, though at 32 percent of GDP external debt remains moderate.[4, 5] The international investment position (IIP) improved in 2011 to -7 percent of GDP from -18 percent of GDP in 2010, as the rand depreciated.

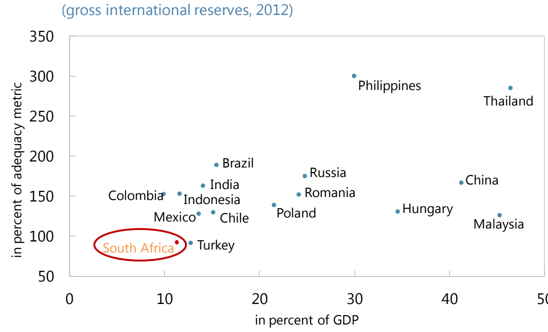
- Reserves (US$47 billion at end-June) are at the low end of the IMF's adequacy metric, and cover about five months of imports and about 80 percent of the gross external financing requirement.

Reliance on Non-FDI Flows to Finance the Current Account Deficit 1/
(in percent of GDP, 2012)



Sources: WEO; and Fund staff estimates.
1/ Peer EM countries with a current account deficit at end-2012.

Low Level of Reserves Relative to Other EMs 1/
(gross international reserves, 2012)



Sources: WEO; and Fund staff estimates.
1/ The IMF composite adequacy metric is a weighted sum of exports, short-term debt at remaining maturity, other external liabilities, and broad money.

Fiscal position

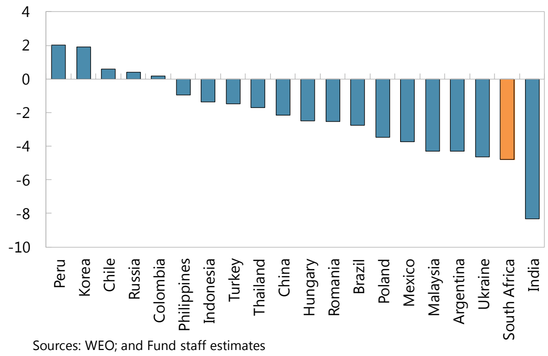
13. South Africa's relative fiscal position among EMs has weakened.

- General government deficits have averaged 5 percent of GDP for the past four years as South Africa took advantage of the fiscal space that existed pre-2008 to support the economy. As a result, government debt increased by 15 percentage points to 42 percent of GDP, slightly above the median in EM peers (Figure 5).

[4] Nonresidents hold 42 percent of total government debt and 36 percent of local currency government bonds. Nonresident holdings of equities were estimated by a study conducted by the Johannesburg Stock Exchange (2012).

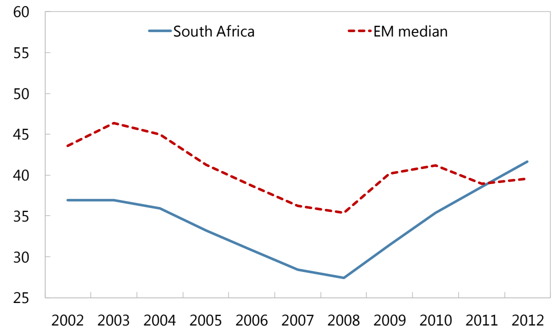
[5] More disaggregated data on the nature of other investment flows would be helpful in refining the external vulnerability assessment.

Elevated Fiscal Deficit
(in percent of GDP, 2012)



Sources: WEO; and Fund staff estimates

Rising Debt
(in percent of GDP, 2012)

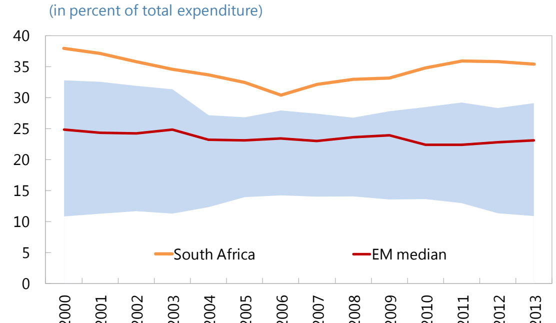


Sources: WEO; and Fund staff estimates

- A cyclical decline in revenues has played a role, but most of the deficit deterioration since 2007/08 is due to a near-doubling of the wage bill which now absorbs more than 35 percent of spending, compared to an average 22 percent among EM peers. This reduces expenditure flexibility and crowds out government capital spending which is increasingly undertaken by public enterprises. Public enterprise borrowing has more than quadrupled to 14 percent of GDP since 2007/08, raising contingent liabilities.

- Last year's agreement to limit public sector real wage increases for the next three years to 1 percent and this year's decision to set explicit expenditure ceilings should facilitate the planned withdrawal of fiscal stimulus. However, the government's poor record in controlling the wage bill and potential spillovers from high wage demands in other sectors represent downside risks. Moreover, at 2.7 percent of GDP in 2012/13, the national government primary deficit falls short of the 1.9 percent of GDP necessary to stabilize the debt under prevailing low interest rates, suggesting debt would rise quickly should the envisaged consolidation fail to materialize or interest rates rise faster than projected.[6]

High Wage Bill Relative to Other EMs
(in percent of total expenditure)



Sources: WEO; and Fund staff estimates.
1/ The shaded area represents the 10 to the 90th percentile of the cumulative distribution function of EM governments' wage bill.

- Rising deficits have more than doubled the government's gross financing need compared to 2008, which at 12 percent of GDP is above the EM average notwithstanding an average debt tenor of 11 years. Nearly 60 percent of the 2012/13 borrowing requirement was financed by nonresidents, which had led to a substantial yield compression before the recent sell-off.

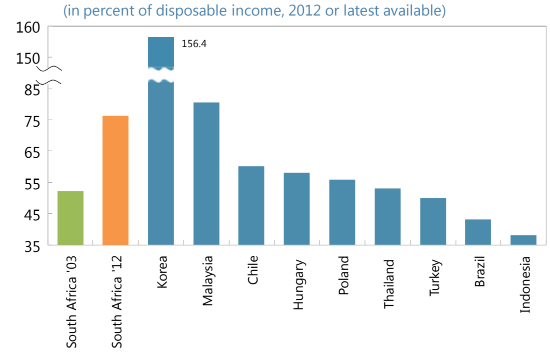
[6] The debt-stabilizing primary balance is estimated to increase to -0.6 percent of GDP in the medium term as global interest rates normalize.

Financial stability

14. Financial soundness indicators remain strong, but the rapid expansion of unsecured lending to households has increased credit risk. Bank capital is well-above the regulatory minimum and profitability remains strong (Figure 6). But unsecured credit to households, mainly personal loans, has more than doubled over the past three years, now accounting for about 12 percent of banks' total credit exposure, which combined with their large mortgage portfolio, brings banks' exposure to highly leveraged households to 60 percent (Box 2). Tighter lending standards and reduced profitability on mortgages, the promulgation of the 2007 Credit Act, combined with the objective to promote financial inclusion, led to a sharp rise in unsecured lending. While the increase in unsecured credit to low-income households from 1.6 to 2.2 percent of disposable income since 2008 has contributed to greater financial inclusion, there is still a need to improve access to finance, especially for SMEs, according to the World Bank.[7] Rising credit has worsened household debt burdens, which now amounts to 76 percent of disposable income, and has added to social vulnerabilities. Higher interest rates, weaker household incomes growth, or lower house prices could pressure households' debt repayments, nonperforming loans (NPLs), and banks' capital given relatively low provisioning in international comparisons. Banks' reliance on short-term wholesale funding provided mostly by residents also represents a vulnerability, though historically it has been stable as it corresponds to corporate deposits and contractual savings in pensions and insurance funds that are subject to capital controls. In addition, South African banking groups' expansion on the African continent would require additional efforts to improve home-host cooperation among regulatory authorities.

High Household Debt Relative to Other EMs

(in percent of disposable income, 2012 or latest available)



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

OUTLOOK AND RISKS

15. The outlook is for subdued growth with the current account deficit remaining high. South Africa's growth is projected at 2.0 percent in 2013, reflecting softer private consumption growth and sluggish private investment, offsetting robust public investment and higher exports. Softer disposable income growth, weaker confidence, and households' high indebtedness hold back private consumption. Private investment is expected to remain lackluster, due to low business confidence and perceived high policy uncertainty, electricity constraints, and softer terms of trade. Growth is projected to rebound to 2.9 percent in 2014 and strengthen to about 3½ percent in the outer years, benefiting from the expected pick-up in global growth and new infrastructure projects relieving bottlenecks and catalyzing private investment and exports. The output gap remains slightly negative in 2018 with the IMF staff's current estimate of potential

[7] World Bank (2013), Economic Update, Issue 4.

growth at about 3 percent, which is subject to considerable uncertainty. Unemployment remains high throughout the projection period. The terms of trade are projected to fall by 7 percent over 2013–2014 and stabilize thereafter. The current account deficit is projected to be about 6 percent of GDP in 2013 and in 2014, and to fall only slightly in the outer years, as public investment remains high.

16. Quicker implementation of structural reforms could deliver better outcomes, while lack of progress would build up vulnerabilities inexorably. Although difficult to quantify, numerous studies suggest tangible and considerable progress on structural reforms would boost growth and employment over the medium term, and through increased investor confidence have also a short-run impact. In particular, research suggests product market reform in South Africa could boost potential growth by 1.2–1.5 percentage points—more if combined with reforms to transport and communication and to raise the supply of skilled labor—and increase employment by nearly 40 percent.[8] Research on EU and OECD countries also suggests comprehensive labor and product market reform can provide a significant boost to the economy.[9] Without structural reforms, the resulting low growth and anemic job creation would lead to increased economic vulnerabilities and could contribute to heightened social tensions.

17. In the face of these vulnerabilities, downside risks weigh heavily on South Africa's outlook (Box 3). A prolonged stop in capital inflows, which could force a disorderly adjustment of the twin deficits and cause a recession, is the main risk. Continued and substantial global repricing of risk or term premia is the most likely external trigger linked to the unwinding of advanced economies' unconventional monetary policies; escalating industrial tensions are the most likely domestic triggers. Even a scenario with a stronger U.S. recovery that leads to a sharp rise in long-term U.S. yields would have negative spillovers on South Africa as it trades heavily with Europe, while its financial conditions are linked to those in the United States: events in global financial markets since May 2013 illustrate the potential for a sharp increase in financing costs. Also, gold prices could fall further with declining demand for safe haven assets. With limited space for countercyclical policies, lower global growth with roots in Europe or persistent weaker growth in China and other major EMs, which could reduce commodity prices considerably, would lower South Africa's exports and growth, with its impact significantly larger if combined with a financial shock. Further delays in the coming on line of new power plants are also a downside risk.

18. South Africa's spillover effects on the rest of Sub-Saharan Africa are deemed modest, but they are larger on its immediate neighbors. Research presented in the IMFs 2012

[8] Faulkner, D. and K. Makrelov (2009), "Productivity-Raising Interventions for the South African Economy: A CGE analysis," Paper presented at the EcoMod 2009 conference, Ottawa, Canada; and Faulkner, D., C. Loewald, and K. Makrelov (2013),"Achieving Higher Growth and Employment: Policy Options for South Africa," Economic Research Southern Africa Working Paper 334.

[9] Barkbu, B., J. Rahman, R. Valdés, and a staff team (2012), "Fostering Growth in Europe Now", IMF Staff Discussion Note No. 12/07; Lusinyan, L. and D. Muir (2013), "Assessing the Macroeconomic Impact of Structural Reforms: The Case of Italy," IMF Working Paper No. 13/22; and Spain: 2012 Article IV Consultation, IMF Country Report No. 12/202.

Regional Economic Outlook for Sub-Saharan Africa suggests that once global growth is taken into account, South Africa's economy has only a limited impact on the rest of the region's growth—caution, however, is called for on the size of spillovers, given data paucity and quality and varying estimates across studies.[10] South Africa's impact on neighboring countries is stronger. The pegs to the rand entail importing monetary and exchange rate policy from South Africa and the Southern African Customs Union revenue sharing mechanism implies significant fiscal linkages. Considerable people and financial flows also create important spillovers. Weaker growth in South Africa could lower exports from, and remittances to, neighboring countries. But higher outward FDI as South African firms seek alternative markets and South Africa's elevated current account deficit and resulting high customs transfers should partly offset the negative impact.

Authorities' views

19. The authorities broadly agree with staff on the macroeconomic outlook. Following the weakness of first quarter GDP growth, they expect that higher growth is required over the remaining period in order for growth to average the 2.7 percent projected in the 2013 budget. Weakness of the first quarter GDP growth data is partly attributed to temporary factors. They also emphasize that the slowdown in Europe and China has further constrained external demand and adversely affected South Africa's terms of trade. Despite its declining share as an export destination, Europe's economic situation remains critical for South Africa, notably for manufacturing and agriculture exports. Nevertheless, the authorities recognize that domestic factors are contributing to sluggish growth and an elevated current account deficit.

20. The authorities concur on the key risks, but highlight South Africa's resilience in previous episodes of capital outflows. A slowdown or sudden stop in capital inflows would likely lead to sharp rand depreciation, which may warrant higher interest rates should the risk of a material and sustained breach of the inflation target become evident. The depreciation is expected to contribute to some narrowing of the current account deficit. The authorities note that in earlier sudden stops episodes, South Africa did not face dollar shortages. Nevertheless, higher funding costs and lower GDP would require some fiscal adjustment. Such an event would complicate macroeconomic dynamics, but would be manageable. Anticipation of the end of unconventional monetary policy in the United States has already resulted in a slowdown in capital inflows, currency depreciation, and higher sovereign yields across EMs. In addition, the authorities view the risk of lower commodity prices as elevated and the risk of a deeper slowdown in Europe as high compared to the April 2013 WEO.

[10] IMF Regional Economic Outlook: Sub-Saharan Africa (2012), "Nigeria and South Africa: Spillovers to the Rest of Sub-Saharan Africa", October, pp. 25–50; Arora, V. and A. Vamvakidis (2010), "South Africa in the African Economy: Growth Spillovers," *Global Journal of Emerging Market Economies,* Vol. 2, Issue 2, pp. 153–171.

POLICIES

Against this lackluster outlook and reduced policy space, South Africa needs to move to a higher and more labor intensive growth path, which will require tackling the key constraints that are holding back the economy, attacking entrenched interests, while also addressing rising vulnerabilities.

A. Demand Management Policies: Supporting Growth while Managing Vulnerabilities

Monetary and exchange rate policy

21. As the SARB noted in the last monetary policy committee statement, monetary policy is in a bind, facing low growth, rand depreciation, and increased inflation uncertainty. The SARB has kept rates on hold since July 2012. Citing subdued core inflation and a persistently negative output gap, it concluded that underlying inflation remains contained even though headline inflation is likely to exceed the upper end of the 3–6 percent band temporarily in the next few months. The SARB assessed that the impact of the depreciation would be offset by softer world food and oil prices, but that risks to the inflation outlook remain on the upside, mainly due to uncertainty surrounding the exchange rate and wage settlements. Inflation expectations remain well anchored, close to the upper end of the target band.[11]

22. A simple Taylor rule helps illustrate the monetary policy tradeoff going forward. With staff's current end-year forecasts for the output gap (about -1½ percent) and inflation (5.7 percent), such a rule suggests that the repo rate could be cut modestly. But if inflation rises in line with the historical exchange rate pass-through (15 percent), the Taylor rule suggests an increase in the policy rate.[12] Further, the tapering of unconventional monetary policy in the United States creates uncertainty about the neutral policy rate, which has been correlated across countries. Moderate space for an interest rate cut could open up if the exchange rate pass-through proves to be low and wage settlements are not excessive. But, a rate increase may become needed if inflation risks become likely to materialize or in the event of a sustained stop in capital inflows. Moreover, in the event of additional demand shocks, monetary policy could be eased. The SARB's communications will continue to play a crucial role in guiding inflation expectations.

23. The SARB's policy has resulted in one of the most flexible exchange rates among EMs, helping South Africa adjust to shocks. Foreign exchange risk on domestic balance sheets is limited, which is a key strength. Also, when the rand depreciates, nonresident investors who

---

[11] Klein, N. (2012), "Estimating the Implicit Inflation Target of the SARB," IMF Working Paper No. 12/177, finds that the SARB's implicit inflation target is in the upper segment of the band and has increased in recent years.

[12] Parsley, D. (2010), "Exchange Rate Pass-Through in South Africa: Panel Evidence from Individual Goods and Services," forthcoming in the Journal of Development Studies.

mainly hold rand-denominated securities share the foreign exchange risk, reducing the dollar value of outflows. Similarly, the international investment position improves with currency depreciation. Finally, limits on the foreign exchange exposure of domestic institutional investors can also have a stabilizing role, as depreciation may require them to repatriate assets.

24. Higher reserves would enhance the SARB's ability to provide FX liquidity in case of disorderly market conditions. Higher reserves would lower the country's risk premium, partly compensating for carry costs. Recent financial crisis episodes showed that, regardless of the exchange rate regime, EMs that held higher reserves suffered lower consumption volatility. The SARB has seldom intervened in the foreign exchange market and when it has in the past, it has done so opportunistically. Other countries, such as Israel, Mexico, and Turkey, have built reserves through regular and pre-announced auctions to buy small amounts of FX, which minimize the impact on the exchange rate. This could also be useful for South Africa.

25. The South African authorities have appropriately relied primarily on macroeconomic policies to manage volatile capital flows. In case of outflows, exchange rate depreciation remains the key adjustment mechanism, accompanied by targeted FX liquidity provision in case of dollar shortages and a tightening of macroeconomic policies in case of financing difficulties. Should large inflows return, the initial policy response should rely on reserve accumulation, and to the extent possible, looser monetary policy. If a surge in capital inflows or disruptive capital outflows were to raise macroeconomic or financial system stability risks, then capital flow management measures could be appropriate in certain circumstances, but should not substitute for warranted macroeconomic adjustment.[13] Outflow liberalization needs to continue to be mindful of the implications for the stability of banks' funding.

26. Measures to boost saving and FDI would lower external vulnerabilities. South Africa's saving rate is low relative to EMs, mainly due to low households' saving (Box 4). The planned fiscal consolidation will help raise saving, but historical patterns suggest it will likely be partly offset by lower corporate saving. Tax measures introduced in the 2013 budget to promote savings are welcome. Incentives for people who do not pay taxes should also be strengthened. The proposed pension reforms, including compulsory preservation, are worth pursuing. Reducing unemployment remains key to boost household income and saving. This would create a virtuous cycle of higher investment, growth, and saving. As the country is likely to remain dependent on foreign saving over the medium term, FDI should be encouraged to provide more stable external funding. Besides measures to improve the investment climate, a one-stop shop for foreign investors that speeds up approvals combined with greater coordination among government agencies would increase South Africa's attractiveness as an investment destination and a gateway to Africa.

[13] IMF (2013), "Guidance Note for the Liberalization and Management of Capital Flows."

Authorities' views

27. Noting the high uncertainty on the inflation outlook, the SARB is ready to move interest rates in either direction consistent with its flexible inflation targeting framework. While the wider negative output gap might suggest room for policy easing, rand depreciation and high wage demands add to inflationary pressures that limit the room for any further policy accommodation. The size of the exchange rate pass-through and the impact of policy interest rates on economic activity are particularly uncertain at this juncture, although the current economic conditions suggest a somewhat weaker exchange rate pass-through than has been the case during previous episodes of rand weakness. The SARB notes that if the exchange rate pass-through proves to be low and wage settlements are moderate, space for a cut could open up. On the other hand, a tighter monetary policy stance may become necessary if there is evidence of significant second-round effects on inflation and an unhinging of inflation expectations. Finally, the SARB has expressed the view that there are limits to the role monetary policy can play in stimulating economic activity and maintains the inflation targets remain appropriate, while stressing that structural reforms are needed to put South Africa on a higher growth trajectory.

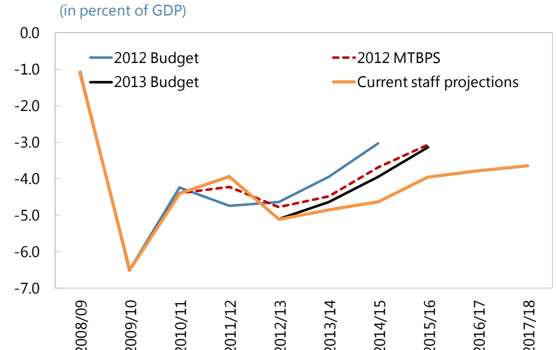
28. South Africa remains fully committed to its flexible exchange rate regime. The exchange rate is a crucial adjustment mechanism and, together with the rand denomination of a large part of fiscal and external liabilities, an important source of resilience in the South African economy. Balance sheet exposure to exchange rate risk in banks, public sector, and households is relatively limited. In the authorities' view, while some depreciation of the rand was warranted in terms of the fundamentals, the rand has possibly overshot its appropriate level and is expected to appreciate to some extent once the global turmoil settles down. However, high exchange rate volatility, if excessive, could become disruptive and result in disorderly markets and sustained divergence from equilibrium. Although the authorities do not intend to use capital flow management measures at present to affect the flows or the exchange rate, they reserve the right to adopt appropriate policy measures should this become necessary.

29. The authorities agree that South Africa would benefit from higher reserves and the modalities of how to achieve this are being worked out. Given the current financial position of the SARB, the government has borne most of the cost of higher reserves over the past few years. The authorities also note that the decline in reserves in May was due to repayment of a maturing Eurobond, and will be replenished once the sovereign issues an international bond later this year.

Fiscal policy

30. The 2013 budget scaled back expenditure growth. Growth in real noninterest expenditure over the next three years has been reduced from an average of 2.9 in last year's Medium Term Budget Policy Statement (MTBPS) to 2.3 percent per year—mainly by trimming programs with underspent

Postponed Fiscal Consolidation
(in percent of GDP)



Sources: National Treasury; and Fund staff estimates.

allocations and reducing the contingency reserve—to reduce the deficit to 3.1 percent of GDP by 2015/16. While this is consistent with the deficit target in last year's MTBPS, the consolidation is more back loaded.

31. Mainly due to lower growth, the 2013 budget deficit is likely to be higher than budgeted and debt will continue to rise without offsetting policy adjustments.

- Staff projections suggest the 2013/14 deficit will fall marginally to 4.9 percent of GDP.[14] This is 0.3 percentage points higher than envisaged in the 2013 budget and 1.2 percentage points higher than envisaged in last year's budget, reflecting the 1½ percentage point downward revisions to staff's growth projections for 2013/14 relative to last year's budget. Relative to previous years, the margin for error in the budget has been reduced given cuts to the contingency reserve.

- Government debt is projected to stabilize at around 47 percent of GDP in 2018/19, 19 percentage points higher than in 2008. Staff analysis suggests that in the absence of offsetting measures, even a modest shock to growth and interest rates would result in debt continuing to rise, with a 10 percent chance that debt will reach 63 percent of GDP by 2020. In addition, state enterprise debt is expected to continue to increase. Rising deficits have also raised gross financing needs. These findings are consistent with the public debt sustainability analysis (DSA) based on the Fund's new DSA template, which suggests that although South Africa's government debt level remains manageable, the relatively high bond spread, large financing requirements, and significant nonresident bond holdings pose risks.[15]

- Nevertheless, likely high multipliers in the current phase of the cycle and below-potential growth argue for allowing automatic stabilizers to work this year, while remaining within existing expenditure ceilings and improving the composition of spending, provided financing conditions allow.

32. Staff analysis suggests the authorities should aim to reduce debt to around 40 percent of GDP in the medium term (Box 5). Determining an appropriate debt benchmark remains highly controversial. Nevertheless, given South Africa's outlook, the magnitude of macroeconomic and fiscal shocks, and cross-country comparisons, reducing the debt-to-GDP ratio to around 40 percent by 2020 would allow the country to rebuild adequate fiscal space. Announcing such a debt benchmark as a guiding principle for fiscal policy over the medium term and the measures to buttress it could help bolster the credibility of the fiscal outlook. Finally, issuing a comprehensive fiscal risk statement, as currently done in several countries including

---

[14] On a calendar year basis the deficit is projected to remain constant in 2013 due to a sharp deterioration in tax collection in the second half of the fiscal year as labor unrest in the mining sector negatively affected both corporate and personal income taxes.

[15] For further details see "South Africa 2013: Article IV Debt Sustainability Analysis" and "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries," IMF Policy Paper, May 6, 2013 available at http://www.imf.org/external/np/pp/eng/2013/050913.pdf.

Australia, Brazil, Chile, Colombia, and Indonesia, would strengthen the monitoring of fiscal risks, including from public enterprise borrowing.

33. Lowering gross debt to 40 percent of GDP will require significant adjustment. The fiscal path outlined in this year's budget implies a 1.8 percent of GDP improvement in the primary balance to –0.4 percent of GDP by 2015/16. The needed additional measures will depend on how soon the adjustment is implemented, the horizon over which the authorities choose to meet the debt benchmark, and spending re-orientation and efficiency. For example, if the debt target is to be reached in 2020, the primary balance would have to average around 0.5 percent of GDP in the post-Medium Term Expenditure Framework (MTEF) period. However, the increasingly challenging financing outlook suggests it may be desirable to introduce some additional measures already during the MTEF-period to demonstrate a tangible improvement in the structural balance. In addition, as done in the 2013 budget, the government will need to reconsider revenue and expenditure plans within the MTEF-period, while protecting social transfers, if the economic environment deteriorates further or if financing conditions deteriorate sharply. A decline in potential growth, for example, would require measures, but because potential growth is not directly observable, if growth persistently disappoints, it would be prudent to adjust fiscal policy gradually. Finally, ongoing reforms to strengthen fiscal management—complemented by expenditure reviews and systematically taking into account program performance at all levels of government—could facilitate re-orienting spending toward investment, encourage spending efficiency, which deliver a more growth-friendly consolidation.

Authorities' views

34. The South African authorities remain committed to fiscal consolidation. They underscore that the budget expenditure figures are now generally regarded as ceilings and fiscal discipline has broad support. South Africa budget statements have indicated clearly that if risks to the economic or fiscal outlook materialize, the government's fiscal program will be revised where appropriate, and the authorities remain committed to this view.

35. The authorities are fully committed to long-term fiscal discipline and recognize the need to rebuild fiscal space to be able to conduct countercyclical fiscal policy. They see merit in incorporating risk analysis into the budget discussions, as reflected in recent budget policy statements. They agree that debt should be low enough to have sufficient room to increase during downturns without destabilizing market expectations and fiscal dynamics. The authorities will also proceed cautiously with pension reforms and the implementation of the national health insurance to ensure their affordability and consistency with fiscal sustainability. The forthcoming long-term fiscal report will highlight the tradeoffs involved in light of the principles of counter-cyclicality, debt sustainability, and intergenerational fairness.

36. The government is intent on improving its service delivery and spending efficiency, as well as carrying out its large infrastructure program, to support sustainable growth. The government is taking measures to improve accountability in service delivery, strengthen procurement through its newly established Chief Procurement Office, and is embarking on a public service reform. Moreover, government departments have been asked to align their planning and expenditure to meet the objectives of the NDP. Spending efficiency is being promoted in a number of ways, and the government is aiming at moving toward performance budgeting, though the authorities underscore that South Africa needs to continue making significant allocations to critical areas, such as education and health, even when outcomes are not fully satisfactory. Finally, the authorities view public infrastructure investment, mostly carried out by public enterprises, as essential for sustained growth.

Financial policies

37. In response to the rapid growth in unsecured lending, the SARB has urged banks to apply more stringent loan assessments and make adequate provisions. And while this appears to have led to some moderation in new lending, unsecured credit is still rising rapidly. At the same time, the authorities are seeking to limit the use of debt collection via wage withholding to mitigate the social implications of over-indebtedness.

38. South Africa remains at the forefront of financial sector regulatory reform globally. The adoption of Basel III earlier this year, the envisaged implementation of the Twin Peaks system from 2014, and several financial sector initiatives will further reinforce South Africa's already strong financial architecture. Including the National Credit Regulator within the Twin Peaks System, as recommended by the 2012 FSB peer review, would consolidate regulation and supervision and market conduct for all financial institutions. The SARB last year introduced a committed liquidity facility that enables banks to meet the liquidity coverage ratio, and very limited new style Basel III type of bail-in capital instruments have been issued by local banks to strengthen banks' loss absorption capacity and enhance long-term stable funding sources, though banks would still find it difficult to meet the net stable funding ratio (NSFR) in the form currently envisaged. A deposit insurance scheme is being developed and the crisis management framework is being improved.

39. Consideration could be given to additional measures to manage rising credit risk, combined with measures to help households deal with high indebtedness. As overall credit growth at 8.3 percent year on year in May remains modest, monetary tightening would not seem the appropriate response to rising unsecured lending. Instead, introducing quantitative affordability criteria (e.g., debt to disposable income ratios) accompanied by consumer protection measures, and limits on mortgage loan-to-value ratios could be considered. Also, to prevent households turning to nonbank lenders at higher costs, programs to improve awareness of the negative impact of over-indebtedness should be bolstered, and ways to assist those in debt distress reach a debt-work out strengthened. Ensuring accurate and comprehensive information on household indebtedness remains instrumental and proposals to expunge the credit history of blacklisted individuals should be resisted as it may lead to an abrupt pull-back of lending. In addition, greater coordination among regulators ahead of the Twin Peaks implementation is needed, and the feasibility of extending the perimeter of regulation and supervision to shadow banking institutions to reduce regulatory arbitrage could also be studied. Moreover, to help banks meet the NSFR when it becomes operational, measures to encourage retail deposits, especially low-cost accounts, are worth pursuing.

Authorities' views

40. The authorities are of the view that unsecured lending does not pose systemic risks and they continue to improve their understanding of the underlying dynamics in this market. Acknowledging that, on average, households are overly indebted, the SARB is of the opinion that banks are managing credit risk well and are well-capitalized. Unsecured lending to households has helped enhance financial inclusion and it is not desirable to have a sudden stop in credit provision. The authorities are confident that after the rapid increase in personal loans in recent years, a soft landing can be achieved. Nevertheless, this episode has highlighted some weaknesses in market conduct and it is important to strengthen consumer protection and improve households' financial literacy. It is also necessary to formalize affordability guidelines. However, too tight affordability guidelines should also be avoided. The SARB shares concerns about a credit information amnesty that would eliminate some of the credit history, and which could induce a sharp reduction in bank lending or higher cost of credit to consumers.

B. Structural Policies

41. The NDP is a wide-ranging vision for inclusive growth and jobs in South Africa (Box 6). It lays out a blueprint for eliminating poverty and reducing inequality by 2030 by creating 11 million jobs on top of the existing 13½ million and increasing labor force participation, sufficient to reduce the unemployment rate from 25 to 6 percent. The plan estimates this will require increasing growth to an average of 5½ percent between 2011 and 2030 by rebalancing the economy toward investment and away from consumption and raising productivity and competitiveness. The plan includes a range of proposals to improve infrastructure, education, healthcare, as well as public service delivery with a focus on strengthening governance and fighting corruption.

42. As the NDP states, "South Africa needs to fix the future, starting today." The commitment to align the budget with NDP priorities is a good start, as are initiatives to improve service delivery and accountability, and progress on key infrastructure projects. In the near term, the authorities should also focus on a few high-impact reforms, quick wins, to build support for the plan and demonstrate the government's effectiveness in implementing structural reforms. Communication of such quick wins would help persuade investors that South Africa's fundamentals are improving and could create positive feedback loops by reducing risk premia and vulnerabilities. The National Treasury's proposed youth employment incentive is an example of a potential quick win: pilots need to start as soon as possible and, if successful, this scheme should be rolled out nationally. The introduction of e-tolling and clarity on several legislative initiatives could help assuage concerns about policy uncertainty. The coming on line of the first units of the new power plants and start of construction of the recently approved manganese railway corridor will boost investor confidence and ease infrastructure bottlenecks. The normalization of industrial relations, especially in mining where in early-July Deputy President Motlanthe oversaw the signing of a framework agreement by all parties—with the notable exception of the Association of Mineworkers and Construction Union which is now the dominant union in the platinum industry—that is intended to lay the foundations for a sustainable solution to the problems afflicting the industry, is critical to boost confidence.

43. Additional reforms to the labor and product markets are needed and would best be done jointly as part of a social bargain. Limited competition in product and labor markets is mutually reinforcing and has resulted in high corporate profitability and prices, and unemployment. A social bargain should include wage restraint in return for industry's hiring commitments, measures to enhance product market competition, and improved public services—in particular, in education and training. Government involvement is critical to ensure the interests of outsiders—outsiders include people without a job and small firms or potential entrants—and society at large are reflected. Even such a bargain could start with an initial set of quick wins that help build trust and, with effective communication, reform momentum. Examples of social compacts include Ireland, Denmark, the Netherlands, and the U.K.[16] The Pact for Mexico is a recent example, including greater labor market flexibility, legislative changes to boost competition, and new social protection guarantees (Box 7).

44. Reforms in product markets would spur competition, lower entry barriers and prices, and promote innovation.

- The Competition Commission has done important work regarding cartels and its new power to conduct market-level inquiries constitutes progress, but more needs to be done. The Commission's ability to deal with abuse of market dominance could be strengthened, for example by moving to effects-based standards in its inquiries. In addition, firms' costs for uncompetitive behavior may need to be raised, and the Commission's resources strengthened.[17]

- There is also a need to identify entry barriers and regulatory mechanisms by which incumbents protect their dominant positions. Given that sectoral characteristics differ significantly, initially targeting a sector that has extensive linkages across firms, e.g., such as Information and Communication Technology, would have important positive spillovers and demonstration effects across the economy.

- OECD research suggests aligning South Africa's onerous product market regulation with international best practice and relaxing employment protection legislation could increase productivity.[18] In contrast with the NDP's proposals to cut red tape, the Licensing of Businesses Bill would likely add to the administrative burden, especially for SMEs.

- Trade liberalization would contribute to increased competition and, in the regional context allow South Africa to maximize benefits from Africa's growth dynamics. Consideration should be given to reducing the number of tariff bands, lowering tariffs, and removing tariffs on imports of raw materials and intermediate inputs.

[16] Annett A. (2007), "Lessons from Successful Labor Market Reformers in Europe," IMF Working Paper No. 07/01.

[17] OECD, Economic Surveys: South Africa 2013.

[18] Bouis, R. and R. Duval (2011), "Raising Potential Growth after the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond," OECD Economics Department Working Paper No. 835.

45. Reforms to labor markets and steps to address skill mismatch would contribute to job creation. Limiting the practice of extending collective bargaining outcomes to firms that did not participate in the bargaining—especially SMEs—would increase wage flexibility and reduce barriers for entry for SMEs. SMEs have a high potential to create jobs and increase the constituency for reform, but need a more flexible labor framework, with the transfer system being responsible for safeguarding a socially agreed minimum living standard. A proposal to restrict the use of temporary contracts—temporary employment has accounted for a large share of employment growth in recent years—should be resisted. Significantly, raising education attainments and greater focus on vocational training are required to address South Africa's skill mismatch. Targeted transport subsidies for job seekers, combined with greater competition in the private transport industry, could help alleviate the problem of spatial dispersion.

46. Though South Africa's flexible exchange rate is an advantage, the experience of peripheral euro area countries holds important lessons for South Africa. Greece, Ireland, Portugal and Spain's low productivity growth, large current account deficits, accompanied by easy foreign financing that masked underlying structural weaknesses are signs that are also present in South Africa.[19] Spain and Ireland's public debt was below 45 percent of GDP in 2008, showing that debt dynamics can quickly become perverse when growth slows and risk premia climb. While contingent liabilities from the financial sector are likely to be significantly smaller than those of Spain and especially Ireland, South African public enterprises' borrowing could lead to the crystallization of contingent liabilities. The lessons are: structural reforms should not be postponed; expansionary policies can only buy time but not sustained growth; and easy financing builds up leverage that can move out of line with repayment capacity.

Authorities' views

47. Keenly aware of the imperative of structural reforms, the authorities are working toward implementing the NDP. They note that some progress is being made in several areas, such as in infrastructure, public service delivery, and accountability. The National Planning Commission will release the first of a series of five-year plans after the elections in 2014 to coincide with the Government's Medium-Term Strategic Framework. The authorities continue to work toward developing social consensus, which will be critical to managing trade-offs between policy options as they arise.

[19] See IMF Portugal, Staff Report for the 2012 Article IV Consultation, for a retrospective analysis of the causes of the crisis.

STAFF APPRAISAL

48. Over the last two decades, South Africa has made great strides in economic and social outcomes, yet unemployment remains unacceptably high. South African institutions and policy frameworks have delivered macroeconomic stability. Living standards have improved markedly. But, market dominance in many sectors and rigidities in product and labor markets have produced an insider-outsider system that creates too few jobs and stifles growth**.**

49. In recent years, South Africa's growth has underperformed and vulnerabilities have increased considerably. While weak external demand contributed, domestic factors—such as flagging competitiveness, an environment not conducive to investment, labor unrest, and infrastructure bottlenecks—played an important role. Elevated fiscal and current account deficits, combined with greater dependency on external debt to finance them, have heightened vulnerabilities.

50. The outlook is for sluggish growth, with considerable downside risks. The government's adoption of the NDP as its blueprint for reform is welcome, though progress on structural reforms is likely to be slow given entrenched opposition. Failure to deliver on structural reforms makes the economy increasingly vulnerable to shocks. The main risk is a sudden and prolonged stop in capital inflows, with either domestic or external triggers, such as tighter global financing conditions. Escalating labor tensions is a key domestic risk. Lower global growth and commodity prices also weigh on South Africa's outlook.

51. A lackluster outlook, both at home and abroad, combined with heightened vulnerabilities and reduced policy space makes progress on structural reform imperative. Demand management policies cannot address the root causes of South Africa's weak growth. Instead, decisive progress on structural reforms, many of which are identified in the NDP, is essential to boost inclusive growth and job creation and lower economic and social vulnerabilities. Quick wins can help build consensus for reform and confidence. Critical product and labor market reforms could be pursued as part of a social bargain. Trade policy should not be used as a tool for industrial policy and trade liberalization could help promote competition and create jobs.

52. The need to support growth while managing vulnerabilities argues for a gradual consolidation while bolstering the credibility of the medium-term fiscal outlook. With debt broadly in line with that of other EMs and weak growth, the government's commitment to stick to the expenditure ceiling is welcome, while revenue can be allowed to move with activity this year. But the authorities should prepare contingency measures that could be implemented quickly were funding conditions to deteriorate sharply. Continued sluggish growth beyond this year, however, and the need to stabilize debt will likely require measures. Also, announcing a debt target that takes into account the significant volatility in the South African economy could strengthen credibility. Ongoing reforms to boost the efficiency of public spending and improvements in expenditure composition would help make the consolidation more growth-friendly.

53. The current monetary policy stance is appropriate and high inflation uncertainty warrants caution. The evolution of capital inflows, the corresponding exchange rate pass-through to inflation, and wage settlements will be critical factors in determining the next monetary policy move. The SARB is rightly ready to move in either direction. In the event of additional demand shocks, monetary policy should provide most of the stimulus, given diminished fiscal space. The present inflation targeting regime has anchored inflation expectations and has provided flexibility to support the economy.

54. South Africa benefits from having one of the most flexible exchange rate regimes among EMs and also needs higher reserves. Rand flexibility helps cope with global shocks and the recent depreciation should help reduce the current account deficit. In addition, increasing international reserves would enhance the authorities' ability to supply foreign exchange liquidity in the event of disorderly market conditions. Opportunistic FX purchases are warranted and consideration could be given to regular and pre-announced auctions. Measures to boost FDI would lower external vulnerability, though structural reforms are needed to strengthen South Africa's low household saving rate and its external position, which is assessed to be weaker than justified by fundamentals and desired policies.

55. South Africa's financial system is well capitalized and supervised, but risks from unsecured lending have risen, warranting some measures. Ongoing efforts to improve the regulatory and supervisory architecture, including through this year's adoption of Basel III standards and the planned twin peaks system are welcome. The rapid expansion of unsecured credit from a low base has contributed to financial inclusion, but has highlighted areas where new measures could play a useful role to bolster financial stability and help households deal with high indebtness. The authorities' watchful monitoring of unsecured lending to ensure that these risks do not become systemic remains critical and increased coordination among regulators ahead of the implementation of the twin peaks system is warranted.

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

Box 1. South Africa: Analysis of External Competitiveness 1/

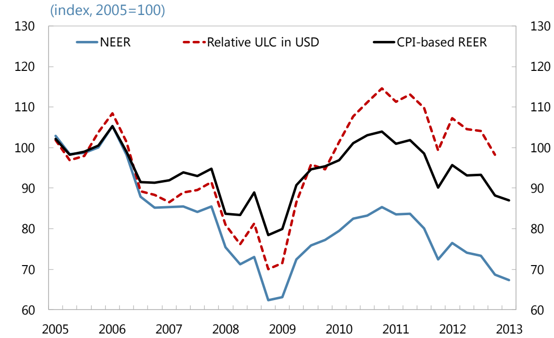
Estimates of the real effective exchange rate (REER) based on unit labor costs are higher than its long-term average, and more appreciated than CPI-based metrics. The recent nominal depreciation of the rand has contributed to a 6 percent decline in the CPI-based REER over the past few months. However, our estimates of the dollar-denominated relative unit labor costs—a proxy for ULC-based REER—show that, albeit on a declining path, South Africa's real exchange rate remains near 10 percent above its 10-year average. A ULC-based REER is likely to be a better indicator than a CPI-based measure as it captures competitiveness gaps on labor-intensive sectors that are of strategic concern for South Africa. Weakening competitiveness is reflected in a falling share of manufacturing exports to 39 percent in 2012 from 53 percent in 2002, while commodities now account for nearly 60 percent of exports.

South Africa's value-added REER (VA-REER) has also appreciated substantially faster than CPI-based metrics. The VA-REER is based on relative GDP-deflators and accounts for vertical specialization in trade by controlling for the import-component of South Africa's exports . As a large importer of intermediate goods, the index is of high relevance for the country. South Africa's GDP deflator has grown faster than CPI in 10 out of the past 13 years, signalling a wider competitiveness gap than suggested by CPI-based metrics. Staff estimates of South Africa's VA-REER indicate an appreciaciation of near 35 percent since its 2008 trough, against a more moderate appreciation of about 26 percent suggested by the CPI-based REER.

Notwithstanding the diversification of its export markets, South Africa's export performance continued to deteriorate in recent years. With the slowdown in advanced economies, South Africa's trade has been reoriented towards emerging and developing economies, with an increasing share of commodities exports that are usually associated with lower value-added than manufacturing. Nevertheless, South Africa's export performance—measured as the ratio of its export volume growth to its trading partners' real domestic demand growth—has been weaker than EM peers'. South Africa's export performance index is about 20 percent lower than in 2005 (on a cumulative basis), in spite of the diversification of its export markets.

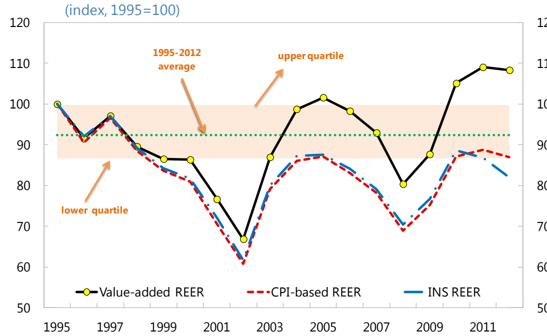
Staff research indicates that commodity-intensive EMs tend to exhibit weaker export performance than manufacturing exporters. Regression analysis suggest that the elasticity of export volumes to trading partners growth is about 0.2 smaller for commodities exporters. Among large EMs, Brazil, Chile, and South Africa have had weaker export performance than China, India, and Mexico, even after controlling for the effects of real effective exchange rate and relative unit labor costs. Put differently, the higher demand for South Africa's commodities exports has not been sufficient to fully offset the impact of subdued manufactured exports. As the latter is typically associated with higher value-added, this has negative implications for external competitiveness and growth.

South Africa: Relative Unit Labor Costs and REER, 2005-12
(index, 2005=100)



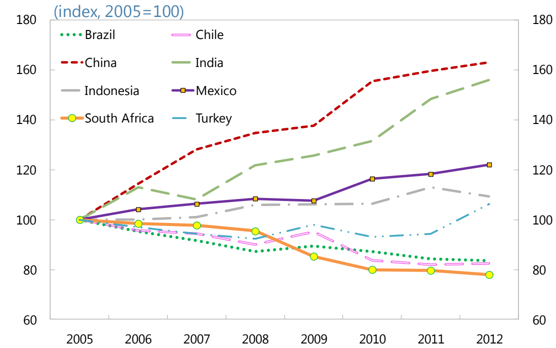
Sources: South African Reserve Bank, Haver, GEE, INS; and Fund staff estimates.

South Africa: Value-Added REER, 1995-2012
(index, 1995=100)



Sources: Bems R. and R. C. Johnson (2012), "Value-Added Exchange Rates", NBER Working Paper 18498, INS, South African Reserve Bank; and Fund staff estimates.

EMs: Export Performance Divergence, 2005-12
(index, 2005=100)



Sources: OECD; and Fund staff estimates.

Export Volumes Panel Data Regression, 1996-2012
Hausman-Taylor Estimation Procedure
(all variables percent change, yoy)

Explanatory Variable	Coefficient	Std. Deviation
Trade partners' demand	0.867	0.080 ***
Terms of trade in USD	-0.280	0.061 ***
Value-added REER	-0.115	0.040 ***
Relative ULC in USD	-0.124	0.064 **
PPP per capita	0.540	0.103 ***
Comm. exp.*Trade partners' demand	-0.231	0.095 **
Constant	-0.347	0.663

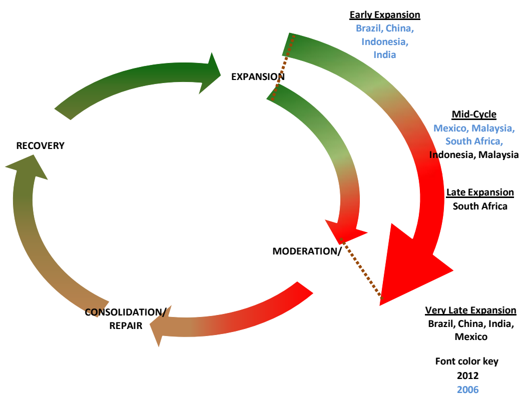
Source: Fund staff estimates
***Significant at 1 percent; **significant at 5 percent, and * significant at 10 percent.

1/ Based on a forthcoming IMF working paper by Roberto Perrelli.

Box 2. South Africa: Credit to Households

South Africa appears at the late stage of the credit cycle, as a mortgage boom before 2008 was followed by rapid unsecured lending growth.[1] During 2001-2007, mortgages grew by an annual average of 22 percent. Mortgage growth slowed substantially after 2008, but unsecured credit including personal loans has nearly quadrupled since 2007.

Credit Cycle



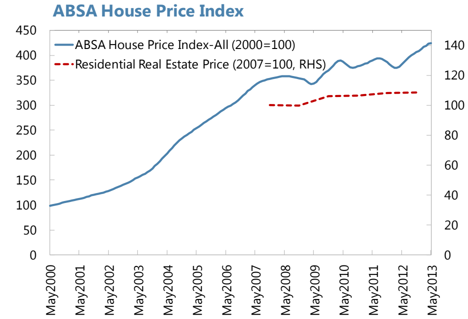
Residential mortgages are subject to rising credit risk given that interest rates have been at historical lows and household indebtedness is elevated. Residential mortgages account for about 36 percent of banks' total credit and 56 percent of lending to households. Over 35(50) percent of (new) mortgages have loan-to-value ratios above 80 percent. After more than tripling in the 2000s, house price indices have displayed mixed signals. CPI-adjusted house prices have dropped by 15 percent after 2008. Higher interest rates, subdued income, and high unemployment could put pressure on household debt and banks' asset quality.

	Total mortgages	New mortgages
LTV>100%	8	23
80%<LTV<100%	30	31
LTV<80%	62	46

Source: South African Reserve Bank.

Unsecured credit now accounts for 12 percent of banks' total credit exposure, with deteriorating asset quality. Although the pace of new unsecured lending has moderated significantly in recent months, the year-on-year growth rate of the outstanding stock remained elevated at 25 percent in May 2013 because the term of unsecured credit lengthened significantly. Roughly, 85 percent of unsecured lending is granted by banks (mainly second-tier banks), with the rest granted by nonbanks. Typically, these loans are short term and carry high fixed rates, but recently the term and size of unsecured lending has become longer and larger. The rand value (number of accounts) of unsecured credit reported as current decreased from 79 (74) percent to 74 (63) percent over the past year. Debt consolidation is reported to have helped consumers lower their debt burden in some cases, but in others, it may have delayed problem recognition.

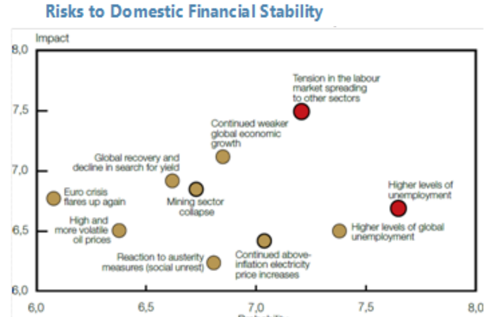
ABSA House Price Index



Sources: ABSA; and South African Reserve Bank.

The key vulnerability of South Africa's banking system is credit risk. Household debt to disposable income ratio increased by nearly 30 percentage points from 2002 to 2009 and has remained elevated at around 76 percent. Benefitting from the currently low interest rate environment, the debt service to disposable income is still at a manageable 8 percent. However, as mortgage rates are linked to the SARB repo rate, a 200 bps increase in interest rates is estimated to bring this ratio to 10–14 percent, close to historical highs. SARB's latest Financial Stability Review cites tensions in the labor market spreading to other sectors and higher levels of unemployment as two critical risks for financial stability, as these would worsen repayment capacity.

Risks to Domestic Financial Stability



Source: South African Reserve Bank

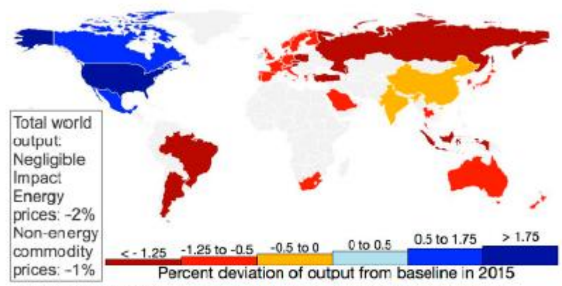
1/ The GFSR estimates credit positions based on a set of indicators including credit/GDP, real house price changes, equity price/book value, gross NPLs ratio, return on assets, corporate debt/equity, and return on equity (GFSR October 2012).

Box 3. South Africa: Spillovers from Global Risk Scenarios and Risk Assessment Matrix

This box explores the implications for South Africa of three global risk scenarios: a capital flow reversal in EMs, slower than expected growth in advanced economies, and a decline in commodity prices.

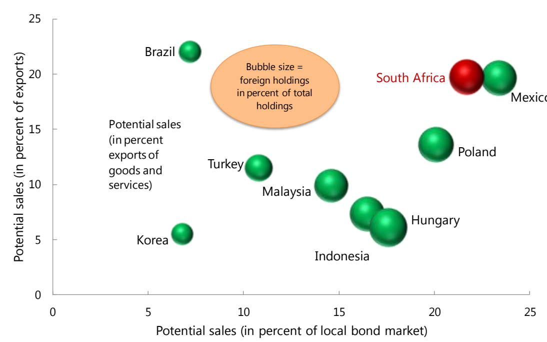
EM capital flow reversal. South Africa may be more exposed than other EMs to capital flow reversals because of its relatively high current account deficit, risky funding mix, high share of nonresident holdings of government debt, and liquid financial markets. For example, in a scenario conducted for the 2013 IMF Spillover Report where U.S. long-term interest rates increase significantly as monetary policy is tightened and stay there for a significant length of time, South Africa is considerably affected as capital outflows would be focused on countries with higher risk profiles. A broad-based persistent capital flow reversal, or even a sudden stop, could lead to a disorderly adjustment in South Africa's twin deficits. Nonresidents hold about US$140 billion of South Africa's debt and equity portfolio liabilities (about 40 percent of GDP). As an example, the sale of the bonds bought by nonresidents after the global financial crisis through end-2012 (about US$20 billion) would amount to about 20 percent of the local bond market and of export receipts. As shown in the market turmoil that started in May 2013, initially the rand would depreciate and yields increase significantly. Stabilizing factors include the fact that government bond holdings are over 90 percent in rand and have long duration, lowering the dollar value of outflows. In addition, domestic nonbank institutional investors have assets exceeding 100 percent of GDP and a relatively low proportion of their portfolio in bonds. However, a sharp reduction in funding for the twin deficits would force a contraction in imports and public spending. The detrimental impact would be exacerbated if accompanied by credit rating downgrades.

Impact of US Monetary Normalization with Term Premium Shock



Source: IMF 2013 Spillover Report
Based on simulations with the G35-S model. The short-term long-term market interest rates are assumed to rise by 100 basis points over 2014Q3-2016Q2 and 2013Q3-2015Q2, respectively.

EMs: Potential Bond Sales by Foreign Investors, 2012
(potential sales in percent of respective axis)



Sources: GFSR; and Fund staff estimates.

Protracted period of slower growth in advanced economies. Although trade with Europe has fallen after the global financial crisis, Europe still accounts for about a fifth of South Africa's exports. A downside scenario discussed in the Spring 2013 WEO assumes that euro area growth recovers more slowly and only up to 1 percent a year by 2018, with GDP ending 4 percent below the WEO baseline. Globally consistent simulations using DSGE models calibrated to 28 economies suggest the scenario would lead to lower growth and inflation, and slightly higher twin deficits. The impact on South Africa would be similar to that on the median EM and smaller than that on the median advanced economy.

Lower commodity prices. Lower commodity prices will hurt South Africa directly and indirectly, e.g., through lower demand for manufacturing products from Sub-Saharan Africa. Although mining accounts for about 8 percent of GDP, supporting activities account for at least an additional 7 percent of GDP, and it generates about two thirds of exports. Because South Africa's aging deep-shaft mines have a high cost structure, lower commodity prices could lead to closures of marginal mines and large job losses creating hysteresis effects. The lower income would lower aggregate demand and reduce public revenue, leading to higher twin deficits and higher risk spreads. As a mitigating factor, the currency would depreciate helping offset the effect of lower commodity prices on earnings.

Box 3. South Africa: Spillovers from Global Risk Scenarios and Risk Assessment Matrix (concluded) 1/

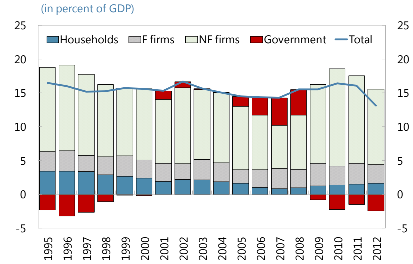
Nature/Source of Threat	Likelihood	Expected Impact on Economy	Policy Responses
External Risks			
Protracted period of slower European growth	*H*	*M.* Delayed recovery and lower potential growth.	Ease monetary policy. Take fiscal measures to ensure debt stabilization against lower potential growth. Structural reforms needed to drive growth.
Distortions from unconventional monetary policy	*H*	*M.* Incentives for excessive risk taking contained by strong financial surveillance and supervision, but significant real exposure from twin deficits.	Assiduous monitoring of systemic risks. Accumulate reserves if capital inflows surge. Prepare contingency plans in case of capital flow reversal (see below).
EM capital flow reversal	*M*	*H.* Despite large rand depreciation, would trigger disorderly adjustment in twin deficits, especially if accompanied by credit rating downgrades.	Let rand depreciate, provide FX liquidity. If needed to ensure adequate fiscal and external financing, increase policy rates.
Financial stress in the euro area re-emerges	*M*	*M.* Lower exports and financing difficulties.	As above in the short term. Structural reforms and trade liberalization to strengthen domestic sources of growth and encourage trade diversification.
Deeper than expected slowdown in emerging markets, and sharp slowdown in China	*M*	*M. L*ower commodity prices, wider current account deficits, and lower growth.	Let the rand depreciate, ease monetary policy, and let automatic fiscal stabilizers work, but take fiscal measures if slowdown is permanent.
Domestic Risks			
Limited progress on structural reforms	*H*	*H.* Lower potential growth, exacerbating economic and social vulnerabilities.	Take fiscal measures to ensure debt stabilization over medium term.
Labor market disruptions and social unrest	*M*	*H.* Lower investor confidence and competitiveness, weaker growth, and worse twin deficits. Labor unrest and high unemployment can also worsen household credit asset quality.	Let rand depreciate, ease monetary policy, let automatic stabilizers work providing financing allows. If financing becomes problematic, same response as in capital flow reversal scenario. Try to broker a national grand bargain to restore industrial peace.
Rising spending pressure, mainly wages	*L*	*M.* Wider fiscal deficit, reduced competitiveness.	Raise taxes, cut other spending, and improve spending efficiency.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff’s subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

Box 4. South Africa: Low Saving Rate

South Africa's national saving rate has been low for decades, but has fallen further in 2012. Saving has averaged 15.5 percent of GDP during 1995–2011, but dipped to about 13 percent of GDP in 2012. Most of the national saving comes from the corporate sector, especially nonfinancial firms. Although general government saving has averaged zero over this long sample, interactions between corporate and general government saving have tended to offset each other. During the mid-2000s, a sharp decline in corporate saving was offset by a rise in government saving. The reverse happened after 2008. In 2012, both corporate and government saving fell, reflecting weak growth. Households' savings have averaged about 2 percent of GDP over the long period, and, albeit on a slight upward trend in recent years, continued to be low at 1.7 percent of GDP in 2012. The household saving rate averaged 3½ percent during 1995–2011, and was at 2.8 percent in 2012.

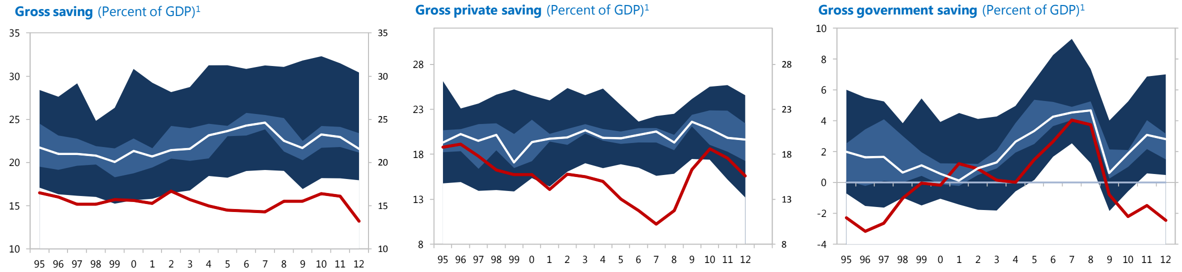
South Africa- National Saving Composition, 1995-12
(in percent of GDP)



Source: South African Reserve Bank.

The saving gap with peer EMs has increased over the last decade. While saving in South Africa remained relatively stable, the median saving rate in EMs rose during the 2000s. This rise in peers' saving rates mainly reflects higher government and a stable private saving rate. In contrast, in South Africa, the private saving rate has been more volatile, falling from 1995 through 2007, rising sharply during the crisis, and falling again since 2011. South Africa's household saving is the lowest of the seven peer EM countries for which data is available. In a broader sample of 42 countries of advanced and EM economies, South Africa's household saving rate ranks in the low 25 percent of the distribution. Government saving followed trends in peer EMs in the 2000s, but has diverged over the last three years.

Gross saving (Percent of GDP)[1] **Gross private saving** (Percent of GDP)[1] **Gross government saving** (Percent of GDP)[1]

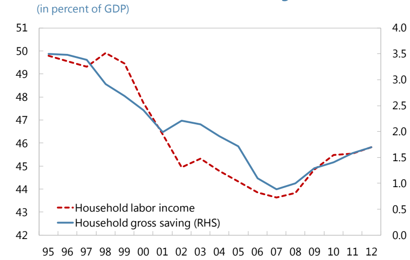


Sources: WEO, South African Reserve Bank; and Haver.
[1] Light blue area represents center quintile of distribution of peer emerging markets, while dark blue represents the other two center quintiles. White line is the median and red line South Africa.

Household saving has moved together with household labor income in percent of GDP.[1] The high structural unemployment and adverse demographics (especially a high young dependency ratio) have been the main culprits for the low level of household saving, with the decline in the labor share of income and households' increasing debt also contributing. Household saving rose modestly after the global financial crisis as wage settlements remained fairly insensitive to the economic cycle.

Looking forward, the national saving rate might increase, but likely only slowly. It is expected to remain below the long-term 15.5 percent average given the expected evolution of fundamentals. A durable increase in labor income would require structural changes in labor and product markets that succeed in creating sufficient jobs to reduce unemployment substantially. However, these measures are likely to be implemented slowly and take some time to have an effect. Expected demographic changes, including lower youth dependency ratio, would tend to increase saving in the medium term. Further, the envisaged fiscal consolidation would also help, but historically has been partly offset by lower corporate saving. On the other hand, the expected increase in public health spending with the introduction of the National Health Insurance would tend to lower saving.

Household Labor Income and Saving
(in percent of GDP)



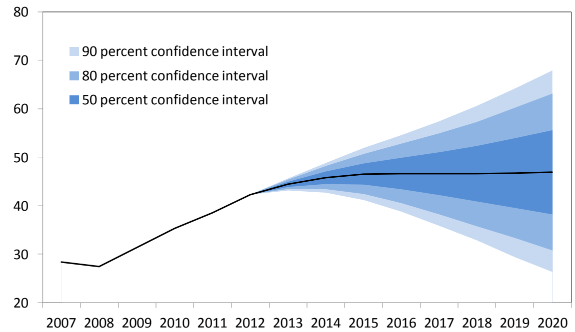
Source: South African Reserve Bank.

1/ World Bank (2011), South Africa Economic Update, Focus on Savings, Investment, and Inclusive Growth.

Box 5. South Africa: Debt Benchmarks 1/

South Africa's government debt has increased rapidly since the 2008 and is projected to continue rise over the medium-term. Debt has increased by nearly 15 percent of GDP since 2008, driven by a near 6 percentage point deterioration in the primary balance. While part of the increase in debt reflects the full play of automatic stabilizers, structural factors, including a rising wage bill, played a bigger role. Simulations using a simple 3-variable VAR suggest government debt will increase from 42 to 47 percent of GDP by 2020, but the results are subject to considerable uncertainty.[2.] There is a 10 percent chance the debt ratio will exceed 63 percent and a 5 percent chance it will reach 68 percent by 2020.

Public debt forecast-Baseline
(percent of GDP)



Source: Fund staff calculations

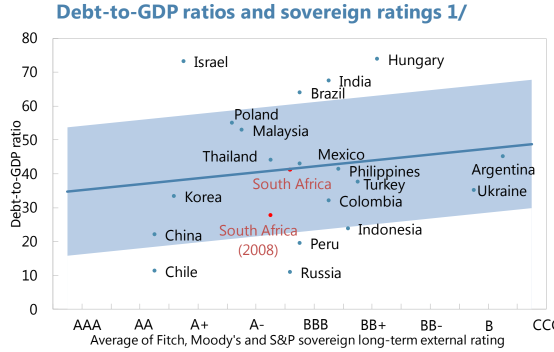
This box explores the question of an appropriate debt benchmark for South Africa. The ongoing debate about the tradeoff between growth and fiscal consolidation suggests there is no easy answer to this question. Moreover, lack of consensus across models and the number of factors driving perceptions about debt sustainability complicates this analysis. The deterioration in South Africa's fiscal position has raised concerns, but its debt is still in line with the average EM, financing has so far been easily available in South Africa's liquid bond market, and the debt maturity and currency composition suggest high debt tolerance.

A debt ceiling around 50–60 percent of GDP appears consistent with debt sustainability.

- Following IMF (2003), the sustainable debt ceiling can be calculated as the discounted sum of future primary surpluses.[3] Using a discount rate of 0.8—consistent with South Africa's EMBIG spread in 2000–07 and the average yield on the U.S. 10-year inflation linked bonds, as well as the IMF's current estimate of potential growth—yields a debt ceiling of around 50 percent of GDP. However a slightly higher discount rate of 0.85 would lower the sustainable debt-to-GDP ratio to around 45 percent, suggesting uncertainty is high.

- The debt ceiling should also be informed by debt levels in other EMs. South Africa's debt in 2008 was low relative to its sovereign rating, but is now closer to that of similarly-rated countries. However, error bands are large.

Debt-to-GDP ratios and sovereign ratings 1/



Sources: Fitch, Moody's, S&P; and WEO.
1/ The shaded area shows the one-standard error bands around the fitted values of a linear regression.

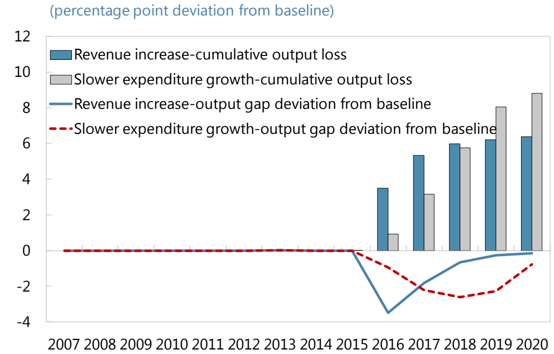
1/ Based on a forthcoming IMF working paper by Magnus Saxegaard (IMF) and Ian Stuart (South African National Treasury).
2/ The VAR includes the output gap, the real exchange rate, and the real interest rate as endogenous variables, and government noninterest expenditure and revenue (both as share of GDP) as exogenous variables.
3/ IMF (2003), "Public Debt in Emerging Markets: Is it too High?," Chapter III, September 2003, World Economic Outlook.

Box 5. South Africa: Debt Benchmarks (concluded)

This debt ceiling and the magnitude of shocks likely to hit the South African economy suggest the authorities should aim to lower the debt-to-GDP ratio to around 40 percent of GDP.

- A government needs to commit to service its debt not only in a baseline scenario, but also when the economy is buffeted by shocks or when fiscal risks materialize. This means the benchmark should be sufficiently below the debt ceiling to allow space to absorb shocks that increase the fiscal deficit.
- Following Mendoza and Oviedo (2004), a debt benchmark which takes into account the impact of shocks can be calculated as the discounted sum of future primary surpluses following a temporary decline in the primary balance. For South Africa, we assume a 3 percentage points of GDP decline in revenues—roughly equal to the decline during the global financial crisis—that is gradually unwound over the next 7 years.[4] Assuming expenditure moves in line with baseline projections, the sustainable debt-to-GDP ratio declines to 35-40 percent of GDP for discount rates ranging from 0.8-0.85.
- The debt benchmark depends not only on the debt ceiling and the discount rate, but also on the target horizon and the degree of confidence about the debt path. A shorter horizon would allow a higher debt benchmark given the buildup of uncertainty over time, but would provide less guidance to investors. On the other hand, a greater degree of confidence about the debt path would require a lower debt benchmark, but would tend to reduce risk premia charged by investors.
- Stochastic simulations using the simple three-variable VAR suggest reducing the debt-to-GDP ratio to just below 40 percent of GDP by 2020 would be consistent with keeping debt below a 60 percent of GDP debt ceiling with a 90 percent degree of confidence. Our simulations suggest this reduction in debt could be achieved either through a 2 percent of GDP increase in revenues or a 4 percent per annum reduction in real spending growth after the current three-year MTEF period.
- Simulations suggest increasing revenue or reducing spending growth would result in a 6–9 percentage loss in output by 2020. However, if structural reforms were implemented that would raise annual growth from 3 to 5 percent, the necessary adjustment would be achieved without further fiscal measures.

Output loss
(percentage point deviation from baseline)



Source: Fund staff calculations

4/ Mendoza, E. and P. M. Oviedo (2004), "Public Debt, Fiscal Solvency, and Macroeconomic Uncertainty in Latin America: The Cases of Brazil, Columbia, Costa Rica, and Mexico," NBER Working Paper 10637.

Box 6. South Africa's National Development Plan 1/

The NDP, launched in August 2012 by the National Planning Commission, aims to eliminate poverty and reduce inequality by 2030. The NDP targets to reduce the number of households living below the poverty line from 39 percent to zero, and the Gini coefficient from 0.7 in 2009 to 0.6 in 2030. The NDP went through extensive consultations with different parts of society.

The NDP focuses on a range of policy areas, especially infrastructure, education, health care, social protection, building a capable state, and promoting accountability and fighting corruption.

- **Infrastructure.** The plan proposes to expand electricity capacity, water supply, public transport, and transport infrastructure to facilitate commodity exports.

- **Education and training.** Actions include: improving the management of the education system; merit-based school principal selections; improving teachers' performance with training remuneration incentives; adult education and a variety of informal training programs.

- **Health care.** The plan aims at improving health management and implementing a national health insurance system to improve the quality of care and public facilities.

- **Building a capable state**. The NDP aims at enhancing the role of the Public Service Commission to monitor standards and improve recruitment, and improving relations between national, provincial, and local governments.

- **Fighting corruption and enhancing accountability,** by giving greater power to the Tender Compliance Monitoring Office, insulating anti-corruption agencies from political interference, setting up a dedicated prosecution team, specialist courts and judges, and developing accountability frameworks.

The NDP will be implemented in phases. First, some steps are planned for 2013 to start implementation. The second phase will involve implementing the 2014–19 Medium Term Strategic Framework, the first five-year building block of the NDP. The 2013 budget Review is the first budget tabled within the framework of the NDP and next year's budget is expected to require line departments to align their spending with the NDP priorities.

1/ www.info.gov.za/issues/national-development-plan.

2/ "Implementation of the National Development Plan—Post-State of the Nation Address media briefing" by Ministers Trevor Manuel and Collins Chabane.

Box 7. Labor and Product Market Reforms—the Mexico Case

Recently, Mexico has embarked on a series of structural reforms to improve labor and product markets, done as part of a social compact, known as the Pact for Mexico, signed by the newly elected President and the main opposition parties. These reforms and their implementation in the context of a social bargain could be of interest to South Africa as they relate to areas where action is needed and the two countries share some similarities in initial conditions.

Labor Market Reforms

The Labor Market Reform Law approved in 2012 includes measures to promote labor market flexibility, increase productivity, and improve labor conditions.[1] The Law introduces temporary trial and training contracts for project-specific and seasonal activities that are expected to boost youth employment, and hourly pay contracts to facilitate part-time employment. Other provisions are expected to lower hiring barriers, including streamlining the settlement of labor lawsuits, limiting compensation for unjustified dismissals to one-year's salary, and eliminating the requirement to terminate employment if a worker leaves the union. The new Law also aims to boost productivity by relaxing seniority rules and including productivity and labor skills as criteria for promotion, while introducing training certification schemes and a National Committee for Productivity. Bans on discrimination, child labor, a regulatory framework for outsourcing, and measures to improve working conditions for mining, rural, and domestic workers, are aimed to improve labor conditions.

Mexico's labor reforms are expected to boost job creation, reduce informality, and increase productivity and growth. The Banco de México and the OECD estimate that these reforms could boost potential growth by 0.15-0.5 percentage points per year.[2] Significant formal job creation is expected. Around two-thirds of the payoff is anticipated to come from new temporary contracts and the measures to increase worker productivity.

Product Market Reforms

Recent anti-trust reforms have strengthened the powers of regulatory bodies to curb anti-competitive practices. The 2011 Competition Law authorizes the Competition Commission (CFC) to impose fines of up to 10 percent of domestic turnover, and carry out on-site searches and impose criminal penalties if necessary. The Commission's new powers have already been applied in several cases and are expected to be a significant deterrent to abuse. The Law also envisages setting up specialized courts with expert judges for all competition and regulation issues. Once operational, these courts should play an important role in supporting competition and policing abuses.

The Telecoms Reform Bill—signed into law in June—includes wide-ranging proposals to improve competition in the telecommunications sector. The Bill establishes a new regulatory body with powers to apply more stringent regulation to dominant firms in the market and, if necessary, force asset sales. The new regulations are expected to increase competition, improve access to broadband internet, and reduce the costs of communication services.

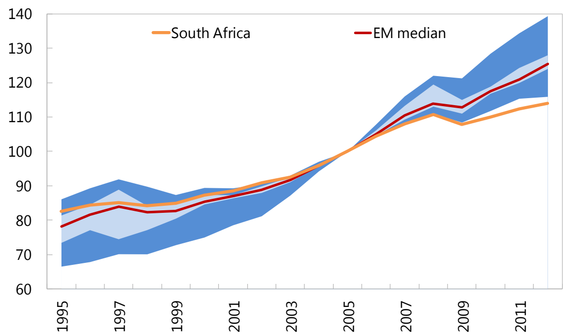
Mexico has also significantly eased procedures to start a business. The time and average cost to open a business has been brought down, while the capital required to start a business has been progressively reduced, reaching zero for low-risk businesses this year. Also, the Federal Commission on Regulatory Improvement is applying a regulatory impact analysis (RIA) to all regulations introduced over the past decade, and has aligned its RIA systems with OECD best practice.

1/ This section draws heavily from the Mexico 2012 Article IV Consultation, IMF Country Report No. 12/36.
2/ For further details see OECD Economic Surveys: Mexico 2013 and Banco de México Inflation Report: October-December 2012.

Figure 1. Improving Living Standards, but Remaining Difficult Structural Challenges

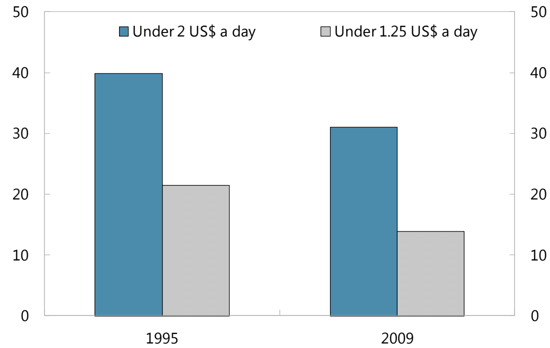
Real GDP per capita has increased by about 40 percent over the last 18 years…

Real GDP per Capita



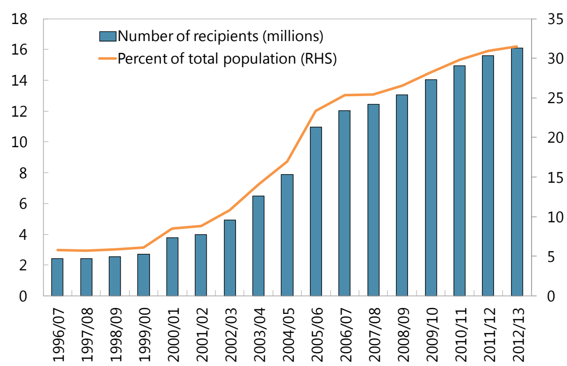
…lowering the poverty rate by about 10 percentage points.

Poverty Head Count
(in percent of population)



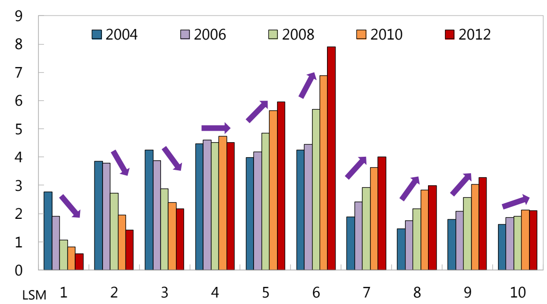
Growth combined with an expanding social safety net that covers young, old and about a third of the population…

Social Grant Recipients



…has improved living standards across the distribution.

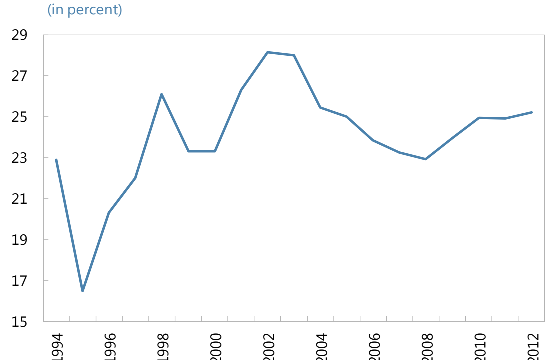
South Africa: Living Standard Measures (LSM) 1/
(weighted total, millions)



1/ The living standard measure groups individuals according to their living standards, using criteria such as degree of urbanization and ownership of cars and major appliances. It divides the population into 10 groups from 1 (lowest) to 10 (highest).

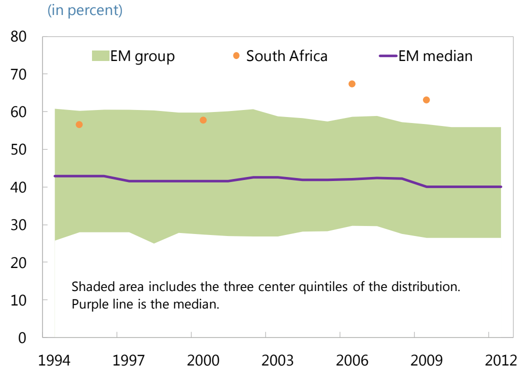
However, unemployment, although lower than in the early 2000, remains structurally high at about 25 percent…

Unemployment
(in percent)



…and inequality has further increased since the end of apartheid.

Emerging Markets: Gini Coefficient
(in percent)

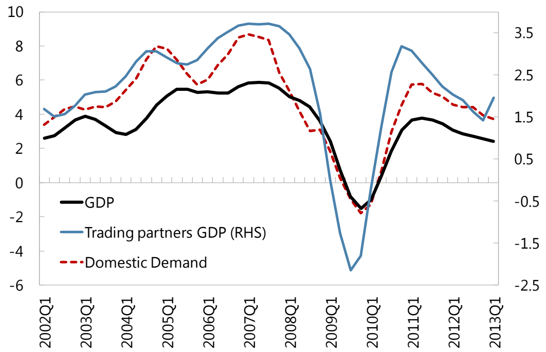


Sources: WEO, World Bank Development Indicators, Investec, South Africa National Treasury, Social Security South Africa, South Africa Audience Research Foundation; and Fund staff estimates.

Figure 2. South Africa: Growth Slowdown

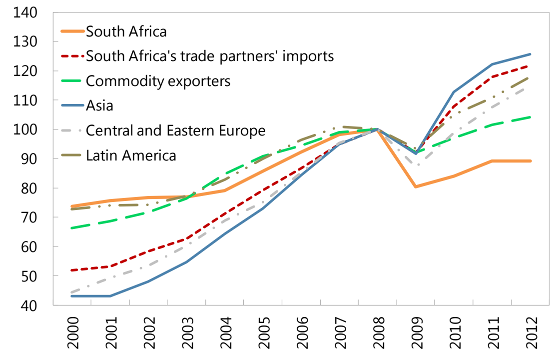
South Africa's growth remains highly correlated with trading partners and has slowed in the past year.

Real GDP and Domestic Demand Growth
(in percent, annual rate)



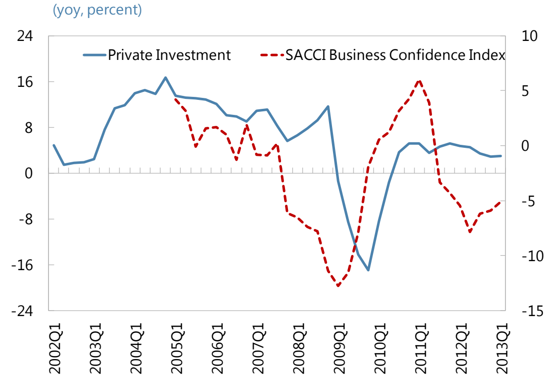
But domestic factors contributed to sluggish growth, as export underperformance shows.

Emerging Markets: Export Volumes
(index, 2008=100)



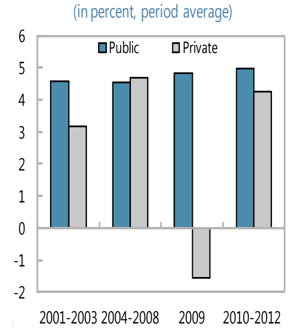
Since 2008, private investment has been anemic....

Investment Momentum
(yoy, percent)

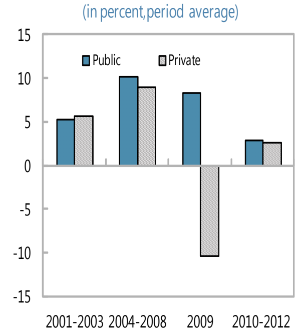


..while public consumption and investment have supported growth.

Real Consumption Growth
(in percent, period average)

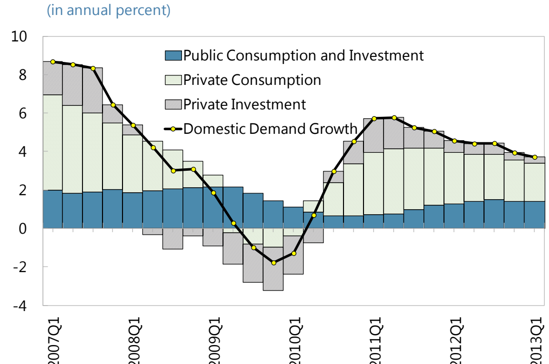


Fixed Investment Growth
(in percent,period average)



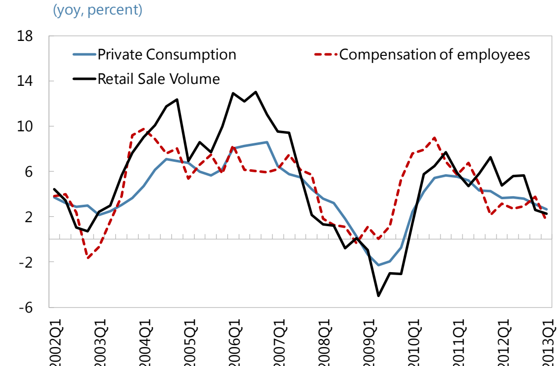
Private consumption remained buoyant even after the global financial crisis,

Contributions to Domestic Demand Growth
(in annual percent)



but has now started to slow.

Consumption Momentum
(yoy, percent)

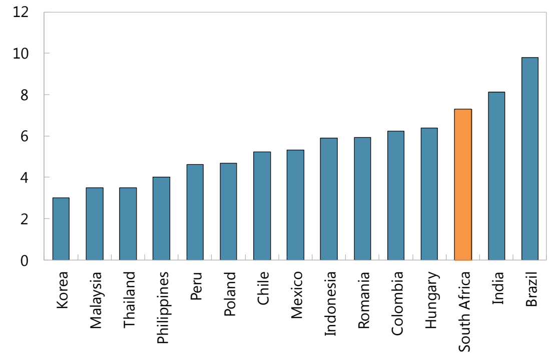


Sources: WEO, Haver; and Fund staff estimates.

Figure 3. Are South African Asset Prices Decoupling?

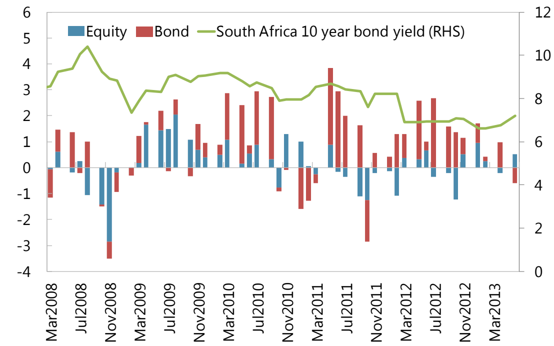
Attracted by relatively high yields and a steep yield curve…

Emerging Markets: 10 Year Bond Yields, 2013Q1
(in percent)



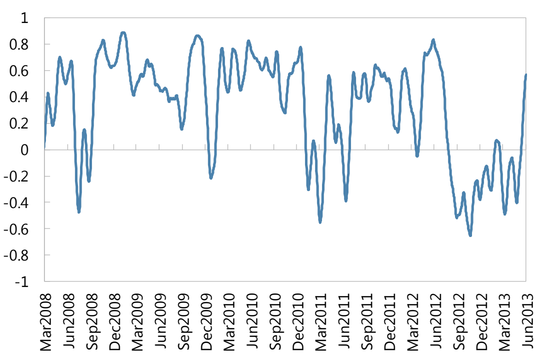
… as other EMs, South Africa benefited from large bond inflows in 2012, which slowed sharply since May 2013 on concerns of QE tapering.

Portfolio flows
(billions of USD)



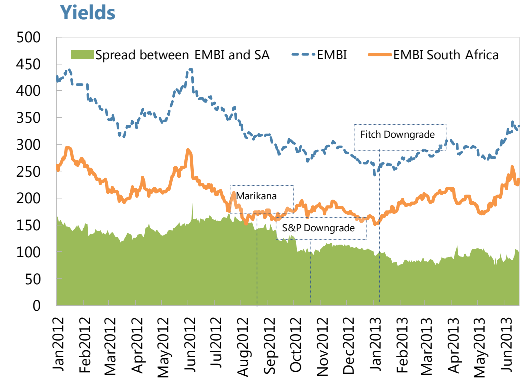
Negative domestic news have led to a decoupling of the rand from the VIX since mid 2012…

ZAR-USD 30-Day Moving Correlations with VIX



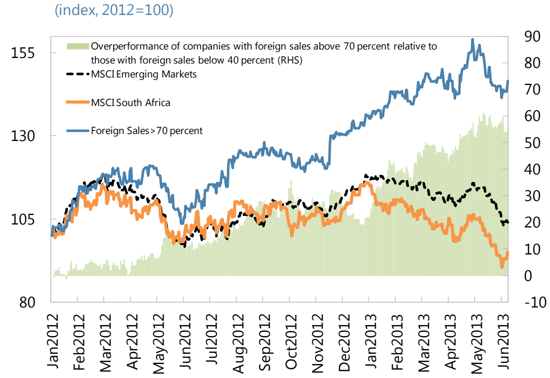
…and a narrowing spread between South Africa's dollar bonds and the EMBI.

Yields



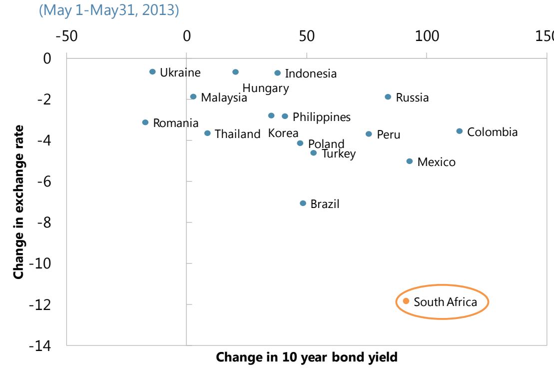
South Africa's equities also underperformed, especially domestic-focused stocks.

Stock Market Performance
(index, 2012=100)



Since the emergence of QE tapering concerns, South Africa's rand and bonds have suffered one of the sharpest sell-offs among EMs.

Changes in exchange rates and bond yield
(May 1-May31, 2013)

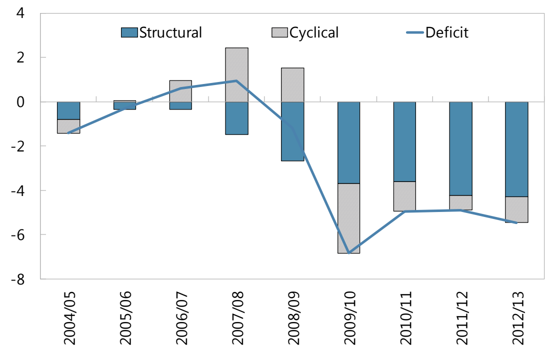


Sources: Bloomberg, Datastream, Haver; and Fund staff estimates.

Figure 4. South Africa: Public Debt in Line with EMs, but Fiscal Vulnerabilities Rising

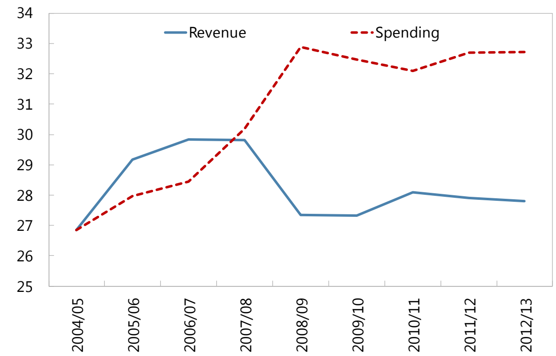
The budget deficit has increased structurally since the crisis, and remains high…

Central Government Balance
(in percent of GDP)



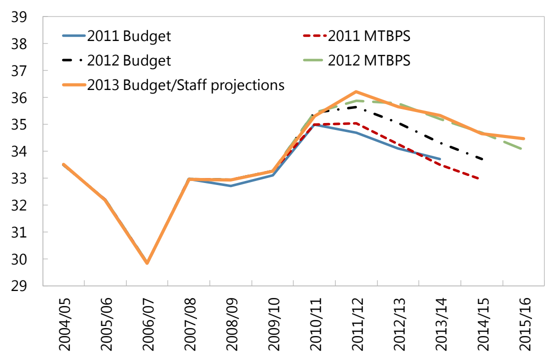
…driven by a policy of maintaining spending despite lower revenues.

Government Revenue and Spending
(in percent of GDP)



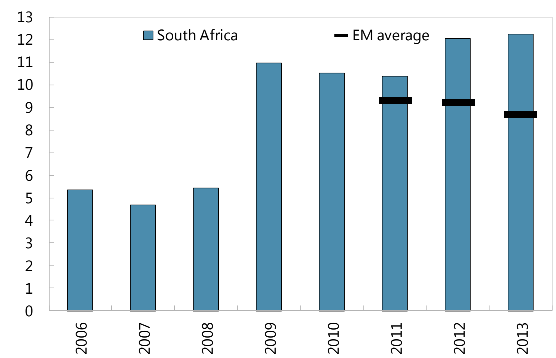
The structural increase in the deficit has been caused by a rising wage bill, which now absorbs a third of spending.

Government wage bill
(in percent of total expenditure)



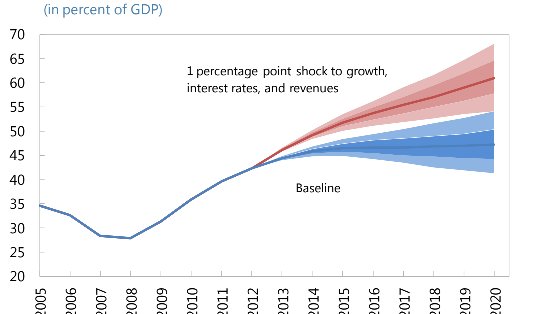
Despite low interest rates, gross financing needs have doubled since 2008 and are higher than the EM average.

Gross Financing Needs
(in percent of GDP)



The government debt-to-GDP ratio is still manageable, but debt dynamics have become more fragile.

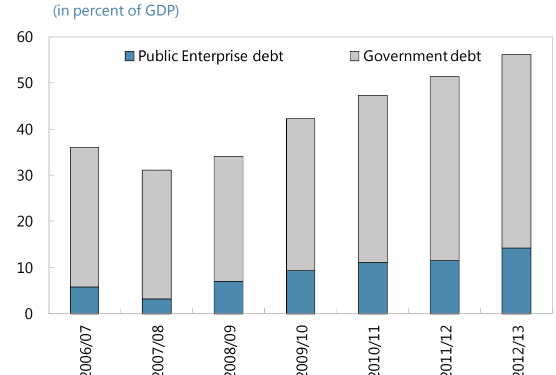
Governemnt Debt Forecast 1/
(in percent of GDP)



1/ The shaded areas represent the 30th, 40th, 50th, 60th, and 70th percentile of the cumulative distribution function.

Public sector indebtedness reached 50 percent of GDP due to public enterprise borrowing for infrastructure projects.

Public Debt
(in percent of GDP)



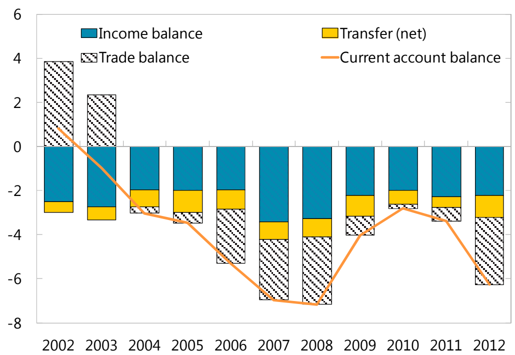
Sources: South African Reserve Bank, South Africa National Treasury, Fiscal Monitor; and Fund staff estimates.

Figure 5. South Africa: Rising External Vulnerabilities

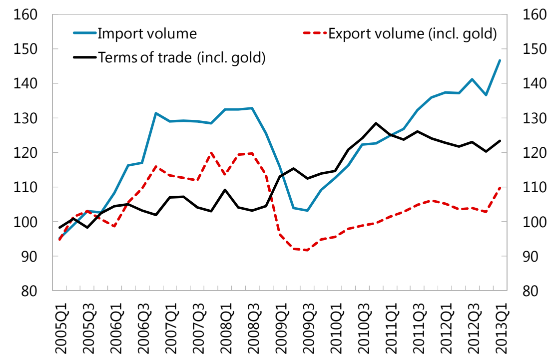
The current account deficit widened to 6.3 percent of GDP in 2012, on the back of a worsening trade deficit….

…. reflecting a surge in import volumes, flat exports, and softer terms of trade.

Current Account Developments
(in percent of GDP)



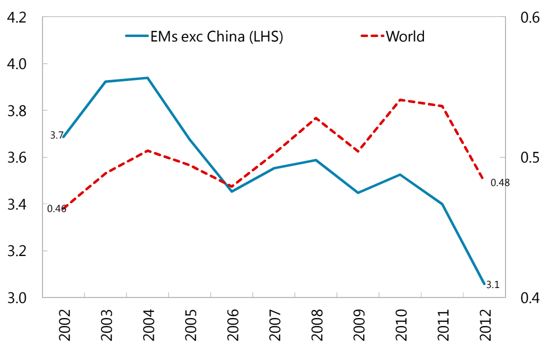
Volumes and Terms of Trade
(index, 2005=100)



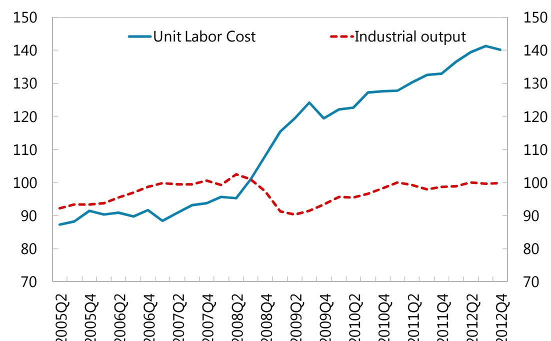
South Africa's global export share has fallen in recent years highlighting its competitiveness issues…

…with its unit labor costs growing faster than manufacturing output since the global financial crisis.

Shares in Global and in EMs Exports
(in percent)



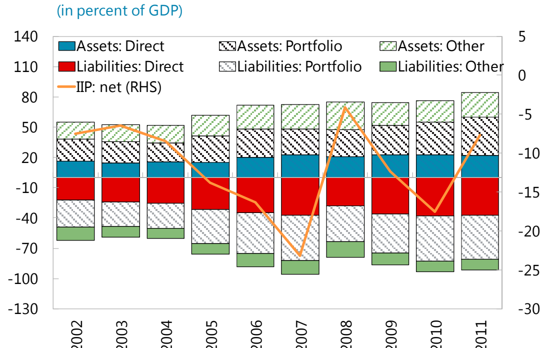
Unit Labor Costs and Industrial Output
(index, average 2008=100)



The international investment position was -7 percent of GDP in 2011 and it may have improved further after the recent rand depreciation.

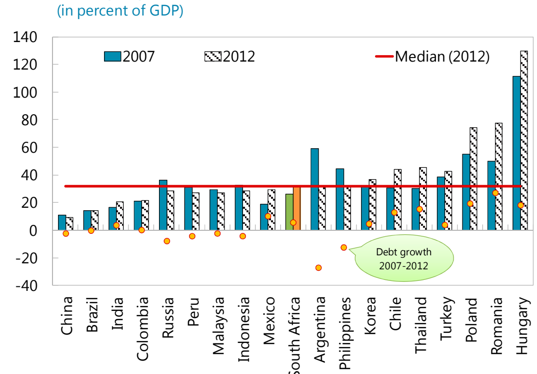
Gross external debt has risen since 2008, and is now in line with the median EM.

International Investment Position 1/
(in percent of GDP)



1/ IIP for 2011 is estimated from BOP flows.

Emerging Markets: Gross External Debt
(in percent of GDP)

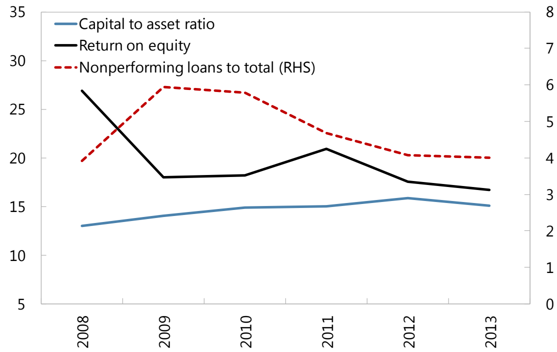


Sources: Haver, InterBank Fund Transfer System, Statistics South Africa, South African Reserve Bank; and Fund staff estimates.

Figure 6. South Africa: A Strong Banking System but Increasing Risk

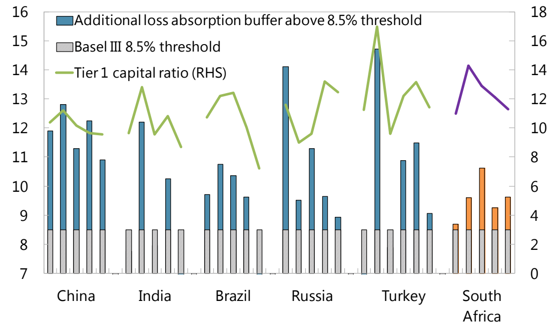
Post 2008, NPLs have fallen, profitability has remained robust, and capital has increased.

Banks' Financial Soundness Indicators
(in percent, as of 2013 April)



But loan loss absorption buffers are moderate ….

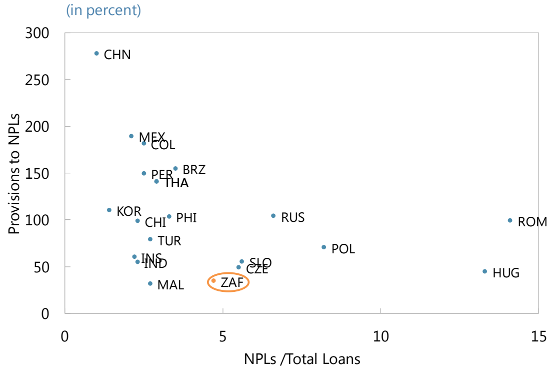
Capital Adequacy and Loss Absorption Buffers 1/



1/ The columns represent the main banks in each country.

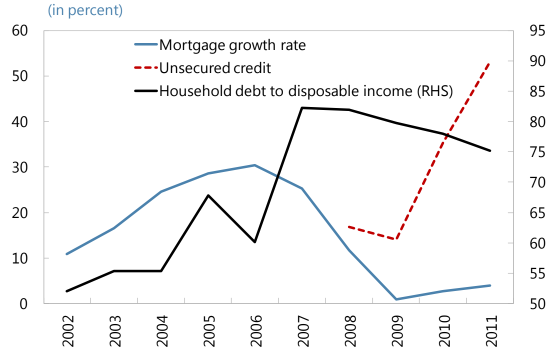
…due to relatively low provisions.

Provisions to NPLs and NPLs to Total Loans
(in percent)



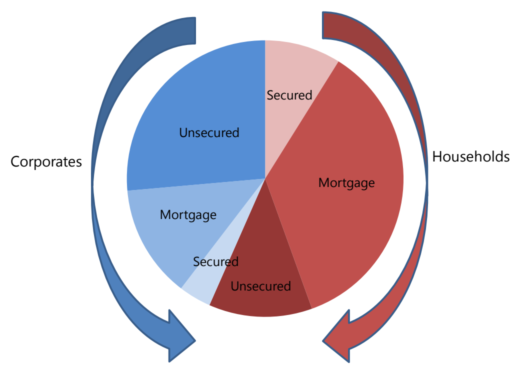
A mortgage boom was followed by rapid unsecured credit growth to highly leveraged households.

Lending to Households
(in percent)



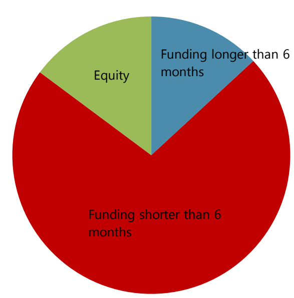
As a result, lending to households represents nearly 60 percent of banks' total loan portfolios.

Distribution of Loans



Also, banks rely heavily on short-term deposits, the majority of which is from domestic institutional investors.

Distribution of Bank Funding Sources

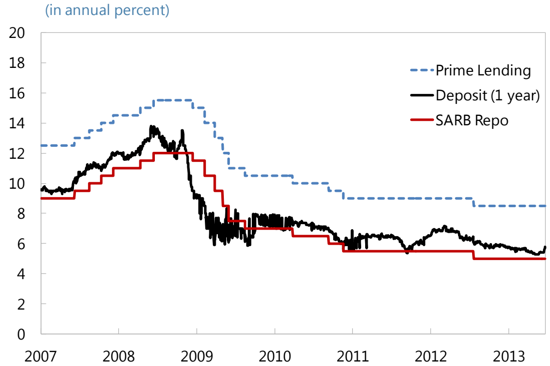


Sources: GFSR, South African Reserve Bank; and Fund staff estimates.

Figure 7. South Africa: Supporting Monetary Policy that Anchors Inflation Expectations

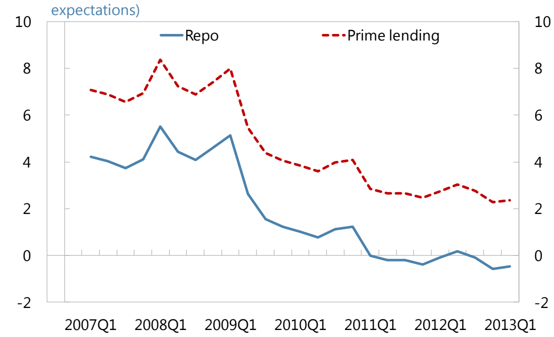
The SARB cut interest rates last in July 2012.

Selected Interest Rates
(in annual percent)



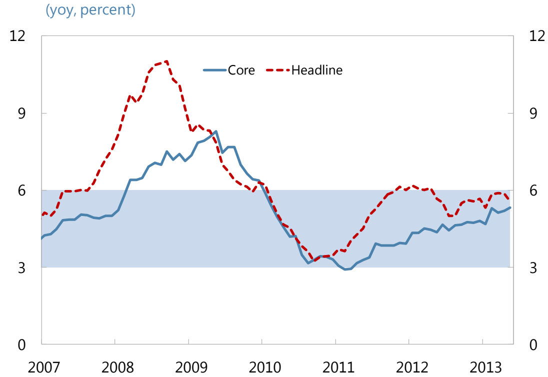
The real repo rate is negative, and real lending rates have fallen by about 5 percentage points since 2008.

Real Interest Rates
(in annual percent, deflated by one-year ahead analysts' inflation expectations)



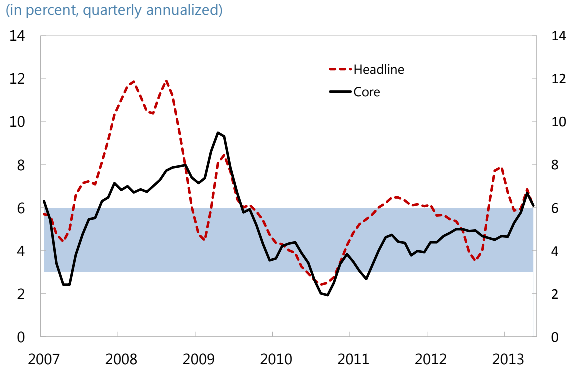
Inflation has been within the band in the past two years.

Headline and Core Inflation
(yoy, percent)



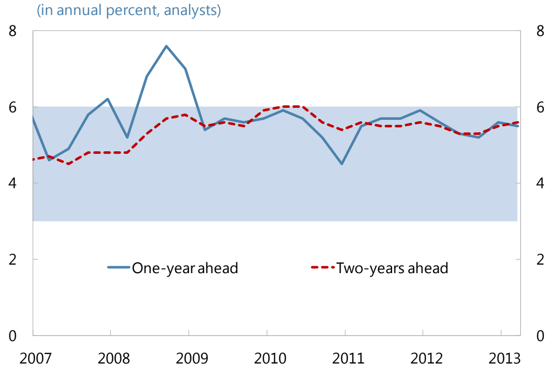
Inflation momentum has exceeded the target band recently, but is volatile.

South Africa Headline and Core Inflation Momentum
(in percent, quarterly annualized)



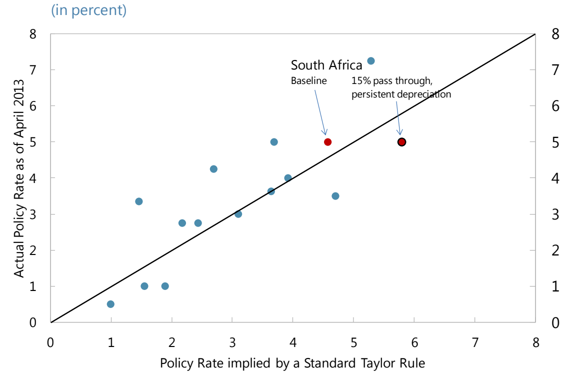
Inflation expectations have remained well anchored, albeit in the upper half of the band.

Survey Inflation Expectations
(in annual percent, analysts)



Prospects of second round effects of rand depreciation have complicated monetary policy decisions.

Taylor Rule and Policy Rates In Inflation Targeting Countries
(in percent)



Sources: SARB, Haver, Bureau of Economic Research South Africa, IMF WEO database; and Fund staff estimates.

Table 1. South Africa: Selected Economic and Social Indicators, 2009–14

Social Indicators

GDP		**Poverty**	
Nominal GDP (2012, billions of U.S. dollars)	384	Headcount ratio at $1.25 a day (2009, percent of population)	13.8
GDP per capita (2011, U.S. dollars)	7972	Undernourishment (2011, percent of population)	5.0
Population characteristics (2011)		**Income distribution (2009)**	
Total	50.5	Income share held by highest 10 percent (percent of population)	51.7
Urban population (percent of total)	62	Income share held by lowest 20 percent (percent of population)	2.7
Life expectancy at birth (years)	53	Gini index	63.1

Economic Indicators

	2009	2010	2011	2012	2013	2014
				Est.	Proj.	
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	-1.5	3.1	3.5	2.5	2.0	2.9
Real GDP per capita	-2.4	2.3	2.8	1.3	0.8	1.7
Real domestic demand	-1.8	4.5	5.1	3.9	2.4	2.8
GDP deflator	8.3	7.2	6.0	5.5	6.7	6.1
CPI (annual average)	7.1	4.3	5.0	5.7	5.9	5.5
CPI (end of period)	6.3	3.5	6.1	5.6	5.7	5.4
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.0	24.9	24.9	25.1	26.0	26.2
Average remuneration (formal nonagricultural, nominal)	11.7	13.6	7.2	8.4	8.8	8.1
Labor productivity (formal nonagricultural)	1.7	3.9	1.2	2.0	2.2	2.3
Unit labor costs (formal nonagricultural)	9.9	9.3	5.9	6.3	6.5	5.7
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	15.5	16.4	16.1	13.2	13.2	13.2
Public (incl. public enterprises)	1.0	-0.5	0.8	-0.1	0.0	0.4
Private	14.5	16.9	15.3	13.2	13.2	12.9
Investment (including inventories)	19.5	19.2	19.5	19.4	19.2	19.3
Public (incl. public enterprises)	8.1	7.1	7.1	7.4	7.6	7.8
Private	13.4	12.2	11.9	11.7	11.6	11.4
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.4	27.3	28.1	27.9	27.8	27.8
Expenditure and net lending	32.9	32.5	32.1	32.7	32.7	32.5
Overall balance	-5.5	-5.1	-4.0	-4.8	-4.9	-4.7
Gross government debt	31.3	35.8	39.6	42.3	43.0	44.7
Government bond yield (10-years and over, percent) 2/	9.0	8.3	8.5	7.3	7.3	…
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	1.8	6.9	8.3	5.2	8.8	9.2
Credit to the private sector	3.0	3.3	5.7	9.3	8.0	8.4
Repo rate (percent) 2/	7.0	5.5	5.5	5.0	5.0	…
External trade (annual percentage change unless otherwise indicated)						
Merchandise exports (billions of U.S. dollars)	66.0	85.4	102.9	93.5	97.3	99.6
percentage change (volume)	-19.5	4.5	5.9	0.1	5.3	5.2
Merchandise imports (billions of U.S. dollars)	65.7	81.7	100.7	102.7	106.2	108.7
percentage change (volume)	-17.4	9.6	9.7	6.3	5.1	4.2
Terms of trade	8.0	7.3	2.3	-2.2	0.4	-1.2
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-11.5	-10.2	-13.6	-24.1	-21.5	-22.7
percent of GDP	-4.0	-2.8	-3.4	-6.3	-6.1	-6.1
Overall balance	0.7	1.2	1.1	0.3	0.0	0.0
Gross reserves (billions of U.S. dollars)	39.7	43.8	48.9	50.7	50.7	50.7
percent of short-term debt (residual maturity)	136.8	145.8	151.6	133.2	133.2	132.9
Total external debt	27.5	28.8	28.1	35.8	35.0	35.5
of which short-term (residual maturity)	10.2	8.3	8.0	9.9	10.8	10.3
Nominal effective exchange rate (percentage change) 3/	23.7	11.3	-16.6	-5.4	-11.7	…
Real effective exchange rate (percentage change) 3/	29.3	12.2	-14.1	-2.3	-8.2	…
Exchange rate (Rand/U.S. dollar) 2/	7.4	6.6	8.1	8.5	10.1	…

Sources: South African authorities, World Bank, IMF INS database; and Fund staff estimates and projections.

1/ General government.

2/ For 2013, end-May data.

3/ For 2013, end-April data.

Table 2. South Africa: Consolidated Government Operations, 2008/09–2015/16 1/

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14		2014/15		2015/16	
					Est.	Auth.	Staff	Auth.	Staff	Auth.	Staff
						billions of rands					
Total revenue and grants	683.5	664.5	757.2	837.0	891.7	985.7	978.7	1091.1	1067.8	1199.8	1170.6
Tax revenue	625.0	604.1	692.7	756.4	827.2	922.9	920.1	1023.4	1005.4	1128.7	1105.7
Non-tax revenue	58.5	60.3	64.4	80.6	64.5	62.8	58.6	67.7	62.4	71.1	64.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	708.5	824.1	877.5	954.2	1055.9	1149.4	1149.8	1244.3	1246.0	1334.1	1337.9
Current expenditure	647.7	733.2	800.3	890.4	983.2	1064.5	1064.9	1146.6	1148.2	1228.7	1232.4
Wages and salaries	233.3	274.1	309.8	345.5	376.6	406.2	406.2	431.7	431.7	459.7	459.7
Other goods and services	117.8	138.6	144.4	161.3	172.2	182.9	182.9	200.1	200.1	213.2	213.2
Interest	58.6	57.1	66.2	76.5	88.3	99.7	100.2	108.7	110.4	118.2	121.9
Transfers	237.9	263.3	279.9	307.1	346.2	375.6	375.6	406.0	406.0	437.6	437.6
Capital expenditure	49.7	57.5	55.7	62.4	71.2	78.0	78.0	88.0	88.0	92.4	92.4
Payment for financial assets	11.1	33.3	21.5	1.4	1.5	2.9	2.9	3.3	3.3	3.0	3.0
Contingency	0.0	0.0	0.0	0.0	0.0	4.0	4.0	6.5	6.5	10.0	10.0
Overall balance	-25.0	-159.6	-120.4	-117.2	-164.1	-163.7	-171.1	-153.2	-178.2	-134.4	-167.3
Primary balance	33.6	-102.5	-54.1	-40.7	-75.8	-63.9	-70.9	-44.5	-67.8	-16.2	-45.3
Structural balance	-43.6	-68.9	-63.3	-86.2	-111.0	...	-123.5	...	-136.8	...	-144.1
Gross government debt	627.0	804.9	990.6	1187.8	1342.5	1522.1	1528.4	1704.1	1730.2	1903.8	1964.5
						percent of GDP					
Total revenue and grants	29.7	27.1	27.7	28.2	27.8	28.0	27.8	28.1	27.8	28.1	27.8
Tax revenue	27.1	24.6	25.3	25.4	25.8	26.2	26.2	26.4	26.2	26.4	26.2
Non-tax revenue	2.5	2.5	2.4	2.7	2.0	1.8	1.7	1.7	1.6	1.7	1.5
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	30.8	33.6	32.1	32.1	32.9	32.7	32.7	32.1	32.5	31.2	31.7
Current expenditure	28.1	29.9	29.3	29.9	30.6	30.2	30.3	29.5	29.9	28.8	29.2
Wages and salaries	10.1	11.2	11.3	11.6	11.7	11.5	11.5	11.1	11.2	10.8	10.9
Other goods and services	5.1	5.7	5.3	5.4	5.4	5.2	5.2	5.2	5.2	5.0	5.1
Interest	2.5	2.3	2.4	2.6	2.8	2.8	2.8	2.8	2.9	2.8	2.9
Transfers	10.3	10.7	10.2	10.3	10.8	10.7	10.7	10.5	10.6	10.2	10.4
Capital expenditure	2.2	2.3	2.0	2.1	2.2	2.2	2.2	2.3	2.3	2.2	2.2
Payment for financial assets	0.5	1.4	0.8	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Contingency	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.2	0.2
Overall balance	-1.1	-6.5	-4.4	-3.9	-5.1	-4.6	-4.9	-3.9	-4.6	-3.1	-4.0
Primary balance	1.5	-4.2	-2.0	-1.4	-2.4	-1.8	-2.0	-1.1	-1.8	-0.4	-1.1
Structural balance	-1.9	-2.8	-2.3	-2.9	-3.5	...	-3.5	...	-3.6	...	-3.4
Gross government debt	27.2	32.8	36.2	39.9	41.8	43.2	43.4	43.9	45.1	44.6	46.6
Memorandum items:											
Fiscal year GDP (billions of rand)	2304	2453	2735	2973	3209	3520	3518	3880	3838	4271	4218
Real GDP growth (percent)	2.4	-0.8	3.4	3.1	2.5	3.0	2.1	3.6	3.0	3.8	3.3

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

1/ Data is on a fiscal year basis (April 1-March 31); The authorities projections are based on the 2013 budget published in February 2013. Revised projections will be released in the 2013 MTBPS in October 2013.

Table 3. Statement of Operations—National Government Main Budget, 2008/09–2014/15 1/

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
					Est.	Proj.	
			percent of GDP				
Revenue	26.4	23.6	24.4	24.9	24.5	24.5	24.7
Taxes	25.9	23.3	24.0	24.2	24.0	24.1	24.3
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	0.5	0.3	0.4	0.6	0.5	0.4	0.4
Expenditure	27.1	29.1	28.6	29.8	29.9	29.9	29.6
Expense	26.8	28.7	28.3	29.4	29.5	29.5	29.1
Interest	2.4	2.3	2.4	2.6	2.8	2.8	2.8
Grants	12.7	14.1	14.0	14.5	14.5	14.2	13.9
of which : provinces	10.7	12.0	11.8	12.2	12.1	11.8	11.5
local governments	2.0	2.1	2.2	2.3	2.4	2.4	2.4
Other expense	11.7	12.3	11.8	12.4	12.2	12.4	12.4
Net acquisition of nonfinancial assets	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Gross Operating Balance (Revenue - Expense)	-0.4	-5.1	-3.8	-4.6	-5.0	-5.0	-4.4
Budgetary balance (Revenue - Expenditure)	-0.7	-5.5	-4.2	-5.0	-5.4	-5.4	-4.9
Extraordinary payments, net	0.2	0.2	0.1	0.1	0.3	0.1	0.1
Net lending (+)/borrowing (–)	-0.6	-5.3	-4.1	-4.8	-5.2	-5.3	-4.8
Net acquisition of financial assets							
Domestic	0.8	2.5	2.2	0.8	-0.8	-0.4	-0.2
Currency and deposits	0.4	1.2	1.5	0.7	-0.8	-0.5	-0.3
Loans	0.4	1.3	0.7	0.0	0.0	0.1	0.1
Net incurrence of liabilities	1.4	7.8	6.4	5.6	4.4	4.8	4.6
Domestic	1.5	6.9	6.3	5.3	4.6	4.9	4.6
Foreign	-0.2	0.9	0.1	0.3	-0.2	-0.1	0.0
Memorandum items:							
Fiscal year GDP (billions of rand)	2,304	2,453	2,735	2,973	3,209	3,518	3,838
Real GDP growth (percent)	2.4	-1.0	3.7	3.1	2.5	2.1	3.0
GDP deflator (percent change)	8.4	7.5	7.6	5.5	5.3	7.3	5.9
Primary balance	1.6	-3.2	-1.8	-2.4	-2.7	-2.6	-2.1
Gross debt	25.0	25.6	29.4	39.9	41.8	43.4	45.1

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

1/ Data is on a fiscal year basis (April 1-March 31). National government comprises the central government and transfer to subnational governments financed by the national revenue fund.

Table 4. South Africa: Balance of Payments, 2009–14

	2009	2010	2011	2012	2013	2014
				Est.	Proj.	
			billions of U.S. dollars			
Balance on current account	-11.5	-10.2	-13.6	-24.1	-21.5	-22.7
Balance on goods and services	-2.5	-0.7	-2.5	-11.7	-11.4	-12.1
Exports of goods and services	77.9	99.4	117.8	108.6	113.0	115.7
Exports of goods	66.0	85.4	102.9	93.5	97.3	99.6
Nongold	59.7	77.3	92.5	84.8	89.6	92.1
Gold	6.3	8.1	10.4	8.7	7.7	7.5
Exports of services	11.9	14.0	14.9	15.1	15.8	16.1
Imports of goods and services	-80.4	-100.1	-120.3	-120.3	-124.5	-127.8
Imports of goods	-65.7	-81.7	-100.7	-102.7	-106.2	-108.7
Imports of services	-14.7	-18.4	-19.6	-17.7	-18.3	-19.1
Balance on income	-6.3	-7.2	-9.2	-8.5	-6.6	-7.4
Income receipts	4.0	4.7	5.3	5.9	6.9	7.2
Income payments	-10.4	-11.9	-14.4	-14.4	-13.5	-14.5
Balance on transfers	-2.7	-2.3	-2.0	-3.8	-3.4	-3.3
Capital flows (including errors and omissions)	13.5	14.5	18.1	25.2	21.5	22.7
Balance on capital and financial account	13.4	9.6	8.1	19.8	18.0	22.7
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	13.4	9.5	8.1	19.8	17.9	22.7
Direct investment	4.2	1.3	6.3	0.2	3.8	4.2
Liabilities	5.4	1.2	6.0	4.6	4.2	4.8
Assets	-1.2	0.1	0.3	-4.4	-0.5	-0.7
Portfolio investment	11.1	10.2	-2.3	6.7	1.5	6.0
Liabilities	12.7	14.7	6.3	11.5	6.5	11.6
Assets	-1.6	-4.6	-8.6	-4.9	-5.0	-5.6
Other investment	-1.9	-1.9	4.1	12.9	12.6	12.5
Liabilities	-4.7	1.1	5.9	8.0	6.4	7.4
Assets	2.8	-3.0	-1.9	4.9	6.2	5.1
Errors and omissions	0.1	4.9	10.0	5.3	3.5	0.0
Overall balance of payments	2.0	4.3	4.5	1.1	0.0	0.0
Gross reserves (end of period)	39.7	43.8	48.9	50.7	50.7	50.7
			percent of GDP			
Balance on current account	-4.0	-2.8	-3.4	-6.3	-6.1	-6.1
Balance on goods and services	-0.9	-0.2	-0.6	-3.0	-3.2	-3.3
Exports of goods and services	27.3	27.4	29.3	28.3	31.9	31.2
Imports of goods and services	-28.2	-27.6	-29.9	-31.3	-35.2	-34.4
Capital flows (including errors and omissions)	4.7	4.0	4.5	6.5	6.1	6.1
Balance on capital and financial account	4.7	2.6	2.0	5.2	5.1	6.1
Errors and omissions	0.0	1.4	2.5	1.4	1.0	0.0
Overall balance of payments	0.7	1.2	1.1	0.3	0.0	0.0
Gross reserves (end of period)	13.9	12.1	12.1	13.2	14.3	13.7
Memorandum items:						
Total external debt	27.5	28.8	28.1	35.8	35.0	35.5
of which short-term (residual maturity)	10.2	8.3	8.0	9.9	10.8	10.3
Medium and long term external debt service 1/	12.0	13.3	11.8	17.3	22.1	25.4

Sources: South African Reserve Bank (SARB); and Fund staff estimates and projections.
1/ Billions of U.S. dollars.

Table 5. South Africa: Monetary Survey, 2009–13

	2009	2010	2011	2012	2013 May
			billons of rands		
Monetary Survey					
Net Foreign Assets	334	338	505	504	614
Net Domestic Assets	1,614	1,745	1,750	1,869	1,840
General government	69	74	13	6	-50
Public Nonfinancial Corporations	32	36	33	34	32
Nonfinancial Private Sector	1,871	1,933	2,044	2,233	2,296
Other items net	-357	-298	-339	-405	-438
Broad Money	1,948	2,083	2,255	2,372	2,454
Central bank					
Net Foreign Assets	266	267	371	402	454
Net Domestic Assets	-142	-131	-215	-228	-284
General government	-107	-110	-197	-233	-292
Public Nonfinancial Corporations	0	0	1	1	1
Nonfinancial Private Sector	0	0	0	0	0
Depository institutions (banks)	12	25	25	38	38
Other items net	-47	-47	-43	-34	-31
Monetary base	124	136	157	174	171
Currency in circulation	78	83	101	112	101
Reserves and others	47	53	55	62	69
			annual percentage change		
Memorandum items:					
Broad money growth	1.8	6.9	8.3	5.2	9.7
Monetary base growth	4.0	9.3	15.2	11.2	12.2
Credit to private sector	3.0	3.3	5.7	9.3	8.3
Broad money multiplier	15.7	15.3	14.4	13.6	14.4

Sources: South African authorities; and IMF's Monetary and Banking Database (MBRF2).

Table 6. South Africa: Financial Soundness Indicators, 2009–13

	2009	2010	2011	2012	2013 April
Capital adequacy					
Risk-weighted capital adequacy ratio (percent)	14.1	14.9	15.0	15.8	15.1
of which Tier 1 capital (percent)	11.0	11.8	12.2	12.6	12.1
Capital to asset ratio (percent)	6.7	7.0	7.2	7.8	...
Asset quality					
Nonperforming loans (percent of outstanding loans)	5.9	5.8	4.7	4.1	4.0
Nonperforming loans net of provisions (percent of regulatory capital)	47.6	40.8	31.0	23.6	...
Earnings, profitability, and efficiency					
Return on assets (percent)	1.1	1.2	1.5	1.3	1.2
Return on equity (percent)	18.0	18.2	21.0	17.5	16.7
Interest income (percent of gross income)	39.5	43.9	49.1	49.6	...
Trading income (percent of gross income)	16.0	13.8	10.5	8.9	...
Non-interest expenses (percent of gross income)	48.8	63.4	54.2	53.1	...
Lending-deposit rate spread	3.2	3.4	3.3	...	...
Personnel expenses (percent of non-interest expenditure)	43.7	43.5	52.6	37.0	...
Liquidity					
Liquid assets (percent of total assets)	6.4	7.5	8.3	8.6	...
Liquid assets (percent of short-term liabilties)	13.0	15.5	16.6	17.4	...
Customer deposits (percent of total non-interbank loans)	46.3	48.0	51.4	52.2	...
Exposure to FX risk					
Effective net open FX position (percent of regulatory capital)	0.8	-0.3	0.8	0.5	...
Foreign-currency-denominated loans (percent of outstanding loans)	7.0	6.7	9.2	8.3	...
Foreign-currency-denominated liabilities (percent of total liabilities)	4.3	4.1	4.5	5.7	...
Sectoral distribution of loans and advances					
Residents	91.6	91.2	90.0	90.5	...
Central Bank	0.2	0.1	0.3	0.2	...
Other financial corporations 1/	12.2	11.2	11.9	12.5	...
General government	0.7	0.9	0.9	0.8	...
Nonfinancial corporations	33.6	32.4	31.3	31.0	...
Households	44.9	46.5	45.6	46.1	...
Nonresidents	9.9	9.5	10.0	9.5	...
Derivatives					
Gross asset position in financial derivatives (percent of regulatory capital)	133.9	124.3	112.5	88.8	...
Gross liability position in financial derivatives (percent of regulatory capital)	126.5	121.5	112.5	87.8	...
Real Estate Market					
Residential real estate prices (annual percentage change)	6.5	0.3	1.7	0.3	...
Residential real estate loans (percent of total loans)	34.9	35.3	32.8	30.3	...
Commercial real estate loans (percent of total loans)	9.7	9.8	9.5	9.1	...
Household debt burden					
Household debt (percent of GDP)	47.9	45.0	44.3	45.7	...
Household debt (percent of disposable income)	81.5	78.6	75.4	76.3	...
Household debt service (percent of disposable income)	10.0	9.0	8.0	7.7	7.7

Sources: South African Authorities; and IMF International Financial Statistics.

1/ Including interbank loans.

Table 7. South Africa: Medium Term Macroeconomic Framework, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
		Est.			Proj.			
National income and prices (annual percentage change)								
Real GDP	3.5	2.5	2.0	2.9	3.3	3.4	3.5	3.5
CPI (annual average)	5.0	5.7	5.9	5.5	5.1	5.0	5.0	5.0
Potential real GDP 1/	2.9	2.8	2.8	2.9	3.1	3.2	3.2	3.2
Output gap (percent of potential real GDP)	-0.1	-0.4	-1.2	-1.1	-1.0	-0.8	-0.5	-0.2
Labor market (annual percentage change)								
Unemployment rate (percent of labor force, annual average)	24.9	25.1	26.0	26.2	26.2	26.1	25.9	25.8
Savings and Investment (percent of GDP)								
Gross national saving	16.1	13.2	13.2	13.2	13.7	13.9	14.1	14.4
Public (incl. public enterprises)	0.8	-0.1	0.0	0.4	0.9	1.2	1.4	1.5
Private	15.3	13.2	13.2	12.9	12.7	12.7	12.8	12.9
Investment (including inventories)	19.5	19.4	19.2	19.3	19.5	19.8	20.0	20.1
Public (incl. public enterprises)	7.1	7.4	7.6	7.8	7.9	8.0	8.1	8.2
Private	11.9	11.7	11.6	11.4	11.4	11.4	11.5	11.5
Fiscal position (percent of GDP) 2/								
Revenue, including grants	28.1	27.9	27.8	27.8	27.8	27.9	28.0	28.1
Expenditure and net lending	32.1	32.7	32.7	32.5	31.9	31.7	31.6	31.6
Overall balance	-4.0	-4.8	-4.9	-4.7	-4.1	-3.8	-3.7	-3.5
Primary balance	-1.7	-2.6	-2.6	-2.3	-1.8	-1.3	-1.1	-0.9
Gross government debt	39.6	42.3	43.0	44.7	46.2	46.8	47.0	47.0
Balance of payments (percent of GDP unless otherwise indicated)								
Merchandise exports (volume, annual percentage change)	5.9	0.1	5.3	5.2	4.7	5.1	5.1	5.6
Merchandise imports (volume, annual percentage change)	9.7	6.3	5.1	4.2	4.3	4.5	4.5	4.9
Current account balance (billions of U.S. dollars)	-13.6	-24.1	-21.5	-22.7	-23.1	-24.2	-25.5	-26.5
percent of GDP	-3.4	-6.3	-6.1	-6.1	-5.9	-5.8	-5.8	-5.7
Overall balance	1.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (billions of U.S. dollars)	48.9	50.7	50.7	50.7	50.7	50.7	50.7	50.7
percent of short-term debt (residual maturity)	151.6	133.2	133.2	132.9	120.7	108.3	99.8	90.8
Total external debt	28.1	35.8	35.0	35.5	36.8	38.1	39.6	41.0

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

1/ Potential real GDP growth is calculated using an HP filter.

2/ General government.

Table 8. South Africa: Indicators of External Vulnerability, 2009–13

	2009	2010	2011	2012	2013
					Proj.
Financial indicators					
General government debt (percent of GDP)	31.3	35.8	39.6	42.3	43.0
Broad money (annual percentage change)	1.8	6.9	8.3	5.2	8.8
Private sector credit (annual percentage change)	3.0	3.3	5.7	9.3	8.0
91 day Treasury bill yield (percent, end-period) 1/	7.8	6.4	5.5	5.3	5.0
91 day Treasury bill yield (real, percent, end-period) 1/ 2/	0.6	2.2	0.4	-0.4	5.0
External indicators					
Exports (annual percentage change in U.S. dollars)	-22.4	29.9	19.0	-9.4	4.1
Export volume (annual percentage change)	-19.5	4.5	5.9	0.1	5.3
Imports (annual percentage change in U.S. dollars)	-27.3	23.9	24.4	1.7	3.5
Import volume (annual percentage change)	-17.4	9.6	9.7	6.3	5.1
Terms of trade (annual percentage change) 3/	8.0	7.3	2.3	-2.2	0.4
Current account balance (percent of GDP)	-4.0	-2.8	-3.4	-6.3	-6.1
Capital and financial account balance (percent of GDP)	4.7	2.6	2.0	5.2	5.1
of which: Net portfolio investment (debt and equity)	3.9	2.8	-0.6	1.7	0.4
Other investment (loans, trade credits, etc.)	-0.7	-0.5	1.0	3.4	3.6
Net foreign direct investment	1.5	0.4	1.6	0.1	1.1
Gross international reserves (billions of U.S. dollars) 1/	39.7	43.8	48.9	50.7	47.0
in months of imports of goods and services 1/	6.0	5.3	4.9	5.1	4.5
in percent of broad money 1/	15.0	14.0	17.6	18.2	17.1
in percent of short-term debt, residual maturity 1/	136.8	145.8	151.6	133.2	126.4
Net international reserves (billions of U.S. dollars) 1/	39.0	43.4	47.9	47.9	44.6
Foreign currency forward position (billions of U.S. dollars) 1/	0.0	4.2	6.5	5.2	4.2
Total external debt (percent of GDP)	27.5	28.8	28.1	35.8	35.0
percent of export earnings	95.9	100.4	91.9	120.1	109.5
External interest payments (percent of export earnings)	3.7	2.9	2.5	3.1	3.0
External amortization payments (percent of export earnings)	11.3	10.1	10.5	11.4	11.3
Exchange rate (vs. U.S. dollars, period average) 4/	8.4	7.3	7.3	8.2	9.4
REER (annual percentage change, end-period) 5/	9.0	15.5	-2.1	-5.5	-7.9
Financial market indicators					
Stock market index (end-period) 1/	27,666	32,119	31,986	39,250	42,016
Net purchases of bonds by nonresidents (billions of U.S. dollars) 6/	1.8	7.1	5.8	10.8	2.2
Net purchases of shares by nonresidents (billions of U.S. dollars) 6/	8.9	5.0	-2.4	-0.4	1.3

Sources: Haver, and Fund staff estimates and projections.

1/ For 2013, June data.

2/ Nominal yield minus CPI inflation.

3/ The terms of trade includes gold.

4/ For 2013, May data.

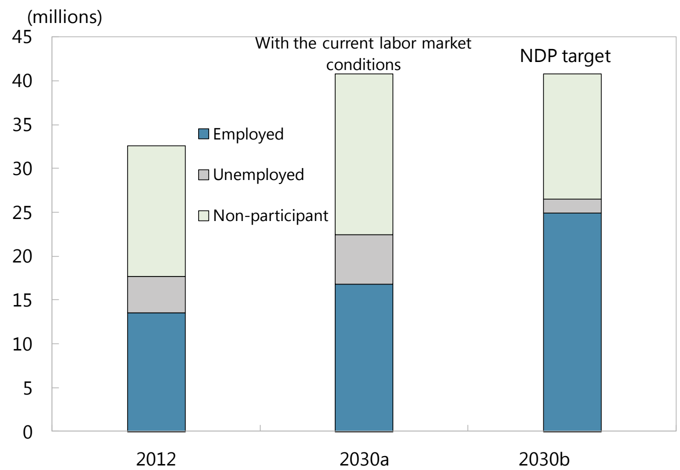
5/ For 2013, April data.

6/ Year to date. For 2013, April data.

Annex I. The Job Challenge

South Africa needs to create jobs for its unemployed, those that have altogether withdrawn from the labor force, and future labor market entrants. In their National Development Plan (NDP), the authorities aim to create 5 million jobs over the next decade, and 11 million by 2030. To achieve this, growth enhancing reforms will have to go hand in hand with measures to improve the functioning of the labor market and to strengthen the country's education system. This annex summarizes existing analysis of the factors contributing to the problem of "too few people work," and policy recommendations.

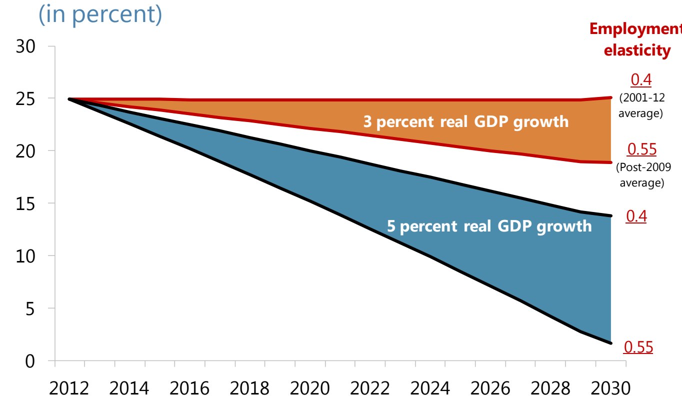
1. South Africa has one of the highest unemployment rates, one of the lowest labor force participation rates, and exhibits one of the highest income inequality in the world. Since the late nineties, South Africa's unemployment rate has persistently hovered above 20 percent and currently stands at 25 percent. Episodes of elevated growth have been accompanied by some decline in unemployment, but have been insufficient to address structural unemployment. Since 2009, growth has been largely jobless. As in many other countries, unemployment is particularly a youth problem, with youth unemployment in South Africa registering 50 percent (ILO, 2013). This is worrying because poor labor market outcomes early in one's career are typically associated with lower life time earnings and less stable employment ("scarring"). Unemployment is also highly concentrated amongst individuals with little formal education and lower skills. In addition, labor force participation at 55 percent is very low in international comparisons, in particular among women. The low share of individuals who are gainfully employed is one contributing factor to South Africa being one of the most unequal societies in the world as measured by the Gini coefficient.



Sources: Stats SA, NDP, and staff estimates

2. The NDP aims at creating 11 million jobs by 2030. It succinctly summarizes the problem as "too few people work," and targets a reduction in the unemployment rate to 6 percent and an increase in the labor force participation rate to 65 percent by 2030, while the working-age population continues to grow. This translates into employment growth of 2½ percent per year in 2013–2030, and—assuming that the historical relationship between growth and job creation remains unchanged—average annual real GDP growth of 5 percent. This compares to estimates of potential growth of 3 to 3½ percent, and an average annual employment growth of 1 percent over 2001–2012. By way of illustration, if South Africa were to grow by 3 percent per annum through 2030, only 3.2 million jobs would be created and unemployment would remain at 25 percent, assuming that without reforms, labor force participation remained unchanged and employment elasticity at 0.4, the 2001–2012 average, down from 0.55 observed in 2010–2012.

Unemployment Rate Projections 1/
(in percent)



Sources: Stats SA, and Fund staff estimates.
1/ Labor force participation rate is assumed to remain at 55 percent, the current level.

3. The needed large-scale job creation requires tackling growth constraints and strengthening the labor relations framework in parallel. Growth of 5 percent or more will only lead to job creation if firms choose to rely on labor rather than turn to more capital intensive methods of production. Hence, the interaction between growth policies and labor market policies is the key for achieving South Africa's employment objectives. In addition, the increasing tendency toward "international trade in skills" as opposed to trade in goods makes even more imperative to have competitive labor market policies for an economy to be able to generate jobs (IMF, 2013).

4. Cross-country comparisons show how the macroeconomic environment and labor market institutions contribute to job creation Countries that have achieved high rates of job creation, such as India, Peru, and Thailand, are characterized by favorable macroeconomic outcomes (Zhan, 2011). Growth was slightly higher than in countries that generated fewer jobs, inflation was substantially lower, the REER depreciated or showed less appreciation, and the current account balance was stronger. In addition, fast job creators tend to have a lower union density, substantially lower average and minimum wage levels than countries that struggle to create jobs, and less restrictive working hours. At present, South Africa does not exhibit these characteristics of job creating economies.

5. Several characteristics of South Africa's labor market have restrained job creation: these are described below:

- **Skill gap:** Current job seekers do not have the skills demanded by employers and the education system does not provide the majority of graduates with these skills.

- **Bottleneck labor relations:** South Africa's wage bargaining framework contributes to real wage outcomes that appear to have little sensitivity to economic conditions, and, in addition, legal provisions on dismissal, in practice, appear to make employers reluctant to take on new workers.

- **Wage setting:** Real wage growth has outpaced productivity growth, even during the 2008/09 crisis when real GDP fell. Given South Africa's fairly high costs of living, even for poor households, workers' demands for higher wages are understandable. Even more so when considering that a single income earner often supports eight or more relatives. However, firms have responded by investing in labor saving capital and have been reluctant to hire. In addition, the mandatory extension of collective bargaining agreements makes it difficult for smaller firms to compete on costs while still creating employment (Bhorat & Mayet, 2012). The practice also makes markets less contestable and contributes to oligopolistic structures that hold back innovation, growth, and job creation.

- **Temporary employment:** So-called labor brokers have been a main source of private sector job creation since 1995. Firms turn to labor brokers because, in practice, it appears to be extremely difficult to dismiss workers for performance reasons. Thus, taking on a new hire when information on his/her skills and work ethic are difficult to establish is a risky proposition from which firms shy away. Unions see labor brokers as undermining collective bargaining and workers' rights and are calling for them to be abolished: an amendment that would restrict the use of labor brokers is currently discussed in Parliament. However, this would come at the high price of even less job creation.

- **Bottleneck spatial gaps:** A legacy of apartheid is that job seekers as well as workers do not live close to the centers of economic activity. As a result, those employed in low-skilled jobs often face transport costs that anecdotally can take up to one third of the take-home wage. In addition, people spend inordinate amounts of time commuting.

- **HIV and AIDS infections:** Although health outcomes have improved in recent years, the HIV/AIDS adult prevalence rate remains one of the highest in the world, negatively affecting the labor supply.

Policy recommendations

- **Youth unemployment:** The youth employment incentive, envisaged in the NDP, and currently under consideration by the government, could be an important trigger to ease the transition of young people into employment and avoid life-long "scarring" effects.

- **On-the-job training:** For those already in the labor market, on-the-job training is instrumental, including through the use of temporary employment contracts and trainee wages combined with training requirements and certification.

- **Education system:** For today's and future students, making school leaders more accountable and providing quality teacher training would be important steps to strengthen the education system. Moreover, infrastructure backlogs need to be addressed, and failures to distribute learning material as it happened with textbooks in one province during 2012 cannot be tolerated. Given South Africa's strong private school system and a very nascent private school industry targeting low-income households, it may be worth exploring whether a school voucher scheme could help incentivize education providers.

- **Wage setting**

    - It is important to stop extending negotiated wages to other firms that were not part of the bargaining process. While discontinuing this mandatory extension will be politically challenging, it would open the way to firm-level bargaining and facilitate wage outcomes that are conducive to employment gains.

- More generally, unemployed outsiders need to gain a voice in wage bargaining, and higher labor force participation would reduce the burden on those gainfully employed to provide for others that do not have a wage income.

- A national minimum wage, as currently proposed by Cosatu, could further slow job creation; the issue of a minimum household income needs to be addressed through social transfers (CDE, 2013).

- **Temporary employment:** Labor brokers should be encouraged, unless problems with dismissal practices are addressed in parallel.

- **Bottleneck spatial gaps:** Better public transport, targeted transport subsides, and introducing more competition in the private mini-bus industry could help lower commuting costs and thus make low-wage jobs more attractive. It would also facilitate job search by reducing the transaction costs of going to interviews. It would be useful to pilot these reforms before applying them nationally.

References

Annett, A. (2007), "Lessons from Successful Labor Market Reformers in Europe," IMF Working Paper No. 07/01.

Haroon, B. and Natasha M. (2012), "Employment Outcomes and Returns to Earnings in Post-apartheid South Africa," Development Policy Research Unit Working Paper 12/152, November 2012.

Bouis, R. and R. Duval (2011), "Raising Potential Growth after the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond," OECD Economics Department Working Paper No. 835.

Center for Development and Enterprise (2013), "Rethinking South Africa's Labor Market: Lessons from Brazil, India and Malaysia," Proceedings of a round table convened by the Centre for Development and Enterprise.

International Labor Organization (2013), "Global Employment Trends for Youth 2013: A Generation at Risk," International Labour Office.

International Monetary Fund, (2013), "Jobs and Growth: Analytical and Operational Considerations for the Fund," IMF Policy Paper, March 14, 2013.

National Planning Commission (2012), "Our Future-make it Work: National Development Plan 2030," National Planning Commission.

Klein, N. (2012), "Real Wage, Labor Productivity, and Employment Trends in South Africa: A Closer Look," IMF Working Paper No. 12/92.

OECD (2012), "Economic Review – South Africa," OECD Publishing.

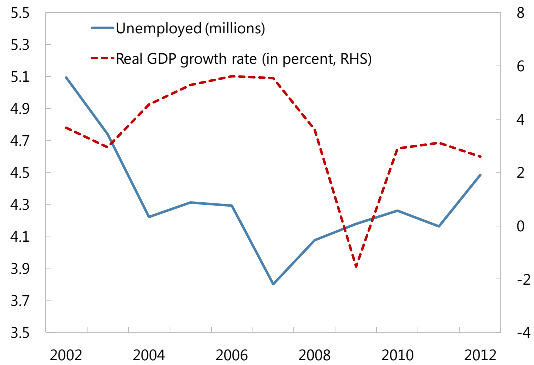
OECD (2013), "OECD Economic Surveys: South Africa 2013," OECD Publishing.

Zhan, Z. (2011), "What Do Fast Job Creators Look Like? Some Stylized Facts and Perspectives on South Africa," IMF African Department Departmental Paper No. 11/6.

Figure A1. South Africa: The Job Creation Challenge

Unemployment is largely structural, and growth since 2010 has not made lasting dents.

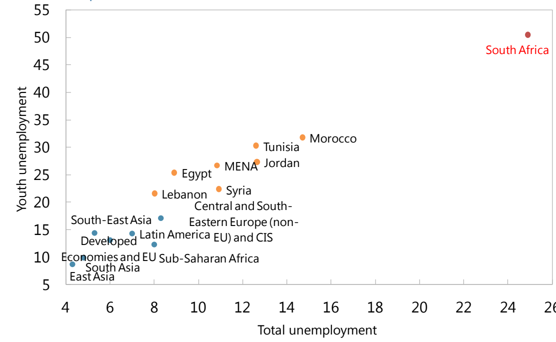
Unemployment and Growth



As in many countries, unemployment is largely a youth problem....

Unemployment Rates by Region 1/

(in percent, 2008 or latest available)



1/ MENA includes Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia.

...and the unemployed lack the skills required by employers.

Skill Composition of the Labor Force 1/

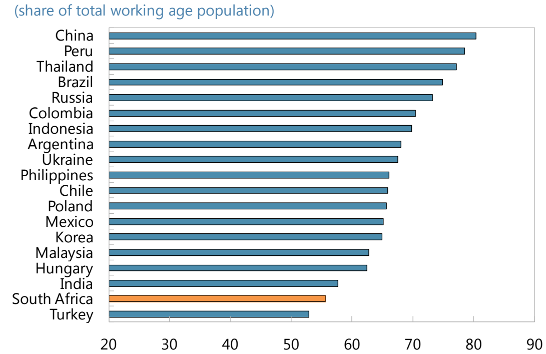
(in percent of total, 2012)

1/ Unskilled: Domestic workers and elementary; Semi-skilled: Plant and machine operators, craft and related.
Skilled: skilled agricultural and fishery workers, service workers, shop and market sales workers, and clerks; Highly-skilled: managers, professionals, technicians and associate professionals.

In addition, too few South Africans are economically active.

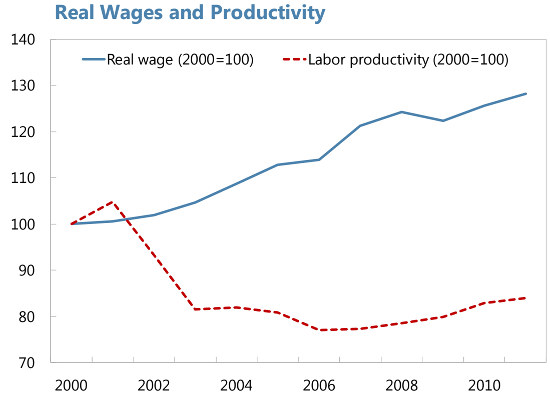
Labor Force Participation Rate

(share of total working age population)



Real wages have outpaced productivity growth, even during downturns.

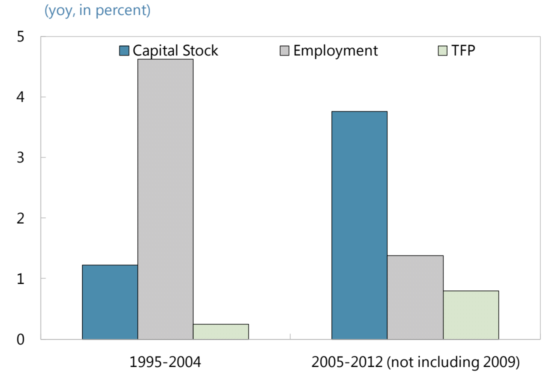
Real Wages and Productivity



And economic growth has relied less on labor.

Growth Accounting

(yoy, in percent)



Sources: Stats SA, ILO, country authorities, WEO, Labour Force Survey, Worldbank WDI database, Haver; and Fund staff estimates.

Annex II. A Synopsis of Product Market Issues in South Africa

South Africa's product market has undergone an important transformation in the past two decades. State control of the economy was reduced and regulation improved. However, the economy still has high levels of concentration and market dominance in several sectors, relatively restrictive regulation and trade regimes, and far-reaching industrial policy.

Achievements of the Past two Decades

1. **From a history of extensive state economic involvement and isolation during apartheid, South Africa has gone through significant liberalization in the past two decades.** By signing the National framework Agreement (NFA) in 1996, all interest groups agreed to restructure the economy and certain state assets, including transportation and telecommunication. The share of state-owned companies dropped markedly, several foreign companies now operate in South Africa, and many South African companies have operations abroad. According to World Economic Forum (2013), South Africa has well developed financial markets, ranked number 3 out of 144 countries.[1] The country also does well on factor allocation, such as intellectual property protection (20th), property rights (26th), the accountability of its private institutions (2nd) and its good market efficiency (32rd).

2. **A series of reforms since the 1990s has led to a substantial liberalization of South Africa's trade.** Effective protection and the anti-export bias fell, with average effective protection for all traded goods falling from 35 percent in 1994 to 9.5 percent in 2006.[2] Particularly strong declines in protection were experienced in textiles, apparel, footwear, and communication equipment.

3. **South Africa has also developed a sophisticated system of competition regulation.** The competition regime, established under the Competition Act of 1998, is centered on three institutions—the Competition Commission, the Competition Tribunal, and the Competition Appeal Court. Each of these institutions is independent of the government. This framework has received positive assessments by the OECD and others.[3]

Characteristics of South Africa's Product Markets

Restrictive product market regulation

4. **Despite these advanced, product market regulation remains relatively restrictive, particularly in the area of barriers to entrepreneurship and to trade and investment.** According to the OECD, South Africa ranks 35 out of 40 countries in the sample—a higher ranking denotes a more

---

[1] Schwab, K. (2013) "The Global Competitiveness Report: 2012-2013," World Economic Forum Insight Report.

[2] Edwards, L., R. Cassim, and D. Van Seventer (2009), "Trade Policy in South Africa," in *South African Economic Policy under Democracy*, Aron, J., Kahn, B. and Kingdon, G., Oxford University Press, Oxford.

[3] OECD (2003), "Competition Law and Policy in South Africa," An OECD Peer Review, May 2003.

restrictive system.[4] It ranks 40 (out of 40) for license and permits system, regulatory and administrative opacity, and regulatory barriers to trade and FDI have particularly contributed to the barriers to entrepreneurship and to trade and investment. In addition, according to a recent survey by Grant Thornton, regulations and red tape is the second largest constraint for business expansion, with the manufacturing sector most affected. [5] Problems include the high cost, complexity, and amount of time it takes to deal with red-tape associated with starting and running a business in South Africa. The proposed Licensing of Businesses Bill, however, which requires all businesses to obtain a business license from their local municipality, has raised concerns that it might impose an additional bureaucratic burden on business, especially SMEs, if passed.

Highly concentrated sectors and market dominance

5. Various sectors remain highly concentrated. South African companies are relatively profitable compared with EM peers, and appear particularly so in sectors with high concentration. New entrants, especially SMEs, often find it difficult to compete with existing firms that have high market dominance, despite government support for startups. These insider-outsider dynamics have resulted in higher prices in some sectors to the detriment of consumers or of other companies that use those goods and services as inputs. For example, some sectors, e.g. telecommunications, transportation, and financial services, provide important inputs to other industries. Hence, economies with costly and inefficient goods and services will find their competitiveness in other industries negatively affected. In the case of telecommunications, despite some deregulation of the telecom market and some price moderation, the sector still has high prices relatively to other countries and internet services remain inefficient.[6] [7]

Trade policy

6. Despite past progress, there remains considerable room for further trade reforms. The current tariff structure remains complex relative to other middle-income economies as measured by the coefficient of variation and the number of tariff bands.[8] Nominal and effective protection rates remain high for many sectors, particularly those producing final consumer goods. Trade in services remains relatively protected. In addition, a number of investment incentives have made the tariff structure more complex, and in some cases are subject to local-content requirements and contingent on export

---

[4] See OCED Indicators for Product Market Regulation for 1998, 2003 and 2008.

[5] Grant Thornton (2012), "Emerging Markets Opportunity Index: High Growth Economies," *International Business Report 2012.*

[6] A series of reforms since the early 1990s has privatized the Telkom and introduced new entrants. Hodge J., S. Truen, B. Cloete, and G. Biacuana (2007), "South African telecommunications prices: An updated international price comparison, with regulatory recommendations" Genesis Analytics Occasional Paper No. 3, November 2007.

[7] Hodge, J. (2005) "Administered Prices: Telecommunications," A report for National Treasury.

[8] Edwards, L. and R. Z. Lawrence (2007), "SACU Tariff Policies: Where should they go from here?" Report prepared for the South African National Treasury as part of the National Treasury/Harvard Growth Project.

performance.[9] Comprehensive trade liberalization does not appear to be emphasized in the government's current policies. In contrast, trade policy seems to be conducted on a case-by-case basis and guided more by industrial policy objectives.

Industrial policy

7. Past and ongoing industrial policies have aimed to bring South Africa to a new growth path and promote industrialization and diversification, but their effectiveness appears elusive. South Africa's industrial policy is articulated mainly in its Industrial Policy Action Plans (IPAP).[10] The IPAP focuses on sectors that are deemed to be most productive and envisages a host of interventions at the micro level, with an emphasis on import substitution. Critics of this approach have highlighted the difficulties of picking winners, the focus on industry as the only sector that could have high job creation potential, and the possibility that the implementation of industrial policies could provide space for rent-seeking behavior.[11]

Competition commission

8. Despite a well-developed system of competition regulation, a focus on improving implementation and further strengthening effectiveness appears needed. Progress has been made in the breaking up of cartels. Nevertheless, it is not unusual for cases to take four to five years from referral by the Commission to the Tribunal hearing being concluded. This follows an investigation period of one to two years by the Commission. Further, although South Africa has embodied in its legal provisions specific effects-based tests for dominance abuse, the test is still broadly form-based in practice. Finally, there is a need to identify entry barriers and regulatory mechanisms by which incumbents continue to protect their market dominance from outsiders.[12]

---

[9] World Trade Organization (2009) "Deeper Integration is necessary for more Balanced Development," *Trade Policy Review: Botswana, Lesotho, Namibia, South Africa and Swaziland*, Annex 4, South Africa.

[10] Industrial Policy Action Plan 2012/13–2014-15, Department of Trade and Industry, Republic of South Africa.

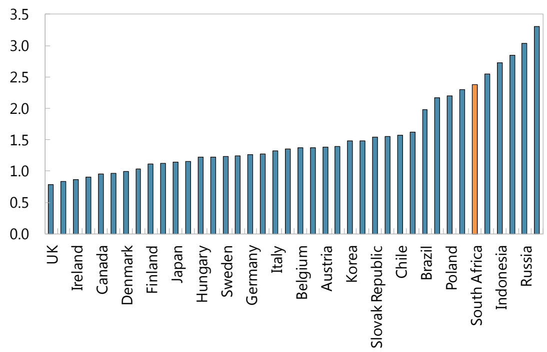
[11] Laubscher, J. "An evaluation of South Africa's industrial policy," available at http://www.sanlam.co.za/wps/wcm/connect/Sanlam_EN/sanlam/media+centre/expert+opinions/an+evaluation+of+south+africas+industrial+policy.

[12] Makhaya, G., W. Mkwananzi and S. Roberts (2012), "How should Young Institutions Approach Competition Enforcement? Reflections on South Africa's Experience" *South African Journal of International Affairs,* March 2012.

Figure A2. South Africa: Product Market Challenges

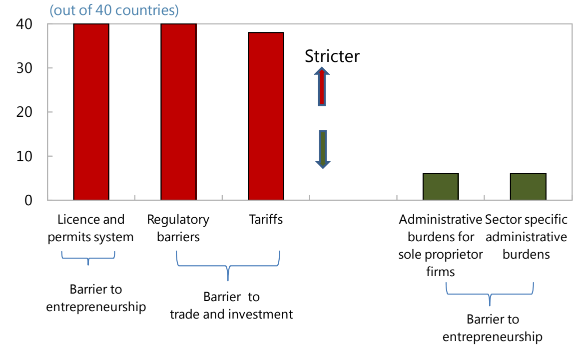
Product market regulation is relatively restrictive.

Product Market Regulation
(index scale of 0-6 from least to most restrictive, 2008)



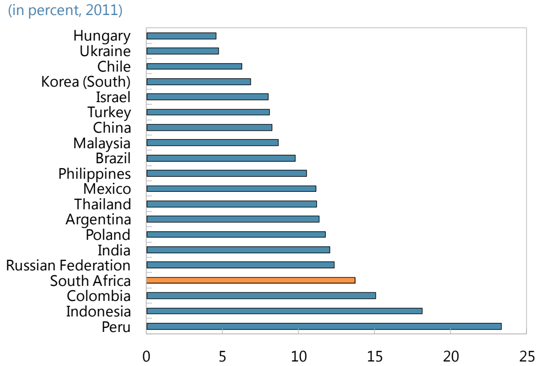
Barriers to entrepreneurship and trade and investment are high relative to other countries.

Product market Regulation Ranking
(out of 40 countries)



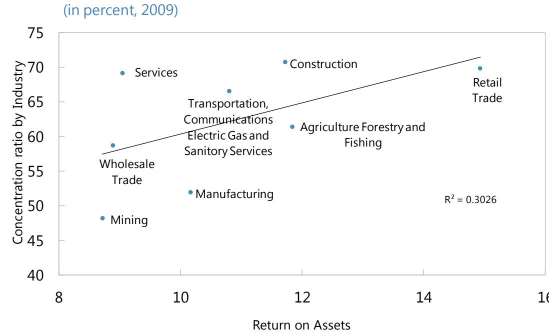
South African firms are relatively profitable.

Return on Assets
(in percent, 2011)



Highly concentrated sectors tend to have higher profitability.

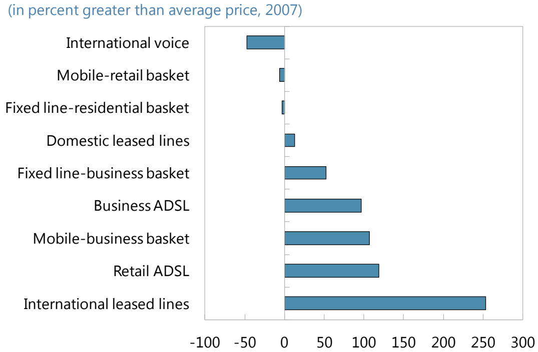
Industry Concentration and Profitability 1/
(in percent, 2009)



1/ Industry concentration is the total asset of top five listed companies as a share of all listed companies in the same sector.

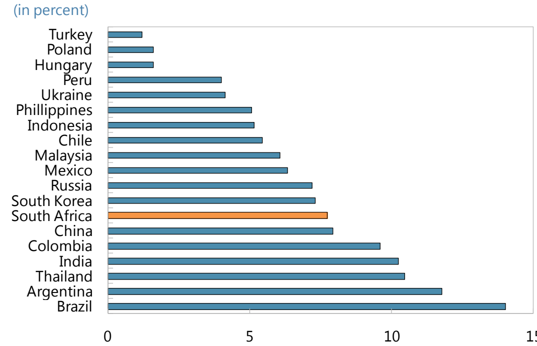
Local prices in the telecommunication sector in South Africa are relatively high.

Telecommunication Price Comparison
(in percent greater than average price, 2007)



The tariff rate remains elevated relative to EM peers.

Tariff Rate 1/
(in percent)



1/ Mean of applied tariff rate during 2009-11 for manufactured products.

Sources: OECD Product Market Regulation Database, Worldscope, World Bank WDI Database, Genesis Analysis; and Fund staff estimates.

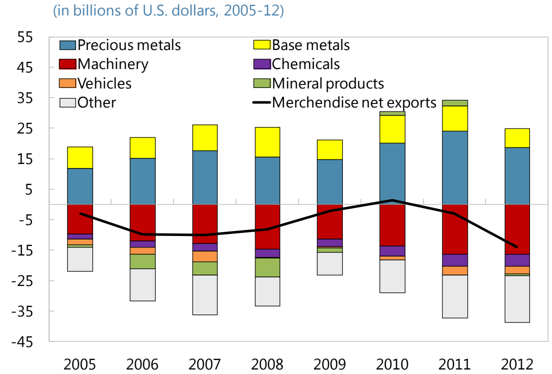
Annex III. External Balance Assessment

1. **South Africa's current account deficit reached 6.3 percent of GDP in 2012—the highest since the global financial crisis.** The deficits in the income account (2.2 percent of GDP) and net transfers (1 percent of GDP) were broadly in line with their 10-year average (2.4 and 0.7 percent of GDP), reflecting the country's low domestic savings and substantial net payments to the other members of the Southern African Customs Union (SACU). [1] The trade deficit, however, was much larger than its 10-year average of ½ percent of GDP. Higher-than-expected income receipts, terms of trade gains, and higher exports to other SACU countries contributed to a narrowing of the current account deficit to 5.8 percent of GDP (in seasonally adjusted terms) in the first quarter of 2013.

2. **The underlying current account deficit was slightly below 6 percent of GDP, reflecting South Africa's low domestic savings and high investment needs.** The cyclically-adjusted current account balance as calculated in the IMF External Balance Assessment (EBA), which adjusts for the economic cycle and the TOT, both for South Africa and its trading partners, was -5.8 percent of GDP in 2012. A separate methodology, which eliminates cyclical factors, as well as other temporary factors, such as the recent labor unrest in the mining sector, and assumes that net transfers to the other members of the SACU and interest rates revert to their historical average, reaches similar conclusions.

3. **A decomposition of South Africa's current account suggests that favorable commodity prices masked the deterioration in export performance.** We decompose South Africa's trade deficits into six main categories, and show that the deficit on the balance of manufactured goods—especially machinery, chemicals, and vehicles—has outgrown the surplus on the trade of mineral products, precious and base metals by a substantial amount in 2012. While part of the deterioration in the commodities surplus could be attributed to labor unrest in the mining sector, South Africa's demand for manufactured imports—driven in large part by capital goods—remained robust, growing faster than domestic demand.

South Africa: Merchandise Deficit Decomposition
(in billions of U.S. dollars, 2005-12)

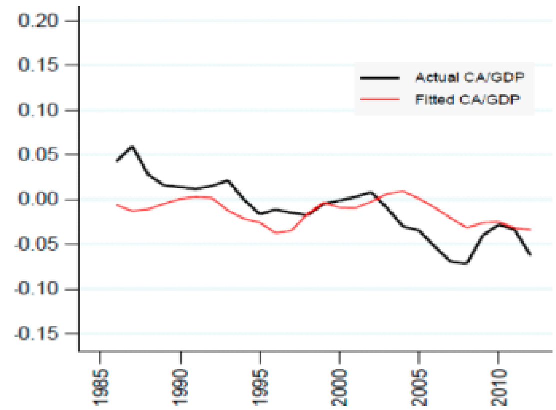


[1] Gross transfers to the other members of the SACU are denominated in local currency, reducing South Africa's foreign exchange needs to finance the current account deficit by near one percentage point of GDP.

4. Model-based estimates continue to suggest that South Africa's external position is weaker than implied by fundamentals and desirable policies. This analysis is based on the IMF's EBA.[2] Two of the EBA approaches are regression-based and entail estimation of the current account balance and the REER for a panel of 50 countries over a period of 25 years, based on macroeconomic fundamentals, relative prices, demographics, and policy variables that can be used to understand the extent to which the exchange rate or current account misalignments are related to policy gaps. The third method—the external sustainability approach—involves a comparison of the projected medium-term current account balance with the one that would stabilize the country's net foreign asset position (NFA) to GDP, at a specific benchmark level against peers' average.

South Africa: Actual and Fitted Current Account Balance

(in share of GDP, 1985-2013)

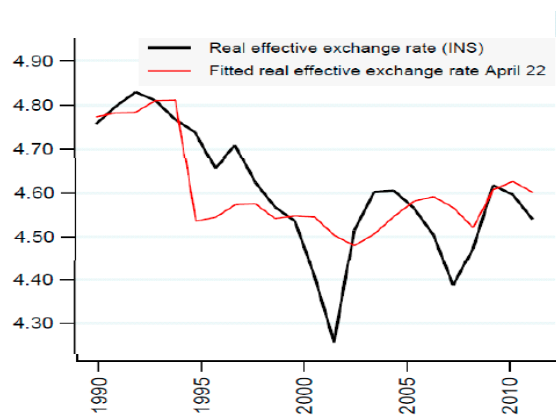


Sources: South African Reserve Bank, INS; and Fund staff estimates.

5. The macro-balance approach and the external sustainability analysis suggest the current account deficit is larger than implied by fundamentals and desired policies. The macro balance estimates yield a gap between the 2012 cyclically adjusted current account and the estimated current account norm of -2.8 percentage points of GDP, but with a large confidence interval. The external sustainability analysis suggests a gap of -4.2 percent of GDP between the 2012 cyclically adjusted current account and a benchmark current account that stabilizes South Africa's NFA/GDP ratio at peers' average (2 percent). Combining these two approaches and taking into consideration the inherent uncertainty of these methods, staff deems the current account to be 2–4 percentage points of GDP weaker than implied by fundamentals and desired policies. Applying mechanically the estimated trade elasticity of 0.2, and taking into account the REER depreciation during the first four months of 2013, the overvaluation of the rand was estimated at 10–15 percent in 2012.[3] While the recent nominal

South Africa: Actual and Fitted Real Effective Exchange Rate

(in natural logarithm of index, 1990-2013)



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

---

[2] See IMF's *2013 Pilot External Sector Report* (SM/13/167) and *2013 Pilot External Sector Report—Individual Economy Assessments* (SM/13/168).

[3] The CGER macro-balance approach suggests an exchange overvaluation of 13 percent; the CGER external sustainability approach suggests an exchange overvaluation of 20 percent.

depreciation should help close this gap, structurally-low domestic saving coupled with robust public infrastructure investment are expected to keep the current account deficit elevated over the medium term. Structural reforms that would help increase household savings are needed to yield a sustained improvement in the current account balance (Box 4).

6. EBA estimates of the CPI-based REER imply a small degree of undervaluation, but these results are highly sensitive to the sample period and not sufficiently reliable. For South Africa, the EBA REER regression suggests a small degree of undervaluation (about 7 percent) as of mid-April.[4] However, the results are highly sensitive to the sample period: the 1990s was a period of major structural shifts in the country, including the abolishment of the multiple currency practice (financial rand). The high volatility of the rand also makes the REER regression results particularly unstable. Moreover, most of the misalignment is not explained by the included regressors, and is probably driven by factors outside of the EBA model. The high volatility of South Africa's REER and the many structural changes that have taken place in the past 20 years make inferences from this method unreliable. Finally, several indicators of external competitiveness, including South Africa's declining share of world exports and the ULC-based REER, point to an overvaluation (see also Box 1)

7. In conclusion, South Africa's external position appears weaker than consistent with medium-term fundamentals and desirable policy settings. The current account deficit has widened sharply, financed to a large degree by debt flows. Several indicators point to competitiveness issues. Though the real depreciation in 2013 should help reduce the gap, structural factors underlie the large current account deficit, suggesting the external position will likely remain weak.

[4] The CGER REER regression suggests an undervaluation of 14 percent.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 19, 2013

Prepared By | The African Department (In collaboration with other departments)

CONTENTS

RELATIONS WITH THE IMF

As of June 30, 2013

Membership Status

Joined: December 27, 1945

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

General Resources Account	**SDR Million**	**%Quota**
Quota	1,868.50	100.00
IMF holdings of currency	1,852.63	99.15
Reserve position	15.91	0.85
Lending to the Fund		
New Arrangements to Borrow	43.42	

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,785.42	100.00
Holdings	1,788.15	100.15

Outstanding Purchases and Loans	None
Latest Financial Arrangements	None

Projected Payments to the IMF

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/interest		0.01	0.01	0.01	0.01
Total		0.01	0.01	0.01	0.01

South Africa has consented to its quota increase under the 14th General Review of Quotas which will essentially double the IMF's quota resources, once effective. South Africa also accepted the proposed amendment to reform the Executive Board. The quota increases will become effective once the proposed amendment to reform the Executive Board entered into force, which occurs once the Fund certifies that three-fifths of the IMF members (i.e., out of currently 188, i.e., 113 members) having 85 percent of the total voting power have accepted the proposed amendment.[1] South Africa's quota under the 14th General Review will increase to SDR 3,051.2 million (R 38.6 billion).

In September 2010 South Africa also agreed to lend the IMF up to SDR 340 million (R 4.3 billion) under the New Arrangements to Borrow (NAB). The NAB is a set of credit arrangements the IMF has with 40 member countries and/or its institutions. Currently 37 of these arrangements are active and thus can be drawn by the IMF to supplement its quota resources for lending purposes. South Africa is paid interest on its loans to the IMF under the NAB based on the SDR interest rate. As of end-May, South Africa had lent SDR 41.2 million (R 570.8 million) to the IMF under the NAB.

On January 7, 2013, the South African Treasury pledged $2 billion (R16.8 billion) to IMF resources, as part of a global drive to increase the IMF's resources by over US$430 billion to help strengthen global economic and financial stability. The South African authorities are now working with the Fund staff to draft a bilateral agreement to this effect.

Exchange rate arrangement

The rand floats against other currencies, and South Africa maintains an exchange system consistent with South Africa's obligations under Article VIII of the IMF's Articles of Agreement. [2] South Africa's de jure exchange rate arrangement is free floating, and the de facto arrangement is floating. Its exchange system is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions. South Africa has continued to gradually liberalize the system of capital controls in place since the apartheid regime.

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

[1] The two additional conditions for the proposed quota increases to become effective have already been met, i.e., the entry into force of the Voice and Participation Amendment of the Fund's Articles of Agreement and the consent of members having not less than 70 percent of the total quotas (as of November 5, 2010) to the increase in their quotas.

[2] South Africa accepted the Article VIII, Section 2(a), 3, and 4 obligations in 1973.

Box 1. Liberalization of Capital Controls on Residents (Selected Measures)

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

March 2010—Authorised dealers were allowed to acquire direct and indirect foreign exposure up to a macroprudential limit of 25 percent of their total liabilities, excluding total shareholder's equity.

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

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

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

October 2011—Authorities (i) removed the restriction on foreign participation in the ownership of money remittance businesses and the requirement to partner with an existing authorized dealer to conduct money remittance business; (ii) approved criteria for consideration of individual foreign investments above R4 million; (iii) announced that all inward-listed shares traded and settled in rand on the Johannesburg Stock Exchange will be regarded as domestic assets; (iv) permitted South African companies to make bona fide new outward foreign direct investments, outside their current line of business, allowing them to diversify their offshore operations from a domestic base; (v) withdrew the prohibition on the transfer of additional working capital for investments below R500 million per applicant company, per calendar year; (vi) allowed South African companies to acquire from 10 to 20 percent equity and/or voting rights, whichever is higher, in a foreign target entity, which may hold investments and/or make loans into any Common Monetary Area (CMA) country; (vii) allowed residents (natural persons) to transfer up to R1 million abroad, as part of the single discretionary allowance, for investment purposes, without the requirement to obtain a tax clearance certificate.

February 2013—South African multinationals were allowed to treat a local subsidiary as a nonresident company for exchange control purposes to encourage retaining treasury operations in South Africa. Authorized dealers were also allowed to invest an additional five percent of their total liabilities, excluding total shareholder’s equity, for expansion into Africa, in addition to the current macro-prudential limit on foreign exchange of 25 per cent.

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

Article IV consultation

The 2012 Article IV consultation was concluded by the Executive Board on August 1, 2012. South Africa is on the standard 12-month Article IV consultation cycle.

Technical assistance

An IMF Fiscal Affairs Department (FAD) mission took place in December 2010 to support capacity for fiscal policy analysis in the Treasury's Fiscal Policy Unit (FPU). In July 2011, senior FPU staff visited the IMF's headquarters to discuss international experience with fiscal rules. In March 2012, an FAD team visited Pretoria to discuss room for further improvement in South Africa's strong budget institutions. In November 2012, an FAD-arranged mission by two external experts visited Pretoria to discuss the forthcoming Long-term Fiscal Report, and in April 2013, a TA mission visited Cape Town to support the authorities in the establishment of a new Parliamentary Budget Office (PBO).

In March 2011, an STA mission took place to conduct the training on the Coordinated Direct Investment Survey for Anglophone Africa in Pretoria.

A number of IMF Legal Department (LEG) missions in 2007–09 assisted the authorities in the ongoing process of rewriting the Income Tax Act and drafting a new Tax Administration Act. The most recent LEG mission took place in November 2008, and a report on this mission was completed in late 2009. LEG has submitted comments on the Tax Administration Act to the authorities by email.

THE JMAP WORLD BANK IMF MATRIX

The IMF South Africa team led by Ms. Laura Papi (mission chief) met with the World Bank South Africa team led by Mr. Asad Alam (country director) on May 30, 2013, to discuss macrocritical structural issues and to coordinate the two teams' work for June 2013–May 2014.

The teams agreed that South Africa's macroeconomic challenges include promoting job creation and improving the long-run inclusive growth needed for maintaining social cohesion. In addition, they noted the increased vulnerabilities, especially external, that pose risks to macroeconomic stability.

Based on this shared assessment, the IMF and the World Bank agreed to support the authorities' efforts on the following macrocritical fronts with these specific actions:

- Fiscal sustainability: The IMF will continue its engagement with the authorities on South Africa's long-term fiscal challenges and risks as part of the surveillance dialogue. For the 2013 Article IV consultation, IMF staff have worked on a paper that discusses what might be an appropriate debt benchmark for South Africa given the magnitude of shocks that the economy is exposed to. In a similar vein, the debt sustainability analysis has been done according to the new guidelines, which focus on risk-based analysis. The IMF will provide follow-up advice on the authorities' forthcoming Long-Term Fiscal Report and remain supportive of the nascent Parliamentary Budget Office. The IMF will also provide advice on managing fiscal risks, and stands ready to share work by FAD on health care reform and seek opportunities, such as workshops with the authorities, to discuss options for the design of reforms in this area and will continue to inform the authorities of best practices from other countries in terms of modeling the implications of health and social security reforms.

- Improvements in the composition of public spending: The IMF continues to call for containing the public sector wage bill and increasing capital spending during the 2013 Article IV consultation. The World Bank is providing technical assistance for ongoing efforts to strengthen government-wide monitoring and evaluation systems and is carrying out a public expenditure tracking survey for health-related spending in the province of Kwa-Zulu Natal.

- Debt and foreign exchange management: Partnering with the South African Reserve Bank (SARB), the World Bank has been supporting efforts in the area of the foreign currency reserves management (including enhancement of SARB's governance and risk management frameworks as well as its investment operations and systems infrastructure), and by supporting the National Treasury in preparing the debt management strategy, reviewing strategic benchmarks and improving the secondary debt market architecture. Also, a new partnership with the Public Investment Corporation (PIC), which manages public assets, will focus on strengthening all aspects of investment operations and infrastructure

- Strengthened public infrastructure: The Eskom Investment Support Project ($3.75 billion IBRD loan) and the Eskom Renewable Energy Support Project ($250 Clean Technology Fund), both being implemented by the World Bank, support the expansion of electricity supply and help South Africa accelerate development of renewable energy generation capacity.

- External vulnerabilities: For the 2013 Article IV consultation, the IMF has worked on a paper that discusses South Africa's competitiveness challenge in an era of global growth moderation and on a paper that analyzes the factors behind South Africa's low saving. The IMF has been asked by the National Treasury to cooperate on a series of workshops that will examine South Africa's external vulnerabilities and seek to achieve broader policy consensus throughout government on how to manage the corresponding risks. The IMF will also stay closely engaged on this matter through its surveillance dialogue.

- Labor market reforms: The IMF has highlighted the urgency of making progress on this area to reduce structural unemployment during the 2012 and 2013 Article IV consultation. Specifically, the IMF has called for increasing the flexibility of the wage bargaining mechanism, especially for small and medium-size enterprises (SMEs) and newly created businesses; increasing the flexibility of labor laws and regulations—and reducing compliance costs—to improve the business environment and increase employment opportunities; and introducing well-designed active labor market measures to encourage youth employment and providing working experience or on-the-job training.

- Product market reforms: The IMF deepened its work on product market competition in the 2013 Article IV consultation, and intends to elaborate further proposals in the context of the 2014 Article IV consultation. The World Bank identified competition as a key impediment to faster and more inclusive growth in its July 2012 Economic Update and is considering more in-depth analysis in one of its upcoming biyearly Economic Updates.

- Tackling high inequality: Recognizing South Africa's exceptionally high levels of exclusion, the World Bank is developing a systematic analytical understanding of the structure of the township economy to grasp its full economic potential for policy action. A World Bank study on the potential of and constraints to private sector development in less developed regions is ongoing. Furthermore, poor education outcomes have been flagged as key determinant hampering inclusive growth, and the World Bank is currently engaging with the Department of Basic Education to strengthen the annual national assessments in order to improve teaching and learning in schools. Additionally, vocational training, particularly for low-income youths, is a strategic priority for the IFC in Sub-Saharan Africa. It will explore the possibility of supporting private sector for- and nonprofit technical education in South Africa, with the aim of: (i) increasing employment opportunities; (ii) raising the productivity of South African firms; and (iii) improving income distribution, given the significant returns to education in the country.

- Financial sector stability and inclusion: The IMF has cautioned in the 2013 Article IV consultation that the rapid increase in personal loans could potentially pose risks to South Africa's financial sector. At the request of the National Treasury and SARB, the World Bank is reviewing South Africa's contingency planning and crisis management framework, assessing the institutional set-up of financial sector supervision, and carrying out a Review of Standards and Codes (RoSC) on Insolvency and Creditor Rights. The Bank is also working with an interministerial working group that is assessing strategic priorities for financial inclusion.

- Private investment program: Promotion of private investment and job creation is at the top of the government agenda, and activities by the IBRD, IFC and MIGA will remain central to this program. The IBRD will continue its support for economic diversification and micro, small and medium enterprise (MSME) development, including technical assistance to the Department of Trade and Industry in promoting MSME development in poorer regions, as well support for enhancement of policies aiming at improving Research and Development efficiency. The IFC's strategy in South Africa will remain focused on innovation, job creation, and poverty reduction by: (i) supporting South African companies "going north" and "going global"; (ii) providing advice and financing in underserved niches of the South African market where IFC can add value; (iii) providing technical assistance and related support for small business, with a focus on the informal sector and education; and (iv) supporting the development of renewable energy and energy efficiency projects.

The teams have the following requests for information from their counterparts:

- The IMF team asks to be kept informed of progress in the macrocritical structural reform areas under the World Bank's purview. Timing: when milestones are reached or in the context of missions (and at least semiannually).

- The World Bank team asks to be kept informed of progress in the macrocritical structural reform areas under the IMF's purview. Timing: when milestones are reached (and at least semiannually).

Table 1 lists the teams' separate and joint work programs during June 2013–May 2014.

STATISTICAL ISSUES

Data provided to the IMF are adequate for surveillance. South Africa subscribed to the Special Data Dissemination Standard (SDDS) on August 2, 1996, and is in observance of specifications for coverage, periodicity, and timeliness of data, although using a flexibility option on the timeliness and periodicity of unemployment data. A Report on Observance of Standards and Codes—Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) was published on October 16, 2001.

Real sector statistics

The national accounts are compiled according to the SNA 1993. In 2009, the base year of the national accounts was changed from 2000 to 2005. At the same time, benchmarking was undertaken to reflect more accurately the structure of the economy and to introduce other methodological changes to the compilation of data. Reporting of real sector data for International Financial Statistics (IFS) is timely.

Labor market statistics are published with lags of three months. Given the seriousness of the unemployment problem, labor market analysis and policy design would benefit from better, more frequent and timely labor market data. A new quarterly Labor Force Survey has been conducted in January 2008.

The consumer price index (CPI) covers all households living in metropolitan and urban areas, which represent approximately 56 percent of the total number of households and 75 percent of private consumption expenditure. The current CPI weights were derived primarily from Stats SA's household expenditure survey. Current price indices, which were rebased to December 2012=100, are calculated according to these weights. These indices form the basis for calculating the year-on-year changes in the CPI for 2013 and the month-on-month change between January 2013 and December 2012. The historical rates of inflation are not revised backward.

Government finance statistics

Data for the GFS Yearbook and IFS are compiled and disseminated according to the GFSM 2001 framework. Data for social security funds and central government's extra budgetary funds have been reported on an accrual basis, starting in 2000 and 2002, respectively. Starting in 2005, the authorities have included additional noncash data for other levels of government, consistent with their migration to accrual reporting. South Africa currently reports data for the consolidated general government for publication in the Government Finance Statistics Yearbook. It also reports monthly data covering the cash operations of the budgetary central government for publication in IFS.

Monetary statistics

Monetary statistics compiled by the SARB are consistent with the methodology recommended in the Monetary and Financial Statistics Manual. South Africa regularly reports good quality monetary statistics for publication in the IFS and the IFS Supplement, although there is room for improving the timeliness of the data on nondepository financial institutions.

Balance of payments statistics

Balance of payments data are broadly consistent with the fifth edition of the Balance of Payments Manual (BPM5). The authorities are also working with their partners in the Southern African Customs Union (SACU) to improve the coverage of intra-SACU trade flows. Data reported for Direction of Trade Statistics differ substantially from external trade data reported for IFS, particularly exports, because of balance of payments adjustments.
Data on the international reserves position are disseminated in line with the requirements of the IMF's template on international reserves and foreign currency liquidity.

Work is ongoing to improve the reliability and accuracy of balance of payments data, with the aim of reducing errors and omissions. Export and import price deflators are expected to be revised in 2013. It would also be useful to disseminate a detailed breakdown of financial account data pertaining to other investment assets and liabilities.

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, June 2013–May 2015

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	$3.75b IBRD Eskom operation	*Note: missions are ad hoc but generally occur twice a year.*	Ongoing
	Ongoing $250m CTF renewable (solar and wind) operation		Ongoing
	Renewable Energy Market Transformation Project (GEF) $6.0m		Ongoing
	Carbon Capture and Storage Development TA, US$14 million		Ongoing
	Cities Support Program Reimbursable Advisory Services (RAS)		Awaiting government clearance on agreement
	PFM dialogue		Ongoing
	Economics of Township Report		July 2013
	Economic Updates		Semiannual
	National Health Insurance TA		Ongoing
	TB and HIV/AIDS Program		Ongoing
	Financial sector stability, including financial inclusion dialogue		Ongoing
	Supporting policies aimed at improving R&D efficiency (TA)		2014
	Study on potential of and constraints to private sector development in less developed regions in South Africa		July 2013
	Monitoring and Evaluation technical assistance		Ongoing
	TA on helping the NT and the relevant stakeholders decide on how to improve the secondary market architecture		Ongoing
	TA supporting the revision of the strategic benchmarks by the NT based on cost and risk analysis through an analytical tool to be developed		Ongoing
	Technical advisory services with the SARB and GEPF/PIC on the management of the official foreign currency reserves and the pension assets respectively		Ongoing
	Basic Education – Learning Assessment		Ongoing
	Private Investment Program		Ongoing

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, June 2013–May 2015 (concluded)			
2. IMF Work Program	Staff visit Workshop on external vulnerabilities Workshop on fiscal risks Workshop on Long-Term Fiscal Report Workshops on parliamentary budget office 2014 Article IV Consultation.	November 2013 October/November 2013 (tentative) October 2013 December 2013 (tentative) September 2013 March 2014 (tentative) May 2014	n.a. n.a. July 2014
3. Joint products in the next 12 months	No joint products planned at this time		

Table 2. South Africa: Table of Common Indicators Required for Surveillance (as of July 10, 2013)

	Date of Latest Observation	Date Received[10]	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange rates	7/10/13	7/10/13	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[1]	5/13	7/2/13	M	M	M		
Reserve/base money	6/13	7/9/13	M	M	M	O, O, LO, O	LO, O, O, O
Broad money	5/13	7/9/13	M	M	M		
Central bank balance sheet	5/13	7/9/13	M	M	M		
Consolidated balance sheet of the banking system	5/13	7/9/13	M	M	M		
Interest rates[2]	7/10/13	7/10/13	D	D	D		
Consumer Price Index	5/13	7/1/13	M	M	M	O, LO, O, O	LO, LO, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	4/13	5/31/13	M	M	M	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of financing[3]–central government	4/13	6/10/13	M	Q	Q		
Stocks of central government and central government-guaranteed debt[5]	5/13	6/29/13	Q	Q	Q		
External current account balance	Q1 2013	7/10/13	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and imports of goods and services [6]	5/13	5/31/13	M	M	M		
GDP/GNP	Q1 2013	6/27/13	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross external debt	Q1 2013	Q2 2013	Q	Q	Q		
International investment position	2011	7/2013	A	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Monthly data for goods. Goods and services are published quarterly on the same schedule as the rest of the balance of payments.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC (October 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.
[10] Reflects the latest information released by the IMF Statistics Department by 07/10/2013.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

July 19, 2013

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Prepared by the Staff Representatives for the 2013 Article IV Consultation with South Africa

PUBLIC DEBT SUSTAINABILITY ANALYSIS

1. **The public debt sustainability analysis is based on the Fund's new Market Access Countries' framework.**[1] The new debt sustainability analysis (DSA) framework, which is being piloted in a number of countries before a full rollout later this year, uses a risk-based approach, which expands upon the basic DSA to include: (i) an assessment of the realisim of baseline assumptions and the projected fiscal adjustment; (ii) an analysis of risks associated with the debt profile (financing structure); (iii) macro-fiscal risks; (iv) a stochastic debt projection taking into account past macro-fiscal volatility; and (v) a standardized summary of risks in a heat map. For South Africa, this expanded analysis is called for by its gross financing requirement which exceeds 10 percent of GDP.

2. **Macroeconomic assumptions.** Growth is projected at 2 percent in 2013, rising gradually to 3½ by 2018 on the back of a recovery in global demand and easing infrastructure bottlenecks. The GDP deflator is expected to average around 6½ percent, consistent with CPI inflation close to the upper range of the authorities' 3–6 percent target range.

3. **Fiscal assumptions.** The impact of weaker-than-budgeted growth on revenues resulted in a sharp widening of the primary deficit in 2012. The 2013 deficit is projected to remain broadly unchanged despite a slow-down in expenditure growth, as automatic stabilizers result in continued weak revenue performance. Consistent with the authorities' 2013 budget, anticipated expenditure restraint and a modest pickup in revenues is expected to result in a gradual narrowing of the deficit over the medium term. The projections do not assume additional fiscal measures that the authorities suggested in the 2012 Medium Term Budget Policy Statement (MTBPS) could become necessary if the deficit does not evolve as anticipated in the 2013 budget. In addition, the framework does not assume any policy response to shocks.

4. **Data coverage.** Consistent with the data on government debt reported by the authorities, the fiscal assumptions in this DSA are based on the national government main budget. While this coverage excludes provincial governments, social security funds, and extra-budgetary institutions, these entities are either not allowed to incur debt or only borrow in small amounts. Moreover, most provincial and municipal expenditure is funded through transfers from the national government main budget and thus already captured in the projections. State-owned enterprises borrowing, however, has increased substantially in recent years and is projected to continue to increase. Around 40 percent of this borrowing is covered by government guarantees. The authorities are in the process of compiling statistics on the indebtedness of the overall public sector.

5. **An expanded debt sustainability analysis is warranted given South Africa's elevated gross financing needs.** Gross financing needs (GFN) are estimated at 12.5 percent of GDP in 2012 and are

---

[1] For further details see "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis," SM/11/211 and "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries," IMF Policy Paper, May 6 2013.

expected to peak at 14.5 percent in 2014, above the 10 percent of GDP trigger based on a conservative assessment of early-warning results.

6. There is no evidence of a systemic projection bias that would undermine the assessment of sustainability. The median forecast errors for real GDP growth and the primary balance between 2004–12 are below 1 percent and in line with other countries. There is some evidence that the GDP deflator in recent years has been underprojected, likely because of stronger than anticipated terms of trade.

7. Cross-country experience suggests the projected fiscal adjustment is feasible. The maximum three-year adjustment in the cyclically adjusted primary balance over the projection period (1.3 percent of GDP) as well as the maximum level of the primary balance (-1.1 percent of GDP) is moderate when compared to the experience in market-access countries with debt above 60 percent of GDP.

8. Primary deficits averaging 3 percent of GDP for the past four fiscal years have resulted in rising debt ratios and higher GFNs. Substantial fiscal stimulus helped cushion the impact of the global economic slowdown on the economy, but also contributed to a 15 percentage point increase in the debt-to-GDP ratio since 2007. Elevated deficits have brought the GFN to 12 percent of GDP, above the EM average notwithstanding a favorable maturity structure.

9. The DSA framework suggests South Africa's government debt-to-GDP ratio is sustainable.

- The framework uses an indicative 70 percent of GDP debt benchmark beyond which a country is reported as high risk (red in the standardized heat map). The benchmark is based on a cross-country early-warning exercise of emerging market countries that have experienced episodes of debt distress.[2] This benchmark compares with the 60 percent of GDP South Africa-specific debt ceiling that staff analysis suggests is consistent with debt sustainability.[3]

- Under the baseline the debt-to-GDP ratio is projected to increase to 48 percent by 2018. This is 20 percentage points higher than in 2008, but below the 70 percent benchmark level in the DSA as well as the South Africa-specific debt ceiling.

- The debt level remains below the DSA benchmark level and the South Africa-specific debt ceiling even if the envisaged fiscal consolidation does not materialize and the primary balance remains unchanged, or with a one-standard-deviation temporary shock to growth or a temporary return of interest rates to historical highs. A customized shock entailing a permanent half a standard deviation reduction in growth—consistent with a decline in potential growth of around one percentage point—would increase debt to around 56 percent of GDP, still below the DSA benchmark level but close to the South Africa-specific debt ceiling.

[2] Debt distress events are defined as default to commercial or official creditors, restructuring and rescheduling events, or IMF financing.

[3] For further details see Box 5 in "South Africa Staff Report for the 2013 Article IV Consultation."

- A macro-fiscal shock—including the standard shocks to growth and interest rates, as well as a primary balance shock (a temporary half a 10-year historical standard deviation deterioration in the primary balance) and an exchange rate shock (consistent with the maximum movement over the past 10 years and an exchange rate pass-through of 0.25 based on cross-country estimates of pass-through in EMs[4])—does result in a sharp increase in the debt-to-GDP ratio to 57½ percent. Note, however, that this is an extreme shock and the results should therefore be treated with caution.

- Fan charts—including an asymmetric fan chart that reflects the predominance of downside risks but also the possibility of greater progress on structural reforms that would boost growth and facilitate an improvement in the primary balance—that take into account the impact of the historical volatility of the aforementioned macro-fiscal variables on the future debt path yield similar results.

- While not explicitly modeled, a contingent liability shock whereby the government would have to absorb state-owned enterprise (SOE) debt would increase risks significantly. If the government has to absorb the entire debt stock of SOE debt—estimated at 13½ percent of GDP at end-2012—and the economy is hit by a persistent shock to growth or to a macro-fiscal shock of the kind described above, the 70 percent debt benchmark would be exceeded. While extreme, this exercise serves to underscore the growing vulnerability posed by contingent liabilities in SOEs.

10. A heat map suggests that despite its low share of foreign currency and short-term debt, South Africa faces risks relating to its gross financing requirement and its debt profile. Even in the baseline, South Africa's GFN is close to the 15 percent of GDP benchmark that is considered high risk. The standard shocks to growth or the primary balance shock, as well as the combined macro-fiscal shock and the contingent liability shock—would push South Africa above the benchmark, indicating an increased risk of financing difficulties. South Africa's local currency bond spread and the relatively large share of debt held by non-residents also point to emerging risks. These findings are consistent with staff's assessment that a sudden stop in capital inflows that could cause a disorderly adjustment in the twin deficits is the main risk facing South Africa.

Authorities' views

11. It is laudable that the IMF has refined its framework for analyzing debt sustainability. While improving transparency, the new framework is conditional on a much broader set of assumptions. This has increased the data-intensity of preparatory work, and widened the scope for discretion and qualitative analysis on the part of Fund staff.

[4] Ca'Zorzi, M., E. Hahn, and M. Sanchez (2007), "Exchange Rate Pass-Through in Emerging Markets." ECB Working Paper No. 739.

12. South African budget statements have indicated clearly that if risks to the economic or fiscal outlook materialize, government's fiscal programme will be revised where appropriate. However, a key assumption in the Fund's analysis is that authorities do not respond to economic developments since the last budget. Consequently, the baseline scenario envisages a pessimistic primary balance outlook. Despite this strong assumption, we take comfort from the fact that projected debt remains comparatively moderate in global terms and is on a path towards stabilization. An explosive debt trajectory is not projected in the baseline scenario nor under a range of shocks.

13. The analysis could be strengthened by engaging with the structure of debt, the potential for flexibility in debt management and its implications for sustainability. In South Africa's case, the vulnerability of the debt profile remains low, with projections assuming a debt-structure that is increasingly long-term and largely denominated in domestic currency. South Africa has sophisticated and experienced debt management institutions and liquid domestic bond markets. Longer term vulnerabilities typically associated with health care and pension systems in advanced economies are also largely absent in South Africa.

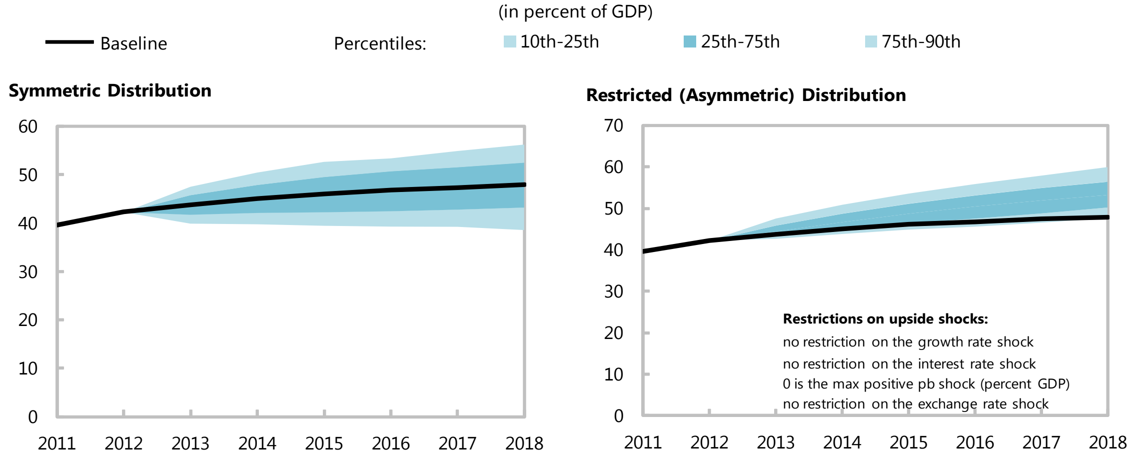
Figure 1. South Africa: Public Sector Debt Sustainability Analysis—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

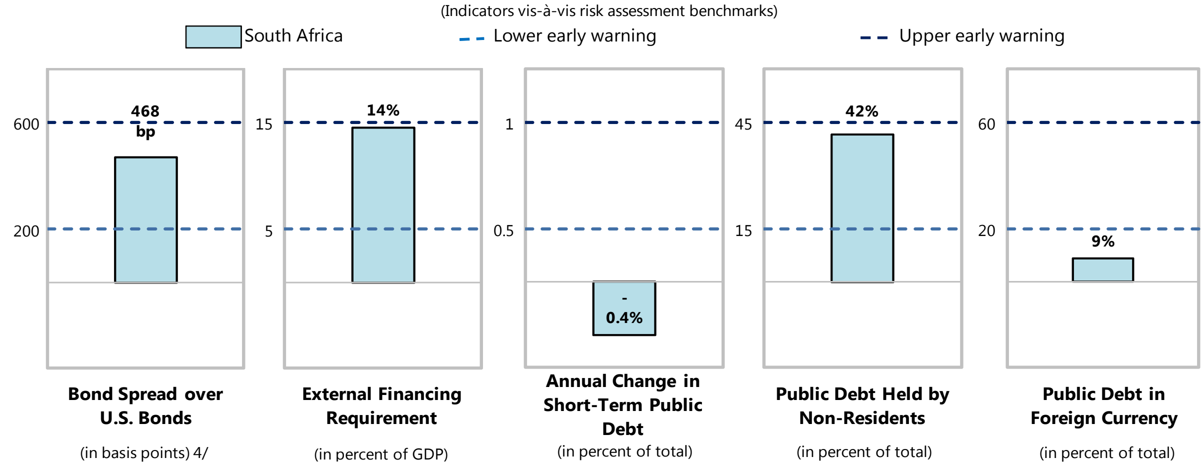
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

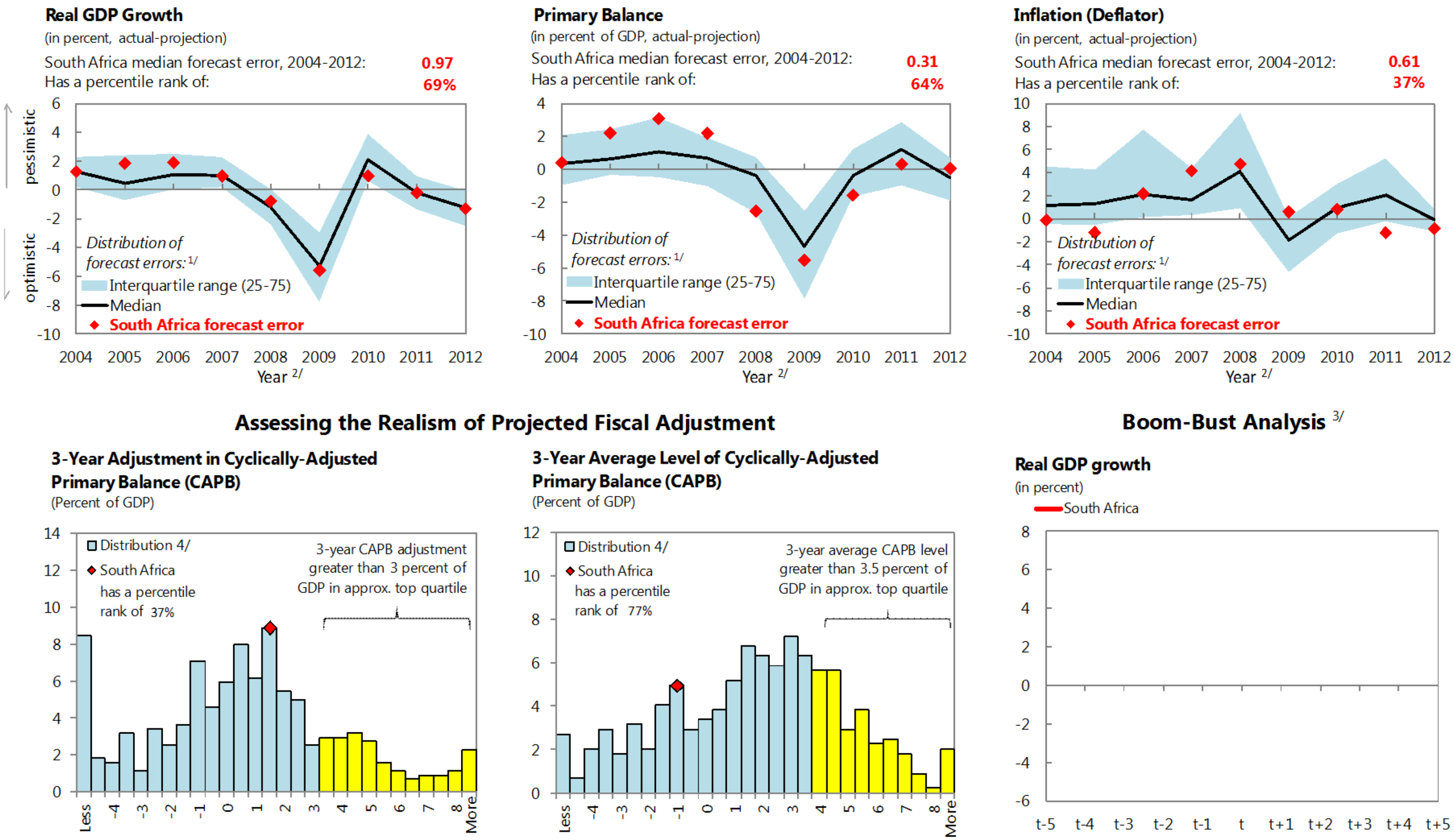
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ An average over the last 3 months, 02-Mar-13 through 31-May-13.

Figure 2. South Africa: Public Sector Debt Sustainability Analysis—Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for South Africa.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. South Africa: Public Sector Debt Sustainability Analysis—Baseline Scenario

(in percent of GDP unless otherwise indicated)

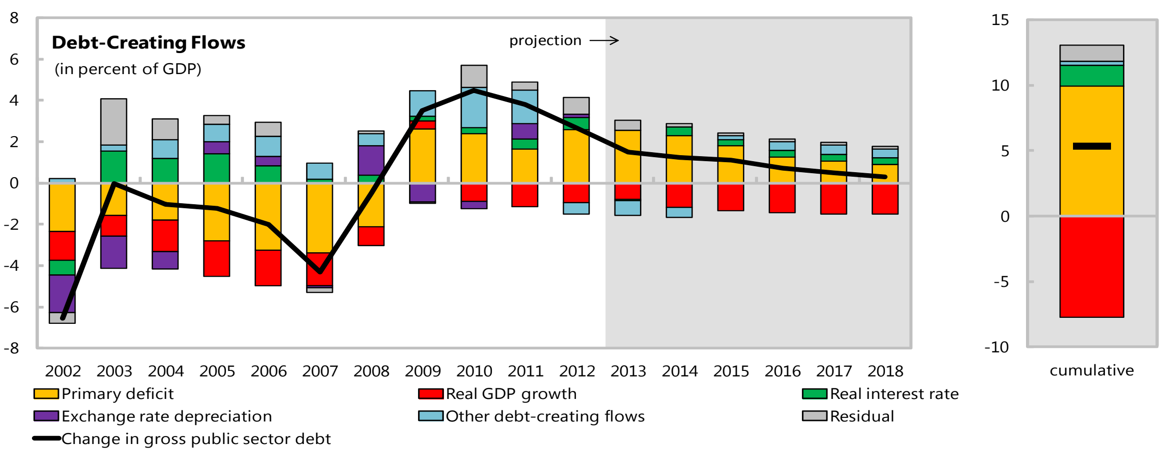
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2002-2010 [2]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	33.4	39.6	42.3	43.8	45.0	46.1	46.8	47.3	47.6
Public gross financing needs	7.5	10.5	12.5	12.0	14.5	13.3	9.8	10.5	10.7
Real GDP growth (in percent)	3.6	3.5	2.5	2.0	2.9	3.3	3.4	3.5	3.5
Inflation (GDP deflator, in percent)	7.4	6.0	5.5	6.7	6.1	6.4	6.4	6.4	6.4
Nominal GDP growth (in percent)	11.3	9.7	8.1	8.8	9.2	9.8	10.0	10.2	10.1
Effective interest rate (in percent) [4]	9.6	7.7	7.2	6.6	7.3	7.3	7.4	7.4	7.4

As of May 31, 2013		
Sovereign Spreads		
Spread (bp) 3/		502
CDS (bp)		193
Ratings	Foreign	Local
Moody's	Baa1	n.a.
S&Ps	BBB	A-
Fitch	BBB	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-0.9	3.79	2.66	1.5	1.2	1.1	0.7	0.5	0.3	5.3	
Identified debt-creating flows	-1.4	3.37	1.87	1.5	1.2	1.1	0.7	0.5	0.3	5.4	
Primary deficit	-1.4	1.7	2.6	2.6	2.3	1.8	1.3	1.1	0.9	9.9	-0.6
Primary (noninterest) revenue and grant	24.7	24.8	24.6	24.6	24.7	24.7	24.8	25.0	25.1	148.8	
Primary (noninterest) expenditure	23.4	26.5	27.2	27.2	26.9	26.5	26.1	26.0	26.0	158.8	
Automatic debt dynamics [5]	-0.9	0.1	-0.2	-0.3	-0.6	-0.9	-1.0	-1.0	-1.0	-4.9	
Interest rate/growth differential [6]	-0.5	-0.7	-0.3	-0.9	-0.8	-1.0	-1.1	-1.2	-1.2	-6.1	
Of which: real interest rate	0.6	0.5	0.6	-0.1	0.4	0.3	0.3	0.3	0.3	1.6	
Of which: real GDP growth	-1.1	-1.1	-0.9	-0.8	-1.2	-1.3	-1.4	-1.5	-1.5	-7.7	
Exchange rate depreciation [7]	-0.4	0.7	0.2	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.9	1.6	-0.5	-0.7	-0.5	0.2	0.4	0.5	0.4	0.3	
Drawdown of deposits (negative)	0.8	0.9	-0.4	-0.5	-0.3	0.3	0.5	0.5	0.5	1.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other public entities	0.1	0.7	-0.1	-0.2	-0.1	-0.2	-0.1	0.0	-0.1	-0.7	
Residual, including asset changes [8]	0.5	0.4	0.8	0.5	0.2	0.2	0.1	0.1	0.1	1.2	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

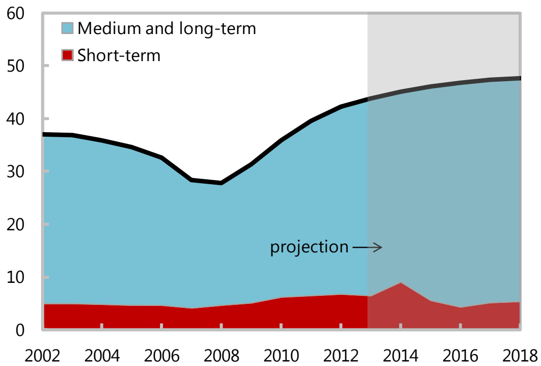
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. South Africa: Public Sector Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

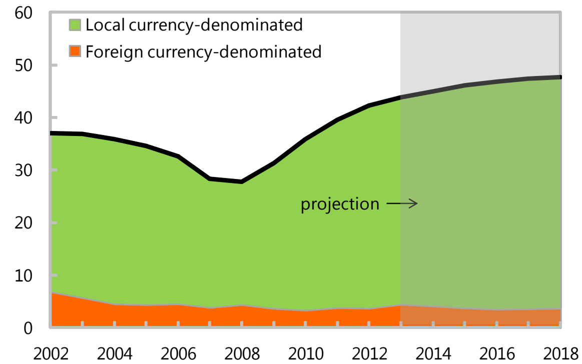
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

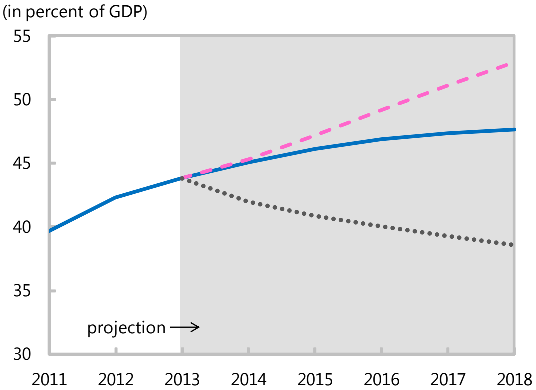


Alternative Scenarios

Baseline Historical Constant Primary Balance

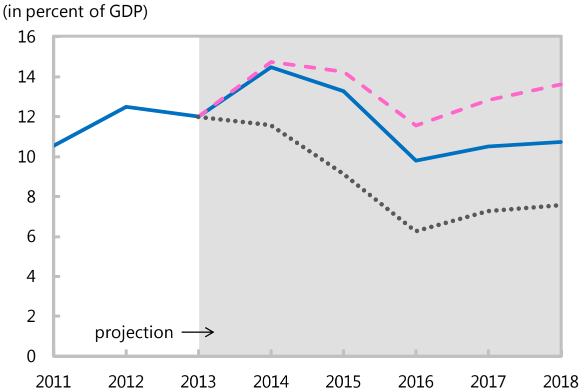
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	2.0	2.9	3.3	3.4	3.5	3.5
Inflation	6.7	6.1	6.4	6.4	6.4	6.4
Primary Balance	-2.6	-2.3	-1.8	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.3	7.3	7.4	7.4	7.4
Constant Primary Balance Scenario						
Real GDP growth	2.0	2.9	3.3	3.4	3.5	3.5
Inflation	6.7	6.1	6.4	6.4	6.4	6.4
Primary Balance	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	6.6	7.3	7.3	7.3	7.4	7.3

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	2.0	3.5	3.5	3.5	3.5	3.5
Inflation	6.7	6.1	6.4	6.4	6.4	6.4
Primary Balance	-2.6	0.6	0.6	0.6	0.6	0.6
Effective interest rate	6.6	7.3	7.8	7.9	8.1	8.2

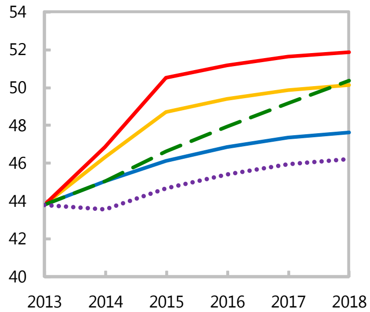
Source: IMF staff.

Figure 5. South Africa: Public Sector Debt Sustainability Analysis—Stress Tests

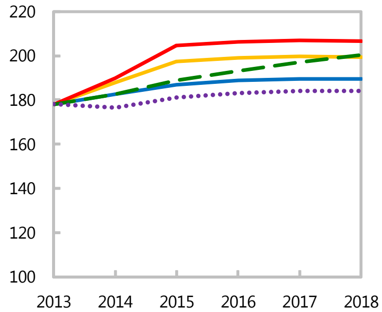
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

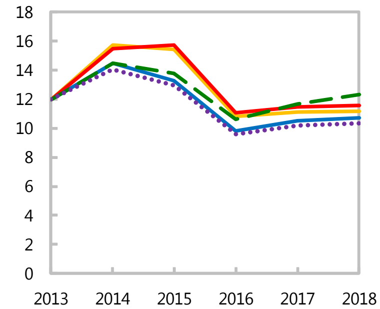
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



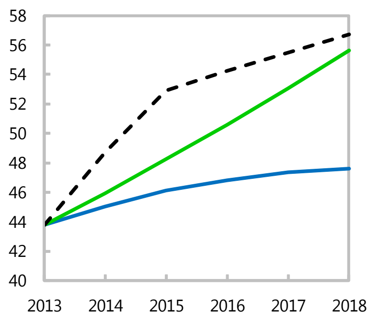
Public Gross Financing Needs
(in percent of GDP)



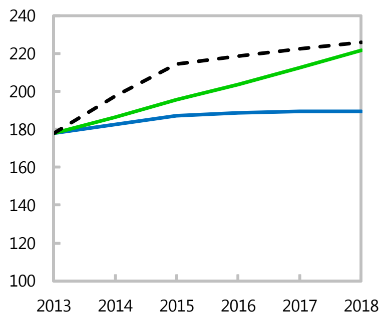
Additional Stress Tests

Baseline
Permanent Real GDP Growth Shock
Combined Macro-Fiscal Shock

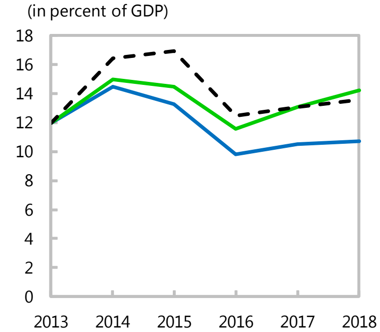
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Primary Balance Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	2.0	2.9	3.3	3.4	3.5	3.5
Inflation	6.7	6.1	6.4	6.4	6.4	6.4
Primary balance	-2.6	-3.6	-3.1	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.3	7.4	7.5	7.5	7.4
Real Interest Rate Shock						
Real GDP growth	2.0	2.9	3.3	3.4	3.5	3.5
Inflation	6.7	6.1	6.4	6.4	6.4	6.4
Primary balance	-2.6	-2.3	-1.8	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.3	8.5	8.8	9.1	9.5
Combined Shock						
Real GDP growth	2.0	0.8	1.2	3.4	3.5	3.5
Inflation	6.7	5.6	5.8	6.4	6.4	6.4
Primary balance	-2.6	-3.6	-3.2	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.5	8.4	8.9	9.2	9.5
Permanent Real GDP Growth Shock						
Real GDP growth	2.0	1.9	2.2	2.4	2.5	2.4
Inflation	6.7	5.8	6.1	6.1	6.2	6.2
Primary balance	-2.6	-2.6	-2.5	-2.3	-2.4	-2.6
Effective interest rate	6.6	7.3	7.3	7.4	7.5	7.5

Real GDP Growth Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	2.0	0.8	1.2	3.4	3.5	3.5
Inflation	6.7	5.6	5.8	6.4	6.4	6.4
Primary balance	-2.6	-3.0	-3.2	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.3	7.3	7.5	7.5	7.4
Real Exchange Rate Shock						
Real GDP growth	2.0	2.9	3.3	3.4	3.5	3.5
Inflation	6.7	13.1	6.4	6.4	6.4	6.4
Primary balance	-2.6	-2.3	-1.8	-1.3	-1.1	-0.9
Effective interest rate	6.6	7.5	7.2	7.3	7.4	7.3

Source: IMF staff.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

14. South Africa's external debt was 36 percent of GDP in 2012, but is projected to reach 41 percent of GDP by 2018. The increase in the external/GDP ratio by 5 percentage points over the medium term reflects the persistently high current account deficit (averaging 6 percent of GDP during this period) on the back of strong public infrastructure investment, structurally low savings, and softer terms of trade. A normalization of global interest rates is expected to worsen the deficit in the net income balance by ½ percent of GDP, while transfers to the other members of the Southern African Customs Union (SACU) should remain close to 1 percent of GDP. The external deficit is expected to be financed to a large extent by non-resident portfolio investment and other debt flows. This includes portfolio equity (which does not add to the debt stock), local-currency bonds, with only a small share expected to come from foreign-currency denominated debt. Net foreign direct investment is projected at 1.2 percent of GDP over the medium term.

15. The rising external debt ratio increases South Africa's vulnerability to external shocks and rollover risk, but risks look manageable against a range of shocks. The large share of external debt denominated in local currency (58 percent) and at fixed interest rates significantly lowers risks. Stress tests indicate that the largest adverse impact would arise from a 30 percent real exchange rate depreciation, and to a lesser extent from a further widening of the noninterest current account deficit. These shocks would push the external debt ratio to 53 percent and 45 percent respectively by 2018. But these are likely to represent upper bound estimates, since the standard DSA does not capture the likelihood of import compression if those shocks were to materialize, and therefore narrower trade deficits. By contrast, a permanent shock to real GDP growth (equivalent to half a standard deviation or about 1 percent in the case of South Africa), as well the standard shock to interest rates (also half a standard deviation or about 50 basis points in the case of South Africa) have only minor effects, and the combined shock has a moderate effect on external debt levels.

Table 1. South Africa: External Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

						Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
Baseline: External debt	26.6	27.5	28.8	28.1	35.8	**35.0**	**35.5**	**36.8**	**38.1**	**39.6**	**41.0**	**-6.8**
Change in external debt	0.3	0.9	1.2	-0.6	7.7	-0.8	0.5	1.3	1.3	1.5	1.4	
Identified external debt-creating flows (4+8+9)	5.6	-2.3	-3.7	-2.3	1.5	-0.2	-0.5	-0.9	-1.2	-1.2	-1.5	
Current account deficit, excluding interest payments	5.5	3.0	2.0	2.3	4.9	4.1	4.3	4.0	3.9	3.8	3.7	
Deficit in balance of goods and services	3.1	0.9	0.2	0.6	3.0	3.2	3.3	3.1	2.9	2.7	2.4	
Exports	35.9	27.3	27.4	29.3	28.3	31.9	31.2	30.8	30.6	30.5	30.5	
Imports	38.9	28.2	27.6	29.9	31.3	35.2	34.4	33.9	33.5	33.1	32.9	
Net non-debt creating capital inflows (negative)	-0.5	-5.0	-2.1	-3.0	-3.9	-5.5	-5.6	-5.7	-5.8	-5.8	-5.9	
Automatic debt dynamics 1/	0.7	-0.2	-3.6	-1.5	0.5	1.2	0.9	0.7	0.7	0.7	0.8	
Contribution from nominal interest rate	1.7	1.1	0.8	1.1	1.3	1.9	1.8	1.8	1.9	2.0	2.1	
Contribution from real GDP growth	-1.0	0.4	-0.7	-0.9	-0.8	-0.8	-1.0	-1.1	-1.2	-1.3	-1.3	
Contribution from price and exchange rate changes 2/	0.0	-1.7	-3.7	-1.7	-0.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-5.3	3.2	5.0	1.6	6.1	-0.6	1.0	2.3	2.5	2.7	2.9	
External debt-to-exports ratio (in percent)	74.3	100.9	105.1	96.0	126.6	109.5	113.9	119.5	124.7	130.0	134.5	
Gross external financing need (in billions of US dollars) 4/	54.6	40.5	40.3	45.8	62.2	59.6	60.9	65.1	71.1	76.3	82.4	
in percent of GDP	20.0	14.2	11.1	11.4	16.2	16.8	16.4	16.6	17.1	17.4	17.8	
Scenario with key variables at their historical averages 5/						**35.0**	**33.7**	**33.5**	**33.3**	**33.1**	**32.9**	**-6.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.6	-1.5	3.1	3.5	2.5	2.0	2.9	3.3	3.4	3.5	3.5	
GDP deflator in US dollars (change in percent)	-7.7	5.9	23.5	7.1	-6.8	-9.7	1.9	2.2	2.3	2.3	2.3	
Nominal external interest rate (in percent)	6.2	4.2	3.9	4.3	4.5	5.0	5.5	5.5	5.5	5.5	5.5	
Growth of exports (US dollar terms, in percent)	9.1	-20.6	27.6	18.5	-7.8	4.1	2.4	4.3	5.1	5.4	5.9	
Growth of imports (US dollar terms, in percent)	8.9	-24.5	24.5	20.1	0.0	3.5	2.6	3.9	4.5	4.7	5.1	
Current account balance, excluding interest payments	-5.5	-3.0	-2.0	-2.3	-4.9	-4.1	-4.3	-4.0	-3.9	-3.8	-3.7	
Net non-debt creating capital inflows	0.5	5.0	2.1	3.0	3.9	5.5	5.6	5.7	5.8	5.8	5.9	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation.

3/ For projection, line includes the impact of price and exchange rate changes.

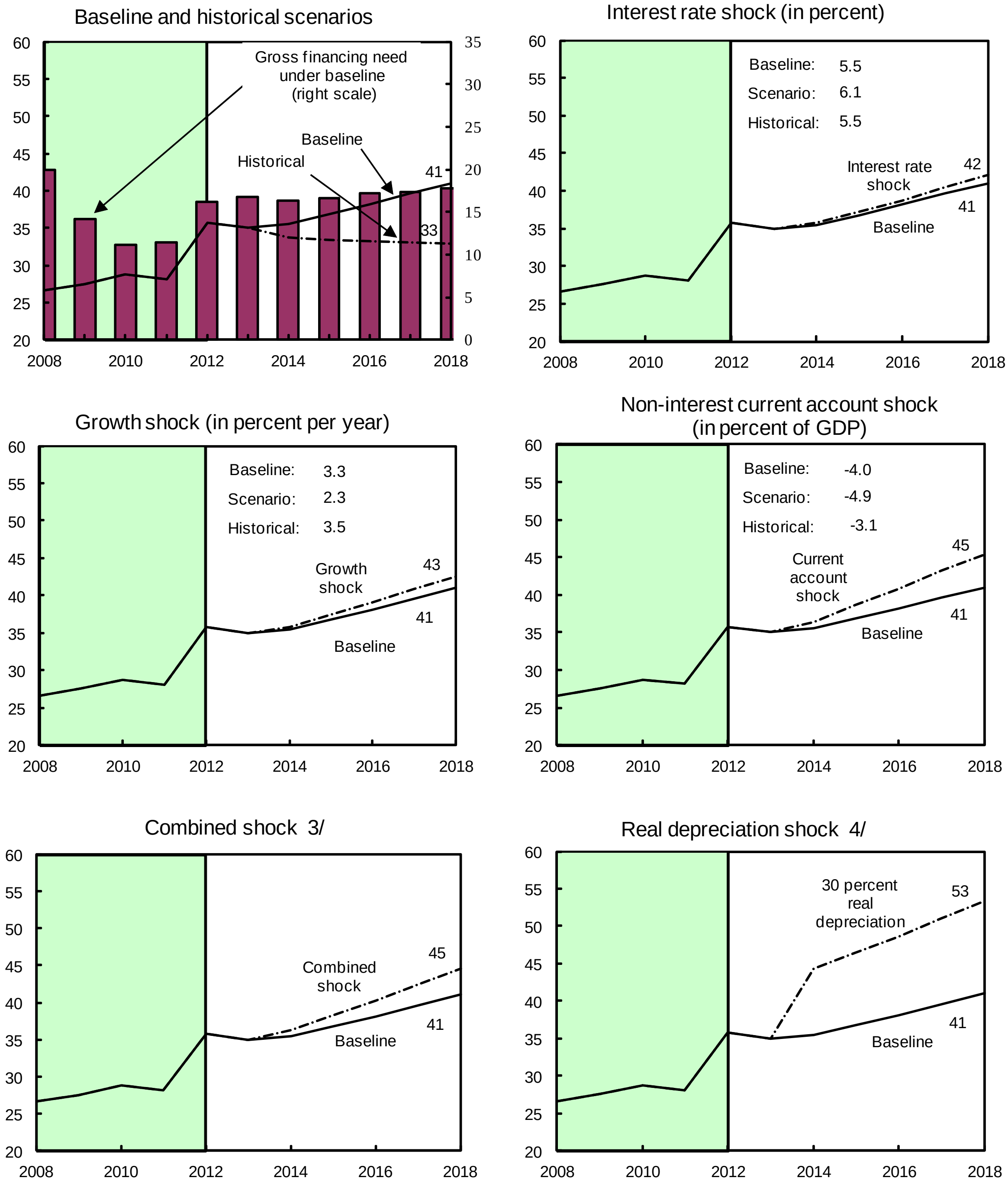
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 6. South Africa: External Debt Sustainability—Bond Tests 1/ 2/

(External debt in percent of GDP)



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

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

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

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

4/ One-time real depreciation of 30 percent occurs in 2014.

Press Release No. 13/373
FOR IMMEDIATE RELEASE
October 1, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with South Africa

On July 31, 2013 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

South Africa's economy has made important strides over the past two decades. Rising income levels have resulted in declining poverty rates, and strong institutions and policy frameworks have contributed to macroeconomic stability and greater integration with the global economy. However, in recent years the country's structural problems that are holding back growth and job creation have come to the fore. The economy has underperformed other emerging markets and commodity exporters, exacerbating South Africa's already-high levels of unemployment (25 percent) and inequality, and contributing to rising social tensions. At the same time, weak trading partner growth, coupled with declining competitiveness and countercyclical fiscal policy, have led to rising fiscal and current account deficits and made South Africa vulnerable to a prolonged reversal of capital inflows and a further repricing of risk premia. The rand has been one of the worst performing emerging market currencies in 2013, and bond yields rose sharply in May and June as concerns over the Fed's tapering of quantitative easing and China's growth outlook led to rising global risk aversion and weaker commodity prices.

The outlook is for continued sluggish growth and elevated current account deficits. Growth is projected at 2 percent in 2013 as weak consumption growth and lackluster private investment offset robust public investment and higher export growth. Growth is expected to rise to about 3 percent in 2014 and 3½ percent in the medium term, as infrastructure investment gradually relieves supply bottlenecks. Unemployment is expected to remain high. A gradual withdrawal of stimulus is projected to result in declining fiscal deficits, but continued high imports for infrastructure investment will likely keep the current account deficit close to 6 percent of GDP throughout the projection period. Quicker implementation of much-needed structural reforms could result in higher growth and job creation.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The balance of risks is tilted firmly to the downside. The main risk is a prolonged stop in capital inflows and a disorderly adjustment in the twin deficits. The trigger could be either external, e.g., a global repricing of risk resulting from an unwinding of unconventional monetary policies in advanced economies, or a further escalation in domestic labor and social unrest. South Africa also remains vulnerable to a further weakening of growth in Europe or a slowdown in China and other emerging markets, particularly if accompanied by a weakening of commodity prices.

Executive Board Assessment

Executive Directors commended the significant macroeconomic progress made by South Africa over the past two decades. However, Directors noted that lower growth in recent years, due to external and domestic factors, has aggravated already high unemployment and inequality. In addition, large current account and fiscal deficits have increased. To address the vulnerabilities, create jobs, and foster inclusive growth, Directors stressed the need for firm policy action and progress on reforms.

Directors welcomed the authorities' National Development Plan, which outlines an integrated strategy for structural reforms. They emphasized the importance of decisive and timely implementation of this plan. Directors underscored that additional labor and product markets reforms, improvements in the business climate, and trade liberalization will also be critical to achieve faster growth and job creation.

Directors agreed with the need for gradual fiscal consolidation and welcomed the authorities' commitment to remain within the medium-term expenditure ceilings. If growth continues to disappoint, they saw merit in allowing automatic stabilizers to operate this year, provided financing conditions permit. Directors underscored the need to stabilize debt and rebuild fiscal buffers, and generally agreed that announcing a debt target could help bolster the credibility of the medium-term fiscal outlook. They commended the authorities' commitment to long-term fiscal discipline and welcomed ongoing reforms to improve spending efficiency.

Directors agreed that the monetary policy stance is finely balanced and the inflation targeting framework remains appropriate. They concurred that the exchange rate pass-through to inflation and wage settlements are critical factors in determining the next monetary policy move. Directors encouraged the authorities to stand ready to adjust interest rates as needed.

Directors observed that South Africa's highly flexible exchange rate is a considerable strength and should be maintained. Noting the costs of accumulating and managing foreign exchange reserves, Directors in general agreed that increasing reserves will further contribute to lower vulnerabilities. They encouraged the authorities to give consideration to regular and pre-announced auctions to buy foreign exchange as done by some other countries. Directors also encouraged the authorities to promote foreign direct investment and considered that structural reforms are also needed to raise the low household savings rate and improve the external position, which is assessed to be weaker than justified by fundamentals.

Directors noted that South Africa’s financial system is well capitalized, but risks from unsecured lending have risen. They welcomed the authorities’ ongoing efforts to improve the regulatory and supervisory architecture, including the recent adoption of Basel III standards. Directors noted that the rapid expansion of unsecured credit from a low base has contributed to financial inclusion, but highlighted areas where new measures could play a useful role to bolster financial stability and help households deal with high indebtedness. They emphasized that heightened vigilance is important to ensure that these risks do not become systemic and encouraged increased coordination among regulators.

South Africa: Selected Economic Indicators, 2009–14

Social Indicators

GDP		**Poverty**	
Nominal GDP (2012, billions of U.S.	384	Headcount ratio at $1.25 a day (2009, percent of	13.8
GDP per capita (2011, U.S. dollars)	7972	Undernourishment (2011, percent of population)	5.0
Population characteristics (2011)		**Income distribution (2009)**	
Total	50.5	Income share held by highest 10 percent (percent	51.7
Urban population (percent of total)	62	Income share held by lowest 20 percent (percent of	2.7
Life expectancy at birth (years)	53	Gini index	63.1

Economic Indicators

	2009	2010	2011	2012	2013	2014
					Proj.	
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	-1.5	3.1	3.5	2.5	2.0	2.9
Real GDP per capita	-2.4	2.3	2.8	1.3	0.8	1.7
Real domestic demand	-1.8	4.5	5.1	3.9	2.4	2.8
GDP deflator	8.3	7.2	6.0	5.5	6.7	6.1
CPI (annual average)	7.1	4.3	5.0	5.7	5.9	5.5
CPI (end of period)	6.3	3.5	6.1	5.6	5.7	5.4
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.0	24.9	24.9	25.1	26.0	26.2
Average remuneration (formal nonagricultural, nominal)	11.7	13.6	7.2	8.4	8.8	8.1
Labor productivity (formal	1.7	3.9	1.2	2.0	2.2	2.3
Unit labor costs (formal	9.9	9.3	5.9	6.3	6.5	5.7
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	15.5	16.4	16.1	13.2	13.2	13.2
Public (incl. public enterprises)	1.0	-0.5	0.8	-0.1	0.0	0.4
Private	14.5	16.9	15.3	13.2	13.2	12.9
Investment (including inventories)	19.5	19.2	19.5	19.4	19.2	19.3
Public (incl. public enterprises)	8.1	7.1	7.1	7.4	7.6	7.8
Private	13.4	12.2	11.9	11.7	11.6	11.4
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.4	27.3	28.1	27.9	27.8	27.8
Expenditure and net lending	32.9	32.5	32.1	32.7	32.7	32.5
Overall balance	-5.5	-5.1	-4.0	-4.8	-4.9	-4.7
Gross government debt	31.3	35.8	39.6	42.3	43.0	44.7
Government bond yield (10-years and over, percent) 2/	9.0	8.3	8.5	7.3	7.3	…
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	1.8	6.9	8.3	5.2	8.8	9.2
Credit to the private sector	3.0	3.3	5.7	9.3	8.0	8.4
Repo rate (percent) 2/	7.0	5.5	5.5	5.0	5.0	…
External trade (annual percentage change unless otherwise indicated)						
Merchandise exports (billions of U.S.	66.0	85.4	102.9	93.5	97.3	99.6
percentage change (volume)	-19.5	4.5	5.9	0.1	5.3	5.2
Merchandise imports (billions of U.S.	65.7	81.7	100.7	102.7	106.2	108.7
percentage change (volume)	-17.4	9.6	9.7	6.3	5.1	4.2
Terms of trade	8.0	7.3	2.3	-2.2	0.4	-1.2
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-11.5	-10.2	-13.6	-24.1	-21.5	-22.7
percent of GDP	-4.0	-2.8	-3.4	-6.3	-6.1	-6.1
Overall balance	0.7	1.2	1.1	0.3	0.0	0.0
Gross reserves (billions of U.S.	39.7	43.8	48.9	50.7	50.7	50.7
percent of short-term debt (residual maturity)	136.8	145.8	151.6	133.2	133.2	132.9
Total external debt	27.5	28.8	28.1	35.8	35.0	35.5
of which short-term (residual	10.2	8.3	8.0	9.9	10.8	10.3
Nominal effective exchange rate (percentage change) 3/	23.7	11.3	-16.6	-5.4	-11.7	…
Real effective exchange rate (percentage change) 3/	29.3	12.2	-14.1	-2.3	-8.2	…
Exchange rate (Rand/U.S. dollar) 2/	7.4	6.6	8.1	8.5	10.1	…

Sources: South African authorities, World Bank, IMF INS database; and IMF staff estimates and projections.
1/ General government.
2/ For 2013, end-May data.
3/ For 2013, end-April data.

Statement by Mr. Saho, Executive Director for South Africa

July 31, 2013

1. My authorities' robust macroeconomic policy frameworks and institutions have delivered sustained growth and price stability in the past two decades, despite adverse domestic and external developments. However, the recovery from the recent global financial crisis is proving to be more challenging than previously anticipated. Economic growth for this year and the next is now expected to be lower than projected in the 2012 Article IV report. This presents a profoundly difficult backdrop for macroeconomic policy in South Africa.

2. My South African authorities generally agree with the staff report that, although a weak external environment is contributing to the ongoing slow recovery, domestic factors are also at play. It is for this reason, amongst others, that my authorities announced in the 2013 Budget Review their determination to address the twin deficits problem, by implementing structural reforms in the labor and product markets, with a view to enhancing inclusive growth and reducing poverty. Indeed, structural reforms are key to achieving the fiscal space needed to meet long-term economic development and social expenditure goals.

Recent Economic Developments and outlook

3. South Africa's economy continues to grow, but at a slower rate than anticipated at the time of the 2012 Article IV consultation. Following the first quarter annualized growth rate of 0.9 percent, overall annual growth is likely to be lower than the 2.5 percent growth rate recorded in 2012. According to the latest Monetary Policy Committee (MPC) statement of the South African Reserve Bank (SARB), the growth forecast for 2013 has been revised down from 2.4 percent to 2.0 percent and from 3.5 percent to 3.3 percent for 2014.

4. It is expected that economic growth in 2015 will accelerate to 3.6 per cent, supported by robust infrastructure investment spending and easing of electricity supply constraints as additional electricity supply from new power plants begin to come on stream. Additionally, water supply and rail capacity upgrades, strong regional growth, and relatively low interest rates will also provide momentum for higher levels of growth. The authorities are aware that the risks to the growth forecasts are on the downside and these include fragility in the global economic growth outlook, slowdown in a number of systemically important emerging market economies, weaknesses in the domestic mining sector, weakening commodities prices, infrastructure constraints, prolonged strike action and rigidities in the labor and product markets.

5. Employment growth remains subdued, particularly in the private sector. The official unemployment rate increased from 24.9 per cent in the fourth quarter of 2012 to 25.2 per cent in the first quarter of 2013. Of particular concern to the South African authorities is the increase in the youth unemployment rate to 52.9 percent in the first quarter.

6. With regard to inflation, the consumer price index for all urban areas in South Africa was 5.6 percent in May 2013, vis-a-vis 5.9 percent for the previous three consecutive months. The main contributors to the inflation outcome were housing and utilities and miscellaneous goods and services which contributed 1.4 and 1.1 percentage points respectively. According to the latest MPC statement, inflation is expected to average 5.9 and 5.5 percent in 2013 and 2014 respectively, while the forecast for 2015 is 5.2 percent. According to the survey conducted by the Bureau for Economic Research at Stellenbosch University during the second quarter of 2013, inflation expectations have remained anchored around the upper end of the inflation target band of 3 – 6 percent.

Monetary and exchange rate policies

7. Monetary policy in South Africa remains supportive of growth. The downside risks to growth have already resulted in the monetary authorities being more tolerant of inflation at the upper end of the target range than would normally have been the case - an approach that is consistent with a flexible inflation targeting framework. Recent developments, however, indicate that some inflationary pressures are beginning to emerge, mainly due to continued currency weakness and higher-than-expected petrol price increases.

8. The risks to the inflation outlook are tilted to the upside and are mainly related to uncertainty regarding exchange rate developments as well as the expected outcome of the present round of wage bargaining which is critical in determining the extent of wage pressures on the inflation outlook. This outlook reduces somewhat the scope for further monetary accommodation. The SARB recognizes the conflicting policy choices relating to rising inflation uncertainty and slowing growth and will continue to monitor developments closely and act appropriately in order to sustain the credibility of its inflation targeting regime.

9. Furthermore, the South African monetary authorities are concerned about the potential impact of the withdrawal of stimulus by advanced countries. It is already becoming clear that uncertainty regarding the timing of the stimulus withdrawal by the US Federal Reserve is already generating capital flow reversals that impact adversely on domestic bond and currency markets in particular. However, it is the view of the authorities that the staff is a bit more alarmist than necessary in expressing their concerns with regard to South Africa's vulnerability if capital flows were to reverse (page 12, paragraph 17). South Africa's flexible exchange rate regime, which the authorities have allowed to operate to adjust to outflows or inflows of capital, has provided a crucial adjustment mechanism which has cushioned the economy against shocks. Even at the height of the global financial crisis, South Africa did not experience liquidity shortages, as several emerging market economies experienced, as the country allowed the exchange rate to adjust to the availability to reserve currency liquidity.

10. Regarding accumulation of reserves, my authorities are aware of the staff advice that it could also be useful for South Africa to build reserves through regular and pre-announced auctions to buy small amounts of FX, as done by other countries, such as Israel, Mexico, and Turkey. My authorities would like to reiterate the view they expressed during the 2012

Article IV consultation, i.e. they recognize the importance of accumulating reserves for precautionary purposes. However, this needs to be balanced against the cost of reserves build up and management. Hence, my authorities will continue the process of opportunistically accumulating reserves without unduly impacting on the exchange rate. The South African authorities are willing to consider any policy advice regarding the accumulation and management of reserves, provided that the potential benefits and costs are robustly established.

Fiscal policy

11. My authorities are committed to pursuing sound fiscal policy management which seeks to balance the need to provide support for economic growth while ensuring sustainable public debt. Owing to weaker than anticipated economic growth and revenue collection below projections, a budget deficit of 5.2 per cent in 2012/13 fiscal year was recorded. The staff report seems to incorrectly suggest that the government wage bill explains most of this deterioration. My authorities view is that most of the deterioration is attributable to a sharp decline in revenues. During 2009/10 when most of the deterioration started to take place, wages and salaries only increased by 1.1 percentage points of GDP (Page 42, Table 2). Tax revenues, however, contracted by 2.5 percentage points of GDP. Since then, both have stabilized.

12. My authorities acknowledge that in the absence of growth picking up, the deterioration may continue. As a result, they have taken additional steps to ensure that expenditure remains firmly under control, by further adjusting the medium-term expenditure allocations to national departments downwards. The authorities stand ready to make further adjustments to the budget during the regular October Adjustment Budget should the circumstances warrant.

13. The authorities have also embarked on efforts to increase the efficiency of taxation and spending and to eliminate waste. To support this endeavor, the Ministers' Committee on the Budget has been assigned the responsibility to oversee expenditure reviews in the coming year and to analyze patterns of public spending, including personnel spending. The reviews will also identify opportunities to improve value for money, such as enhanced procurement controls and the phasing out of projects that are ineffective or no longer aligned with policy priorities.

14. On the tax front, a committee has been set up to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. Its mandate includes examining the overall tax base and burden, the corporate tax system and the mining tax regime, including the appropriate tax mix between personal income tax, corporate income tax and value added tax.

15. With regard to the wage bill, the authorities note the assertion by staff that the growth of the wage bill has crowded out government capital expenditure "which is increasingly undertaken by public enterprises" (Page 10, first bullet, SM/13/226). My authorities do not agree with this assertion. Their view is that public enterprises continue to

be responsible for economic infrastructure, and have not been required to take on any new role as a result of spending pressures elsewhere in the budget. While they acknowledge "crowding out" from the wage bill as a long run concern, they consider the main obstacle to government's social infrastructure spend in the short to medium term as lack of capacity resulting in under spending, particularly in municipalities.

Financial stability

16. South Africa's financial soundness indicators remain strong, but the rapid expansion of unsecured lending to households has increased credit risk. South Africa's unsecured consumer lending market has experienced significant growth in recent years, following the introduction of the National Credit Act in 2007. This growth was also supported by the decline in interest rates to a near 40-year low, and strong nominal wage increases. My authorities do recognize the increased credit risk, nevertheless they note that the development has rendered access to finance more inclusive.

17. It is also important to note that unsecure credit growth has moderated recently. On the basis of information from six banks that are significant role players in the unsecured retail credit market, the year-on-year (y-o-y) growth in unsecured retail other (which largely consists of unsecured personal term loans) has tapered off since peaking at 33.6 per cent in August 2012 to 19.0 per cent in May 2013. The y-o-y growth in retail other category consisting of loans greater than R30 000 decreased from a peak of 71.2 per cent in November 2012 to 40.3 per cent in May 2013. Unsecured loans in the retail other category consisting of loans equal to or less than R30 000 has been contracting since March 2013.

18. My authorities do not expect the sector to experience a 'hard landing' in view of the current moderate inflation and low interest rate environment, as well as heightened regulatory scrutiny. In any event, the unsecured credit levels are still too small compared with the overall banking assets to pose any threat to the overall stability of the banking system.

Structural Reforms

19. As the staff report pointed out, my authorities are aware of the imperatives of structural reforms. As a result, the 2013/14 Budget, which is consistent with the National Development Plan (NDP), has mapped out an integrated strategy for accelerating inclusive growth, eliminating poverty and reducing inequality. The Department of Performance Monitoring and Evaluation has started to develop a medium-term strategic framework that will guide NDP implementation over the next five years. Already, some progress has been made in several areas such as infrastructure, public service delivery, and accountability. In this regard, my authorities are committed to improving capacity to plan, procure, manage and monitor projects, as well as working more closely with the private sector at various stages of the project development cycle.

20. On product market reforms, the Competition Commission's powers have been strengthened, and the South African authorities are committed to enhancing the level of

competition in a various sectors. The ultimate objective is to encourage free entry and exit by stakeholders. In addition to issuing licenses and setting tariffs, regulators are now called upon to place more emphasis on stimulating market competition and promoting affordable access to quality services. The authorities acknowledge that fulfilling this role will require capacity building in regulatory institutions and discussions are ongoing as to how best to achieve this.

21. Finally, with regard to labor market reforms, it is important to recognize that labor markets in South Africa are relatively more complicated, primarily due to the legacies of apartheid. Therefore, reforming the labor market is a long-term project and my authorities are committed to developing social consensus, which will be critical for managing trade-offs between reform options.