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April 20, 1982

To: Members of the Executive Board
From: The Secretary
Subject: South Africa - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation discussions with South Africa.

This subject has been tentatively scheduled for discussion on Wednesday, May 26, 1982.

Att. (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 1982 Article IV Consultation

Prepared by the Staff Representatives for the 1982 Article IV
Consultation with South Africa

Approved by L. A. Whittome and S. Mookerjee

April 19, 1982

I. Introduction

A staff team, consisting of Messrs. Knobl (EUR), Aghevli (ETR), Dell'Anno, Lipschitz, Wein (all EUR), Burton (EP-EUR), and Mrs. Carlson (EUR), held Article IV consultation discussions in Pretoria, Cape Town, and Johannesburg from February 22 to March 6, 1982. The mission met with the Minister of Finance, Prof. O. Horwood, the Governor of the Reserve Bank, Dr. G. de Kock, and the Director General of Finance, Dr. J. de Loor, as well as other representatives of the Department of Finance, other government departments, and the Reserve Bank. Dr. D. Brand, Principal Resident Representative of South Africa to the IMF and the IBRD, attended the meetings as an observer. South Africa accepted the obligations of Article VIII, sections 2, 3, and 4, of the Fund Agreement as from September 15, 1973.

II. Background

The recovery of the South African economy from the protracted recession of the mid-1970s began in late 1977 and proceeded erratically and hesitantly through the end of 1979 (Chart 1). With the sharp increase in the gold price in 1979-80, the balance of payments constraint was removed for a time. Economic policy in 1980 was designed to strengthen the expansionary trend and encourage a fuller utilization of the economy's growth potential than previously. The buoyant gold market and easy financial policies served to underpin consumer and business confidence, and the economy expanded at an unsustainably high rate in 1980. In marked contrast to the slack conditions in most other countries, real domestic demand rose by 13 1/2 per cent and the growth of real GDP nearly doubled to 8 per cent (Table 1). Despite the rapid growth of the economy, however, unemployment of unskilled (predominantly black) labor remained the weak element in an otherwise bright economic picture.

In the course of the year, signs of domestic constraints on growth began to emerge. Notwithstanding the increase in the number of skilled immigrants, shortages of skilled labor became widespread and pushed up

labor costs. Inflation increased from 14 per cent during 1979 to 15 1/2 per cent during 1980, despite a significant appreciation of the rand. The volume of imports rose sharply by over 21 1/2 per cent. At the same time, external market conditions weakened, and nongold export volumes fell by 1 per cent (Table 2). These negative developments in the external trading environment were masked by the high price of gold, which ensured that the current account of the balance of payments remained in substantial surplus (4 1/2 per cent of GDP).

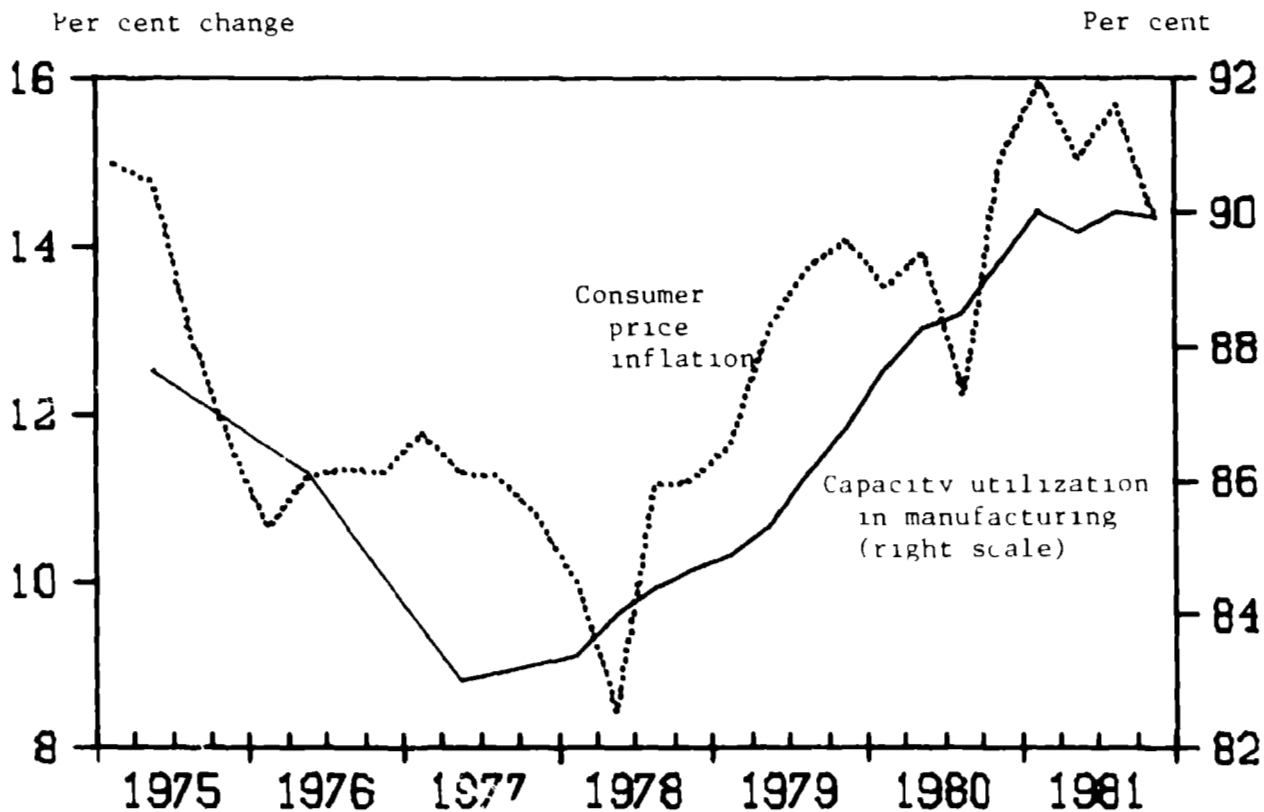
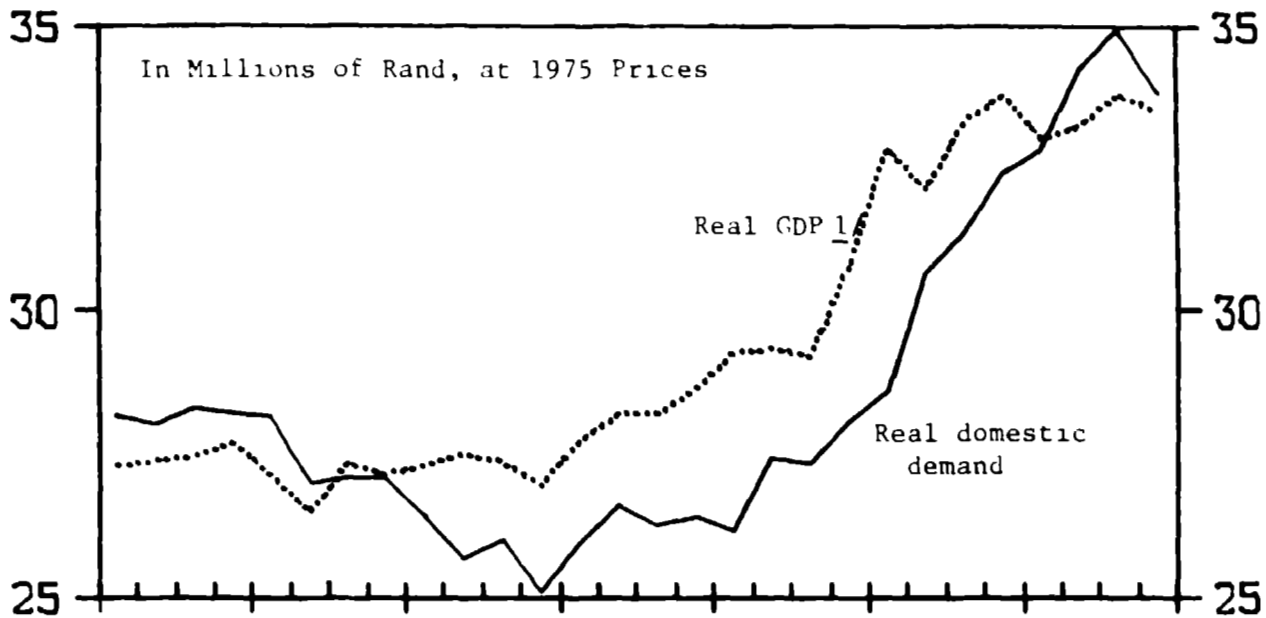
Monetary policy in 1980 was excessively expansionary. Although there was some relaxation of exchange control, as well as an appreciation of the rand, the large external surplus was allowed to undermine domestic monetary control. The main monetary aggregates rose faster than nominal income. Interest rates were well below those on foreign capital markets and the domestic rate of inflation (Chart 2); the prime interest rate was below 10 per cent throughout the year, and the Treasury bill rate below 5 per cent for most of the year.

By contrast, fiscal policy in 1980/81 (year beginning April) was relatively restrictive. Some stimulus was provided by tax concessions to individuals and companies, which led to a 1 percentage point reduction of nongold revenues as a proportion of GDP. However, with expenditure declining in relation to GDP and revenues from tax and lease payments of gold mining companies soaring, the Exchequer deficit fell from almost 3 1/2 per cent of GDP in 1979/80 to about 1/2 per cent in 1980/81 (Table 3).

In 1981, while the growth of domestic demand remained buoyant (10 1/2 per cent), capacity constraints became binding, and the rate of growth of real GDP slowed to below 5 per cent. Continued excess demand kept the rate of inflation relatively high (15 per cent), and competition for skilled labor led to an acceleration in nonagricultural unit labor costs, from 12 per cent in 1980 to 18 per cent in 1981, putting some pressure on profits. By the fourth quarter of 1981, there were signs that the vigorous expansion of the past two years was coming to an end.

The balance of payments constraint re-emerged in 1981. With the fall in the gold price, continuing weak markets for South Africa's other major exports, and buoyant import demand, the current account of the balance of payments moved sharply into deficit (Chart 3). The volume of nongold merchandise exports fell by more than 13 per cent. Strong demand coupled with domestic supply constraints resulted in a 15 1/2 per cent increase in the volume of imports. The current account position swung from a surplus of 4 1/2 per cent of GDP in 1980 to a deficit of 5 1/2 per cent (or R 4 billion). The massive turnaround in the current account was not accompanied by a reversal of capital flows of a similar magnitude, as, for most of the year, relative interest rates did not favor borrowing abroad. Consequently, net foreign assets fell by almost R 3 billion, and the exchange rate depreciated significantly.

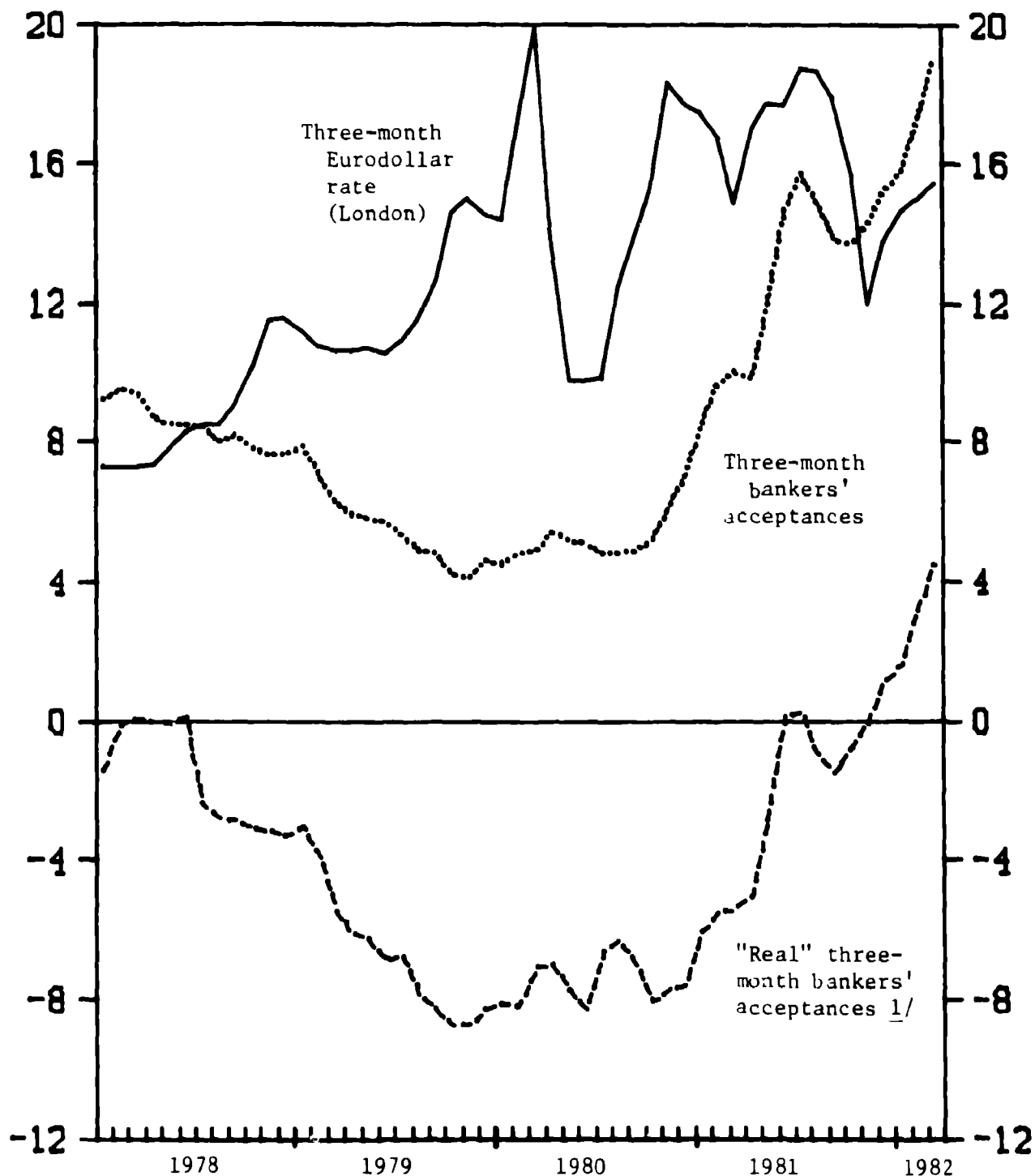
CHART 1 SOUTH AFRICA DEMAND, SUPPLY, AND INFLATION



Source South African Reserve Bank, Quarterly Bulletin.

1/ Adjusted for changes in the terms of trade.

CHART 2
SOUTH AFRICA
INTEREST RATE DEVELOPMENTS
(per cent per annum)



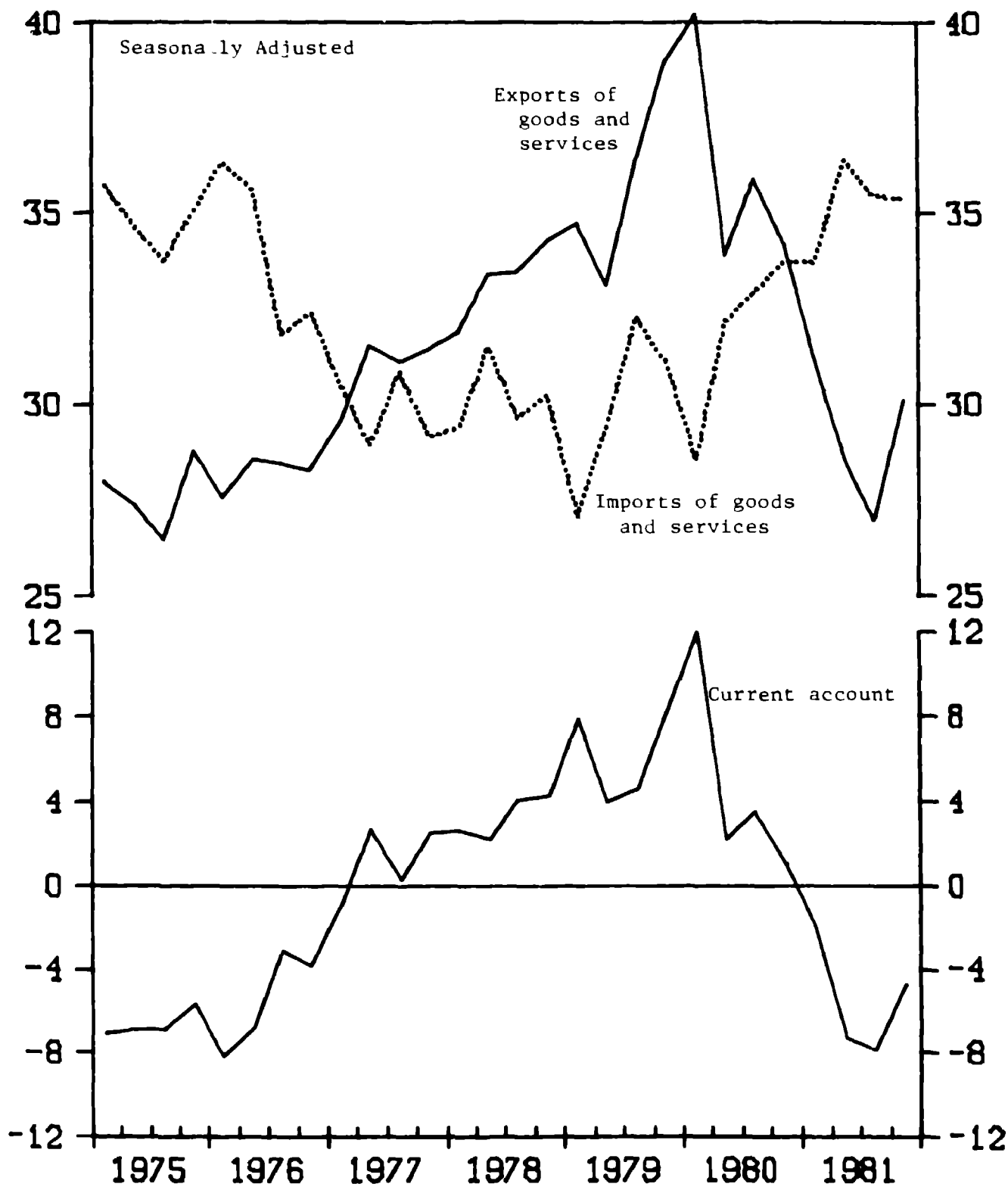
Sources. South African Reserve Bank, Quarterly Bulletin, and IMF, International Financial Statistics.

1/ Deflated by the consumer price index.

CHART 3

SOUTH AFRICA

DEVELOPMENTS IN EXPORTS, IMPORTS AND THE
CURRENT ACCOUNT
(PER CENT OF GDP)



Source South African Reserve Bank, Quarterly Bulletin.

III. The Policy Discussions

The sensitivity of the South African economy to the gold price in particular and primary commodity prices in general creates a chronic dilemma for policy. The crux of the dilemma lies in the judgment as to whether shifts in the terms of trade are transitory or likely to be sustained (Chart 4). 1/ The authorities indicated that early in 1981, when the balance of payments moved into deficit, adjustment was delayed, partly because of uncertainties regarding the duration of the downswing in commodity prices and the seriousness of domestic supply constraints. Thus, the balance of payments difficulties were initially exacerbated by easy financial policies aimed at shielding the economy from the unfavorable external influences. Later in the year, as the need for adjustment became clear, the authorities moved to tighten their policy stance, and by early 1982 a number of strong adjustment measures had been taken. These included an increase in interest rates to more realistic levels and additional taxes to help contain the budget deficit. At the time of the staff visit, it was clear that authorities were acutely aware of the need for adjustment, and the discussions focused principally on appropriate financial and exchange rate policies in this context. Incomes policy was not assigned a formal role in economic management.

1. Monetary policy

Until relatively recently, monetary policy in South Africa relied largely on administrative controls, including quantitative credit ceilings, an administered overdraft rate, and a reliance on captive markets for the sale of government paper. The system was characterized by relatively easy access to Reserve Bank credit and, consequently, at times, inadequate control of the monetary base. As a result, the monetary aggregates were distorted by large-scale disintermediation and reintermediation in response to changes in the availability and relative costs of credit. 2/ The abolition of quantitative credit ceilings in September 1980 was followed by substantial reintermediation during early 1981.

The monetary aggregates, which grew at excessive rates in 1980, continued to do so in 1981, despite the contractionary effect of the balance of payments deficit in the latter year. Bank rate was raised five times in 1981, but only by the end of the year did interest rates become positive in real terms. Little effective restraint was actually exercised during 1981, and broad money (M3) increased by 20 per cent after a rise of 23 1/2 per cent during 1980 (Table 4).

Two developments created special difficulties for monetary control in 1981. First, the large maize crop, coupled with weak export markets,

1/ For example, a fall of about \$100 in the average price of gold from \$460 per fine ounce in 1981 (the price in mid-April was \$362) would, by itself, reduce export earnings by over 2 1/2 per cent of GDP and government revenues by almost 1 1/2 per cent of GDP in a year.

2/ For a more detailed description, see Recent Economic Developments, Chapter VI.

led to a large inventory accumulation and a substantial increase in agricultural financing at preferred rates through the Land Bank, a quasi-government institution. The largest previous financing requirement had been about R 1.1 billion, but in 1981 R 2.3 billion was required. Land Bank bills count as liquid assets, for compliance with the banks' liquid asset requirement, and are thus in direct competition with Treasury bills. The huge expansion of Land Bank bills swamped the banks with liquid assets and, given their direct or indirect access to the discount window, removed the constraint on credit expansion. Second, some difficulties emerged in the financing of the government deficit late in 1981. At the time of the budget, the Public Debt Commissioners (PDCs) had indicated to the Exchequer that they would invest some R 1.85 billion in government securities. However, owing to unanticipated large-scale withdrawals that reduced the availability of funds to the PDCs, their subscription turned out to be well below expectations. As banks' holdings of Land Bank paper were already large and yields on government paper were not sufficiently attractive for nonbank financing, the Reserve Bank was required to finance both the Exchequer deficit and the strategic commodity reserve directly. This led to an expansion of the cash base, and so further reduced the restraint on banks.

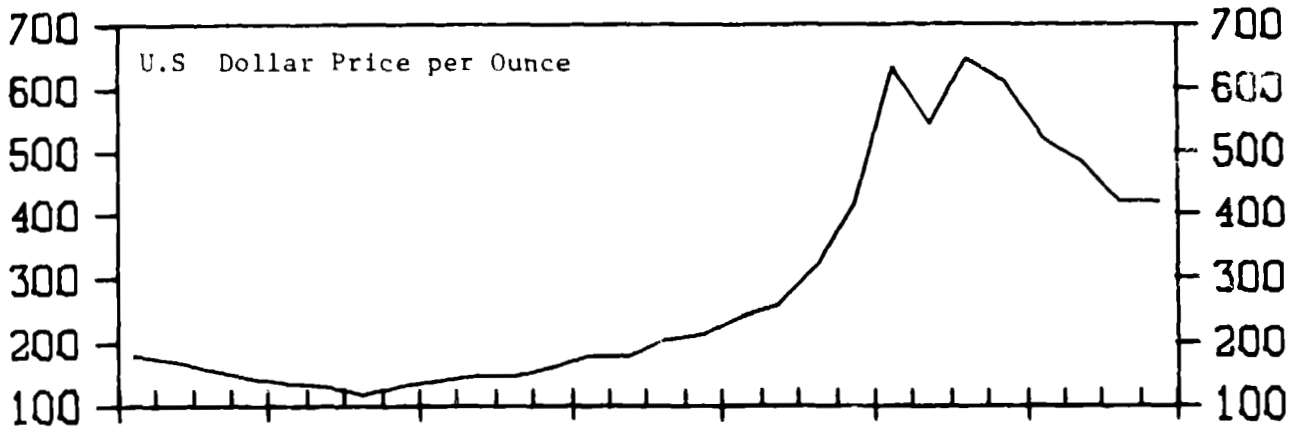
In early 1982, however, various policy changes were introduced to improve monetary control. ^{1/} In January, for the first time, the Treasury Bill rate was allowed to rise substantially above Bank rate in an attempt to attract nonbank subscriptions, and, in February, government bonds were for the first time issued by tender. Also, the link between the banks' prime rate and Bank rate was broken, and, along with most other interest rates, the prime rate was allowed to rise sharply. By the time of the mission visit, real rates were positive and more in line with those abroad.

In the view of the staff, the recent liberalization of interest rates should improve the efficiency of the channeling of financial savings into productive investment. The general increase in interest rates is also consistent with the objective of reducing domestic demand and should encourage an inflow of external capital. However, a continuing shortcoming of the present system is the maximum interest rate of 20 per cent imposed on certain bank lending.

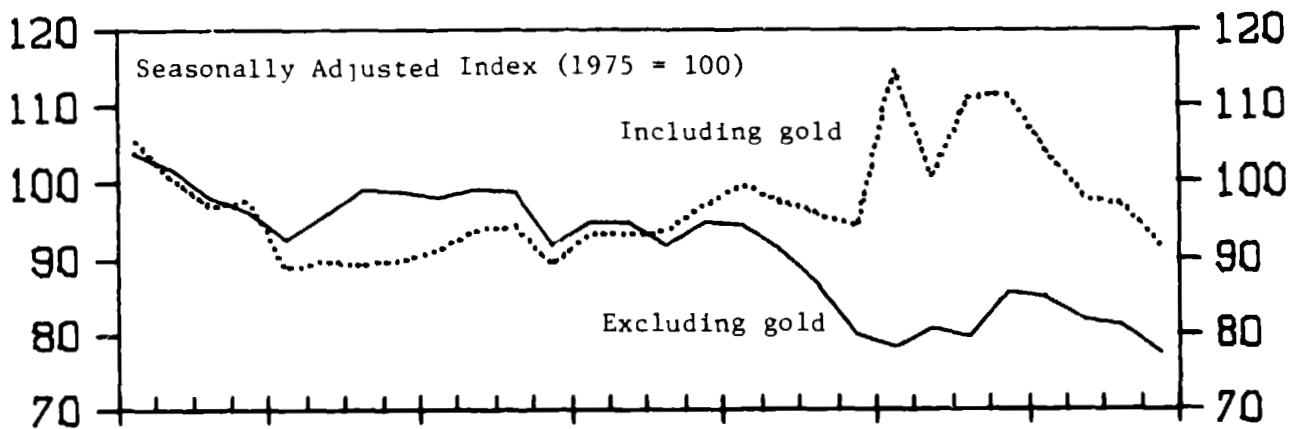
The task of monetary management in 1982/83 has been eased by the tight budget and the recent increase in interest rates--the prime rate is currently 20 per cent. The authorities have indicated that they intend to limit the overall monetary expansion to less than the projected inflation rate, this would represent a sharp reduction from the rates of expansion of the past two years. There are already indications that monetary growth is beginning to slow and, in order to prevent an undue tightening in the money market, the Reserve Bank lowered reserve requirements at the end of March.

^{1/} For details, see Recent Economic Developments, Chapter VI.

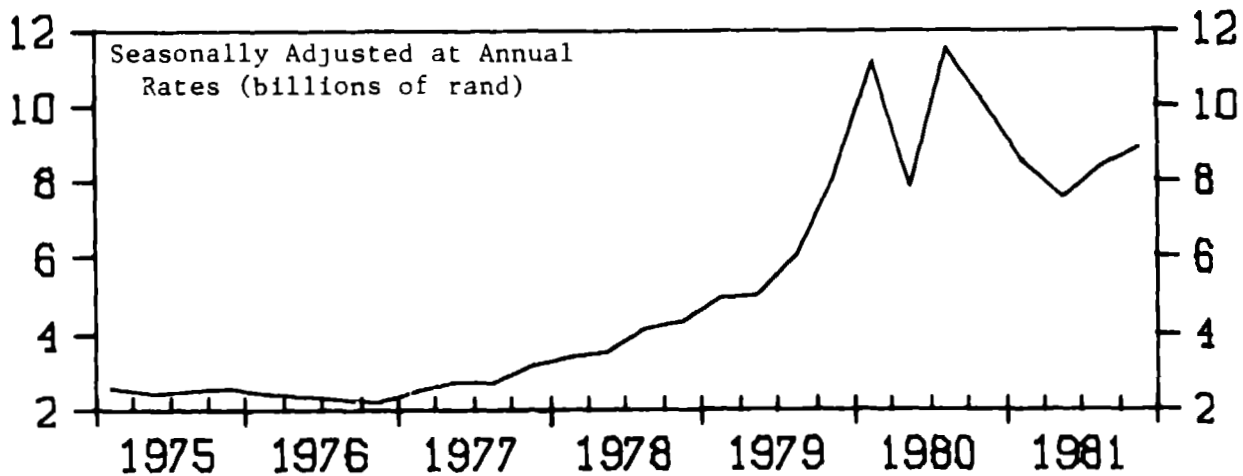
CHART 4
SOUTH AFRICA
GOLD AND THE ECONOMY
GOLD PRICES



TERMS OF TRADE



VALUE OF NET GOLD OUTPUT



Sources. South African Reserve Bank, Quarterly Bulletin, and IMF, International Financial Statistics.

2. Fiscal policy

Fiscal policy has played a major role in economic management in recent years. Between 1976/77 and 1980/81 (fiscal years beginning April), the authorities gradually reduced public spending as a proportion of GDP, from 27 1/2 per cent to 23 per cent, in line with the medium-term objective of increasing the share of resources available to the private sector. Discretionary changes in taxation were the main instrument for short-term fiscal management. Thus, tax rates were reduced in 1979/80 and 1980/81, as gold revenues rose sharply.

The introduction of the budget for 1981/82 was delayed until August on account of the general elections in June 1981, but at that time the need for adjustment was not seen to be overwhelming. Expenditures were budgeted to rise by about 16 1/2 per cent. Revenues were conservatively budgeted to decline by 1 per cent, owing largely to much lower tax and lease payments by the gold mines. Revised expenditure estimates show an increase of almost 20 per cent (to 23 1/2 per cent of GDP), with the overrun accounted for principally by higher debt servicing costs and defense. While receipts from the gold mines are now estimated to be almost 42 per cent lower than in 1980/81, much the same as budgeted, an unanticipated buoyancy of other tax receipts has resulted in a substantial increase in revenues over the initial estimates. Total revenue is now estimated to have increased by over 7 1/2 per cent. Within the total, the most significant revision is for personal income tax receipts, which rose by almost 50 per cent. The larger-than-expected increase in personal income taxes is attributable to sharply higher personal incomes for skilled workers, coupled with the progressivity of the tax structure. In all, the budget deficit (before borrowing) was contained to 2 3/4 per cent of GDP, significantly less than budgeted (Table 3).

With the further weakening in the price of gold, the need for adjustment had become more pressing by the beginning of 1982, and additional taxes were introduced in February to contain the budget deficit. A 10 per cent surcharge was imposed on imports and the general sales tax was increased from 4 per cent to 5 per cent. Both measures had no appreciable effect on revenues in 1981/82, but are expected to raise revenues by over 1 1/2 per cent of GDP in 1982/83.

The 1982/83 budget, introduced shortly after the departure of the mission, confirms the authorities' strong commitment to fiscal austerity. Expenditures are budgeted to rise by only 11 1/2 per cent. Even with the possibility of some expenditure overruns, it seems likely that there will be a fall in real spending. Much of the restraint falls on defense expenditure and investment outlays. To a lesser extent, certain transfers--e.g., to provincial governments--will also be affected. Expenditure on education is budgeted to rise by more than 20 per cent. The authorities would have preferred the increase of 18 per cent in public sector pay to have been kept lower. They stressed, however, that a wage increase was necessary to restore the competitiveness of public sector salaries in order to attract qualified personnel.

The revenue estimates are based on an average gold price substantially lower than in the previous fiscal year, resulting in a decline of nearly 60 per cent in gold-related revenues. In order to limit the overall budget deficit, the authorities have introduced a number of additional revenue measures, including a loan levy on individuals equivalent to 5 per cent of income taxes, a 10 per cent income tax surcharge on companies, and selective increases in excise taxes for luxury goods. These measures, together with those announced in February, are expected to increase revenues by an amount equivalent to over 2 per cent of GDP. Nongold revenues are budgeted to rise by almost 25 per cent.

As a result of the planned fall in real expenditures and the substantial tax effort, the overall deficit is projected to be limited to about R 2.3 billion, unchanged from 1981/82 in terms of GDP at about 2 3/4 per cent. No recourse by the Exchequer to the Reserve Bank is envisaged for any budgetary or extrabudgetary financing, and the entire budget deficit is expected to be financed from nonbank sources. This financing should be facilitated by flexibility in setting interest rates on government securities. The authorities indicated that they would take additional fiscal measures during the year if these appeared necessary to the achievement of their objectives.

3. External policies

The large current account surplus in 1980 had been bottled up in the domestic economy because of controls on capital outflows and had consequently led to an excessive expansion of the domestic monetary aggregates. With hindsight, the authorities now believe that it would have been preferable to have allowed some more easing of capital controls.

With the turnaround of the current account in 1981 (Chart 4), the authorities gradually moved to adjust domestic financial policies to contain demand. In managing the exchange rate, they adopted a policy of leaning against the wind: some (12 per cent effective) depreciation of the rand was allowed, and substantial (almost R 3 billion) official balance of payments financing was provided. Private capital inflows (of about R 1 billion) financed the rest of the current account deficit.

The easy domestic financial conditions and relatively low interest rates provided little incentive for private capital inflows in the first part of 1981. Initially, the external deficit was financed by running down reserves and by recourse to short-term foreign borrowing. Because of the pressure on official reserves, in late August and September the Reserve Bank adjusted the forward exchange rate against the U.S. dollar to favor external financing of trade. This policy proved costly as actual exchange rate movements deviated from the forward rates quoted, and the Reserve Bank moved instead to a neutral policy of allowing forward rates to reflect interest rate differentials. In the latter part of the year, the authorities resorted to gold swaps with foreign commercial banks to boost foreign exchange holdings. At the end of March

1982, gross official reserves stood at SDR 3.0 billion (less than two months of imports of goods and services), with gold officially valued at market-related prices, excluding gold, reserves were equal to only SDR 0.6 billion.

The authorities indicated that their gold marketing policy was to base sales on balance of payments needs. When the overall balance tended to be in deficit, the policy was to sell the full gold production, though not necessarily on a weekly basis. In 1980, when the overall balance was in surplus, the Reserve Bank had withheld a small part of the production from the market.

The authorities intend to complement domestic financial austerity with adequate flexibility in the exchange rate to ensure the rapid adjustment of the external payments position. After the depreciation of the rand in 1981, South Africa's competitive position--as measured by exchange rate adjusted relative price movements--was about the same as in mid-1980 (Chart 5). The authorities recognized that if the adverse terms of trade shift since mid-1980 was sustained, an improvement in competitiveness would be required for nontraditional export growth to fill the gap left by traditional exports. While they expressed some concern about the price effects of a further depreciation and the psychological impact of the rand falling below parity with the U.S. dollar, they acknowledged that some further depreciation might be required in order to reconcile the real growth objective with the necessity for adjustment. Shortly after the departure of the mission, the rand fell below parity with the dollar for the first time in its history; during the first three months of 1982, the rand depreciated by 2 1/2 per cent in effective terms.

The objective for 1982 is to limit the current account deficit to about 3 1/2 per cent of GDP (US\$3 billion), compared with 5 1/2 per cent in 1981, though the outcome will depend crucially on the price of gold. At least US\$2 billion is targeted to be financed by private external borrowing. The authorities emphasized that this financing objective was feasible and noted that in the first quarter of the year there had already been substantial short-term capital inflows in response to the tightening of monetary policy.

Under the existing dual exchange system, all equity investments by nonresidents are eligible to use the financial rand, while the proceeds of sales of such investments must also be converted into foreign exchange through the financial rand. ^{1/} Income from these investments, however, can be remitted at the commercial rand exchange rate. Since the financial rand is allowed to float freely--it is usually at a substantial discount vis-à-vis the commercial rand--there can be no net capital inflow through this medium. Consequently, the capital inflows would have to take the form of loan capital.

^{1/} A limited number of other transactions also take place through the medium of the financial rand. For details, see Recent Economic Developments, Chapter VII.

The need for official financing for 1982 is not expected to exceed US\$1 billion. The authorities stressed that, given the substantial borrowing undertaken in 1981, it was essential to limit official financing and foster adjustment, particularly since their good credit rating was based on confidence in their economic management.

The authorities regard the 10 per cent import surcharge imposed in February as a revenue-raising rather than an import-restraining device. The import surcharge applies to those nongovernment imports which are not subject to GATT bindings and will have some distorting effect on trade. The authorities intend to remove the surcharge as soon as this is feasible from a budgetary standpoint.

4. Structural constraints

Though in the short term the balance of payments constraint is the foremost consideration in the formulation of financial policies, other constraints of a structural nature affect economic performance. With the rise in capacity utilization in 1980 and 1981, bottlenecks developed because of a severe shortage of skilled labor. In the medium term, the authorities hope to increase the supply of skilled labor through government and government-sponsored manpower-training programs, and by encouraging private sector training programs through substantial tax incentives. The Government has also relaxed or removed various restraints on the mobility and use of available labor resources. Nevertheless, considerable scope remains for progress in these areas.

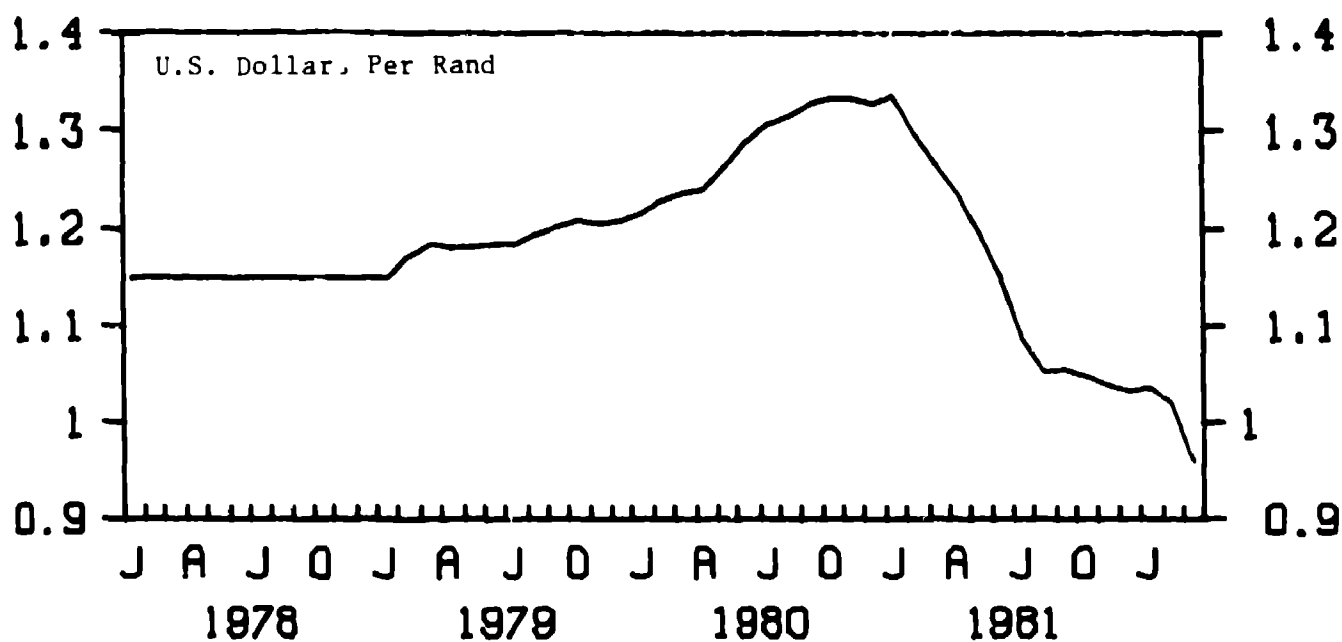
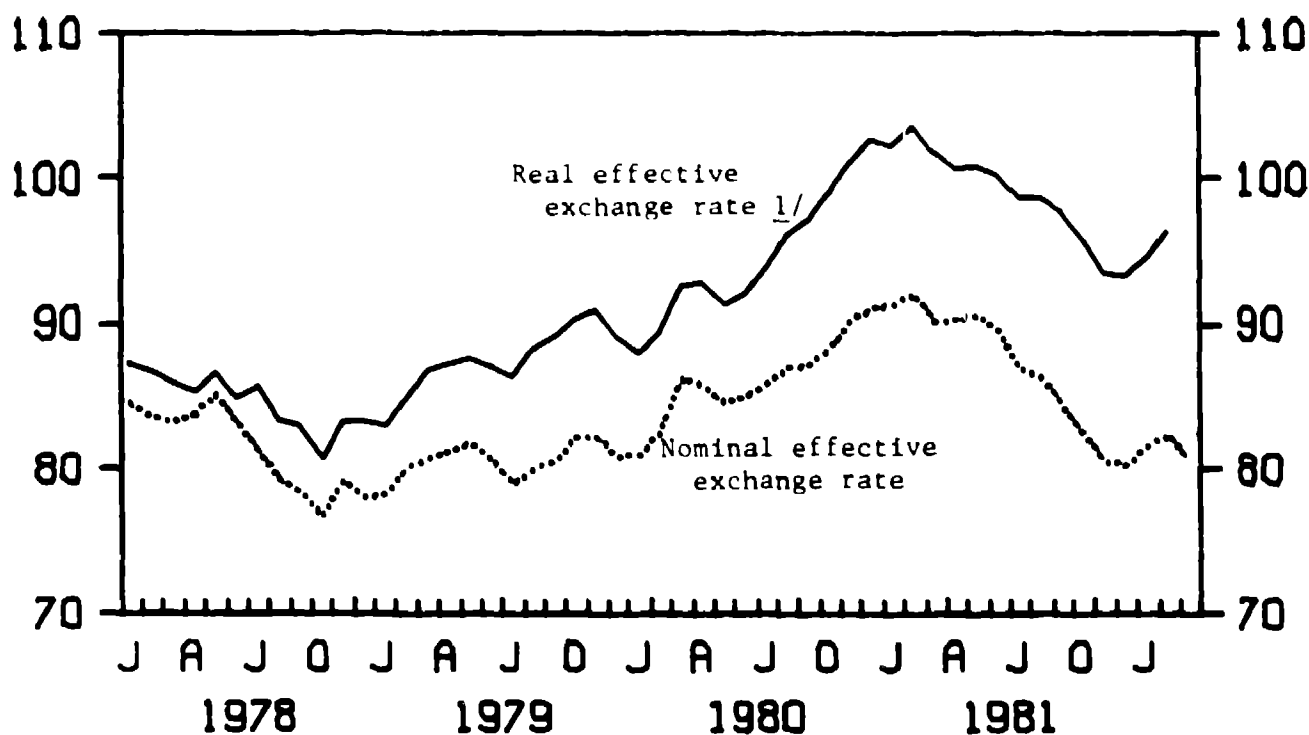
Infrastructural bottlenecks also constrain growth, especially near cyclical peaks. Exports, in particular coal exports, were constrained in 1981 by limited railway and shipping facilities. Investment to improve this infrastructure is being undertaken, but, in view of the external payments position and the need for stricter financial policies, it may be difficult to maintain the real level of such investment in the short run.

The authorities also intend to reduce the country's dependence on imported oil. Government policy encourages the substitution of abundant domestic coal for foreign oil, both in final use and by the technical conversion of coal to oil. In particular SASOL, a public sector corporation, has pioneered the conversion of coal to oil. Coal sold on the domestic market is priced above production costs but well below world market prices.

5. The short-term economic outlook

The current external environment does not present a propitious setting for the difficult task of adjustment faced by the South African authorities. For 1982, prospects for most major exports continue to be unfavorable. Despite a projected 2.5 per cent increase in the volume of gold production, an average gold price of \$350 per fine ounce would reduce gold earnings in 1982 by about 22 per cent in U.S. dollar terms. The diamond market remains depressed, export earnings from copper are

CHART 5 SOUTH AFRICA EXCHANGE RATE DEVELOPMENTS (1975-100)



Sources: IMF, International Financial Statistics, and staff calculations

1/ Relative consumer prices adjusted for exchange rate changes

expected to fall substantially further, and most other mineral exports are also expected to see a slight continued downward trend. Earnings from coal, the one bright spot in 1981, are projected to rise further. Some improvement in agricultural export volumes is likely, although the maize crop is not expected to match last year's output. In the aggregate, the volume of (nongold) merchandise exports is expected to rise by about 3 per cent in 1982, with the price in U.S. dollar terms projected to fall by about 1 per cent. Exports are expected to pick up in the latter part of the year and in 1983, in response to the recovery in the industrial countries.

Most of the burden of adjustment in 1982 will be borne by merchandise imports, which, in volume terms, are expected to fall by about 14 per cent. In large measure, this fall reflects an intentional running down of inventories. The volume of oil imports is projected to decline by 15 per cent in 1982 as a result of a slackening of demand and a pause in strategic stockpiling. Most of the import bill consists of intermediate and capital goods. The projected fall in investment should therefore exert a general restraining influence. With the fall in imports, and despite the unfavorable export market conditions, the current account deficit is projected to decline from 5 1/2 per cent of GDP in 1981 to 3 1/2 per cent of GDP in 1982, and to improve further in 1983.

The economy has so far exhibited a surprising resilience to unfavorable external circumstances and more restrictive financial policies. Given existing supply constraints, the external payments position, and the need for stricter financial policies, it seems likely that there will be a substantial reduction in the rate of growth. The official Reserve Bank projections envisage a growth rate of real GDP in 1982 of about 1-2 per cent; private consumption expenditure is projected to rise by 2 1/2 per cent and gross fixed investment to fall by 1 1/2 per cent. These projections, however, were based on a slightly more favorable gold price assumption and somewhat less restrictive policy assumptions than now seem plausible. Consequently, the actual outcome may fall somewhat short of these projections, and the staff expects that there will be little or no growth in 1982 (Table 1).

Despite the projected easing in demand pressures, consumer price inflation is likely to continue at a relatively high (14-15 per cent) rate in 1982. A number of factors--including the lagged effect of depreciation, the rise in the general sales tax, the import surcharge, announced increases in postal and communications tariffs, expected increases in agricultural prices, and the recent increases in transport and freight rates--mitigate against a greater improvement in the inflationary situation. The GDP deflator is expected to increase somewhat more slowly, at about 11-12 per cent, reflecting a substantial deterioration in the terms of trade.

Overall, the projections for 1982 envisage a rather rapid adjustment to the adverse developments in the external sector. Over the longer run, with the labor force growth rate of about 2.7 per cent per annum, the

authorities believe that a growth rate of about 5 per cent is consistent with the maintenance of a constant unemployment rate. It is unlikely that this long-run rate will be achievable even during 1983 without some reversal of the negative terms of trade shift that has occurred over the last year.

IV. Staff Appraisal

Changes in economic conditions in South Africa have, in recent years, been dominated by fluctuations in the price of gold and the policy response to these fluctuations. With the sharp fall in the price of gold and stagnant conditions in markets for other important exports during 1981, the foreign exchange constraint, which had been temporarily removed in the previous year, re-emerged as an obstacle to growth. Nevertheless, the economy continued its expansion, though at a slower pace. Expansionary financial policies, which were aimed at shielding the economy from external influences, kept domestic demand buoyant and the rate of inflation high. The consequent rapid growth of imports, together with the fall in exports, led to a sharp turnaround in the current account balance to a large deficit. The swing in the current position was not accompanied by a reversal of capital flows of a similar magnitude, as relative interest rates did not favor borrowing abroad for much of the year. Consequently, net foreign assets fell sharply and the exchange rate depreciated.

The staff believes that expansionary monetary policy delayed adjustment after the balance of payments had moved into deficit in 1981. The rapid monetary expansion reflected in large part substantial agricultural financing through the Land Bank and, late in the year, the large recourse of the Government to the Reserve Bank. By early 1982, however, the stance of financial policy had shifted from one of accommodation to one designed to bring about adjustment. Domestic interest rates were allowed to rise to more realistic levels, and prebudget tax measures were introduced in an effort to keep public finances under control.

Over the next year, the authorities intend to pursue a policy of reducing the growth of broad money to a rate significantly below that of the expected inflation rate. In view of the excessive growth in the monetary aggregates over the last two years, the staff regards this policy as entirely appropriate. The authorities' intention to eliminate the Government's recourse to the banking system for deficit financing should contribute significantly to controlling liquidity expansion. In the past, however, a major source of the increase in liquidity has been the financial system's easy access to Reserve Bank discount facilities. The Reserve Bank needs to control this source of liquidity creation by continued use of discount penalties as an active instrument of monetary management.

The task of monetary management has been facilitated considerably by the authorities' success in overcoming resistance to raising interest

rates. An appropriate level and structure of interest rates should help channel financial savings into productive investment more efficiently. Higher interest rates are also consistent with the objectives of encouraging inflows of external capital and reducing domestic demand. It is important, however, that monetary policy not impinge excessively on the more productive sectors of the economy. In this context, the policy of extending unrestrained credit to farmers at below market rates and the remaining ceiling on certain bank lending should be reviewed.

The budget for 1982/83 reflects the authorities' commitment to adjustment. Expenditures are budgeted to fall in real terms. It would have been preferable, however, if the increase in public sector pay could have been curbed more to allow greater expansion in essential areas, such as manpower training and infrastructural investment. Shortages of skilled labor are a major bottleneck to the growth process, and every effort should be made to train and utilize the large pool of unskilled labor in the country.

On the revenue side, the authorities have made a substantial effort to raise taxes. The new taxes are expected to more than compensate for the sharp fall in gold-related revenues. As a result, the overall deficit is budgeted to be contained at less than 3 per cent of GDP and to be financed without recourse to the banking system. In the unfavorable economic environment, this represents an austere budget that should make a major contribution to adjustment. Moreover, the authorities have indicated that they stand ready to take additional measures if required. The staff notes that the authorities regard the recently introduced import surcharge as primarily being a temporary revenue-raising measure, but urges its removal and its replacement, if necessary, by domestic taxes as soon as circumstances permit.

With relatively low prices for gold and stagnant conditions in the external environment, the prospects for export growth do not seem bright over the near future. A substantial reduction in imports, resulting from the tightening of domestic demand and last year's depreciation of the currency, is likely, but the current account deficit is expected to remain uncomfortably high--that is, some 3 1/2 per cent of GDP. After the large decline in net official reserves in 1981, the authorities' intention to limit official financing to US\$1 billion is appropriate. Most of the financing in 1982 will, therefore, need to come through private capital inflows. The more realistic level of domestic interest rates should help in this regard. The financing requirement over the next year seems manageable, but a current deficit of such a large magnitude cannot be sustained over the medium term. However, with current policies and projections, a further improvement is expected in 1983.

Restraint in monetary and fiscal policies will make a major contribution to the adjustment of the balance of payments, but additional flexibility in the use of external policies may also be required. The depreciation of the currency during 1981 has improved the competitive position of the exporting and import-substituting sectors. This

improvement, however, has served mainly to offset the preceding appreciation of the rand and the relatively high rate of domestic inflation. The effective exchange rate adjusted for relative consumer prices at the end of 1981 was at about the same level as in mid-1980. It is important that adequate cost-price incentives are provided for a more rapid development of the nontraditional export and import-substituting sectors. The recent depreciation of the rand to below parity with the dollar demonstrates the authorities' commitment to maintaining flexibility in their exchange rate policy. This flexibility should help mitigate the potential conflict between the objectives of adjustment and growth.

Given domestic supply constraints and the need for external adjustment, it seems inevitable that there will be a substantial reduction in the rate of growth. At the same time, it is not likely that the inflationary situation can be improved significantly in the short run because of the lagged effect of the depreciation of the rand and the increases in administered prices. This outlook for growth and inflation is consistent with the targeted reduction in the current account deficit.

The South African authorities should be commended for their considerable efforts to improve the external payments position in an unfavorable international environment. The authorities' commitment to adjustment is demonstrated by the strong measures already undertaken and by the stringent financial policies proposed for the next year. The implementation of these policies will facilitate a rapid correction of the imbalance in the international payments position.

Table 2. South Africa External Developments and Forecasts

(In millions of rand)

	1978	1979	1980	1981	1982 Forecast ^{1/}
Nongold exports, f.o.b.	7,449	8,813	9,643	9,238	11,250
Percentage change in volume	5.2	5.0	-0.8	-13.5	3 1/2
Percentage change in unit value	12.6	12.7	10.3	11.8	16 1/2
Gold exports, f.o.b.	3,864	6,003	10,141	8,338	7,650
Percentage change in volume	2.2	-2.7	-6.8	0.7	2 1/2
Percentage change in unit value	35.1	59.7	81.0	-18.3	-10 1/2
Total exports, f.o.b.	11,313	14,816	19,784	17,666	18,900
Imports, f.o.b.	-8,019	-9,739	-14,207	-18,171	-18,500
Percentage change in volume	-0.1	-0.5	21.6	15.6	14
Percentage change in unit value	16.7	22.0	20.0	10.6	18 1/2
Trade balance	3,294	5,077	5,577	-505	400
Services and transfers, net	-1,964	-2,107	-2,747	-3,442	-3,500
Current balance	1,330	2,970	2,830	-3,947	-3,100
In per cent of GDP	3.3	6.2	4.5	5.5	3 1/2
Long-term capital	5	-1,024	-608	357	...
Short-term capital ^{2/}	-810	-1,529	-1,691	755	..
Overall balance	525	417	531	-2,535	.
Memorandum items					
Terms of trade ^{3/} (change in per cent)	2.3	3.8	11.6	-10.7	-9 1/2
Market growth	7.1	8.2	-2.0	--	3 1/2
Gross official reserves (in SDR billions) ^{4/}	1.8	3.7	5.7	3.4	
(Excluding gold holdings)	0.3	0.3	0.6	0.6	.
Effective exchange rate (change in per cent) ^{5/}	-8.5	+3.1	+12.3	-11.9	.

Sources: South African Reserve Bank, Quarterly Bulletin, data provided by the South African authorities, and staff estimates

^{1/} Staff forecast

^{2/} Including net errors and omissions

^{3/} Goods and nonfactor services.

^{4/} End of period, gold at national valuation.

^{5/} December on December

Table 1. South Africa: Domestic Developments
and Forecasts

(Changes, in per cent, from previous year)

	1969-79 Average	1979	1980	1981	1982 Forecast ^{1/}
Demand and output (in constant prices)					
Private consumption	3.6	2.5	8.9	6.3	1
Public consumption	5.1	2.4	7.4	2.3	2
Gross fixed investment	4.0	2.0	13.9	6.7	-1 1/2
Stockbuilding ^{2/}	-0.5	0.9	3.1	4.5	-3 1/4
Total domestic demand	3.2	3.4	13.5	10.5	-3
Foreign balance ^{2/}	0.6	0.9	-4.4	-5.4	3 1/4
GDP	3.5	4.0	7.8	4.7	1/2
Prices, wages, employment, and output					
Consumer prices	9.6	13.1	13.8	15.2	14 1/2
GDP deflator	11.1	15.1	21.7	8.9	11 1/2
Salaries and wages per worker in non- agricultural sector (in constant prices)					
Whites	-0.5	-1.0	3.3	5.6	3/
Nonwhites	5.5	0.5	4.3	1.5	3/
All population groups	1.7	-0.9	3.5	4.4	3/
Manufacturing output	4.1	9.0	10.3	6.9	
Hourly wages in manufacturing	14.6 ^{4/}	12.5	16.7	18.1	
Production per man-hour	3.0 ^{4/}	4.5	4.7	2.8	
Unit labor costs	11.3 ^{4/}	7.7	11.5	14.9	
Personal disposable income	13.5	16.7	22.3	19.7	
Savings ratio (in per cent)	9.5	8.8	7.8	5.9	

Sources. South African Reserve Bank, Quarterly Bulletin; and information provided by the South African authorities.

^{1/} Staff forecast

^{2/} Contribution to growth of GDP, the contribution by stockbuilding includes statistical discrepancies

^{3/} January-September 1981 compared with a year earlier.

^{4/} Compound annual average for 1972-79.

Table 3. South Africa: Summary of the State Revenue Account

	<u>1981/82</u>	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>		<u>1982/83</u>
	In millions of rand, at current prices <u>1/</u>	<u>Actual</u>	<u>Actual</u>	<u>Budget estimate</u>	<u>Revised estimate</u>	<u>Budget estimate</u>
		Percentage change over previous year				
Revenue (excl. loan levy)	14,290	20.3	36.0	-1.1	7.4	11 0
Of which from:						
Gold mining companies	2,129	74.2	142.0	-40 5	-41.5	-61 0
Expenditure	<u>16,350</u>	<u>15.0</u>	<u>19.2</u>	<u>16.3</u>	<u>19.9</u>	<u>11 1/2</u>
Overall deficit						
In millions of rand	2,060	1,656.0	331.0	2,709.9	2,060.0	2,380 0
In per cent of GDP	2.8	3.4	0.6	3 9	2 8	2 3/4

Source: Ministry of Finance, Budget Speeches.

1/ Revised estimate.

Table 4. South Africa: Monetary Survey

(Percentage changes; end of period)

	1978	1979	1980	1981	<u>1982</u> February
Net gold and foreign exchange <u>1/</u> (change in per cent of M3)	4.1	2.8	3.1	-13.6	-16.2
Net domestic credit	8.8	13.3	20.3	33.8	29 4
Credit to private sector	14.5	15.6	29.1	35 0	31.0
M3	16.5	14 7	23 5	20.2	16.8
M2	12.6	13.3	27.4	25 1	22 5
Memorandum item					
Monetary base	12 0	14.8	21.8	16.8	15 9 <u>2/</u>

Source: South African Reserve Bank, and IMF, International Financial Statistics

1/ Excluding valuation changes.

2/ January

Fund Relations with South Africa
(As of March 31, 1982)

Quota	SDR 636 million.
Status	Article VIII, as from September 15, 1973.
Fund holdings of South African rand	SDR 636.0 million or 100.0 per cent of quota.
SDR position	Holdings are SDR 115.5 million or 52.4 per cent of net cumulative allocation of SDR 220.4 million.
Gold distribution	273,865 fine ounces.
Exchange system	The South African authorities do not maintain margins in respect of exchange transactions. Certain capital transactions take place in a separate insulated market in which the "financial" rand is traded at a freely determined exchange rate, usually at a discount over the "commercial" rate. The exchange rate of the "commercial" rand on March 31, 1982 was R 1 = US\$0.95; on the same date the discount of the financial rand was 20.2 per cent.
Last consultation	February/March 1980, completed by the Executive Board on June 9, 1980.

South Africa (1978-1981) (1)

Area and Population

Area		
Population (1980)	2800	
Employment in manufacturing sector (as at December 1980)	1100	

MF Position March 31, 1981

Debt		R 100 million
and holdings of foreign assets per cent of GDP		12

Flows of SDRs		R 100 million
Exchange rate	R 1 = S\$ 1.48	

<u>National Accounts</u>	1980	1978	1979	1980	1981
	In millions of rand at current prices		Percentage change in real terms		
Private consumption	37,655	11.1	2.5	8.9	8.1
Public consumption	9,527	-	-	4	2
Gross fixed investment	18,298	-3.0	2.0	3.4	6
Change in stocks (including residual item) 1/	1,048	1.8	0.9	1	-
Total domestic demand	2,528	1.8	3.4	13.3	13.5
Exports of goods and services	20,173	4.5	2.1	-1.7	-7.6
Imports of goods and services	21,707	0.7	-1.0	18.9	14.2
Gross domestic product	1,194	2.9	4.1	8	4.7

<u>State Revenue Account</u>	1978/79	1979/80	1980/81	1981/82
	In millions of rand			
Revenue	4,008	9,888	10,000	14,000
Expenditure	9,955	11,444	13,441	16,000
Overall deficit	-1,817	-1,556	-3,441	-2,000

<u>Balance of Payments</u>	1978	1979	1980	1981
	In billions of rand			
Merchandise exports	11.3	14.8	19.8	1
Net gold output	3.9	5.0	10.1	4.3
Merchandise imports	-4.0	-4	-14.2	-15.1
Net invisibles and transfers	-2.0	-2.1	-2.4	-3
Current balance	1.3	3.3	2.4	-3.9
Net long-term capital	-	-1.0	-0.6	0.4
Net short-term capital (including errors and omissions)	-0.4	-	-1	0.4
Net capital (including errors and omissions) 2/	-0.4	-2.6	-	1.1
Overall balance	0.9	0.7	1.8	-2.4
Level of reserves at end-year (in millions of SDRs (35 per cent of GDP))	66	651	49	498

<u>Monetary Aggregates</u> (end-per)	1978	1979	1980	1981
	In billions of rand			
Bank of South Africa	1.2	1.2	1.2	1.2
Bank of South Africa	1.2	1.2	1.2	1.2
Bank of South Africa	1.2	1.2	1.2	1.2
Bank of South Africa	1.2	1.2	1.2	1.2

Prices (annual % change)				
Consumer prices				
Exports of goods and services				
Imports of goods and services				

1. Contribution to growth of GDP
2. Exports ended March 1981 Excludes South-west Africa (1980)
3. Excluding short-term liabilities relative to reserves