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CONFIDENTIAL

November 8, 1982

To: Members of the Executive Board  
From: The Secretary  
Subject: South Africa - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for South Africa agreed at Executive Board Meeting 82/141, November 3, 1982.

Att: (1)



### Stand-By Arrangement--South Africa

Attached hereto is a letter, with annexed memorandum, dated October 4, 1982 from the Minister of Finance of the Republic of South Africa, requesting a stand-by arrangement and setting forth the objectives and policies that the authorities of South Africa intend to pursue for the period of the stand-by arrangement. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from November 3, 1982 to December 31, 1983, South Africa will have the right to make purchases from the Fund in an amount equivalent to SDR 364 million, subject to paragraphs 2, 3, and 4 below, without further review by the Fund.

2. Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 159 million until January 31, 1983; the equivalent of SDR 200 million until April 30, 1983; the equivalent of SDR 254 million until July 31, 1983; and the equivalent of SDR 308 million until October 31, 1983. None of these limits shall apply to a purchase under the stand-by arrangement that would not increase the Fund's holdings of South Africa's currency in the credit tranches beyond 25 per cent of quota.

3. South Africa will not make purchases under the stand-by arrangement that would increase the Fund's holdings of South Africa's currency in the credit tranches beyond 25 per cent of quota:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limit on domestic credit of the banking system, described in paragraph 5 and Table 1 of the memorandum annexed to the attached letter; or

(ii) the limit on net credit to the Government, described in paragraph 5 and Table 1 of the same memorandum,

are not observed; or

(b) during any period after July 31, 1983 in which understandings pursuant to the last sentence of paragraph 3 of the attached letter have not been reached, or such understandings having been reached, are not being observed; or

(c) during the entire period of this stand-by arrangement, if South Africa

- (i) imposes restrictions on payments and transfers for current international transactions; or
- (ii) introduces new or modifies existing multiple currency practices other than the transfer of transactions from the financial rand market to the commercial rand market; or
- (iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or
- (iv) imposes or intensifies import restrictions for balance of payments reasons.

When South Africa is prevented from purchasing under the stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and South Africa and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. South Africa's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of South Africa. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 4, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and South Africa and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund and may be made in SDRs if, on the request of South Africa, the Fund agrees to provide them at the time of the purchase.

6. South Africa shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

7. (a) South Africa shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as South Africa's balance of payments and reserve position improves.

(b) Any reductions in South Africa's currency held by the Fund shall reduce the amounts subject to repurchases under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

8. During the period of the stand-by arrangement, South Africa shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to South Africa or of representatives of South Africa to the Fund. South Africa shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of South Africa in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

9. In accordance with paragraph 4 of the attached letter, South Africa will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation, because any of the criteria in paragraph 3 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while South Africa has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning South Africa's balance of payments policies.

Pretoria, October 4, 1982

Dear Mr. de Larosière:

1. After a period of buoyant economic growth and strong balance of payments performance sustained by an improvement in the terms of trade stemming from high gold prices, South Africa's economic performance deteriorated considerably during 1981. Economic growth weakened, owing mainly to physical constraints, and the balance of payments swung into deficit. The main causes of the deterioration were a sharp decline in the prices of gold and of other major exports, and an inordinate rise in aggregate demand emanating from an accumulation of excess liquidity during the two preceding years of balance of payments surplus. Although monetary policy initially remained too accommodating, the authorities gradually moved during 1981 to bring about adjustment through restrictive financial policies and a flexible exchange rate policy. Since early 1982 these policies have been tightened and a stabilization program is in effect to bring about a sustainable balance of payments position during 1983.

2. The attached memorandum describes the economic and financial objectives of the program in support of which the Government of South Africa requests the use of Fund resources under a 14-month stand-by arrangement in the amount of SDR 364 million. At the same time, a separate request for a purchase under the compensatory financing facility is also being submitted.

3. The principal economic objective for 1983 is to limit the external current account deficit to 2 per cent of GDP (R 1.8 billion), compared with a projected deficit of about 6 per cent of GDP (close to R 5 billion) in 1982. Taking capital flows into consideration, the overall balance of payments deficit in 1983 is projected to be about R 1 billion. To achieve this, various actions in the monetary, fiscal, trade, and exchange fields have been taken. These are reviewed in the attached memorandum, which also describes performance criteria for (a) domestic credit of the banking system and (b) net credit to government of the banking system. Before July 31, 1983 the Government of South Africa will review with the Fund the progress of the program, in order to reach further understandings on exchange rate policy and removal of the import surcharge.

4. The Government believes that the policies described in the attached memorandum are adequate to achieve the objectives of the program. However, it will take any additional measures that might become necessary for this purpose. Furthermore, South Africa will consult with the Fund in accordance with the policies of the Fund.

Sincerely yours,

/s/

O.P.F. Horwood  
Minister of Finance

Mr. Jacques de Larosière  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431, USA

Memorandum on the Economic Policies of the Republic of South Africa

1. During 1980 the South African economy experienced unprecedented economic growth. The sharp increase in the gold price had removed the balance of payments constraint and, until the latter part of the year, domestic supply conditions did not constitute a serious constraint on output. Business and consumer confidence boosted expenditure, and economic policies were designed to accommodate demand and promote growth. However, by the end of 1980, owing to the recession in South Africa's major export markets and the weakening of the gold price, the balance of payments constraint re-emerged. At the same time, high capacity utilization rates and shortages of skilled labor contributed to an acceleration of inflation. Despite uncertainties about the duration of the recession abroad and the adverse shift in the terms of trade, and about the seriousness of domestic supply constraints, the need for adjustment was recognized. However, at that stage the excess liquidity and abnormally low interest rates inherited from the two preceding years of large balance of payments surplus provided more than enough scope for demand to rise unduly, and added to the difficulties facing the monetary authorities. It therefore took some months before the attempts of the authorities to bring about a meaningful tightening of the financial situation began to show positive results. Later in the year, and into 1982, economic policies were tightened further and strong adjustment measures have now been introduced.

2. It is clear with hindsight that, during 1981 as a whole, monetary policy was too accommodating, in part because a number of specific institutional problems weakened monetary control. Reintermediation, after the abolition of quantitative constraints on bank credit in September 1980, led to a swelling of the monetary aggregates in early 1981. Because of the record maize crop, there was an unprecedented amount of concessional credit to the agricultural sector. Easy and relatively cheap access to the Reserve Bank's discount window undermined the reserve constraint on commercial banks' credit expansion. In the latter part of the year, the Reserve Bank was forced to temporarily finance more of the government deficit than had initially been planned. In addition, large losses on official forward exchange contracts contributed importantly to monetary expansion. Fiscal policy was far more cautious, but it, too, in retrospect, did not fully respond to the need for adjustment in 1981/82. The growth of expenditure accelerated to 21 per cent, owing chiefly to substantial increases in interest payments on the public debt and in the government wage bill. On the revenue side, although receipts from the gold mines, which had contributed more than a quarter of total revenues in the previous year, fell by over 40 per cent, there was a compensating increase in other tax revenues. The deficit amounted to about 3 per cent of GDP, and although this was not high by historical standards, it did--in the context of the generally buoyant demand for credit--serve temporarily to exacerbate the difficulties of monetary control. External policies were allowed greater flexibility in 1981. In response to the worsening external position, the value of the rand was allowed to depreciate substantially and about R 3 billion of official balance of payments financing was provided.



3. In early 1982 the Government shifted the thrust of economic policy from accommodation to adjustment. Monetary policy was considerably tightened. Interest rates were allowed to rise and are now positive in real terms and better aligned with those abroad. The link between Bank rate and the prime lending rate was broken, and the prime rate, which had already risen from 9 1/2 per cent in early 1981 to 17 per cent in December of that year, increased further to 20 per cent in March 1982. Treasury bill rates were allowed to rise substantially to attract nonbank subscriptions. Strict interest rate penalties have been imposed on recourse to the Reserve Bank's discount window. In addition, the usury ceilings on bank lending up to amounts of R 100,000 have been raised, interest rates on government paper have been allowed to respond to market forces, and the concessional element in agricultural finance through the Land Bank has been greatly reduced. In response, by mid-1982 the rate of growth of the major monetary aggregates had fallen substantially, and bank deposit rates, which are market determined, had risen significantly. The need for further tightening of fiscal policy was already recognized before the end of the 1981/82 fiscal year and significant tax measures were introduced. The budget for 1982/83 went further in the direction of austerity. The overall deficit was budgeted at about 2 3/4 per cent of GDP despite a projected fall of over 50 per cent in gold-related revenues. This required substantial new revenue measures, including a loan levy on individuals, an income tax surcharge on companies, and selected increases in excise taxes on luxury goods. Together with pre-budget measures, these changes are expected to yield an amount equivalent to over 2 per cent of GDP and to increase nongold revenues by almost a quarter. Government expenditure in 1982/83 was budgeted to decline in real terms. The stricter monetary and fiscal policies have been accompanied by continued exchange rate flexibility. After a 14 per cent effective depreciation during 1981, the rand has depreciated by a further 10 per cent in the first seven months of this year. In early 1982, for the first time in its history, it was allowed to fall below parity with the U.S. dollar, and by end-August 1982 it stood at R 1 = US\$0.87. Although these measures have already begun to curtail demand, the balance of payments has deteriorated further in the first half of 1982, owing chiefly to the continued weakness of export markets and the further decline in gold prices. The Government is determined to strengthen its adjustment efforts until a sustainable external payments position is reached.

4. The objective of the stabilization program is to adjust the economy to the changed external conditions as rapidly as possible without jeopardizing the longer-term growth potential of the economy. In order to safeguard the program, the Government has based its policy planning on a conservative view of the future gold price. The current account deficit, which averaged about 2 per cent of GDP over the postwar period, is to be reduced progressively from the equivalent of about 6 per cent of GDP (close to R 5 billion) in 1982 to 2 per cent of GDP (R 1.8 billion) in 1983. Taking into account projected capital inflows, the overall payments deficit should decline from R 2 1/2 billion in 1982 to around R 1 billion in 1983. The principal instruments for achieving this objective will be

credit policies, fiscal policies, and continued flexibility of the exchange rate. A slow recovery abroad is assumed, and very little improvement in the nongold terms of trade. Because of the substantial depreciation of the rand over the past 18 months and the recent adjustments in administered prices, consumer price inflation is expected to rise from 14 per cent in 1981 to 16 per cent in 1982, before falling back to 14 per cent in 1983. After the vigorous real growth over the last two years, the demand restraint in 1982/83 will bring about a period of consolidation; real GDP is projected to remain flat in 1982 and to decline slightly in 1983. The Government will, however, continue to press ahead with infrastructural development and training programs to reduce the domestic bottlenecks that have constrained growth in the past.

5. The emphasis of monetary policy has been on curtailing demand and containing the external payments deficit and domestic costs. As noted in paragraph 3, a number of policy initiatives have recently been introduced to strengthen control over the monetary aggregates. Consistent with the real output, price, and external payments projections, the Government has targeted the growth of broad money (defined as M2 plus long-term deposits with the banking system) at about 12 per cent during 1982, and about 10 per cent during 1983. The expansion of domestic credit of the banking system is to be limited over the program period, as is the increase in net credit to Government. The ceilings for both are set out in Table 1. Should the price of gold decline significantly from the level assumed in the program, more vigorous adjustment will be required in order to attain the external objective. Accordingly, the rate of growth of domestic credit will be progressively reduced if the price of gold were to decline substantially from this level on a sustained basis. In limiting monetary growth, the Government will not rely on quantitative ceilings on commercial bank lending, but rather on management of the cash base and flexibility on interest rates. Such an interest rate policy would attract external capital and, accordingly, the Government intends to limit to exceptional circumstances the provision of incentives in the form of forward exchange rates to encourage the use of foreign credits. Market-determined interest rates will also help elicit adequate domestic savings and ensure an economically efficient allocation of credit.

6. The Government regards fiscal restraint as essential to the success of the stabilization program. As stressed in paragraph 3, the budget for 1982/83, which projects a reduction in real spending and a substantial tax effort, already represents a shift toward fiscal austerity. The budget deficit of R 2.4 billion, or about 2 3/4 per cent of GDP, will not be exceeded and will be financed entirely outside the banking system. However, the higher-than-expected rate of inflation has put pressure on spending, and the Government has raised the general sales tax, effective September 1, 1982, from 5 per cent to 6 per cent, in order to adhere to the original deficit target. This additional tax effort will also boost revenues in the next fiscal year by about 3/4 per cent of GDP. The budget for 1983/84, which has yet to be formulated in detail, will also be consistent with the financial program. It is intended to reduce total government spending again in real terms, to further reduce the

overall deficit to some 2 per cent of GDP (about R 2 billion), and to finance it entirely outside the domestic banking system. Moreover, the Government does not expect to borrow externally more than R 300 million (net) during the period of the arrangement. Over the past two years, government consumption expenditure has risen rapidly, owing chiefly to the need to maintain salaries competitive with the private sector. However, with the slowing down of the real economy and wage inflation, smaller increases in the wage bill are envisaged. Additional restraint on other current spending will permit expenditures on important infrastructural projects and on critical training programs to be continued to help ease domestic supply constraints. In addition, the Government intends to take appropriate tax measures to achieve the fiscal objective.

7. In February 1982 the Government introduced a 10 per cent surcharge on nongovernment imports that were not subject to GATT bindings. The primary purpose of this measure was to raise revenue rather than restrict imports and, at the time of its introduction, the Government indicated that it was of a temporary nature and would eventually be phased out. Revenue raised through this surcharge amounted to R 340 million during the period through end-September 1982. However, the Government recognizes that the surcharge, although an efficient means of raising revenues, also produces distortions of trade. Accordingly, on October 4, 1982, the Government announced that, effective January 1, 1983, the surcharge rate would be reduced to 7 1/2 per cent. The Government intends to phase out the surcharge completely during the program period. The date for the complete removal will be decided in conjunction with the 1983/84 budget and the mid-term review of the program.

8. The balance of payments objective of the program is to be achieved principally through an improvement in the trade account. The Government recognizes that the achievement of this goal will require the maintenance of a flexible exchange rate policy. The rand has depreciated considerably during the past 18 months. The Government considers the current level of the real effective exchange rate to be broadly appropriate for safeguarding the competitive position of the exporting and import-substituting sectors. Should external circumstances require it, the Government will pursue its exchange rate policy with the appropriate degree of flexibility.

9. The Government of South Africa has followed a prudent external debt management policy limiting its direct borrowing to the smoothing out of reversible fluctuations in official reserves and limiting the issuance of external debt guarantees to the financing of a small number of commercially viable projects. The stock of outstanding public and publicly guaranteed debt with a maturity of over one year amounted to US\$5.6 billion at the end of March 1982, while its servicing in 1982 will be equivalent to about 8 per cent of exports of goods and nonfactor services. The Government intends to continue its prudent external debt policy during the period of this arrangement, with the debt service ratio expected to remain below 10 per cent over the medium term. In addition, the Government intends to exercise restraint on its short-term borrowing abroad.

Table 1. Ceilings on Net Credit to Government and Domestic Credit  
of the Banking System

(In millions of rand)

	Banking System	
	Net credit to Government	Domestic credit
Amount outstanding on June 30, 1982	6,933	31,353
Amount outstanding on December 31, 1982	8,050	34,150
Amount outstanding on March 31, 1983	7,500	35,450
Amount outstanding on June 30, 1983	8,200	36,650
Amount outstanding on September 30, 1983	8,100	37,450
Amount outstanding on December 31, 1983	8,500	38,600

Note: Net credit to Government includes Exchequer foreign borrowing and those items in the banking system accounts which are classified by the South African authorities as "other items, net" but which are for the account of the Government.

The ceilings on domestic credit of the banking system will be adjusted to reduce the growth of domestic credit by half a percentage point at an annual rate for each US\$10 that the price of gold, averaged over the three-month period ending on the date a credit ceiling is to be met, falls below US\$300 per fine ounce. Any such reduction will be applied cumulatively in respect of consecutive quarters in which an adjustment is required.