INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 08/137
FOR IMMEDIATE RELEASE
October 22, 2008

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation with South Africa

On September 8, 2008 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with South Africa.[1]

Background

South Africa's economic performance has strengthened in the last several years, with real GDP growing by 5–5½ percent in 2005–07, inflation declining to mid-single digits until recently and employment growing steadily. Growth last year was driven by strong domestic demand, with private consumption and investment spending supported by robust consumer and business sentiment. Household consumption was also boosted by growing disposable income, rising employment, and wealth effects from rising asset prices until late in the year. Total employment grew by 3.4 percent in the year to September 2007 and the unemployment rate declined to 23 percent.

However, 2008 saw a slowdown in activity reflecting the cumulative impact of electricity power shortages, the global slowdown, and past monetary tightening. Real GDP growth slowed to 4.2 percent (year-on-year) in the first half of 2008, and subsequent high-frequency indicators point to further moderation.

Inflation pressures have intensified further. Twelve-month CPIX inflation has been rising since early 2007—reaching 13 percent in July 2008, well above the South African Reserve Bank's (SARB) 3–6 percent target range—mainly reflecting rising global food

[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.

and fuel prices and, until recently, demand pressures.[2] Inflation expectations for the year ahead have picked up markedly. In response to the deteriorating inflation outlook, the SARB has raised its policy interest rate by 300 basis points since June 2007, to 12 percent by June 2008, but decided to keep it on hold in August in light of falling commodity prices and some moderation in inflation expectations.

Credit to the private sector has begun to moderate but still remains resilient, expanding by 20.3 percent in the year ending in June 2008. Household debt rose slightly to a record level of 78¼ percent of disposable income by the first quarter of 2008. Pushed mainly by rising interest rates, household debt service has risen to about 11¼ percent of disposable income, but remains below historic highs.

Asset prices continued to rise rapidly in 2007 but has moderated significantly since then. Strong commodity prices drove the JSE all-share index up by 16 percent in 2007. In 2008 the index fell by 4 percent through July, reflecting weakness in financial and manufacturing share prices, which were only partially offset by the strong performance of resource equities. Residential property prices recently slowed considerably, growing by about 4 percent in the year ending in June 2008.

The current account deficit expanded sharply to 7¼ percent of GDP in 2007 and almost 9 percent in the first quarter of 2008, driven by strong public and private investment and rising international oil prices, before narrowing somewhat to 7¼ percent of GDP in the second quarter of 2008. The deficit was financed by a mixture of equity and debt-creating inflows, bringing external debt to 26½ percent of GDP by end-2007. Net portfolio flows were negative in the first quarter of 2008 and the current account deficit was covered by the proceeds from a large foreign direct investment (FDI) deal and an increase in nonresident bank deposits; net portfolio inflows turned positive again in the second quarter. Risk premia on South African debt in international markets rose steeply in the first quarter of 2008, reflecting turmoil in global financial markets, before moderating somewhat by mid-year.

The SARB has maintained a flexible exchange rate system, with a publicly-announced policy of purchasing foreign exchange on the market only to bolster its reserve position. Consistent with this policy, gross reserves grew to US$34.9 billion by June 2008— well over 200 percent of short-term external debt. After depreciating markedly in early 2008, the rand strengthened somewhat by end-July 2008. In real effective terms, the rand has depreciated by 10 percent in the 12 months ending April 2008.

The fiscal balance of the national government turned into a surplus of 0.9 percent of GDP in FY2007/08, bringing government debt down to about 28 percent of GDP. The surplus, the second in a row, reflected a large increase in tax revenue, owing to strong economic activity over most of the period and continued collection efforts. Total public debt, including obligations of public enterprises and local governments, fell to about 35 percent of GDP.

[2] The CPIX—the measure targeted by the SARB—excludes interest payments on mortgage loans.

Executive Board Assessment

Executive Directors welcomed the significant economic strides made by South Africa over the past several years, reflected in high economic growth, low inflation, and rising employment. These achievements have been based on sound macroeconomic policies and a transparent policy framework. South Africa's economic fundamentals remain strong, the external debt is low, and the financial system is resilient.

Recent developments, however, have heightened economic vulnerabilities and made more challenging the achievement of the authorities' medium-term growth strategy. In particular, global food and fuel price shocks have boosted inflation and the external current account deficit, while economic growth has slowed in the context of still-high levels of unemployment and inequality. On the domestic side, an elevated household debt and debt service burden poses further risks to growth and possibly to pockets of the financial system. The deterioration of the economic outlook has heightened the risk of a slowdown of capital inflows. Directors accordingly underlined the importance of continuing to address the constraints to economic growth and job creation, while taking steps to preserve macroeconomic stability and strengthen economic resilience. This will require redoubled efforts to raise South Africa's national saving rate, improve infrastructure, and implement further structural reforms.

Directors welcomed the authorities' pursuit of a prudent fiscal policy, and their intention to maintain a broadly neutral fiscal stance in 2008 while strengthening the social safety net in response to the increase in food prices. Directors acknowledged South Africa's pressing infrastructure and social spending needs, and noted the authorities' plan to raise public investment significantly. Given the importance of sustaining investor confidence and the limited scope for raising private saving, most Directors called for an increase in public saving so as to bring the structural public sector borrowing requirement to zero over the next few years. This should be achieved mainly by containing current expenditure and increasing spending efficiency. Several Directors suggested that the authorities explore options for addressing infrastructure and social needs that would avoid weakening fiscal policy—for example, by relying more widely on public-private partnerships established within an appropriate transparent regulatory regime.

Directors considered that the inflation targeting framework has served South Africa well. They supported the tightening of monetary policy so far in 2008 to contain inflation expectations and the second-round effects of the food and fuel price shocks. They noted the central bank's current pause in further tightening, but considered that the authorities should stand ready to raise interest rates further if supply shocks resume or domestic demand pressures do not dampen as expected. Some Directors considered that conditions warrant the resumption of monetary tightening. Directors also considered the effective lengthening of the policy horizon for bringing inflation back within target range to be appropriate, given the increase in inflationary pressures. They commended the high quality of the central bank's written communications and public discussions, and underscored the continued importance of a clear communication strategy for containing inflation expectations.

Directors considered that South Africa's floating exchange rate has served as a useful buffer against external shocks, limiting foreign exchange exposure in balance sheets and discouraging speculative inflows. While acknowledging the considerable uncertainty surrounding estimates of the equilibrium value of the currency, Directors took note of the staff's tentative assessment that the currency may be moderately overvalued. Directors supported the authorities' policy of gradually building up international reserves.

Directors welcomed the Financial Sector Assessment Program (FSAP) update finding that South Africa's financial system is sound, well capitalized, and well regulated. They stressed the importance of the authorities' continued proactive engagement with banks to ensure that capital and liquidity buffers are adequate—especially in the current context of a less benign environment, including high exposure to the household sector. Directors called for prompt implementation of the FSAP update recommendations—in particular, those relating to deeper forward-looking financial stability analysis based on bank-level data, and to an improved regulatory framework based on consolidation of the supervision of financial conglomerates and strengthened insurance and pension supervision.

Directors stressed the importance of structural reforms to boost productivity and employment growth. Possible fiscal reforms to be explored include deficit-neutral modifications to revenue and expenditure policies aimed at strengthening incentives to invest and work. Directors also encouraged the authorities to persevere with steps to open the economy to greater international competition, strengthen product and labor market competition, and improve education outcomes.

South Africa: Selected Economic Indicators, 2004-08
(Annual percent change, unless otherwise indicated)

	2004	2005	2006	2007	2008 Proj.
Real GDP	4.9	5.0	5.4	5.1	3.8
CPI (metropolitan areas, annual average)	1.4	3.4	4.7	7.1	11.3
CPIX [1, 2]	4.3	4.0	5.0	8.6	11.6
Broad money [2]	13.1	20.5	22.5	23.6	26.3
Unemployment rate (percent)	26.2	26.7	25.5	23.0	22.9
National government budget balance (percent of GDP) [3]	-1.6	-0.6	0.4	0.9	0.5
National government debt (percent of GDP) [3]	36.4	35.3	33.1	28.6	25.6
External current account balance (percent of GDP)	-3.2	-4.0	-6.5	-7.3	-9.0
External debt (percent of GDP)	20.8	19.1	22.2	26.6	29.6
Gross reserves (SARB, in months of next year's total imports)	2.6	2.9	3.1	3.2	3.3
International liquidity position of SARB (billions of U.S. dollars) [2]	11.4	17.2	23.0	31.3	34.9
U.S. dollar exchange rate (rand per U.S. dollar) [2]	5.63	6.33	6.97	6.81	...

Sources: South African Reserve Bank; IMF, International Financial Statistics; and staff estimates and projections.
[1] The CPIX is equal to the CPI excluding interest payments on mortgage loans.
[2] End of period.
[3] Calendar year.