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December 1, 1993

To: Members of the Executive Board

From: The Acting Secretary

Subject: South Africa - Staff Report for the 1993 Article IV Consultation, and Request for a Purchase Under the Compensatory and Contingency Financing Facility

Attached for consideration by the Executive Directors is the staff report for the 1993 Article IV consultation with South Africa and its request expected to be received for a purchase equivalent to SDR 614.43 million under the CCFF, which is tentatively scheduled for discussion on Wednesday, December 22, 1993. A draft decision appears on page 22.

Mr. Lipschitz (ext. 38866) or Mr. Rozwadowski (ext. 37862) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the GATT Secretariat, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 1993 Article IV Consultation and Request for a Purchase Under the Compensatory and Contingency Financing Facility

Prepared by the African Department
and the Policy Development and Review Department

(In consultation with the Fiscal Affairs, Legal, Monetary and Exchange Affairs, Research, and Treasurer's Departments)

Approved by E. L. Bornemann and Anoop Singh

November 30, 1993

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I. Introduction

A staff mission visited Pretoria, Johannesburg, and Cape Town during October 7-18, 1993 to conduct the 1993 Article IV consultation discussions and to discuss prospective access to Fund resources under the compensatory and contingency financing facility (CCFF). 1/ The Managing Director has been informed that the South African authorities will shortly request a purchase in an amount equivalent to SDR 614.43 million (45 percent of quota) under the CCFF decision (Decision No. 8955-88/126, adopted August 23, 1988, as amended). This request will relate to a shortfall in merchandise export earnings combined with an excess in cereal import costs for the year ending June 1993. South Africa has no outstanding purchases under the CCFF or other Fund facilities and has accepted the obligations of Article VIII, Sections 2, 3, and 4.

At the Executive Board meeting that concluded the 1991 Article IV consultation (EBM/91/192, 11/11/91), Directors expressed the hope that the removal of the last legislative pillars of apartheid would be followed quickly by agreement on a new political dispensation. It was understood that policies in the new South Africa would need to address the economic and social aspirations of the majority of the population. But Directors cautioned that the Government should focus on establishing conditions conducive to more rapid growth with lower inflation, and that the political objective of short-term social upliftment should not be pursued at the expense of the longer-term growth potential of the economy. Against this background, Directors were concerned about the widening imbalance in the government accounts.

The last two years have seen enormous political changes that will present both opportunities and challenges to economic policy; these are described in part in the staff report for the 1992 Interim Article IV consultation (SM/92/189, 10/14/92). General elections have been set for April 27, 1994. Parliament has passed legislation to establish a

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1/ The staff team comprised Mr. Lipschitz (AFR), Ms. Meesook (PDR), Messrs. Ibrahim, Rozwadowski, and Gordon (all AFR), Mr. Chadha (RES), and Ms. Duane (AFR). The mission met with Mr. Derek Keys, Minister of Finance and of Trade and Industry; Dr. Chris Stals, Governor of the Reserve Bank; and other senior officials in the Reserve Bank, the Development Bank of South Africa, the Manpower Commission, the Central Economic Advisory Service, the Industrial Development Corporation, and in the Departments of Finance, State Expenditure, Agriculture, Trade and Industry, and Manpower. Mr. François le Roux, South Africa's Principal Resident Representative to the IMF, attended the meetings. Members of the mission also met with representatives of the African National Congress (ANC), the Inkatha Freedom Party (IFP), the Pan Africanist Congress (PAC), various business forums, and the Congress of South African Trade Unions (COSATU).

Transitional Executive Council (TEC)--a multiparty body that will oversee the policies of the present Government in the run-up to the elections. Agreement has been reached on an interim constitution that is expected to have a major influence on the final constitution to be adopted by the new Parliament after the elections. But there are still difficult political hurdles to be negotiated: most importantly, the Freedom Alliance--a coalition that includes the Inkatha Freedom Party, the Conservative Party, and the Afrikaner Volksfront--withdrew from the negotiations and was not party to the agreement on the constitution. If the Alliance participates in the elections there will be a better chance of reducing the level of violence and establishing conditions conducive to free and fair elections.

The progress toward a new political dispensation prompted the ANC to call, in September 1993, for a lifting of trade and financial sanctions against South Africa. This elicited a positive response, and many of South Africa's trading partners have already abolished sanctions. At the same time the authorities reached agreement with foreign creditor banks on the repayment of South Africa's foreign debt after the expiration of the third interim debt agreement in December 1993.

Even before the establishment of the TEC, economic policy-making became more collaborative and consensus-oriented. As a precursor to the Subcouncil on Finance under the TEC, and, perhaps even to the modalities of economic decision making in the Government of National Unity that will follow the elections, a multiparty forum has been set up, under the chairmanship of the Minister of Finance, to review and advise on major macroeconomic policy decisions. The recent agreement with foreign creditor banks, for example, was approved by this body before it was finalized. Similarly, it was this body that, after discussions in which the staff participated, decided upon a request for a purchase under the CCFF.

In the last two years, the World Bank has devoted considerable resources to preparations for an envisaged resumption of lending to South Africa. The South Africans have expressed particular interest in the possibility of Bank involvement in the areas of urban services and the reform of industrial and trade policies, but the Bank has also done preparatory work in various other sectors, including education, health, and rural development.

Medium-term scenarios are presented in Appendix I; South Africa's relations with the Fund are summarized in Appendix II; basic data and social and demographic indicators are provided in Appendices III and IV, respectively. Appendix V describes South Africa's exchange restrictions and recent changes in exchange arrangements. Appendix VI contains background material for the CCFF calculations, while the authorities' Statement of Policies constitutes Appendix VII. An accompanying paper on Economic Issues provides background information and develops more fully some of the arguments referred to in this staff report.

II. Background to the Policy Discussions

Despite the considerable advantages of the South African economy--its enormous mineral endowment and the sophistication of its economic and financial institutions--economic policy in the next few years will face difficult hurdles. It will have to aim at restoring an economy damaged by decades of apartheid, years of sanctions, and deep recession since 1989 (Table 1 and Chart 1). Apartheid has left huge backlogs in areas such as education and training, housing and social infrastructure, and health care. It will be difficult to redress these backlogs quickly while still respecting basic fiscal and external constraints. Moreover, the effects of sanctions and the recession have weakened the economy and lessened its capacity to realize the expectations of the economically disadvantaged.

The financial sanctions that came into force in 1985 imposed a severe balance of payments constraint on an economy already enervated by political uncertainty (Chart 2). After a long tradition of being a net user of external savings, South Africa was denied access to international capital markets, obliging it not only to depend on its own domestic savings but also to repay foreign capital on a significant scale. To contain the capital outflow, the authorities reintroduced the financial rand system and negotiated a series of interim arrangements for the restructuring of part of the external debt. 1/ At the same time, both exchange rate policy and an intensification of trade protection were used in support of restrictive financial policies to bring about the required shift in the external current account balance.

Consequently, since 1986, South Africa has generated current account surpluses, averaging 2-3 percent of GDP per annum, compared with deficits of about the same magnitude previously. These surpluses allowed capital repayments of over 2 percent of GDP annually, and, until recently, some buildup in reserves. However, the containment of the external disequilibrium was at the expense of a slowdown in output growth, which was exacerbated by the investment-dampening effect of political uncertainty.

In mid-1989 the economy entered a recession from which it is just now beginning to emerge. The recession was remarkable for its duration and its harshness on employment. It was initiated by a drop in investment and then substantially exacerbated, in 1992, by a drought that reduced agricultural production by 25 percent. Between the third quarter of 1989 and the fourth quarter of 1992, real GDP dropped by 5 percent: industrial production fell

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1/ At the end of August 1985, South Africa imposed a "standstill" in respect of part of its foreign debt, largely short-term bank claims. The standstill was followed by three successive interim arrangements that provided for the gradual repayment of a portion of the affected debt, and allowed for the conversion of part of the debt into medium- and long-term loans outside the standstill net.

by 5 percent, production in the primary sector by about 22 percent, and the output of the services sector rose slightly. By 1992, per capita GDP was some 15 percent below the level of the early 1980s (Chart 3) and the investment ratio had dropped by one third, to about 15 percent of GDP, barely sufficient to offset capital depreciation. Output in the first half of 1993 was almost 1 percent higher than in the second half of 1992 (seasonally adjusted annual rate), but this is almost entirely attributable to the end of the drought; investment remains depressed (aside from a few large projects under special depreciation allowances) and there has been no pickup yet in industry.

While most recessions in South Africa have been characterized by some labor hoarding and a corresponding drop in productivity, this recession saw layoffs leading the drop in output, a loss of more than 300,000 jobs in the formal sector of the economy between 1989 and 1993, and an increase in nonfarm productivity over the same period. With the labor force growing by some 370,000 workers each year, the last few years have seen a surge in unemployment. Official calculations show that about 45 percent of the labor force was unable to find jobs in the formal sector in 1992; the situation has worsened appreciably since then.

Inflation, having been stuck at around 15 percent for the first two years of the recession, began to come down in the course of 1992. By September 1993, the 12-month rate of consumer price inflation had fallen to 9 percent (of which 2 percentage points were attributable to an increase in the value-added tax (VAT) rate earlier in the year) and producer price inflation had dropped below 6 percent. While relative price developments continued to appear unfavorable to investment and employment--unit labor costs were still increasing more rapidly than value added deflators--company profits in some sectors were being maintained by cost cutting, chiefly through retrenchments.

Fiscal discipline was eased considerably after 1990. The central government deficit (excluding extraordinary revenue) rose from 3 percent of GDP in 1990/91 to 8½ percent in 1992/93 (Chart 4). 1/ Besides the effects of the recession and the drought, the widening of the deficit reflected the introduction of the VAT at a lower rate than the general sales tax it replaced and a steep upward trend in expenditure on health, welfare, and education: the increase in spending on social services has amounted to 2½ percentage points of GDP over the last three years. In addition there were substantial off-budget allocations to various quasi-governmental bodies for housing and other social infrastructural expenditures.

The budget for 1993/94 sought--by means of higher indirect taxes, some fiscal drag, and a reduction in drought-related expenditure--to cut the deficit to 7 percent of GDP. The Government has also tried, by

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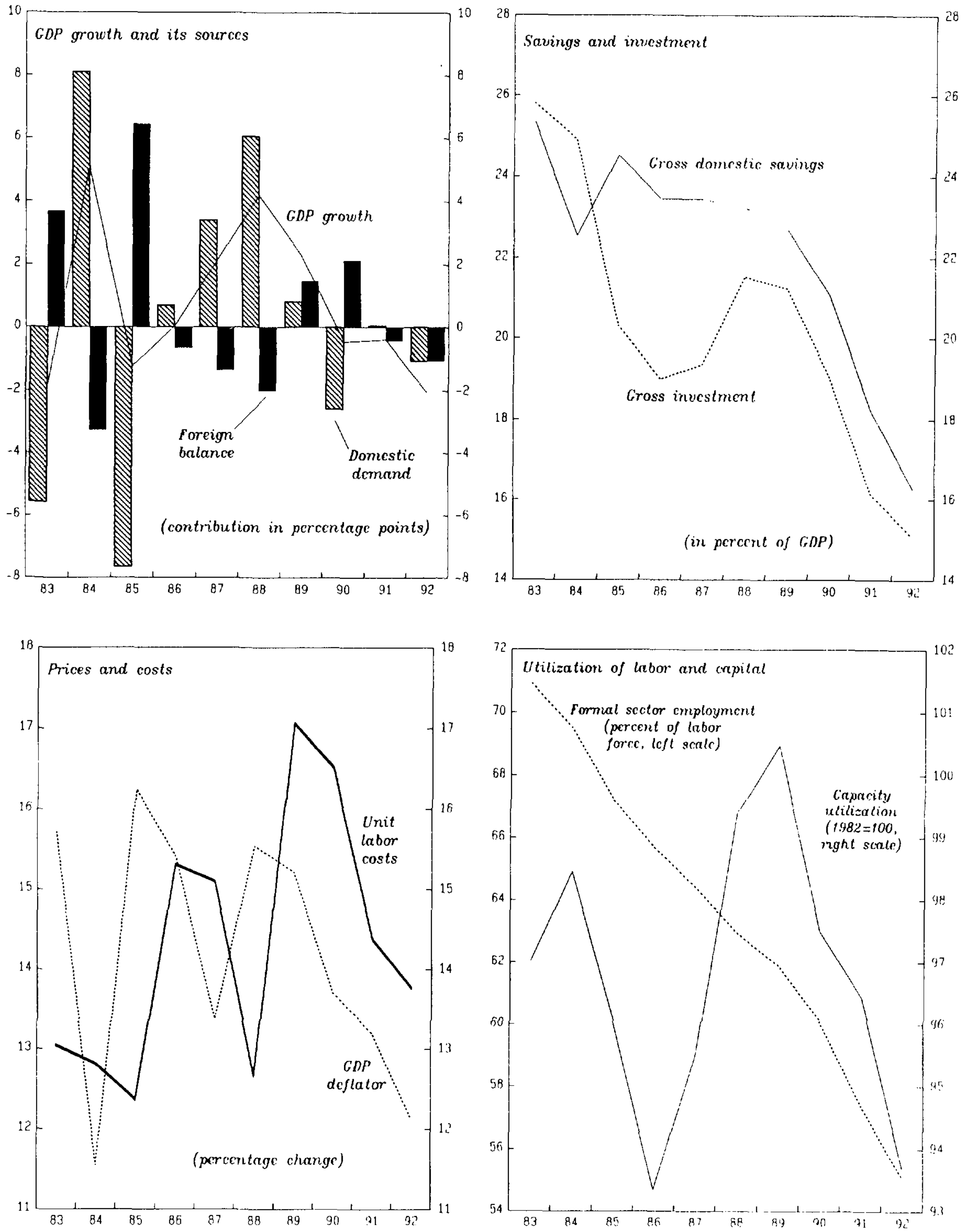
1/ Fiscal years run from April 1 through March 31.

CHART 1
SOUTH AFRICA

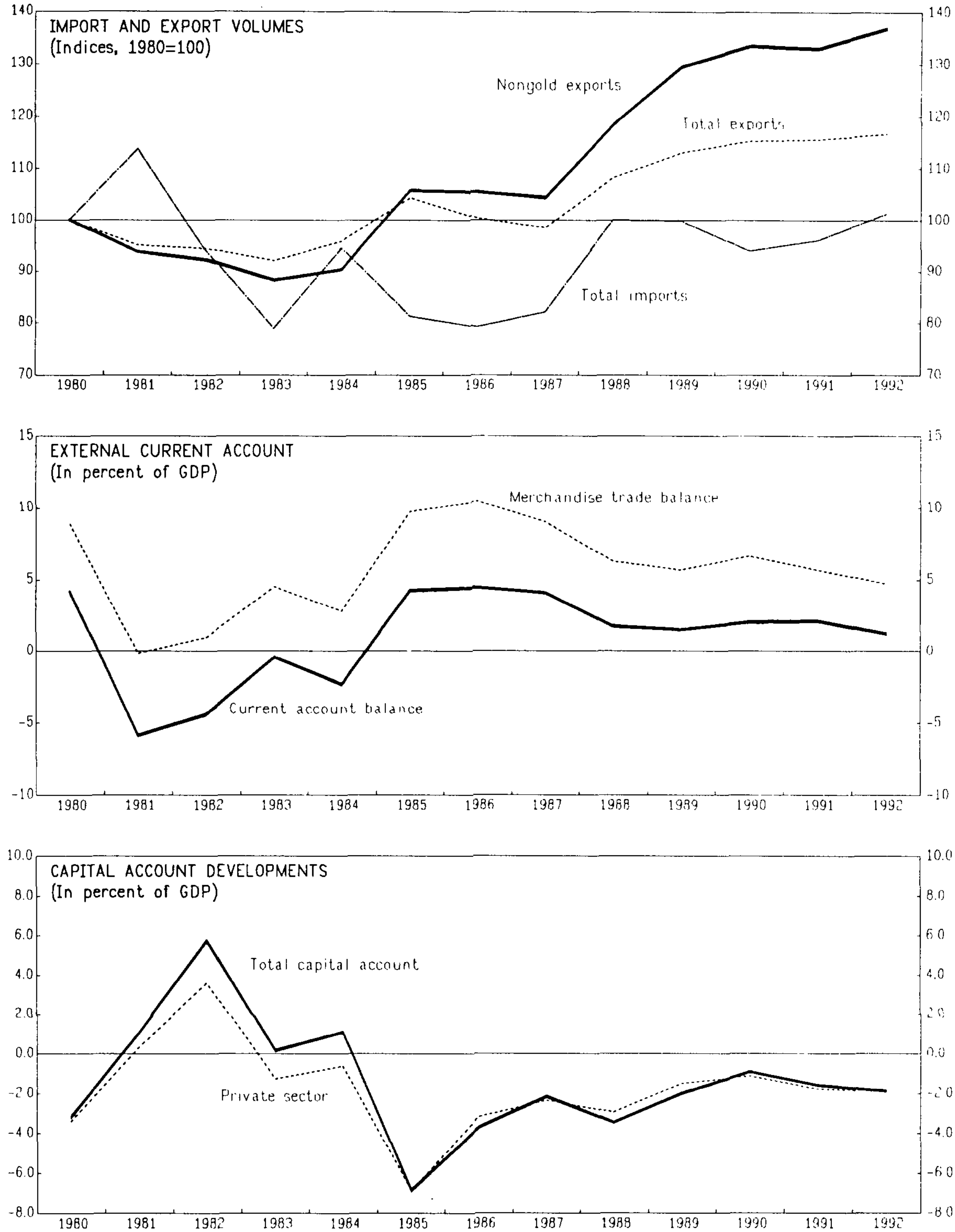
ECONOMIC DEVELOPMENTS, 1983-92



Source: South African Reserve Bank, Quarterly Bulletin.

CHART 2
SOUTH AFRICA

SELECTED BALANCE OF PAYMENTS INDICATORS, 1980-92

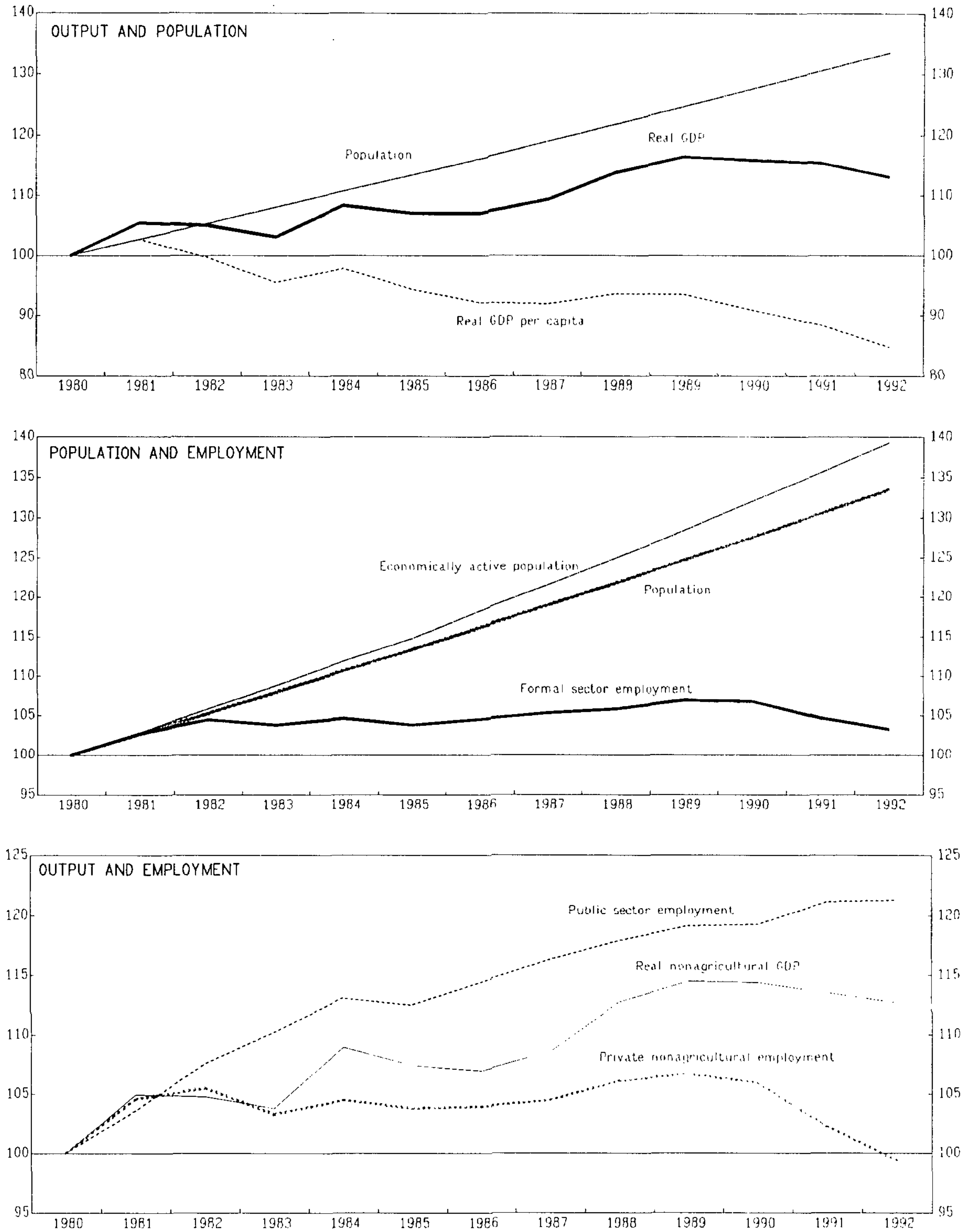


Source: South African Reserve Bank, Quarterly Bulletin.

CHART 3
SOUTH AFRICA

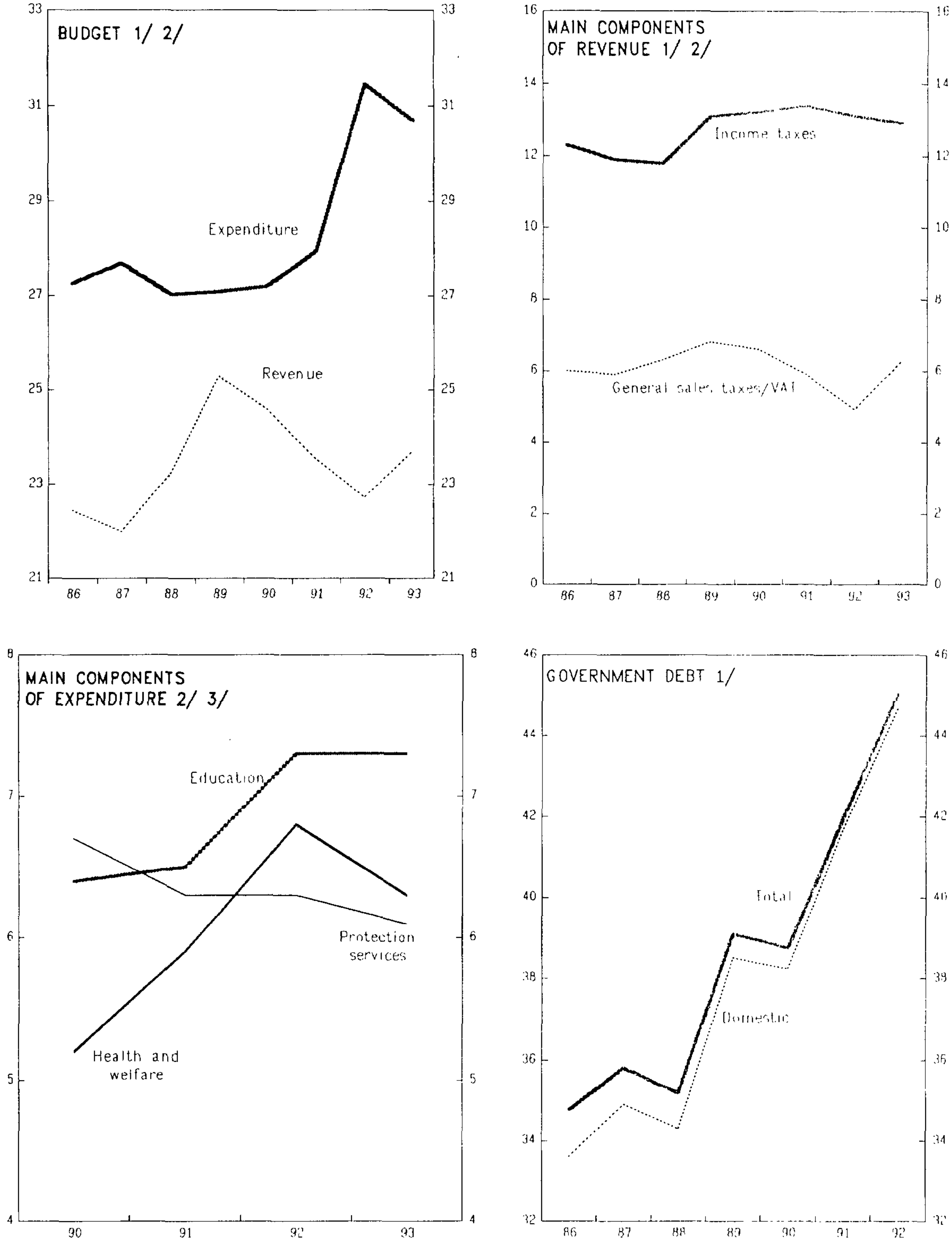
OUTPUT AND EMPLOYMENT, 1980-92

(Indices, 1980 = 100)



Source: South African Reserve Bank.

CHART 4
SOUTH AFRICA
GOVERNMENT FINANCES
(In percent of GDP)



Sources: South African Reserve Bank, Quarterly Bulletin; Department of Finance.

1/ Central Government.
2/ Fiscal year beginning April 1; budget estimate for 1993/94.
3/ General government.

restructuring the company tax and by shifting the overall tax burden back to indirect taxation, to address the problem of low domestic saving and investment. To date the deficit objective seems close to being attainable; despite inflation (and thus nominal income) being somewhat lower than projected, both revenue and expenditure are running slightly ahead of projections. Nevertheless, the combination of large deficits, slow growth, and high real interest rates has made for a fairly rapid accumulation of government debt. Officially, the central government debt ratio is still slightly below 50 percent of GDP, but it is much higher if one includes various government debt guarantees that are likely to end up on the government accounts, and higher still if one takes into account the actuarial underfunding of the government pension system.

Monetary policy has remained restrictive throughout the recession. The annual growth corridors for broad money (M3) (defined as percentage changes between fourth quarter averages) have been reduced from 14-18 percent in 1989 to 6-9 percent in 1993 (Chart 5). Since 1990 the upper limit of the range has been below the most recent actual fourth quarter-to-fourth quarter rate of consumer price inflation, and actual M3 growth has been generally within or close to the specified corridor. 1/

The data on credit expansion and the growth of broad money in real terms confirm that monetary policy has been highly restrictive. Correspondingly, despite the recession, interest rates have been positive in real terms throughout this period, with short-term real rates being above 5 percent (and the prime rate above 7 percent) at times over the last two years (Chart 6). As discussed below (Section III.4), it is arguable that, in the last year, faced with a predetermined fiscal position and pressures in the foreign exchanges, monetary policy was forced into a tighter stance than would have been desirable from a purely domestic point of view. It seems clear too that the costs of an anti-inflationary monetary policy over the last few years have been exacerbated by a degree of inertia in price and wage expectations.

The balance of payments, as noted above, has been severely constrained by the dearth of external financing stemming from financial sanctions. The series of current account surpluses (depicted in Chart 2) has brought about a steady decline in external indebtedness from more than 40 percent of GDP in 1985 to about 15 percent at present. The part of the debt caught in the standstill net has been reduced from US$14 billion (almost 60 percent of total debt) in August 1985 to about US$5 billion (30 percent of the total) at present. Even with this impressive reduction in the debt ratio to a

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1/ Broad money has seen virtually no growth to date in 1993, while the narrower aggregates have increased relatively rapidly. This may reflect some intercorporate credit consolidation, a change in relative interest rates across the maturity spectrum, the recent restructuring of reserve requirements, and, perhaps, the pickup in economic activity.

relatively low level, external finance has continued to be a binding constraint on economic policy during the last year and is likely to remain so in the short run.

Foreign exchange and gold reserves peaked in August 1992 and have since fallen to levels regarded as inadequate by the authorities. The current account was weakened in 1992 by the effects of the drought and by a continuation of the prolonged unfavorable trend in the terms of trade; the surplus dropped to only 1.2 percent of GDP from over 2 percent in the previous year. Although the most recent data show the current account strengthening again, reserves have been drained by sizable net capital outflows since the latter part of 1992. Domestic borrowers have been loath to roll over foreign loans at the prevailing high margins, and there are indications that some foreign banks have been curtailing credit lines to South African borrowers. As a result, net official reserves dropped from two months of imports of goods and services in August 1992 to only three weeks of imports in September 1993. Moreover, even assuming that trade credits and some short-term financing can be rolled over in 1994, scheduled debt repayments will amount to more than 2 percent of GDP. 1/

There is broad support in South Africa for the view that, with the end of sanctions, trade should provide the engine of growth to the economy. The trade policy reform that is planned for the next few years (see Section III. 5) will aim at reducing protection and redressing the anti-export bias in the system. The competitiveness of South African producers is critical to ensuring that trade reform does not founder on the fear of further job losses. Although export volume has more or less kept up with demand in partner countries in recent years, this has been more a reflection of weak domestic demand than of competitiveness. Thus, even after the 7 percent real effective depreciation of the commercial rand in the first nine months of the year, 2/ the staff remains concerned that South African manufacturing is not sufficiently competitive to provide the envisaged impetus to growth (Chart 7).

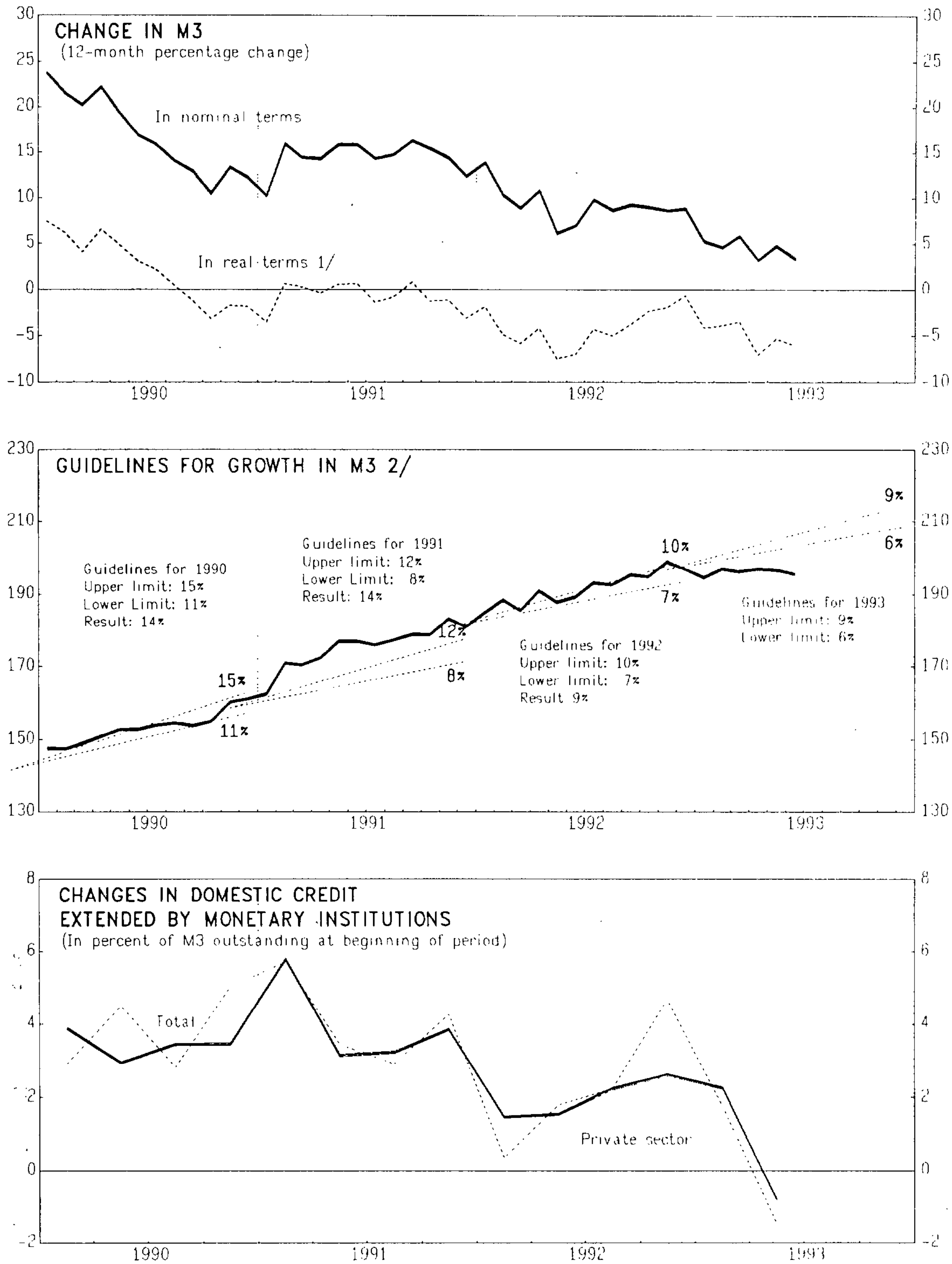
1/ South Africa recently concluded the 1994 Debt Arrangement with foreign creditor banks to regularize the part of its debt still affected by the debt standstill; the arrangement will be implemented over an eight-year period ending in mid-2001. The finalization of this agreement effectively eliminated South Africa's external arrears on capital repayments that have been outstanding since the coming into effect of the standstill. The terms of the agreement envisage 60 percent of the debt being repaid after 1998 when other existing obligations are much smaller. Nevertheless, it includes a commitment to repay 10 percent of the outstanding stock of debt in February 1994 and a further 3 percent in August.

2/ While most international transactions are conducted via the commercial rand, nonresidents' transactions in specified South African assets go through the financial rand market. A description and analysis of the financial rand system is contained in Chapter V of the accompanying paper on Economic Issues.

CHART 5

SOUTH AFRICA

SELECTED MONETARY INDICATORS, 1990-93



Source: South African Reserve Bank, Quarterly Bulletin.

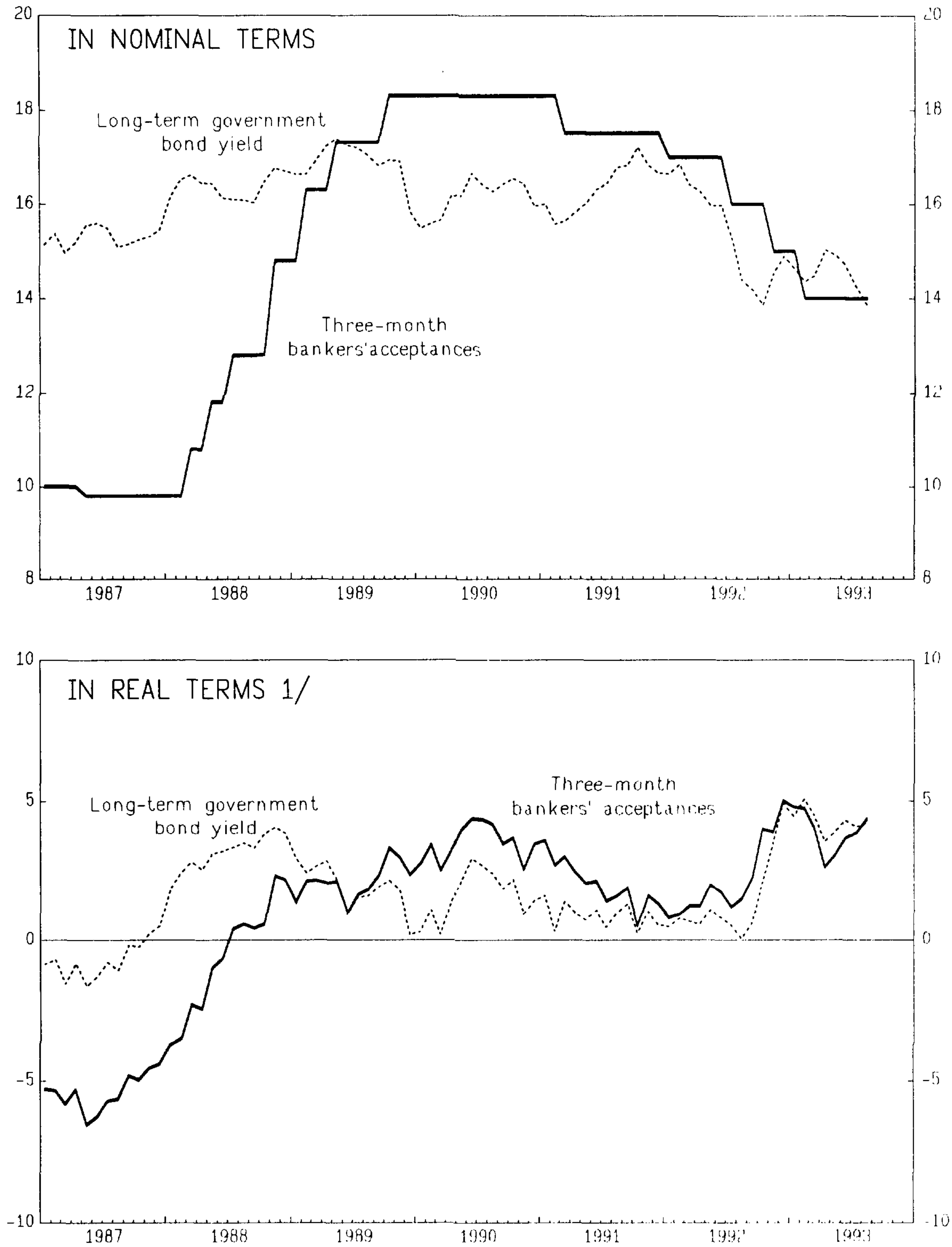
1/ Corrected for the change in consumer prices.

2/ Base of guidelines is average for fourth quarter (seasonally adjusted).

CHART 6
SOUTH AFRICA

INTEREST RATE DEVELOPMENTS, 1987-93

(In percent)

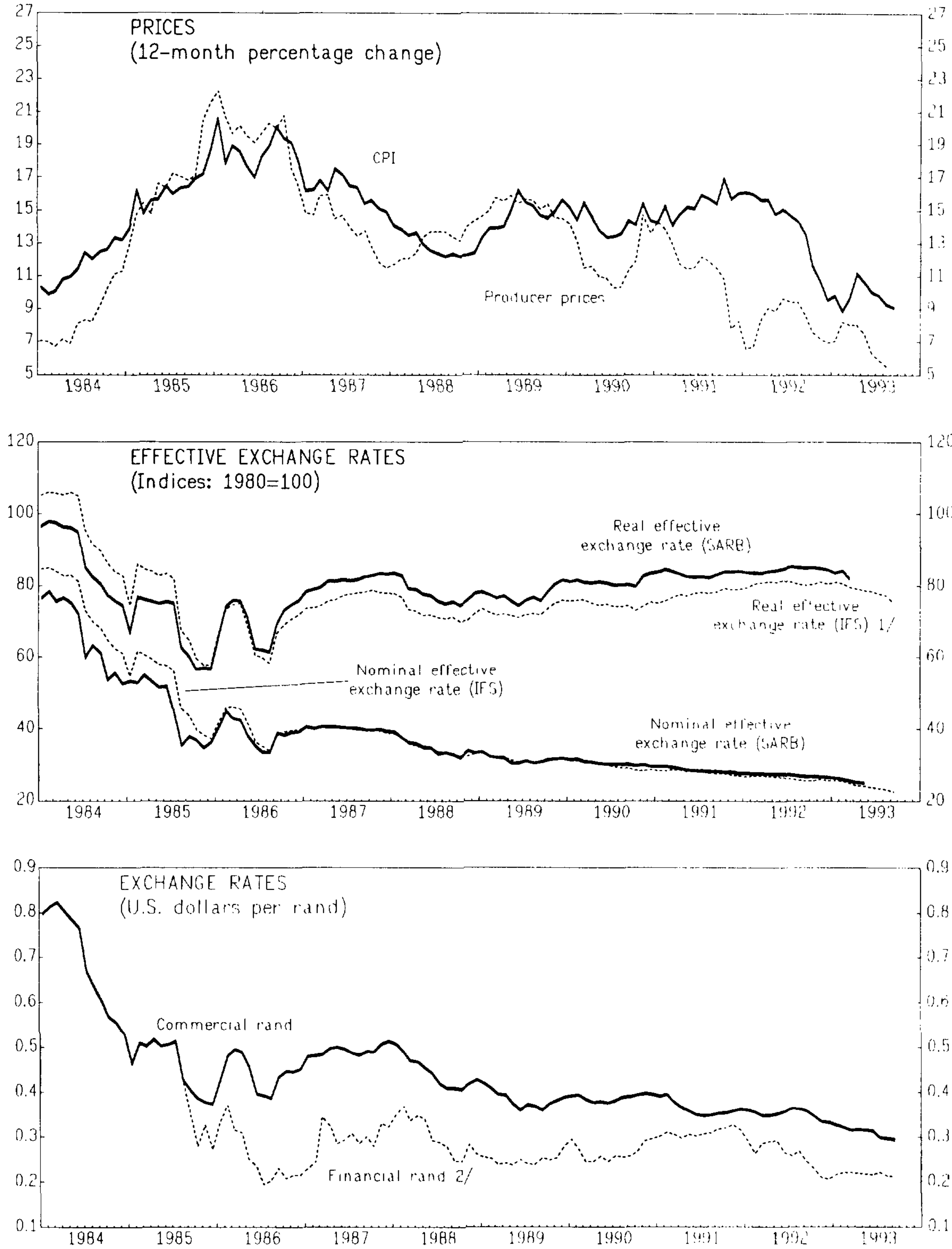


Source: South African Reserve Bank, Quarterly Bulletin; IMF, International Financial Statistics.

1/ Corrected for the change in consumer prices.

CHART 7
SOUTH AFRICA

PRICES AND EXCHANGE RATES, 1984-93



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

1/ Based on relative consumer prices.
2/ The financial rand was unified with the commercial rand in early 1983 before being reintroduced in 1985 following the imposition of financial sanctions.

III. Report on the Discussions

The discussions focused on two sets of issues: the immediate cyclical issues with which the authorities are grappling, and the longer-run structural considerations that, while already the subject of vigorous debate, will fall chiefly to the next Government to deal with. Of course, the two are not really separable. Indeed, a principal concern is that policies aimed at relieving the recession in the short run should not have detrimental longer-term effects.

The staff argued that the origins and special characteristics of the recession are not conducive to successful countercyclical macroeconomic policies: the economic data are not characteristic of a conventional Keynesian recession (that is, excess saving and a relaxation of the balance of payments constraint), the drought had nothing to do with slack demand, the weakness of investment is attributable in large part to violence and transitional uncertainties, and most of the unemployment is structural rather than cyclical. Thus, while the economy would not be entirely impervious to policy-induced demand stimulus in the short run, such stimulus would probably only paper over the fundamental problems and the output effects would prove unsustainable over time.

Economic developments beyond 1994 will depend upon the ability of the new Government to deliver benefits, inspire confidence, and adhere to sound economic policies. The Government will face three daunting sets of structural problems that will require urgent attention.

First, unemployment is very high and rising, and there is a significant insider-outsider problem in the labor market. Progress on employment may well be the most difficult task that the new Government will face. It will require the building of some sort of realistic political consensus on wages and productivity and, possibly, a re-examination of the institutional structures that govern wage settlements.

Second, it will be essential to heal the wounds of apartheid--that is, to make some visible progress in redressing the inherited social backlogs. Balancing this objective against the need to provide sufficient scope for private sector investment and growth and to respect the basic economic and financial constraints in the economy will require wisdom and adroit political and financial management.

Third, if trade is to be the engine of growth, domestic producers will have to be competitive in world markets. This is related to the issue of wages and productivity, but also to regulatory impediments to efficiency, trade policy reform, and exchange rate policy.

The discussions encompassed all of these issues and the extent of convergence of views was encouraging.

1. <u>The short-term outlook</u>

The short-term projections discussed were based on the macroeconomic policies that the authorities intend to implement. The fiscal framework involves reducing the Central Government deficit to 6 percent of GDP in 1994/95 (compared with a projected 7 percent in 1993/94). In this context, the Government has undertaken not to allow a real increase in civil service wages. On monetary policy, the authorities intend to maintain the present restrictive stance.

Staff projections are not significantly different from those of the authorities. The recovery to date has been weak and narrowly based. The staff expects growth of about ½ percent this year and perhaps 2-2½ percent in 1994. The projected increase in output in 1993 is attributable almost entirely to the end of the drought, with no appreciable rise in nonagricultural activity foreseen. Consumption remains weak and fixed investment continues to fall in real terms; positive demand stimulus in 1993 is expected to come from an end to inventory de-stocking (partly a rebuilding of agricultural stocks) and a recovery in net exports, which, of course, performed poorly in 1992 and early 1993. The projection for 1994 incorporates some slight growth in private consumption and fixed investment during the year and a modest pickup in nonagricultural production; however, about 1½ percentage points of the projected growth is simply statistical carryover from developments in the course of 1993.

Producer price inflation has fallen below 6 percent in the most recent 12 months, and consumer price inflation is currently about 9 percent on the same basis, or 7 percent excluding the effect of the April 1993 increase in the VAT rate. The outlook for 1994, assuming fiscal and monetary conditions in line with the pronouncements of the present Government, should be consistent with a consolidation of these gains on inflation. The unemployment situation, however, is dire, with almost half of the labor force unable to find jobs in the formal sector. Growth in employment in 1994 would have to be almost 3 percent--that is, higher than the projected growth of output--for there to be any reduction in the unemployment rate. Thus, unemployment is almost bound to worsen further next year.

In light of the end of the drought and more favorable gold prices, the current account surplus is expected to increase from 1 percent of GDP to about 1½ percent in 1993--a level more in line with the weakness of domestic demand. Even with imports beginning to pick up, this level of the current account surplus should remain more or less stable in 1994.

Projections beyond 1994 depend very much on the policies and priorities of the new Government: the extent to which it will be able to restore civil order, alleviate uncertainties, and foster confidence in the future of the economy. The staff has therefore addressed projections beyond 1994 in the form of alternative scenarios--see Appendix I and Chapter IV of the accompanying paper on Economic Issues--rather than simply midpoint estimates. These scenarios throw light on how investment, unit labor costs and government spending interact to influence the evolution of employment, output and the balance of payments. The motivating questions are not only how to achieve sustained growth in output but also how to make inroads into South Africa's pressing unemployment problem without compromising fiscal and external sustainability. The scenarios suggest, first, that even with favorable assumptions regarding labor market conditions, an increase in the investment ratio on the order of 8 percentage points of GDP would be needed to lower unemployment significantly. Second, since the fiscal stance of the Government is already of questionable sustainability, and government dissaving threatens to crowd out any incipient rise in private investment, growth strategies involving a large increase in government spending are risky.

2. Unemployment and the labor market

The staff's analysis of the labor market indicates that little of the current unemployment is cyclical. 1/ There is a large "wage gap"--that is, real wages in the formal sector are far above any conceivable market clearing level. The recent history of wage increases unmatched by productivity gains has (a) prompted retrenchments, (b) encouraged more capital-intensive production, and (c) shifted activity out of the formal economy (thereby narrowing the tax base).

The emerging institutional structure is likely to increase the degree of centralization of wage negotiations: the Congress of South African Trade Unions (COSATU) is the dominant voice for labor and it plays a major role in the ANC-led political alliance. More centralized negotiations militate against wage settlements that are responsive to differences in firm- and region-specific factors. In recent discussions the COSATU leadership has shown some sensitivity to the worsening insider-outsider problem--that is, high wage settlements that, while possibly benefiting the majority of union members, are forcing more and more workers out of the formal economy--and has argued that COSATU, being a broad political movement, seeks to represent all of labor. In the final analysis, however, the efficacy of centralized wage negotiations and, perhaps, an incomes policy will depend on whether COSATU chooses to represent the narrow interests of its members or the labor force as a whole.

The new Government will face the problem that market-clearing wages at current levels of productivity could be below levels deemed consistent with meeting basic needs. Clearly productivity-enhancing training programs will be part of the solution; but these will take time to bring results and it is unlikely that productivity gains will suffice to solve the problem. A solution will probably require simultaneous action on various fronts:

1/ An analysis of the labor market is contained in Chapter II of the accompanying paper on Economic Issues.

besides training, there will have to be wage restraint, a competitive exchange rate, trade reform to counter the anti-export bias in the present system, and policies to encourage economic networks between the formal and informal sectors of the economy (e.g., through subcontracting). There is already a vigorous domestic debate on the possible efficacy of incomes policy, perhaps combined with further depreciation. The risk in such a strategy is that if the incomes policy does not hold, all of the recent gains on inflation could be lost. The staff argued for greater austerity in public sector wages which have outpaced private sector wages in recent years; the outlook for the next fiscal year is for civil service wage increases about in line with the rate of inflation.

3. Fiscal policy

As indicated by the 1993/94 budget and various policy pronouncements, the present Government is committed to reducing recurrent expenditure and the deficit. The Government that will assume power after the April 1994 election will have to reconcile a need to cut the large deficit with enormous post-election pressures for additional spending. Even the most sanguine projections show relatively modest growth and further increases in unemployment in 1994; such an outcome will almost certainly elicit calls for a more expansionary fiscal stance and, in particular, job creation programs. Possibly even more compelling will be the desire to use fiscal policy to redress inherited economic disparities.

The staff found fairly broad agreement among its various interlocutors in South Africa--the Government, the parties in Parliament, and the nongovernmental groups--that the scope for countercyclical fiscal policy was severely constrained. (This agreement is on the macroeconomic envelope, not necessarily on its content; within broadly agreed magnitudes for government expenditure and taxation, there is likely to be substantial disagreement on the allocation of resources and the incidence of taxation.) The government deficit is already too high to allow a significant program of deficit spending or tax cuts. Moreover, the major part of the deficit appears to be structural rather than cyclical. 1/ Apart from some of the academic advisors to the ANC, there was general concern that an easing of fiscal policy would run up against constraints--that is, the scarcity of domestic saving and foreign financing, and the need to preserve the sustainability of the Government's financial position--that would lessen the scope for fiscal action over the longer run. (Some of these arguments are elaborated upon below.)

There is less than full agreement on the appropriate role of fiscal policy over the longer run; but even here there is some evidence of a

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1/ Chapter III of the accompanying paper on Economic Issues contains an analysis of the deficit that attempts to identify cyclical and structural components.

growing appreciation of the limits consistent with prudent financial policies. The potential budget cost of eliminating the racial discrepancies in social spending can be calculated under various assumptions. The figures below, for example, show the cost that would be incurred if government spending for all race groups were to be equalized at the level thus far applicable to whites.

Cost of Equalizing Social Spending at White Levels 1/
(percentage points of GDP in excess of the 1993/94 appropriations)

Non-tertiary Education	Health	Social Welfare	Total	Memorandum Item: Housing 2/	Total including Housing
9.1	1.2	0.3	10.6	0.6	11.2

Notably these figures exclude the potential cost of any land redistribution schemes and of the substantial extension of electricity and telephone services that is being considered by the parastatals. Nevertheless, they show a potential for increasing social expenditures equivalent to over 11 percentage points of GDP.

It is clear that the present tax base could not accommodate additional spending of anything near this magnitude without severe repercussions for economic activity in the private sector; social spending will, therefore, have to be equalized at a lower level. 3/ The case for fiscal restraint is based on considerations of the savings-investment balance and on the question of sustainability.

On the savings-investment balance, it is important to recognize that private fixed investment at present amounts to only about 11 percent of GDP, barely sufficient to replace depreciation (text table).

1/ This updates calculations in Occasional Paper 91, January 1992 and is based on figures for per capita spending on white South Africans from 1990--spending classified by race groups is no longer available.
2/ Assumes clearance of backlog at 10 percent per annum plus provision of housing to new urban arrivals.
3/ Direct tax rates are already relatively high by regional or international standards, and substantial increases would likely discourage domestic saving, investment, and entrepreneurship (see Occasional Paper 91, Chapter VI, and Chapter III of the accompanying paper on Economic Issues).

Savings-Investment Balances
(In percentage points of GDP)

	Private saving		Government saving (gross)		Foreign saving 1/		Change in inventories		Private fixed investment		Public sector investment 2/		Total saving and investment
1967	18.2	+	5.9	+	2.8	=	4.5	+	12.3	+	10.1	=	26.9
1972	21.3	+	3.5	+	0.9	=	-1.2	+	14.1	+	12.8	=	25.7
1977	25.1	+	2.4	+	-0.6	=	-1.1	+	13.7	+	14.3	=	26.9
1982	19.8	+	1.0	+	4.4	=	-2.7	+	15.9	+	12.0	=	25.2
1987	25.3	+	-1.8	+	-4.1	=	0.2	+	11.8	+	7.4	=	19.4
1992	20.4	+	-4.2	+	-1.2	=	-0.9	+	11.4	+	4.5	=	15.0

The present low level of saving available for investment reflects both government dissaving and foreign capital repayments. A sustainable rate of growth of per capita income consistent with visible progress on unemployment would require an additional 8-10 percentage points of investment. Without a corresponding boost to domestic saving, reduced government dissaving, or capital inflows, an incipient increase in investment of this magnitude would be thwarted by crowding out and would likely prove inflationary. 3/ It is difficult to see any solution to this problem that does not include some discipline on government dissaving. Moreover, the savings-investment identity highlights the link between fiscal policy and the balance of

1/ Positive foreign saving corresponds to an external current account deficit.

2/ The public sector consists of the public authorities (general government and business enterprises) and the public corporations.

3/ The lifting of sanctions might bring in some foreign financing and cyclical factors could reduce government dissaving by perhaps 1-2 percentage points. But this would still leave the economy well short of an adequate level of saving. This discussion is elaborated upon in the medium-term scenarios (Appendix I and Chapter IV of the accompanying paper on Economic Issues). Notably, the rate of investment and growth required for progress against unemployment is sensitive to factor prices: with lower unit labor costs, less investment is needed.

payments constraint: at the margin, government expenditure is financed by foreign borrowing at market rates plus risk premiums. This is particularly relevant in circumstances where, unless current account surpluses can be continued, scheduled repayments of foreign debt will require significant new foreign borrowing even before allowing for an increase in foreign reserves.

On sustainability, it is worth noting that the government debt ratio is rising rapidly (Chart 4). Moreover, as noted earlier, if one includes off-budget items, government guarantees that are likely to be called, and the actuarial underfunding of the state pension funds, it is much higher than the official figure of 45 percent of GDP. The staff's analysis (see Chapter III of the accompanying paper on Economic Issues) suggests that under various reasonable permutations of growth rates and real interest rates, the current structural deficit would lead to increases in debt that would soon swamp the Government's servicing capacity. Moreover, insofar as private investors are likely to delay commitments until the new Government is perceived to be following a sustainable policy path, attempts to engineer a recovery through fiscal expansion may well be detrimental even in the short run.

Although the case for fiscal discipline was not in serious dispute in general terms, the mission found widespread fears in official and business circles that competing demands on the government purse would compromise financial prudence. The staff stressed that, over the next few years, the Government would be faced with critical choices: to accommodate pressing social needs within a sustainable financial framework it will be essential to shift expenditures away from areas such as defense, social services for the relatively wealthy, and the excessive layers of bureaucracy spawned by apartheid. In any event, a rapid amelioration of the economic circumstances of those disadvantaged by apartheid will not be possible through fiscal policy alone.

4. Monetary policy and the exchange rate

Despite the stringency of monetary policy throughout the recession, there is surprisingly little disagreement, across the political spectrum, with the position of the Reserve Bank. It is broadly accepted that much of the burden of stabilization in the last few years has had to be borne by monetary policy--the dearth of foreign financing and growing government deficits necessitated restrictive credit policies and high real interest rates. Moreover, many attribute the high cost of stabilization--that is, the negative effects of tight money on the real economy--to wage rigidity.

In the last year monetary policy has been constrained by bouts of expectations-driven downward pressure on the rand. With limited reserves available for intervention, the Reserve Bank has had to choose between taking a tougher stance than was generally viewed as appropriate for an economy in recession or permitting a more pronounced depreciation. An important element in assessing the appropriateness of the monetary stance, therefore, has been a judgment on the extent to which a sharper nominal depreciation of the rand would have been offset by higher wage settlements. On this there is remarkable unanimity in Government, business and academia: all agree that a more rapid depreciation would have elicited a domestic inflationary reaction (albeit, perhaps not immediately). This suggests that, especially in light of the low level of reserves, the monetary authorities have had no option but to continue their highly restrictive stance. To do otherwise would have risked reversing the hard-won gains on inflation for no lasting beneficial effect on employment or output.

In light of the analysis in the foregoing sections, the case for an easing of monetary conditions will rest on (a) confidence in the economy, as reflected in the foreign exchanges; (b) fiscal performance and the domestic savings-investment balance, which will influence real interest rates; and (c) the responsiveness of wage settlements to conditions in the labor market.

The competitiveness of South African manufacturing is critical to an outward-oriented growth strategy. Although South Africa has run sizable trade surpluses during the period since the imposition of sanctions and the substantial real depreciation of the rand in 1985, this has required a depressed level of domestic demand and an interventionist trade policy. It is difficult to gauge the absolute level of competitiveness so soon after the lifting of sanctions--that is, it is not clear whether the post-sanctions world of 1994 will be sufficiently more benign to allow export-led growth without a further real depreciation. Clearly, relative price movements have eroded South Africa's competitive position since 1985. (Table 2 shows this to be true for a variety of indicators: relative price considerations have worked against resources shifting into the production of either exports or import substitutes, and have encouraged a shift in consumption toward imports.)

To the extent that balance of payments, growth, and employment considerations do warrant a further real depreciation, the question is how this can be achieved. If the prevailing view of the labor market is correct, any nominal depreciation will have to be relatively gradual to avoid a domestic cost response and get as much real improvement in competitiveness as possible. Besides this, all the considerations related to improving productivity and reducing both direct and indirect labor costs are equally relevant to the issue of competitiveness.

The mission found a widespread consensus in South Africa that the financial rand system should eventually be abolished. As recent developments illustrate, however, the capital account of the balance of payments remains highly vulnerable to changes in sentiment in reaction to domestic political developments, and in these circumstances, the authorities believe that it would be premature now to consider a phasing out of capital controls or an ending of the financial rand system. The normalization of relations with foreign bank creditors, however, constitutes the removal of an exchange restriction subject to Fund approval under Article VIII. 1/

5. Trade policy 2/

The authorities recognize that South Africa's trade regime has been inward looking, with excessive protection and intervention. The international sanctions imposed in 1985 drove the country to resort further to a policy of self-sufficiency. Trade policy has comprised many *ad hoc* interventions at the request of the industries concerned; as a result, the present system is characterized by an extraordinarily complex and highly variable set of tariff rates, formula duties (which, in effect, set a lower threshold price for certain imports) in cases where there is a perception of dumping, and some remaining import licensing restrictions.

Progress has been made in replacing import licensing by tariff equivalents, but, thus far, efforts to lower import protection and correct the bias against exports have been piecemeal. In particular, the General Export Incentive Scheme (GEIS) introduced in 1990, while successful in expanding manufactured exports through subsidies, has proved expensive, is subject to abuse, and does not necessarily foster better use of resources. The staff has also been critical of tax relief (under Section 37E of the Income Tax Act) for large-scale beneficiation projects; this is a costly means of promoting exports and will have only a small effect on employment; the program was closed to new projects in September 1993.

There seems to be widespread acceptance that more open trade is essential to growth and that, toward this end, a comprehensive trade reform is required. The tariff system has been under active review with the aim of rationalizing its structure and reducing the inherent anti-export bias. South Africa's recent tariff offers to its GATT partners are consistent with these objectives. If the Uruguay Round is concluded by early 1994 as planned, all quantitative controls will be converted to tariffs within 1994; the tariffs will be substantially simplified and reduced to a maximum level of 30 percent within the Round's five-year time frame for most products; and unfair trade practices will be countered by anti-dumping actions or countervailing duties compatible with the GATT provisions. The GEIS is slated to be abolished by end-1997. Incentives for exporters would be replaced by an improved duty drawback and rebate scheme that would seek to approximate a free trade regime for exporting activities. Furthermore, the

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1/ The 1994 Debt Arrangement, agreed with a Technical Committee representing banks, has been signed by all the members of the Technical Committee and published as a proclamation in the Government Gazette. The agreement provides for the repayment of affected debt during 1994-2001.

2/ Chapter VI of the accompanying paper on Economic Issues contains a more complete discussion of trade policy, while regional issues are taken up in Chapter VII.

import surcharge is intended to be eliminated by mid-1994 provided the balance of payments is under control.

However, there remains a thorny question of the speed of adjustment for specific industries. Concerns have focused particularly on the potential effects of lower tariffs on employment in a few key industries (motor vehicles, textiles, and electronics) that were established behind high and sustained protective barriers and are not at present competitive internationally. These have been classified as industries subject to restructuring, requiring a longer period of adjustment and continued protection during the transition period. The staff acknowledged that the fear of job losses was legitimate in the present environment of very high unemployment, but expressed concern that the short-term objective of maintaining employment should not interfere with the ultimate aim of efficient allocation of resources in the context of an open and competitive economy. It is important that the conditions set for these industries be consistent with an appreciable rate of adjustment.

IV. Access Under the CCFF

The South African authorities are expected to request shortly a purchase under the CCFF decision in an amount equivalent to SDR 614.43 million (45 percent of quota), comprising SDR 409.62 million (30 percent of quota), with respect to a shortfall in merchandise export earnings for the 12-month period ended June 1993 (under Section 12(a)(i) of the decision), and SDR 204.81 million (15 percent of quota) with respect to an excess of cereal import costs for the same period (under Section 31(b)(i) of the decision) (Table 3). Actual data are available through the end of the shortfall/excess year. The request is the first by South Africa since 1982. The attached statement (Appendix VII) outlines the broad policy intentions for the coming period; these have been discussed among, and agreed upon by, the major political groups.

1. Calculation of compensable amount and causes of export shortfall

South Africa's export earnings increased slightly in the two years through June 1991 reflecting, in part, improved manufactured exports. Export earnings fell by 3 percent in the following year and by a further ½ percent in the year ended June 1993. These earnings are projected to rise by about 4½ percent in each of the two post-shortfall years. This pattern results in a calculated shortfall of SDR 564 million, significantly higher than the expected request.

The calculated shortfall is largely attributable to a shortfall in the export value of gold, platinum, other minerals and metals, and agricultural products, while excesses have been calculated for diamonds and nonfood manufactured commodities (for a detailed description of developments in the various export categories, see Appendix VI). The decline in export earnings from gold, platinum, and other minerals and metals reflects primarily lower world market prices for these products, caused by the world economic recession and substantial increases in their exports by the former Soviet Union and China. In the period immediately ahead, growth in the major industrial countries is expected to have some positive influence on these prices. Indeed, gold and platinum prices have already recovered, and the futures markets for these minerals show higher prices for 1994-95, although the platinum price is unlikely to reach the high levels prevailing in 1990-91. Similarly, the Fund's projections for prices of nonprecious metals show a gradual recovery in 1994-95. The price decline is therefore judged to be temporary and beyond the control of South Africa.

The drop in export earnings from agricultural crops reflects the recent severe drought in southern Africa, which sharply reduced the exportable volumes of sugar, maize and, to a lesser extent, wool. Production of these crops has already recovered and their export volumes should return to normal levels. Exports of nonfood manufactured goods--notably chemical products, machinery, and electrical and transport equipment--which expanded markedly in recent years, are expected to continue their good performance.

2. Calculation of compensable amount and cause of excess cereal import costs

The drought that hit southern Africa in early 1992, one of the worst in this century, had far-reaching adverse effects on South Africa's production of maize, the staple food crop, other food and export crops, and the livestock sector (also, see Appendix VI). The northern and central regions, where most crops are grown, were hardest hit, and maize production fell from its normal level of 7.5-8 million metric tons to about 3 million metric tons in 1992/93. As a consequence, South Africa had to import about 1 million metric tons of maize in the year ended June 1992 and another 3.3 million metric tons in the following year, whereas the country normally exports about 1-2 million metric tons. The declining price of maize in the world market during 1992-93 helped contain the import costs. Wheat and sorghum imports also rose substantially.

Maize production in the 1993/94 season has already recovered to a level somewhat higher than usual and output in 1994/95 can be expected to be within the normal range. Taking into consideration the need to rebuild stocks, this production pattern results in a calculated excess of cereal import costs of SDR 239 million (of which SDR 222 million can be attributed to maize); this is slightly higher than the expected request. It is evident that the sharp drop in cereals production and the associated import costs originated from the drought. As such, the excess costs of cereal imports are considered to be both temporary and beyond the control of South Africa.

3. Balance of payments need, cooperation with the Fund, and capacity to repay

As described in Section II, South Africa's balance of payments position weakened substantially during the past year. Gross official reserves declined sharply beginning in the latter half of 1992, reflecting in part significant declines in the prices of South Africa's major commodity exports, and the effects of the severe drought in Southern Africa that shifted South Africa from a net exporter of staple food crops to a net importer. The requested CCFF purchase would help to restore reserves by the end of 1994 to a level equivalent to six to eight weeks of imports, taking into consideration large debt service obligations due in that year in connection with the most recent debt arrangements.

The extraordinary political transition underway implies that future developments in the South African economy are attended by unusual uncertainties. The South African authorities, however, have maintained a constructive policy dialogue with the Fund through regular Article IV consultations and staff visits. Macroeconomic management in recent years has been aimed at achieving financial stability in difficult circumstances. For the period ahead, the authorities are resolved upon a cautious fiscal and monetary stance--balancing the need to correct social inequalities and improve the living standards of the majority of the population against resource constraints. In this undertaking, the authorities have the broad support of the major nongovernmental political groups that are likely to participate in a government of national unity following the April 1994 elections.

South Africa made repurchases of outstanding financial obligations to the Fund on a timely basis during the late 1970s and the mid-1980s, when external pressures were substantial. If the financial policies in support of structural and social reforms remain judicious over the medium term, and assuming that South Africa's financing requirements (as shown in Table 4) are satisfied, South Africa's external position should improve. Under the baseline scenario, although the current account could show a deficit of 1-1½ percent of GDP by 1998, increased capital flows both in the form of private investment and portfolio lending are projected to help boost reserves to a level roughly equivalent to three months' imports. Over the longer term, the external current account deficit is expected to narrow. On this basis, South Africa should be able to meet its payments obligations to the Fund without difficulty (Table 5).

V. Staff Appraisal

South Africa is at the beginning of a fundamental transformation that is both inspiring and fraught with difficulties. It is inspiring because, at last, one is able to envisage the resources of the country--its enormous natural endowment, its wealth of entrepreneurship, and its sophisticated economic and financial institutions--being put to work to better the lives of all the people. It is fraught with difficulties because the economy is still largely mired in recession and is scarred by eight years of sanctions and decades of apartheid. It will take time to ameliorate these conditions and popular aspirations may well be inconsistent with the pace dictated by fiscal and external constraints.

The short-term outlook is difficult. The recession has been long and particularly harsh on employment. The emerging recovery is narrowly based and, thus far, disappointingly anemic. Real growth is unlikely to be significantly above ½ percent in 1993 and perhaps 2½ percent in 1994; the increase in output this year is attributable to a recovery of agriculture, and most of that in 1994 is statistical carry-over with very little quarter-to-quarter growth. This outlook is consistent with a consolidation of the gains on inflation, but it implies a worsening of an already dire unemployment problem.

The unusual characteristics of the recession militate against successful countercyclical demand management: the drought was a supply-side problem, the weakness of investment is attributable mainly to the unsettled political conditions, most of the unemployment is structural rather than cyclical, and there is little evidence at present of the excess saving and the easing of the external constraint that is characteristic of a Keynesian recession. Indeed, with continuing short-term capital outflows and scheduled debt repayments equivalent to about 2 percent of GDP in 1994, any demand stimulus might quickly run up against a balance of payments constraint.

The scope for fiscal measures is circumscribed by the size of the deficit (7 percent of GDP) and the rapidly increasing government debt ratio. Moreover, in circumstances of extraordinarily weak fixed investment, the Government is already absorbing a sizable proportion of scarce domestic saving. Unless government dissaving can be reduced further, there is a danger that any incipient upturn in investment could be crowded out; competition between the Government and the private sector for scarce resources could weaken the balance of payments and undermine the recent progress on inflation. Thus fiscal policy aimed at short-run objectives could pose problems for investment and growth over the medium term.

Monetary policy has been fettered by negative sentiment in the foreign exchanges since the latter part of 1992, and real interest rates have been very high for the stage of the cycle. With downward pressure on the rand and a diminution of reserves available for intervention, any easing of monetary policy has had to be traded off against a more rapid depreciation. The appropriate trade-off is difficult to strike: on the one hand, a number of indicators suggest that a depreciation to improve competitiveness may be warranted; on the other, too rapid a depreciation could mean a reversal of the major gains made against inflation, and, by eliciting a wage response, could offset any initial boost to competitiveness. In light of the relatively muted wage response, the staff's judgment is that the depreciating trend thus far in 1993--an 11 percent effective depreciation in nominal terms and 7 percent in real terms--has been appropriate. Changes in exchange rate expectations or lower wage settlements could pave the way for easier monetary conditions, but there is probably not much scope for easing the restrictive stance of monetary policy in the present circumstances.

In light of these considerations, it is the staff's view that implementation of the policies described in the authorities' Statement of Policies would constitute the maintenance of a prudent macroeconomic stance.

Beyond the immediate future and the elections scheduled for April 1994, the Government will face three daunting sets of structural imperatives.

First, staff calculations suggest that wage developments in the last few years have driven labor out of formal sector employment. This is a thorny issue because, at present levels of productivity, competitive wage rates are likely to be unacceptably low relative to basic needs. There is no simple solution to the problem: the principal components of any strategy must include wage restraint, some further depreciation of the rand, trade liberalization (to correct an anti-export bias), and policies aimed at enhancing productivity and thereby reducing unit labor costs. It is likely too that some entrepreneurial solutions--such as increased subcontracting from the formal to the informal sectors--will play a significant role.

Second, it will be essential to redress the social backlogs inherited from the apartheid system, but it will be difficult to do this quickly, while respecting economic constraints and maintaining financial discipline. Staff calculations indicate that it would be prohibitively costly to equalize government spending on social services for all race groups at the level enjoyed by whites. In light of the already high level of government dissaving and the saving constraint on investment, too ambitious an increase in social spending would have a sharply detrimental influence on investment, growth, and financial stability. Rather, the Government will have to embark on a substantial reordering of priorities and reallocation of expenditure--away from defense, excessive layers of bureaucracy, and social spending on the relatively wealthy, and toward meeting the needs of the truly disadvantaged--and, perhaps, a campaign of dampening aspirations. This will be a formidable test of economic policy over the next few years.

Third, there is broad agreement in the country that international trade should serve as an engine of growth. This will require South African manufacturing to be competitive in international markets--the international counterpart to domestic relative prices that promote employment and growth. The staff supports the envisaged changes in trade policy--lower, more uniform, and more stable tariffs; the abolition of import licensing restrictions; the replacement of formula duties by more acceptable anti-dumping procedures; mechanisms to ensure that exporters have access to inputs at competitive prices; and, in time, an end to the General Export Incentive Scheme. These changes should shift trade policy away from import protection and toward an environment open to market forces and conducive to export growth. The strategy of trade reform and export-led growth should not be allowed to founder on fears of job losses, relative price rigidities, and a lack of competitiveness. Neither should the reform be made contingent on the outcome of the Uruguay Round.

The staff believes that proper weight has been given to considerations of domestic stability in the management of exchange rate policy. The termination of the exchange restriction implicit in the debt standstill is welcome. The dual exchange market, however, constitutes a multiple currency practice subject to Fund approval under Article VIII; in the absence of a clear timetable for its elimination, approval is not recommended at this time.

The authorities are expected to request a purchase under the CCFF in an amount equivalent to SDR 614.43 million (45 percent of quota), of which SDR 409.62 million (30 percent of quota) will be in respect of an export earning shortfall and the remaining SDR 204.81 million (15 percent of quota) in respect of an excess cost of cereal imports. The purchase would help raise South Africa's gross official reserves to a level that would allow it to sustain modest external shocks. The staff is satisfied that the export shortfall and import excess are largely attributable to circumstances beyond the control of the authorities and are temporary in nature. On the basis of past relations with the Fund and the policies that the authorities intend to follow over the next year, the staff is also satisfied that South Africa meets the requirements of cooperation under paragraphs 12(a)(i) and 31(b)(i) of the CCFF decision. As indicated in the Statement of Policies accompanying this report, the Government and the major nongovernmental political groups that are likely to participate in the Government of national unity after the April 1994 elections are agreed on a commitment to prudent macroeconomic policies as they strive to remove structural impediments to growth and redress social inequalities.

Accordingly, the staff would recommend that the Executive Board approve the request for a purchase under the CCFF once a request has been received. The staff's assessment is that South Africa is expected to be in a position to repay its future financial obligations to the Fund as they fall due and the authorities have indicated their intention to do so.

It is proposed that the next Article IV consultation with South Africa take place on the standard 12-month cycle.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

South Africa - Request for Purchase Under the Compensatory and Contingency Financing Facility

1. The Fund has received a request by the Government of South Africa for a purchase in an amount equivalent to SDR 614.43 million for the compensatory financing of a shortfall in export receipts from merchandise under Section II and an excess in the costs of its cereal imports under Section IV of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund approves the purchase in accordance with the request.

Table 1. South Africa: Selected Economic Data, 1988-93.

	1992 In millions of rand at current prices	1988	1989	1990	1991	1992	1993 Official Project-ions
			(Percentage change at constant prices)				
National accounts							
Private consumption	203,407	5.3	2.8	2.1	0.3	-2.3	0.0
Public consumption	69,727	1.7	3.7	2.6	5.2	0.3	-0.5
Gross fixed investment	52,060	8.9	5.1	-2.0	-8.4	-9.9	-3.0
Total domestic demand	314,283	6.8	0.9	-2.7	0.0	-1.1	0.5
Exports of goods and non-factor services	78,070	9.8	4.6	1.9	0.3	1.0	2.0
Imports of goods and non-factor services	65,285	21.9	-0.2	-5.8	2.1	5.4	1.0
Gross Domestic Product	327,068	4.2	2.3	-0.5	-0.4	-2.1	0.5
				(Percentage change)			
Prices, wages, and employment							
Consumer prices		12.9	14.7	14.3	15.3	13.9	10.0
Consumer prices (end of period)		12.4	15.6	14.4	16.0	9.5	...
GDP deflator		15.5	15.2	13.7	13.2	12.1	10.0
Remuneration per worker 1/		15.3	18.0	16.9	15.8	15.2	...
				(In billions of rand)			
Balance of payments							
Merchandise exports		32.1	38.4	42.7	44.7	49.0	53.6
Gold exports		19.7	19.1	18.2	19.6	18.4	21.6
Merchandise imports		39.4	44.3	43.4	47.4	51.9	57.8
Services and transfers, net		-9.0	-9.8	-12.2	-10.7	-11.5	-11.9
Current account balance		3.4	3.5	5.3	6.2	3.9	5.7
(In billions of U.S. dollars)		1.5	1.3	2.1	2.2	1.4	1.8
(In percent of GDP)		1.7	1.5	2.0	2.1	1.2	1.6
Long-term capital, net		-1.2	-0.6	-0.1	-1.7	-1.5	...
Short-term capital, net 2/		-5.7	-4.1	-2.3	-3.0	-4.7	...
Capital account balance		-6.9	-4.7	-2.4	-4.8	-6.2	...
Gross international reserves 3/		6.7	6.9	7.3	9.8	11.2	...
Central government finances 4/							
Revenue 5/		48.1	61.1	66.8	72.3	75.8	88.2
Expenditures		55.9	65.5	73.9	85.9	104.9	114.2
Deficit before borrowing		7.8	4.4	7.1	13.6	29.1	26.0
(In percent of GDP)		3.8	1.8	2.6	4.4	8.4	7.0
Monetary aggregates				(Percentage change)			
Broad money, end-period		27.2	22.6	12.2	12.5	8.0	...
Bank credit to private sector, end-period		27.7	20.2	15.7	14.5	8.7	...
Exchange rates							
Period average							
U.S. dollars per rand		-10.4	-13.3	1.3	-6.3	-3.2	...
Nominal effective rate		-13.8	-8.8	-5.6	-6.2	-6.0	...
Real effective rate		-5.5	0.4	3.0	3.8	3.8	...
End-period							
U.S. dollars per rand		-18.8	-6.2	-1.0	-6.6	-10.2	...
SDR per rand		-14.4	-4.0	-8.6	-7.1	-6.5	...
				(In percent)			
Interest rates (period average)							
Discount rate		14.5	18.0	18.0	17.0	14.0	...
Treasury bill rate		12.0	16.8	17.8	16.7	13.8	...
Government bond yield		16.4	16.9	16.2	16.3	15.4	...
Prime rate		15.3	19.8	21.0	20.3	18.9	...

Sources: South African Reserve Bank, Quarterly Bulletin; and International Monetary Fund, International Financial Statistics.

1/ At current prices; non-agricultural sector.
2/ Includes errors and omissions of current as well as capital account.
3/ Billions of rand at end-period; national valuation of gold.
4/ Department of Finance data. Fiscal year beginning April 1. Budget data for 1993.
5/ Ordinary revenue.

Table 2. South Africa: Selected Indicators of Competitiveness, 1985-93

(Indices: 1985 = 100)

	1985	1986	1987	1988	1989	1990	1991	1992	1993 1/
Real effective exchange rate (IFS)	100.0	92.2	104.0	98.2	98.6	101.5	105.4	109.4	101.9
Real effective exchange rate (SARB)	100.0	103.4	119.9	114.8	114.1	119.5	122.8	124.5	119.8
Terms of trade (SARB) 2/	100.0	102.6	105.7	105.0	103.6	105.0	103.0	103.8	101.8
Production of exports 2/									
Export price/Unit labor cost in non-agriculture	100.0	102.9	96.5	93.0	89.3	83.3	75.9	70.8	...
Export price/CPI	100.0	99.0	90.6	86.3	84.3	79.4	70.8	64.6	62.6
Export price/PPI	100.0	99.7	94.7	91.2	89.0	86.4	81.0	79.5	79.6
Export price/Domestic components of PPI	100.0	100.4	94.3	90.3	88.5	85.6	79.7	77.5	77.5
Export price/Import components of PPI	100.0	97.2	95.8	94.1	91.0	89.9	86.6	88.3	89.3
Production of import substitutes									
PPI (manufactures)/Import components of PPI	100.0	97.0	101.8	104.7	105.0	107.2	110.8	114.9	117.4
PPI (manufactures)/Unit labor cost (manufactures)	100.0	103.0	103.9	105.4	104.3	100.2	98.2	91.6	...
PPI (domestic goods)/Import components of PPI	100.0	96.8	101.6	104.2	102.8	105.0	108.7	113.9	115.2
PPI (domestic goods)/Unit labor cost (nonagriculture)	100.0	102.6	102.4	103.1	100.9	97.3	95.3	91.3	...
Consumption substitution									
CPI (goods)/Import price	100.0	103.4	116.6	121.7	122.9	132.2	145.5	160.5	162.6
Memorandum items:									
Labor share in nonagriculture	100.0	99.8	101.8	100.7	102.1	103.5	103.8	105.3	...
Labor share in manufactures	100.0	97.1	96.2	94.8	95.9	99.8	101.8	109.2	...

Sources : South African Reserve Bank (SARB) Quarterly Bulletin; and International Monetary Fund, International Financial Statistics (IFS).

1/ SARB data on real exchange rate and data on producer prices through August. Rest of data through September.

2/ Export price excludes gold.

Table 3. South Africa: Compensatory Financing Request--Calculation of the Amount of Compensation, 1993

(In millions of SDRs)

	Year Ending June					
				Projections		Shortfall/
	1991	1992	1993	1994	1995	Excess 1/
Earnings	17,339	16,790	16,755	17,474	18,283	564 2/
Gold 3/	5,068	4,858	4,801	5,002	5,092	162
Platinum	1,622	1,241	1,137	1,418	1,524	240
Diamonds	571	1,008	924	862	944	-78
Coal	998	1,080	1,041	994	1,207	20
Other minerals and metals	1,562	1,434	1,382	1,432	1,416	62
Agricultural products	882	830	684	842	959	150
Manufactured goods	6,636	6,339	6,786	6,923	7,142	-26
Cereal import costs	206	255	503	179	178	239
Of which: maize	(--)	(119)	(308)	(5)	(--)	(222)
Net amount			803			
Earnings shortfall			564			
Excess in cereal import costs			239			
Proposed purchase 4/			614.43			
Export element			409.62			
Cereal element			204.81			

Sources: Data provided by the South African authorities; and staff estimates and projections.

1/ Geometric averages of export earnings for the five-year period centered on the shortfall year are used to calculate the export shortfalls; negative figures represent excesses. Arithmetic averages for the same period are used to calculate the cereal import excesses.

2/ The constraint that exports in the post-shortfall period not exceed 20 percent of their average in the pre-shortfall period is not binding in this case.

3/ Net gold exports; for 1994-95, assumed to equal 97 percent of projected gold production.

4/ The proposed purchase is equivalent to 45 percent of quota, 30 percent on account of a shortfall in export earnings plus 15 percent on account of an excess in cereal imports.

Table 4. South Africa: Balance of Payments Projection, 1993-2000

	1993	1994	1995	1996	1997	1998	1999	2000
				(In billions of U.S. dollars)				
Current account	1.7	1.9	1.1	-0.1	-1.5	-1.6	-1.3	-0.8
Exports	27.6	28.9	30.1	31.1	32.2	33.8	35.7	37.7
Merchandise	23.8	24.9	25.9	26.8	27.8	29.2	30.8	32.6
Nonfactor services	3.8	4.0	4.1	4.3	4.4	4.6	4.9	5.2
Imports	-22.8	-24.0	-26.1	-28.3	-30.5	-32.0	-33.3	-34.5
Merchandise	-18.1	-19.1	-20.8	-22.5	-24.3	-25.4	-26.4	-27.4
Nonfactor services	-4.7	-4.9	-5.4	-5.8	-6.3	-6.6	-6.8	-7.1
Factor services	-3.2	-3.1	-2.9	-3.0	-3.3	-3.5	-3.8	-4.1
Transfers	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital account	-3.1	-1.4	0.9	2.5	2.0	2.4	2.2	1.8
Medium- and long-term capital	-1.1	-1.8	0.7	2.2	1.7	2.0	1.8	1.4
Drawings	0.7	0.2	3.0	4.2	4.3	4.1	4.8	4.9
Amortization	-1.8	-2.0	-2.2	-2.0	-2.6	-2.2	-3.0	-3.5
Short-term	-2.0	0.4	0.2	0.3	0.3	0.4	0.4	0.4
Overall balance	-1.4	0.5	2.1	2.4	0.5	0.7	0.9	1.0
Financing	1.4	-0.5	-2.1	-2.4	-0.5	-0.7	-0.9	-1.0
Gross official reserves	0.1	-0.4	-1.8	-2.2	0.1	-0.3	-0.9	-1.0
Short-term liabilities	1.3	-0.1	-0.3	-0.2	-0.6	-0.4	--	--
Net use of Fund resources	0.9	--	--	--	-0.4	-0.4	--	--
Other	0.5	-0.1	-0.3	-0.2	-0.2	--	--	--
Memorandum items:								
Current account (in percent of GDP)	1.5	1.6	0.9	-0.1	-1.1	-1.2	-0.9	-0.5
Gross official reserves	2.9	3.3	5.1	7.2	7.2	7.5	8.3	9.3
Gross official reserves (in months of imports)	1.5	1.7	2.3	3.1	2.8	2.8	3.0	3.2

Source: Staff estimates consistent with the baseline medium-term scenario.

Table 5. South Africa: Indicators of Fund Credit, 1993-2000

	1993	1994	1995	1996	1997	1998	1999	2000
Outstanding Fund credit								
In millions of U.S. dollars	854.1	854.1	847.6	844.5	421.0	--	--	--
In percent of quota	45.0	45.0	45.0	45.0	22.5	--	--	--
In percent of GDP	0.7	0.7	0.7	0.7	0.3	--	--	--
In percent of exports of goods and nonfactor services	3.1	3.0	2.8	2.7	1.3	--	--	--
Debt service due the Fund 1/								
In millions of U.S. dollars	--	38.1	43.3	41.6	456.8	436.3	0.7	--
In percent of quota	--	2.0	2.3	2.2	24.4	23.3	--	--
In percent of GDP	--	--	--	--	0.3	0.3	--	--
In percent of exports of goods and nonfactor services	--	0.1	0.1	0.1	1.4	1.3	--	--
In percent of debt service due	--	1.1	1.1	1.0	8.8	8.3	--	--
In percent of gross official reserves	--	1.2	0.9	0.6	6.4	5.9	--	--

Sources: Data provided by the South African authorities; and staff estimates and projections.

1/ Excluding SDR charges.

Medium-Term Scenarios

The staff has prepared three medium-term scenarios (as distinct from forecasts or projections) to illustrate how investment, unit labor costs and government spending interact to influence the evolution of employment, output, and the balance of payments (Table 6). The driving questions for these exercises are not only how to achieve sustained growth in output but also how to make inroads into South Africa's pressing unemployment problem without compromising fiscal and external sustainability. The scenarios suggest: first, that even with favorable assumptions regarding labor market conditions, an increase in the investment ratio on the order of 8 percentage points of GDP would be needed to lower unemployment significantly; and, second, that since the fiscal stance of the Government is already of questionable sustainability, growth strategies involving a large increase in government spending are risky.

The projections are made in the context of a model with standard specifications. Demand is determined in a Keynesian fashion: consumption depends on disposable income; imports are related to domestic demand and relative prices; and exports depend on world market growth and relative prices. A formal model of investment would be inappropriate in the present circumstances where investment is so dominated by uncertainty regarding the future political and economic environment. Therefore in the scenarios that follow, alternative investment paths are specified exogenously. This permits one to see what rates of investment would be needed in order to bring sustained growth in employment and income. The production function in the model is CES (with an elasticity of substitution of 0.5); aggregate supply is solved for as a function of the capital stock, which is predetermined, and the real product wage, which is specified exogenously. The output gap--measured as the percentage deviation of aggregate demand from aggregate supply--influences inflation via an expectations-augmented Phillips curve; there is also feedback from the output gap to demand via the real effective exchange rate, which appreciates when there is excess demand.

1. Baseline scenario

Three main assumptions characterize the baseline scenario. First, the lifting of sanctions and the reduction of politically-generated uncertainty cause fixed investment to rise steadily, from about 16 percent of GDP initially to 20 percent in 1997, and to remain at the higher level. Second, government dissaving is reduced over time as a percentage of GDP by scaling back current expenditures (as a percentage of GDP), and there is a slight increase in government investment. The average tax rate is unchanged. The net effect is a gradual reduction in the government deficit as a percentage of GDP. 1/ Third, the real wage remains constant in spite of labor-augmenting technical progress of 1 percent a year. This implies that real unit labor costs are declining gradually, increasing the demand for labor and reinforcing the incentives for investment. 2/

In the short term, the demand-side effect of the increase in investment propels the economy out of the 1989-93 recession and raises employment by 4 percentage points in 1995. This is a significant increase in absolute terms but small relative to the initial unemployment rate. In the medium term, the more rapid capital accumulation raises the equilibrium growth rate of GDP to 3 percent per annum. This growth brings a 2½ percent annual increase in employment, somewhat less than the 2.7 percent rate of growth of the labor force: thus the medium-term growth of supply does not bring any further reduction in the unemployment rate.

In spite of this relatively slow growth, the baseline scenario does not entail unsustainable domestic or external borrowing. As a result of the scaling back of government consumption (as a percentage of GDP), the ratio of government debt to GDP eventually returns to the 1994 level, slightly under 50 percentage points of GDP. In the external sector, the rise in the investment ratio during 1995-98 causes the current account to switch from a surplus of 1½ percent of GDP to a deficit of about 1 percent of GDP, reflecting strong aggregate demand and, in particular, the high import content of investment. However, by the end of the period, the current account returns to approximate balance and the debt ratio begins to decline as increases in aggregate supply cause the real effective exchange rate to depreciate, increasing exports and causing a substitution of domestic for imported goods.

2. Scenario 1: Doubling government capital expenditure

Could the growth of output and employment be raised in a sustainable fashion by an aggressive public investment program?. To address this question, Scenario 1 examines the consequences of increasing government capital expenditures to 3 percent of GDP--double the level in the baseline scenario--starting in 1995. It is assumed that the political pressures to maintain the level of government services will be such as to preclude an offsetting decrease in the real level of government consumption, so the increased government investment will give rise to larger government primary deficits. Other features of the scenario are relatively favorable to the

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1/ Real interest rates are assumed to be unchanged at end-1993 levels.

2/ Real unit labor costs decline by less than labor's efficiency rises because the increased efficiency induces a substitution of labor for capital, which increases unit labor costs. Naturally, unit labor costs cannot decline forever; a continuing decline would eventually bring full employment. Thereafter, in a steady state, the real wage would rise at the same rate as the labor-augmenting factor productivity and the unit labor costs would be constant.

growth impact of government investment: it is assumed that government investment is as productive as private investment and that there is only a modest crowding out of private investment. 1/

While the growth of output and employment is slightly higher in Scenario 1 than in the baseline (output growth reaches 3.2 percent per annum compared with 2.9 percent), the question posed by this exercise is whether the larger government deficits are sustainable. This depends on whether the increase in the growth of output--and thus of the tax base--is sufficient to offset the increase in the growth of debt. The answer suggested by the scenario is not encouraging: the ratio of government debt to GDP rises by 20 percent during the eight-year period from 1994 to 2002. The strong implication of this result is that the deficits entailed by even a fairly modest government investment drive would be unsustainable.

In the medium term, Scenario 1 is characterized by a lower inflation rate than the baseline scenario, but the current account deficits and the external debt ratios are higher. The low inflation rate is a consequence of the growth in supply and the fact that the exercise assumes away the problem of external financing. In practice, however, external finance might constitute the binding constraint on a scenario of this sort, in which case a much more rapid rate of depreciation would elicit higher inflation. Of course, in the long run, as in the baseline scenario, the capital accumulation brings a strong supply response, which restores the current account to balance: the external debt ratio peaks in the year 2000 and declines thereafter. It would not be wise, however, to be sanguine about external viability, in spite of South Africa's small initial foreign debt ratio. There are plausible scenarios where higher crowding out and a relatively low productivity of government investment combine to reduce the long-run growth of supply, leading to unsustainable current account deficits.

3. Scenario 2: Lower unit labor costs and higher private investment

Under what conditions can output and employment grow enough to generate a significant reduction in unemployment? It follows from first principles that a reduction of structural unemployment requires an increase in the productivity of labor relative to the real wage. This suggests three potential sources of a reduction in unemployment. First, private investment

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1/ The crowding out of private investment by public investment results from the signal sent to investors by an unsustainable government primary deficit. As discussed in the accompanying paper on Economic Issues, an unsustainable deficit raises the probability of inflation, higher taxes or severe financial imbalances during the lifetime of investment projects under consideration. It is difficult to quantify the effect this would have on investment; however, this effect is likely to be significant in South Africa where the initial policy stance will constitute the new Government's entire track record.

can raise labor productivity by equipping each worker with more capital. Second, the real product wage may be reduced. Third, there may be an "exogenous" increase in labor productivity or a reduction in the "indirect costs of labor" related, for example, to the political normalization. In principle there may be a trade-off between the three sources in that a given rate of employment growth could be attained with, say, a higher real wage, if there were an offsetting higher investment ratio. At the same time, the three sources are interrelated since a drop in unit labor costs, whether due to an exogenous increase in productivity or to a reduction in the real wage, is likely to raise investment. Accordingly, Scenario 2 is based on the assumption that in 1995 there is a 3 percent drop in unit labor costs relative to the baseline scenario and that, partly in consequence, the investment ratio rises gradually by 4 percentage points relative to the baseline, that is, to 24 percent of GDP.

The reduction in unit labor costs, combined with the demand-related effects of increased investment, gives rise to a sharp rise in employment during 1995-97. More significant for the longer term, the equilibrium GDP growth rate rises to 4½ percent a year, consistent with employment growth of 4 percent a year over the medium term, or considerably higher than the growth rate of the labor force. Thus the combination of reduced unit labor costs and high investment holds out the prospect of reducing unemployment considerably over the medium term.

Under the assumptions of Scenario 2 the government debt ratio drops sharply but the external debt ratio rises. The government debt ratio falls because of the rapid increase in output, which raises the tax base, while spending is maintained at the same real levels as in the baseline scenario. The implication is clear: the rapid growth generated in Scenario 2 would permit a more rapid increase in government spending, including on social services. The widening current account deficits during the first four years of this projection are the consequence of the high import content of investment; nevertheless the question whether finance would be available is as relevant here as in Scenario 1. However, when the investment rate stops rising and cost reductions stemming from lower unit labor costs are reflected in improved competitiveness, the growth rate of imports falls significantly and export growth rises. Thus the external debt ratio levels off, implying that the balance of payments is viable. 1/

The present exercise makes it clear that a strong increase in the investment ratio (8 percentage points compared with the current level) combined with a significant reduction in unit labor cost would be necessary

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1/ Two further remarks are warranted. First, insofar as the current account deficits are financed by direct investment, the accumulation of external debt will be lower than that recorded in Table 6. Second, the external debt ratio attained in this scenario remains low by international standards and lower than was normal in South Africa before the 1985 debt moratorium.

to bring substantial and sustained increase in employment. As suggested above, the model implies that there is a trade-off between the investment ratio and the real wage in the sense that the same trajectory of employment could be reached with a higher wage rate if the investment ratio were also higher. The way in which the trade-off is resolved in practice will depend in part on the flexibility of the labor market, in part on labor productivity, and in part on the responsiveness of investment to profit opportunities.

Table 6. South Africa--Medium Term Scenarios

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
BASELINE										
					(percent changes)					
Real GDP	1.0	2.0	3.2	2.0	2.1	2.3	2.6	2.8	2.9	2.9
GDP deflator	9.7	8.1	8.3	8.5	8.8	8.8	8.7	8.6	8.4	8.3
Employment	0.4	1.2	3.9	1.6	1.6	1.6	2.0	2.2	2.3	2.4
Unit Labor Cost	0.3	0.7	0.7	-0.4	-0.5	-0.7	-0.6	-0.5	-0.5	-0.5
Export volume	2.2	2.0	2.4	1.7	1.9	3.0	3.5	3.7	3.8	3.8
Import volume	1.1	2.4	7.1	6.4	6.1	2.9	1.9	1.8	1.8	1.8
REER	-4.1	--	1.1	2.2	1.8	0.1	-0.8	-1.1	-1.1	-1.2
					(in percent of GDP)					
Fixed Investment	15.3	15.6	16.9	18.1	19.3	19.6	19.6	19.6	19.5	19.4
Private saving	20.0	21.6	22.1	22.4	22.7	22.9	22.9	22.9	22.9	22.8
Current account	1.5	1.6	0.9	-0.1	-1.1	-1.2	-0.9	-0.5	--	0.5
Government deficit	6.5	6.5	5.5	5.7	5.8	5.7	5.5	5.0	4.5	4.0
External debt	15.1	14.0	13.3	13.6	13.9	14.4	14.6	14.3	13.5	12.2
Government debt	47.2	49.5	49.8	50.7	51.4	51.9	52.0	51.6	50.8	49.6
Debt service ratio 1/	10.6	11.2	11.8	11.7	13.3	11.7	13.1	13.6	12.9	10.3
SCENARIO 1: HIGH GOVERNMENT INVESTMENT										
							(percent changes)			
Real GDP			3.4	2.0	2.3	2.6	2.9	3.1	3.1	3.2
GDP deflator			8.4	8.6	8.8	8.8	8.7	8.5	8.3	8.1
Employment			4.2	1.6	1.8	1.8	2.3	2.5	2.6	2.7
Unit Labor Cost			0.8	-0.5	-0.6	-0.7	-0.6	-0.5	-0.5	-0.5
Export volume			1.9	1.7	2.1	3.2	3.8	4.0	4.0	4.0
Import volume			9.6	6.4	6.1	3.0	2.0	1.7	1.7	1.7
REER			1.9	2.2	1.5	-0.2	-1.1	-1.5	-1.5	-1.5
							(in percent of GDP)			
Fixed Investment			17.5	18.8	20.0	20.4	20.4	20.3	20.2	20.2
Private saving			22.2	22.7	23.1	23.4	23.6	23.7	23.7	23.7
Current account			-0.1	-1.1	-2.0	-2.0	-1.6	-1.0	-0.4	0.1
Government deficit			6.9	7.3	7.6	7.6	7.6	7.2	6.7	6.2
External debt			13.8	14.7	15.6	16.6	17.3	17.4	16.9	15.9
Government debt			51.1	53.4	55.5	57.4	58.9	59.8	60.3	60.2
Debt service ratio 1/			11.9	12.3	14.4	13.2	15.0	15.8	15.4	11.6
SCENARIO 2: LOW UNIT LABOR COSTS AND HIGH INVESTMENT										
							(percent changes)			
Real GDP			6.8	3.2	3.1	3.6	3.9	4.5	4.7	4.7
GDP deflator			7.8	8.0	8.3	8.5	8.2	7.7	7.3	6.8
Employment			9.8	3.3	2.7	3.0	2.8	3.8	4.2	4.1
Unit Labor Cost			-2.4	0.1	-0.4	-0.7	-1.0	-0.6	-0.5	-0.6
Export volume			4.9	1.9	1.5	2.2	4.6	5.2	5.2	5.4
Import volume			9.6	8.9	10.1	9.1	1.9	1.6	2.3	1.6
REER			-2.8	1.8	2.5	1.4	-2.5	-3.4	-3.3	-3.7
							(in percent of GDP)			
Fixed Investment			17.6	19.5	21.9	24.0	24.0	23.9	24.0	23.8
Private saving			21.5	21.6	21.7	21.6	21.2	20.7	20.2	19.6
Current account			0.6	-0.9	-2.7	-4.3	-3.7	-2.9	-2.3	-1.4
Government deficit			4.1	3.8	3.4	2.8	1.9	0.7	-0.6	-2.0
External debt			13.3	13.8	15.3	18.3	21.1	23.0	24.1	24.3
Government debt			47.1	46.1	44.7	42.6	39.8	36.1	31.5	26.2
Debt service ratio 1/			11.9	11.9	14.0	13.8	17.4	19.7	20.6	16.8

Source: Staff projections.

1/ External debt service payments as a percentage of exports of goods and nonfactor services.

South Africa: Fund Relations
(As of October 31, 1993)

I. Membership Status: Joined 12/27/45; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	1,365.40	100.0
Fund holdings of currency	1,365.36	100.0
Reserve position in Fund	.05	.0

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	220.36	100.0
Holdings	4.17	1.9

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	11/03/82	12/31/83	364.00	159.00

VI. Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 10/31/93	Forthcoming 1993	1994	1995	1996	1997
Charges/interest	--	2.3	8.9	8.9	8.9	8.9
Total	--	2.3	8.9	8.9	8.9	8.9

VII. Exchange Rate Arrangement

The currency of South Africa is the South African Rand. On November 11, 1993, the (commercial) rate was US$0.2975 = R 1. The freely floating "financial" rand system operates with respect to the local sale and redemption proceeds of South African securities and other investments in South Africa owned by nonresidents, capital remittances by emigrants and immigrants, and approved outward capital transfers by residents. The exchange rate for the financial rand is usually at a discount from the commercial rand rate; the discount is currently about 22 percent, and the exchange rate of the financial rand was US$0.2312 = R 1 on November 11, 1993. South Africa formally accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement, as from September 15, 1973.

VIII. Article IV Consultation

The 1992 Interim Article IV consultation was completed on October 28, 1992 on a lapse-of-time basis (SM/92/189). The most recent Executive Board meeting was on November 11, 1991 when the 1991 Article IV consultation was completed (SM/91/192).

IX. Technical Assistance

A technical assistance mission from the Fiscal Affairs Department visited South Africa from February 1-16, 1993 to assist with the administration of the recently introduced value added tax.

South Africa--Basic Data

Area and population

Area	1.22 million square kilometers
Population (1992)	38.9 million
Population growth rate (1992)	2.20 percent
Employment in non-agricultural sector (September 1990)	5.0 million

IMF position (September 30, 1993)

Quota	SDR 1365.4 million
Fund holdings of rand (in percent of quota)	100
Holdings of SDRs (in millions)	4.2
Exchange rate (September 30, 1993)	R 1 = US$ 0.2912

National Accounts	1992 In millions of rand at current prices	1988	1989	1990	1991	1992
		(Percentage change in real terms)				
Private consumption	203,407	5.3	2.8	2.1	0.3	-2.3
Public consumption	69,727	1.7	3.7	2.6	5.2	0.3
Gross fixed investment	52,060	8.9	5.1	-2.0	-8.4	-9.9
Total domestic demand	314,283	6.8	0.9	-2.7	0.0	-1.1
Exports of goods & non-factor services	78,070	9.8	4.6	1.9	0.3	1.0
Imports of goods & non-factor services	65,285	21.9	-0.2	-5.8	2.1	5.4
Gross Domestic Product	327,068	4.2	2.3	-0.5	-0.4	-2.1
Central government finances 1/		(In millions of rand)				
Revenue		48,672	64,096	67,122	73,106	76,901
Expenditure		55,927	65,459	73,947	85,861	103,770
Deficit before borrowing		7,255	1,364	6,826	12,755	26,870
(in percent of GDP)		(3.5)	(0.6)	(2.5)	(4.2)	(8.1)
Balance of payments						
Non gold exports		32,125	38,384	42,735	44,709	49,010
Gold exports		19,701	19,140	18,177	19,587	18,356
Merchandise imports		39,408	44,266	43,408	47,385	51,883
Services and transfers, net		-9,035	-9,791	-12,180	-10,724	-11,543
Current account balance		3,383	3,467	5,324	6,187	3,940
Net long-term capital		-1,173	-606	-102	-1,730	-1,511
Net short-term capital (including errors and omissions)		-5,690	-4,098	-2,308	-3,045	-4,701
Net capital (including errors and omissions) 2/		-6,863	-4,704	-2,410	-4,775	-6,212
Overall balance 3/		-3,480	-1,237	2,914	1,412	-2,272
Level of official reserves at end-year						
(in millions of dollars)		2,171	2,028	2,399	2,954	3,195
(in months of imports)		1.3	1.2	1.4	1.7	1.7
Monetary aggregates		(In percentage change over previous period)				
Broad money (M3), year end		27.2	22.6	12.2	12.5	8.0
Prices and wages						
Consumer prices, year average		12.9	14.7	14.3	15.3	13.9
Remuneration per worker, year average (in nonagricultural sector)		15.3	18.0	16.9	15.8	15.2

Sources: South African Reserve Bank, Quarterly Bulletin, and International Monetary Fund, International Financial Statistics.

1/ Department of Finance data. Fiscal year beginning April 1. Figures are for total revenue.
2/ Excluding short term liabilities relating to reserves.
3/ Net of reserve-related liabilities, SDR allocations, and valuation adjustments.

Social and Demographic Indicators - South Africa

Area

1.22 million square kilometers

Population (1992)

38.9 million
Annual rate of growth: 2.2 percent

Population characteristics (1990)

Population density:	32 per sq. km.
Urban population (percentage of total)	60
Proportion in capital city as a percentage of urban population	11
Population age structure (percent):	
0-14 years	38
15-64	58
65 and above	4

Health

Life expectancy at birth (1989)	
Black	57
White	73
Infant Mortality (percentage of live births, 1988)	
Black	5.7
White	1.3

Labor force (1992)

Female (percentage of labor force)	36
Percentage of employment	
Agriculture	11
Mining	9
Industry	25
Government	17

GDP per capita (1989)

In US dollars	2,460
Black	670
White	6,530

Nutrition (1989)

Per capita calorie intake per day	3,122

Education (1985)

Adult literacy (15+, percentage)	
Black	80.0
White	99.3

Source: IMF Occasional Paper Number 91, January 1992; World Bank, World Development Report, 1992, Central Statistical Services, March 1993.

Exchange Arrangements

A full description of South Africa's exchange arrangements as of December 31, 1992 is given in Exchange Arrangements and Exchange Restrictions, Annual Report 1993. At present, South Africa maintains one exchange restriction subject to approval under the Fund's Article VIII, namely, the multiple exchange practice arising from the dual exchange market. At end-September 1993, South Africa concluded the 1994 Debt Arrangements with creditor banks, effectively eliminating its external arrears on capital repayments that had been outstanding since late 1985.

Other changes in the exchange system since end-1992 include:

Imports and import payments:

June 2, 1993: It was announced that the system of import licensing would be phased out and replaced by tariff measures.

Payments for Invisibles:

September 1, 1993: The indicative annual limits on allowances that authorized dealers may provide for travelling to countries other than neighboring countries were raised as follows: (i) the basic tourist allowance, from R 19,000 to R 20,000 for an adult and from R 9,500 to R 10,000 for a child; (ii) the limit on additional allowances for business travel was raised from R 28,000 to R 30,000.

Background Material for CCFF Calculations: Analysis of the Shortfall in Earnings from Merchandise Exports and Excess in Cereal Import Costs

In the year through June 1991, the value of South Africa's exports rose slightly in terms of SDRs; this was attributable both to rising prices of platinum and key agricultural products as well as to greater volumes of manufactured exports as South Africa was able to expand its markets. The price of gold, the largest export earner, began to fall in early 1992 and continued its downward trend through the first quarter of 1993, while the prices of platinum, ferrochrome, manganese, and copper dropped sharply. Two main reasons accounted for their decline: the world economic recession and substantial increases in exports of these metals by the former Soviet Union (FSU) and China. The movement in world market prices for these metals and the severe drought that hit much of southern Africa in 1991-92 were the most important factors underlying South Africa's export shortfall and an excess in cereal import costs over the 12-month period ended June 1993. Some reversal of the unfavorable export price situation is expected in the near future as the world economic recovery takes hold and the FSU sales stabilize. The adverse impact of the drought on agricultural production has also evidently passed.

I. Shortfall in Earnings from Merchandise Exports

The total export shortfall for the period ended June 1993 was calculated to be SDR 564 million (41 percent of South Africa's quota) (Table 7). The shortfall is estimated to come largely from shortfalls in earnings from platinum, gold, other minerals and metals (including in particular ferrochrome and manganese ore), and most agricultural products. In contrast, diamonds, deciduous fruits, and most nonfood manufactures contributed negatively to the overall export shortfall.

1. Gold

During the year ended June 1993, a shortfall of SDR 162 million (over one-quarter of the total shortfall) is estimated for exports of gold. 1/ Earnings from gold exports accounted for about 29 percent of total merchandise exports in the shortfall year. The low earnings were the result

1/ Gold exports comprise net foreign sales of gold plus changes in gold holdings of the Reserve Bank and other banking institutions. This definition eliminates the influence on the export data of the South African authorities' policy on gold holdings.

of a decline in the world price of gold throughout 1992, to a seven-year low of US$329 per troy ounce in the first quarter of 1993 (Table 8). World economic recession and large sales, especially by the FSU states, depressed its price. South Africa is the largest gold producer, accounting for about 28 percent of total output in 1992. The world price of gold picked up significantly beginning in the second quarter of 1993; this was initiated by precautionary purchases following the European Community ERM currency crisis and a large (reported) Chinese bullion acquisition. The price rally continued as a consequence of the unrest in South Africa, uncertainty over the situation in Russia, and interest rate cuts by the Bundesbank. The price reached US$400 for a brief period in July, and has settled around US$360-370 for the past few months. Also, the earlier low price of gold boosted demand for jewelry, especially in the Middle East. More fundamentally, gold and jewelry demand expanded as a result of a booming Chinese economy and the rising wealth in Asia. While it is expected that demand for gold will remain reasonably firm, supply is not likely to expand significantly in the near future: environmental pressure reduces the possibility of any new projects in North America; exploration has shifted to Latin America where it will take a number of years for any new fields to develop; and FSU production is expected to fall in the next few years as general economic problems affect the gold mines. Following the example of the procedure used by the Fund to project the price of crude petroleum, gold prices for the first post-shortfall year were projected on the basis of gold futures market prices prevailing at the time of the staff mission to South Africa. For the second post-shortfall year, prices were assumed to be unchanged in real terms.

South Africa's gold mining industry has suffered for the past decade from rising unit costs, stemming from the fact that mining at greater depths, combined with higher wages and restrictive labor practices, has become increasingly uneconomical. Thus, several mines have closed down or scaled down production. Notwithstanding some actions to rationalize operation and recent tax reforms benefiting the gold mine industry, total output has been on a declining trend. The small increase in output in the shortfall year arose largely from the mining of higher grade ore, as profit margins fell with the lower price. Gold production and export volume in the post-shortfall years are projected to fall from 19.9 million troy ounces in the shortfall year to 19.4 million troy ounces, roughly the same average level prevailing in the preceding three years. Although the industry has been successful in slowing down the rise in the unit cost of production, high wage rates in relation to the current gold price still render investment in any new mines unprofitable and some old mines have been depleted to the point that they are no longer sufficiently economical to remain in operation. The long-term prospects for the industry are more favorable owing to several recent policy changes: the introduction in 1992 of the Mineral Act, 1991 aimed at increasing the accessibility of mineral resources; selective permitting of Sunday labor in order to improve productivity; an understanding with labor unions to link wage demands to productivity; and the abolition of mining lease monies in respect to privately held mineral rights.

2. Platinum-group metals

A shortfall of SDR 240 million (over 40 percent of the total shortfall) is estimated for exports of platinum-group metals for the year ended June 1993. Earnings from platinum accounted for about 7 percent of total merchandise exports in the shortfall year. Platinum prices, which had already fallen by 17 percent in the year ended June 1992, dropped by a further 17 percent in the shortfall year--to about US$360 per ounce--in line with a declining world demand on account of the deepening economic recession in major industrial countries and stockpiling by traders and users during the preceding period when sales by Russia flooded the market.

Notwithstanding the falling price trends, production capacity of the South African platinum mines has expanded substantially since early 1992 to meet the anticipated growth in world demand in the automobile and jewelry industries. Improved car sales are already observed in the United States and expected to be followed in Western Europe and Japan; accelerated use of platinum-based autocatalysts is envisioned in new car models; and supply by Russia is anticipated to fall further with escalating production bottleneck encountered in that country. South Africa is the largest producer of platinum-group metals, accounting for about half of total world output in 1991, with the FSU producing most of the remainder. Thus, a strong demand for platinum-group metals from South Africa is expected. Production and export volume, which increased by some 10 percent in the shortfall year, is projected to rise by another 30 percent in the following two years, reaching 191 metric tons in 1995. The platinum price projections underlying the CCFF calculations are based on the same method as that for the gold price projections discussed above.

3. Diamonds

Diamonds contributed negatively to the export shortfall in the year ended June 1993, with an excess of SDR 78 million. Diamonds accounted for about 5½ percent of South Africa's total exports in that year. South Africa sells its diamonds to the Central Selling Organization (CSO) of De Beers Consolidated Mines, a company that markets the major share of the world diamonds. In 1992-93, CSO both relaxed purchasing quotas imposed on contracted producers and increased the offer price for rough diamonds. These actions were prompted by favorable conditions in the world diamond markets affecting the demand-supply balance: in spite of continued recession, the U.S. demand for gem diamonds increased considerably, attributable to low interest rates on alternative capital investment; the imposition of a VAT on polished diamonds in Russia almost halted production of such diamonds; and political disruptions in Angola and Zaire drastically reduced the volume of rough diamond sales from these sources.

As a consequence, South Africa's sales of diamonds rose sharply in the year ended June 1992, with improvements in both volume and unit price--the latter reflecting higher quality gems. 1/ This performance weakened slightly in the early half of 1993 as the economic upturn in industrial countries proved not to materialize, but demand continued to be solid. In the medium term, it is expected that the market will continue to be strong: in the United States, De Beers plans to continue its aggressive advertising campaign; and demand from Japan and the Pacific Rim countries is expected to increase in line with rising prosperity.

4. Coal

Coal accounted for about 6 percent of total exports in the shortfall year. The shortfall on coal exports in the year ended June 1993 (SDR 20 million) is expected to result from an increase in the export volume in the two post-shortfall years in line with the growing capacity at Richards Bay; domestic demand is projected to stabilize as a result of the substitution of hydropower in electricity generation. In the longer term, continued growth of steam coal as a source of power is expected, and exports to both Asia and Europe are projected to rise substantially.

5. Other minerals and metals

A shortfall of SDR 62 million is estimated for exports of other minerals and metals for the year ended June 1993. Earnings from these products accounted for more than 8 percent of total merchandise exports in the shortfall year. Shortfalls in exports of ferrochrome, manganese ore, copper, and nickel were offset in part by excesses in exports of iron ore and minor products.

Exports of ferrochrome and chrome ore show the largest shortfall--nearly SDR 62 million, an amount equivalent to the overall shortfall for this group of commodities. Eighty percent of world output of these metals goes into the fabrication of stainless steel. Recession in the industrial countries depressed their world market prices beginning in 1990. Furthermore, in 1991-92, large amounts of ferrochrome from the FSU and China entered the market at very competitive prices. World demand for stainless steel has begun to pick up in line with the recovery of the car industry. With an anticipated reduction of exports from the FSU restoring market balance, a modest improvement in ferrochrome price is foreseen, and the export quantity by South Africa is projected to rise gradually to the pre-shortfall level.

Export shortfalls from manganese ore, copper, and nickel each accounted for about 3-6 percent of the total shortfall. Much of world output of manganese and nickel is also used in the processing of steel, and the

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1/ Since diamonds are not a homogeneous commodity and the value of a carat varies with the size and quality of a stone, a precise breakdown into volume and unit value data is not reliable. South Africa exports both gem and industrial diamonds, but the former account for most of the earnings.

products underwent a similar pattern of world oversupply and falling prices as demand stagnated but the FSU exported large quantities. The manganese and ferro-manganese industry in South Africa reduced its production significantly in 1991-92. A recovery in their price and export volume is projected consistent with an economic upturn. South African production of nickel, however, was not scaled down, it being a by-product of platinum mining. Beginning in 1995, a large proportion of nickel domestic sales is expected to be absorbed by the local Columbus steel project, thereby reducing the volume available for exports. An oversupply of copper was compounded by high levels of exports from the other former CMEA members and re-exports by China. The authorities expect the copper market to become more favorable, with China emerging as a main importer and a strong growth in demand by newly industrialized economies in Asia. The CCFF calculations, however, are based on continued falling prices in the post-shortfall years in line with Fund projections.

6. Agricultural products

A shortfall of SDR 150 million (about one quarter of the total shortfall) is estimated for the exports of agricultural products, which accounted for about 4 percent of the total earnings from merchandise exports in the shortfall year. Shortfalls from exports of sugar, maize, and wool each contributed 6-7 percent of the total shortfall. Sharp reductions in the export volumes generated by the drought and, in the case of wool, a continued rapid drop in the world market price explained the shortfall.

The impact of the drought on the production of cane sugar covered two years, with annual output in 1992-93 falling from its normal level of 2-2.3 million metric tons to 1.5 and 1.3 metric tons, respectively. Domestic annual consumption accounted for about 1.4 million tons and the export volume, which ranged between 0.7-0.8 million tons in the three preceding years, dropped sharply to 0.35 million tons in the year ended June 1993; the falling sugar price in the world market since early 1991 was exacerbated in the case of South Africa by existing long-term contracts that shifted the product mix in favor of raw sugar (as against the higher-unit-value refined product). The exportable surplus in the post-shortfall year is projected to decline further to 0.25 million tons. With some recovery of production in 1994 and a return to the normal level in 1995, it is projected that the volume available for exports would increase sharply to 0.9 million tons in the year ending June 1995.

Maize is the main staple, used for animal feeds as well as human consumption, and the major export crop. With normal weather conditions, annual maize production can be expected to be in the range of 7.5-8 million metric tons; domestic use accounts for about 6.5-7 million tons; and South Africa exports 1-2 million tons of maize and maize products--to overseas destinations as well as within Africa. Severely hit by the drought in most regions, South Africa's 1992/93 crop, at 3 million tons, was the lowest in forty years. Exports in the year ended June 1993 were negligible, comprising only maize products; instead, South Africa imported over

4 million tons of grains in the two years ended June 1993. The harvesting of the 1993/94 crop indicates that output is likely to be higher than usual, reaching 8.9 million tons and allowing exports to resume at 1.2 million tons. Assuming normal production in the following year, annual export earnings from maize are projected to average about SDR 84 million in the two post-shortfall years.

The wool price in the world market has dropped sharply since 1991 and at mid-1993 stood at its lowest level in two decades. This has resulted in some farmers switching to the production of meat. In addition, the 1992/93 drought had an adverse impact on the quality of wool and mohair. Exports of wool during the post-shortfall years are projected to recover in line with its price movements in the world market.

Citrus and deciduous fruits were not affected by the drought: citrus is cultivated mainly in irrigated areas and deciduous fruit in the Southwestern Cape, which was unaffected by the drought. They contributed negatively to the overall export shortfall in the year ended June 1993, with a combined excess of SDR 31 million. Production and export volumes of deciduous fruits have expanded considerably since 1989, especially to EC markets, which now account for about 80 percent of South African exports of these products. Demand and prices, however, can fluctuate considerably with climatic conditions in Europe itself, and the projections of exports for the CCFF calculations were conservative compared with recent trends.

7. Manufactured goods

Manufactures contributed negatively to the overall export shortfall in the year ended June 1993, with an excess of SDR 26 million. Although food products, such as canned fruits and vegetables, were indirectly affected by the drought (providing a shortfall of SDR 47 million), exports of other products continued to expand. In particular, exports of machinery and electrical equipment, and of vehicles and transport equipment have increased substantially since 1989 and are projected to continue their solid performance; markets in Africa have grown and new markets have been established in Asia.

Manufactures accounted for 40 percent of total export earnings in the shortfall year, compared with 33 percent in the year ended June 1989. In addition to a gradual opening up of foreign markets, a combination of factors contributed to this expansion: the low level of domestic demand and high level of surplus production capacity, which encouraged domestic producers to shift to overseas markets; a depreciation of the nominal effective rate of the rand; and the assistance under the General Export Incentive Scheme introduced in 1990. For the post-shortfall years, manufactured exports are conservatively assumed to grow by 2-3 percent. Beginning in 1995, the growth in manufactured exports can be expected to escalate sharply as large-scale, export-oriented projects receiving benefits under Section 37E of the Income Tax Act come on stream; since their timing is uncertain, increased exports from these projects are not incorporated into the CCFF calculations. These include beneficiated industries producing steel, aluminum, and petrochemicals. Over the long term, a rationalizationof the tariff system to eliminate its inherent anti-export bias is envisaged to help boost manufactured exports considerably.

II. Excess in Cereal Import Costs

The excess in cereal import costs for the period ended June 1993 was calculated to be SDR 239 million (17½ percent of South Africa's quota) (Table 9). Most of the estimated excess (SDR 222 million) can be attributed to imports of maize, the remaining excess being accounted for by imports of wheat and sorghum. However, barley--grown in the Southwestern Cape, unaffected by the drought--experienced a bumper crop, which offset somewhat the overall excess.

South Africa consumes about 10 million tons of cereal annually, of which maize accounts for 7 million tons, followed by wheat (2 million tons), rice, sorghum, barley (0.2-0.4 million tons each) and small amounts of oats and rye. In a normal year, South Africa is more than self-sufficient in maize production and about 1-2 million tons are exported. Wheat output is somewhat short of domestic consumption; about 0.5 million tons are imported each year while about 0.1-0.2 million tons of wheat products are exported. Rice is entirely imported as it is not grown locally; a small amount of sorghum is also imported; and the demand and supply for barley are just about in balance. In the near future, the small increase in domestic requirements of cereals in line with growing population is expected to be met adequately by domestic supply.

As described above, maize output in 1992/93 (corresponding to the 1991/92 growing season) was less than half the normal level, notwithstanding a slightly larger planting area than in the preceding year. Yield declined to about one third of the normal level. Consequently, instead of exporting, South Africa imported about 1 million tons of maize in the year ended June 1992 and another 3.3 million tons in the following year, at a total cost of more than SDR 400 million. Maize stocks, normally maintained at about 1 million tons, were reduced by about a third. Maize production in the post-excess year has already recovered to a level moderately higher than average. Thus, the need for maize imports has clearly terminated and, even taking into account some restocking, South Africa should be able to realize the export volume attained in the past.

Wheat production also fell from its normal level of almost 2 million tons to less than 1.3 million tons in 1992/93. Although stocks were reduced by about one third to less than 1 million tons, supply could not meet domestic demand. In the year ended June 1993, import volume rose to 0.8 million tons while the export quantity (largely of wheat flours and products) was maintained. Similarly, the output of sorghum in 1992 declined by more than half, to 0.1 million tons. To meet the domestic requirement, about 0.16 million tons were imported and stocks were reduced marginally.

The CCFF calculations assume that output of both grains in the post-shortfall years will be restored to the normal levels and that, even with a rebuilding of stocks, their import requirements will be reduced to the pre shortfall levels.

Table 7. South Africa: Earnings from Merchandise Exports 1989-95 and Shortfalls of Major Items for Year Ending June 1993

	Year ending June							Geometric shortfall in year ending June 1993	
						Projections			
	1989	1990	1991	1992	1993	1994	1995	Amount	Percent of quota
	(In millions of SDRs)								(Percent)
Earnings	17,236	17,301	17,339	16,790	16,755	17474	18283	564	41
Gold 1/	6,058	5,573	5,068	4,858	4,801	5,002	5,092	162	12
Platinum	1,435	1,565	1,622	1,241	1,137	1,418	1,524	240	18
Diamonds	738	828	571	1,008	924	862	944	-78	-6
Coal	847	1,008	998	1,080	1,041	994	1,207	20	1
Other minerals and metals	1,746	1,704	1,562	1,434	1,382	1,432	1,416	62	5
Ferrochrome	494	464	378	339	262	291	364	62	5
Copper	406	375	383	350	299	286	277	17	1
Nickel	297	266	205	176	124	156	82	18	1
Iron ore	169	210	217	202	209	189	209	-4	--
Manganese ore	139	171	163	154	90	102	117	32	2
Other 2/	242	219	215	214	398	408	367	-90	-7
Agricultural products	750	1,056	882	830	684	842	959	150	11
Citrus	66	75	91	112	116	107	121	-7	--
Deciduous fruit	99	140	183	173	253	268	295	-24	-2
Wool	300	253	207	180	127	154	147	34	2
Sugar	165	234	175	152	51	37	139	42	3
Maize	42	283	71	57	3	85	83	36	3
Other 3/	78	70	155	156	133	191	174	27	2
Manufactured goods	5,662	5,567	6,636	6,339	6,786	6,923	7,142	-26	-2
Food	656	791	801	877	726	716	755	47	3
Chemical products	582	560	584	737	710	690	680	-32	-2
Textiles	452	433	451	461	403	375	355	4	--
Machinery/electrical equipment	303	356	392	473	558	586	625	-38	-3
Vehicles/transport equipment	161	245	352	484	623	730	803	-49	-4
Paper and paper products	331	360	422	399	390	385	380	5	--
Plastic goods	100	94	130	182	168	170	175	-4	--
Other	3,078	2,727	3,504	2,727	3,207	3,271	3,369	-3	--
	(Percentage change)								
Earnings		0.4	0.2	-3.2	-0.2	4.3	4.6		
Gold 1/		-8.0	-9.1	-4.2	-1.2	4.2	1.8		
Platinum		9.1	3.7	-23.5	-8.3	24.7	7.4		
Diamonds		12.2	-31.1	76.7	-8.4	-6.7	9.5		
Coal		19.0	-1.0	8.2	-3.6	-4.5	21.4		
Other minerals and metals		-2.4	-8.3	-8.2	-3.6	3.6	-1.1		
Ferrochrome		-6.1	-18.4	-10.4	-22.7	10.9	25.1		
Copper		-7.8	2.1	-8.6	-14.5	-4.4	-3.0		
Nickel		-10.4	-22.7	-14.4	-29.5	25.8	-47.7		
Iron ore		24.7	3.5	-7.3	3.9	-9.8	10.6		
Manganese ore		23.4	-4.8	-5.7	-41.4	13.7	14.8		
Other 2/		-9.5	-1.5	-0.6	85.7	2.7	-10.1		
Agricultural products		40.7	-16.5	-5.9	-17.6	23.1	13.9		
Citrus		14.6	21.3	23.2	3.1	-7.4	13.2		
Deciduous fruit		41.1	30.2	-5.3	46.5	5.9	10.0		
Wool		-15.7	-18.1	-13.3	-29.3	20.9	-4.3		
Sugar		42.4	-25.3	-13.3	-66.1	-28.6	278.0		
Maize		567.1	-74.9	-19.5	-94.2	2,453.9	-1.9		
Other 3/		-10.4	120.9	0.6	-14.5	43.8	-9.3		
Manufactured goods		-1.7	19.2	-4.5	7.0	2.0	3.2		
Food		20.7	1.2	9.5	-17.2	-1.4	5.4		
Chemical products		-3.8	4.3	26.2	-3.6	-2.9	-1.4		
Textiles		-4.2	4.2	2.1	-12.6	-6.9	-5.3		
Machinery/electrical equipment		17.5	10.0	20.6	18.0	5.1	6.7		
Vehicles/transport equipment		52.5	43.6	37.6	28.7	17.1	10.0		
Paper and paper products		8.8	17.2	-5.4	-2.2	-1.3	-1.3		
Plastic goods		-5.8	38.9	39.8	-7.8	1.2	2.9		
Other		-11.4	28.5	-22.2	17.6	2.0	3.0		

Sources: Data provided by the South African authorities; and staff estimates and projections.

1/ Gold exports in 1994 and 1995 are assumed to equal 97 percent of projected gold production.
2/ Ferromanganese, asbestos, chrome ore, lead, silver, and miscellaneous minerals and metals.
3/ Canned fruit and miscellaneous vegetable products.

Table 8. South Africa: Value, Volume and Unit Value Series for Major Commodity Exports, 1989-95

	Year ending June					Projections	
	1989	1990	1991	1992	1993	1994	1995
	(1993=100; In terms of SDRs)						
Value							
Gold	126	116	106	101	100	104	106
Platinum	126	138	143	109	100	125	134
Coal	81	97	96	104	100	96	116
Copper	136	125	128	117	100	96	93
Ferrochrome	188	177	144	129	100	111	139
Iron ore	81	100	104	96	100	90	100
Manganese ore	154	190	181	171	100	114	131
Citrus	57	65	79	97	100	93	105
Wool	236	199	163	141	100	121	116
Sugar	320	456	341	295	100	71	270
Volume							
Gold	102	99	99	96	100	98	98
Platinum	99	94	99	90	100	121	129
Coal	90	102	96	102	100	107	108
Copper	82	90	105	98	100	111	104
Ferrochrome	115	109	121	106	100	109	108
Iron ore	78	90	90	78	100	77	87
Manganese ore	279	207	146	129	100	123	126
Citrus	82	99	101	110	100	105	106
Wool	113	116	121	114	100	113	96
Sugar	276	247	255	254	100	70	259
Unit Value							
Gold	124	118	106	105	100	106	108
Platinum	127	146	145	121	100	103	104
Coal	90	95	100	102	100	89	107
Copper	166	140	122	120	100	86	89
Ferrochrome	163	163	119	122	100	102	129
Iron ore	104	111	115	124	100	117	115
Manganese ore	55	92	124	132	100	93	104
Citrus	70	65	78	88	100	88	99
Wool	209	172	135	124	100	107	121
Sugar	116	184	133	116	100	101	104
Memorandum item:							
	(Thousand tons)						
Maize exports	2,797	4,990	1,316	1,504	77	1,550	1,500

Sources: Data provided by the South African authorities; and staff estimates and projections.

Table 9. South Africa: Imports of Cereals, 1989-95

	Year ending June							Arithmetic excess in year ending June 1993	
						Projections			
	1989	1990	1991	1992	1993	1994	1995	Amount	Percent of quota
	(In millions of SDRs)								(Percent)
A. Calculation of excesses									
Cereal import costs	141	149	206	255	503	179	178	239	17
Maize	5	--	--	119	308	5	--	222	16
Wheat	--	12	90	21	80	55	56	20	1
Barley	33	34	39	34	25	44	48	-13	-1
Rice	103	100	74	76	71	70	69	-1	--
Sorghum	--	--	1	2	17	3	3	12	1
Oats	--	3	2	2	2	2	2	--	--
	(Percentage changes)								
Cereal import costs		6	38	24	97	-64	-1		
Maize		-95	--	--	159	-98	--		
Wheat		--	642	-77	280	-31	1		
Barley		5	13	-12	-27	77	9		
Rice		-4	-25	2	-7	--	-1		
Sorghum		-76	902	389	592	-83	1		
Oats		--	-13	--	-16	6	4		
B. Value, volume and unit values									
	(Indices: Excess year=100)								
Value									
Maize	2	--	--	39	100	2	--		
Wheat	--	15	112	26	100	69	70		
Barley	131	138	156	137	100	177	192		
Rice	146	141	105	107	100	100	98		
Sorghum	1	--	3	14	100	17	17		
Oats	--	136	119	119	100	106	110		
Volume									
Maize	2	--	--	33	100	2	--		
Wheat	--	12	108	25	100	75	65		
Barley	127	116	141	167	100	155	159		
Rice	127	112	100	93	100	100	99		
Sorghum	1	--	3	14	100	19	19		
Oats	--	97	108	114	100	111	111		
Unit value									
Maize	88	84	n.a. 1/	118	100	89	n.a. 1/		
Wheat	n.a. 1/	128	104	104	100	92	107		
Barley	104	119	110	82	100	114	121		
Rice	115	126	106	116	100	100	99		
Sorghum	117	113	108	104	100	88	89		
Oats	n.a. 1/	140	110	104	100	95	99		
Memorandum item:									
	(Thousand tons)								
Maize import volume	57	3	--	1,080	3,301	59	--		

Sources: Data provided by the South African authorities; and staff estimates and projections.

1/ Not applicable because of zero imports.

December , 1993

Dear Mr. Camdessus,

As you know, the Government and the principal nongovernmental groups that make up the Transitional Executive Council (TEC) have been engaged in discussions with the staff of the IMF on economic policies aimed at alleviating South Africa's balance of payments difficulties. The recent strains in the balance of payments are attributable chiefly to lower prices for commodity exports and a drought that necessitated large imports of maize. The Government intends soon to request a purchase under the Compensatory and Contingency Financing Facility (CCFF) with respect to the shortfall in export earnings and the excess in cereal import costs during the year ended June 1993.

The attached Statement of Policies outlines the economic program during the period ahead. We believe that the successful conclusion of the present Article IV consultation together with the understandings reflected in the attached Statement of Policies demonstrate South Africa's willingness to cooperate with the Fund to find appropriate solutions to the country's balance of payments difficulties and fulfill the test of cooperation set forth in paragraphs 12 and 31 of the Executive Board Decision on the CCFF.

Yours sincerely,

Derek L. Keys
Minister of Finance and of
Trade and Industry

[to be announced]
Chairman,
Transitional Executive Council

Attachment

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Statement of Policies

1. South Africa stands at an historic watershed. The first multiracial elections are scheduled for April 27, 1994. The Transitional Executive Council (TEC), a body co-responsible with Government for, *inter alia*, international financial agreements in the period until the elections, will be set up on December 6, 1993. The United Nations lifted its economic sanctions on October 8, 1993 and most of South Africa's trading partners followed suit. The stage is now set in South Africa for more openness to international trade and investment, with the benefits flowing to all of the people.

2. The progress on political and constitutional issues in South Africa occurred against a backdrop of difficult domestic economic circumstances and an increasingly severe balance-of-payments constraint. The year through June 1993 saw large drought-related maize imports, export receipts depressed by the drought and by low prices of gold and other metals, and a sharp loss of foreign exchange reserves. The Government and the political parties that make up the TEC are determined that the political transition not be allowed to founder on economic developments. Therefore, their macroeconomic strategy is aimed at a resumption of investment and growth, a consolidation of the progress against inflation, and a sustainable balance of payments. In support of these policies South Africa intends to request a purchase under the CCFF in an amount equivalent to SDR 614 million (45 percent of quota), with respect to an excess in cereals imports and an export shortfall. Recent developments in the economy and South Africa's policies are outlined below.

3. Macroeconomic developments in South Africa have been disquieting. The recession, which began in 1989, has been more harsh than any other since the 1930s. Real per capita GDP is now more than 15 percent lower than in the early 1980s, and more than 40 percent of the labour force is unable to find work in the formal sector. Equally troubling, from the perspective of growth prospects over the medium term, has been the drop in gross saving and investment ratios: in 1992, fixed investment was barely sufficient to replace depreciating capital. On the positive side, inflation has been reduced: the underlying inflation rate is currently around 7½ percent per annum compared with an average rate of about 15 percent during 1985-1991.

4. In part the present dire circumstances are related, both directly and indirectly, to the historical system of apartheid, the national and international reaction to it, and uncertainties associated with the ongoing political transformation. Severe race-based distortions in the labour market and disparities in education and training under apartheid were exacerbated in recent years by the breakdown of segments of the educational system. Since 1985, financial sanctions in the form of the cessation of

international lending have compelled South Africa to restrain demand in order to make payments on its international debt. At the same time, rising uncertainty resulting from the political transition and the upsurge of violence has persuaded domestic and foreign entrepreneurs to adopt a wait-and-see attitude to investments in South Africa. Exogenous factors have exacerbated matters further. The 1992 drought reduced real agricultural production by 25 percent, and South Africa's terms of trade have deteriorated steadily throughout the recession.

5. The external balance of payments position worsened in 1992 and 1993 owing to drought-related maize imports, low export receipts reflecting the effects of the drought and unfavorable metal prices, and an unwillingness on the part of domestic enterprises to refinance external debt at the high prevailing margins set by lenders. Gross official gold and foreign exchange reserves have dropped by US$2.2 billion since August 1992; their current level is US$2.6 billion, equivalent to only 5 weeks of imports of goods and services.

6. Government finances came under increasing pressure in the early 1990s. Revenues were reduced by the weak cyclical position. At the same time it proved difficult to contain spending: expenditures on social services-- education, health, and the social pensions--were increased as part of a drive towards correcting racial disparities in per capita spending, and special budgetary allocations were necessitated by the 1992 drought. In 1992/93 these factors contributed to a budget deficit equivalent to an unprecedented 8½ percent of GDP. In 1993/94, the deficit is budgeted to fall to a little under 7 percent of GDP, chiefly as the result of an increase in the VAT and a reduction in drought-related aid.

7. Monetary policy has carried much of the burden of South Africa's adjustment during the 1990s. In the last four years real interest rates have generally been positive (with key rates rising to almost 7 percent in late 1992), and in the last three years the growth of broad money and bank credit extended to the private sector have been negative in real terms. In 1993, in light of the low level of foreign exchange reserves, continued monetary stringency has been necessary to moderate downward pressure on the rand resulting from political developments. An easing of policy would have brought sharper depreciation that would have risked a further undermining of confidence and a resurgence of inflation. The tight monetary policy has played a major role in reducing inflation. The 12-month rate of consumer price inflation fell steadily from more than 16 percent in December 1991 to less than 10 percent in December 1992. The underlying rate at present is somewhat lower: some 2 percentage points of the 9½ percent inflation in the twelve months through October are attributable to the increase in the VAT. Also, the rand depreciated by 9 percent in nominal effective terms during the first 11 months of the year, and by nearly 7 percent in real effective terms through August.

8. In order to redress the social backlogs that are the legacy of decades of apartheid and its predecessor policies, South Africa's economic policies must be driven by the objective of durable growth in which all can

share equitably. This will require political stability and a package of macroeconomic and structural policies that addresses the problems of high unemployment and weak investment, respects financial constraints, and promotes confidence in the economic management of the country. The outlines of this package are sketched in the following paragraphs.

9. On fiscal policy, despite the pressures for additional expenditure that will arise in the social and political transition that South Africa is now embarked upon, there is widespread understanding that increases in the government deficit would jeopardize the economic future of the country. At the same time it is recognized that unless social needs are addressed in a responsible manner, socio-political and economic stability would be difficult to obtain and sustain.

10. Fiscal policy in 1994/95 will aim at lowering non-interest recurrent expenditures to 22½ of GDP (as against slightly over 23 percent in the 1993/94 budget) and reducing the Central Government deficit to about 6 percent of GDP. This fiscal framework will seek to continue the process involved in the reduction of the budget deficit--from 8½ percent of GDP in 1992/93 to a projected 7 percent in 1993/94--but, in light of the importance of maintaining a competitive tax structure, will emphasize expenditure containment rather than raising taxes. The budgetary situation will be helped by a post-Apartheid fiscal bonus--the ending of wasteful duplication and extra layers of bureaucracy that was part of the legacy of the system--although these savings will be small in relation to total expenditure. Also, the Government is committed to containing the civil service wage bill consistent with no real increase in wage rates.

11. The attainment of the quantitative fiscal objectives will require further reordering of government priorities, both between and within functional categories. Steps to reallocate expenditure away from defence will be continued as far as is feasible and the savings from this source could be supplemented in due course by lower spending on law and order and general administration. The resources thus freed could contribute to further redressing of the social backlog: most urgently to improving education and training (so as to give workers the human capital necessary to empower them in the labour market and raise productivity and incomes in a sustainable way), and to expanding access to basic health services. A major challenge is therefore to continue to shift priorities in order to extend coverage to those areas where basic needs are currently not being met and to achieve an equitable distribution of government spending.

12. The thrust of South Africa's monetary policy during the past year will be maintained during 1994. While inflation has been lowered significantly, it is essential that the conduct of monetary policy be such as to safeguard this achievement. Accordingly, money growth guidelines will be set so as to accommodate real growth, projected at 1½ percent and a further slight drop in the inflation rate. (In implementing these guidelines monetary policy will remain under review during the year: stronger than projected economic activity and an easing of the external constraint--as evidenced by a build-up in reserves and a strengthening of

the rand--would warrant a more accommodating stance). The influence of the monetary targets on interest rates, the exchange rate, and the real economy will depend on a variety of factors: most importantly, wage developments, fiscal policy, and confidence in the economy as reflected in capital flows and exchange rate expectations. With realistic wage settlements, a realization of fiscal objectives, and a restoration of confidence, the monetary targets will be consistent with lower interest rates and higher investment.

13. Maintaining the competitiveness of the South African economy is fundamental to the objective of durable growth of output and employment. Competitiveness is influenced by a combination of internal developments--wage rates and productivity--and by exchange rates. The beneficial effects of a nominal depreciation can be easily offset by the reaction of domestic factor prices leading to a spiral of depreciation and inflation. On the other hand, internal adjustment can promote employment and investment in a non-inflationary environment. An understanding of these issues has been fostered by the National Economic Forum, a tripartite body (employers, unions, and government) that has assumed a greater role in the discussion of policy options and the formulation of policies.

14. The South African labour market is distorted by enormous inequities in the distribution of education and job skills. At present levels of productivity, it will be impossible to absorb the vast number of unemployed workers at even a modest living wage. The medium-term solution, of course, is to boost productivity by improving education and training--this is a national priority in which government and business will have to participate equally. For the immediate future, the Government and the social partners are already embarked on a discussion of policies designed to couple wage restraint and training in order to foster investment and promote employment. The role of Government will depend chiefly on moral suasion and on leadership in setting civil service wages that are sensitive to the magnitude of unemployment.

15. The balance of payments position will remain difficult in 1994. Even assuming that trade credits and short-term Reserve Bank credits can be rolled over, repayments will amount to some 2 percent of GDP (US$ 2.1 billion) and official reserves have already been substantially depleted. The relatively low stock of foreign debt (15 percent of GDP) should make it possible, with the lifting of sanctions, for South Africa to benefit from capital inflows. A sustained capital inflow would ease the resource constraint, reduce the pressure on external reserves, and eventually facilitate an ending of capital controls and the financial rand mechanism. But a spontaneous surge in capital inflows cannot be counted on in the initial stages of the transition as investors may continue to be hesitant to commit resources to South Africa. In the meantime, therefore, although there will be no intensification of exchange restrictions, the financial rand mechanism will be retained as a buffer against foreign disinvestment, and the authorities will refrain from net intervention in the financial rand market. The strategy, starting immediately, is to restore confidence by

showing evidence of political stability and financial discipline and by regularizing the external debt situation.

16. The third interim debt agreement between South Africa and its foreign creditor banks expires on 31 December 1993, at which point some US$ 5 billion of principal will remain past due. South Africa and the commercial banks have negotiated an agreement under which this amount will be repaid over about eight years. Under the terms of the agreement 10 percent of the debt will be repaid in February 1994 and a further 3 percent in August 1994. This will be followed by half-yearly instalments (commencing on 15 February 1995) in amounts that will dovetail with existing fixed repayment obligations. Approximately 40 percent of the amount of outstanding affected debt will be repaid during the first five years and the remaining 60 percent during the last three years of the tenor of the new arrangement. In light of the sharp fall in other debt service obligations from 1998, the agreed maturity structure will smooth out the amortization schedule.

17. Finally, trade and industrial liberalization will be an important part of the restructuring of the South African economy. The objective is a shift from an inward-looking economy (isolated by sanctions) to an export-oriented economy with world demand providing an engine for growth. Correspondingly, regulatory intervention will have to give way to greater reliance on market forces. Specifically, the protection system will be simplified and rationalized. Import licensing and non-tariff barriers will continue to be phased out. The revised industrial tariff structure offered to GATT in the context of the Uruguay Round would reduce the number of industrial tariff lines by two thirds. Moreover, it would represent a trade-weighted average cut in the maximum level of tariffs of one third. The implementation of this offer is expected to result in greater uniformity and stability of the system. Formula duties will be phased out as new anti-dumping legislation and systems become effective and the restructuring of the economy progresses. Provided the balance of payments situation is under control, the import surcharge will be eliminated by mid-1994. With respect to export promotion, the General Export Incentive Scheme (GEIS) currently serves as the main instrument by which the policy induced anti-export bias is offset. However, in conjunction with the tariff reform, the system of duty drawbacks and rebates is being streamlined in order to allow exporters freer access to imported inputs at world prices. Progress toward this end will create a climate conducive to the phasing out of GEIS.

November 29, 1993