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CONFIDENTIAL

April 21, 1987

To: Members of the Executive Board

From: The Acting Secretary

Subject: South Africa - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the South African rand.

Mr. Bélanger (ext. 8671) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Real Effective Exchange Rate--Information Notice

Prepared by the European Department and the External Relations Department

(In consultation with the Legal Department and the Research Department)

Approved by L. A. Whittome and J. T. Boorman

April 21, 1987

The recent evolution of South Africa's real effective exchange rate, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, as of January 1987, the South African rand has appreciated in real effective terms by more than 10 percent since the last occasion on which the Executive Board had the opportunity to discuss South Africa's exchange rate policy--the staff report for the 1986 Article IV consultation (SM/86/185, 7/30/86, and Sup. 1, 9/9/86). The appreciation is estimated to have amounted to 10.7 percent in the four months to January 1987.

The real effective exchange rate for the rand has fluctuated widely over the past several years. Between the end of 1983 and the end of 1985, the rand was under almost uninterrupted downward pressure. Larger-than-expected surpluses on the current account owing to the rise in the price of gold, and a slowdown in capital outflows following the declaration of a selective standstill on debt repayments and the reintroduction of a dual exchange market, 1/ strengthened the external value of the commercial rand in early 1986. In March, the exchange rate of the commercial rand vis-à-vis the U.S. dollar thus averaged just under R 1 = US$0.50, which was over 32 percent above its average level against the U.S. dollar in December 1985. However, by the middle of 1986, during the period immediately before and following the reimposition of a state of emergency, the rand fell back to its end-December 1985 level of US$0.38. Since then, it has strengthened significantly under the impetus of the rise in the price of gold, rising to US$0.46 by the end of 1986. In nominal effective terms, the rand appreciated by 6.6 percent in the course of the year.

1/ Previously, the dual exchange market had been unified in February 1983.

During the first quarter of 1987, the commercial rand remained strong, averaging US$1 = R 0.48, as the continuing high gold price and falling imports sustained a large current account surplus. The conclusion of a second Interim Debt Arrangement in March 1987, covering the period until June 1990, added further to the strength of the rand. The financial rand, which had been very weak throughout most of 1986, trading at discounts of up to 50 percent vis-à-vis the commercial rand, strengthened likewise in the early part of 1987 with the discount at about 30 percent at end-March 1987. Following the strengthening of the rand in the second half of 1986, the rate of inflation slowed somewhat, falling from 18 percent in December 1986 to just over 16 percent in January and February 1987.

During the last eight quarters, the current account of the balance of payments registered steady surpluses of about R 1.6 billion per quarter. For 1986 as a whole, the current account surplus amounted to R 7.2 billion (5.2 percent of GDP), R 1.3 billion more than the surplus recorded in 1985. The strong performance of the current account in the last two years reflected depressed merchandise imports and the sharp increase in the value of gold exports. The surpluses on the current account were, however, accompanied by very large net capital outflows, amounting to R 9.2 billion in 1985 and R 6.1 billion in 1986. At the end of 1986, South Africa's holdings of foreign exchange stood at US$363 million, US$55 million more than a year earlier, while physical gold holdings stood at approximately the same level as a year before (4.82 million ounces or US$1.9 billion at market-related prices). Merchandise imports exchange reserves surged to the equivalent of US$1,063 million, while physical gold holdings rose to 5.3 million ounces over this period.

On the policy front, the authorities responded to the weak growth performance in the last two years by introducing two stimulatory fiscal packages (in September 1985 and June 1986). The mini-budget of February 1987 included some limited tax concessions, but further stimulation via expenditures was not considered; nevertheless, such measures are not precluded from the full budget for 1987/88 to be presented in early June. Monetary policy eased significantly in the course of 1986, and money market interest rates fell significantly. Broad money (M3) grew by 9.3 percent in the 12 months to end-1986, well below the target ranges set by the Reserve Bank (16 to 20 percent). The target ranges adopted for 1987 aim at achieving a growth rate of M3 between 14 and 18 percent and are based on a projected growth rate of GDP of 3 percent and a gradual decline in the rate of inflation. However, as noted in SM/86/185, the authorities consider the monetary targets only broadly indicative of policy intentions as indicated also by the quite broad ranges that have been adopted.

Staff Appraisal

In concluding the 1986 Article IV consultation with South Africa on September 17, 1986, Executive Directors emphasized that financial policies should be formulated in terms of a predictable and transparent medium-term strategy to dampen inflation and improve the fiscal balance, so as to restore confidence and accelerate job creation. To this end, they underscored the importance of reorienting policies toward more labor-intensive methods.

The recent real appreciation of the rand, which reflected a combination of continuing high rates of consumer price increases and a strengthening of the value of the rand, eroded part of the gains in competitiveness realized since mid-1983. As long as the external value of the rand is primarily determined by political circumstances and exogenous factors such as the price of gold, as was the case in the last year and a half, the authorities have little leeway to affect the external value of the rand through policy measures. Against the background of growing trade sanctions against South Africa, it is unlikely that the authorities will give first priority to the maintenance of competitiveness. Rather, financial policies are likely to be oriented more directly at sustaining domestic demand.

The authorities are aware that their chosen policy stance requires a degree of price stability that does not act as an obstacle to the growth objective but at the same time does not take precedence over it. Reflecting a growing concern regarding the continued high inflation rate, the recent mini-budget took a cautious approach with regard to expenditure measures, although judgment on the stance of fiscal policy will need to await the full budget presentation in early June. The scaling down of the target ranges for M3 presents a further positive step, albeit that its impact on the degree of monetary tightness continues to be obscured by the large portfolio shifts which have been taking place in the wake of disinvestment from South Africa. Issues with regard to external financial developments and the policy framework of the authorities will be reviewed more thoroughly in the context of the 1987 Article IV consultation discussions with South Africa, which are scheduled to take place in June 1987.

Table 1. South Africa: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate 1/ 2/	Nominal Effective Exchange Rate 1/	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars 1/	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1982						
I	101.6	92.7	109.6	78.7	125.4	125.1
II	98.5	87.6	112.5	72.3	130.6	130.4
III	96.8	85.2	113.7	67.7	134.1	134.3
IV	102.3	88.0	116.3	69.0	138.8	138.8
1983						
I	107.3	90.0	119.3	71.8	143.2	143.0
II	110.2	91.2	120.9	71.5	146.8	146.8
III	113.0	92.7	122.0	70.2	150.0	150.1
IV	108.7	88.0	123.7	66.3	153.8	153.7
1984						
I	105.8	84.4	125.4	63.1	157.7	157.6
II	105.5	82.1	128.5	61.0	163.0	163.3
III	92.4	70.2	131.6	49.5	168.4	168.3
IV	84.3	62.7	134.5	42.8	173.9	173.7
1985						
I	81.6	58.9	138.7	38.2	181.3	181.2
II	83.2	58.2	143.0	39.6	189.1	189.6
III	71.2	48.4	147.2	34.8	195.8	195.7
IV	58.4	38.3	152.7	29.4	204.4	204.0
1986						
I	71.7	44.6	160.7	36.3	216.0	216.0
II	68.1	41.2	165.5	34.8	222.5	223.2
III	61.5	35.6	172.6	31.4	232.8	232.6
IV	70.6	39.4	179.2	34.8	242.8	242.2
Monthly						
1986						
Sep. 3/	66.6	38.0	175.4	33.7	237.1	236.7
Oct.	69.3	39.1	177.4	34.6	239.8	239.3
Nov.	70.6	39.5	179.1	34.6	242.7	242.4
Dec.	71.8	39.7	181.1	35.1	246.0	244.9
1987						
Jan.	73.7	40.4	182.6	37.3	248.5	247.4
Percentage change						
Sep. 1986–Jan. 1987	10.7	6.4	4.1	10.7	4.8	

Source: Information Notice System.

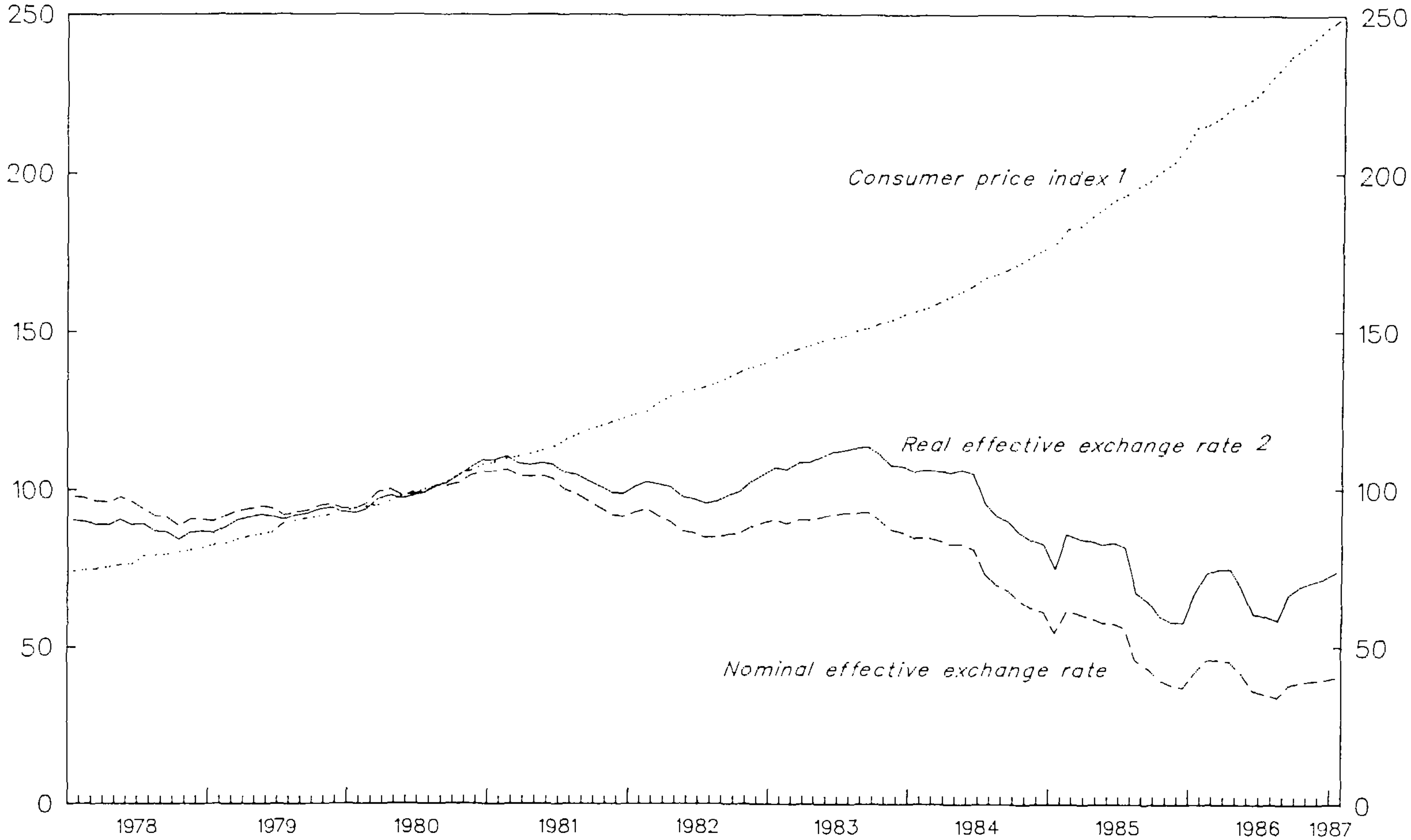
1/ Increases mean appreciation.
2/ Using seasonally adjusted price indices.
3/ Date of latest consideration by Executive Board.

CHART 1

SOUTH AFRICA

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980=100)



Source: Information Notice System.

1 Seasonally adjusted.

2 Trade weighted index of nominal exchange rate deflated by seasonally adjusted consumer prices; increase means appreciation.