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July 30, 1986

To: Members of the Executive Board

From: The Secretary

Subject: South Africa - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with South Africa, which is tentatively scheduled for discussion on Friday, September 12, 1986.

Mrs. Junz (ext. 8849) or Mr. Dell'Anno (ext. 8791) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

SOUTH AFRICA

Staff Report for the 1986 Article IV Consultation

Prepared by the European Department

Approved by L. A. Whittome and Eduard H. Brau

July 29, 1986

I. Introduction

A staff team consisting of H. B. Junz, U. Dell'Anno, J. K. Salop, and J. Van 't dack, with K. Moran as secretary (all EUR), conducted Article IV consultation discussions in Pretoria and Cape Town from May 21 to June 6, 1986. The team met with Mr. B. du Plessis, Minister of Finance; Dr. G.P.C. de Kock, Governor of the South African Reserve Bank; and with senior officials from the various government departments, the South African Reserve Bank, the Development Bank of Southern Africa, and the Small Business Development Corporation. The mission also met with a broad spectrum of corporate leaders in both the public and private sectors. Mr. A. Peacey, South Africa's Principal Resident Representative to the Fund and the IBRD, attended the meetings as an observer.

South Africa accepted the obligations of Article VIII, Sections 2, 3, and 4, as of September 15, 1973. Repurchases still outstanding under a stand-by arrangement and a CFF drawing approved in 1982 amount to SDR 109 million and SDR 477 million, respectively. Of these, SDR 188.5 million fall due in the second half of 1986 (Appendix IV).

On the occasion of the Executive Board discussion of the 1985 Article IV consultation with South Africa (SUR/85/61, 6/13/85), Directors underscored the importance of the pursuit of firm financial policies over the medium term and of effectively addressing the structural problems in the economy so as to bring inflation under control and to promote balanced growth, in part through the preservation of the improvement in the external competitive position, which had been secured by the large depreciation of the rand. They urged the authorities to take major steps to enhance the geographical and occupational mobility of labor, to narrow the existing large gap in educational opportunities between various population groups and to take fundamental action to increase competition in the domestic market. This, it was argued, would lead in time to a clear improvement of the growth potential of the economy.

II. Background

Economic, financial, and sociopolitical conditions in South Africa came under increasing strain in 1985 and 1986 as political unrest at home and pressures abroad for a significant reduction of political and social inequalities interacted. The consequent erosion of confidence has prolonged the cyclical downturn of 1984 and has frustrated policy attempts to engineer a recovery. Whereas political uncertainties play a major role in the apparent unresponsiveness of the economy to easier demand management policies, the slowness with which policies addressed the aftermath of the commodity boom of the 1970s together with the rigidities imparted largely by the apartheid laws, are important elements as well.

1. Structural problems

The economic adjustment problems inherited from the 1970s are largely associated with the dependence of the economy on gold. The gold bonanza of the second half of the 1970s led to an excessively optimistic attitude regarding general income growth and, through the associated upward pressure on the exchange rate, squeezed the competitiveness of the rest of the economy (Chart 1). With wage pull emanating from the mining sector, real wage increases outran productivity growth elsewhere in the economy. This was facilitated by the restrictive labor laws, which limited the growth of both the skilled labor force and productivity. At the same time that exchange rate and wage developments eroded international competitiveness, inadequate competition at home militated against spontaneous adjustment. Efficient resource allocation was further inhibited by the perceived need for a high degree of self-sufficiency in a wide range of manufactured products, including energy, steel, and military equipment. These developments, which largely reflected the economic consequences of the policy of apartheid, contributed both to a narrowing of the South African export base and a generally high-cost structure of output.

The lack of resistance to high-cost operations probably reflects the fact that the relatively recent swing to a free market philosophy in South Africa finds its expression more in a laissez faire orientation than in fostering market competition. Thus, producers have been able to increase profit margins in efforts to recapture cost increases, a tendency that has resulted in cost-push spirals that have ratcheted up the underlying rate of inflation (Table 1). Financial and monetary policies in the 1980s, while in principle oriented toward reducing inflationary pressures, in practice accommodated them and, in fact, through frequent changes of course, may at times have added to the risk premia exacted in the private sector.

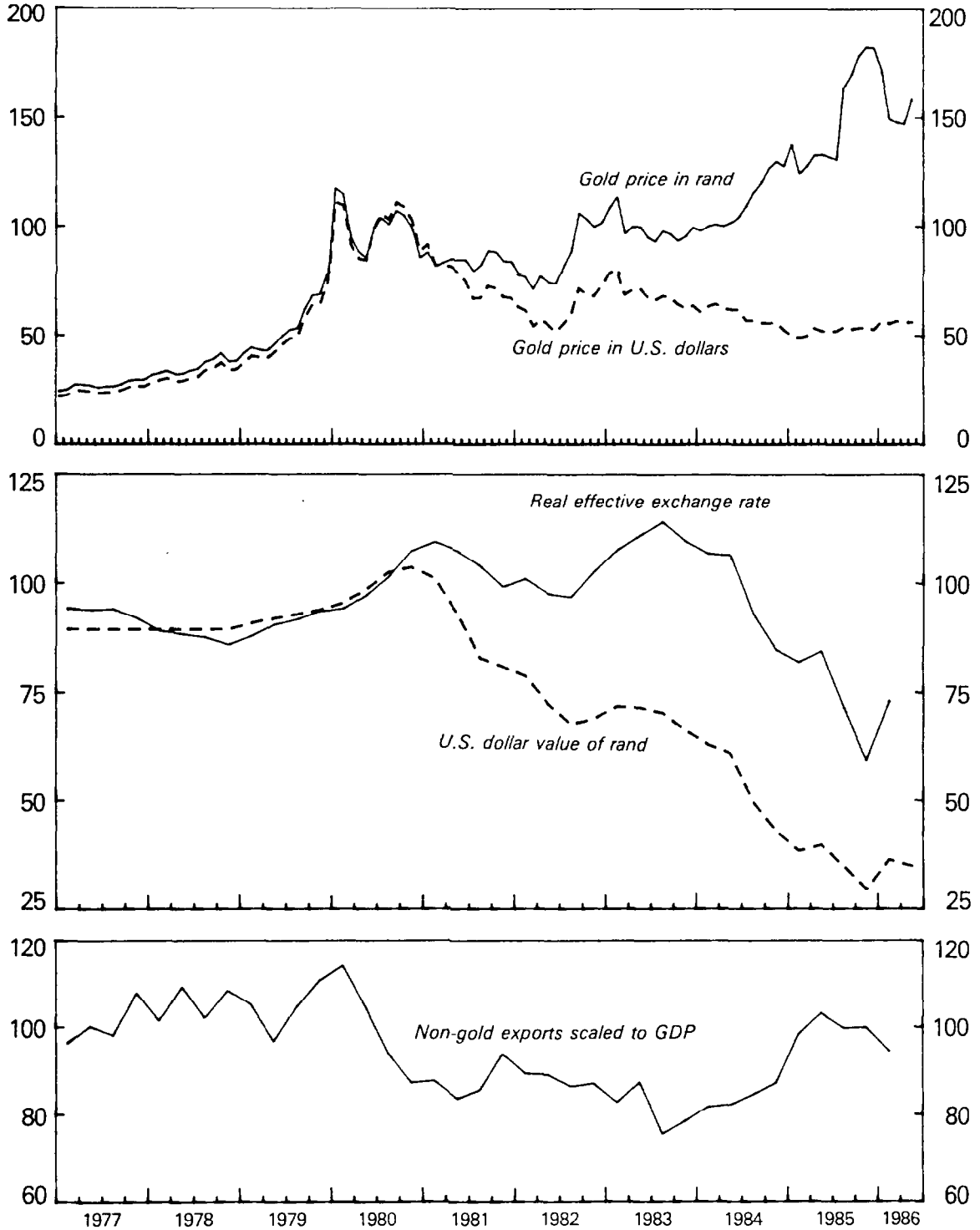
The inflationary environment contributed to the slowing of economic growth in the 1980s--in fact, GNP in real terms was barely higher in 1985 than in 1980--and has brought about a structure of output and savings that has become increasingly inadequate to deal with the need to

CHART 1

SOUTH AFRICA

INDICES OF GOLD PRICES, EXCHANGE RATES, AND NON-GOLD EXPORTS

(1980 = 100)



Sources: IMF, Datafund; and staff calculations.

increase employment and bring about a resumption of balanced growth. Employment, in the face of a labor force that rises by about 2 1/2 percent per annum rose by less than 4 percent over the five-year period, not least because real wage increases continually outstripped productivity growth (Chart 2). In the process, the public sector became the employer of last resort (Table 2).

Table 1. South Africa: Manufacturing Sector: Elements of Inflation, 1970-85

(Percentage changes from preceding period)

	1970-79 1/	1980	1981	1982	1983	1984	1985
Unit labor costs	9.6	11.8	15.9	22.7	15.2	9.1	14.6
Import prices	14.3	20.2	10.7	15.2	10.0	8.2	23.6
Profit margins	...	...	7.1	-1.7	13.6	12.7	6.6
Producer prices of domestic goods	12.2	15.1	13.8	14.5	10.7	8.2	15.2
Total producer prices	12.7	16.1	13.5	13.9	10.5	8.3	16.9
Consumer prices	10.3	13.8	15.2	14.7	12.3	11.7	16.2
Nominal wage per worker	12.5	17.0	19.6	19.1	13.2	13.5	11.6

Sources: South African Reserve Bank, Quarterly Bulletin; and staff estimates.

1/ Compound annual averages.

These developments, in turn, have been reflected in an adverse shift in the structure of savings (Table 3). The government position swung from large positive current savings in the 1970s to significant dissaving in the 1980s (Chart 3). At the same time, inflation and the rising burden of taxation eroded the savings propensity of households so that the lion's share of savings (about 90 percent) is currently accounted for by depreciation flows and corporate savings. Domestic savings have tended to be heavily, if intermittently, augmented by inflows of external capital. In the second half of the 1970s, such flows reversed in response to social unrest and growing criticism abroad of the system of apartheid. However, the effects of this reversal on confidence in general and on investment in particular were more than offset by the skyrocketing price of gold. Consequently, gross fixed investment rose strongly through the early 1980s. Inflows of foreign capital turned positive again in 1981, but were related increasingly to the acquisition of financial assets. With the flaring up of political

Table 2. South Africa: Change in the Sectoral and Racial Structure of Employment, 1970-85 1/

(Percentage of total employment and thousands employed)

	1970		1975		1980		1983		1985	
					(Employment by sector)					
	Total	Of which: Blacks	Total	Of which: Blacks	Total	Of which: Blacks	Total	Of which: Blacks	Total	Of which: Blacks
Mining	17.5	15.7	13.6	12.0	15.6	13.8	14.4	12.6	15.4	13.6
Of which: Gold	11.4	10.3	8.2	7.3	9.8	8.8	9.9	10.3	8.9	9.3
Manufacturing	28.8	15.3	28.6	16.4	28.6	15.5	27.5	26.3	14.7	13.9
Public sector	24.8	11.9	25.8	13.3	27.3	13.8	29.2	29.6	15.4	15.6
Services	4.0)		5.7)		5.8)		6.4)		6.7)	
Other	24.9)	14.2	26.3)	16.4	22.7)	14.2	22.5)	14.5	22.0)	14.2
Total	100.0	57.1	100.0	58.1	100.0	57.3	100.0	57.2	100.0	57.3
					(Total employment)					
Number of employed (thousands)	3,748.0	2,140.2	4,598.3	2,670.7	4,874.8	2,794.7	5,010.6	2,864.4	5,057.9	2,899.6

(Public sector employment, June 1985)

	Whites	Coloreds	Asians	Blacks	Total
Employment (in thousands)	557	172	39	747	1,515
As a percentage of total employment for each group	39.7	29.3	21.3	27.0	30.7

Sources: Central Statistical Services, Bulletin of Statistics; and data provided by the South African authorities.

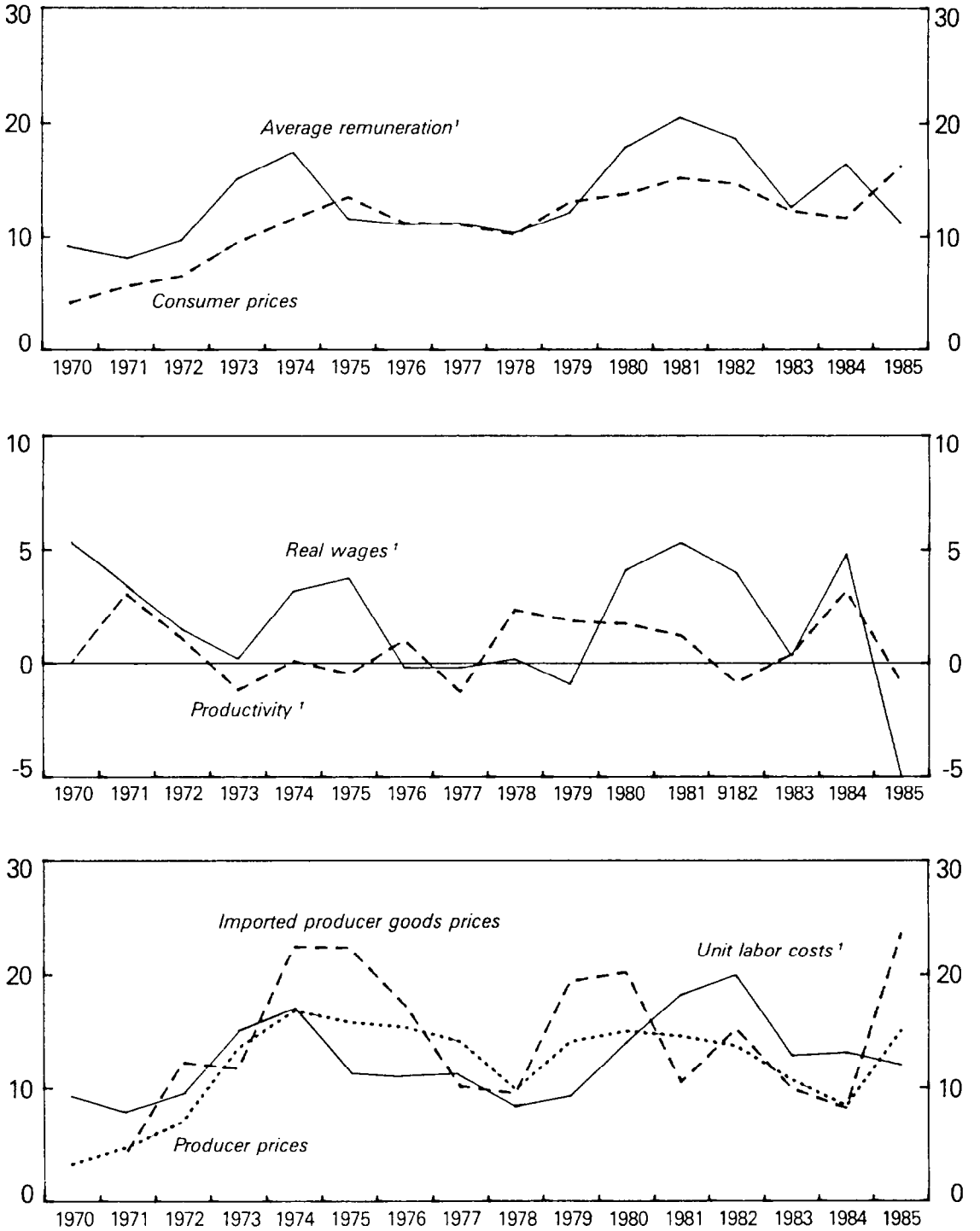
1/ The figures from 1980 onward exclude employment in the so-called independent states Transkei, Bophuthatswana, Venda, and Ciskei, which in 1970 accounted for about 12 percent of the black active population.

CHART 2

SOUTH AFRICA

WAGE AND PRICE INDICES (1980 = 100)

(Percentage changes)



Sources: IMF, Datafund; and South African Reserve Bank, *Quarterly Bulletin*.

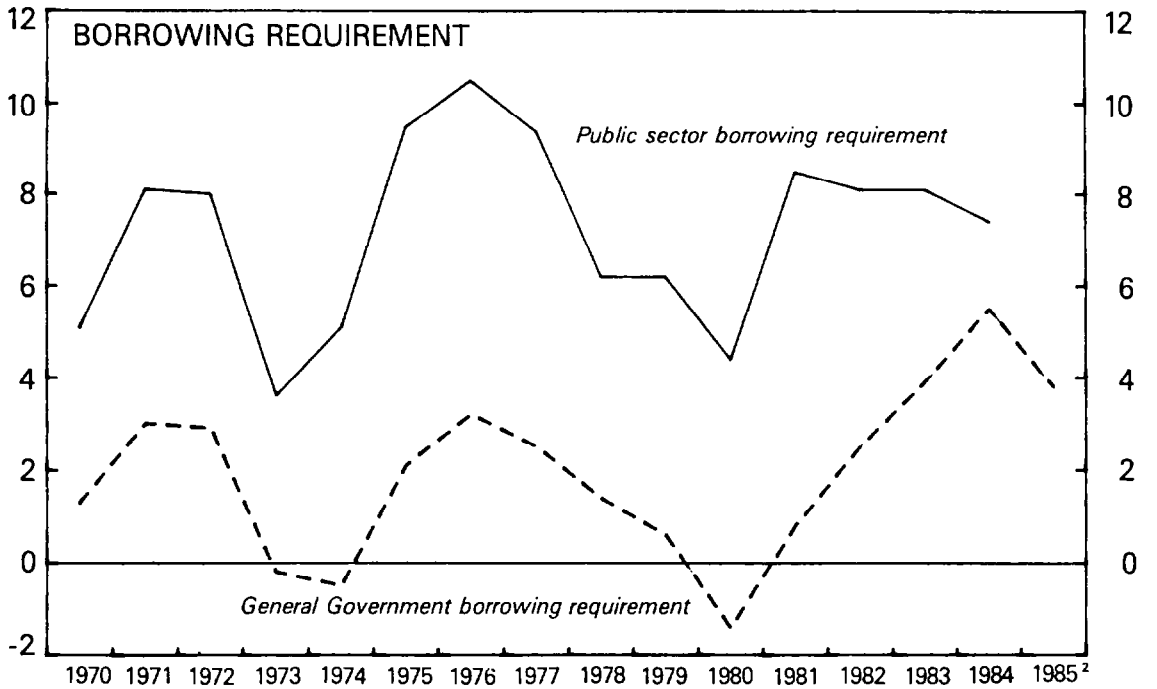
[1] In the non-agricultural sector.

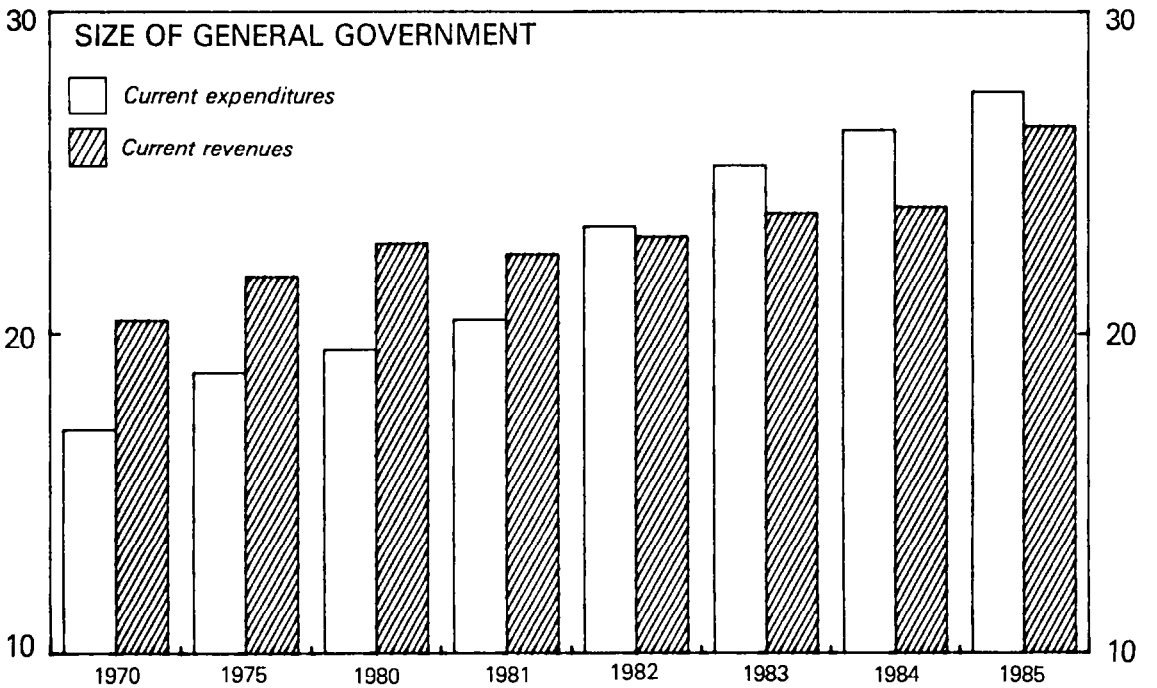
CHART 3

SOUTH AFRICA

PUBLIC SECTOR DEVELOPMENTS[1]

(In percent of GDP)





Source: South African Reserve Bank, *Quarterly Bulletin*.

[1] The public sector comprises the general government and the nonfinancial public enterprises. The general government includes the central government, provincial administrations, and the local authorities. The borrowing requirements are derived from the national financial accounts.

[2] Estimate.

Table 3. South Africa: Structure of Savings, 1970-85

(In percent of total)

	1970-76	1977-80	1981-84	1984	1985
Sources:					
Households	26.1	21.8	9.3	9.2	13.1
Corporations	14.3	25.1	30.7	34.6	29.2
Government	12.6	7.0	-2.7	-10.4	-4.0
Depreciation	47.0	46.1	62.7	66.6	61.7
Gross domestic savings	100.0	100.0	100.0	100.0	100.0
Net capital inflow	16.2	-12.1	9.6	2.2	-26.5
Change in foreign reserves (increase -)	2.4	0.2	1.0	3.6	3.9
Gross domestic investment	118.6	88.1	110.6	105.8	77.4
Gross domestic investment as a percentage of GDP	29.0	27.9	28.1	26.3	22.2
Gross domestic savings as a percentage of GDP	24.6	31.9	25.3	24.9	28.7

Source: South African Reserve Bank, Quarterly Bulletin.

tensions in 1984, access to foreign savings was curtailed once again and turned heavily negative in 1985 with the withdrawal of credit lines by foreign banks.

The decline in investment activity, from the equivalent of 32 percent of GDP at the beginning of the 1980s to 22 percent equivalent in 1985, reflected in part a secular downturn associated with the completion of large public sector projects, but perhaps more importantly the steady decline (since 1982) in manufacturing investment by the private sector associated with structural problems on both the supply and the demand side: the scarcity of skilled labor presented supply bottlenecks, while, with the output structure skewed largely to a high-income pattern of demand, consumption began to show signs of saturation (Chart 4). This negative turn in the propensity to invest more than outweighed a boom in office and shopping center construction and a growing tendency to substitute capital for labor. The latter went hand in hand with the increases in the cost of labor and was further supported by the relative cheapness of capital, with real interest rates negative during most of the period (Chart 5).

2. Cyclical developments

The structural problems, which have become deeply imbedded in the economy, have blunted responsiveness to demand management policies, while the sensitivity of the economy to swings in the terms of trade has given rise to a significant degree of volatility. The recent past accordingly has been characterized by sharp U-turns on the policy path. Thus, at the beginning of the recent cycle, in mid-1984, the monetary authorities hit the brake hard and fiscal policy was tightened as well. By late 1984, when the policy-induced downturn began to manifest itself increasingly, further downward pressures emanated from the internal and external sociopolitical environment (Chart 6). Domestic demand fell back sharply, but the associated fall in real output was cushioned by a large improvement in the foreign balance. Nevertheless, labor shedding, particularly in the nonmining private sector, accelerated and unemployment rose.

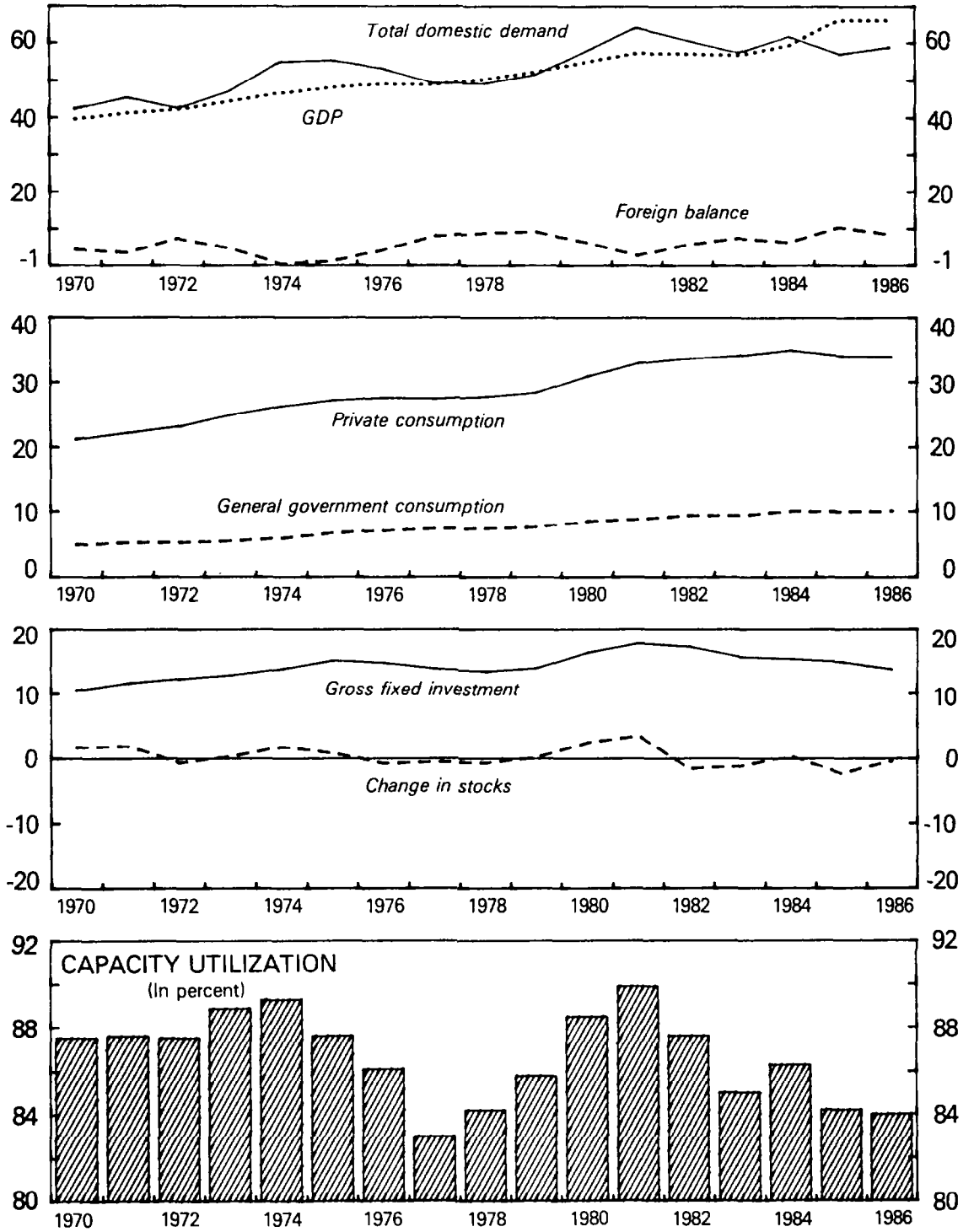
Registered unemployment among the whites, coloreds, and Asians (mainly skilled workers), which had not exceeded 1 1/2 percent of the labor force for many years, doubled between 1984 and 1985 to 2.8 percent, where it has remained; unemployment among blacks, on the basis of unofficial estimates, could be as high as 30 percent, and in some areas perhaps exceeds 50 percent. Slack goods and labor markets, together with a freeze on general pay increases in the public sector, helped reduce the rise in nominal wages from 16 1/2 percent in 1984 to 11 1/2 percent in 1985. The real pay of white workers declined by nearly 5 percent and that of blacks by 1 1/2 percent, the first such decline since 1971. The effect of wage moderation on the rate of inflation was, however, obscured by the impact of the depreciation of the rand and by increases in administered prices so that the annual rate

CHART 4

SOUTH AFRICA

AGGREGATE SUPPLY AND DEMAND

(In billions of 1980 rand and percent)



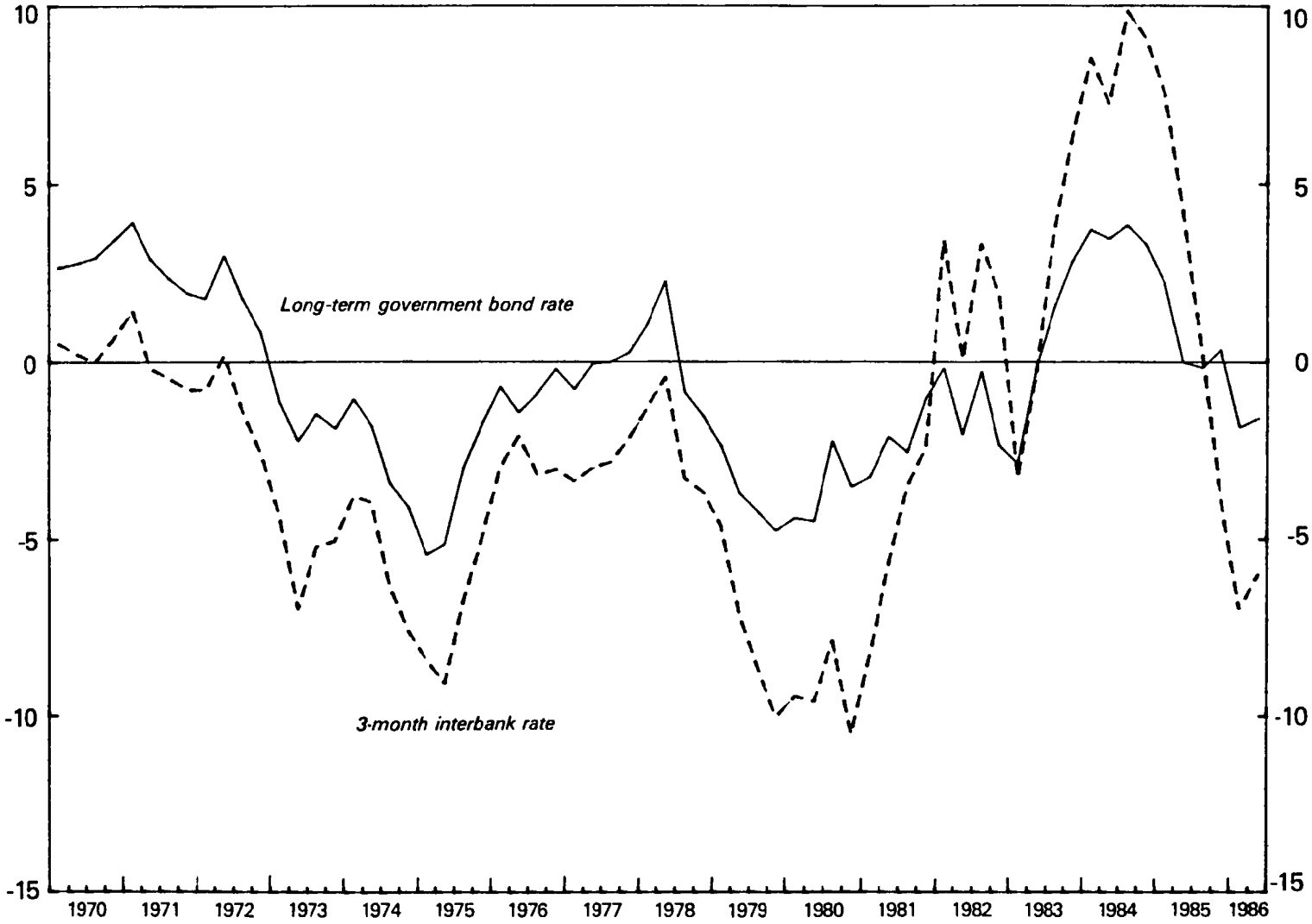
Source: IMF, Datafund.

CHART 5

SOUTH AFRICA

REAL INTEREST RATES[1]

(Percent per annum)



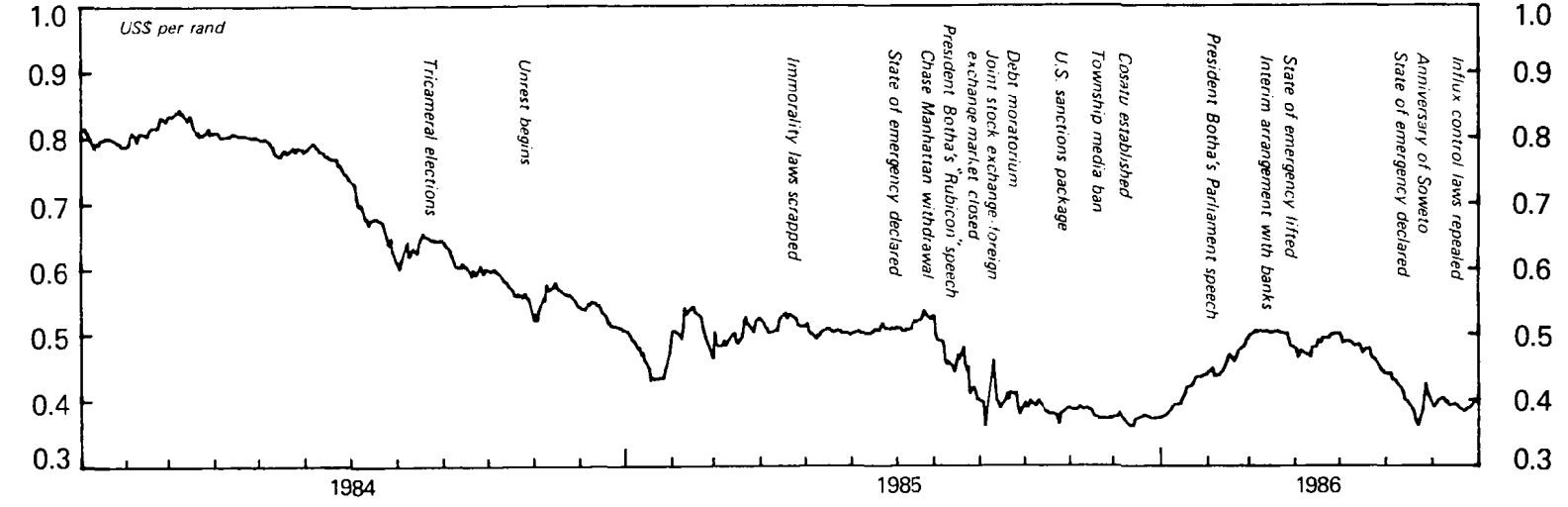
Source: IMF, Datafund.

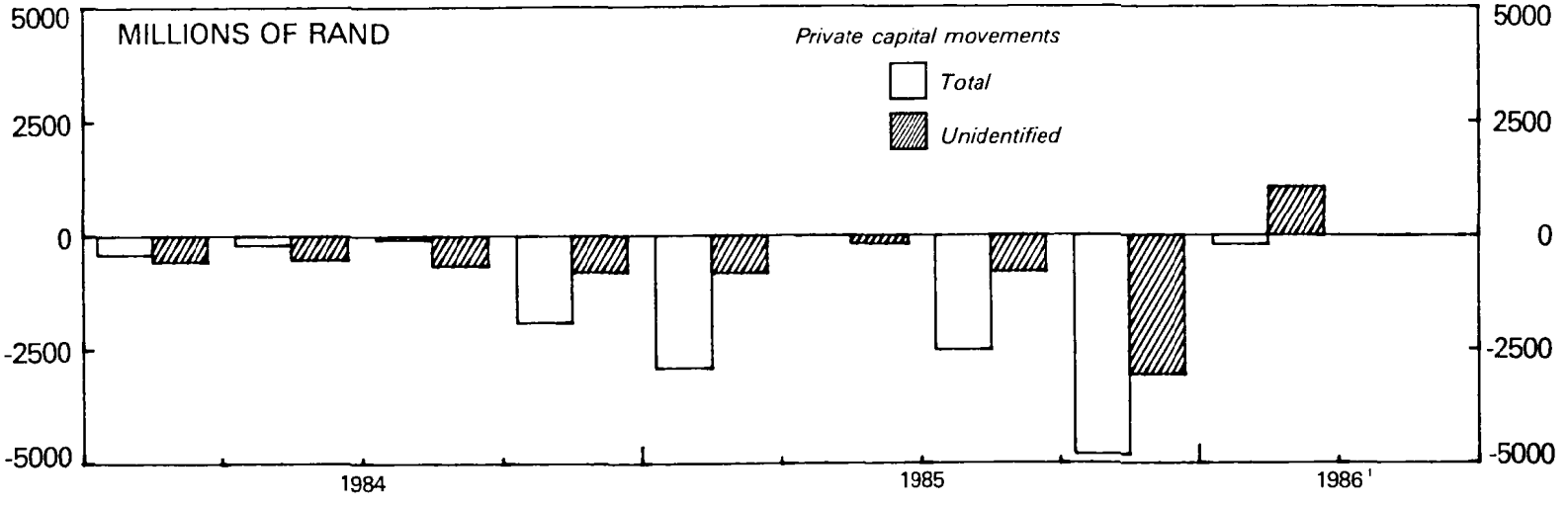
[1] Nominal rates deflated by contemporaneous change in consumer prices.

CHART 6

SOUTH AFRICA

CHRONOLOGY OF EVENTS IN SOUTH AFRICA





Sources. IMF, Datafund, and South African authorities.

[1] Capital flows in the fourth quarter of 1985 and the first quarter of 1986 should be considered together. See footnote 1, Table 4.

of inflation, as measured by the consumer price index, accelerated from 13 1/4 percent in December 1984 to over 21 percent in the first quarter of 1986 before receding to about 17 1/2 percent in recent months.

By May 1985, the authorities judged that the swing into substantial surplus on the current account of the external balance and the moderation of wage pressures at home provided sufficient scope to allow their concern regarding unemployment and its effect on social unrest to be translated into a shift of policy toward the promotion of economic growth. However, external financial pressures undercut the potential positive influences this policy shift might have exerted on economic activity. Capital outflows in 1985 accelerated, swamping the large positive swing in the current account--by US$4 billion (about 8 percent of GDP)--to a surplus of over US$3.1 billion (Table 4). The improvement in the current account reflected a 16 percent fall in the volume of imports and a 22 percent rise in the volume of nongold exports. This rise more than offset the downward pressure on gold exports resulting from domestic strikes and the ban on sales of Krugerrand in other countries.

The heavy outflow of capital was in large part related to the decision of certain foreign banks to withdraw their credit lines to South African residents. This exacerbated the domestic capital flight that had been triggered by the intensification of political and economic pressures for foreign disinvestment. In September, faced with unprecedented downward pressures on the rand and with limited foreign exchange holdings, the South African authorities decided to impose a standstill on certain capital repayments of foreign debt by South African residents and to reintroduce the dual exchange rate system that had been discontinued in 1983. Strong downward pressures on the rand continued, however, and, in average trade-weighted terms, the exchange value of the rand declined by 36 percent in the 12 months to December 1985; in real effective terms the depreciation amounted to 29 1/2 percent. In the face of mounting pressures on the exchange rate and on reserves, the Reserve Bank entered into new gold swap arrangements with overseas banks. The Bank's short-term liability position, expressed in U.S. dollars, remained virtually unchanged in the 12 months to December 1985, indicating some outflow of funds, as a certain part of the liabilities is in nondollar currencies. With more than two fifths of reserves in dollars, there was little gain to the reserve position from the depreciation of the dollar, so that gross official reserves with gold valued at market prices fell by US$0.52 billion to US$1.74 billion at the end of 1985. At the end of June 1986, gross official reserves stood at US$1.46 billion, equivalent to almost seven weeks of projected 1986 imports, and the Reserve Bank's short-term foreign liabilities had fallen by some US$0.6 billion.

In response to the growing uncertainty facing the private sector, the stance of monetary and fiscal policy was eased further in the second half of 1985. Government spending exceeded levels budgeted for 1985/86 in the latter part of the fiscal year and a surcharge on imports was

Table 4. South Africa: Balance of Payments Summary

	1983	1984	1985 1/	1986 2/	1984 1/ First half	1984 1/ Second half	1985 1/ First half	1985 1/ Second half	1985 1/ Fourth quarter	1986 1/ First quarter	1986 1/ Second quarter
	(In millions of U.S. dollars)						(In billions of U.S. dollars)				
							(Seasonally adjusted, annual rates)				
Nongold exports	9,177	8,709	9,059	9,075	9.4	8.0	9.3	8.8	8.6	10.1	10.4
Gold exports	8,927	7,997	6,944	7,225	8.5	7.5	6.7	7.2	7.1	6.9	7.0
Imports	-14,262	-14,720	-10,258	-11,050	-16.3	-13.1	-11.0	-9.5	-8.8	-12.9	-10.9
Net services and transfers	-3,568	-3,017	-2,623	-3,250	-3.2	-2.8	-2.7	-2.6	-2.4	-3.3	-3.0
Current balance	274	-1,031	3,122	2,000	-1.7	-0.4	2.4	3.9	4.5	0.8	3.5
(in percent of GDP)	(0.3)	(-1.3)	(6.0)	(3 1/4)	(-2.1)	(-0.7)	(4.3)	(7.6)	(9.3)	(1.4)	(...)
							(Not seasonally adjusted, actual rates)				
Current balance	274	-1,031	3,122	2,000	-0.6	-0.4	1.4	1.8	1.1	0.4	0.9
Long-term capital	-214	1,695	-9	...	0.7	1.0	0.2	-0.3	-0.1	-0.3	...
Private sector	-1,311	553	-436	...	0.4	0.1	-0.1	-0.4	-a	-0.2	...
Public sector	1,097	1,142	427	...	0.3	0.9	0.3	0.1	-a	-0.1	...
Short-term capital 3/	-84	-1,574	-4,414	...	-0.4	-1.1	-1.4	-3.0	-1.8	-0.1	...
Private sector	-165	-1,569	-4,368	...	-0.5	-1.1	-1.4	-3.0	-1.8	-1.0	...
Public sector	81	-5	-46	...	a	-a	-a	-a	-a	-a	...
Overall balance	-24	-910	-1,301	...	-0.3	-0.6	0.2	-1.5	-0.8	-a	...

Sources: South African Reserve Bank, Quarterly Bulletin; and staff estimates.

1/ Preliminary; the import and short-term capital flows in the fourth quarter of 1985 and the first quarter of 1986 should be considered jointly because of large petroleum transactions spanning these quarters.

2/ Staff projections; assumes a U.S. dollar/rand exchange rate of 0.39 for the second half of 1986, which yields an average rate of R 1 = US$0.4233 for the year 1986 as a whole.

3/ Including errors and omissions.

a - less than 50,000.

Note: Half-yearly data may not add due to rounding.

imposed, in part to keep the deficit from soaring. Expenditures, which originally had been programmed to remain stable in real terms, exceeded that level by 4 1/4 percent and revenues rose by 8 1/2 percent compared with a programmed 4 percent. In addition to the receipts from the import surcharge, the overage on the revenue side largely reflected the tax yield from windfall profits that had accrued to the corporate sector from the depreciation of the rand. As gross flows overshot original estimates on both sides of the balance sheet, the budget deficit, at 2.8 percent equivalent of GDP, remained close to its targeted level (Table 5).

The easing of monetary policy during the course of the year was quite dramatic, with the discount rate coming down in successive steps by more than 10 percentage points between May 1985 and May 1986. At the same time, the 90-day bankers' acceptance rate fell by nearly 12 percentage points to 11 percent, well below the rate of inflation. Despite the strongly negative real short-term interest rates, private sector demand for bank credit weakened through 1985 and early 1986 and the growth rate of the principal monetary aggregates fell continuously.

Whereas in the last quarter of 1985 the economic downturn appeared to be bottoming out, the promise of an upturn was not fulfilled. In fact, following a short-lived buying spree in anticipation of large price increases associated with the rand depreciation, all major components of domestic demand began to weaken once again. Thus, the policy discussions took place against the background of rising social tensions, the realization of the need for massive job creation, and an economy that appeared largely unresponsive to positive stimuli in the face of eroding confidence and a climate of growing uncertainty.

III. Policies and Policy Issues

1. Stance of policy

The policy discussions with the South African authorities were framed in terms of a strategy that sought to marry apparently conflicting short-term and longer-term objectives. The stated medium-term macroeconomic policy objectives have been to control inflation through restrictive financial policies, to free resources by reducing the share of government in the economy and, generally, to pursue a policy designed to provide more breathing space for the private sector and to increase responsiveness to market forces. However, with domestic demand falling away rapidly and the rise in unemployment aggravating political tensions, the authorities had felt compelled to set aside their medium-term goals. For the short term, the official view was that the Keynesian model was most relevant under current circumstances and that fiscal stimulus and an accommodative monetary policy were called for. The immediate goal was to bring the growth rate of GDP back to the

Table 5. South Africa: Central Government Finances 1/

	1985/86		1986/87	1983/84	1984/85	1985/86	1986/87
	Budget estimate	Outcome	Budget estimate 2/				
	(In millions of rand)			(Percentage changes)			
Revenue	28,322	29,809	33,627	11.2	22.7	27.2	12.8
Personal income tax	8,637	8,404	10,276	32.3	28.2	15.5	22.3
Gold mining related	2,441	3,052	2,820	35.0	-11.2	54.6	-7.6
Other corporate income tax	4,534	5,302	6,471	-11.8	17.2	32.7	22.0
General sales tax	8,300	8,105	9,425	21.8	51.3	38.2	16.3
Other inland revenues	2,401	2,815	2,095	2.9	23.2	15.8	-25.6
Customs and excise duties	2,009	2,131	2,540	-15.1	-2.3	12.9	19.2
Expenditures	31,609	33,271	37,998	14.7	21.9	22.2	14.2
Economic classification 3/							
Current expenditures	28,468	30,104	33,743	18.1	24.1	22.2	12.1
Of which:							
Wage bill	6,811	6,831	8,634	24.7	28.2	1.0	26.4
Public debt costs	4,578	5,049	5,233	25.2	32.2	25.1	3.6
Capital expenditures	3,141	3,167	4,255	-6.5	4.0	22.3	34.3
Functional classification 3/							
Defense	4,509	4,938	5,557	8.1	20.7	18.1	12.5
Education	5,110	5,127	6,202	13.5	19.6	21.5	21.0
Welfare	1,781	1,783	2,110	...	...	72.1	18.3
Agriculture	1,087	1,137	901	...	...	17.2	-20.8
Deficit	3,287	3,462	4,371	...	...	...	...
			(As a percentage of GDP)				
Memorandum items:							
Deficit	2.7	2.8	3.0	3.5	3.5	2.8	3.0
Revenue	23.5	24.1	23.0	20.6	21.5	24.1	23.0
Expenditure	26.3	26.9	26.0	24.1	25.0	26.9	26.0
Education	4.2	4.1	4.2	3.8	3.9	4.1	4.2
Interest on public debt	3.8	4.1	3.6	3.3	3.7	4.1	3.6
Defense	3.7	4.0	3.8	3.7	3.8	4.0	3.8

Sources: Department of Finance, Statistical/Economic Review, 1986/87, and Estimate of Revenue for the Financial Year Ending 31 March 1987; data provided by the authorities; and staff estimates.

1/ Fiscal year ending March 31.
2/ Excluding likely overruns and the impact of the June fiscal package.
3/ Due to recent changes in the budgetary accounting system and to constitutional changes, the components of expenditures on an economic and functional classification are largely estimated.

3-3 1/2 percent range, where, it was estimated, the unemployment rate would stop rising. Indeed, at the time of the mission, the authorities were preparing a stimulatory fiscal package.

2. Fiscal policy

On the expectation that the upturn in economic activity toward the end of 1985 portended a broader recovery, the original budget proposals for 1986/87 sought to provide only a moderate degree of stimulus. The deficit accordingly was targeted at the equivalent of 3 percent of GDP, a little above the expected outcome for 1985/86. At the same time, government expenditure was budgeted to fall in real terms as expenditure growth was set at 14 percent with an expected inflation rate of 15 percent. An across-the-board cut of 2 percent in departmental appropriations was to create room for increases in the wage bill, in expenditures for job creation and training, housing and infrastructure, welfare assistance, and education; and in assistance to the small businesss sector. On the revenue side, tax concessions to individuals were to hold revenue growth to 13 percent. However, the 1986/87 budget had already been overtaken by events before its promulgation as the underlying assumptions failed to materialize.

The weakness of economic activity fed on itself as uncertainties regarding the political environment exacerbated the cyclical elements of the downturn. In turn, this interfered with the authorities' ability to effect socioeconomic changes designed to calm political tensions. The authorities hoped that they could break out of this vicious circle with a stimulatory fiscal package that would spark an increase in income and bolster confidence in general. The higher borrowing requirement implied in such a package was not expected to crowd out private expenditures inasmuch as domestic capital markets were viewed as sufficiently flush to support a considerably higher level of domestic demand. As the relatively low demand for credit reflected in part a scaling down of investment plans by public enterprises, the authorities considered that, even in a broader perspective, a modest fiscal package would not necessarily lead to an increase in the share of the economy's resources claimed by the public sector. Even so, the South African representatives acknowledged that expenditure overruns, such as have become typical over the past several years, were likely to arise in 1986/87 also. These overruns could range between a conservative 1 1/2 percent of budgeted expenditures and a more likely 4 percent and would come on top of failure to implement about one half of the department-wide spending cuts that had been announced in the budget. In 1986/87, in contrast with previous years, expenditure overruns were unlikely to be offset by overages on the revenue side. Accordingly, the budget deficit, that had been programmed at 3 percent of GDP, was likely to run at 4 percent even before a stimulatory fiscal package.

The authorities were aware that, in the inflationary environment and with lack of confidence constituting the main barriers to a recovery, a fiscal stimulus package that was not seen as part of a broader strategy might not have a lasting effect. Nevertheless, they

considered that absence of action would carry a greater risk than that inherent in the possibility that their newest actions might have only a fleeting impact. In the event, the authorities announced an R 1.2 billion package, of which R 700 million, or 1/2 percent of GDP equivalent, would affect fiscal 1986/87 thereby bringing the deficit to a likely 4 1/2 percent of GDP. The fiscal package sought to strike a balance between purely anticyclical measures and those that fit into the authorities' medium-term objectives. Thus, about half of the 1986/87 stimulus is to come from the additional funds for infrastructure and housing programs, job creation, training and aid to small business and half from a reduction in excise taxes on cars, agricultural assistance and the removal of the surcharge on some imported inputs into production.

3. Monetary policy

Beginning in 1986, the authorities adopted monetary targeting as a guide to the exercise of monetary policy. Reflecting the recent behavior of velocity and the forecast evolution of real activity and inflation, the range for the growth of the broad aggregate M3 in 1986/87 was set between 16 and 20 percent. In the event, M3 has been growing at a rate of about 11 percent in the 12 months through May 1986 (Table 6).

Table 6. South Africa: Financial Indicators 1/

	1985				1986	
	Mar.	June	Sept.	Dec.	Mar.	May
	(Percentage changes from previous year)					
Credit to private sector	20.1	17.4	16.6	15.2	14.9	13.5
Credit to Government	14.8	10.3	40.9	65.6	36.7	52.3
Of which:						
Loss on forward cover	(25.7)	(23.7)	(41.1)	(47.1)	(34.0)	(35.4)
M3	16.5	16.3	12.9	12.3	11.1	10.7
	(Contribution to M3 growth over previous year)					
Credit to private sector	17.3	17.0	16.0	14.8	14.7	13.2
Credit to Government	1.8	1.3	5.0	8.3	4.4	6.3
Of which:						
Loss on forward cover	(3.1)	(3.0)	(5.0)	(6.0)	(4.1)	(4.3)
Net foreign assets	-4.7	-2.4	-4.4	-5.8	-3.7	-4.3
Other items, net	--	0.5	-3.8	-5.1	-4.4	-4.4

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

1/ Totals may not add due to rounding.

Given the slow growth of the nominal money supply relative to the target, the authorities feel sanguine about their low interest rate policy. But, it could well be that the actual course of events mandates a downward revision of the original target. First, the deterioration of the external financial climate has brought with it a portfolio shift that has tended also to boost the velocity of M3. Disinvestment by foreigners has absorbed M3-type balances of residents, while the proceeds are held in financial rand deposits not counted in the money supply. Further, the inability of domestic borrowers to access foreign capital markets has increased the corresponding supplies of equities and bonds available to domestic investors, who in turn have acquired them in lieu of M3-type assets and this has been matched by a drop in external reserves. Second, while nominal GDP appears to be developing more or less as assumed, the split into real GDP growth and inflation is much more unfavorable. As a consequence, inflation expectations appear to have ratcheted upward keeping long-term interest rates high even as the authorities have pushed short-term rates down, thereby reducing the attractiveness of M3-type assets relative to other financial but nonmonetary assets. Indeed, staff calculations suggest that, when these influences are taken into account, the appropriate target range could be as low as 9-11 percent.

While M3 is growing at an annual rate of only about 11 percent, the basic question, nevertheless, arises whether the low interest rate policy may not be counterproductive and, in fact, be lending support to the rise in inflation expectations. This question takes on further significance as long-term interest rates have remained stubbornly high. This seems to suggest that markets do not expect short-term interest rates to remain at these low levels, which, in the institutional context of variable rate bank lending, means that neither consumers nor corporations are likely to take on more debt than already planned. Moreover, since households currently seem to be intent upon restoring their balance sheets, lower interest rates and higher inflation expectations could lengthen this process.

Although the South African representatives were firm in their conviction that positive real interest rates remained necessary for the medium and long term, they took the view that the present economic situation warranted low short-term interest rates, even at negative real levels, in order to trigger some forward momentum in the economy. They stressed, however, that the Reserve Bank as the dominant force in the money market was in a position to effect a rise in interest rates quickly should a sudden turnaround in economic activity so warrant. With capital controls deterring arbitrage flows, changes in relative interest rates were considered to have virtually no effect on either the balance of payments or the exchange rate, so that domestic considerations could be the sole determinant of interest rate policy. However, since only a fraction of capital transactions is covered by the

control mechanism and, in any event, leakages through the current account are rife, arbitrage incentives could swell credit demand to finance these capital flows.

4. External policies

The external financial pressures that had culminated in the imposition of a debt standstill in September 1985, according to the authorities, were not related to objective economic conditions in, or to overborrowing by, South Africa but were politically motivated. Once these pressures had manifested themselves, however, the large amount of debt maturing over the next 12 months--US$13.4 billion--made a temporary moratorium inevitable. The immediate effect was the virtual foreclosing of access to international financial markets, in contrast with the ease of access that a high credit rating had previously bestowed, forcing South Africa to become a net exporter of capital to the rest of the world. These circumstances precipitated a reintroduction of foreign exchange controls, contravening the authorities' previous orientation which had been to liberalize regulations governing international transactions. South Africa's relatively large short-term debt exposure had contributed to its vulnerability to a withdrawal of foreign banks' short-term credit lines. The fast buildup of short-credit debt had begun in 1981 and 1982, when it was the main element in the 40 percent rise of total foreign debt (Chart 7). Subsequently, the growth of foreign debt leveled off, but short-term debt had continued to grow as rising domestic interest rates encouraged private borrowers to seek foreign financing--usually on an uncovered basis.

An element encouraging borrowing abroad had been the generally advantageous forward cover provided by the authorities. While of limited practical importance under present conditions, the authorities were terminating their long-term cover facility for public sector entities, in order to induce borrowers to take account of the foreign exchange risk in making their decisions with respect both to borrowing and to costing. Through August 1985, the authorities had been in the process of terminating their forward cover facility for private sector transactions and originally had set a cut-off date of end-August 1986. However, with the reintroduction of the dual exchange market last September, progress toward the creation of a proper forward exchange market was halted and, because of concern about possible disruptive effects on the spot market, the authorities decided to postpone their withdrawal from the forward market. The cumulative loss to the Government of the forward cover facility since its inception at the end of 1980 through March 1986 totaled some R 8 billion.

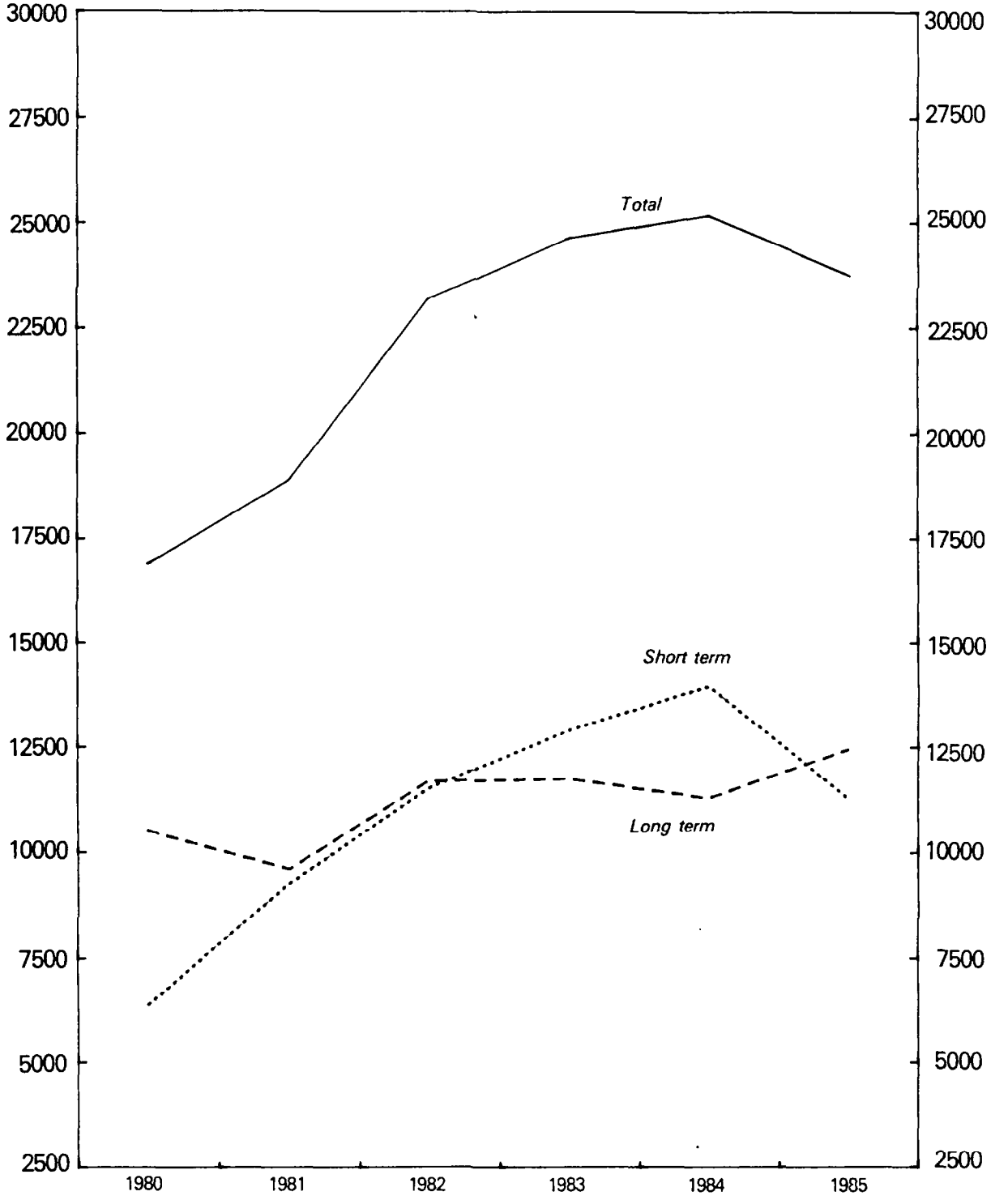
With respect to regularizing payment conditions, the South African representatives felt that the system established at the time of the standstill had been improved in the Interim Arrangements with bank

CHART 7

SOUTH AFRICA

FOREIGN DEBT[1]

(In millions of U.S. dollars)



Source: South African authorities.

[1] For 1980-84, as of December 31; for 1985, as of August 28.

creditors concluded on March 25, 1986. 1/ These arrangements extended the standstill for agreed categories of debt through June 1987, except for downpayments of 5 percent. Exclusions from the standstill, i.e., bearer bonds, credits on trade delivered after January 1, 1985, loans to the South African Reserve Bank, and officially guaranteed debt, cover about 42 1/2 percent of maturities. On the whole, these exclusions were considered not to interfere materially with the objective of equal treatment of creditors as the authorities had expected the level of exposure in the latter two credit categories to remain broadly unchanged.

Under the arrangements, South African borrowers can settle their maturing foreign debts by payment into a special restricted account thereby transferring such indebtedness to the South African Government. In practice, only relatively small amounts of maturing debt have been thus transferred. Creditor banks apparently preferred to continue their relationship with individual borrowers, in part because this could entail a certain interest rate advantage. With respect to debt outside the net, the expectations of broad maintenance of exposure have not been fulfilled as both the exposure vis-à-vis the Reserve Bank and the inflow of trade credits have been less than expected. Furthermore, despite the reinstitution of the financial rand more financial resources have tended to flow abroad than anticipated. In part, such transactions have been effected through the current account with both dividend and interest payments abroad concealing what in other circumstances would be classified as capital transactions. In addition, there is some evidence of over- and underinvoicing of trade transactions.

Since August 1985, capital outflows, including unrecorded transactions, are estimated to have amounted to US$3 1/2 billion. These amounts understate the actual disinvestment that has taken place since the proceeds of equity sales and other disinvestment transactions officially can leave the country only through the financial rand, that is, not at all on a net basis. As a consequence, large deposits representing the countervalue of disinvestment transactions are building up in financial rand accounts (which are not included in the monetary aggregates). Although the relative thinness of the market in financial rand makes it volatile, the discount from the commercial rate, which has ranged from a low of 12 percent per annum in September 1985 to 42 percent currently, does indicate the continued outward pressure of capital flows. The authorities considered that the export of savings, at a time when they were introducing significant sociopolitical changes and were trying to cope with rising unemployment, constituted a serious constraint; they expressed disappointment that the external environment had not improved.

1/ See EBS/85/214 (9/9/85) for a discussion of the system prior to March 1986.

The downward pressure on the exchange rate associated with the sea change in the perception of the external financial position of South Africa of last August came on the heels of a virtually continuous downward slide of the rand from a mid-1983 high. Between mid-1983 and August 1985, the rand depreciated in real effective terms by two fifths, and in terms of U.S. dollars from the equivalent of US$0.93 to US$0.36 where, large intervening fluctuations notwithstanding, it more or less remains. While the authorities have no particular target for the exchange rate, they have tended to intervene regularly in the foreign exchange market not only to smooth minor fluctuations but also, when foreign reserves were sufficient, to damp declines in the rand. Indeed, given the effort to restore confidence so as to allow anticyclical policies to become effective, the exchange rate for the commercial rand had become a barometer of confidence with the dividing line at about US$0.50. The South African representatives also considered that the "purchasing power parity" level of the rand appeared to be well in excess of US$0.50. This attitude was echoed also in the private sector where there was a conviction that the rand at a US$0.40-0.42 level was substantially undervalued, so that movements of the rand below that level took on a negative connotation. The success in penetrating international markets, even under circumstances of growing political resistance to South African exporters, was taken as a windfall. Because of uncertainties regarding the continued access to overseas markets and because exchange rate expectations were pitched at a higher level of the rand, it was considered that current levels had not, and would not, bring about a lasting shift of resources into the traded goods sector.

5. Structural policy issues

In view of the rapid labor force growth and the high rate of unemployment and underemployment of the black population in South Africa, the focal point of any medium-term strategy is the need for massive job creation. In fashioning such a strategy, the constraint imposed by the inability to draw on foreign savings and the implications for international competitiveness of a move toward more labor-intensive production methods must be addressed. Thus, the real exchange rate would need to decline in order for exports to expand sufficiently to meet both the import requirements associated with the need for job creation and the prospect, at least for the foreseeable future, of significant repayments of external debt. To sustain the real exchange rate even at current levels implies an improvement in unit labor cost performance--and a likely further fall in real wages--which could yield the dual benefit of better relative price performance, hence greater export sales, and improved demand for labor, hence lower unemployment. Such labor cost developments would need to be supported by structural changes, including increased competition, within the domestic economy so as to assure that the burden of adjustment would not fall inordinately on labor and that the benefits of adjustment would indeed be translated into jobs.

A wage policy that is productivity-related and a better productivity performance would help reverse some of the past increases in the capital labor ratio. 1/ Integration of the currently unemployed or underemployed into the consumption stream would imply a restructuring of output toward those goods and services that are demanded by the lower-income levels and favor more labor intensive production methods. But, any significant shift in the capital/labor ratio presupposes appropriate costing of capital, that is, an appropriately positive real interest rate and a predictable monetary policy. Whereas it might not be too difficult to achieve an appropriate price for capital, clearly it is much harder to achieve a price for labor consistent with full employment at a time when demands for increases in the standard of living are escalating. The labor market in South Africa has long been characterized by the coexistence of a shortage of skilled labor, which commanded relatively high wages, with a large pool of low-paid unskilled workers. In response to the dictates of social policy, the wage gap between skilled and unskilled workers has been halved from almost 7 to 1 in 1970 to 3 1/2 to 1 in 1985. But the increase in the latter's wages took place without commensurate improvements in productivity, thus discouraging job creation. In fact, the reduction in the wage gap has been associated with an apparent diminution of job opportunities as black employment in the nonagricultural sector remained stagnant between 1980 and 1985.

The South African representatives acknowledged that a considerable part of the poor productivity performance derived from the apartheid laws. But they argued that efforts to upgrade the skills of the black labor force and the elimination of impediments to geographical and occupational labor mobility now constituted central elements of their social and economic policy. Various legal impediments to geographical or occupational mobility had been lifted or were in the process of being lifted including: statutory job reservations; the influx control laws; Section 3 of the Physical Planning Act of 1957; 2/ and restrictions on trading and other business activities by nonwhite population groups in central business districts and other industrial areas in terms of the Group Areas Act. The authorities consider that the implementation of these measures could have an important impact on labor flows even though in general they represent only first steps toward the application of a market-oriented system that allows a free flow of resources, and although the easing of some elements of the Group Areas Act that has taken place is still circumscribed in its application and its major provisions have not been repealed.

1/ The capital labor ratio rose by 22 1/2 percent between 1975 and 1985 and by 8 percent between 1980 and 1985. A reversal to the level of 1980 would cut the annual rate of growth required to meet the employment objective by about 1/4 percentage point and a return to the 1975 level would reduce the required growth rate by 3/4 percentage point.

2/ Dictating a maximum black-to-white employee ratio of 2.5 to 1 in designated white areas.

Aside from geographic and occupational mobility, elimination of the productivity gap would require an upgrading of housing, education and health standards for the black community. To this end, the authorities have set a goal of parity in per capita public expenditures on education and health for all population groups to be reached by fiscal 1996/97. To meet this goal and to provide the housing facilities associated with the absorption of black labor into the economy would involve a quantum jump in public expenditures in these areas. Indeed, unless the tax base can be broadened, the implied revenue requirements could absorb about the entire postulated increase in real personal incomes over the period (see Appendix I on Medium-Term Scenarios of Central Government Finances). The authorities are contemplating basic changes in the tax system and, in formulating their tax policy, are awaiting the report of the Margo Commission, which is studying the tax system. In this connection, it would appear useful to cost out alternative scenarios of social adjustment patterns so as to build sufficient flexibility into a revised tax system to meet the needs of the medium term. The authorities indicated that work in this area was being undertaken, but at the time of the discussions no conclusions had as yet been drawn.

In a broader context, the fundamental changes--and attendant costs--involved in absorbing perhaps 2 million unemployed and providing jobs for some 1/4 million school leavers a year, require that available resources be used at top efficiency. The authorities postulated that the economy would need to grow at a 3-3 1/2 percent annual rate just to stabilize unemployment and that a 4 1/2-5 percent rate of growth over some sustained period of time would be necessary to absorb the large existing reservoir of unemployed labor as well. It was thought that the economy could generate sufficient savings at home to sustain a 3-3 1/2 percent annual growth rate on the assumption that external debt repayment needs would moderate. 1/ A 5 percent growth rate, however, is not considered achievable without renewed access to foreign savings, although the postulated savings gap could be reduced by efforts to promote the propensity to save at home and to improve the pattern of investment. The latter, in addition to a decisive abatement of inflationary pressures, would require a revision of both tax policies and the regulatory framework governing financial institutions. The present tax system encourages the intermediation of savings through institutional investors, such as insurance companies, pension funds, and mortgage institutions, with the former required to hold between 33 percent and 53 percent of their assets in government or quasi-government securities. The result has been an investment pattern that is biased against risk taking and entrepreneurship. With appropriate

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1/ In 1986, capital outflows are estimated to equal about 4 1/4 percent of GDP and to absorb about 15 percent of domestic savings. If the repayment agreements established in 1986 were to hold through 1987, capital outflows would absorb about 8-9 percent of domestic savings, equaling about 2 percent of GDP, according to staff estimates.

incentives in place, the existing level of investment, at 22 percent of GDP, particularly in view of the possible reduction in the capital-labor ratio noted earlier, might go a considerable way toward meeting current and prospective needs.

The authorities in formulating their job-creation strategy are putting considerable reliance on the expansion of the informal economy and, in particular, on creating opportunities for the small business community. Efforts in this direction are underpinned also by their continued commitment to their policies of moving forward on deregulation, privatization and antitrust. While privatization did not immediately involve the large public monopolies, efforts were mainly directed at rationalizing the public sector by shedding those services that could be largely self-sustaining in a private sector environment and that could be based on a system of user charges. In this regard, negotiations currently under way are limited to construction and operation of toll roads. Recognizing the stultifying effect of overregulation on the economy, and in line with their laissez faire orientation, the authorities had embarked upon an extensive review of all existing regulations. They have accepted, in principle, the need to exempt small business activities from many regulations and are considering the promotion of competition via the Competition Board and relaxation of price controls; recently legislation was introduced to prohibit practices of price collusion and price agreements.

6. Prospects

The modest upturn in economic activity toward the end of 1985 was short lived and followed by renewed declines in private sector demand. This motivated the authorities to inject a fiscal stimulus equaling about 1/2 percent of GDP and to continue their accommodative monetary policy. This was judged sufficient to preserve the targeted growth rate for real GDP of 3 percent for 1986 over 1985. Subsequently, however, the authorities revised their growth projection for 1986 down to 1 1/2 to 2 percent. On the official forecast for 1986 as a whole, private consumption expenditure remains subdued as real disposable income declines. However, some pickup in income streams, and therefore also in expenditure, is forecast for the second half of the year and is to continue into 1987. This is based, in part, on an evolution of public sector wages in line with inflation and the ultimate effect of the easier monetary stance. Over the course of the year, investment demand is projected to continue to decline, although by progressively smaller amounts. With domestic demand continuing weak, imports--following the sharp fall in 1985--are projected to recover only modestly, while exports--largely reflecting negative trends in the early part of the year--are estimated to fall slightly below 1985 levels. Accordingly, the external sector should exert a slight drag on economic activity.

In the staff's view, and on the basis of the latest indicators, even the revised official forecast may be rather optimistic. With

confidence in the private sector continuing to wane, the downward tendencies in the economy seem unlikely to bottom out soon, let alone change course. Nevertheless, with the relatively low level of inventories, any strengthening of demand would quickly be translated into production increases. Staff estimates, therefore, project a relatively flat second half of the year which, with the positive carry over from late 1985, would leave GDP, year over year, flat as well. Current account developments consistent with this forecast would yield a surplus of US$2 billion. With monetary policy continuing to be oriented toward employment creation, inflation is unlikely to moderate substantially. Consumer prices, thus, are expected to rise by about 17 1/2 percent in 1986 (Table 7).

The staff's assessment of the immediate prospect for the economy assumes, as does the working forecast of the authorities, that the economic effects of the current external and internal political tensions will not worsen. This assumption is clearly crucial. In fact, although the discussions with the authorities did not dwell on alternative assumptions, there is an ongoing public debate within South Africa of the siege economy option, with an influential segment of the private sector advocating its early adoption. On this view, increasing external pressures would erode progressively the ability of the South African economy to cope with isolation, hence an early preemptive move would be called for, a move that also would save scarce resources in terms of debt service. Furthermore, as the argument goes, the "go-it-alone" option also would help reignite positive growth in the economy: investment demand, associated with a restructuring of the economy toward greater self-sufficiency, and the increase in capacity utilization that would accompany a falling away of most imports, would not only put a floor under the level of economic activity, but could spark a significant takeoff. In addition, the attendant improvement of employment prospects would help stem the brain drain as well. An element in the reasoning of the proponents of this strategy is the prospect that assets currently owned by foreign investors could, under an isolationist policy, be acquired at distress prices. Those arguing on the side of the "go-it-alone" option policy in part base their conclusions on the example of Rhodesia at the time of UDI 1/ and point to the upsurge in investment and employment that occurred during the period of sanctions.

The counter arguments, which appear to be supported by a majority of the business sector and the official financial establishment, emphasize the likely costs of pursuing an isolationist policy course. On this view, South Africa's 60-65 percent foreign trade involvement factor would make the costs of disengaging from the rest of the world quite wrenching, despite self-sufficiency in food and other essentials. Rhodesia's experience suggests that, even at lower trade involvement levels, an isolation policy's short-term benefits to the

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1/ Unilateral Declaration of Independence.

Table 7. South Africa: Domestic Developments and Forecasts

(Changes in percent from previous year)

	1970-80	1981-85	1983	1984	1985 2/	1986
	Average 1/					Staff forecasts
Demand and output (in constant prices)						
Private consumption	4.1	3.0	1.5	2.5	-2.7	-3/4
Public consumption	6.0	3.3	-0.2	7.4	-0.8	4
Gross fixed investment	5.4	-1.7	-9.1	-1.9	-2.8	-8
Stockbuilding 3/	-0.5	-1.1	-3.4	4.8	-5.0	2 3/4
Total domestic demand	3.9	-0.3	-5.4	7.5	-7.8	1
Exports of goods and services	2.2	0.8	-5.5	7.6	8.3	-1 1/2
Imports of goods and services	2.8	-4.1	-17.1	19.5	-14.4	1 3/4
Real GDP	3.5	1.1	-2.5	5.0	-1.0	—
Nominal GDP	16.2	14.3	11.6	18.1	12.9	16
Prices, wages, and costs						
Consumer prices	10.0	14.0	12.3	11.7	16.2	17 1/2
GDP deflator	12.3	13.1	14.3	12.5	14.1	16
Salaries and wages per worker (in nonagricultural sector (In constant prices)	1.6	1.0	0.7	4.3	-4.1	—
Productivity 4/	1.3	0.6	0.2	3.0	-0.7	-1
Unit labor costs 5/	10.3	15.0	12.8	13.0	12.0	18 1/2
Personal disposable income	14.9	14.5	12.9	15.8	15.8	18
Personal savings ratio (in percent)	10.2	4.4	2.8	3.7	5.9	7

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

1/ Compound annual averages, except for productivity, unit labor costs, and the personal savings ratio.
2/ Preliminary.
3/ Including errors and omissions; first differences are expressed as a percentage of GDP in the previous period.
4/ Output per person employed in nonagricultural sector.
5/ In nonagricultural sector.

level of activity are likely to be outweighed by its legacy in terms of high-cost operations and a capital stock ill suited to re-entry into the world at large. Indeed, the pervasive involvement of foreign investment in the economy would point to the high cost of embarking on a policy of autarky. 1/

The pervasive interlinkages with other African countries are suggestive of the potential external costs of the "go-it-alone" strategy. The countries that form a customs union with South Africa--Botswana, Swaziland and Lesotho (the BLS countries)--are highly interlinked with South Africa in other respects as well. The customs union agreement, provides more than 60 percent of current government revenue for both Lesotho and Swaziland. South Africa is the most important supplier of imports to the BLS countries, and also constitutes one of the most important markets for their exports. Further, remittances of migrant workers from these countries contribute large portions of total income; in the case of Lesotho they equal the value of total domestic production. While the interlinkages with other countries in the sub-Saharan area are more modest than those with the BLS countries, they nevertheless are of considerable importance (see Appendix II). On the whole, it is estimated that foreign labor from African countries in South Africa may number 1 1/2 million workers remitting perhaps US$3/4 billion annually. In addition there are important links in terms of transportation, the provision of electricity, joint use of water resources, and management services, particularly in cross-border harbor facilities.

7. Trade policy and other matters

The South African representatives noted that with the pressure for import protection abating as a result of the depreciation of the rand, they had continued the process of dismantling quantitative import controls. 2/ At the same time, they recorded their concern regarding the intensification of measures abroad that curtail access of South African exports to international markets. The authorities were making efforts to adapt tariffs so as to avoid the emergence of inefficient industries and to leave sufficient scope for competition in the domestic

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1/ Tentative estimates of foreign participation by sector, which relate to the value of equity investment held by foreigners to the capital stock at replacement value, indicate a foreign involvement factor of perhaps 20 percent (Table 8). The highest level, of over 40 percent, is recorded in the trade and catering sector followed by 30 percent in the financial and other services sector.

2/ On July 1, 1985, some 2,400 items, including products of important industries, such as iron and steel, were released from import control. Following restrictions imposed by the Swedish Government on trade with South Africa, imports from Sweden were subjected, however, to import licensing from June 1, 1986. At present, about 23 percent of total imports remain subject to quantitative import restrictions.

market. However, the domestic content program, which provides protection to the motor vehicle industry, was being re-evaluated with a view to extending it to medium and heavy commercial vehicles.

Table 8. South Africa: Estimates of Foreign Involvement in the Economy by Sector 1/

(In percent)

	1980	1984
Mining and quarrying	27.4	16.2
Manufacturing	34.7	29.1
Electricity, gas, and water	13.4	14.9
Wholesale and retail trade, catering, and accommodation	30.4	43.0
Transport, storage, and communications	4.2	8.4
Finance, insurance, real estate, and business services	20.0	30.2
Community, social, and personal services	3.1	4.2
Other	1.9	4.5
Total	15.3	20.0

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

1/ Foreign participation as measured by foreign direct investment assets as a percentage of capital stock at replacement value.

To finance the widening of the fiscal deficit in conjunction with efforts to support economic activity a 10 percent import surcharge on all imports not bound by GATT rules (about 55 percent of total imports) was imposed late in September 1985. However, since the surcharge was imparting a cost-push impact on a number of key sectors, the authorities subsequently decided to eliminate it on a number of raw materials and intermediate goods with effect from July 1, 1986.

In another development, the trilateral monetary agreement between South Africa, Lesotho, and Swaziland was amended with effect from April 1, 1986. 1/

In September 1985, the authorities reinstituted the dual exchange arrangements that had existed until 1983. 2/ At the end of September 1985, the coverage of the commercial rand was limited by excluding remittances of profits earned and capitalized before January 1, 1984. Except for restrictive features that may be involved in the exchange arrangements between South Africa, Lesotho, and Swaziland, the exchange controls of South Africa do not evidence restrictions on the making of payments and transfers for current international transactions. As regards the dual exchange arrangements, the multiple currency practice applicable to capital transfers only is not subject to approval by the Fund.

Staff Appraisal

The economic policy problems faced by the South African authorities in 1985 and increasingly in 1986 are composed of essentially three strands: (1) structural adjustment problems that are in part the legacy of the overly buoyant 1970s and in part are rooted in the sociopolitical environment; (2) the effects of mounting tensions in the latter; and (3) the policy-induced cyclical downturn that started in the second half of 1984. The interaction of these three strands has led to growing unemployment at a time when job creation is a priority, high inflation expectations at a time when a rise in the underlying savings capacity of the economy is crucial as access to foreign savings has disappeared, and a climate of uncertainty which has compounded the cyclical elements in the downturn. As a consequence, the authorities, so far, have been unable to set the economy on a positive course through the application of traditional demand management tools. In fact, the picture presented by the latest economic indicators is one more consistent with an economy in a new period of contraction than one poised for recovery. This lack of resilience finds its roots in the lack of confidence that pervades the private sector and is likely to persist until a consensus for sociopolitical change can be achieved.

1/ The new treaty, in conjunction with the bilateral agreements with Lesotho and Swaziland, could give rise to a restriction on making current payments and transactions which would require the Fund's prior approval. The three countries have, in effect, created a treaty-based right among themselves to refuse to convert certain balances of each other's currencies. This would occur if, as provided in the agreement, the balances held by the country requesting conversion would fall below a given proportion of its domestic currency issued and/or rand liabilities.

2/ EBS/79/220 (4/16/79) and EBS/85/214 (9/9/85).

Under the circumstances, any assessment of the economic situation in South Africa cannot be divorced from noneconomic considerations. In any context, the task facing economic policy is a formidable one as it involves a program of fundamental social change with far-reaching implications for the longer term growth and employment pattern of the economy. The absence of a clear formulation of what this implies in terms of redistribution of incomes generally and for changes in the tax burden and cost structure more specifically, impedes rational decision-making in the private sector. Thus, first and foremost, there is a need for the Government to cost out and to explain the medium-term economic implication of its own announced objectives for structural change and, within this framework, to make clear its priorities and policy intentions.

In designing a medium-term strategy account must be taken of the external constraints facing the economy. The surplus of exports of goods and services over imports projected for 1986 (at 3 1/2 percent of GDP) does not derive from oversavings, but rather reflects underspending in relation to the growth needs of the economy. Accordingly, a return to a more satisfactory growth path would be accompanied by a progressive erosion of the surplus on external current account. In contrast with past growth cycles, the economy cannot fall back on foreign savings to help finance the imports needed to sustain growth nor can it depend upon a re-establishment of the comparative advantage commodity producers enjoyed in the 1970s. Thus, an export-oriented growth strategy is indicated. This raises the question of the underlying competitive situation of the South African economy.

During the 1970s, the gold bonanza helped boost the exchange rate for the rand to levels that severely hampered the establishment of a competitive domestic manufacturing sector. The recent exchange rate adjustments--although they stem largely from externally induced capital movements--may well have reversed that situation. Although there is scope for cost reductions through efficiency increases, the recent decline in the real exchange rate needs to be sustained by a drop in real wages; and as long as inflation remains high, this would be reflected in downward adjustments of the nominal exchange rate. From this point of view, it appears unfortunate that the nominal level of the exchange rate tends to be seen as a barometer measuring the efficacy of financial policy and the level of confidence in the private sector.

On the domestic side, the twin priorities are the creation of job opportunities and the control of inflation. In fact, these need to go hand in hand and require both appropriate stabilization policy and structural changes. In the past, fiscal and monetary policy together with the distortions in the labor market encouraged capital-intensive production. Recently, a start has been made to reduce the tax incentives toward capital-intensive production patterns in the nonmining sector, but the proposed introduction of a payroll tax to provide a revenue base for the local authorities clearly is at odds with manpower

policy. On the monetary side, the low interest rate policy continues to encourage high capital-labor ratios, both by keeping inflation expectations high and by putting too low a cost on capital expenditures.

A second deterrent to a shift in the structure of factor inputs has been the low productivity of labor relative to wages. The elimination of black/white wage gaps is a major goal of manpower policy, but wage levels must not run ahead of productivity because job opportunities would thereby be destroyed. Over the past 15 years, the remuneration gap, in real terms, between blacks and whites in the nonagricultural sector has been about halved. Although it is not possible to make appropriate adjustments for differentials in skill levels, it is quite obvious that there remains some way to go before full parity is achieved. Indeed, efforts to upgrade the skills of the black population are an essential element in the elimination of wage gaps on a sound economic basis. But if the trend toward job destruction is to be redressed, the loss of productivity inherent in the apartheid laws needs to be reversed. In the absence of such reversal, there is little chance of achieving parity in productivity on the factory floor, even if skill levels were brought up to par.

Though legal constraints to the mobility of labor are beginning to be removed, the massive needs for job creation imply an equally massive shift of budgetary expenditure toward infrastructure, housing, education, and training. The authorities have declared their intention to achieve parity in per capita expenditures on education and health for all population groups over the next ten years. At the same time they are postulating a 4.1 percent per annum real increase in education expenditures over the period. Staff calculations suggest that these two targets, as now formulated, are not compatible (see Appendix I). Uncertainties of this sort, together with the past experience of burgeoning public expenditures, cannot but create fears in the private sector regarding future increases in the tax burden. The rapid increase in the tax burden in recent years and the perception that this may represent only the beginning of an accelerating trend surely goes some way toward explaining the current aversion to spending in the private sector.

In restoring confidence, credibility of the Government's efforts and ability not only to gain control of the growth of public expenditure, but also to effect a restructuring of expenditures within the limits of the overall resources of the economy is essential. From this point of view, the past and continuing expenditure overruns have been very costly, as has the tendency to fashion piecemeal policy adjustments. This would apply also to the recent stimulatory measures. Formulating an appropriate expenditure policy is further complicated by the lack of transparency in the budgetary process, the weak coordination between expenditure and revenue policies and in the setting of priorities among expenditure categories, e.g., there would appear to be a lack of consistency between education and manpower policies. The plans to put spending under strict discipline and to

improve financial control--through the adoption of management by objectives/zero base budgeting and the introduction of both cash limits on departmental spending and sunset legislation with regard to spending and regulatory bills--would seem well advised.

The contemplated reduction of regulatory controls also should help reduce budgetary expenditures and, besides, increase the vitality of the private sector and enlarge the tax base. The proliferation of red tape that attends private initiative surely impedes the efforts to expand the small business community and tends to strengthen the oligopolistic tendencies in the economy. A firm follow-through on the Government's intention to reduce and rationalize the regulatory burden could bring about significant savings in costs. Perhaps most important in this process would be the dismantling of the bureaucratic apparatus that should become redundant with the lifting of various apartheid laws.

Within the conduct of monetary policy, the adoption of monetary targeting should allow interest rates to move more in line with market signals than previously. But the recent slow growth of M3 relative to its targets should not be taken as an affirmation of the appropriateness of the authorities' low interest rate policy. The mere fact that long-term interest rates not only stayed relatively high, but rose in the second half of 1985 even as short-term rates declined, indicates that this policy has little credibility and with variable interest rates on bank credits, neither household nor business spending is thus encouraged. In fact, this policy could be counterproductive in that it both fuels inflation expectations and retards the resumption of consumer spending to the extent that it prolongs the restoration of household balance sheets to desired levels. Moreover, attention needs to be paid to the possible effects on external capital flows. Capital controls notwithstanding, leads and lags and incentives for interest and dividend stripping are affected by relative interest rates. Within the authorities' medium-term strategy, articulation of illustrative targets for money growth and the inflation rate over the next three years or so would be helpful.

Management of the economy in the period ahead poses formidable challenges. But some positive elements emerge. First, capital investment, at some 22 percent of GDP, may go a considerable way toward meeting the needs of the economy if it moves to less capital-intensive production methods. This is particularly so because a number of large scale capital investments in energy and transportation have been completed and will no longer need to pre-empt so large a share of available savings. With large-scale public sector investment winding down, the private sector should have more room to expand investment and effect the necessary restructuring toward more productive activities, even in the absence of access to foreign savings. Second, progressive integration of the black population into the cash economy should give rise to a pattern of demand that is consistent with a more labor-intensive production structure.

Political uncertainties notwithstanding, the private sector's responsiveness to incentives can be improved, but only if the Government provides a greater measure of certainty about its intentions. This will require increased transparency about government spending and taxation in a credible medium-term framework. That framework will need to specify a set of policy priorities that is perceived to be consistent with the external, financial, and domestic sociopolitical constraints and around which a social consensus can be forged. In the process, a reaffirmation of the commitment to market-oriented processes will be necessary. Whereas it may seem to some that the "stability" that can be gained through intervention in the market mechanism will help bring spending decisions on stream, the longer-run distortions and costs that would follow are clear. In that respect, it is encouraging that the authorities are formulating their policies on the assumption that a "siege economy" policy should be eschewed. The cost of that option entails both an increase in government intervention in the economy and, by removing competition and channeling resources into high cost operations, would compound the underlying structural problems of the South African economy, which spring from already excessive tendencies in both these directions.

In line with the above policy stance, the authorities continue to reaffirm their commitment to meeting, in a timely manner, their external financial obligations within the context of the Interim Agreement reached with foreign bank creditors. With the current exchange rate level, and in the absence of a significant deterioration in the external environment, a US$2 billion current account surplus in 1986 seems achievable. This surplus compares with an officially estimated net capital outflow of some US$2 1/2 billion under the debt standstill. The authorities are operating under the assumption that inflows of new trade credits will suffice to fill the payment gap. Given the unpredictability of capital flows and the depleted level of reserves, the authorities see no possibility but to continue the dual exchange rate system that was reimposed in September 1985. They consider, however, that the need to operate with these controls is not compatible with their basic orientation to free up the foreign exchange market. Thus, they would lift these controls as soon as conditions permit.

It is foreseen that the Article IV consultation with South Africa will remain on the usual 12-month cycle.

Medium-Term Scenarios of Central Government Finances

The South African authorities have stated their intention to achieve parity, in terms of per capita expenditures on education and health for all population groups and to upgrade housing for the black population over the next ten years. This involves large changes on public expenditure in these categories. Whereas, particularly in the areas of housing, the authorities expect considerable contributions to be made by the private sector, to the extent that these contributions are work-related, they will take the form of tax expenditures and, thus, impact the budget as well. The question arises to what extent resources in the economy suffice to bring about a massive change in social expenditure with a minimum of friction. The medium-term scenarios presented in Table 9 illustrate the general magnitudes that might be involved. They postulate a growth rate of GDP of 3 percent per annum in real terms. This, within a program of social change, would be sufficient to prevent further increases in unemployment given the assumption that the capital-labor ratio would shift downward over time. With 3 percent growth and a labor force increase of 2 1/2 percent per annum, real increases in wages would be held to 1/2 percent, in line with labor productivity. However, as educational and training programs begin to show results, labor productivity is likely to be enhanced progressively, and a higher real growth rate, with an attendant higher growth of real income, would materialize.

Two basic scenarios are contrasted, one in which the growth rate of social expenditures is limited to that of GDP and one in which major strides are taken to upgrade educational and social standards of the black population. In the latter scenario, the budget deficit is constrained to the authorities' policy aim of the equivalent of 3 percent of GDP and additional revenue requirements are shown as increases to the income tax bill of individuals.

The scenario that postulates a 3 percent growth rate for GDP, and an increase in social expenditures in line with GDP growth, yields over the period a central government deficit that falls to just below 2 percent of GDP by 1996/97. This narrowing of the budget is based upon expenditure restraint in other public expenditure categories and a revenue growth that assumes an income tax elasticity of 1.25. This yields a trend rate of growth of individual income taxes of 3 3/4 percent per annum. 1/

The extensive social reform scenario postulates that parity of expenditures in education is to be achieved at a level that implies an annual reduction of 5 percent in expenditure per white pupil and an annual reduction of 3 1/2 percent per Asian pupil. Educational expenditures would therefore need to rise by a rate of 10 percent per

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1/ Growth rates are expressed in constant 1986/87 prices.

annum in real terms. 1/ If at the same time public expenditures on welfare, health, and housing were to be doubled--probably a conservative assumption--and the base growth rate of other expenditures was left unchanged from that in the first scenario, public expenditures, in real terms, would need to grow at an annual rate of 3.6 percent over the ten-year period. Given the assumed constraint on the growth of the budget deficit, this would imply a rate of growth of 4.3 percent for revenues in real terms, 2 percentage points more than in the base scenario. However, with the potential abatement of social tensions and the scope for deregulation of apartheid laws implied in these medium-term assumptions, a significant restructuring of budgetary expenditures would be possible. Under this more favorable assumption, the estimated increase in expenditures could be brought back to 2.9 percent per annum.

Against the backdrop of the achievement of a central government deficit of 3 percent of GDP, both scenarios, incorporating an accelerated social expenditure program, would require a substantial increase in revenues, ranging between R 4.4 billion (2.2 percent of GDP) and R 8.3 billion annually (4.2 percent of GDP), depending on the degree to which a restructuring of other expenditures can be implemented. With the assumption that these increases would fall on individuals, the increase in their tax burden would be substantial. 2/

The overall tax burden, including general sales taxes and excise duties, on personal income of households in 1986 would not appear unduly high at 20 percent, even taking into account the absence of a social safety net covered by tax revenues. However, the income tax base is relatively narrow, including only about 60 percent of household income. Accordingly, the tax burden on those effectively paying income taxes can be calculated at some 28 percent of taxable income. The financing of a pervasive social program would cause a further rise in the share of taxation paid out of personal income of at least 3 percentage points. Without a broadening of the tax base beyond its current 60 percent share of personal income, this would increase the tax burden on those effectively paying income taxes to over 33 percent, under the assumption that a restructuring of other public expenditures is implemented. The additional revenue requirement on these assumptions would absorb one fifth of the income growth of taxpayers over the period. If, however, the current tax base were not to grow beyond the

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1/ Currently, expenditures on education per black pupil are estimated to lag those spent on colored pupils by a factor of 4 1/2, those spent on Asian pupils by a factor of 7, and those spent on whites by a factor of 8 1/4.

2/ As noted before, greater spending on social programs would enhance labor productivity, and could give rise to a higher growth rate of the wage bill under the accelerated social expenditure programs. If labor productivity growth were to double and wages reflected this increase, about R 1 billion of the necessary revenue increase would be secured automatically.

increase in average wages, new entrants into the labor market would fall outside the income tax system and the tax base would narrow to below 50 percent of personal income. Consequently, the tax burden on those paying income taxes would exceed 40 percent and the postulated increase in personal income of taxpayers would be nearly fully absorbed by the additional revenue requirement.

Table 9. South Africa: Medium-Term Scenarios of Central Government Finances 1/

	1986/87	1996/97		
		With GDP trend growth of 3 percent per year	Accelerated social expenditure projection: With trend growth of other public expenditures	Accelerated social expenditure projection: With restructuring of other expenditures
	Estimate			
		(In billions of 1986/87 rand)		
I. Expenditures				
Education: universities and technicians	1.2	1.3	1.3	1.2
Education: primary and secondary schooling	5.0	6.7	13.1	13.1
Welfare and health	4.9	6.6	9.8	9.8
Housing	1.2	1.6	2.4	2.4
Wage bill	8.6	9.5	9.5	7.7
Defense	5.6	6.2	6.2	5.6
Other expenditures	13.5	14.9	14.9	13.5
Total	40.0	46.8	57.2	53.3
(In percent of GDP)	(27.4)	(23.9)	(29.2)	(27.2)
II. Revenues 2/				
Income taxes	19.3	25.2	34.2	30.3
Corporations	9.0	11.0	11.0	11.0
Individuals	10.3	14.9	23.2	19.3
General sales taxes	9.4	11.5	11.5	11.5
Customs and excises	2.3	2.8	2.8	2.8
Other revenues	2.7	2.8	2.8	2.8
Total	33.7	43.0	51.3	47.4
(In percent of GDP)	(23.1)	(21.9)	(26.2)	(24.2)
III. Deficit	6.4	3.8	5.9	5.9
(In percent of GDP)	(4.4)	(1.9)	(3.0)	(3.0)
		(Annual average growth rates)		
I. Expenditures				
Education: universities and technicians	...	1.0	1.0	—
Education: Primary and secondary schooling	...	3.0	10.1	10.1
Welfare and health	...	3.0	7.2	7.2
Housing	...	3.0	7.2	7.2
Wage bill	...	1.0	1.0	-1.0
Defense	...	1.0	1.0	—
Other expenditures	...	1.0	1.0	—
Total	...	1.6	3.6	2.9
II. Revenues 2/				
Income taxes	...	2.7	5.9	4.6
Corporations	...	2.0	2.0	2.0
Individuals	...	3.8	8.5	6.5
General sales taxes	...	2.0	2.0	2.0
Customs and excises	...	2.0	2.0	2.0
Other revenues	...	0.5	0.5	0.5
Total	...	2.3	4.3	3.5
		(In 1986/87 rand)		
Memorandum items:				
Expenditure on education per pupil 3/	700	940	1,295	1,295
Of which: Whites	2,160	940	1,295	1,295
Blacks	260	940	1,295	1,295
Asians	1,850	940	1,295	1,295
Coloreds	1,165	940	1,295	1,295
		(Annual average growth rate)		
Expenditure on education per pupil	...	3.0	6.3	6.3
Of which: Whites	...	-8.0	-5.0	-5.0
Blacks	...	13.7	17.4	17.4
Asians	...	-7.0	-3.5	-3.5
Coloreds	...	-2.1	1.1	1.1

Source: Staff calculations.

1/ GDP is assumed to grow by 3 percent per year, allowing consumption and imports to grow by 2 percent. Mining output is assumed to grow by 1 percent per year. The wage bill is assumed to grow in line with GDP growth, while the income tax elasticity is set at 1.25.

2/ Under the accelerated social expenditure projections, the central government deficit is constrained at 3 percent of GDP. Total revenues, and in turn individual income taxes, are derived residually from this deficit target.

3/ Staff calculations, based on the estimated school population and spending on education by population groups in 1986.

Interlinkages Between South Africa and the Neighboring States

South Africa is the dominant economic entity in southern Africa. It is the main trading partner for many of the neighboring states and a focal point for regional transportation and communications networks. South Africa's relations with other African nations date from colonial times and, while some have been suspended since the advent of independence in Africa, others have been maintained. Many of the links between South Africa and its neighbors were forged by private mining interests, involving the movement of labor into South Africa and the flow of capital and technology into the neighboring states. This pattern continues, with South Africa employing its neighbors' workers and providing technical and managerial expertise for mining and transport projects. Table 10 summarizes the various relations between South Africa and its neighbors.

Over 350,000 migrant workers from neighboring countries are legally employed in South Africa, with associated remittances estimated at over US$500 million (in 1984). The total number of foreign workers, including illegal migrants, could be as high as 1 1/2 million and the actual annual remittance flow could be between US$3/4-1 billion. Migrant workers with valid contracts are employed mainly in mining. The number of foreign workers employed by the South African mining industry has declined over the past decade, reflecting in part increased mechanization in mining and in part, with the relative rise in wages, increased supply of, but also an increased preference for, local workers. For all South African mines together, the proportion of migrants in total black employment declined from 60 percent in the mid-1970s to 40 percent at present. Some 140,000 workers from Lesotho--more than half Lesotho's domestic work force--are legally employed in South Africa. About 25 percent of Botswana's male labor force (28,000) works in South Africa; for Zimbabwe and Swaziland the corresponding percentage is about 15 percent (7,500 and 22,000 workers, respectively); and for Malawi and Mozambique less than 5 percent (30,000 and 69,000 workers, respectively). For Mozambique, workers' remittances from South Africa are the largest single source of foreign exchange earnings, and for Lesotho they equal GDP.

Transport forms a critical linkage between South Africa and the neighboring states, with South Africa controlling the rail transport system for seven countries from Lesotho to eastern Zaire. South Africa aside, the remaining rail links for the involved countries would be inadequate under present conditions to carry current levels of trade. The landlocked states, e.g., Lesotho, Botswana, Swaziland, Zambia, and Zimbabwe, rely greatly on South African rail and harbor facilities for their imports and exports. Virtually all imports and exports of Botswana, Lesotho, and Swaziland are routed through South Africa. In addition, South Africa transports an average 45 percent of the combined imports and exports of Zambia, Zimbabwe, Zaire, and Malawi.

South Africa is an important trading partner for the countries in the region. In 1985, well over 90 percent of Lesotho's imports came from South Africa, while for Botswana and Swaziland the corresponding percentage was only slightly less, 85 percent. South Africa is also the most important supplier to Zimbabwe, Zambia, and Malawi and an important export market for Lesotho, Swaziland, and Zimbabwe. Botswana, Lesotho, and Swaziland are South Africa's partners in a customs union. Under the governing agreement, South Africa collects all tariffs on imported goods and pays a prorated share of revenues to the other members under a specified formula. 1/ Revenues from the customs union represent about 55 percent of total government revenues in Lesotho and 15 percent in Botswana and include an important grant element.

In view of the importance of trade with South Africa, the recent sharp depreciation in the rand has generally caused these countries to rethink their exchange rate policies, and to consider whether to depreciate with the rand and take the expansion of market shares outside South Africa--and the domestic inflationary consequences--or to forgo the depreciation and risk the loss of important markets in South Africa. In particular, in the aftermath of the sharp depreciation of the rand in 1985, the Botswana authorities reduced the weight of the rand in their currency basket from 75 percent to 65 percent, and raised that of the SDR from 25 percent to 35 percent, when calculated in terms of U.S. dollars. In Swaziland, concerns over the large and abrupt depreciations of the rand and the lilangeni and its implication for inflation, and, particularly, the domestic cost of servicing foreign debt, led the authorities to renegotiate the previous agreement with South Africa. Under the Common Monetary Agreement (CMA), the rand no longer serves as legal tender in Swaziland, effective July 1, 1986, and Swaziland is now in a position to pursue an independent monetary and exchange rate policy. Nevertheless, the authorities have so far continued to peg the lilangeni to the rand at par. In Lesotho, exchange rate policy has remained unchanged. Imported inflation, obviously, is a problem with the sharp depreciation of the rand, but with South Africa Lesotho's principal export market, pegging to the rand has maintained competitiveness vis-à-vis South African producers and conferred an advantage over other competitors.

As to the other neighboring countries, in Malawi the pursuit of a flexible exchange rate policy designed to prevent an appreciation in the real effective exchange rate of the kwacha as measured on a trade-weighted basis, has been made more difficult by the sharp drop in the exchange rate of the South African rand. An appreciation of the kwacha vis-à-vis the rand is quickly reflected in a loss of market shares both at home and in South Africa; in addition, the rand exchange rate determines a large proportion of Malawi's freight cost, as about 90 percent of Malawi's foreign trade is channeled through South Africa. In Mozambique, there has apparently been little by way of

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1/ See Lesotho--Recent Economic Developments (SM/85/288, 11/4/85).

policy debate on exchange rate policy and in the appropriate rate of the metical vis-à-vis the rand. This may largely reflect the fact that the official value of the metical is only about one thirty-fifth of the parallel market rate. In Zambia, where trade with South Africa figures quite heavily (11.3 percent of combined exports and imports), the policy debate has not focused on the level of the kwacha vis-à-vis the rand inasmuch as the kwacha has depreciated substantially against all currencies, since the inception of the foreign exchange auction in October 1985. In Zimbabwe the South African rand has by far the largest weight in their currency basket of currencies used to determine the exchange rate of the Zimbabwe dollar, but, reflecting the declining importance of South Africa as a trading partner, the weight of the rand in the basket has been progressively reduced.

Table 10. South Africa: Interlinkages Between South Africa and Neighboring States

	Botswana 1/	Lesotho 1/	Swaziland 1/	Malawi	Mozambique	Zambia	Zimbabwe
Exchange rate arrangements	Pula pegged to basket of 65 percent rand and 35 percent SDRs	Loti pegged to to rand	Lilangeni pegged to rand	Kwacha pegged to a trade-weighted basket of currencies	Metical pegged to a trade-weighted basket of currencies	Free float of the kwacha basket of currencies	Zimbabwe dollar pegged to a trade-weighted basket of currencies
Trade weights vis-à-vis South Africa 2/	74.6	95.4	64.2	27.9	...	—	33.4
Percentage change in bilateral rate vis-à-vis rand between December 31, 1984 and May 31, 1986	0.3	...	...	41.6	-16.0	-64.9	1.9
Percentage change in nominal effective rate between December 31, 1984 and May 31, 1986	-3.7	-1.8	-10.7	-24.8	—	-74.7	-18.4
Percentage change in real effective rate between December 31, 1984 and May 31, 1986	-6.6	1.8	-10.3	-21.3	—	-58.0	-16.4
Imports from South Africa (in percent of total)	75 3/	95 3/	80-85 4/	38 5/	14 6/	23 5/	19
Exports to South Africa (in percent of total)	6 3/	94 3/	20-30 4/	8 5/	6 6/	1 5/	18
Transport dependency on South Africa	Highly to totally dependent	Highly to totally dependent	Partial	Partial	None; ships through Maputo	Partial; also ships through Dar es Salaam	Highly dependent
South African tourists (as a per centage of total) 4/	65	95	60	40	—	3	25
Migrant workers employed in South Africa in 1985 7/	27,814	139,827	22,255	30,144	68,665	833	7,428
(As a percentage of wage earners)	17	50	15	5	3	1	16
Workers' income remitted home in 1984 (in millions of U.S. dollars)	38	358	52	21	57	...	1
(As a percentage of goods and services exports)	4	85	10	6	45	...	...
(As a percentage of GNP) 8/	4	50	9	2	3	...	...
Receipts from SACU 9/ (in millions of U.S. dollars)	79	73	61	...	...	...	...
(As a percentage of government revenue)	15	54	56	...	...	...	...

Source: European Department in consultation with other departments.

1/ Members of the South African Customs Union (SACU).
2/ IMF trade weights used for effective exchange rate calculations.
3/ Including trade with the other members of the SACU, but mainly with South Africa.
4/ Staff estimates.
5/ IMF, Direction of Trade Statistics, various issues.
6/ Unofficial.
7/ Registered workers with valid labor contracts only, as defined by the South African authorities; the total foreign work force may amount to 1 1/2 million compared with a count of legal migrants of 350,000.
8/ Based on GNP estimates in The World Bank Atlas, 1986.
9/ South African Customs Union; fiscal year 1985/86.

Medium-Term Debt Projections

In the circumstances of the current inability to repay maturing debt in a timely fashion, medium-term debt projections must be even more tentative than usual. It is clear that with some US$10 billion equivalent of external debt becoming payable at the end of the current Interim Arrangement agreed with foreign commercial bank creditors, in June 1987, assumptions will need to be made regarding either spontaneous rollovers or further extensions of negotiated agreements. For illustrative purposes, it is convenient to assume that the pattern of repayment over the projection period will be similar to that established currently with respect to commercial bank and other debt caught up in the standstill net, i.e., a repayment of 5 percent of principal annually.

The underlying assumptions on which the medium-term projections shown in Table 11 are built assumes real GDP growth in the industrial countries to be 3 percent a year and an interest rate based on a 7 percent LIBOR. Gold prices are held constant in real terms, while U.S. dollar prices of oil and manufactured goods rise by 4 1/2 percent. Real GDP growth for the domestic economy is projected at 3 percent per annum and the output elasticity of import demand is assumed to be slightly over 1, reflecting maintenance of the real exchange rate at recent levels.

Under these assumptions, international reserves would approach the level of 11 weeks' import coverage registered during the first half of the 1980s until the end of 1989. However, the bulge in the debt maturity profile that occurs in 1990-91 would bring reserves back down to the equivalent of 7 weeks of imports compared with a 5-week level projected for 1986. This implies, on the above assumptions, that the real exchange rate and/or domestic expenditure growth might need to be reduced below what is assumed in the scenarios.

On August 31, 1983 South Africa made an early repurchase of SDR 50 million; subsequently, it made repurchases of SDR 79.5 million each on February 7 and May 7, 1986.

In September 1975 South Africa purchased SDR 80 million under the gold tranche and four months later a further SDR 80 million under a stand-by arrangement in the first credit tranche. The Fund approved a new stand-by arrangement in August 1976 under which SDR 75 million was purchased immediately, SDR 39 million in January 1977, and SDR 38 million in May 1977. In November 1977 South Africa purchased SDR 160 million under the CFF.

IV. SDR Department

(a) Net cumulative allocation: SDR 220.4 million.

(b) Holdings: SDR 3.5 million or 1.6 percent of net cumulative allocation.

(c) Current designation plan: The rand is not included in the current plan.

V. Administered Accounts: Not applicable.

VI. Overdue Obligations to the Fund: None.

B. Nonfinancial Relations

II. Exchange system: The South African authorities do not maintain margins in respect of exchange transactions. The dual exchange rate system, under which the "financial" rand is traded at a freely determined exchange rate (usually at a discount over the "commercial" rate), was unified on February 7, 1983, but was reinstated on September 2, 1985. The exchange rate of the rand in June 1986 averaged R1 = US$0.3956, compared with R1 = US$0.5063 in June 1985 and R 1 = US$0.3732 in December 1985.

VIII. The last Article IV consultation discussions took place in February/March 1985, and the consultation was completed by the Executive Board on June 7, 1985.

Medium-Term Debt Projections

In the circumstances of the current inability to repay maturing debt in a timely fashion, medium-term debt projections must be even more tentative than usual. It is clear that with some US$10 billion equivalent of external debt becoming payable at the end of the current Interim Arrangement agreed with foreign commercial bank creditors, in June 1987, assumptions will need to be made regarding either spontaneous rollovers or further extensions of negotiated agreements. For illustrative purposes, it is convenient to assume that the pattern of repayment over the projection period will be similar to that established currently with respect to commercial bank and other debt caught up in the standstill net, i.e., a repayment of 5 percent of principal annually.

The underlying assumptions on which the medium-term projections shown in Table 11 are built assumes real GDP growth in the industrial countries to be 3 percent a year and an interest rate based on a 7 percent LIBOR. Gold prices are held constant in real terms, while U.S. dollar prices of oil and manufactured goods rise by 4 1/2 percent. Real GDP growth for the domestic economy is projected at 3 percent per annum and the output elasticity of import demand is assumed to be slightly over 1, reflecting maintenance of the real exchange rate at recent levels.

Under these assumptions, international reserves would approach the level of 11 weeks' import coverage registered during the first half of the 1980s until the end of 1989. However, the bulge in the debt maturity profile that occurs in 1990-91 would bring reserves back down to the equivalent of 7 weeks of imports compared with a 5-week level projected for 1986. This implies, on the above assumptions, that the real exchange rate and/or domestic expenditure growth might need to be reduced below what is assumed in the scenarios.

Table 11. South Africa: Projected Debt Outstanding on Various Dates Based on Assumption of Successive 5 Percent Interim Arrangements

(In millions of U.S. dollars)

	End-1985	End-1986	End-1987	End-1988	End-1989	End-1990	End-1991
Reserve Bank	1,187	683 1/	683 1/	683 1/	683 1/	683 1/	683 1/
Bearer bonds 2/	2,899	2,662	2,354	2,113	1,823	1,144	—
IMF 3/	871	465	--	--	--	--	--
Official 4/	1,996	2,176	2,176	1,893	1,649	1,352	718
Payable public sector	6,953	5,986	5,213	4,689	4,155	3,179	1,401
Nonpayable public sector 5/	2,692	2,633	2,544	2,435	2,312	2,186	2,077
Total public sector	9,645	8,619	7,757	7,124	6,467	5,365	3,478
Nonpayable private banking 5/	8,814	8,426	8,021	7,603	7,183	6,763	6,438
Nonpayable private nonbanking 5/	2,122	2,084	2,032	1,965	1,887	1,824	1,751
Nonpayable private sector	10,936	10,510	10,053	9,568	9,070	8,587	8,189
Payable private nonbanking 6/	2,398	1,128	1,093	1,064	1,028	995	874
Total private sector	13,334	11,638	11,146	10,632	10,098	9,582	9,063
Total	22,979	20,257	18,903	17,756	16,565	14,947	12,541
Implied capital outflow	--	2,722	1,354	1,147	1,191	1,618	2,406
Forecast current account surplus 7/	--	2,000	1,700	1,800	1,800	1,850	1,900
Implied reserve change	--	-722	346	653	609	232	-506
Reserves	1,740	1,018	1,364	2,017	2,626	2,858	2,352
Desired reserves 8/	--	2,337	2,538	2,745	2,967	3,210	3,475
Reserve gap	--	1,319	1,174	728	341	352	1,123

Sources: South African Standstill Coordinating Committee; and IMF staff estimates.

1/ Reserve Bank loans held at level of end-June 1986.
2/ Bearer bonds are assumed repaid per repayment schedule.
3/ IMF is assumed repaid per repurchase schedule.
4/ Officially guaranteed credits are assumed to increase in net terms by US$180 million in 1986, which is then repaid over five years. For 1987, the US$36 million in respect to this inflow exactly offsets an earlier official forecast net inflow of US$36 million; thus, 1987 remains at the 1986 level. For subsequent years, payments are according to the repayment schedule plus US$36 million per year.
5/ "Nonpayable" is assumed repaid as follows: Five percent of payments due over September 1985-April 1986 are paid in April 1986. Five percent of remaining repayments due through June 1987 are paid on maturation, whereupon successive one-year interim arrangements are assumed to be agreed, with 5 percent installments on all mature and maturing repayments to be repaid on respective due dates or anniversaries thereof.
6/ Assumes 35 percent rollover of maturing debt outstanding as of August 31, 1985. According to South African documentation, total includes US$328 million of officially guaranteed credits.
7/ Staff forecast.
8/ Based on staff forecast of imports and assumed reserve coverage of 11 weeks.

Fund Relations with South Africa
(As of end of June 1986)

I. Membership Status

South Africa is an original member of the Fund. The obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement have been accepted as from September 15, 1973.

(A) Financial Relations

II. General Department

(a) Quota — SDR 915.7 million

(b) Total Fund holdings of South African rand — SDR 1,501.7 million or 164.0 percent of quota

		Amount	Percent of quota
(c) Fund credit	CFF	SDR 477.0 million	52.1
	Credit tranche (ordinary)	SDR 109.0 million	11.9
	Total	SDR 586.0 million	64.0

(d) Reserve tranche position — None.

(e) Current operational budget — The rand is not included in the current budget.

(f) Lending to Fund — None.

III. Stand-By or Extended Arrangement and Special Facilities

(a) Current: None.

(b) Previous: In November 1982, the Fund approved a 14-month stand-by arrangement for an amount equivalent to SDR 364 million (57 percent of the then-quota) and a purchase equivalent to SDR 636 million (100 percent of the then-quota) under the CFF. South Africa drew SDR 159 million under the stand-by arrangement but made no further drawings afterward.

On August 31, 1983 South Africa made an early repurchase of SDR 50 million; subsequently, it made repurchases of SDR 79.5 million each on February 7 and May 7, 1986.

In September 1975 South Africa purchased SDR 80 million under the gold tranche and four months later a further SDR 80 million under a stand-by arrangement in the first credit tranche. The Fund approved a new stand-by arrangement in August 1976 under which SDR 75 million was purchased immediately, SDR 39 million in January 1977, and SDR 38 million in May 1977. In November 1977 South Africa purchased SDR 160 million under the CFF.

IV. SDR Department

(a) Net cumulative allocation: SDR 220.4 million.

(b) Holdings: SDR 3.5 million or 1.6 percent of net cumulative allocation.

(c) Current designation plan: The rand is not included in the current plan.

V. Administered Accounts: Not applicable.

VI. Overdue Obligations to the Fund: None.

B. Nonfinancial Relations

II. Exchange system: The South African authorities do not maintain margins in respect of exchange transactions. The dual exchange rate system, under which the "financial" rand is traded at a freely determined exchange rate (usually at a discount over the "commercial" rate), was unified on February 7, 1983, but was reinstated on September 2, 1985. The exchange rate of the rand in June 1986 averaged R1 = US$0.3956, compared with R1 = US$0.5063 in June 1985 and R 1 = US$0.3732 in December 1985.

VIII. The last Article IV consultation discussions took place in February/March 1985, and the consultation was completed by the Executive Board on June 7, 1985.

South Africa - Statistical Issues

1. Outstanding statistical issues

a. Monetary accounts

A mission on money and banking statistics took place in May/June 1986. The preliminary findings of the mission were as follows: (1) the Reserve Bank of South Africa has improved its statistical coverage of monetary institutions and has introduced new measures of narrow money and broad money, the latter including nondeposit instruments such as shares issued by building societies and National Savings Certificates; (2) the external accounts of deposit money banks as presently reported omit substantial amounts of foreign borrowing by banks, which are directly onlent to the private sector; it is understood that, under the new Banking Act, these foreign liabilities will be reported as part of the banks' external accounts. It was also established that the coverage of balance sheet data on other nonmonetary institutions could be greatly expanded.

As a result of the visit, steps will be taken to revise the coverage of monetary financial institutiolns in IFS and to broaden the coverage of data on other financial institutions. It is also expected that the data in IFS on banks' external assets and liabilities will be greatly improved once the new reporting requirements under the new Banking Act have been implemented.

b. International banking statistics

In light of problems referred to in section a (2) above, South Africa's cross-border interbank liabilities in the international baning statistics are at present calculated from reports received from major international banking centers, rather than in the report forms received from the Reserve Bank. Cross-border interbank liabilities reported by South Africa are about US$7.0 billion lower than the amount reported by major banking centers.

c. Government finance

The 1985 Government Finance Statistics Yearbook (GFSY) includes data for the consolidated central government and provincial and local governments only through 1982. Data on expenditure, lending minus repayments, and capital expenditure by function are not published in the GFSY because the corresponding data for extrabudgetary units are not available. Problems arise in effecting improvements in the coverage and currencies of government finance statistics because of difficulties in collecting data from the large number of extrabudgetary units, as well as for the homelands and the provincial administrations.

2. Coverage, currentness, and reporting on data in IFS

The table below shows the currentness and coverage of the data published in the country page for South Africa in the July 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the South African Reserve Bank, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in July 1986 IFS
Real sector	- National accounts	Q4 1985
Government finance	- Prices: CPI	April 1986
	WPI	March 1986
	- Production	March 1986
	- Employment	December 1985
	- Earnings	n.a.
Government finance	- Deficit/surlpus	March 1986
	- Financing	March 1986
	- Debt	March 1986
Monetary accounts	- Monetary authorities	March 1986
	- Deposit money banks	March 1986
	- Other banking institutions	March 1986
	- Insurance companies	Q3 1985
Interest rates	- Discount rate	April 1986
	- Bank lending/deposit rate	March/April 1986
	- Government bond yield	April 1986
External sector	- Merchandise trade:	
	Values	April 1986
	Prices: Import prices	March 1986
	Unit values	Q1 1985
	- Balance of payments	Q3 1985
	- International reserves	May 1986
	- Exchange rates	May 1986

South Africa: Selected Economic and Financial Indicators, 1981-85

	1981	1982	1983	1984	1985
	(Annual percentage changes, unless otherwise specified)				
Demand, output, and prices					
Real domestic demand	11.4	-5.6	-5.4	7.5	-7.8
Real output at factor cost	4.5	-0.8	-2.4	5.1	-0.6
Agriculture	5.7	-9.1	-26.9	13.7	14.9
Mining	-1.3	-0.5	0.2	2.6	0.5
Manufacturing	6.8	-3.0	-6.6	3.0	-5.3
General government	2.4	4.0	5.0	4.2	—
GDP deflator	9.3	13.6	14.3	12.5	14.1
Consumer prices	15.2	14.7	12.3	11.7	16.2
External sector					
Nongold export value, f.o.b. 1/	-12.3	-14.8	-2.1	-5.1	4.0
Nongold export volume	-10.1	-0.7	-10.2	8.9	22.1
Gold export value 1/	-26.5	-16.8	11.9	-10.4	-13.2
Gold export volume	-2.9	1.5	-0.8	6.4	-1.9
Import value, f.o.b. 1/	14.3	-20.0	-14.3	3.2	-30.3
Import volume	14.6	-17.9	-18.5	21.1	-15.8
Terms of trade (including gold; deterioration -) 1/	-12.3	-13.6	5.4	0.6	4.6
Nominal effective exchange rate (average depreciation -)	1.9	-9.6	6.7	-14.0	-23.7
Real effective exchange rate (average depreciation -)	4.9	-5.2	11.3	-11.8	-20.7
Government budget 2/					
Revenue	8.3	19.1	11.2	22.7	27.2
Total expenditure	20.9	18.6	14.7	21.9	22.2
Money and credit 3/					
Net credit to Government 4/5/	62.0	-5.6	40.1	9.2	71.0
Credit to private sector 5/	34.4	20.5	17.8	28.4	17.0
Broad money (M3) 6/	17.6	15.4	16.4	18.2	12.3
	(In percent of GDP)				
Central government budget deficit (State Revenue Account) 2/	2.8	2.8	3.5	3.5	2.8
Savings of general government	2.0	-0.3	-1.5	-2.4	-1.1
Gross domestic savings	28.3	21.9	24.6	23.0	26.5
Gross domestic investment	33.8	25.9	24.3	24.3	20.5
External current account balance	-5.5	-4.0	0.3	-1.3	6.0
Debt service ratio 7/	...	...	15.8	19.6	23.0 8/
Overall balance of payments (in millions of U.S. dollars)	-4,566	-2,968	274	-1,031	3,122

Sources: IMF, International Financial Statistics; and data provided by the South African authorities.

1/ In U.S. dollar terms.
2/ Fiscal year beginning April.
3/ In through-the-year terms.
4/ Including credit from the Reserve Bank to finance losses incurred on account of forward exchange contracts.
5/ Old definition; based on the monetary banking sector.
6/ New definition; based on consolidated balance sheet of the banking sector, building societies, and the Post Office Savings Bank.
7/ Interest payments on total foreign debt and amortization of medium- and long-term debt, in percent of exports of goods and nonfactor services.
8/ *Staff estimate on the assumption that all long-term debt would have been paid as due. In* the context of the debt standstill declared by South Africa, the actual ratio is estimated to have been 19.1 in 1985.

Basic Data

Area and population

Area	1,182,345 sq. km.
Population (at June 1984)	31,590,000
Employment in nonagricultural sector (December 1985)	5,144,900

IMF position (June 30, 1986)

Quota (in millions of SDRs)	915.7
Fund holdings of rand (as percent of quota)	164.0
Holdings of SDRs (in millions)	3.5
Exchange rate	R 1 = US$0.4045

National accounts

	1985	1983	1984	1985
	In millions of rand at current prices	Percentage change in real terms		
Private consumption	65,194	1.5	2.5	-2.7
Public consumption	20,725	-0.2	7.4	-0.8
Gross fixed investment	28,173	-9.1	-1.9	-2.8
Change in stocks (including residual item)	-7,142	-3.4	4.8	-5.0
Total domestic demand	106,950	-5.4	7.5	-7.8
Exports of goods and services	39,930	-5.5	7.6	8.3
Imports of goods and services	-27,820	-17.1	19.5	-14.4
Gross domestic product	119,060	-2.5	5.0	-1.0

Central government finances 2/

	1983	1984	1985
	In millions of rand		
Revenue	19,088	23,426	29,809
Expenditure	-22,350	-27,234	-33,271
Deficit before borrowing	-3,262	-3,808	-3,462

Balance of payments

	1983	1984	1985
	In millions of rand		
Merchandise exports, f.o.b.	20,136	24,379	35,478
Net gold exports	9,929	11,684	15,460
Merchandise imports, f.o.b.	-15,863	-21,355	-22,544
Net invisibles and transfers	-3,968	-4,434	-5,822
Current balance	305	-1,410	7,112

Basic Data (continued)

	1983	1984	1985
	In millions of rand		
Net long-term capital	-238	2,563	-97
Net short-term capital (including errors and omissions)	-93	-2,582	-10,321
Net capital (including errors and omissions) 3/	-331	-19	-10,418
Overall balance	-26	-1,429	-3,306
Level of reserves at end-year (in millions of SDRs, IFS definition)	1,059	504	456
Monetary aggregates (end of period)	1983	1984	1985
	Percentage changes over previous year		
Broad money (M3) 4/	16.4	18.2	12.3
Bank credit to private sector 5/	17.8	28.4	17.0
Bank credit (net) to Government 5/6/	40.1	9.2	71.0
Prices and wages (annual average)			
Consumer prices	12.3	11.7	16.2
Price deflators			
Exports of goods and services	12.3	12.5	31.4
Imports of goods and services	10.3	11.1	25.9
Real remuneration per worker 7/			
Whites	-1.1	3.9	-4.9
Nonwhites	1.4	6.6	-1.4

1/ Contributions to growth of GDP.
2/ Years beginning April 1.
3/ Excluding short-term liabilities related to reserves.
4/ New definition; see footnote 6 in Appendix VI.
5/ Old definition; see footnote 5 in Appendix VI.
6/ Includes credit from the Reserve Bank to finance losses on account of forward exchange contracts.
7/ In the nonagricultural sector.