INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

November 17, 2014

KEY ISSUES

Context. South African citizens' living standards have improved substantially in the first twenty years of democracy. But in recent years the economy has underperformed peers. The outlook is lackluster, with low growth, high unemployment, and elevated twin deficits. As in many emerging markets, weak external demand and soft commodity prices contributed to these outcomes, but deep-seated structural factors also played an important role. After years of accommodation, fiscal and monetary policies are constrained by rising vulnerabilities. With the elections over, the government has an opportunity to implement structural reforms, essential to address unemployment, poverty, and inequality.

Structural reforms. An extensive public infrastructure program will ease binding electricity and transport bottlenecks over time. Besides improved state-owned enterprise efficiency, greater private sector participation would help as public balance sheets are stretched. Normalization of industrial relations, combined with greater competition in product markets, more inclusive labor markets, and reduced skill mismatches, remain indispensable to boost job-rich and sustainable growth, lower vulnerabilities, and enhance the economy's ability to rebalance toward exports and investment.

Fiscal and monetary policies. With rising vulnerabilities, macroeconomic policies are rightly factoring in the risks South Africa faces. As planned in the 2014 Medium-Term Budget Policy Statement, fiscal consolidation is needed to ensure debt stabilization over the medium term. Under staff's baseline, further measures may be needed. The recent large drop in oil prices and the envisaged fiscal adjustment may enable the South African Reserve Bank to stay accommodative for longer. Higher interest rates may become necessary if global financial conditions tighten sharply.

Policies to enhance resilience. The Financial Sector Stability Assessment (FSSA) concludes that financial sector risks are elevated but manageable. It recommends heightened scrutiny of asset quality and liquidity risks. To complement the authorities' regulatory reform of the financial sector, the FSSA advises enhanced stress tests, group-wide supervision, a strengthened financial safety net, and a clearer allocation of responsibilities and coordination among institutions. The flexible exchange rate regime and a favorable currency composition of external debt are effective buffers against capital flow volatility, but higher reserves and policies to facilitate foreign direct investment would further strengthen resilience.

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Discussions took place in Pretoria, Johannesburg, and Cape Town, September 17–30, 2014. The staff comprised Ms. Papi (head), Messrs. Anand, Mu, Saxegaard, (from HQ), Torres, Wu (all AFR), and Perrelli (SPR). Mr. Schimmelpfennig (Senior Resident Representative) assisted the mission. Mr. Todani (OED) also participated in the discussions.

CONTENTS

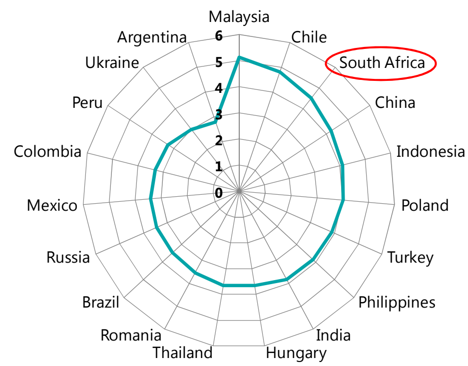
TABLES

ANNEXES

CONTEXT: SUBSTANTIAL PROGRESS IN THE PAST 20 YEARS AND CHALLENGES AHEAD

1. **South Africa has made substantial progress in its first 20 years of democracy.** As the government's Twenty Year Review states, "…the country has emerged from its deeply divided and violent past into a peaceful, robust and vibrant democracy that has made major strides in improving the lives of its citizens".[1] Since 1994, real per capita GDP growth averaging 1½ percent annually and social assistance that now reaches nearly 30 percent of the population have resulted in much improved living standards, with increased access to education and healthcare (Figure 1). Strong institutions and policy frameworks have delivered macroeconomic stability and a globally-integrated economy.

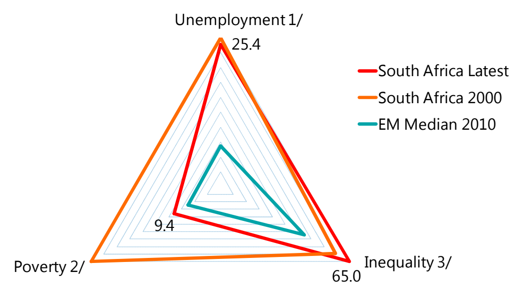
South Africa Has Strong Institutions



Source: World Economic Forum Global Competetiveness Index, 2014-15

2. **The country's aspiration is a society free of poverty with low levels of unemployment and inequality, which requires addressing deep-seated structural issues.** A 25 percent unemployment rate and differences in labor income and wealth have resulted in one of the most unequal societies in the world. Poverty is high relative to other emerging markets (EMs). These challenges largely result from structural problems.[2] Barriers to entry in product markets and above-market-clearing wage settlements between labor unions and large firms contribute to insider-outsider dynamics that leave large segments of the population excluded from economic activity (Figure 2). Poor educational outcomes, skill mismatches, spatial divides, and limited opportunities for entrepreneurship during apartheid hinder employment and small and medium enterprise (SME) development. Supply bottlenecks, especially in electricity, but also in transport, are increasingly constraining growth. Tense industrial relations are leading to prolonged strikes, which are on an upward trend and result in lost workers' income, lower production, and weak investor confidence.

High Unemployment, Poverty and Inequality



Note: the highest value scaled to 100; a smaller value represents a better outcome.
Sources: WDI, Presidency of the Republic of South Africa: 20 Year Review
1/ percent, 2014 2/ $1.25 a day, percent of population, 2011
3/ GINI coefficient: South Africa figure is from WDI, 2011

[1] The Presidency, Republic of South Africa (2014), "Twenty-Year Review, South Africa 1994-2014".

[2] See IMF (2013), "South Africa: 2013 Article IV Consultation", IMF Country Report No. 13/303 and OECD (2013), "Economic Surveys: South Africa 2013" for more details on South Africa's structural issues.

3. **The South African economy is also facing challenges in the near term.** Since 2010, growth, driven mainly by consumption, has been weak, and the private sector has created too few jobs, despite supportive macroeconomic policies and ample global liquidity providing easy financing for the large twin deficits. Going forward, headwinds stem from tighter global financial conditions, the uneven global recovery, and reduced policy space. Also, commodity prices and credit, which provided a fillip to growth in the boom years, are no longer as supportive.

4. **With the elections over, the government has an opportunity to make strides in addressing the country's challenges.** The African National Congress (ANC) won 62 percent of the vote in the May 2014 elections (66 percent in 2009). President Zuma stated that radical socio-economic transformation to push back the triple challenges of poverty, inequality, and unemployment is the priority in his second term.[3] The policies, which have the large infrastructure program at its core, are articulated in the Medium-Term Strategic Framework (MTSF), which is the implementation roadmap of the National Development Plan (NDP) and the ANC manifesto. Structural economic reforms are executed through the Industrial and Policy Action Plan and New Growth Path, which emphasize the role of a developmental state and industrial policy, and through "budget decisions that contribute to making the NDP a reality" (Annex I).[4]

5. **The 2014 Article IV consultation centers on policies to boost growth and job creation and strengthen resilience.** In particular, it focuses on: (i) macro-critical structural reforms to generate job-rich growth and increase the economy's flexibility; (ii) fiscal policy in a constrained environment; (iii) policies to further enhance financial sector resilience, as recommended by the 2014 Financial System Stability Assessment (FSSA).

STRUCTURAL CHALLENGES AND VULNERABILITIES WEIGH ON GROWTH

6. **South Africa's growth remains weaker than peer countries'.**[5]

- Real GDP growth declined to 1.9 percent in 2013 and to 1.3 percent (y/y) in 2014:H1 due mainly to protracted strikes and reduced electricity availability, as well as soft external demand (Figure 3).[6] Stagnant real disposable income and decelerating credit growth to

[3] President Jacob Zuma, State of the Nation Address, June 17, 2014.

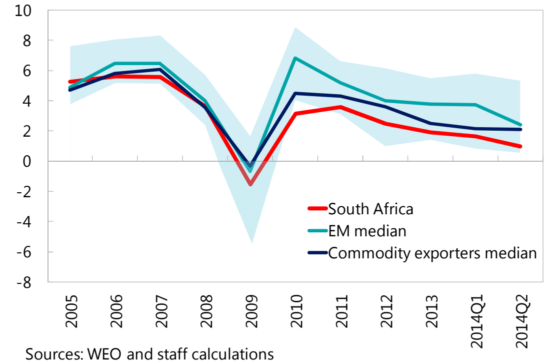
[4] Minister Nhlanhla Nene, 2014 Medium-Term Budget Policy Statement Speech, October 22, 2014.

[5] For the purpose of this report, EM comparators are Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, Thailand, Turkey, and Ukraine. Commodity exporter comparators are Australia, Brazil, Canada, Chile, Colombia, Peru, and Russia.

[6] GDP will be rebased according to the System of National Accounts 2008 in November 2014. This may affect South Africa's metrics, but is unlikely to affect the main trends and ratios significantly.

highly-indebted households weakened private consumption. A five month strike in the platinum industry—the longest since the return to democracy in 1994—was followed by a month long strike in the metal and engineering sectors. Investor confidence remains low and high-frequency indicators point to continued sluggish economic activity, though recovering from the strikes.

South Africa's Growth Has Underperformed Peers 1/
(real GDP growth, percent)



Sources: WEO and staff calculations
1/ The light blue area represents the three center quintiles for other EMs.

- While several EMs are facing growth challenges, since 2010 South Africa's growth is estimated about ⅔ of a percentage point lower per annum than expected given trading partners' growth.

- The unemployment rate remained at 25½ percent in 2014:Q3. The private sector has recovered less than 40 percent of the jobs lost in 2008–10, while most new jobs during this period have been created in the public sector.

7. Although difficult to pinpoint, the evidence points to lower potential growth.

- As in many EMs, several studies suggest that South Africa's potential growth has declined in the past few years. This is consistent with staff estimates which indicate that potential growth has fallen to 2–2½ percent—implying a negative output gap of about ½–1¼ percent in 2014—as what were initially perceived to be cyclical factors turn out to be increasingly structural.[7]

Estimates of South Africa's potential growth
(in percent)

Klein (IMF, 2011)	3.3 (1994-2010); 1.7 (2010)
SARB (2013)	3.9 (2000-07); 2.9 (2008-11)
SARB (2014) 1/	3.0 -3.5
Montalto (Nomura, 2014)	2 (2014); 3-3.5 (in the long run)
J.P. Morgan (2014)	3.0
Kemp (Bureau for Economic Research, 2014)	2.5
Tsounta (IMF, 2014)	2.8 - 3.2 (average 2013-2017)
Staff's latest estimates	
HP filter	2.1 (2014)
Production function approach	2.4 (2014)
Multivariate filter	2.0 (2014)

Sources: IMF, SARB, Bureau for Economic Research, J.P. Morgan, and Nomura.
1/ March, 2014, Monetary Policy Statement

- Declining productivity growth is the main driver behind lower potential growth, which might be related to increasingly-binding structural constraints. At the same time, the contribution of labor to potential growth has been limited and capital intensity has risen.

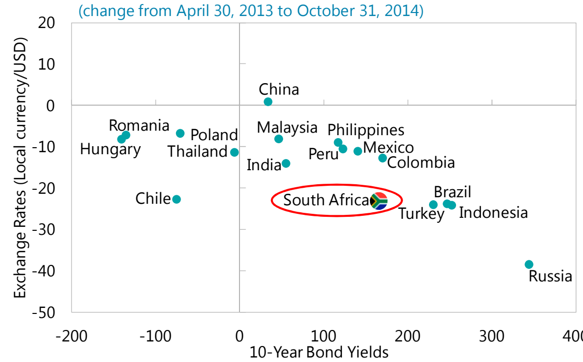
8. South Africa was among the EMs most affected by risk-off episodes that started with Fed tapering concerns. As in other EMs, portfolio inflows slowed from May 2013 and

[7] Wu, Y. (2014), "Estimating South Africa's Potential Growth", South Africa 2014 Article IV Selected Issues.

turned to outflows in the second and fourth quarter of 2013 and again in 2014:Q3, resulting in sharp sell-offs in the rand and fixed income markets (Figure 4). Large twin deficits, a sizable share of foreign holdings in rand government debt, and deep financial markets explain these outcomes, combined with accommodative monetary policy and absence of FX intervention. Equity inflows, mainly in companies with large operations abroad, fared better in 2014. Nevertheless, at end-October 2014, the rand-dollar exchange rate (the real effective exchange rate (REER) was 23 (11) percent below its end-2012 level, and local bond yields about 110 basis points (bps) higher, raising borrowing costs mainly for the government and state-owned enterprises (SOEs).

South Africa Among the EMs Most Affected by Market Volatility

(change from April 30, 2013 to October 31, 2014)



Source: Bloomberg, L.P.

9. Bank lending rates, which matter more for households and private corporates and are linked to the policy rate, have also risen. Besides the South African Reserve Bank's (SARB) 75 bps repo increase since January 2014, factors contributing to tighter domestic financial conditions include: Basel III's more stringent capital and liquidity requirements; the placement of African Bank (a small bank specialized in unsecured lending) under curatorship in August 2014, credit rating downgrades, and tighter lending standards as asset quality of unsecured lending is deteriorating.[8] The impact is falling mainly on households, especially in lower income segments, which are highly indebted and have benefitted less from housing and stock price rises.[9] Private firms are less affected, as retained earnings typically fund a large share of their investment.

10. External rebalancing has started, though limited considering the large depreciation.

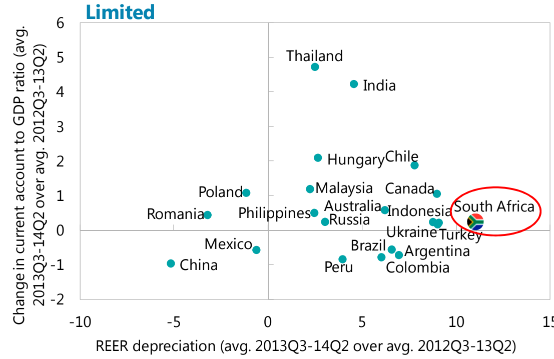
- The current account deficit reached 5.8 percent of GDP (5.6 percent cyclically adjusted) in 2013 and 5.4 percent of GDP in 2014:H1, reflecting strikes, persistent competitiveness problems, soft terms of trade, and weaker trading partners' demand (Figure 5).

[8] Moody's August 2014 downgrade of the four largest banks was mainly triggered by the appropriate decision to bail in senior unsecured bond holders and wholesale depositors of African Bank, lowering the likelihood of government support for other financial institutions rather than a reassessment of these banks' stand-alone credit rating. Other rating agencies did not downgrade South African banks at that juncture. S&P's June 2014 downgrade and Moody's November 2014 downgrade of the largest banks followed the sovereign downgrade.

[9] Mu, Y. and Y. Wu (2014), "The Impact of Tighter Financial Conditions on the South African Economy", South Africa 2014 Article IV Selected Issues.

- Although trade volumes have begun to adjust, South Africa's exports have remained subdued despite a substantial and prolonged depreciation. A staff study suggests that the exports of firms in sectors with higher electricity intensity, greater product market concentration, and more marked labor market rigidities have responded less to the depreciation.[10]

Slow External Rebalancing Has Started Albeit Limited

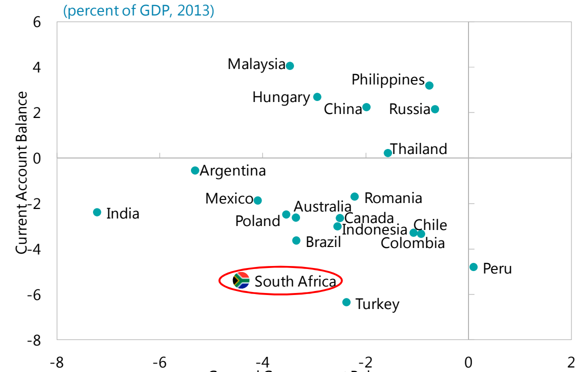


Sources: Haver, IFS

11. Despite sources of resilience, vulnerabilities remain elevated.

- **External.** The external position remains weaker than implied by desirable policies and fundamentals (Box 1 and Annex II). The current account deficit remains some 2½ percent of GDP wider than the estimated norm, implying a REER overvaluation of 5-20 percent. However, the exchange rate adjustment alone is unlikely to bring about the required external rebalancing. With structurally-low savings, largely due to high unemployment and easier access to credit, the current account deficit is likely to remain elevated, unless structural constraints ease or tighter financing conditions force a sharp import compression. Gross financing needs of 17 percent of GDP, low FDI, large unrecorded transactions (whose sustainability is uncertain), and low reserve coverage contribute to high external vulnerability, despite a modest international investment position (-6 percent of GDP in June 2014), a favorable currency composition of external debt, and capital controls on residents (Figure 6).[11]

Elevated Twin Deficits
(percent of GDP, 2013)



Source: WEO

- **Fiscal.** Despite fiscal efforts, rising government debt (46 percent of GDP in FY2013/14 from 27 in FY2007/08), above the EM median, contributed to an S&P downgrade to BBB- in June 2014 and to Moody's downgrade to Baa2 in November 2014, both with a stable outlook.[12] Significant SOE borrowing—especially by the electricity monopoly Eskom—means public sector debt is growing even faster. A large domestic institutional investor base mitigates refinancing risk for the government.

---

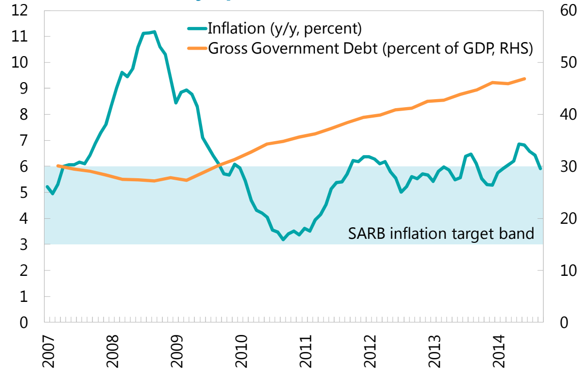
[10] Anand, R. and R. Perrelli (2014), "South Africa's Export Performance: Any Role for Structural Factors?", South Africa 2014 Article IV Selected Issues.

[11] In September 2014, the SARB started publishing quarterly international investment position data, in compliance with the IMF Special Data Dissemination Standard and the G-20 Data Gaps Initiative.

[12] Fitch revised the outlook to negative in June 2014, but kept its BBB rating.

- **Inflation** declined to 5.9 percent in September underpinned by lower fuel and food prices, after staying above the SARB's 3–6 percent band for six months.

Reduced Policy Space



Sources: StatsSA, Haver

- **Corporates and households.** Private corporates have relatively low leverage and high, but declining, profitability. Household balance sheets, especially those of lower-income households, are relatively weak. High unemployment, inequality, and labor tensions constitute additional vulnerabilities that are not easily captured in standards metrics.

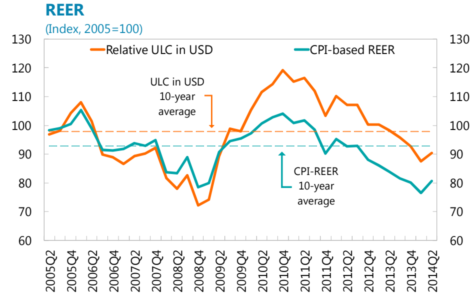
Box 1. External Sector Assessment

The IMF external balance assessment (EBA) estimates South Africa's current account (CA) norm at -2.4 percent of GDP and a CA gap of -3.2 percent of GDP for 2014. The external sustainability (ES) approach yields a CA gap of -2.6 percent of GDP. Due to wide confidence intervals and uncertainty related to the effect of depreciation in the pipeline, staff assess the CA balance to be 1½ to 3½ percent of GDP weaker than implied by medium-term fundamentals and desirable policy settings.

The EBA CPI-based REER regression estimates an undervaluation for 2014, but other competitiveness indicators, including the EBA CA and ES gap estimates, and South Africa's declining share of world's exports, continue pointing to overvaluation. Also, the unit labor cost (ULC)-based REER, which better captures competitiveness, remains closer to its 10-year average than the CPI-based REER. Based on the EBA CA gap and ES estimates, staff assess the REER as overvalued by 5-20 percent, although structural factors are hindering the CA adjustment to the depreciation.

ULC-based REER Has Depreciated Less than CPI-based REER

(Index, 2005=100)



Sources: SARB, Haver, IMF GEE, and staff calculations

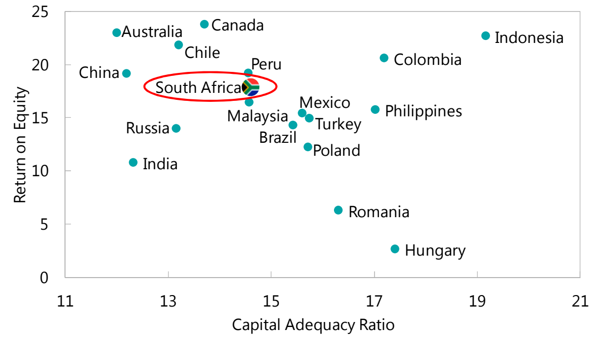
Non-FDI flows, particularly portfolio and other investment liabilities, have accounted for most of the financing of the CA deficit in recent years. A sharp slowdown of capital inflows would complicate the financing of the CA deficit, but these risks are attenuated by the floating exchange rate, the large share of long-term local currency bonds, and large assets under management of domestic institutional investors, subject to capital controls.

South Africa's exchange rate regime is one of the most flexible among EMs, and FX intervention is rare. Reserves cover 5 months of imports and close to 80 percent of gross external financing needs, but remain slightly below the lower bound of the IMF's reserve adequacy metric.

Gross external debt has increased to 41.8 percent of GDP in 2014:Q2 from about 25 percent of GDP in 2009, but short-term external debt (12.7 percent of GDP) remains manageable. The net IIP position (-6.1 percent of GDP in 2014:Q2) has improved with depreciation, due to 55 percent of external debt being in rand while most external assets are in foreign currency.

- **Financial.** The FSSA concluded that financial sector risks and vulnerabilities are elevated but manageable given a challenging operating environment (Annex III). Capital buffers are relatively high, and regulation and supervision are strong (Figure 7). The main risks are credit risk, which is rising, reliance on wholesale funding, high interconnectedness, and a large OTC derivatives market. The placement of African Bank under curatorship last August has had limited spillovers.

Banks Are Profitable and Have Relatively High Capital Buffers
(percent, latest)



Source: IMF Financial Soundness Indicators Database

A LACKLUSTER OUTLOOK WITH ELEVATED RISKS

12. Real GDP growth is projected to slow to 1.4 percent in 2014 and recover only modestly thereafter. The rebound to 2.1 percent in 2015 is predicated on improved labor relations allowing inventory rebuilding to offset the drag from financial and fiscal tightening.[13] A muted recovery is expected over the medium term, as slowly easing infrastructure constraints and the global recovery provide some support for private investment and exports. However, Eskom recently announced that electricity shortages will continue even after the two new power plants start operations owing to overdue maintenance on the old system. Hence, growth is projected to average 2¾ percent in 2016–19, with unemployment remaining close to 25 percent. The current account deficit is projected to fall modestly to 4½ percent of GDP by 2019 as major import-intensive infrastructure projects are completed. Inflation is projected to fall further in 2015 on account of easing oil and food prices, and tighter monetary and fiscal stances.

13. Risks are tilted to the downside. Further delays in relieving electricity constraints, more strikes, and lower-than-projected growth are deemed the key domestic risks, with adverse implications for the twin deficits (Box 2). External risks also weigh heavily, especially a sharp surge in global financial market volatility, whose impact on vulnerable EMs, including South Africa, could be particularly marked (Box 3).[14] Lower global growth and commodity prices could weaken South Africa's exports and growth, pressure the fiscal accounts, and result in retrenchments, though lower oil prices could be a partial offset. Also, the weak economy could undermine financial institutions' asset quality. High interconnectedness, concentration, and the size of the financial system could amplify these risks. Combinations of these risks could lead to capital

[13] A 125 bps increase in the SARB repo rate is assumed by end-2017: the magnitude is broadly in line with analysts' expectations, but the timing is postponed by one year.

[14] IMF (2014), "October 2014 World Economic Outlook".

outflows, especially if accompanied by a downgrade to sub-investment grade.[15] The growth and jobs outlook would brighten if substantial progress is made on structural reforms.

Box 2. Risk Assessment Matrix 1/

Nature/Source of Threat	Likelihood	Expected Impact on Economy	Policy Responses
Abrupt surges in global financial market volatility	***H***	***H***. Capital flow reversals could trigger a disorderly adjustment in the current account deficit, especially if accompanied by credit rating downgrades and spillovers to the financial system.	Provide FX liquidity if dollar shortages appear. Increase policy rate to ensure adequate fiscal and external financing. May also need to tighten fiscal policy further if financing becomes problematic.
Protracted period of slower global growth	***H***	***M***. Protracted period of lower growth and worse twin deficits, especially if accompanied by lower commodity prices.	Structural reforms needed to drive growth. Take additional fiscal measures to ensure debt stabilization over medium term.
Further delays in the completion of power plants	***M***	***H***. Lower investment, growth, and employment, with adverse implications for the twin deficits.	Explore options to ration electricity demand more efficiently, greater private participation.
Further labor market disruptions	***M***	***H***. Weaker growth, worse twin deficits, lower investor confidence, and layoffs.	Intensify dialogue with social partners.
Increased state intervention and reduced economic flexibility	***M***	***M***. Lower growth and employment, exacerbating vulnerabilities.	Try to broker a national grand bargain to jump start structural reforms.
Deterioration in banks' asset quality and liquidity shortfalls.	***M***	***M.*** Decreased lending to the private sector and increased spillovers in a highly interconnected system, with adverse implications for growth, the fiscal outlook, and financial stability.	Conduct asset quality reviews, and adjust provisioning accordingly. Encourage banks to rely on stable funding sources. The CLF will also help once it becomes operational in 2015.

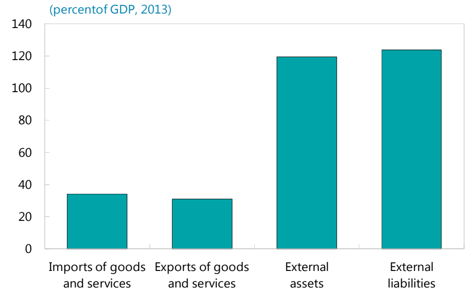
1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly.

[15] South Africa benefits from a high share of institutional investors, who typically provide more stable funding than retail investors but also tend to reduce exposure significantly with downgrades to sub-investment grade and take longer to return. For further details see IMF (2014), "April 2014 Global Financial Stability Report".

Box 3. Channels of Inward Spillovers

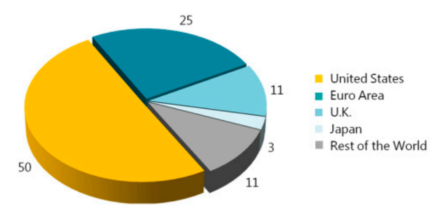
South Africa's liquid and open financial markets are a source of strength, but also expose it to volatile capital flows. Gross external assets and liabilities each exceed 100 percent of GDP, though the net international investment position is small. Nonresidents' holding of South Africa's securities have increased markedly in recent years, reaching US$200 billion at end-2013 (57 percent of GDP). A high share of equities in non-resident holdings (about 70 percent) and the long duration of South Africa's bonds entail that potential capital outflows would be markedly less. As U.S. investors account for half of all portfolio investment, South Africa's equity and bond markets are mainly linked to financial conditions in the U.S. In contrast, BIS foreign claims statistics suggest bank flows depend more on European banks, especially U.K. banks.

Financial and Trade Openness
(percentof GDP, 2013)



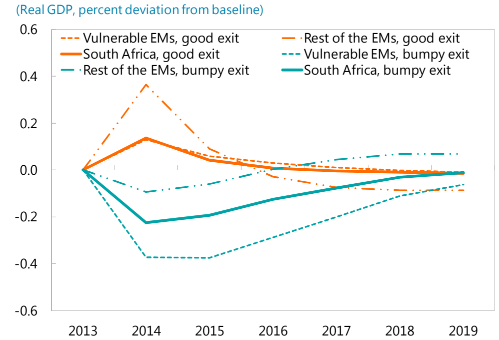
Sources: Haver and Coordinated Portfolio Investment Survey.

Source of Foreign Portfolio Investment
(percent of total foreign portfolio investment, 2013)



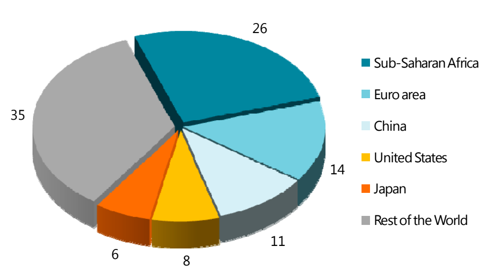
The impact of key advanced economies' monetary policy normalization on South Africa will likely depend on the nature of the exit from unconventional monetary policies. The 2014 IMF Spillover report finds that a Fed exit driven by a stronger-than-expected recovery would generally benefit emerging markets including South Africa, though South Africa's moderate trade linkages with the U.S. limits these benefits. But a bumpy exit due to unexpected monetary tightening would hurt EM growth, especially vulnerable ones: the impact on South Africa is in between the one on vulnerable EMs and the rest of the group.

Emerging Markets: Good and Bumpy U.S. and U.K. Monetary Exits
(Real GDP, percent deviation from baseline)

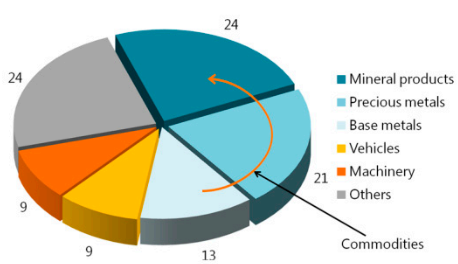


Inward spillovers could also occur through trade and commodity channels. China is the largest individual market for South Africa's exports. A one percentage point slowdown in China's growth is estimated to lower South Africa's growth by 0.6 percentage points cumulatively over two years.[1] This includes the impact through the prices of commodities, which account for over half of South Africa's goods exports. However, a lower oil price (accounting for 20 percent of goods imports) could be a partial offset. Sub-Saharan Africa now accounts for 26 percent of South Africa's exports, while the euro area's importance has declined in recent years.

Export Markets
(percent of total exports, average 2010-2013)



Export Products
(percent of total exports, average 2010-2013)



Sources: South African Revenue Service, Haver, and staff calculations

1/ IMF (2014), "April 2014 World Economic Outlook".

14. Rising trade and financial linkages may be increasing spillovers to, and spillbacks from, the rest of Sub-Saharan Africa (SSA), though these have been muted thus far.[16] SSA has become the most important destination for nonmineral exports and a major investment destination for South African corporates and banks, possibly resulting in increased regional spillovers going forward.[17] This offers promising opportunities for South Africa, but could also amplify the commodity price impact and expose the country to potential negative spillbacks from mispricing of risks and less developed regulatory structures.

Authorities' views

15. The authorities broadly agree on the near-term outlook and are more sanguine than staff about South Africa's medium-term growth prospects. While the differences for 2014 are small, they view staff's medium-term growth forecast as too cautious, pointing to continued strong public investment in infrastructure and easing supply constraints that should spur private investment and growth. The authorities also expect a stronger rebound in private consumption expenditure, anticipating higher employment growth, continued positive wealth effects, and reduced household debt levels. They emphasize that the MTSF will bolster confidence and reduce policy uncertainty.

16. The authorities concur with the key risks and vulnerabilities, but highlight South Africa's resilience. While acknowledging that domestic factors have played a key role in the recent growth slowdown, the authorities underscore that key trading partners' protracted slowdown and soft commodity prices have been a major drag. They consider further delays in easing electricity constraints as the main domestic risk. While acknowledging that structural factors have lowered potential growth, officials argue that some policies can reverse this trend quickly, such as opening up borders for skilled workers. They are concerned about the slow adjustment in the current account deficit, given that U.S. monetary policy normalization will likely make external financing more challenging. However, the flexible exchange rate, the relatively low and mainly rand-denominated external debt and the large domestic institutional investor base provide resilience.

[16] Basdevant, O., A. Jonelis, B. Mircheva, and S. Slavov (2014), "The Mystery of Missing Spillovers in Southern Africa: Some Facts and Possible Explanations," IMF Working Paper 14/03.

[17] See the IMF Pan-African Cross Border Project for further details of South Africa banks expansion into SSA.

POLICIES TO BOOST JOB-RICH GROWTH AND RESILIENCE

Minister Nene: "…the biggest constraints to a faster rate of growth are domestic factors, in other words things that are within our powers to fix"[18]

17. The authorities' macroeconomic policies and Fund views in previous Article IV consultations have been broadly aligned, but progress on structural reforms remains mixed. The authorities have adhered to stringent expenditure ceilings and committed themselves to debt stabilization, but have not adopted a debt anchor. The SARB has appropriately balanced elevated inflation and weak growth, but, with the rand under pressure, has not increased reserves. Structural reform progress includes ongoing public infrastructure projects, the Employment Tax Incentive, a renewed focus on SMEs, and the proposed social and economic impact assessments of legislative initiatives (Text Table 1). Also, South Africa recently concluded an Economic Partnership Agreement with the European Union, is negotiating the renewal of the Africa Growth and Opportunity Act, and pursuing greater integration with SSA. But some recent legislative initiatives (see paragraph 44) could adversely affect jobs and the business environment and could contribute to policy uncertainty.

18. Structural reforms are macro-critical and indispensable, as macroeconomic policies are constrained by increasingly-binding structural impediments, vulnerabilities, and prevailing downside risks. The 2014 Medium-Term Budget Policy Statement (MTBPS) marks a shift in fiscal policy to address vulnerabilities, encouraging a rebalancing of the economy from consumption to investment and exports, and ensuring sustainable long-term growth and support for critical social programs. The SARB highlights inflation risks from further depreciation, a higher exchange rate pass-through as margins have fallen, and a wage-price spiral. Structural rigidities hindering the current account adjustment to the depreciation force macroeconomic policies to play a greater role in reducing the current account deficit by lowering domestic absorption, as external financial conditions become less benign. Hence, addressing structural constraints is essential to generate more growth and jobs, as well as to improve the external position, facilitate the economy's rebalancing, and allow macroeconomic policies to be more counter-cyclical. A substantial increase in employment is the key component to achieve greater inclusiveness.

Authorities' views

19. The authorities agree that the space for further countercyclical policies is limited and structural reforms are necessary to raise growth and lower vulnerabilities. The 2014

[18] Minister Nhlanhla Nene, Budget Vote 10 Speech: National Treasury, July 21, 2014.

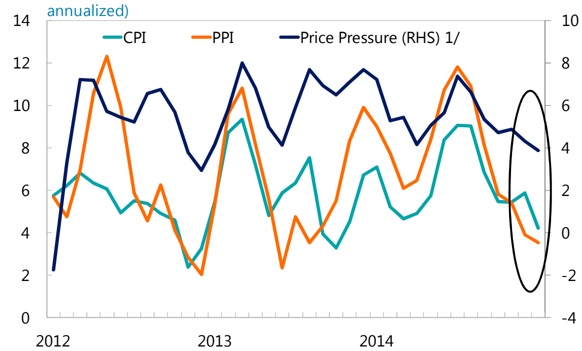
MTBPS notes that “debt levels have approached the limits of sustainability”. Similarly, the SARB highlights the challenge of subdued growth and relatively high inflation and the limited effectiveness of monetary policy in addressing the root causes of South Africa’s weak growth. The authorities also acknowledge that structural constraints are preventing the country from benefiting fully from the global recovery and the currency depreciation.

A. Monetary Policy

20. Inflation is likely to have peaked. Since 2011, headline and core inflation have been driven mainly by the large depreciation, even though the negative and rising output gap has moderated exchange rate pass-through (Figure 8). In 2014, food inflation has also contributed to the inflation increase. Inflation momentum is declining, which is likely to continue as evidenced in falling PPI inflation. Inflation expectations remain broadly stable.

Inflation Momentum is Declining

(seasonally adjusted, 3-month moving average percentage change, annualized)



1/ PMI input prices - PMI output prices

Sources: StatsSA, MarkIt, Haver, and staff calculations

21. Monetary policy is finely balanced.

- A simple Taylor rule using a 0.4 percent real neutral rate (the 2010–13 average), a 6 percent inflation target, the top of the SARB’s band, and staff’s inflation forecast argues against a rate increase. However, over the medium term the SARB is appropriately aiming for inflation below 6 percent and the neutral rate is highly uncertain but likely higher than in recent years, all pointing to the need for higher policy rates.[19] On balance, therefore, with the recent large drop in oil prices and the announced fiscal consolidation, the SARB may be able to afford to stay accommodative for longer, though an increase in rates will ultimately be needed.

- In case of materialization of risks to inflation or inflation expectations, or significantly tighter external funding conditions, policy rate hikes may become necessary sooner to bolster the SARB’s credibility and facilitate external funding.

- To help guide expectations, the SARB could consider enhancing its communications by publishing inflation projections conditional on explicit interest rate and exchange rate assumptions, as some other inflation targeting central banks do.

[19] Estimates of Taylor rules for South Africa reveal a very small weight on the exchange rate, suggesting only including inflation and the output gap is appropriate in normal times.

Authorities' views

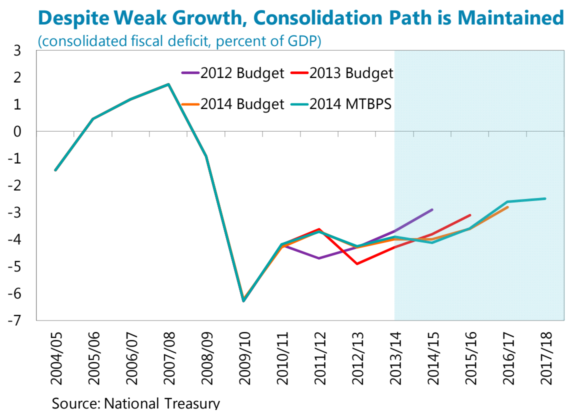
22. The Reserve Bank has announced it is on a gradual and data-dependent normalization process. SARB officials emphasize that the monetary stance remains accommodative. However, over the medium term, real interest rates will have to turn positive to avoid exacerbation of imbalances and possible asset bubbles, and to encourage savings. Inflation expectations remain anchored at the upper end of the target band and subject to the risk that continued depreciation could move them to a higher plateau. Staff expect that the SARB's Monetary Policy Committee will assess in its next meeting on November 20, inter alia, how the recent large drop in oil prices and the government's fiscal consolidation strategy expressed in the 2014 MTBPS may affect the stance of monetary policy going forward. Moreover, the SARB remains committed to transparent communication and outreach, but believes that releasing interest rate and exchange rate assumptions could lead to reduced operational flexibility, as markets could interpret these assumptions as targets.

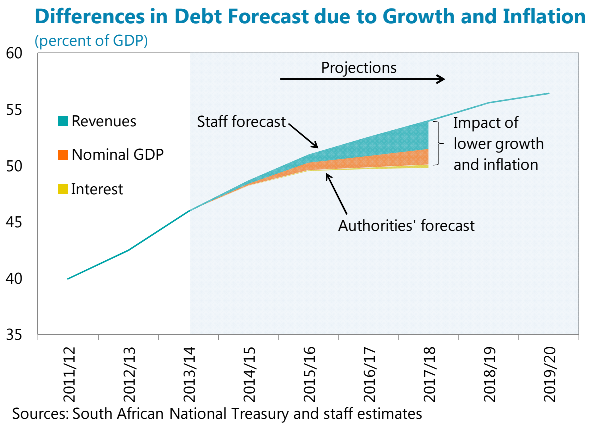
B. Fiscal Policy

23. Acknowledging that "fiscal consolidation can no longer be postponed", the authorities have announced a front-loaded package of measures to narrow the deficit and stabilize debt.[20] Despite weaker growth, the 2014 MTPBS maintains the 2014 Budget targets, reducing the deficit from 3.9 percent of GDP in FY2013/14 to 2.5 percent of GDP by FY2017/18, which in the authorities' framework results in debt stabilizing just below 50 percent of GDP. Expenditure ceilings over the next two years have been reduced by a cumulative 0.6 percent of GDP by freezing spending on nonessential goods and services, restraining the government wage bill, and reducing transfers to public entities, while aligning spending with the MTSF, protecting core social services, and enhancing efficiency. Revenue measures yielding a cumulative 0.6 percent of GDP over two years are to be announced in the 2015 Budget.

24. The fiscal consolidation announced in the 2014 MTBPS is significant, but may not be sufficient to stabilize debt over the medium term. Automatic stabilizers are expected to result in a deterioration of the primary balance to -1.1 percent of GDP in FY2014/15 from -0.8 percent in FY2013/14 (the cyclically-adjusted primary balance is estimated to remain unchanged). In FY2015/16, the fiscal adjustment is expected to result in a 0.5 percent of GDP improvement in the primary balance, which is projected to reach 0.2 percent of GDP by FY2017/18 (Figure 9). Also, rising borrowing costs are expected to keep the consolidated deficit close to 3 percent of GDP. Under staff's baseline scenario, debt is projected to rise to 56 percent of GDP by FY2019/20.

[20] Minister Nhlanhla Nene, MTBPS Speech, October 22, 2014.





25. Multiple risks affect the fiscal outlook.

- Wage demands in public sector wage negotiations have started at 15 percent, though the MTBPS has signaled that "any departure from the path of CPI-linked cost-of-living adjustments will require either a reallocation of resources from other spending areas…or prompt a need to reduce government employment" and initial demands are typically significantly higher than final settlements. The weak state of several SOEs' balance sheets could require further support from the sovereign, but the government has announced that future support will be deficit-neutral and contingent on sound restructuring plans with strong oversight. In addition, the planned national health insurance could add to spending pressures and the mooted nuclear power plants could entail a large public debt increase. Growth could continue to disappoint. Higher-than-projected interest rates and weaker terms of trade would also weigh on the fiscal accounts.

- In the Debt Sustainability Analysis (DSA), shocks to medium-term growth and contingent liabilities would raise debt to 66–72 percent of GDP by 2019, compared to the 70 percent of GDP threshold in the DSA and the 60 percent ceiling the 2013 Article IV considered appropriate for South Africa. Under the same shock scenarios, the financing need would exceed 15 percent of GDP, the DSA high-risk threshold.

26. Stabilizing debt below 50 percent of GDP as the 2014 MTBPS plans is appropriate, and consideration could be given to reducing debt to safer levels in the longer run.

- For example, staff simulations indicate that meeting the 2014 MTBPS debt projection (50 percent of GDP) by 2020 would require about 1½ percent of GDP in additional measures.[21] The resulting impact on growth would depend on the degree of frontloading and could be offset by an accommodative monetary policy stance, high credibility, and by implementing

[21] Saxegaard, M. and J. Torres (2014), "A Discussion of Fiscal Consolidation Options in South Africa", South Africa 2014 Article IV Selected Issues.

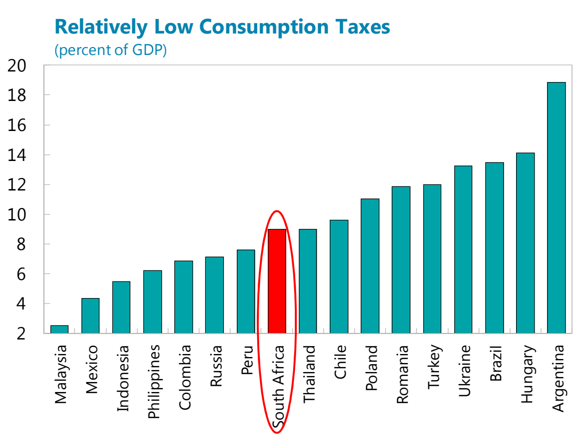
pro-growth structural reforms. Protecting the poorest from the consolidation would cost only a modest amount and could be done within existing well-targeted social grants.

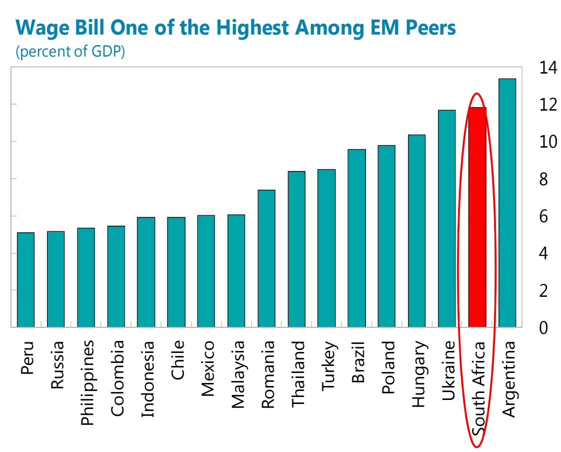
- Over the longer term, to ensure that debt remains below 60 percent of GDP, it would be advisable to maintain a tight fiscal stance to reduce debt to 40 percent of GDP and allow space for macro-fiscal shocks that could have a significant impact on South Africa.[22] Adopting a formal debt anchor could enhance the transparency of the fiscal framework and strengthen the perceived commitment to fiscal sustainability by enforcing corrections for past slippages.

27. The composition of the adjustment is a political choice, but cross-country analysis suggests the wage bill is relatively high and consumption taxes are relatively low.

- The increase in tax collection since 1994 is testament to the efforts of the South African Revenue Service, which have contributed to a robust tax system that compares favorably internationally. Tax revenue in percent of GDP is now close to the EM median. Revenue from consumption taxes, however, are relatively low, even though a World Bank study suggests South Africa's consumptions taxes are broadly neutral due to zero-rating of basic food items.[23] The Davis Tax Committee tasked with assessing the tax policy framework might identify other revenue sources.

- Primary expenditure as a share of GDP is close to the EM median, and the above-mentioned World Bank study finds that the progressivity of in-kind social spending is high compared to other countries. But, the government wage bill is one of the highest among peers. This is offset by the welcome absence of wasteful subsidies, a problem in many peer countries.





Source: WEO

---

[22] For further details, see Saxegaard M. (2014), "Safe Debt and Uncertainty in Emerging Markets: An Application to South Africa", forthcoming IMF Working Paper.

[23] World Bank (2014), "South Africa Economic Update (Sixth Edition)-Fiscal Policy and Redistribution in an Unequal Society".

28. As the 2014 MTBPS underscores, spending composition and quality is critical to ensure the fiscal strategy supports the objectives of growth, employment, and equity. South Africa's challenges stem partly from poor service delivery. For example, although South Africa's spending on education is high compared to other EMs, educational outcomes are poor (see Figure 2). The 2014 MTBPS recognizes that "our expenditure on public services achieves less than it should". To improve spending efficiency, the Chief Procurement Office is working toward centralizing procurement and the 2014 MTBPS states that "we will continue to fight waste and corruption, supported by our audit institution and stringent monitoring and reporting requirements". In addition, undertaking spending reviews, evaluating the impact of tax incentives in achieving growth and employment goals, and addressing the Auditor General's recommendations could help improve the impact of government programs, and minimize the adverse growth impact of the consolidation while bolstering public support for it.

Authorities' views

29. The authorities maintain that this year's budget deficit slippage is likely to be small, but acknowledge fiscal risks. Despite weaker-than-expected growth, the contingency reserve, underspending in some areas, and the depreciation will likely offset part of the revenue underperformance in the first half of the year. The authorities acknowledge that fiscal risks are significant, but argue that "the fiscal package will mitigate some of these risks, including helping to reduce the current account deficit" while acknowledging that a "deterioration in the economic outlook…would require consideration of additional measures".[24] Though fiscal policy continues to be guided by the principles of counter-cyclicality, debt sustainability, and intergenerational fairness, the focus will rotate from counter-cyclicality to sustainability.

30. The authorities remain firmly committed to fiscal sustainability and to taking the measures necessary to achieve this objective. The medium-term consolidation path outlined in the 2014 Budget remains an appropriate roadmap. Growth and inequality concerns will determine the pace and composition of the adjustment. Improving service delivery and spending efficiency will reduce the burden of adjustment and render it more socially acceptable. Further, stronger growth in the medium term will buoy tax revenue, allowing fiscal space to be rebuilt at the same time as spending can be expanded to achieve the goals of eliminating poverty and lowering inequality. Finally, while the government will support strategic SOEs, it will explore ways to divest nonstrategic assets and will encourage high standards of efficiency in public investment projects.

31. Treasury officials deem that expenditure ceilings and a deficit reduction path remain appropriate anchors of their fiscal framework. The government aims to stabilize public debt and begin to rebuild fiscal space. This will be achieved by remaining within the primary expenditure limits set in the medium-term framework and reducing the primary deficit.

[24] 2014 MTBPS.

The authorities do not consider that adopting a debt-to-GDP ceiling or benchmark would be an appropriate fiscal anchor, given the multitude of factors affecting debt, including the debt management strategy, and believe that it might undermine the credibility of their well-understood fiscal framework.

32. The authorities point out that several factors underpin South Africa's sustainable debt position. They emphasize that net debt at about 40 percent of GDP remains low. The maturity of the government debt portfolio is well structured, and debt denominated in foreign currency is only about 10 per cent of the total, which limits the consequences of rand depreciation. A smooth maturity profile, with the average term-to-maturity above 13 years, and a large domestic institutional investor base suggest that the impact of short-term swings in global capital markets could be well absorbed.

C. Policies to Strengthen Resilience

33. As the FSSA notes, the challenging operating environment for the financial sector puts a premium on tighter scrutiny of asset quality and ensuring adequate liquidity. The events surrounding African Bank provided a reminder that asset quality can deteriorate quickly in a weak economy and that even a small institution can entail systemic risk in a highly-interconnected system. The authorities' decisive action, led by the SARB, in the case of African Bank limited contagion and the proposed bail-in of senior unsecured creditors is a welcome step in reducing the too-big-to-fail premium for the large banks.

34. The ongoing twin peaks reform provides an opportunity to address priority areas to enhance financial sector resilience, including strengthening macro- and micro-prudential supervision and a more robust financial safety net.

- **Macro-prudential supervision.** The SARB should have the resources and authority to collect granular data and perform regular stress testing, especially of systemically important financial institutions. The tests should be conducted on a system-wide basis, including cross border operations, and be used to validate banks' own stress test results (Text Table 2).

- **Micro-prudential supervision.** The design and implementation of the proposed twin peaks reform should address overlaps, gaps, and inconsistencies in supervision, with clear demarcation of supervisory responsibilities and accountability. In particular, group-wide supervision and greater coordination between supervisory authorities are essential given high interconnectedness and a large financial system (300 percent of GDP).[25] Enhancing regulation of collective investment schemes, including introducing variable net asset values

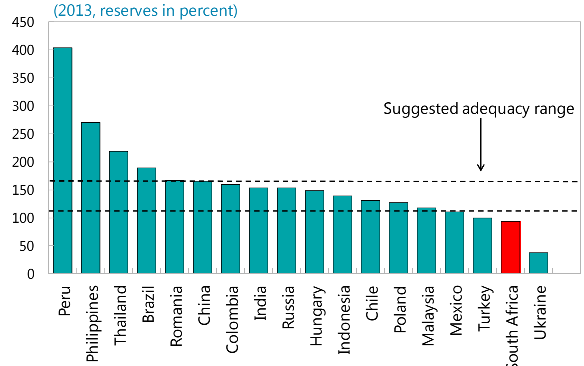
[25] Under the planned twin peaks reform, the SARB will be responsible for the prudential supervision of banks, insurers, financial conglomerates and financial market infrastructures through a Prudential Authority. The Financial Services Board will become the Market Conduct Authority and will be responsible for consumer protection through its market-conduct supervision.

for money market funds, should strengthen market discipline and lead to higher banks' retail deposits and less reliance on short-term wholesale funding.

- **Financial safety net.** Early intervention powers of the SARB and other prudential regulators should be enhanced. The intervention of African Bank demonstrates the need to introduce a resolution regime for banks and systemic nonbank financial institutions that is in line with the Financial Stability Board's Key Attributes of Effective Resolution. A deposit insurance scheme founded on depositor preference would also be an important plank in the crisis management framework, which can potentially encourage a shift from wholesale to retail funding**.**

35. The flexible exchange rate has helped manage volatile capital flows, but higher reserves could also help prepare against surges in market volatility. South Africa's reserves remain below the IMF's reserve adequacy metric and most EMs', many of which have recently increased reserves taking advantage of renewed capital inflows. The BRICS' Contingency Reserve Arrangement would enable South Africa to draw US$10 billion (US$3 billion without an IMF-supported program). As the expected tightening of financial conditions puts a premium on strengthening buffers, the authorities could also consider pre-announced small regular FX purchases that would not interfere with the floating exchange rate regime (as done by Israel, Mexico, and Turkey). In addition, during risk-on episodes and in the event of large transactions, the SARB could be more opportunistic in purchasing foreign exchange. Although FX purchases beyond needed base money creation would have to be sterilized, the carry costs can be viewed as insurance costs that lower the probability and impact of a negative external financing shock and the country's external funding costs.

South Africa's Reserves Remain Below the IMF's Reserve Adequacy Metric
(2013, reserves in percent)

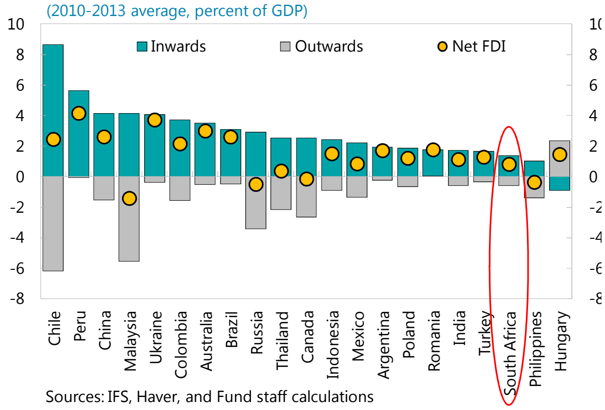


Sources: IFS, WEO, and IMF staff estimates

36. Improving the business environment and allowing greater private participation in infrastructure projects could attract more FDI. Despite no capital controls on non-residents and recent changes to facilitate leveraging the country's position as gateway to Africa, South Africa's inward FDI remains low relative to other EMs. At the same time, greater outward FDI, which over time will generate higher dividends, has contributed to higher reliance on portfolio inflows to finance the current account deficit. Hence, attracting more FDI is likely to require improving the business environment and greater consistency of policies and legislative initiatives given South Africa's recent sliding in some investor perception surveys, such as the World

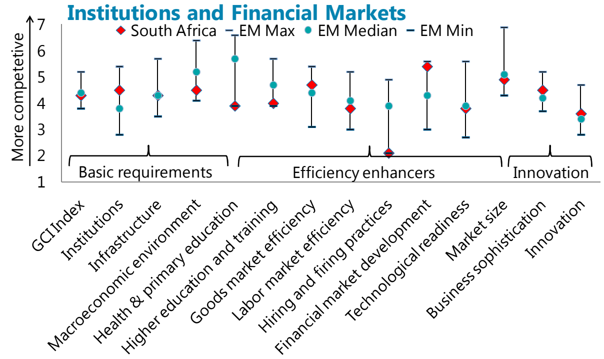
Economic Forum.[26] Further, allowing greater private sector participation in the large infrastructure projects holds the promise of raising more stable funding sources. The authorities could also explore more official financing. Finally, building on last year's improvements of trade data, enhancing balance of payments statistics by lowering unrecorded transactions might uncover a more favorable picture of the funding mix.

South Africa's FDI is Relatively Low
(2010-2013 average, percent of GDP)



Sources: IFS, Haver, and Fund staff calculations

Challenging Education and Labor, but Strong Institutions and Financial Markets



Sources: WEF Global Competitiveness Index (2014/15), OECD, and staff calculations.

Authorities' views

37. The authorities concur with the FSSA assessment on financial stability. They agree that a weak economy and external vulnerabilities will continue to weigh on the financial sector, but underscore that the financial sector is sound. The intervention in relation to African Bank, which had a unique business model, is not symptomatic of wider problems in the system. The banking system remains robust, based on good levels of capitalization, liquidity, and profitability. The authorities also emphasize mitigating factors with regard to banks' dependence on short-term wholesale funding, noting that wholesale deposits have historically been stable aided by prudential limits on domestic investors' foreign exposure. To further improve systemic surveillance, the authorities will conduct top-down macroprudential stress tests to complement the existing bottom-up exercises conducted by banks and insurance firms and devote more resources to validate bottom-up stress test results.

38. The authorities broadly concur with the FSSA recommendations to strengthen financial resilience. They find the BCP, IAIS and IOSCO assessments comprehensive and balanced, and consider them useful tools for enhancing the regulatory and supervisory framework. The authorities have already taken a number of recommendations into consideration in drafting legislation for the proposed twin peaks regulatory structure. In particular, they welcome the recommendation to break down silos and strengthen regulatory coordination,

---

[26] South Africa's position in the 2014 WEF Global Competitiveness Report fell to 53rd place from its best placement of 40 in 2005. Similarly, South Africa slipped to 43rd position in 2014 from 28th position in 2005 in the World Bank Doing Business Indicators.

proposing to include the National Credit Regulator in the membership of the new Financial Stability Oversight Committee. They also recognize the need to enhance group-wide supervision in view of the high interconnectedness, and for stronger regulation of collective investment schemes, including money market funds. The authorities have some questions on how best to implement deposit insurance, but view the recommendation in line with the Financial Stability Board's Key Attributes.

39. The authorities reiterate the importance of exchange rate flexibility. A large depreciation compared to other EMs has demonstrated their commitment to a free floating currency regime, which continues to be the key adjustment mechanism to external shocks. Exposure to exchange rate risk in banks', corporations', and households' balance sheets is limited, and SOEs are required to hedge fully their exchange and interest rate risks. The authorities concur with the assessment that South Africa's external position remains weak, as the current account deficit is above normal levels, especially considering the weak growth. Nevertheless, they note that part of the current account deficit reflects income payments related to non-resident purchases of rand assets, which are not caused by any particular policy setting or action.

40. The authorities agree with the desirability of higher reserves and are mulling options to achieve this goal. The trend in portfolio flows this year has not provided opportunities to accumulate reserves, but the SARB remains open to opportunistic purchases. The Treasury, which has borne most of the cost of higher reserves in the recent past, is unable to commit resources at this stage given the fiscal situation. Also, the SARB remains concerned about sterilization costs increasing its losses and about investors' possibly interpreting FX intervention in the manner suggested by staff as a change in exchange rate policy that could undermine capital inflows at a delicate juncture.

D. Structural Reforms to Generate Job-Rich Growth

41. Easing infrastructure bottlenecks, reducing skill mismatches, reforming product and labor markets, and liberalizing trade are priorities.[27] As envisaged in the NDP, efforts to

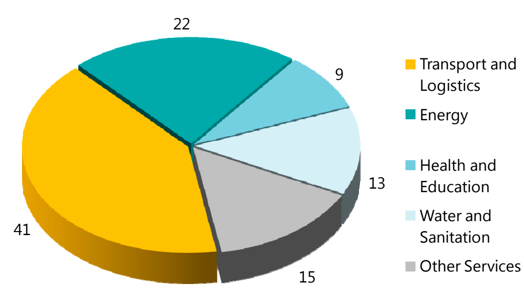
[27] "Achieving Higher Growth and Employment: Policy Options for South Africa" by Faulkner, D. et al. (2013) estimates that reducing infrastructure gaps, easing the skill constraint, and increasing investment could raise potential growth to nearly 8 per cent and decrease unemployment to around 12 percent by 2025. Similarly, "Trade Policy in South Africa" by Edwards, S. et al. (2009) suggests that trade liberalization in South Africa has a considerable impact on productivity and trade performance. "An Analysis of Industry Concentration in South Africa Manufacturing, 1972-2001" by Fedderke, J. and D. Naumann (2005) finds that increased concentration in manufacturing in South Africa is detrimental to output growth and investment, while "Competition and Productivity Growth in South Africa" by Aghion, P. et al. (2007) finds a strong negative effect of the price-cost margin (an inverse measure of product market competition) on productivity growth. Finally, "High Unemployment Yet Few Small Firms: The Role of Centralized Bargaining in South Africa" by Magruder, J. R. (2012) finds that sectoral wage agreements decrease employment in affected industries by 8–13 percent, with losses concentrated among small firms. This is qualitatively consistent with findings of "Unemployment and the Automatic Extension of Collective Wage Agreements" by de Serres, A. and F. Murtin (2013) on the impact of administrative extension in OECD economies.

close infrastructure gaps, improve education and training, and strengthen public service delivery and accountability are essential to lift obstacles to private sector job creation and investment, diversify the economy, and raise productivity and competitiveness. Several studies suggest that the payoff of these measures could be substantial. In addition, other studies indicate that increasing product market competition would boost productivity growth and output, and that reforming the current system of sectoral bargaining agreements would have a positive impact on employment, particularly for smaller firms. Consensus is even stronger that a high degree of trust between firms and workers leads to lower unemployment, which points to the urgency of improving industrial relations in South Africa.[28] President Zuma noted, "Given the impact of the untenable labor relations environment on the economy, it is critical for social partners to meet and deliberate on the violent nature and duration of the strikes."[29] Finally, trade liberalization also appears to have a considerable impact on productivity and exports. Mexico provides a current example of a country that has embarked on a comprehensive and ambitious structural reform program in areas where action is needed in South Africa. Moreover, while structural reforms take time, recent experience of countries including India, Mexico, and the Philippines suggest that already the credible announcement of a reform package coupled with some quick wins can have a significant positive impact.[30]

Infrastructure

42. Large infrastructure projects are advancing, though they will take time to bear fruit. The 2014 Budget envisages some US$80 billion in infrastructure investments over three years, with SOEs expected to account for about half. Among key projects, Eskom's two coal-fired power stations, Medupi and Kusile, and Ingula, a pumped storage scheme, are advancing albeit with delays. These should start increasing generation capacity in 2015, though Eskom expects that energy availability will improve meaningfully only in about three years owing to overdue maintenance and grid upgrading. Transnet, a large SOE responsible for rail, ports, pipelines and other freight logistics, is in the early phases of its US$29 billion investment, aimed at augmenting and developing coal, iron and manganese rail lines, upgrading passenger rail lines, and improving port container handling capacity.

Large Public Infrastructure Program
(percent of total proposed expenditure)



Source: South Africa National Treasury.

[28] Blanchard, O., F. Jaumotte, and P. Loungani (2013), "Labor Market Policies and IMF Advice in Advanced Economies During the Great Recession," IMF SDN/13/02.

[29] President Jacob Zuma, State of the Nation Address, June 17, 2014.

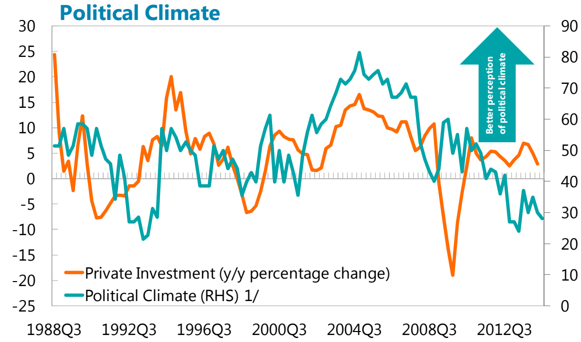
[30] See De Bandt, O. and O. Vigna (2008), "The Macroeconomic Impact of Structural Reforms," Quarterly Selection of Articles - Bulletin de la Banque de France, Issue 11.

43. The authorities' package for Eskom is a multipronged strategy aimed at ensuring energy security. It includes a 0.6 percent of GDP equity injection from leveraging nonstrategic government assets, higher debt, and greater efficiency in Eskom's operations to limit cost overruns, optimize maintenance, and improve procurement. In the short run, a peak-load pricing approach to demand management, while continuing to protect the poorest households, could contribute to minimizing the impact of electricity shortages on growth. Over the medium run, as the government has stated, "tariff adjustments remain the key mechanism that will provide the electricity supply industry with a sustainable solution" complemented by efficiency-enhancing measures.[31] Higher electricity tariffs need not increase overall inflation if accompanied by product market reforms that can lower other costs. A forthcoming IMF study of the Fiscal Affairs Department on public investment suggests that South Africa has room to improve its ability to deliver on investment projects. With state owned enterprises' balance sheets stretched and constrained fiscal space, allowing greater private participation in infrastructure with appropriate safeguards is a necessity.

Product and Labor Markets and International Trade

44. Some recent measures and proposals may help protect vulnerable workers and improve labor relations, but others are likely to hinder job creation and business expansion. The Employment Tax Incentive is likely to generate jobs by reducing the cost of employing young, inexperienced workers, and by improving their future employability (see Text Table 1). The government is exploring options to reduce the incidence of prolonged strikes, such as a secret strike ballot and compulsory arbitration. Some of the recent legislation aims at creating decent work and protecting vulnerable workers, but restrictions on temporary employment, responsible for the majority of private jobs created since 2008, could cost jobs. Similarly, the proposal to introduce a national minimum wage to lessen income inequality should be carefully studied, as the average sectoral minimum wage in South Africa is 62 percent of the average formal wage, compared to the 37 percent OECD average, and without lower sub-minima for younger workers as in many OECD countries.[32] Hence, depending on its level and formulation, a national minimum wage may increase unemployment, especially for lower-skilled workers. In addition, new visa restrictions for certain

Investment is Correlated with Perceptions of Political Climate



Sources: SARB, BER
1/ 100 minus the percentage of respondents in the manufacturing sector that rate the general political climate as a constraint on their business.

[31] National Treasury, Media Statement, September 14, 2014.

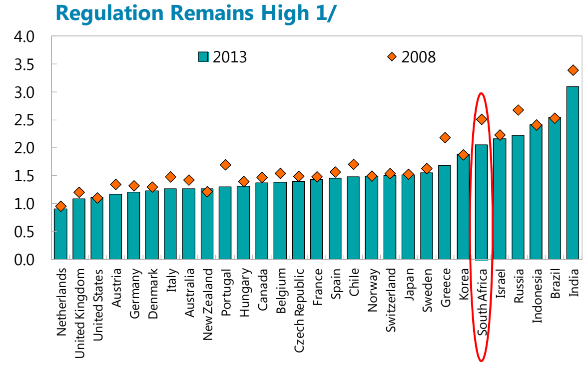
[32] See National Treasury (2011), "Confronting Youth Unemployment: Policy Options for South Africa", Discussion Paper.

skilled workers could hamper business expansion and job creation.[33] Finally, the co-existence of different development plans and policy initiatives perceived to be going in different directions contribute to investors' concerns regarding policy uncertainty.

45. Product and labor market reforms remain critical to achieve the ultimate objective of more jobs and a more inclusive economy. Increased product market competition will help reduce the wage-productivity gap by lowering the cost of living and enhancing productivity. Simultaneous labor market reforms—increasing the influence of outsiders in wage setting, exempting SMEs from the extension of collective bargaining outcomes, and reducing firing costs, as recommended by the OECD—will limit job losses from lower profit margins and facilitate new firms' entry. These reforms could be pursued as part of a social bargain including wage restraint in return for industry's hiring commitments, and government's providing better quality education and training, and targeted transport subsidies.[34] The role of the government is critical in ensuring that the interests of outsiders, the unemployed and small firms, are represented in the bargain. All these efforts should provide job opportunities, jumpstarting a virtuous cycle of growth, more jobs, and lower inequality.

46. Product market reforms in sectors with extensive linkages to the rest of the economy—such as ICT, transport, and finance—could have large multiplier effects. Reduced communication charges due to increased competition and lower bank fees are welcome. In ICT, there is also a need to allocate spectrum competitively and ensure access to low-cost, high speed international bandwidth. In transport, South Africa has high freight prices, e.g., port tariffs on containers for which Transnet is a monopoly provider, and transport costs for workers are high. Lowering costs of transport and telecommunications would lower the costs of doing business and improve competitiveness. Fostering more competition among financial institutions would result in a greater supply of financial services at lower costs, especially for SMEs and lower income households. To this end, the FSSA recommends reducing the entry capital requirements to encourage the establishment of smaller banks, adopting a rules-based exit framework, closing regulatory and supervisory gaps that favor incumbents, and improving access to financial information and literacy that can help users compare prices and terms. While a careful balance is needed between financial stability and

Despite Improvement, Product Market Regulation Remains High 1/



1/ OECD Product Market Regulation, higher number means more restrictive

[33] Behar, A. (2005), "Does Training Benefit Those Who Do Not Get Any? Elasticities of Complements and Factor Price in South Africa" shows that a rise in the supply of skilled workers leads to higher demand for unskilled labor.

[34] See Ngarachu, M., A. Schimmelpfennig, and V. Schoer (2014), "The Long and Costly Road to Work: Transport Costs and Reservation Wages in South Africa", forthcoming IMF Working Paper.

the objective of a less concentrated financial system, there is room to accommodate more competition in the current environment of strong prudential regulation and supervision.

47. The government focus on promoting SMEs and greater trade, especially with Africa, is welcome, though additional reforms are needed. SMEs have high potential for job creation and benefit from SSA growth. To complement the authorities' initiatives to promote SMEs, the product and labor market reforms described above are vital, combined with lower regulatory compliance costs and a financial structure that can provide adequate financing (see above). The National Employers Association of South Africa's, representing about 3000 SMEs in the metal sector, refusal to accept the outcome of sector wage bargaining last July citing it being unaffordable to its members is a reminder that existing labor arrangements hurt SMEs more. Building on initiatives to facilitate trade and recent trade agreements and better infrastructure, reaping the full benefits of increased trade integration will also require reducing behind-the-border costs, streamlining the number of tariff bands, and lowering tariff and nontariff barriers.

Authorities' views

48. The authorities emphasize that they have a hierarchy of plans to achieve the vision enshrined in the NDP, implemented through the MTSF. The NDP, which has primacy over other plans, aims to eliminate poverty and inequality by 2030. In President Zuma's words: "It is our roadmap for the next 20 years. All the work we do in government is now part of the comprehensive National Development Plan, including all operational plans, be they social, economic or political."[35] The MTSF implements the NDP and provides indications of key interventions that will be undertaken in the next five years, prioritizes policy actions, and strengthens accountability. It focuses primarily on investing in infrastructure and boosting trade and competition. Within the NDP vision, key policy instruments—the New Growth Path, which focuses on creating decent jobs; the National Infrastructure Plan, which guides the roll-out of infrastructure; and the Industrial Policy Action Plan, which focuses on promoting investment and competitiveness in selected sectors—will continue to drive the government's policy agenda. In addition, the proposed socio-economic assessment of legislative initiatives will also enhance policy consistency toward achieving the NDP objectives.

49. The government is redoubling efforts to accelerate infrastructure projects and is also exploring ways to increase private participation. Besides the R847bn infrastructure projects planned for FY2013/14–2015/16, the authorities are committed to further invest in electricity and explore alternative sources of energy, including nuclear, through Eskom, but possibly also other entities. They are working on improving port capacity and upgrading and

[35] The Presidency: Department of Planning, Monitoring and Evaluation (2014), "Medium-Term Strategic Framework 2014-19".

expanding integrated public transport. Transnet's locomotive and wagon fleets upgrade and expansion programs are progressing as planned. The Infrastructure Development Act, which came into effect on July 1, 2014, will fast-track the implementation of the National Infrastructure Plan by establishing into law the Presidential Infrastructure Coordinating Commission, which coordinates catalytic projects that can accelerate development and growth through the 18 Strategic Infrastructure Projects. The renewable energy independent power producer program has been a success, considering the take-up and lower costs in successive rounds. This can be expanded and diversified into gas, hydroelectric, coal and cross-border projects. To this end, the government has constituted an infrastructure task team to identify constraints to private sector participation in infrastructure.

50. The authorities are well-aware of other structural challenges and have started addressing them. The introduction of the Employment Tax Incentive scheme will improve the employability of youth. Ongoing skills development programs, employment services, and recent legislations regulating nonstandard employment, enhancing enforcement and compliance, expediting dispute resolution, and protecting vulnerable workers will create decent jobs. In May 2014, a new ministry dedicated to small business development was created to coordinate government interventions to boost the SME sector. The Competition Commission has initiated formal market inquiries to assess competition distortions, and a number of investigations into the pricing of intermediate inputs are underway. Various interventions addressing competition problems in telecommunications have resulted in a substantial reduction in retail prices. The recently concluded EPA with the EU would boost South African exports, and the development of special economic zones will help increase the value-added of exports.

51. Concerning recommendations related to competition, the authorities point to recent progress. For example, in the banking system, they argue that the top banks already compete to a great extent and while a more competitive system is welcome, this is not possible to achieve in the short to medium term, and may increase financial stability risks. Hence, they are reluctant to reduce entry capital requirements, but are more open to supporting measures to continue to lower bank charges and allow greater scope for alternative platforms, such as mobile banking and community-based banks, to broaden financial access.

STAFF APPRAISAL

52. South Africa has made impressive strides in its first two democratic decades, but faces difficult challenges. Living standards have improved considerably. However, insider-outsider dynamics in product and labour markets, skill mismatches, and apartheid legacies have kept unemployment unacceptably-high and the gains unequally shared. Besides a weak external backdrop, domestic factors, including electricity shortages and tense industrial relations, are increasingly holding back growth and job creation. The outlook remains lacklustre. Downside risks prevail.

53. Structural reforms are imperative to ensure better growth and job prospects for all citizens and reverse the inexorable rise in vulnerabilities. With past growth drivers having run their course and constrained policy space, resolute and consistent action to lift structural impediments is the only option for sustainable and inclusive growth that slashes unemployment, poverty, and inequality. Structural reforms are also macro-critical and necessary to lower vulnerabilities, increase the scope for countercyclical macro policies, and raise the economy's ability to rebalance toward exports and investment.

54. The government's focus on infrastructure is welcome, but needs to be accompanied by a normalization of industrial relations and product and labor market reforms. Improving critical infrastructure, especially electricity availability, is vital. With public balance sheets stretched, greater private participation in infrastructure would help. Normalizing industrial relations should be accorded high priority. The government's enhanced focus on implementation of the NDP is welcome and should be complemented by concomitant reforms to raise product market competition and labor market inclusiveness in the context of a social bargain.

55. The recently-announced 2014 MTBPS appropriately prioritizes the sustainability of public finances, long-term growth, and core social services. The mix of revenue and expenditure measures is well-balanced. Containing the wage bill is essential to achieve the planned consolidation and so is an increase in taxes. Further adjustment may be necessary to ensure public debt stabilizes and is reduced to safer levels. Greater spending efficiency would improve public service delivery and the public sector contribution to sustainable growth. Plans to strengthen SOEs' efficiency and oversight are welcome.

56. Monetary policy can remain accommodative for longer. The SARB has aptly balanced elevated inflation and the weak economy. The recent decline in oil prices and the planned fiscal consolidation may have given the SARB room to delay interest rate increases, which remain needed over the medium term. In contrast, the re-emergence of inflation risks may require higher interest rates sooner. Strong communication continues to be important to guide inflation expectations.

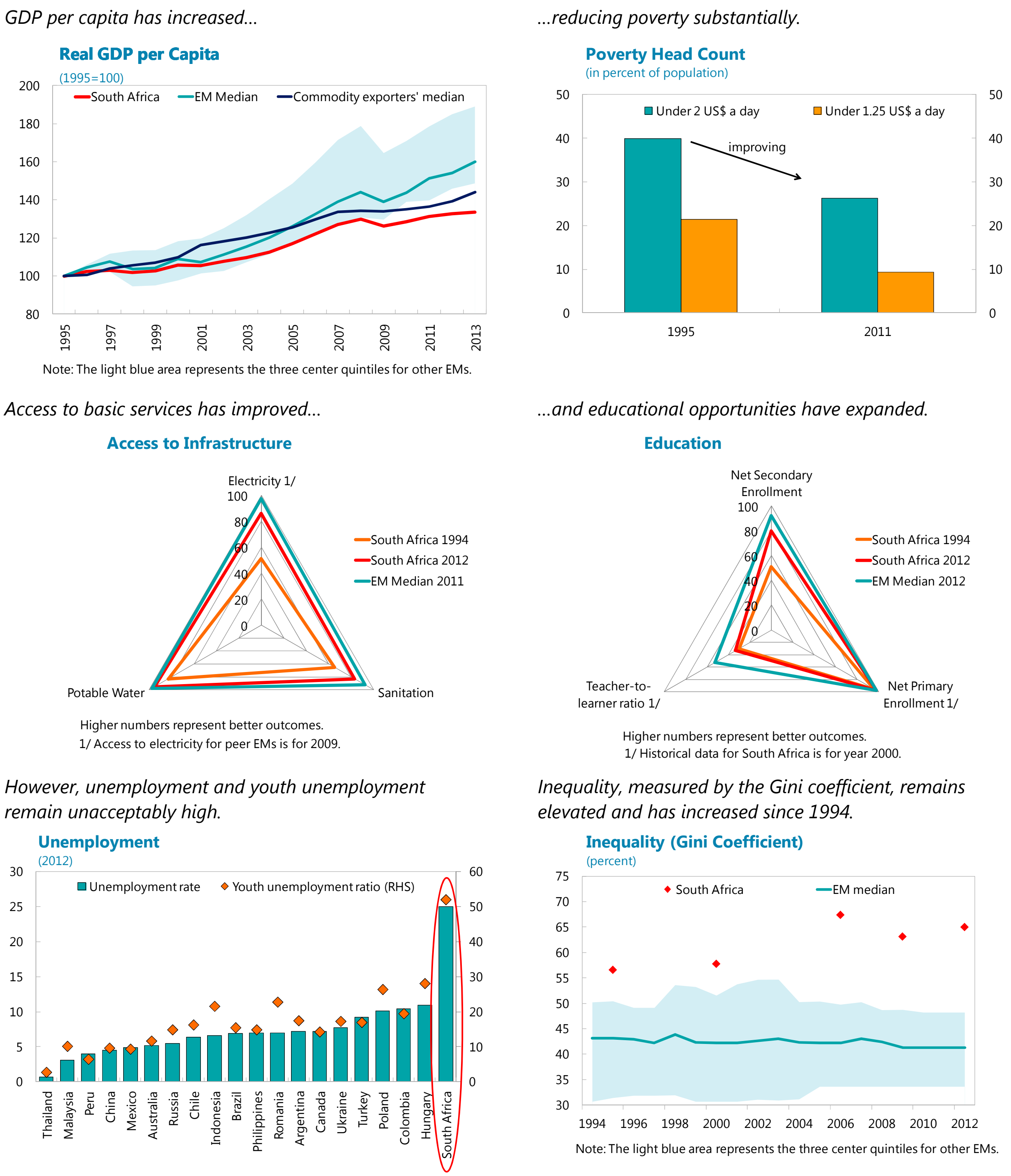
57. Given the challenging operating environment, the FSSA recommends heightened scrutiny of credit and liquidity risks. Overall, financial sector risks and vulnerabilities are elevated but manageable. Given the system's large size and high interconnectedness, prolonged weak growth and tightening financial conditions require intensified scrutiny of asset quality and potential liquidity pressures. To this end, regular stress testing on a system-wide basis is important to strengthen macroprudential supervision.

58. The FSSA advises that the authorities' reforms of the financial architecture should include closing supervisory and regulatory gaps and strengthening the financial safety net. Group-wide supervision, clear demarcation of accountability, and greater coordination among supervisory authorities are needed. Introducing deposit insurance and enhancing regulation of collective investment schemes could reduce liquidity risks and boost market discipline. The crisis and resolution framework should be upgraded to give the SARB early intervention powers. And a more competitive financial system could improve financial access and lower intermediation costs.

59. South Africa's flexible exchange rate regime remains a source of strength and higher reserves and policies to achieve a more stable external financing mix would boost resilience. The floating exchange rate regime and external debt largely in local currency have helped manage external vulnerabilities against volatile capital flows. Higher reserves would enhance South Africa's preparedness for less benign global financial conditions. In addition, improving the business environment, greater regulatory clarity, and increased private participation in infrastructure projects could attract more FDI and reduce reliance on volatile portfolio flows.

60. It is proposed that South Africa remain on the standard 12-month Article IV cycle.

Figure 1. South Africa: Significant Progress in The First 20 Years of Democracy

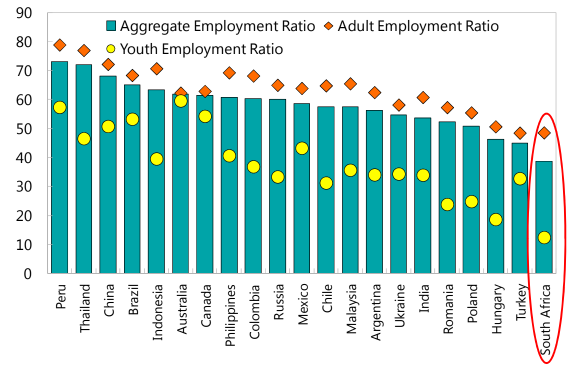


Sources: Presidency of the Republic of South Africa: 20 Year Review, World Development Indicators, and WEO.

Figure 2. South Africa: Structural Constraints are Holding Back Growth and Job Creation

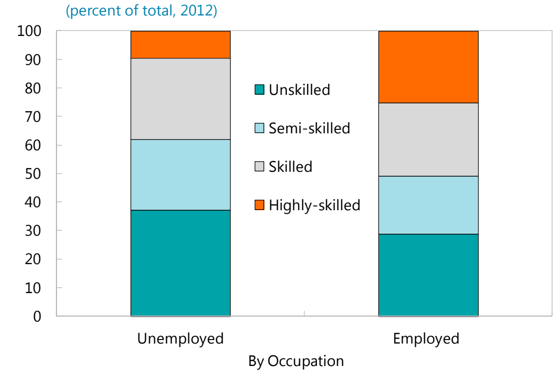
Employment, particularly youth employment, remains low mainly due to…

Employment Ratios
(percent)



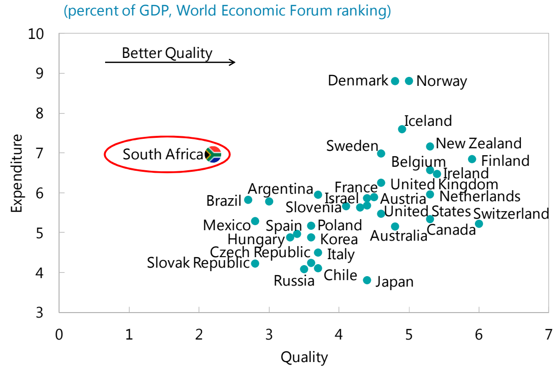
…high skill mismatches,…

Skill Composition of the Labor Force
(percent of total, 2012)



…poor educational outcomes, and apartheid legacies.

Education Expenditure vs. Quality
(percent of GDP, World Economic Forum ranking)



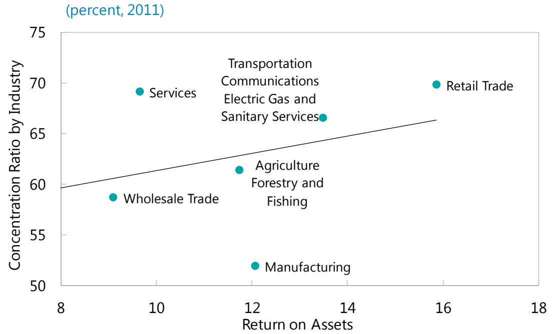
Rigid labor markets…

Labor Market Characteristics

Note: higher numbers indicate greater flexibility.

…and high costs in the economy, driven by high concentration and high margins,…

Industry Concentration and Profitability
(percent, 2011)



Note: Industry concentration is the total asset of top five listed companies as a share of all listed companies in the same sector.

…have widened the wage productivity gap.

Unemployment Rates and Rankings for How Well Pay Reflects Productivity

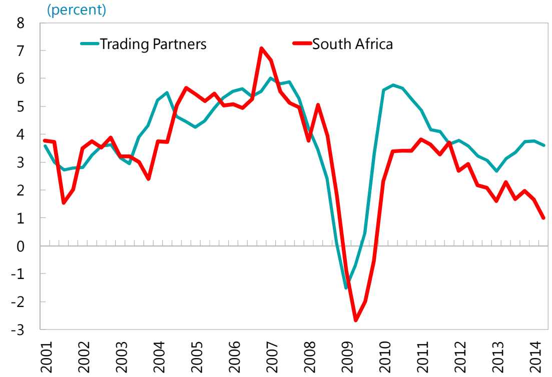
Sources: StatsSA, ILO, OECD, WEF 2014/15, South Africa Budget 2013/14, Corporate Vulnerability Utility, WEO, and staff calculations.

Figure 3. South Africa: Activity is Recovering After The Strikes, But Remains Sluggish

South Africa's growth remained below trading partners' in 2013 and slowed further in 2014H1…

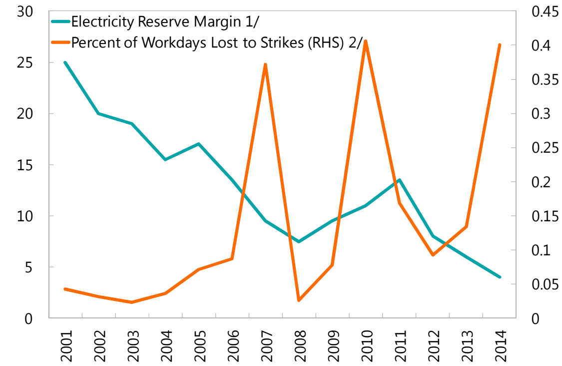
Real GDP Growth

(percent)



…driven by rising days lost to strikes and electricity constraints.

Structural Constraints

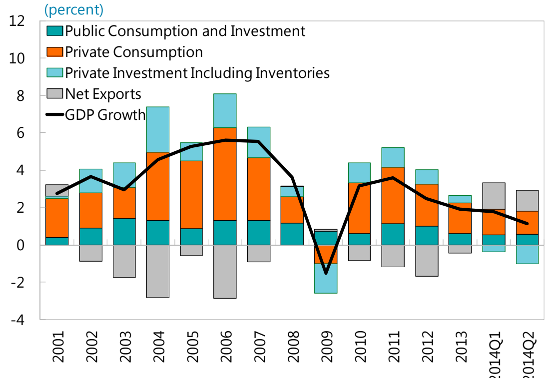


1/ 2014 data is through June. 2/ 2014 data is through September.

The slowdown is broad-based, but driven more by weak private domestic demand.

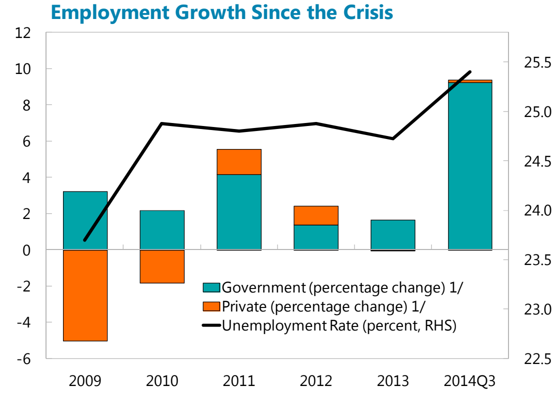
Contributions to Growth

(percent)



Job creation has been anemic, driven by the government. The unemployment rate has risen to 25½ percent.

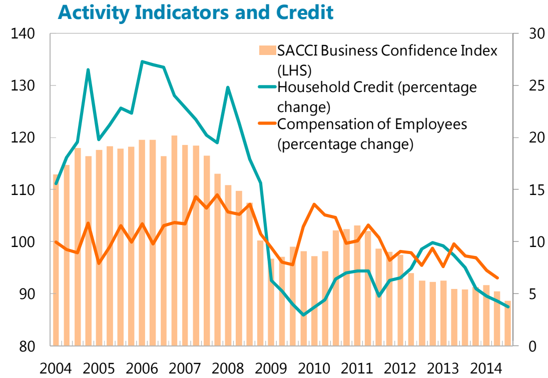
Employment Growth Since the Crisis



1/ Government and private employment data is through 2014Q2.

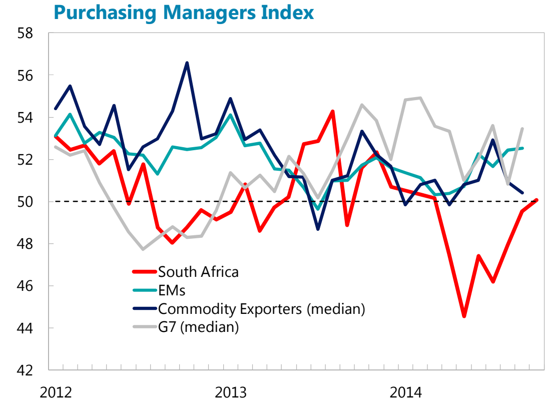
Business confidence remains subdued, and credit to households and disposable income growth decelerated.

Activity Indicators and Credit



Forward-looking indicators point to sluggish activity, despite some rebound following the end of the strikes.

Purchasing Managers Index

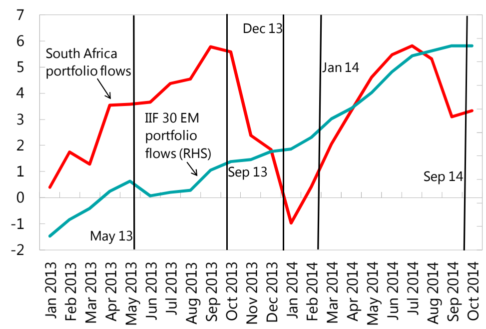


Sources: SARB, StatsSA, Eskom, Andrew Levy Employment, Haver, MarkIt, BER, WEO, and staff calculations.

Figure 4. South Africa: One of the Emerging Markets Most Affected by Risk-off Episodes 1/

Portfolio flows to South Africa were among the most affected by risk-off episodes that started with Fed tapering concerns.

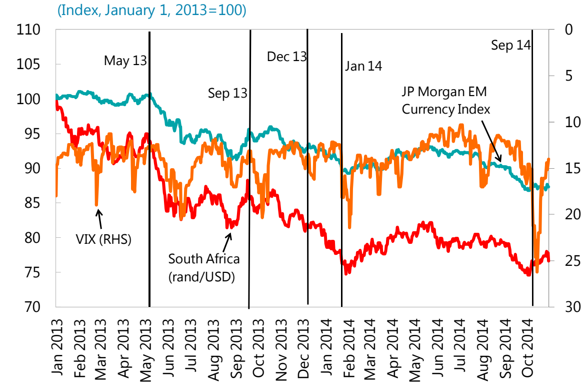
South Africa: Cumulative Portfolio Inflows
(billions of US dollars)



Note: Portfolio flows = bond(trading) + equity flows.

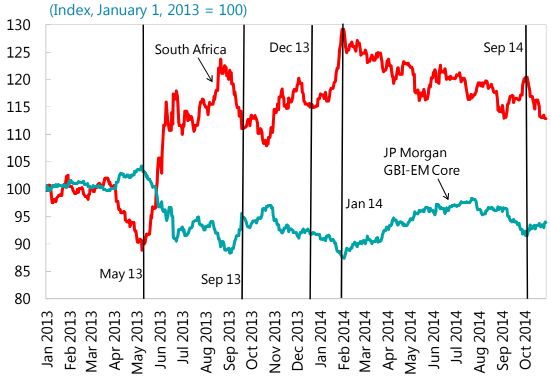
Since January 2013 the rand has depreciated by 23 percent.

Exchange Rates and Market Volatility
(Index, January 1, 2013=100)



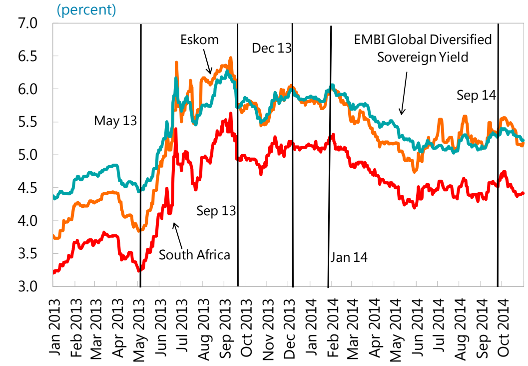
Government bond yields increased during the same period...

10-Year Bond Yields
(Index, January 1, 2013 = 100)



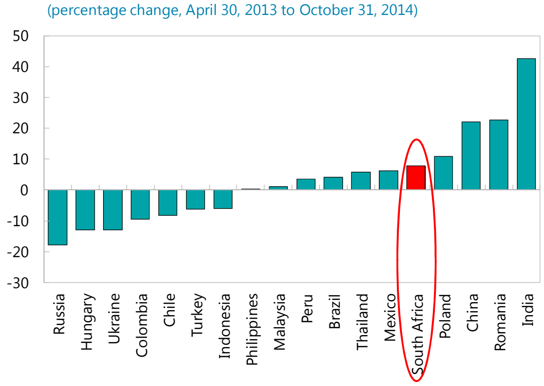
...and so did South Africa's external debt yields.

USD Eurobond Yields
(percent)



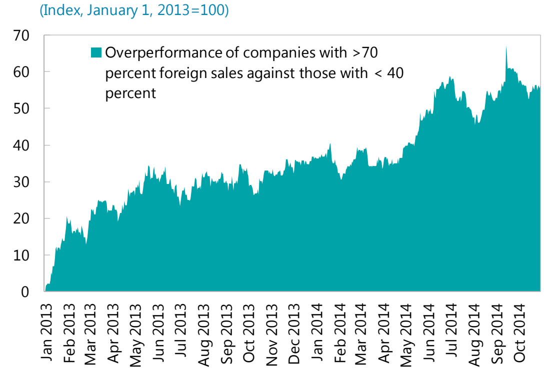
The South African stock market performed well during the tapering period...

Stock Market Performance
(percentage change, April 30, 2013 to October 31, 2014)



...but it is not very representative of the domestic economy, as major listed companies have large foreign operations.

Stock Market Performance
(Index, January 1, 2013=100)

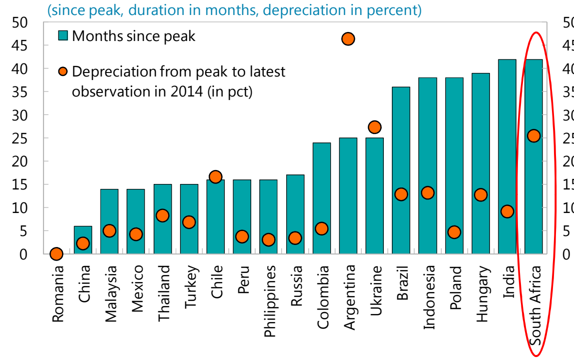


1/ May 2013: Fed taper talk; September 2013: Taper delay; December 2013: Announcement of January tapering; January 2014: Fed tapering and increased risk aversion towards EMs; September 2014: Increased global risk aversion.
Sources: Bloomberg, L.P., IIF, and staff calculations.

Figure 5. South Africa: External Rebalancing Has Started Albeit Limited

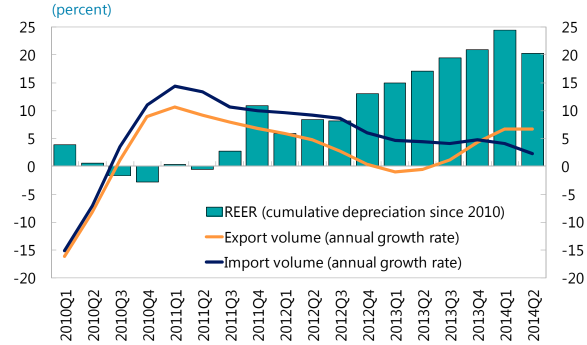
South Africa has had one of the longest and most intense depreciation spells since the post global financial crisis…

Duration and Intensity of REER Depreciation Spells, 2011-14
(since peak, duration in months, depreciation in percent)



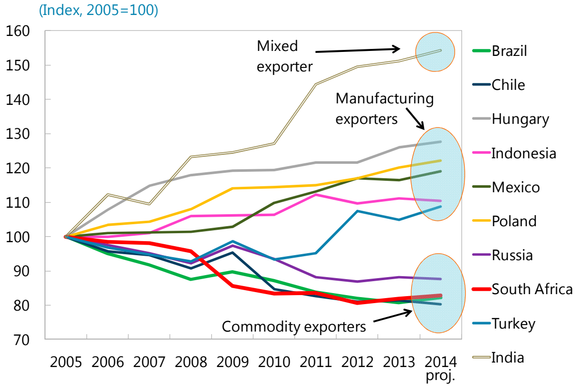
…but South Africa's trade volumes have responded to the REER depreciation rather slowly.

REER Cumulative Depreciation and Annual Growth of Trade Volumes, 2010-14
(percent)



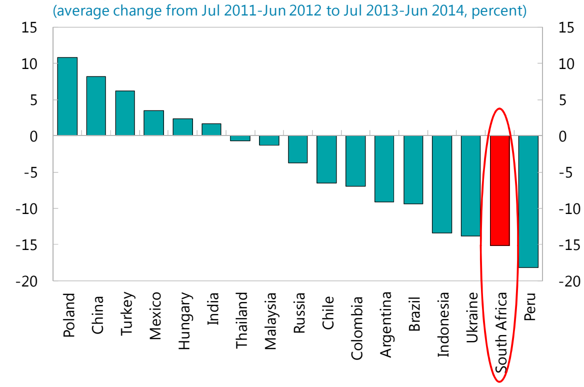
South Africa's export performance, though in line with commodity exporters, has lagged EMs…

Export Performance, 2005-14
(Index, 2005=100)



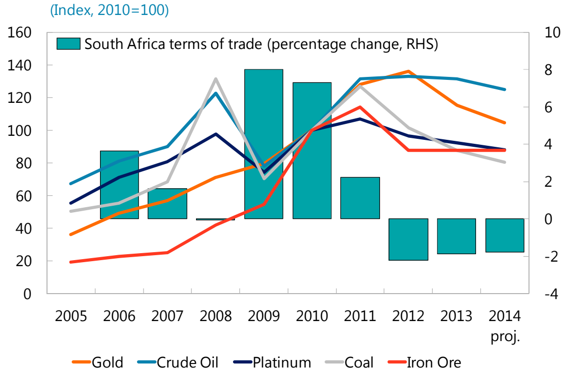
…resulting in a 15 percent drop in its share of world's exports since 2011.

Change in Shares of Worlds Exports, 2011-14
(average change from Jul 2011-Jun 2012 to Jul 2013-Jun 2014, percent)



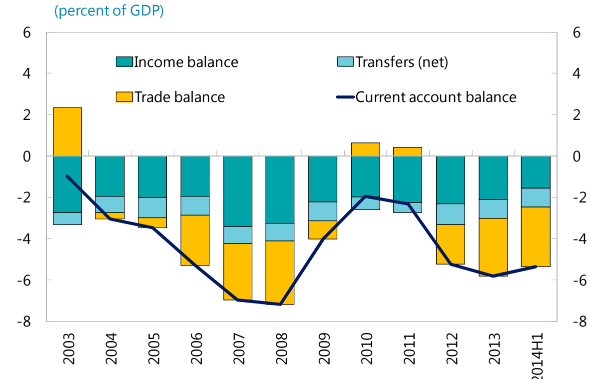
Weaker terms of trade have contributed to a wider trade deficit in recent years…

Commodity Prices
(Index, 2010=100)



…keeping the current account deficit elevated.

Current Account Developments
(percent of GDP)



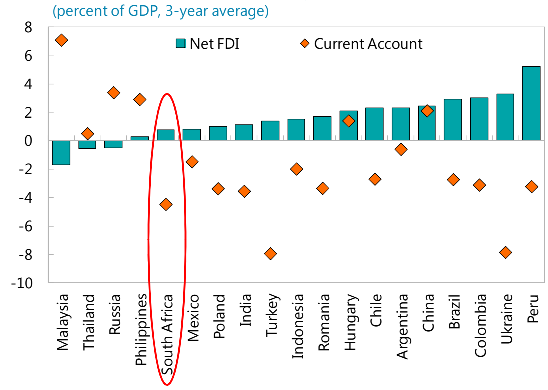
Sources: SARB, OECD, Haver, WEO, and staff calculations.

Figure 6. South Africa: Vulnerabilities Remain Elevated

South Africa has a sizable current account deficit and low FDI.

Current Account and Foreign Direct Investment

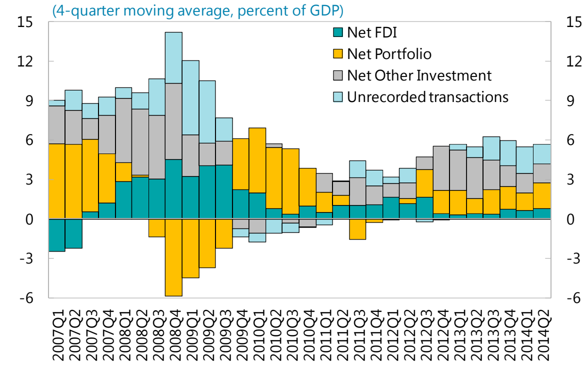
(percent of GDP, 3-year average)



The financing mix has deteriorated.

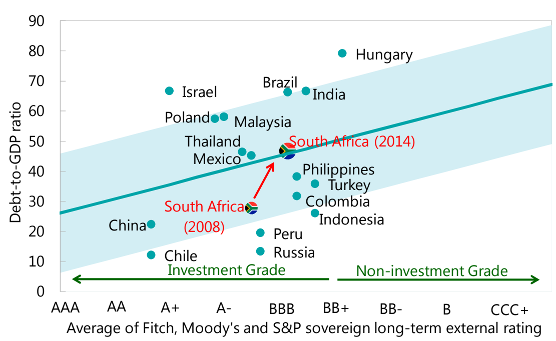
Capital Inflows

(4-quarter moving average, percent of GDP)



Fiscal vulnerabilities have been increasing.

Government Debt and Ratings

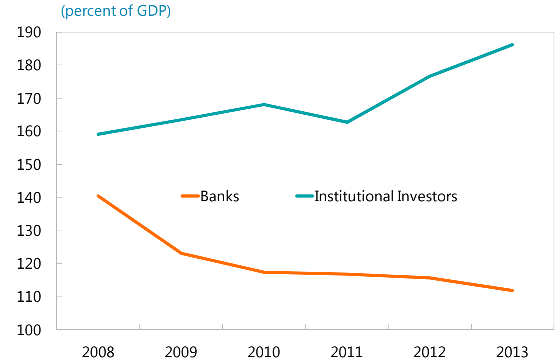


Note: The shaded area shows the one-standard error bands around the fitted values of a linear regression.

Large domestic institutional investors, subject to capital controls, are mitigating factors.

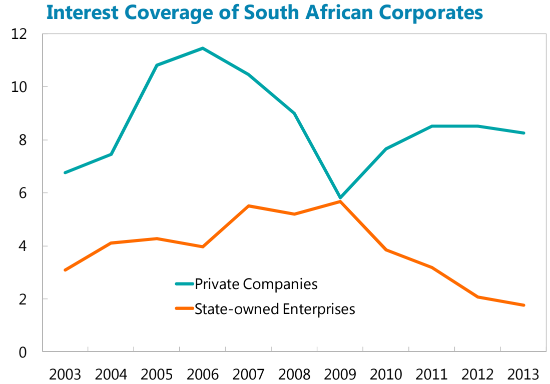
Domestic Institutional Investors' Assets

(percent of GDP)



The public corporate sector has been weakening, but private firms are still strong.

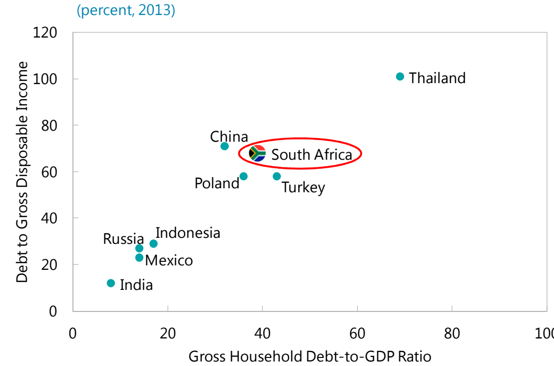
Interest Coverage of South African Corporates



Household indebtedness remains elevated.

Household Indebtedness

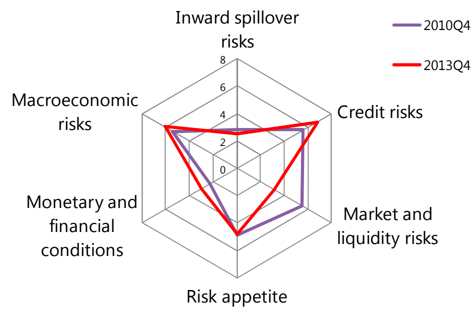
(percent, 2013)



Sources: SARB, Bloomberg, L.P., BIS, Capital IQ, CEIC, FSI, IFS, WEO, and staff calculations.

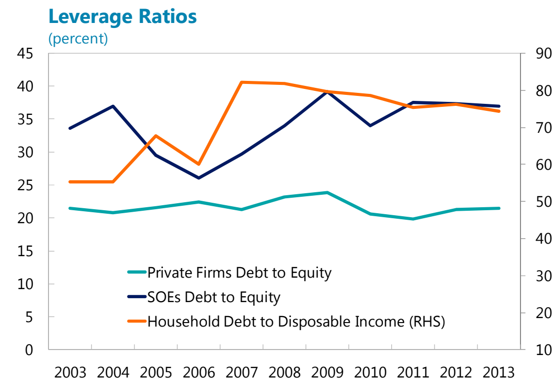
Figure 7. South Africa: Financial Sector Risks Are Elevated But Manageable

Credit and macroeconomic risks are increasing.

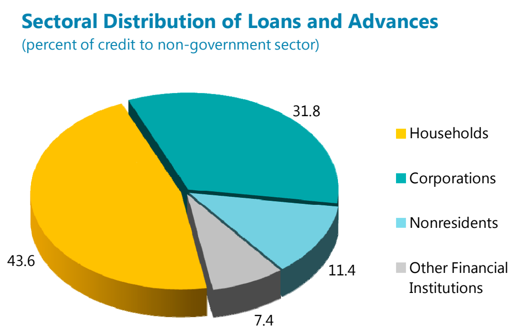


Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Credit risk is mainly from highly-indebted households.

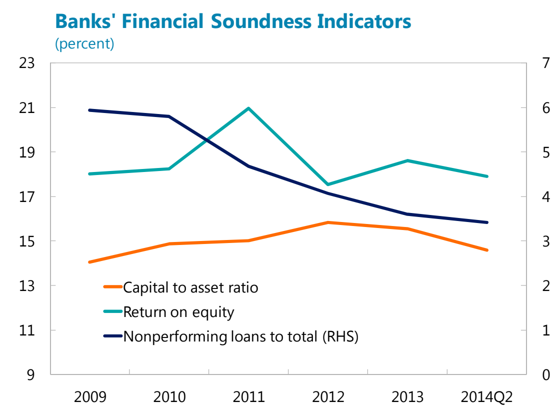


Loans to households account for the largest part of banks' lending.

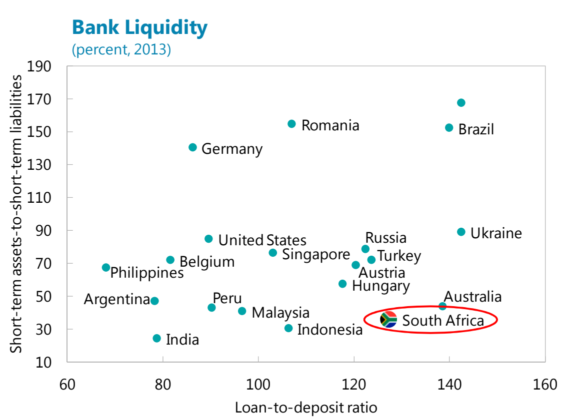


Source: South Africa Reserve Bank

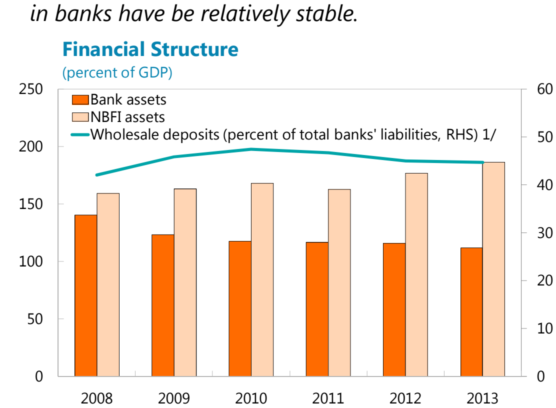
However, banks' buffers are relatively high.



Liquidity remains relatively low...



...though large domestic institutional investors' deposits in banks have be relatively stable.



1/ Deposits from NBFIs and corporations

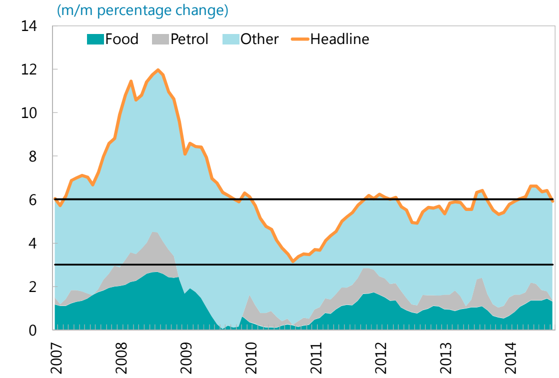
Sources: SARB, Bloomberg, L.P., BIS, Moody's KMV, Capital IQ, FSI, IFS, and staff calculations.

Figure 8. South Africa: Inflation Momentum is Easing and Inflation Expectations Are Stable

Inflation has been broad based, with food prices playing a bigger role in 2014, but inflation momentum is declining.

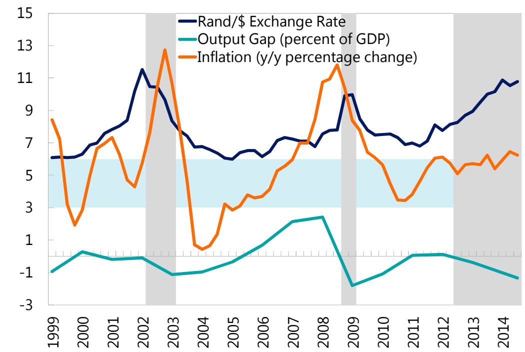
CPI Inflation Components

(m/m percentage change)



Depreciation has been the main driver, despite moderate pass-through due to a negative and rising output gap.

Exchange Rate, Inflation and Output Gap 1/

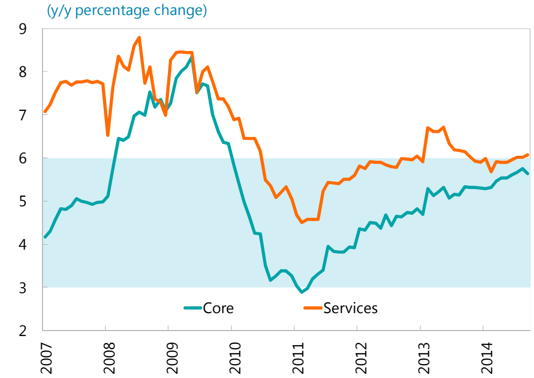


1/ Light grey areas represent a negative and rising output gap.

While core inflation has been creeping up underpinned by depreciation, nontradable inflation has moderated since mid-2013.

Core and Services Inflation

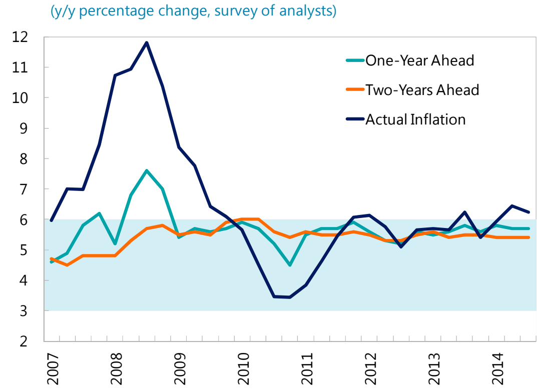
(y/y percentage change)



Inflation expectations remain stable, but close to the target ceiling.

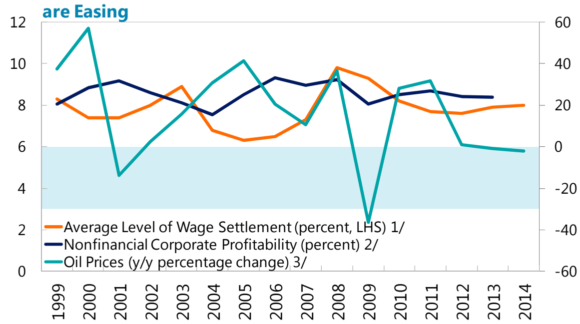
Inflation Expectations

(y/y percentage change, survey of analysts)



While recent wage settlements and weaker corporate profits could pressure inflation, oil price declines are likely to dominate.

Wage Settlements, Corporate Profitability, and Oil Prices are Easing

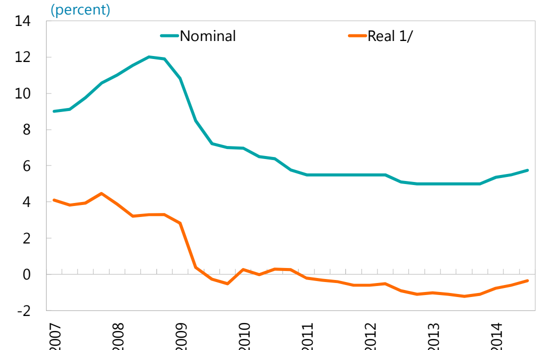


1/ 2014 data is through June.
2/ Return on equity, weighted by market capitalization.
3/ 2014 data is through October 23th.

Monetary policy remains accommodative.

Policy Rate

(percent)



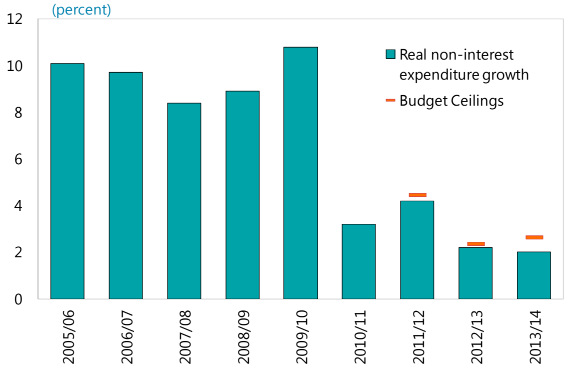
1/ Nominal rate deflated with one-year inflation expectations

Sources: SARB, StatsSA, Haver, WEO, and staff calculations.
1/ Light blue areas represent the SARB target inflation band of 3-6 percent.

Figure 9. South Africa: Fiscal Risks Mitigated by the Medium-Term Budget Policy Statement

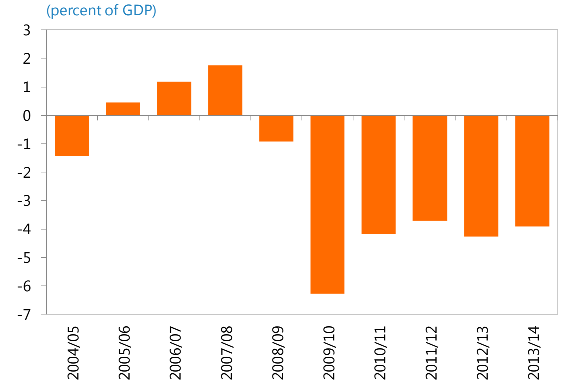
The authorities have adhered to stringent spending ceilings and expenditure growth has moderated…

Expenditure Growth
(percent)



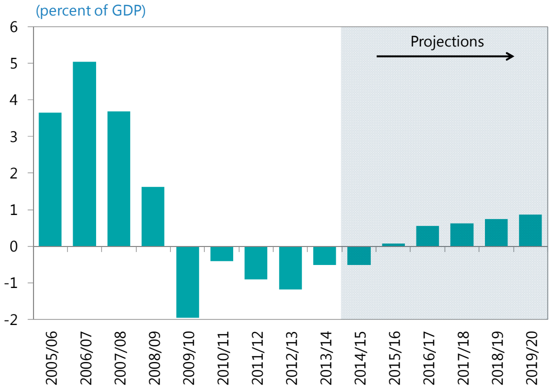
…but low growth has kept the deficit high.

Consolidated Government Balance
(percent of GDP)



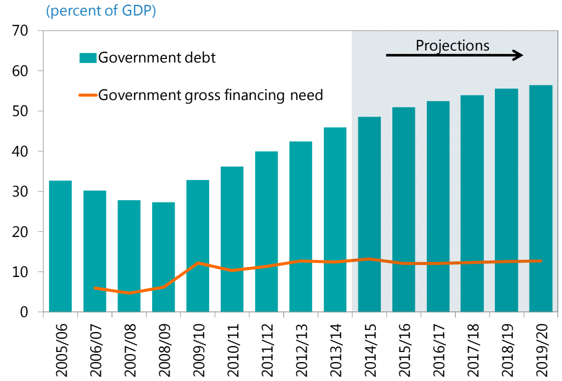
The fiscal trajectory announced in the 2014 MTBPS entails significant fiscal effort…

Structural Primary Balance
(percent of GDP)



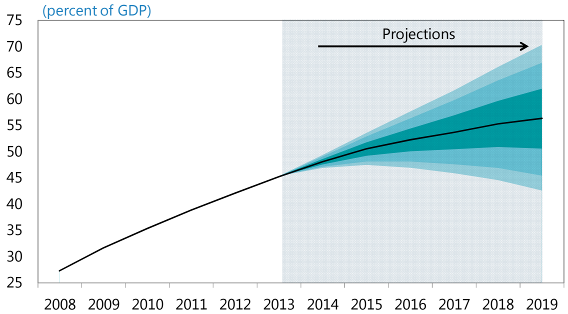
…but may be insufficient to stabilize debt or lower gross financing needs over the medium term.

Debt and Gross Financing Need
(percent of GDP)



Debt dynamics are vulnerable to shocks.

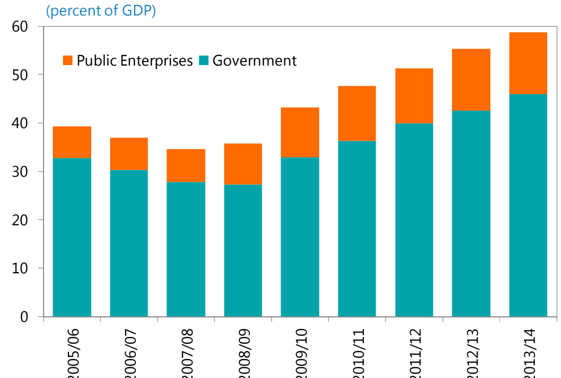
Government Debt Forecast 1/
(percent of GDP)



1/ The solid line represents the median debt forecast. The shaded area represents the 5th, 10th, 25th, 75th, 90th, and 95th percentiles of the distribution function.

State-owned enterprise debt has also increased.

Public Debt
(percent of GDP)



Sources: South Africa National Treasury, SARB, WEO, and staff calculations.

Text Table 1. Key Legislative Measures		
Legislation	**Key Features**	**Status**
	Legislation related to labor markets	
The Employment Tax Incentive Act	Provides tax incentives to firms for hiring unemployed youth. The 2014 budget provides for 0.03 percent of GDP in forgone tax revenue to support this initiative.	Came into effect on January 1, 2014.
The Employment Equity Amendment Act	Addresses unfair discrimination and implements affirmative action measures to promote equitable workplaces. Puts onus of proof on employers for not meeting Broad-Based Black Economic Empowerment (B-BBEE) targets, and introduces heavier fines for non-compliance, linked to turnover.	Came into effect on August 1, 2014.
The Labor Relations Amendment Act	Protects vulnerable groups from increased informalization of labor and ensures decent work conditions for them. Tightens regulations on labor broking, subcontracting and outsourcing; introduces equal pay for work of equal value; and facilitates unionization of workers.	Signed into law by the President.
The Basic Conditions of Employment Amendment Act	Strengthens child labor regulations; enlarges government's powers to regulate sectoral determinations, including extension of sectoral determination to those not covered by any other sectoral determination; enhances enforcement and raises penalties for non-compliance.	Awaits presidential approval.
	Legislation Related to Land	
The Restitution of Land Rights Amendment Bill	Extends the original deadline of December 31, 1998 to December 31, 2018 for filing claims for the restitution of land by those dispossessed during the apartheid rule.	Signed into law by the President.
The Property Valuation Bill	Establishes the office of Valuer-General, with exclusive powers to value property in cases of expropriation, land reform, or other acquisition (such as leasing). Empowers the government to proceed with expropriation irrespective of any dispute over the compensation due.	Signed into law by the President.
The Expropriation Bill	Empowers all the three levels of government, constitutional entities, and parastatals to expropriate in public interest. Allows government to take ownership and possession before paying compensation.	Submitted to Parliament.
The Private Security Industry Regulation Amendment Bill	Introduces a requirement of minimum 51 percent domestic shareholding, with excess shareholding to be disposed-off in accordance with the investment bill, which is under consideration.	Passed by Parliament.
The Electronic Deeds Registration Bill	Intends to reform land administration and standards of governance.	Likely during the current term of the government.
The Regulation of Land Holdings Bill	Prohibits future purchases of land by foreigners, and only allows for lease holding by foreigners.	Likely during the current term of the government.

Text Table 1. Key Legislative Measures (concluded)		
Legislation	**Key Features**	**Status**
The Extension of Security of Tenure Amendment Bill	Prevents mass evictions following the conversion of workers' long-term residence on commercial farms into various forms of land tenure.	Likely during the current term of the government.
The Communal Property Associations Amendment Bill	Allows the registration of title deeds in the name of individual households so that it could be used as collateral for bank loans.	Likely during the current term of the government.
The Communal Land Tenure Bill	Reforms the communal land tenure system to secure the rights of 'traditional communities.'	Likely during the current term of the government.
Other Legislation		
The Immigration Act	Introduces a "critical skills" visa category, and mandates the Department of Trade and Industry's recommendation for all business visas. Introduces new regulations on travelling minors.	Came into effect on April 1, 2014.
The Infrastructure Development Act	Aims to fast-track the implementation of the government's infrastructure development plan.	Came into effect on July 1, 2014.
The Special Economic Zones Bill	Establishes special economic zones to support industrialization.	Adopted by Parliament.
The Mineral and Petroleum Resource Development Amendment Bill	Empowers the government to declare certain mineral 'strategic' (including coal) and to secure the supply and price of such 'strategic minerals' for domestic industry.	Passed by the National Assembly.
The Promotion and Protection of Investment Bill	Modernizes the current investment regime to replace bilateral investment treaties. Advocates a balance of rights and obligations applicable equally to all investors in South Africa, whether foreign or local.	Submitted to Parliament.
The Women Empowerment and Gender Equality Bill	Fosters gender equality in public and private sectors through: realizing progressively at least 50 percent representation of women in decision-making structures; improving access to education, training and skills development; promoting women's reproductive health; and eliminating discrimination and harmful practices.	Adopted by the National Assembly.
The Broad-Based Black Economic Empowerment Amendment Act	Introduces an offence and penalty regime for persons found guilty B-BBEE fronting. Establishes a B-BBEE Commission to oversee, supervise and promote adherence with the B-BBEE Act.	Signed into law by the President.

Text Table 2. Key Financial System Stability Assessment Recommendations
Priority Recommendations (Timeframe 1-2 years)
Twin Peaks Reform
Define clear and comprehensive institutional, governance and accountability arrangements for prudential and market conduct regulation, including National Credit Regulator and other relevant institutions.
Publish a roadmap for regulatory reform, with adequate resource allocation, monitoring and evaluation, to carefully implement the move to twin peaks and minimize transition risks.
Micro-prudential
Strengthen group-wide supervision, focusing on credit and interconnectedness risks; monitor intra-group transactions and aggregate exposures, and conduct joint on-site visits.
Clarify objectives and strengthen the operational independence of all financial sector supervisors in the relevant legislation in line with international standards.
Enhance regulatory requirements of collective investment schemes (CIS), particularly for disclosure, valuation and accounting, introduce variable net asset valuation for money market funds, and strengthen the supervision of CIS managers.
Fully implement Solvency Assessment and Management and Treating Customers Fairly initiatives; give high priority in legislation to protecting policyholder rights and entitlements.
Macro-prudential
Continue building a top-down stress test framework for the banking sector and give SARB more resources for data collection and analysis.
Financial Safety Nets
Introduce a resolution regime compliant with the Key Attributes for, and make the SARB the resolution authority of, all banks and Systemically Important Financial Institutions (SIFIs).
Adopt depositor preference and introduce an ex ante funded deposit insurance scheme, with a back-up credit line from the National Treasury.
Remove constraints to early intervention powers and improve legal protection for resolution officials.
OTC Derivatives Market Reforms and Oversight
Improve data collection of OTC derivatives and enhance surveillance of the OTC derivatives market.
Consider establishing a local central clearing counterparty, with credit lines from the SARB and securities collateral placed at a central securities depository to reduce dependency on local banks.
Competition
Adopt international best practices on provision and disclosure of market information to retail customers and to potential entrants into the payments and clearance systems.

Table 1. South Africa: Selected Economic and Social Indicators, 2010–15

Social Indicators

GDP		**Poverty**	
Nominal GDP (2013, billions of U.S. dollars)	351	Headcount ratio at $1.25 a day (2011, percent of population)	9.4
GDP per capita (2013, U.S. dollars)	6599	Undernourishment (2012, percent of population)	5.0
Population characteristics (2013)		**Income distribution (2011)**	
Total	53.2	Income share held by highest 10 percent of population	53.8
Urban population (percent of total)	64	Income share held by lowest 20 percent of population	2.5
Life expectancy at birth (years), 2014	61	Gini index	65.0

Economic Indicators

	2010	2011	2012	2013	2014	2015
					Proj.	
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	3.1	3.6	2.5	1.9	1.4	2.1
Real GDP per capita	1.6	2.1	0.9	0.3	-0.2	0.5
Real domestic demand	4.4	5.2	3.9	2.5	1.2	1.8
GDP deflator	7.7	5.9	4.5	5.8	5.9	5.4
CPI (annual average)	4.3	5.0	5.7	5.8	6.1	5.2
CPI (end of period)	3.5	6.1	5.7	5.4	5.7	5.5
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.9	24.8	24.9	24.7	25.3	25.2
Average remuneration (formal nonagricultural, nominal)	13.5	7.2	7.5	7.6	6.8	7.1
Labor productivity (formal nonagricultural)	3.9	1.4	1.3	1.4	1.4	1.5
Unit labor costs (formal nonagricultural)	9.3	5.8	6.2	6.1	5.3	5.4
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	17.1	16.8	14.2	13.5	13.6	14.0
Public (incl. public enterprises)	-0.5	0.8	-0.9	-0.9	-0.9	-0.6
Private	17.6	16.0	15.1	14.4	14.5	14.6
Investment (including inventories)	19.1	19.1	19.4	19.4	19.3	19.4
Public (incl. public enterprises)	7.0	7.0	7.1	7.2	7.3	7.3
Private	12.1	11.8	11.8	12.1	12.3	12.3
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.5	27.9	28.3	28.9	29.2	29.5
Expenditure and net lending	32.4	31.9	32.6	33.1	33.7	33.8
Overall balance	-4.9	-4.0	-4.3	-4.2	-4.4	-4.3
Primary balance	-2.3	-1.3	-1.4	-1.1	-1.2	-0.9
Structural balance (percent of potential GDP)	-3.6	-3.8	-4.2	-3.9	-3.9	-3.7
Gross government debt 2/	35.3	38.8	42.1	45.2	48.1	50.5
Government bond yield (10-year, percent) 3/	8.5	8.3	7.6	7.3	7.9	...
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	6.9	8.3	5.2	5.9	6.4	7.6
Credit to the private sector	3.3	5.7	9.3	6.6	7.7	7.9
Repo rate (percent) 3/	5.5	5.5	5.0	5.0	5.8	...
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-7.2	-9.4	-20.0	-20.4	-19.4	-19.0
percent of GDP	-2.0	-2.3	-5.2	-5.8	-5.7	-5.4
Exports growth (volume)	9.0	6.8	0.4	4.2	2.6	3.5
Imports growth (volume)	11.0	10.0	6.0	4.7	1.8	2.3
Terms of trade (percentage change)	7.3	2.2	-2.2	-1.9	-1.8	-0.1
Overall balance	1.2	1.1	0.3	0.1	0.0	0.0
Gross reserves (billions of U.S. dollars)	43.8	48.9	50.7	49.6	49.6	49.6
percent of short-term debt (residual maturity)	145.8	151.6	133.2	130.2	126.1	115.7
Total external debt	30.5	29.2	37.1	38.9	42.4	44.9
of which short-term (residual maturity)	8.2	8.0	10.0	10.9	11.6	12.3
Nominal effective exchange rate (percentage change, end-period) 4/	11.3	-16.6	-5.4	-15.3	-7.3	...
Real effective exchange rate (percentage change, end-period) 4/	12.0	-4.7	-12.2	-12.4	-2.9	...
Exchange rate (Rand/U.S. dollar, end-period) 3/	6.6	8.1	8.5	10.5	10.9	...

Sources: South African Reserve Bank and National Treasury, Haver, Bloomberg, World Bank, IMF INS database; and Fund staff estimates and projections.

1/ General government unless otherwise indicated.
2/ National government.
3/ For 2014, end-October data.
4/ For 2014, September data.

Table 2. South Africa: Consolidated Government Operations, 2010/11–2017/18 1/

	2010/11	2011/12	2012/13	2013/14	2014/15		2015/16		2016/17		2017/18	
					Auth.	Staff	Auth.	Staff	Auth.	Staff	Auth.	Staff
	billions of rand											
Total revenue and grants	765.0	846.2	908.9	1,012.7	1,093.9	1,084.5	1,199.5	1,185.3	1,323.0	1,291.7	1,434.6	1,407.4
Tax revenue	656.3	720.9	771.7	856.6	931.9	924.1	1,035.1	1,017.9	n.a.	1,111.8	n.a.	1,213.7
Non-tax revenue	18.6	28.2	28.1	29.4	24.8	24.5	20.0	20.9	n.a.	21.2	n.a.	21.6
Provinces, social security, and other entities	90.1	97.0	109.1	126.7	137.3	135.9	144.4	146.5	n.a.	158.7	n.a.	172.2
Total expenditure	880.0	953.1	1,045.1	1,147.4	1,247.1	1,248.5	1,344.0	1,346.7	1,436.7	1,441.9	1,553.0	1,561.0
Current expenditure	756.4	838.3	919.1	1,006.0	1,093.1	1,094.6	1,171.6	1,174.4	1,247.1	1,252.2	1,323.7	1,331.7
Wages and salaries	309.9	345.9	374.8	407.6	440.7	440.7	470.6	470.6	501.8	501.8	533.5	533.5
Other goods and services	137.7	153.8	167.9	177.8	189.5	189.5	193.8	193.8	200.2	200.2	213.0	213.0
Interest	75.3	81.7	93.4	107.5	120.8	122.2	133.3	136.0	145.3	150.5	155.9	163.9
Transfers	233.5	257.0	283.0	313.1	342.3	342.3	373.9	373.9	399.7	399.7	421.4	421.4
Capital expenditure	101.1	111.8	121.1	137.5	149.9	149.9	164.0	164.0	174.6	174.6	184.3	184.3
Payment for financial assets	22.4	3.1	4.9	3.8	4.0	4.0	3.4	3.4	0.0	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.0	0.0	0.0	5.0	5.0	15.0	15.0	45.0	45.0
Primary balance	-39.6	-25.3	-42.8	-27.1	-32.4	-41.8	-11.2	-25.4	31.6	0.3	37.5	10.3
Overall balance	-114.9	-107.0	-136.2	-134.7	-153.2	-164.0	-144.5	-161.4	-113.7	-150.2	-118.4	-153.6
Structural primary balance	-11.3	-26.9	-37.5	-17.3	n.a.	-19.6	n.a.	0.6	n.a.	21.0	n.a.	26.7
Gross government debt	991	1,188	1,366	1,585	1,790	1,800	1,998	2,031	2,180	2,268	2,379	2,530
	percent of GDP											
Total revenue and grants	27.8	28.4	28.4	29.4	29.5	29.3	29.7	29.7	30.2	29.9	30.0	30.0
Tax revenue	23.9	24.2	24.1	24.8	25.1	25.0	25.7	25.5	n.a.	25.7	n.a.	25.9
Non-tax revenue	0.7	0.9	0.9	0.9	0.7	0.7	0.5	0.5	n.a.	0.5	n.a.	0.5
Provinces, social security, and other entities	3.3	3.3	3.4	3.7	3.7	3.7	3.6	3.7	n.a.	3.7	n.a.	3.7
Total expenditure	32.0	32.0	32.7	33.3	33.6	33.7	33.3	33.8	32.8	33.4	32.5	33.3
Current expenditure	27.5	28.1	28.7	29.2	29.4	29.6	29.0	29.4	28.4	29.0	27.7	28.4
Wages and salaries	11.3	11.6	11.7	11.8	11.9	11.9	11.7	11.8	11.4	11.6	11.2	11.4
Other goods and services	5.0	5.2	5.2	5.2	5.1	5.1	4.8	4.9	4.6	4.6	4.5	4.5
Interest	2.7	2.7	2.9	3.1	3.3	3.3	3.3	3.4	3.3	3.5	3.3	3.5
Transfers	8.5	8.6	8.8	9.1	9.2	9.2	9.3	9.4	9.1	9.3	8.8	9.0
Capital expenditure	3.7	3.7	3.8	4.0	4.0	4.1	4.1	4.1	4.0	4.0	3.9	3.9
Payment for financial assets	0.8	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.3	0.3	0.9	1.0
Primary balance	-1.4	-0.8	-1.3	-0.8	-0.9	-1.1	-0.3	-0.6	0.7	0.0	0.8	0.2
Overall balance	-4.2	-3.6	-4.3	-3.9	-4.1	-4.4	-3.6	-4.0	-2.6	-3.5	-2.5	-3.3
Structural primary balance (percent of potential GDP)	-0.4	-0.9	-1.2	-0.5	n.a.	-0.5	n.a.	0.0	n.a.	0.5	n.a.	0.6
Gross government debt 2/	36.0	39.8	42.7	45.9	48.2	48.6	49.5	50.9	49.7	52.5	49.8	53.9
Memorandum items:												
National budget primary balance (percent of GDP)	-2.4	-2.3	-2.4	-1.8	-1.8	-2.0	-1.0	-1.4	0.0	-0.8	0.1	-0.7
National budget overall balance (percent of GDP	-4.8	-4.8	-5.2	-4.7	-4.8	-5.1	-4.1	-4.6	-3.2	-4.1	-3.0	-4.0
Fiscal year GDP (billions of rand)	2,750	2,982	3,199	3,449	3,712	3,701	4,034	3,989	4,386	4,321	4,775	4,690
Real GDP growth (percent)	3.7	3.2	2.3	1.9	1.6	1.4	2.6	2.2	2.9	2.7	3.1	2.8

Sources: South African National Treasury and Fund staff estimates and projections.

1/ Data is on a fiscal year basis (April 1-March 31); The authorities projections are based on the 2014 Medium-Term Budget Policy Statement from October 2014 which does not provide the composition of revenue for the outer years of the projection period.

2/ National government.

Table 3. South Africa: Balance of Payments, 2010–15

	2010	2011	2012	2013	2014	2015
					Proj.	
			billions of U.S. dollars			
Balance on current account	-7.2	-9.4	-20.0	-20.4	-19.4	-19.0
Balance on goods and services	2.3	1.7	-7.3	-9.9	-10.7	-9.6
Exports of goods and services	103.7	123.8	114.4	109.3	107.0	107.8
Exports of goods	89.7	108.9	99.3	95.1	92.9	93.1
Nongold	81.5	98.5	90.6	88.5	86.8	87.1
Gold	8.1	10.4	8.7	6.6	6.1	6.0
Exports of services	14.0	14.9	15.1	14.2	14.1	14.7
Imports of goods and services	-101.3	-122.0	-121.7	-119.1	-117.8	-117.4
Imports of goods	-82.9	-102.4	-104.1	-102.7	-102.1	-101.3
Imports of services	-18.4	-19.6	-17.7	-16.4	-15.7	-16.1
Balance on income	-7.2	-9.2	-8.9	-7.4	-6.0	-6.7
Income receipts	4.7	5.3	5.9	6.7	7.9	8.6
Income payments	-11.9	-14.4	-14.8	-14.1	-13.9	-15.3
Balance on transfers	-2.3	-2.0	-3.8	-3.2	-2.7	-2.7
Capital flows (including errors and omissions)	11.5	13.9	21.1	20.9	19.4	19.0
Balance on capital and financial account	12.0	9.1	21.4	14.4	16.3	19.0
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	11.9	9.1	21.3	14.4	16.2	18.9
Direct investment	3.7	4.5	1.6	2.6	3.4	3.4
Liabilities	3.6	4.2	4.6	8.2	4.0	4.2
Assets	0.1	0.3	-3.0	-5.6	-0.6	-0.8
Portfolio investment	10.2	-1.1	6.6	6.2	4.5	3.7
Liabilities	14.7	6.3	11.6	7.4	9.6	9.3
Assets	-4.6	-7.4	-4.9	-1.2	-5.1	-5.6
Other investment	-1.9	5.7	13.1	5.6	8.4	11.8
Liabilities	1.1	5.9	8.1	5.2	6.8	8.7
Assets	-3.0	-0.3	5.0	0.5	1.6	3.1
Errors and omissions	-0.5	4.8	-0.2	6.5	3.1	0.0
Overall balance of payments	4.3	4.5	1.1	0.5	0.0	0.0
Gross reserves (end of period)	43.8	48.9	50.7	49.6	49.6	49.6
			percent of GDP			
Balance on current account	-2.0	-2.3	-5.2	-5.8	-5.7	-5.4
Balance on goods and services	0.6	0.4	-1.9	-2.8	-3.2	-2.7
Exports of goods and services	28.4	30.6	29.9	31.1	31.6	30.9
Imports of goods and services	-27.7	-30.2	-31.8	-34.0	-34.8	-33.7
Balance on capital and financial account	3.3	2.3	5.6	4.1	4.8	5.4
Direct investment	1.0	1.1	0.4	0.7	1.0	1.0
Portfolio investment	2.8	-0.3	1.7	1.8	1.3	1.1
Other investment	-0.5	1.4	3.4	1.6	2.5	3.4
Errors and omissions	-0.1	1.2	-0.1	1.9	0.9	0.0
Overall balance of payments	1.2	1.1	0.3	0.1	0.0	0.0
Gross reserves (end of period)	12.0	12.1	13.3	14.1	14.6	14.2
Memorandum items:						
Total external debt	30.5	29.2	37.1	38.9	42.4	44.9
Foreign currency debt	13.9	13.6	15.8	17.4	19.4	20.2
of which short-term (residual maturity)	8.2	8.0	10.0	10.9	11.6	12.3
Medium- and long-term external debt service	3.6	3.0	4.6	6.4	7.9	7.6
International investment position (net)	-23.3	-8.4	-14.3	-4.1	n.a.	n.a.
GDP at current prices (US$ billion)	365.2	404.3	382.3	350.8	338.8	348.9

Sources: South African Reserve Bank; and Fund staff estimates and projections.

Table 4. South Africa: Monetary Survey 2009–14

	2009	2010	2011	2012	2013	2014 September
			billions of rand			
Monetary Survey						
Net Foreign Assets	334	338	505	504	641	628
Net Domestic Assets	1,614	1,745	1,752	1,869	1,872	2,077
General government	69	74	6	-4	-94	-65
Public Nonfinancial Corporations	32	36	33	34	30	39
Nonfinancial Private Sector	1,871	1,933	2,044	2,233	2,381	2,537
Other items net	-357	-298	-330	-394	-445	-434
Broad Money	1,948	2,083	2,257	2,373	2,514	2,705
Central bank						
Net Foreign Assets	266	267	371	402	486	517
Net Domestic Assets	-142	-131	-215	-228	-295	-326
General government	-107	-110	-204	-246	-318	-350
Public Nonfinancial Corporations	0	0	1	1	1	1
Nonfinancial Private Sector	0	0	0	0	0	0
Depository institutions (banks)	12	25	25	38	39	58
Other items net	-47	-47	-36	-21	-18	-36
Monetary base	124	136	157	174	191	191
Currency in circulation	78	83	101	112	119	113
Reserves and others	47	53	55	62	72	77
			annual percentage change			
Memorandum items:						
Broad money growth	1.8	6.9	8.3	5.2	5.9	7.9
Monetary base growth	4.0	9.3	15.2	11.2	9.8	12.3
Credit to private sector	3.0	3.3	5.7	9.3	6.6	7.8
Broad money multiplier	15.7	15.3	14.4	13.6	13.2	14.2

Source: South African Reserve Bank.

Table 5. South Africa: Financial Soundness Indicators 2009–14

	2009	2010	2011	2012	2013	2014Q2
			in percent			
Capital adequacy						
Risk-weighted capital adequacy ratio	14.1	14.9	15.0	15.8	15.6	14.6
of which Tier 1 capital	11.0	11.8	12.2	12.6	14.1	13.5
Capital to asset ratio	6.7	7.0	7.2	7.8	7.9	7.7
Asset quality						
Nonperforming loans (percent of outstanding loans)	5.9	5.8	4.7	4.1	3.6	3.5
Nonperforming loans net of provisions (percent of regulatory capital)	47.6	40.8	31.0	23.6	19.1	18.4
Earnings, profitability, and efficiency						
Return on assets	1.1	1.2	1.5	1.3	1.5	1.4
Return on equity	18.0	18.2	21.0	17.5	18.6	17.9
Interest income (percent of gross income)	39.5	43.9	49.1	49.6	48.1	53.5
Trading income (percent of gross income)	16.0	13.8	10.5	8.9	7.8	7.0
Non-interest expenses (percent of gross income)	48.8	63.4	54.2	53.1	56.3	57.9
Personnel expenses (percent of non-interest expenditure)	43.7	43.5	52.6	37.0	47.3	48.9
Liquidity						
Liquid assets (percent of total assets)	15.8	16.0	15.7	16.2	16.6	17.9
Liquid assets (percent of short-term liabilties)	32.8	32.0	32.6	33.0	33.0	34.7
Customer deposits (percent of total non-interbank loans)	46.3	48.0	51.4	52.2	53.1	53.3
Exposure to FX risk						
Effective net open FX position (percent of regulatory capital)	0.8	-0.3	0.8	0.5	0.3	0.9
Foreign-currency-denominated loans (percent of outstanding loans)	7.0	6.7	9.2	8.3	8.7	9.8
Foreign-currency-denominated liabilities (percent of total liabilities)	4.3	4.1	4.5	5.7	6.3	7.2
Sectoral distribution of loans and advances						
Residents	91.6	91.2	90.0	90.5	89.2	88.6
Central Bank and other financial corporations 1/	12.4	11.3	12.2	12.7	11.2	12.7
Other financial corporations	4.3	5.8	6.1	7.4	7.1	7.4
General government	0.7	0.9	0.9	0.8	0.7	0.6
Nonfinancial corporations	33.6	32.4	31.3	31.0	31.1	31.8
Households	44.9	46.5	45.6	46.1	46.2	43.6
Nonresidents	9.9	9.5	10.0	9.5	10.8	11.4
Derivatives (percent of regulatory capital)						
Gross asset position in financial derivatives	133.9	124.3	112.5	88.8	70.4	61.8
Gross liability position in financial derivatives	126.5	121.5	112.5	87.8	75.4	65.1
Real Estate Market						
Residential real estate prices (annual percentage change)	6.5	0.3	1.7	0.3	8.7	9.6
Residential real estate loans (percent of total loans)	34.9	35.3	32.8	30.3	28.5	27.1
Commercial real estate loans (percent of total loans)	9.7	9.8	9.5	9.1	8.8	8.8
Household debt						
Household debt (percent of GDP)	47.9	45.0	44.3	45.7	45.1	45.2
Household debt (percent of disposable income)	81.5	78.6	75.4	76.3	74.3	74.5
Household debt service (percent of disposable income)	10.0	9.0	8.0	7.7	7.7	7.9

Source: South African Reserve Bank.

1/ Including interbank loans.

Table 6. South Africa: Medium-Term Macroeconomic Framework, 2011–19

	2011	2012	2013	2014	2015	2016	2017	2018	2019
						Proj.			
National income and prices (annual percentage change)									
Real GDP	3.6	2.5	1.9	1.4	2.1	2.5	2.8	2.8	2.8
CPI (annual average)	5.0	5.7	5.8	6.1	5.2	5.5	5.5	5.4	5.4
Output gap (percent of potential real GDP)	0.1	0.1	-0.4	-1.3	-1.6	-1.5	-1.1	-0.8	-0.4
Labor market (annual percentage change)									
Unemployment rate (percent of labor force, annual average)	24.8	24.9	24.7	25.3	25.2	25.0	24.9	24.7	24.5
Savings and Investment (percent of GDP)									
Gross national saving	16.8	14.2	13.5	13.6	14.0	14.4	14.8	15.2	15.4
Public (incl. public enterprises)	0.8	-0.9	-0.9	-0.9	-0.6	-0.2	0.2	0.4	0.5
Private	16.0	15.1	14.4	14.5	14.6	14.5	14.6	14.8	15.0
Investment (including inventories)	19.1	19.4	19.4	19.3	19.4	19.6	19.8	19.9	19.9
Public (incl. public enterprises)	7.0	7.1	7.2	7.3	7.3	7.2	7.0	6.9	6.8
Private	11.8	11.8	12.1	12.3	12.3	12.5	12.8	13.0	13.2
Fiscal position (percent of GDP) 1/									
Revenue, including grants	27.9	28.3	28.9	29.2	29.5	29.7	29.8	29.9	30.0
Expenditure and net lending	31.9	32.6	33.1	33.7	33.8	33.5	33.3	33.3	33.2
Overall balance	-4.0	-4.3	-4.2	-4.4	-4.3	-3.8	-3.5	-3.3	-3.2
Primary balance	-1.3	-1.4	-1.1	-1.2	-0.9	-0.3	0.0	0.2	0.5
Gross government debt 2/	38.8	42.1	45.2	48.1	50.5	52.2	53.6	55.2	56.3
Balance of payments (percent of GDP unless otherwise indicated)									
Exports (volume, annual percentage change)	6.8	0.4	4.2	2.6	3.5	4.2	4.0	4.0	4.0
Imports (volume, annual percentage change)	10.0	6.0	4.7	1.8	2.3	3.2	3.2	3.2	3.2
Current account balance (billions of U.S. dollars)	-9.4	-20.0	-20.4	-19.4	-19.0	-19.1	-19.1	-18.8	-18.9
percent of GDP	-2.3	-5.2	-5.8	-5.7	-5.4	-5.2	-5.0	-4.7	-4.5
Overall balance	1.1	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (billions of U.S. dollars)	48.9	50.7	49.6	49.6	49.6	49.6	49.6	49.6	49.6
percent of short-term debt (residual maturity)	151.6	133.2	130.2	126.1	115.7	105.8	96.8	88.8	81.3
Total external debt	29.2	37.1	38.9	42.4	44.9	46.7	48.8	50.7	52.6

Sources: Haver, South African National Treasury, World Bank, and Fund staff estimates and projections.

1/ General government unless otherwise indicated.

2/ National government.

Table 7. South Africa: Indicators of External Vulnerability 2009–14

	2009	2010	2011	2012	2013	2014 Proj.
Financial indicators						
Gross government debt (percent of GDP)	31.6	35.3	38.8	42.1	45.2	48.1
Broad money (annual percentage change)	1.8	6.9	8.3	5.2	5.9	6.4
Private sector credit (annual percentage change)	3.0	3.3	5.7	9.3	6.6	7.7
91 day Treasury bill yield (percent, end-period) 1/	7.8	6.4	5.5	5.3	5.1	5.9
91 day Treasury bill yield (real, percent, end-period) 1/ 2/	0.5	2.2	0.4	-0.4	-0.6	-0.1
External indicators						
Exports (annual percentage change in U.S. dollars)	-22.8	35.2	21.0	-8.7	-4.3	-2.3
Export volume (goods and services, annual percentage change)	-19.5	9.0	6.8	0.4	4.2	2.6
Imports (annual percentage change in U.S. dollars)	-27.1	25.7	23.1	1.9	-1.3	-0.6
Import volume (goods and services, annual percentage change)	-17.4	11.0	10.0	6.0	4.7	1.8
Terms of trade (annual percentage change) 3/	8.0	7.3	2.2	-2.2	-1.9	-1.8
Current account balance (percent of GDP)	-4.0	-2.0	-2.3	-5.2	-5.8	-5.7
Capital and financial account balance (percent of GDP)	5.5	3.3	2.3	5.6	4.1	4.8
of which: Net portfolio investment (debt and equity)	3.9	2.8	-0.3	1.7	1.8	1.3
Other investment (loans, trade credits, etc.)	-0.7	-0.5	1.4	3.4	1.6	2.5
Net foreign direct investment	2.2	1.0	1.1	0.4	0.7	1.0
Gross international reserves (billions of U.S. dollars) 1/	39.7	43.8	48.9	50.7	49.6	48.7
in months of imports of goods and services 1/	5.9	5.2	4.8	5.0	5.0	5.0
in percent of broad money 1/	15.0	13.9	17.6	18.2	20.7	19.5
in percent of short-term debt, residual maturity 1/	136.8	145.8	151.6	133.2	130.2	123.8
Net international reserves (billions of U.S. dollars) 1/	39.0	43.4	47.9	47.9	45.5	43.1
Foreign currency forward position (billions of U.S. dollars) 1/	0.0	4.2	6.5	5.2	3.6	2.9
Total external debt (percent of GDP)	29.0	30.5	29.2	37.1	38.9	42.4
percent of export earnings	101.2	102.7	91.6	117.9	117.8	134.4
External interest payments (percent of export earnings)	3.7	2.8	2.4	3.0	3.1	3.4
External amortization payments (percent of export earnings)	11.3	9.7	10.1	11.2	11.1	12.4
Exchange rate (Rand/U.S. dollar, period average) 4/	8.4	7.3	7.3	8.2	9.7	10.8
Real effective exchange rate (annual percentage change, period average) 5/	9.0	15.5	3.3	-8.3	-12.7	-7.1
Financial market indicators						
Stock market index (end-period) 1/	23,324	28,509	31,848	35,262	42,057	49,723
Net purchases of bonds by nonresidents (billions of U.S. dollars) 6/	1.8	7.1	5.8	10.8	0.2	-4.0
Net purchases of shares by nonresidents (billions of U.S. dollars) 6/	8.9	5.0	-2.4	-0.4	0.0	2.5

Sources: Haver and Fund staff estimates and projections.

1/ For 2014, October data.
2/ Nominal yield adjusted deflated by current CPI inflation.
3/ The terms of trade include gold.
4/ For 2014, January through October average.
5/ For 2014, January through September average.
6/ For 2014, January through September data.

Annex I. The Authorities' Development Plans

- ***National Development Plan (NDP), 2012,*** (National Planning Commission, http://www.npconline.co.za/pebble.asp?relid=25) is the government's strategic plan. The NDP aims at creating 11 million jobs by 2030, and sets growth and investment targets to achieve it. It focuses on infrastructure, education/skill development, and better public service delivery to reach these goals, and emphasizes that South Africa requires both a capable and developmental state and "a vibrant and thriving private sector able to investment, employ people and penetrate global markets." It envisages "…professionalizing the public service, strengthening accountability, improving coordination, and prosecuting corruption" as means.

- ***Medium-Term Strategic Framework (MTSF), 2014,*** *(*Department of Planning, Monitoring and Evaluation, http://www.thepresidency-dpme.gov.za/Pages/default.aspx) is the government's framework to implement the NDP and the ANC's 2014 election manifesto over 2014–19.[1] The MTSF targets reducing unemployment to 14 percent and raising investment to 25 percent of GDP. In Minister Radebe's words, "The aim of the MTSF is to ensure policy coherence, alignment and coordination across government plans." It maintains the focus on public infrastructure and calls for increased dialogue between government and businesses. It aims at promoting SMEs and strengthening competition.

- ***Industrial Policy Action Plan (IPAP 2014/15, 6th annual edition)*** (Department of Trade and Industry, http://www.dti.gov.za/industrial_development/industrial_development.jsp), focuses on government intervention and trade policy to stimulate industrial development and diversify exports. It supports "beneficiation" of natural resources as a national industrialization program, and promotes creation of "decent work" and diversification of the economy through industrial policy. Identified sectors include textile, metal processing, automobile, agro-processing, business processing services etc.

- ***New Growth Path* (NGP, *2009)*** (Economic Development Department, http://www.economic.gov.za/communications/publications/new-growth-path-series), identifies key sectors to diversify and grow the economy and create "decent" jobs (5 million jobs by 2020). The NGP starts by identifying where employment creation is possible. The sectors identified are: infrastructure, the agricultural value chain, the mining value chain, the green economy, manufacturing sectors included in IPAP 2 (metal fabrication, machinery and equipments etc.), tourism, and certain high level services. It then analyses the policies and institutional developments required to take advantage of these opportunities. To that end, it combines macroeconomic and microeconomic interventions.

[1] The ANC manifesto (http://www.anc.org.za/2014/anc-manifesto/together-we-move-south-africa-forward/) states that achieving these goals requires "that we build a democratic developmental state capable of mobilizing all sectors and boldly intervening in the economy in favor of workers and the poor." Also, the manifesto states that "Within the NDP vision, critical policy instruments will continue to drive government's policy agenda," and these policy instruments include the NGP, the National Infrastructure Plan, and the IPAP."

Annex II. External Sector Assessment

	South Africa	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Gross external debt has increased to 42 percent of GDP in 2014:Q2 from near 25 percent in 2009, but short-term external debt (about 12 percent of GDP) remains manageable. About 55 percent of external debt is denominated in rand. Nevertheless, a sudden stop of portfolio inflows remains an important source of vulnerability. **Assessment**. The net IIP position (-6.1 percent of GDP in 2014:Q2) is relatively low and hence not a major source of risk, including because it improves with depreciation. However, gross liabilities (126 percent of GDP) are large and the IIP position is expected to deteriorate given the projected large current account (CA) deficits.	*The external position is weaker than implied by desirable policy settings and medium-term fundamentals.* Though it has started to adjust, the CA deficit continues to be elevated and mainly financed by non-FDI flows. The real depreciation should boost net exports, but structural problems are slowing the CA adjustment. Low saving relative to investment that is buoyed by large infrastructure projects implies substantial CA deficits over the medium term. In spite of a favorable maturity structure and currency denomination of external debt, gross external financing requirements are relatively high and vulnerabilities are elevated. A slowdown of capital inflows would complicate the financing of the CA deficit and, if severe, could induce a significant growth slowdown. **Potential policy responses** Implementation of the authorities' National Development Plan would help improve competitiveness over the medium term, but additional labor and
Current account	**Background.** The CA deficit is projected at 5.7 percent of GDP in 2014 (5.6 percent of GDP cyclically adjusted), compared to 5.8 percent of GDP in 2013, on the back of weak exports (partly due to strikes), resilient imports and softer terms of trade. Export and import volumes have started to adjust, reflecting lagged effects of the depreciation. However, South Africa's competitiveness problems and structural constraints hinder the CA adjustment. In addition, domestic demand has offered limited support to the external rebalancing. Low saving coupled with robust public infrastructure investment is expected to keep the CA deficit elevated over the medium term, notwithstanding the planned fiscal consolidation. **Assessment.** EBA estimates a CA norm of -2.4 percent of GDP and a gap of -3.2 percent of GDP for 2014. Staff assesses the CA to be 1½ to 3½ percentage points weaker than implied by medium-term fundamentals and desirable policy settings.[1]	
Real exchange rate	**Background.** Since end-2010, the CPI-based REER has depreciated 26 percent. The average for January-September 2014 is 15 percent below its 10 year average. In contrast, the ULC-based REER, which reflects differences in domestic costs of production more accurately, is near its 10-year average. While the EBA REER regression (which uses CPI-Based REER) estimates an undervaluation for 2014, other indicators, including the EBA CA gap estimate and South Africa's declining share of world's exports, continue pointing to overvaluation. **Assessment**. Considering the more reliable CA gap estimate, the staff assesses the REER as overvalued by 5-20 percent.[2] Gauging the appropriate exchange rate for South Africa is challenging due to its structural changes since 1994 and high REER volatility; in essence REER history provides little guidance.[3] Also, the sensitivity of trade flows to the exchange rate movements appears lower than implied by long-run elasticities—estimates of such elasticities are subject to high uncertainty due to structural changes. With substantial lags, the weaker rand has started reducing the CA deficit, but structural factors will likely keep the external position weaker than justified by fundamentals and desired policies over the medium term. Hence the exchange rate is still deemed overvalued, but the extent of overvaluation is difficult to pinpoint.	

Capital and financial account: flows and policy measures	**Background.** FDI is lower than in most of South Africa's peers, while portfolio and other investment flows, particularly foreign purchases of local currency government bonds, have accounted for most of the financing of the CA deficit. In 2013 and in the first half of 2014, unrecorded transactions financed a substantial part of the current account deficit. **Assessment.** The risks posed by the reliance on non-FDI flows and nonresident financial holdings are significant but mitigated by the floating exchange rate, the fact that the portfolio inflows go into long-term local currency bonds and equities, the large share of index-tracking investors, and the large domestic institutional investor base. Nevertheless, a sharp slowdown or sudden stop of capital inflows would complicate the financing of the external deficit, possibly prompting a disorderly adjustment.	product market reforms that increase competition and bring domestic costs in line with productivity growth are essential. The planned fiscal consolidation and modest monetary tightening are expected to alleviate external vulnerabilities. As financing conditions allow, a build-up of reserves would strengthen the country's ability to deal with FX liquidity shocks. Increasing household saving will require faster growth in household incomes through much faster employment growth, which in turn requires structural reforms.
FX intervention and reserves	**Background**. South Africa's exchange rate regime is one of the most flexible among EMs. Intervention is rare. Reserves cover five months of imports (close to 80 percent of gross external financing needs), but are expected to remain slightly below the lower bound of the IMF's composite adequacy metric. Gold reserves account for about 10 percent of reserves. **Assessment**. As financing conditions allow, reserve accumulation is desirable.	
Technical background notes	[1] The CA gap presented here results from the CA regression approach and the External Sustainability (ES) approach. The ES approach compares the CA balance expected to prevail in the medium term with the one that would stabilize South Africa's stock of net foreign assets at its peers' benchmark. According to this approach, to stabilize South Africa's NFA at the peers' level, South Africa's CA deficit would need to be less than 2 percent of GDP, compared to staff's projection of a CA deficit between 4 and 5 percent of GDP over the medium term. The CA regression approach yields a gap for 2014 of 3.2 percent of GDP. Hence, the staff's gap range is centered on -2½ percent of GDP. [2] Using the CA gap range and applying a long-run elasticity would suggest an REER overvaluation of about 10-20 percent. Considering the uncertainty regarding the elasticity and the possibility that it may be lower, but also the fact that CA has started to adjust and hence some deficit reduction is in the pipeline, the range here is 5-20 percent. [3] The history of South Africa's REER divides roughly into two periods and levels: before 2000 the average level was much higher than the post-2000 average. Moreover the REER has fallen steeply over the last several years. In this context, REER regression-based models such as EBA that use CPI-based REERs are very likely to point to current undervaluation, unless they can link the full downward trend of the REER to deteriorating fundamentals. It appears that the level of the REER that is consistent with a given level of the current account has declined over time, but empirical models are unable to explain this shift.	

Annex III. Main Findings of the 2014 Financial System Stability Assessment and its Macro-Financial Linkages[1]

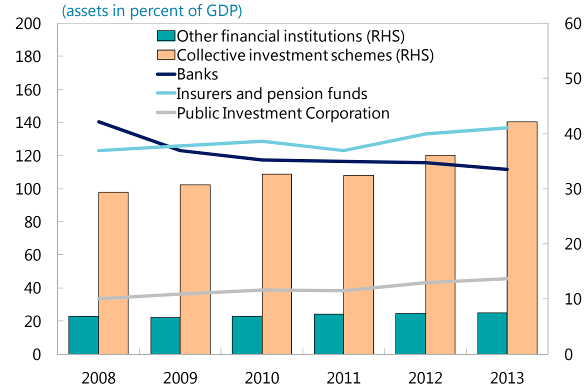
The IMF 2014 FSSA concludes that financial sector risks and vulnerabilities are elevated but manageable. South Africa's financial system operates in a challenging economic environment, characterized by low growth, high unemployment, and elevated twin deficits. Banks' high reliance on wholesale funding and large derivatives markets, combined with elevated external vulnerability, make South Africa susceptible to contagion and sudden stops of capital flows. Nevertheless, relatively high capital buffers, sound regulation and supervision, and capital controls on non-bank financial institutions (NBFIs) mean risks are currently manageable. This annex provides an overview of the FSSA assessment of financial sector risks and how they interact with the broader economy.

A. Financial Industry Structure

South Africa's financial sector is large and highly concentrated. Financial sector assets amount to about 300 percent of GDP. The top five banks hold 90 percent of assets, the top five insurers account for 74 percent of the long-term insurance market, and the seven largest fund managers control 60 percent of unit trust assets. This concentrated structure enables major financial institutions to achieve returns on equity and assets higher than in more competitive economies. The existing legal framework limits entry, particularly in the banking sector: the minimum capital requirements for banks are between 4 and 100 times higher than in EM countries. Also, access to clearance and payments systems and regulatory and supervisory gaps favor incumbents. Certain bank charges have been reduced and pricing has become more transparent since the Competition Commission's 2008 Banking Enquiry, but more competition among financial institutions could result in a greater supply of financial services at lower intermediation costs, especially for SMEs and lower income households.

Financial Structure

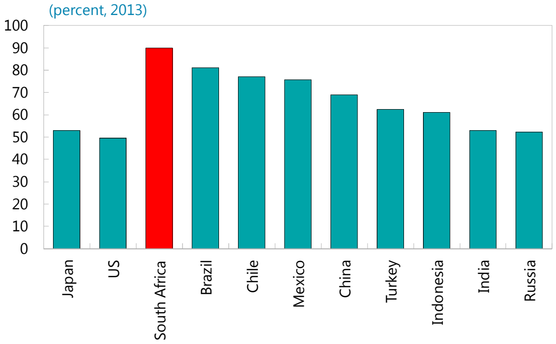
(assets in percent of GDP)



Sources: SARB and IMF staff calculations

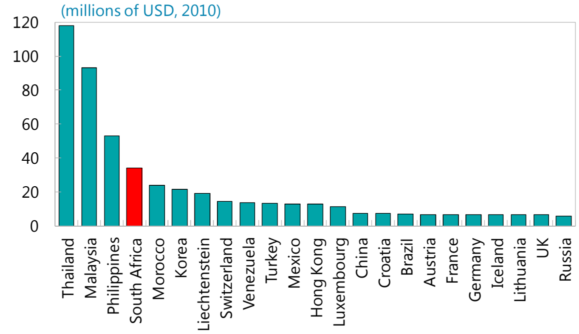
[1] This annex draws mainly on the 2014 Financial System Stability Assessment (FSSA).

5-Bank Asset Concentration Ratio[1]
(percent, 2013)



Sources: Bankscope and IMF staff calculations.
[1] Assets of five largest banks as a share of total commercial banking assets.

Minimum Capital Required to Set Up a Bank in the Country
(millions of USD, 2010)

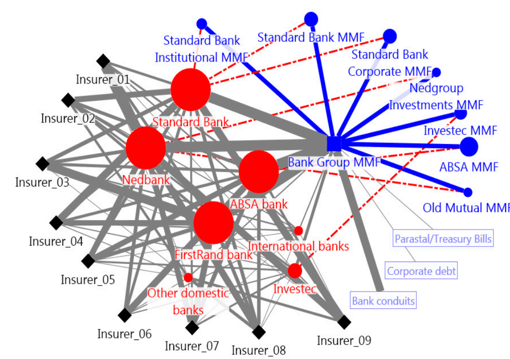


Sources: World Bank: Bank Supervision and Regulation Survey, and national authorities

B. Interconnectedness

South Africa's financial system is also highly interconnected. All major banks are affiliated with insurance companies that underwrite a substantial proportion of private pension assets, and some banks own asset management companies that offer money market funds and provide the bulk of banks' wholesale funding together with other NBFIs. This exposes NBFIs to significant counterparty risks and banks to liquidity risks. There are substantial levels of related party transactions within financial groups.

A Highly Interconnected Financial System

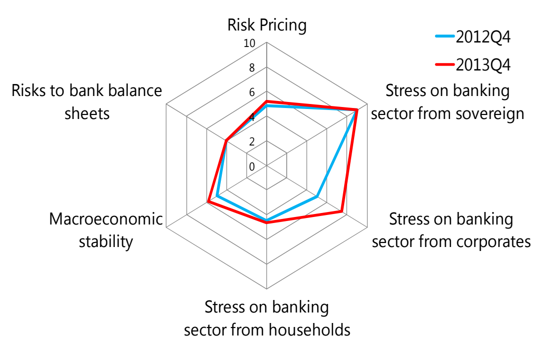


Source: 2014 South Africa FSSA

C. Credit Risk

Owing to elevated households' indebtedness and banks' large exposure to households, the main source of credit risk is banks' retail portfolios, despite the recent increase stemming from corporates, which overall continue to have robust balance sheets and profitability. FSSA stress tests conclude that banks and insurance companies are resilient to severe shocks, reflecting relatively high capital (Tier 1 capital 13.5 percent in June 2014.)

Banks' Credit Risks

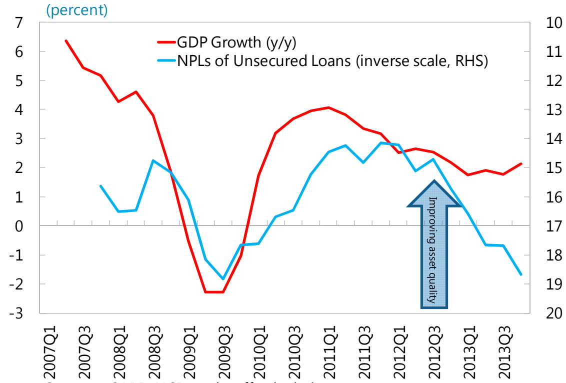


Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Though nonperforming loan (NPL) ratios are still falling (3.5 percent in June 2014 from 3.6 percent in December 2013), the fall is mainly because banks continue to clear up poor mortgage portfolios from 2006-08 and resulting from the top 5 banks. However, NPLs of unsecured credit have increased significantly and so have the NPLs of smaller banks.[2] In South Africa, it appears that NPLs of unsecured credit start increasing sooner than NPL on mortgages.

GDP Growth and NPLs of Unsecured Lending

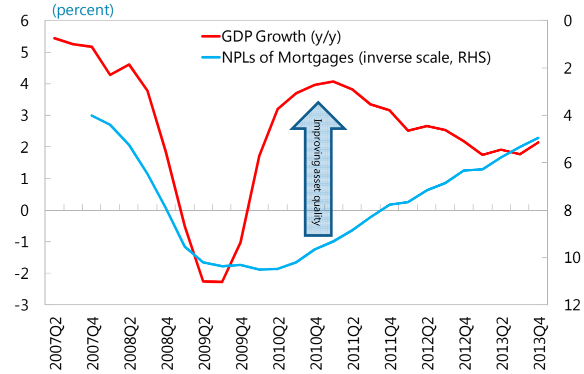
(percent)



Sources: SARB, NCR, and staff calculations

GDP Growth and NPLs of Mortgages

(percent)



Sources: SARB, NCR, and staff calculations

Simple regressions confirm that NPL ratios of mortgages and unsecured credit are positively related with the policy rate and unemployment, while inversely correlated with GDP growth and employee compensation. Policy rates increases have a significant impact on the asset quality of mortgages, but not on unsecured credit, likely because the interest rate on unsecured credit is capped by regulation, though high.

Hence, protracted low growth and higher interest rates could lead to a deterioration in asset quality, especially from highly-indebted households. SMEs are also relatively more susceptible to tighter financial conditions and downturns than larger firms, as their profitability is typically weaker. Tighter financial conditions, in turn, have a significant impact on activity, creating a negative feedback loop.[3]

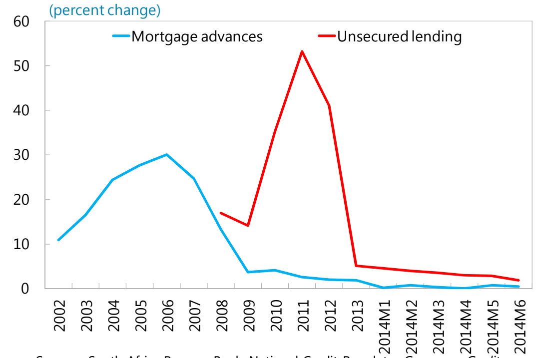
Households

Leverage, especially among low and middle-income households, increased significantly in the run-up to the global financial crisis, and remains high historically and compared to other EMs. In the 2000s, mortgage lending grew substantially, followed by a rapid expansion of unsecured lending. The share of households with impaired records has increased to nearly half. African bank, a small bank specializing in unsecured lending, was placed under curatorship in August 2014 after reporting record losses. Also, 48 percent of new mortgages, and 35 percent of mortgages outstanding, have loan-to-value (LTV) ratios above 80 percent, leaving banks with a relatively small collateral buffers.

[2] See SARB Financial Stability Review, September 2014.

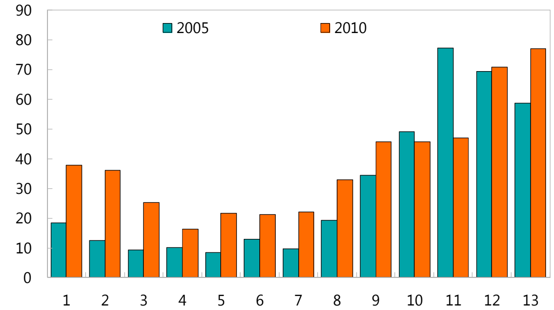
[3] Mu, Y. and Y. Wu, (2014), "The Impact of Tighter Financial Conditions on the South African Economy", South Africa 2014 Article IV Selected Issues.

South Africa: Domestic Credit Growth
(percent change)



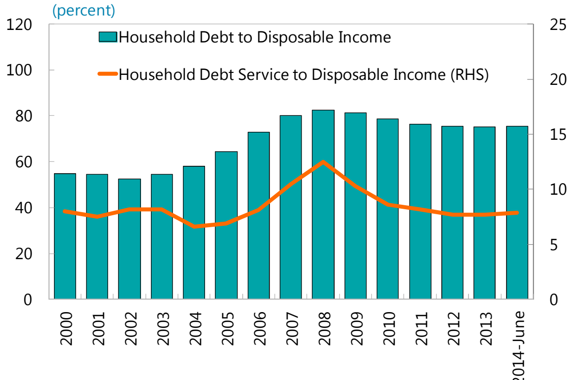
Sources: South Africa Reserve Bank, National Credit Regulator *Consumer Credit Market Report*.

Debt to Income Ratios by Income Groups
(percent)



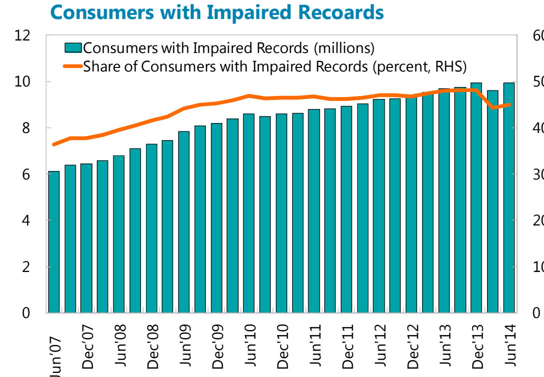
Source: South Africa StatsSA Household Surveys
Note: X-Axis is income groups from low to high.

Household Financial Obligations
(percent)



Sources: National Credit Regulator and IMF staff calculations

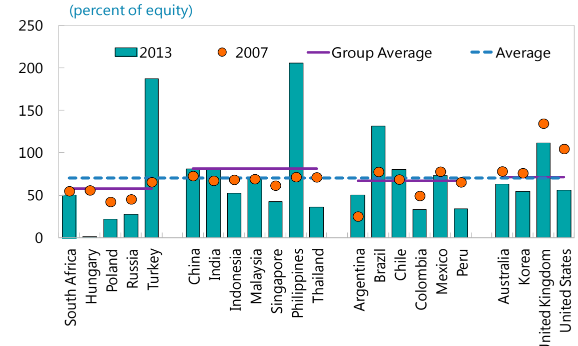
Consumers with Impaired Recoards



Sources: National Credit Regulator and IMF staff calculations

However, mitigating factors include the fact that high-income households, who hold sizable assets, account for 95 percent of mortgages (which are mostly at floating rates), while unsecured loans to households (mostly at fixed rates) were 11.7 per cent of the total gross credit exposure of the banking sector as of January 2014. [4]

Debt
(percent of equity)



Sources: Corporate Vulnerability Utility and staff calculations

Corporates

Overall corporate leverage is low by international comparisons. Though return on assets and interest coverage ratio (ICR) have recently declined, profitability is still healthy, partly because large firms typically benefit from significant market power. Corporate debt to equity at 48 percent is low.

However, a few state-owned enterprises (SOEs) have significantly increased their leverage (much of it in foreign currency) mainly to fund large infrastructure projects. Contingent liabilities from SOEs

[4] Unsecured loans are defined as the SARB's unsecured lending to retail counterparties, which includes credit cards, overdrafts, personal loans and financing provided to small and medium enterprises (SMEs) in the retail sector (SARB Financial Stability Review, March 2014).

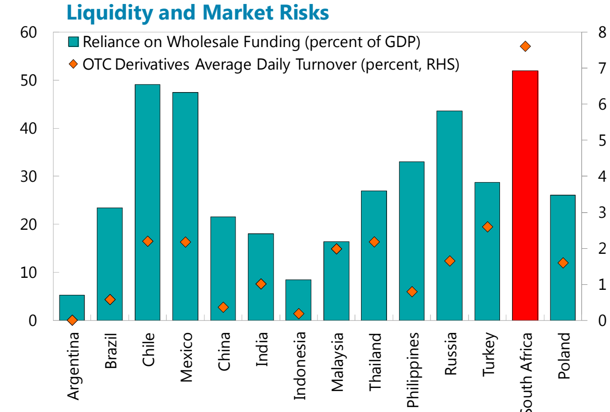
constitute a fiscal risk that could weigh on the sovereign's creditworthiness with spillovers to all South African borrowers, including financial institutions. Other fiscal risks are also considerable and would similarly have adverse feedback loop effects on the financial system.

The FSSA corporate stress tests suggest that borrowing cost increases and earning declines would have a significant impact on SOEs' debt-servicing capacity, while private firms would fare reasonably well. While all SOEs are required to hedge their currency, interest rate, and commodity price risks, tighter financial conditions could increase their cost of funding and hedging. Nevertheless, the risks from SOEs to the whole corporate sector remain contained as private firms account for over two thirds of the South African corporate sector (86 percent of total corporate sector assets).

D. Liquidity and Market Risks

Wholesale funding—mostly short-term and from domestic NBFIs—accounts for about 50 percent of total. This, together with relatively high loan to deposit ratio (127 percent), makes it challenging for South African banks to meet Basel III liquidity requirements, especially the net stable funding ratio. However, these risks are mitigated by NBFIs' large assets under management (about 200 percent of GDP), capital controls on residents, NBFIs' historically stable bank deposits, and the SARB's Committed Liquidity Facility.

Liquidity and Market Risks



Sources: 2014 October GFSR and staff calculations

South Africa's external vulnerability exposes it to surges of global financial market volatility, though the flexible exchange rate and external debt mainly denominated in rand are important mitigating factors. Sizable foreign holdings (about a third) in deep local capital markets (345 percent of GDP capitalization), a deep over-the-counter (OTC) derivatives market (notional value of about 9 times GDP), and the rand being used as an EM proxy are key conduits for global risks. Although banks' net FX positions are small and banks themselves do not rely heavily on external funding, sharply higher global risk aversion could spillover to domestic markets and push banks' funding and hedging costs higher. Banks are also exposed indirectly to shocks that affect NBFIs' asset values, especially a decline in equity prices, as equities account for over half of their portfolios.

The FSAA concludes that despite high short-term liabilities, the impact of higher interest rates on banks' capital ratios is modest, as the majority of the loans are at floating rates. However, the impact would be felt indirectly via deteriorating asset quality.

E. Supervision and Regulation

Regulation and supervision of banks and insurance are overall sound. The South African Reserve Bank is a proactive supervisor, with a high level of compliance with international standards on effective banking supervision. Insurance companies are also well regulated. Collective investment schemes, which have grown rapidly in recent years, are lightly regulated. The authorities are in the process of carrying out a major reform of the regulatory architecture, based on a twin peaks model.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 17, 2014

Prepared By

The African Department
(In collaboration with other departments and the World Bank)

CONTENTS

RELATIONS WITH THE IMF

As of October 31, 2014

Membership Status

Joined: December 27, 1945

Accepted the obligations of Article VII Sections 2, 3, and 4 of the IMF's Articles of Agreement on September 15, 1973.

General Resources Account	**SDR Million**	**%Quota**
Quota	1,868.50	100.00
IMF holdings of currency (Exchange Rate)	1,782.79	95.41
Reserve Tranche Position	85.71	4.59
Lending to the Fund		
New Arrangements to Borrow	45.22	

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,785.42	100.00
Holdings	1,788.19	100.16

Outstanding Purchases and Loans None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov 03, 1982	Dec 31, 1983	364.00	159.00
Stand-By	Aug 06, 1976	Aug 05, 1977	152.00	152.00
Stand-By	Jan 21, 1976	Aug 06, 1976	80.00	80.00

Projected Payments to the IMF

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/interest		0.01	0.01	0.01	0.01
Total		0.01	0.01	0.01	0.01

South Africa has consented to the quota increase under the 14th General Review of Quotas which will essentially double the IMF's quota resources, once effective. South Africa also accepted the proposed amendment to reform the Executive Board. The quota increases will become effective once the proposed amendment to reform the Executive Board enter into force, which occurs once the Fund certifies that three-fifths of the IMF members (i.e., 113 members out of the currently 188) having 85 percent of the total voting power have accepted the proposed amendment.[1] South Africa's quota under the 14th General Review will increase to SDR 3,051.2 million (R 38.6 billion).

In September 2010, South Africa also agreed to lend the IMF up to SDR 340 million (R 4.3 billion) under the New Arrangements to Borrow (NAB). The NAB is a set of credit arrangements the IMF has with 40 member countries and/or its institutions. Currently 37 of these arrangements are active and thus can be drawn by the IMF to supplement its quota resources for lending purposes. South Africa is paid interest on its loans to the IMF under the NAB based on the SDR interest rate. As of end-May, South Africa had lent SDR 41.2 million (R 570.8 million) to the IMF under the NAB.

In 2012, the South African pledged $2 billion (R16.8 billion) to boost IMF resources, as part of a global drive to help strengthen global economic and financial stability. Subsequently, a bilateral borrowing agreement between the South African Reserve Bank (SARB) and the IMF has been approved by the IMF's Executive Board.

Exchange rate arrangement

The rand floats against other currencies, and South Africa maintains an exchange system consistent with South Africa's obligations under Article VIII of the IMF's Articles of Agreement.[2] South Africa's de jure exchange rate arrangement is free floating, and the de facto arrangement is floating. Its exchange system is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions. South Africa has continued to gradually liberalize the system of capital controls in place since the apartheid regime.

With the abolition of the financial rand in 1995, all exchange controls on nonresidents were eliminated. Nonresidents are free to purchase shares, bonds, and other assets and to repatriate dividends, interest receipts, and current and capital profits, as well as the original investment capital. Foreign companies, African governments, and institutions may list equity and debt instruments on South Africa's securities exchanges.

[1] The two additional conditions for the proposed quota increases to become effective have already been met, i.e., the entry into force of the Voice and Participation Amendment of the Fund's Articles of Agreement and the consent of members having not less than 70 percent of the total quotas (as of November 5, 2010) to the increase in their quotas.

[2] South Africa accepted the Article VIII, Section 2(a), 3, and 4 obligations in 1973.

Box 1. Liberalization of Capital Controls on Residents (Selected Measures)

October 2009—The authorities (i) raised the lifetime limit on individuals investment offshore to R4 million from R2 million a year and (ii) increased the single discretionary allowance to R750,000 from R500,000.

March 2010—Authorised dealers were allowed to acquire direct and indirect foreign exposure up to a macroprudential limit of 25 percent of their total liabilities, excluding total shareholder's equity.

October 2010—Authorities (i) eliminated the 10 percent levy on the capital South Africans can transfer upon emigration, (ii) raised the limit on offshore investments by individuals to R4 million a year from R4 million in a lifetime, and (iii) raised the single discretionary allowance to R1 million from R750,000.

December 2010—Limits that resident institutional investors can invest offshore were raised by 5 percentage points, and now range from 25 to 35 percent of their retail assets depending on the type of institutional investor.

January 2011—Authorities allowed qualifying international headquarter companies, subject to approved registration with the Financial Surveillance Department of the South African Reserve Bank, to raise and deploy capital offshore without exchange control approval.

October 2011—Authorities (i) removed the restriction on foreign participation in the ownership of money remittance businesses and the requirement to partner with an existing authorized dealer to conduct money remittance business; (ii) approved criteria for consideration of individual foreign investments above R4 million; (iii) announced that all inward-listed shares traded and settled in rand on the Johannesburg Stock Exchange will be regarded as domestic assets; (iv) permitted South African companies to make bona fide new outward foreign direct investments, outside their current line of business, allowing them to diversify their offshore operations from a domestic base; (v) withdrew the prohibition on the transfer of additional working capital for investments below R500 million per applicant company, per calendar year; (vi) allowed South African companies to acquire from 10 to 20 percent equity and/or voting rights, whichever is higher, in a foreign target entity, which may hold investments and/or make loans into any Common Monetary Area (CMA) country; (vii) allowed residents (natural persons) to transfer up to R1 million abroad, as part of the single discretionary allowance, for investment purposes, without the requirement to obtain a tax clearance certificate.

February 2013—South African multinationals were allowed to treat a local subsidiary as a nonresident company for exchange control purposes to encourage retaining treasury operations in South Africa. Authorized dealers were also allowed to invest an additional five percent of their total liabilities, excluding total shareholder’s equity, for expansion into Africa, in addition to the current macro-prudential limit on foreign exchange of 25 per cent.

February 2014—Unlisted technology, media, telecommunications, exploration, and other research and development companies may raise foreign funds for their operations upon approval. (ii) JSE-listed companies may have a secondary listing and/or list depository receipt programs on foreign exchanges to facilitate local and offshore FDI expansion and may authorize transfers from the parent company to the HoldCo up to R 2 billion a calendar year. (iii) Unlisted entities may establish one HoldCo for African and offshore operations, without subjecting to exchange control restrictions.

Exchange controls on capital transactions by residents have been gradually relaxed. The authorities' main objective has been to move toward a system based on prudential limits and supervision, and away from a rigid system of quantitative controls. Box 1 above summarizes recent measures.

Article IV consultation

The 2013 Article IV consultation was concluded by the Executive Board on July 31, 2013. South Africa is on the standard 12-month Article IV consultation cycle.

Technical assistance

An IMF Fiscal Affairs Department (FAD) mission took place in December 2010 to support capacity for fiscal policy analysis in the Treasury's Fiscal Policy Unit (FPU). In July 2011, senior FPU staff visited the IMF's headquarters to discuss international experience with fiscal rules. In March 2012, an FAD team visited Pretoria to discuss room for further improvement in South Africa's strong budget institutions. In November 2012, an FAD-arranged mission by two external experts visited Pretoria to discuss the forthcoming Long-term Fiscal Report, and in April 2013, a TA mission visited Cape Town to support the authorities in the establishment of a new Parliamentary Budget Office (PBO).

An FAD mission visited Pretoria In August 2013 to discuss options for the National Treasury to strengthen their performance management systems. In December 2013, the National Treasury and FAD held a joint workshop on fiscal risks. In June 2014, FAD missions provided advice on expenditure reviews and on options for further strengthening the PBO, while a mission visited the South African Revenue Service (SARS) to conduct a pilot of the Tax Administration Diagnostic Assessment Tool (TADAT). A FAD mission on VAT gaps took place in August 2014.

In March 2011, an STA mission took place to conduct the training on the Coordinated Direct Investment Survey for Anglophone Africa in Pretoria.

In May 2014, an MCM mission took place to conduct the training on banking sector stress test for the SARB.

A number of IMF Legal Department (LEG) missions in 2007–09 assisted the authorities in the ongoing process of rewriting the Income Tax Act and drafting a new Tax Administration Act. The recent LEG mission took place in November 2008, and a report on this mission was completed in late 2009. LEG has submitted comments on the Tax Administration Act to the authorities by email.

THE JMAP WORLD BANK IMF MATRIX

The IMF South Africa team led by Ms. Laura Papi (mission chief) met with the World Bank South Africa team led by Mr. Asad Alam (country director) on September 22, 2014, to discuss macrocritical structural issues and to coordinate the two teams' work for October 2014–September 2015.

The teams agreed that South Africa's macroeconomic challenges include promoting job creation and improving the long-run inclusive growth needed for maintaining social cohesion. In addition, they noted the increased vulnerabilities, especially external, that pose risks to macroeconomic stability.

Based on this shared assessment, the IMF and the World Bank agreed to support the authorities' efforts on the following macrocritical fronts with these specific actions:

- **Fiscal sustainability:** The IMF will continue its engagement with the authorities on South Africa's long-term fiscal challenges and risks as part of the surveillance dialogue. The debt sustainability analysis is being done according to the new guidelines, which focus on risk-based analysis. The IMF will provide advice on managing fiscal risks, and stands ready to share work by FAD on health care reform and seek opportunities, such as workshops with the authorities, to discuss options for the design of reforms in this area and will continue to inform the authorities of best practices from other countries in terms of modeling the implications of health and social security reforms.

- **Improvements in the composition of public spending**: The World Bank is providing technical assistance for ongoing efforts to strengthen government-wide monitoring and evaluation systems and has conducted a public expenditure tracking survey for health-related spending in the province of Kwa-Zulu Natal.

- **Debt and foreign exchange management:** Partnering with the South African Reserve Bank (SARB), the World Bank has been supporting efforts in the area of the foreign currency reserves management (including enhancement of SARB's governance and risk management frameworks as well as its investment operations and systems infrastructure), and by supporting the National Treasury in preparing the debt management strategy, reviewing strategic benchmarks and improving the secondary debt market architecture. Also, a new partnership with the Public Investment Corporation (PIC), which manages public assets, will focus on strengthening all aspects of investment operations and infrastructure

- **Strengthened public infrastructure:** The Eskom Investment Support Project ($3.75 billion IBRD loan) and the Eskom Renewable Energy Support Project ($250 Clean Technology Fund), both being implemented by the World Bank, support the expansion of electricity supply and help South Africa accelerate development of renewable energy generation capacity.

- **Product market reforms:** The World Bank supports ongoing dialogue on rural development and land reform through reimbursable advisory services aiming to address some of the unique challenges of the country such as accelerating land reform, exploring effective model to support land reform and smallholder agriculture, and promote nonfarm rural enterprises development for job opportunities and social equity.

- **Tackling high inequality:** Recognizing South Africa's exceptionally high levels of exclusion, the World Bank has just completed a report on the township economy in South Africa. Poor education outcomes have been flagged as key determinant hampering inclusive growth, and the World Bank is currently engaging with the Department of Basic Education to strengthen the annual national assessments in order to improve teaching and learning in schools. Additionally, vocational training, particularly for low-income youths, is a strategic priority for the IFC in Sub-Saharan Africa. It will explore the possibility of supporting private sector for- and nonprofit technical education in South Africa, with the aim of: (i) increasing employment opportunities; (ii) raising the productivity of South African firms; and (iii) improving income distribution, given the significant returns to education in the country. In the 6th Economic Update on South Africa due to be released November 4, the World Bank has assessed the impact of various taxes and social spending on measures poverty and inequality rates, fiscal policy on poverty and inequality.

- **Financial sector stability and inclusion:** The IMF concluded the Financial Sector Stability Assessment. At the request of the National Treasury and SARB, the World Bank is reviewing South Africa's contingency planning and crisis management framework, assessing the institutional set-up of financial sector supervision, and carrying out a Review of Standards and Codes (RoSC) on Insolvency and Creditor Rights. The Bank is also working with an interministerial working group that is assessing strategic priorities for financial inclusion. The World Bank is preparing a US$100 million financial intermediation loan to the Land Bank of South Africa in support of wholesale financing targeting emerging black farmers. A World Bank study will address the poverty and social impact of mobile financial services in Southern Africa.

- **Private investment program:** Promotion of private investment and job creation is at the top of the government agenda, and activities by the IBRD, IFC and MIGA will remain central to this program. The IBRD will continue its support for economic diversification and micro, small and medium enterprise (MSME) development, including technical assistance to the Department of Trade and Industry in promoting MSME development in poorer regions, as well support for enhancement of policies aiming at improving Research and Development efficiency. The IFC's strategy in South Africa will remain focused on innovation, job creation, and poverty reduction by: (i) supporting South African companies "going north" and "going global"; (ii) providing advice and financing in underserved niches of the South African market where IFC can add value; (iii) providing technical assistance and related support for small business, with a focus on the informal sector and education; and (iv) supporting the development of renewable energy and energy efficiency projects.

The teams have the following requests for information from their counterparts:

- The IMF team asks to be kept informed of progress in the macrocritical structural reform areas under the World Bank's purview. Timing: when milestones are reached or in the context of missions (and at least semiannually).
- The World Bank team asks to be kept informed of progress in the macrocritical structural reform areas under the IMF's purview. Timing: when milestones are reached (and at least semiannually).

Table 1 lists the teams' separate and joint work programs during October 2014–Septebmer 2015.

STATISTICAL ISSUES

Data provided to the IMF are adequate for surveillance. South Africa subscribed to the Special Data Dissemination Standard (SDDS) on August 2, 1996, and is in observance of specifications for coverage, periodicity, and timeliness of data, although using a flexibility option on the timeliness and periodicity of unemployment data. A Report on Observance of Standards and Codes—Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) was published on October 16, 2001.

Real sector statistics

The national accounts are compiled according to the SNA 1993. In 2009, the base year of the national accounts was changed from 2000 to 2005. At the same time, benchmarking was undertaken to reflect more accurately the structure of the economy and to introduce other methodological changes to the compilation of data. Reporting of real sector data for International Financial Statistics (IFS) is timely. Statistics South Africa and the SARB are in the process of compiling GDP data according to SNA2008, with a new base year of 2010. The new GDP data from the production and income approaches are expected to be published on November 25, 2014.

Quarterly labor market statistics are published one month after the end of the previous quarter. Given the seriousness of the unemployment problem, labor market analysis and policy design would benefit from better and more frequent labor market data. A new quarterly Labor Force Survey has been conducted since January 2008.

The consumer price index (CPI) covers all households living in metropolitan and urban areas, which represent approximately 61 percent of the total number of households based on the 2010/11 Income and Expenditure Survey . The current CPI weights were derived primarily from Stats SA's household expenditure survey. Current price indices, which were rebased to December 2012=100, are calculated according to these weights. These indices form the basis for calculating the year-on-year changes in the CPI for 2013 and the month-on-month change between January 2013 and December 2012. The historical rates of inflation are not revised backward.

Government finance statistics

Data for the Government Finance Statistics Yearbook and IFS are compiled and disseminated according to the Government Finance Statistics Manual 2001 framework. Data for social security funds and central government's extra budgetary funds have been reported on an accrual basis, starting in 2000 and 2002, respectively. Starting in 2005, the authorities have included additional noncash data for other levels of government, consistent with their migration to accrual reporting. South Africa currently reports data for the consolidated general government for publication in the Government Finance Statistics Yearbook. It also reports monthly data covering the cash operations of the budgetary central government for publication in IFS.

Monetary statistics

Monetary statistics compiled by the SARB are consistent with the methodology of the Monetary and Financial Statistics Manual. South Africa reports regular and good quality monetary statistics for publication in the IFS, although there is room for improving the timeliness of the data on other financial corporations.

Balance of payments statistics

Balance of payments data are broadly consistent with the fifth edition of the Balance of Payments Manual (BPM5). The authorities have improved the coverage of trade flows within the Southern African Customs Union (SACU) in late 2013. Data reported to Direction of Trade Statistics still differ from external trade data reported to IFS. The authorities plan to release the balance of payments and international investment position data in BPM6 format at the end of 2014.

Data on the international reserves position are disseminated in line with the requirements of the IMF's template on international reserves and foreign currency liquidity. In late 2014 the authorities started to report quarterly data on the international investment position.

Work is ongoing to improve the reliability and accuracy of balance of payments data, with the aim of reducing errors and omissions. It would also be useful to disseminate a detailed breakdown of financial account data pertaining to other investment assets and liabilities.

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, October 2014–September 2015			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date**
1. Bank Work Program	▪ $3.75b IBRD Eskom operation	*Note*: missions are ad hoc but generally occur twice a year.	Ongoing
	▪ Ongoing $250m CTF renewable (solar and wind) operation		Ongoing
	▪ Renewable Energy Market Transformation Project (GEF) $6.0m		Ongoing
	▪ Carbon Capture and Storage Development TA, US$14 million		Ongoing
	▪ Land Bank Financial Intermediation Loan (US$100m)		Due to Board in March 2015
	▪ Cities Support Program Reimbursable Advisory Services (RAS)		Ongoing
	▪ Rural Development and land reform Reimbursable Advisory Services (RAS)		Ongoing
	▪ PFM dialogue		Ongoing
	▪ Economics of Township Report		Recently Completed
	▪ Economic Updates		Semiannual
	▪ National Health Insurance TA		Ongoing (Knowledge Hub)
	▪ TB and HIV/AIDS Program		Ongoing (Knowledge Hub)
	▪ PETS-QSDS in Gauteng Province		2015
	▪ Financial sector stability, including financial inclusion dialogue		Ongoing
	▪ South Africa Regulatory Reform		2014
	▪ Supporting policies aimed at improving R&D efficiency (TA)		2014
	▪ Study on potential of and constraints to private sector development in less developed regions in South Africa		Recently Completed
	▪ Economic Diversification and MSME Development		2015
	▪ Monitoring and Evaluation technical assistance		2015
	▪ TA on helping the NT and the relevant stakeholders decide on how to improve the secondary market architecture		Ongoing

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, October 2014–September 2015 (concluded)

Title	Products	Provisional Timing of Missions	Expected Delivery Date
	▪ TA supporting the revision of the strategic benchmarks by the NT based on cost and risk analysis through an analytical tool to be developed		Ongoing
	▪ Technical advisory services with the SARB and GEPF/PIC on the management of the official foreign currency reserves and the pension assets respectively		Ongoing
	▪ Basic Education – Learning Assessment		Ongoing
	▪ Private Investment Program		Ongoing
2. IMF Work Program	▪ Staff visit	May 2015 (tentative)	n.a.
3. Joint products in the next 12 months	No joint products planned at this time		

Table 2. South Africa: Table of Common Indicators Required for Surveillance (as of October 29, 2014)

	Date of Latest Observation	Date Received[10]	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange rates	10/29/14	10/29/14	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[1]	9/14	10/29/14	M	M	M		
Reserve/base money	9/14	10/9/14	M	M	M	O, O, LO, O	LO, O, O, O
Broad money	9/14	11/7/14	M	M	M		
Central bank balance sheet	9/14	10/9/14	M	M	M		
Consolidated balance sheet of the banking system	9/14	11/7/14	M	M	M		
Interest rates[2]	10/29/14	10/29/14	D	D	D		
Consumer Price Index	9/14	10/22/14	M	M	M	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	FY13/14	10/22/14	Y	Y	Y	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of financing[3]–central government	9/14	10/30/14	M	M	M		
Stocks of central government and central government-guaranteed debt[5]	6/14	9/9/14	M	Q	Q		
External current account balance	Q2 2014	9/9/14	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and imports of goods and services[6]	9/14	10/31/14	M	M	M		
GDP/GNP	Q2 2014	8/28/14	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross external debt	Q2 2014	10/13/14	Q	Q	Q		
International investment position	Q2 2014	10/13/14	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Monthly data for goods. Goods and services are published quarterly on the same schedule as the rest of the balance of payments.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC (October 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.

[10] Reflects the latest information released by the IMF Statistics Department by 11/07/2014.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

November 17, 2014

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Prepared by the Staff Representatives for the 2014 Article IV Consultation with South Africa

The increase in government debt to 46 percent of GDP in FY2013/14 from 27 percent of GDP in FY2008/09 has raised fiscal risks. Recognizing this fact, the 2014 Medium-Term Budget Policy Statement (MTBPS) announced a package of fiscal measures aimed at narrowing the deficit and stabilizing debt. Notwithstanding these measures, this debt sustainability analysis (DSA) suggest that the debt ratio may continue to rise over the projection horizon, albeit more slowly than in recent years. Also, further negative shocks represent a significant risk to the debt and financing outlook. In particular, a realization of contingent liabilities from state-owned enterprises (SOEs) could push debt above the DSA 70 percent of GDP high-risk threshold, and the debt-to-GDP ratio could exceed 60 percent if the economy were buffeted by a permanent growth or combined macro-fiscal shock. In addition, South Africa's gross financing need are projected to remain elevated and exceed the high risk 15 percent of GDP threshold under several of the shock scenarios considered in the analysis. Risks to the fiscal outlook have increased since the 2013 Article IV consultation, but South Africa's public debt remains sustainable under staff's baseline as the fiscal package announced in the 2014 MTBPS is expected to mitigate some of these risks and the maturity and currency composition of South Africa's debt is favorable.

PUBLIC DEBT SUSTAINABILITY ANALYSIS[1]

1. **Macroeconomic assumptions.** Real GDP growth is projected at 1.4 percent in 2014 but is expected to increase to 2.1 percent in 2015 and 2.5 percent in 2016 as a result of some normalization in labor relations and easing supply constraints. Over the medium term, growth is projected at around 2.8 percent. The GDP deflator is expected to average around 5½ percent, consistent with CPI inflation close to the upper range of the South Africa Reserve Bank's (SARB) 3–6 percent target range.

2. **Fiscal assumptions.** The FY2014/15 national government primary fiscal deficit is projected to deteriorate to 2 percent from 1.8 percent in FY2013/14 as growth continues to disappoint. The package of revenue and expenditure measures outlined in the 2014 MTBPS is expected to result in a gradual narrowing of the primary deficit over the medium term. The amount of consolidation is, however, not expected to be sufficient to stabilize the debt-to-GDP ratio, which is projected to rise to 57 percent of GDP by 2019. Consistent with the MTBPS, the projections include stock-flow adjustments to capture the practice of paying interest on bonds at the coupon rather than the market interest rate as well as valuation effects on inflation-linked and FX bonds. The projections do not assume any additional fiscal measures that the 2014 MTBPS has signaled could be considered if necessary to achieve the government's fiscal objectives.

3. **Data coverage.** Consistent with the data on government debt reported by the authorities, the fiscal assumptions in this DSA are based on the national government's main budget. While this coverage excludes provincial governments, social security funds, and extra-budgetary institutions, these entities are not allowed to incur debt. Moreover, most provincial and municipal expenditure is funded through transfers from the national government and thus is already captured in the projections. The DSA also excludes SOEs, whose indebtedness has increased rapidly in recent years. Around 45 percent of SOEs' borrowing is covered by government guarantees and the DSA therefore includes an analysis of the fiscal impact of the realization of these contingent liabilities.

4. **An expanded debt sustainability analysis is warranted given South Africa's elevated gross financing needs.** Gross financing needs (GFN) are estimated at 12.8 percent of GDP in 2013 and expected to peak at 13.4 percent in 2014, above the 10 percent of GDP trigger based on a conservative assessment of early-warning results.

5. **There is no evidence of a systemic projection bias that would undermine the assessment of sustainability.** The median forecast errors for real GDP growth, the primary balance, and the GDP deflator between 2005–13 are below 1 percent and in line with other countries.

6. **Cross-country experience suggests the fiscal adjustment assumed in the DSA is feasible.** The maximum three-year adjustment in the cyclically-adjusted primary balance over the projection period (1.1 percent of GDP) as well as the maximum three-year level of the cyclically-adjusted primary balance (0.5

[1]Based on the debt sustainability analysis for market access countries. For further details see: "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis," SM/11/211 and "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries," IMF Policy Paper, May 6 2013.

percent of GDP) is moderate when compared to the experience in market access countries with debt above 60 percent of GDP.

7. National government primary deficits averaging 2¼ percent of GDP for the past four fiscal years have resulted in rising debt ratios and higher GFNs. Substantial fiscal stimulus helped cushion the impact of the global economic slowdown on the economy, but also contributed to a 19 percentage point increase in the debt-to-GDP ratio since 2008. Elevated deficits have brought the GFN to about 13 percent of GDP, above the EM average notwithstanding a favorable maturity structure.

8. The fiscal outlook is subject to several downside risks. With initial wage demands at 15 percent, there is a risk that a higher-than-budgeted public sector wage settlement puts upward pressure on spending. The government's plans for nuclear energy and a national health insurance could also significantly increase spending pressures. At the same time, the weak state of SOEs' balance sheets could trigger calls for further government's support, while a tightening of global financial conditions could put upward pressure on borrowing costs.

9. The DSA framework suggests South Africa's government debt-to-GDP ratio is sustainable in the baseline scenario, but remains vulnerable to shocks.

- The framework uses an indicative 70 percent of GDP debt benchmark beyond which a country is reported as high risk (red in the standardized heat map). The benchmark is based on a cross-country early-warning exercise of emerging market countries that have experienced episodes of debt distress.[2]

- Under the baseline, the debt-to-GDP ratio is projected to increase to 57 percent by 2019. This is 29 percentage points higher than in 2007, but below the 70 percent high-risk threshold.

- The projected debt level in 2019 increases to slightly above 60 percent of GDP if none of the envisaged fiscal consolidation materializes and the primary balance remains unchanged, or with a one-standard-deviation temporary shock to growth.

- A customized shock entailing a permanent reduction in growth—growth remains at the 2014 level throughout the projection horizon—results in a significant increase in debt to around 66 percent of GDP.

- A macro-fiscal shock—including standard shocks to growth and interest rates, and a primary balance shock (a temporary half of a 10-year historical standard deviation deterioration in the primary balance) and an exchange rate shock (consistent with the maximum movement over the

[2] Debt distress events are defined as default to commercial or official creditors, restructuring and rescheduling events, or IMF financing.

past 10 years and an exchange rate pass-through of 0.25 based on cross-country estimates of pass-through in EMs)—results in a sharp increase in the debt-to-GDP ratio to 68 percent.[3]

- A contingent liability shock where 75 percent of the government's guarantee commitments—estimated at 14 percent of GDP in FY2013/14—is realized would increase debt to 72 percent of GDP, slightly above the high risk threshold. While extreme, this exercise serves to underscore the growing risks posed by contingent liabilities from SOEs, both to the fiscal outlook directly and indirectly through its potential impact on investor confidence.

- The DSA also includes fan charts that take into account the impact of the historical volatility of macro-fiscal variables on the future debt path. Both an asymmetric version that reflects the predominance of downside risks, and a symmetric version that takes into account the possibility of more rapid progress on structural reforms that would boost growth and improve the primary balance, yield similar results to the afore-mentioned stress tests, with the former suggesting there is a 10 percent chance that the debt-to-GDP ratio could exceed the DSA high-risk threshold of 70 percent of GDP by 2019.

10. The heat map suggests that despite its low share of foreign currency and short-term debt, South Africa faces risks relating to its GFN and its debt profile. Even in the baseline, South Africa's GFN is close to the 15 percent of GDP benchmark that is considered to be high risk. The standard shocks to growth and the primary balance, as well as the contingent liability shock, the permanent growth shock, and the combined macro-fiscal shock—would push the GFN above the high risk benchmark, indicating an increased risk of financing difficulties. South Africa's local currency bond spread and the relatively large share of debt held by non-residents also point to emerging risks, though the large domestic institutional investor base and capital controls on residents are mitigating factors. These findings are consistent with staff's assessment that while South Africa's debt remains sustainable, risks to the fiscal outlook have increased since the 2013 Article IV consultation, even after taking into account the consolidation measures announced in the MTBPS.

[3] Ca'Zorzi, M., E. Hahn, and M. Sanchez (2007), "Exchange Rate Pass-Through in Emerging Markets." ECB Working Paper No. 739.

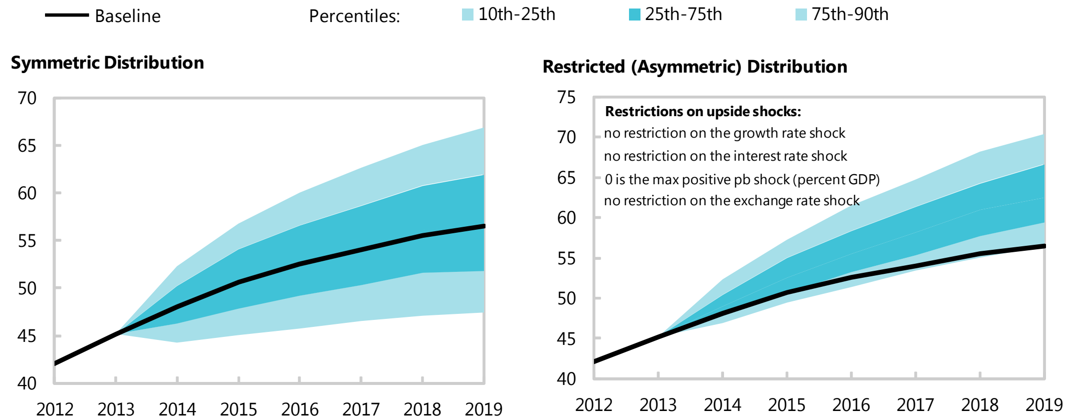
Figure 1. South Africa: Public Sector Debt Sustainability Analysis—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

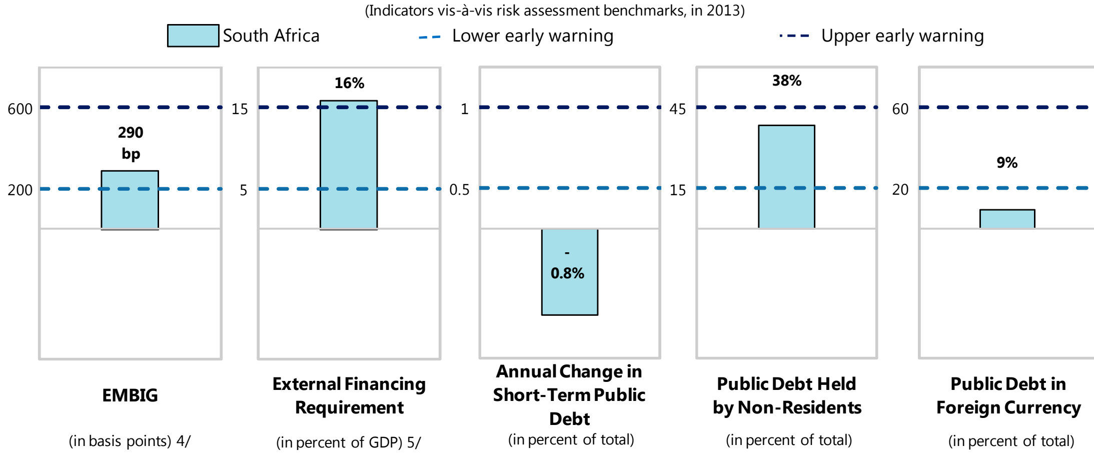
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

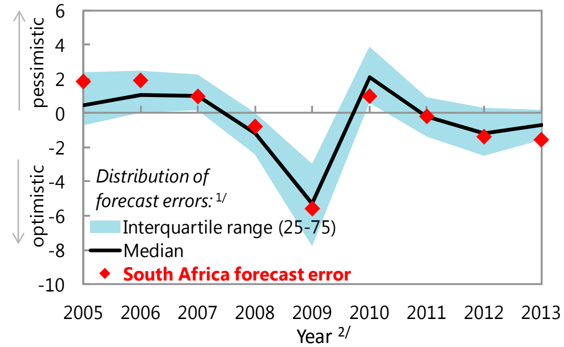
4/ EMBIG, an average over the last 3 months, 30-Jul-14 through 28-Oct-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

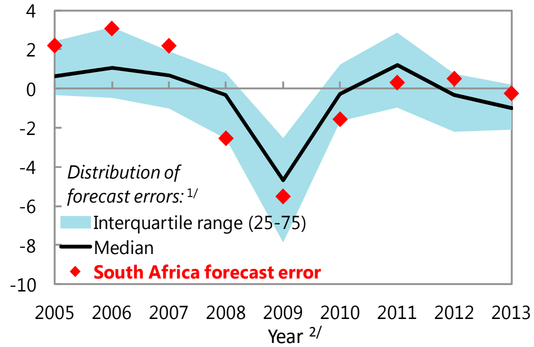
Figure 2. South Africa: Public Sector Debt Sustainability Analysis—Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

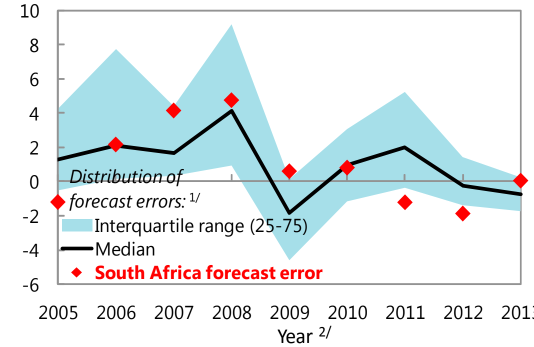
Real GDP Growth
(in percent, actual-projection)
South Africa median forecast error, 2005-2013: **-0.19**
Has a percentile rank of: **48%**



Primary Balance
(in percent of GDP, actual-projection)
South Africa median forecast error, 2005-2013: **0.31**
Has a percentile rank of: **69%**

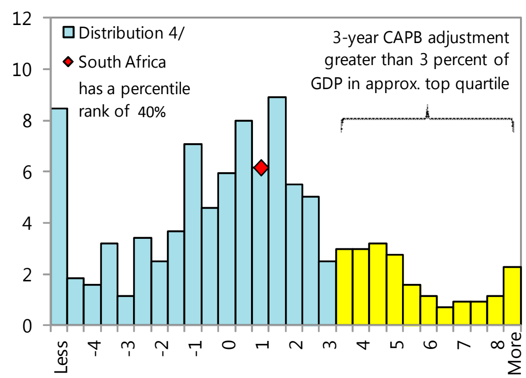


Inflation (Deflator)
(in percent, actual-projection)
South Africa median forecast error, 2005-2013: **0.61**
Has a percentile rank of: **40%**

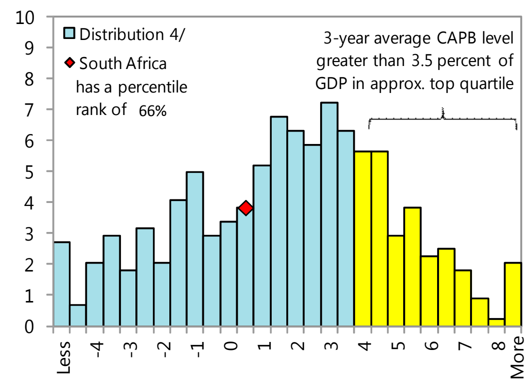


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

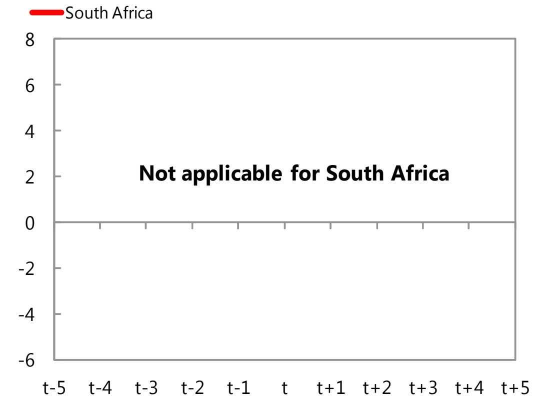


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for South Africa, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. South Africa: Public Sector Debt Sustainability Analysis—Baseline Scenario

(in percent of GDP unless otherwise indicated)

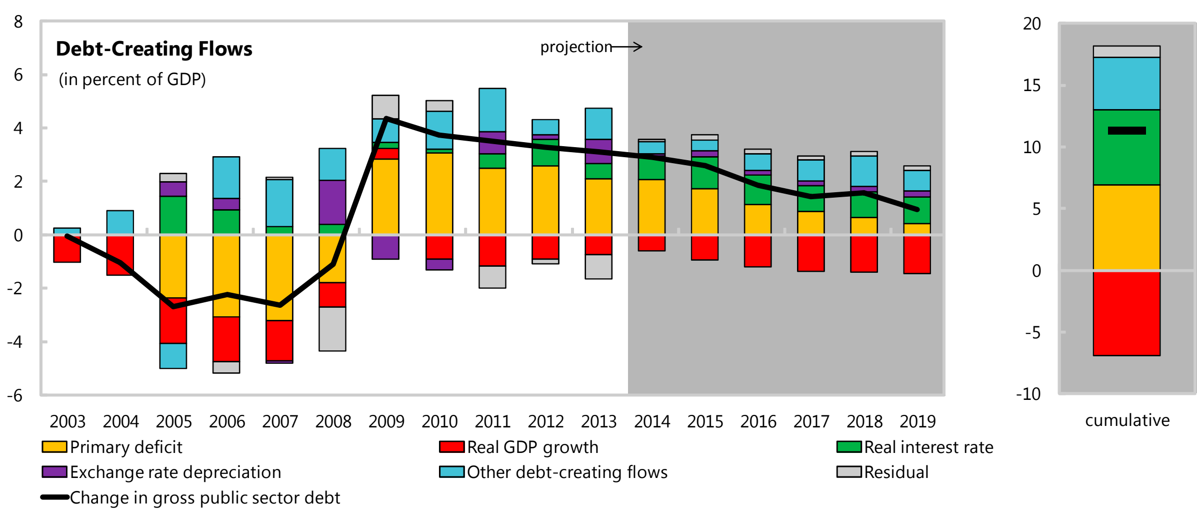
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	33.1	42.1	45.2	48.1	50.7	52.6	54.0	55.6	56.5
Public gross financing needs	8.4	12.6	12.8	13.4	12.9	12.8	12.5	12.6	12.7
Real GDP growth (in percent)	3.6	2.5	1.9	1.4	2.1	2.5	2.8	2.8	2.8
Inflation (GDP deflator, in percent)	6.9	4.5	5.8	5.8	5.4	5.6	5.6	5.5	5.5
Nominal GDP growth (in percent)	10.8	7.0	7.8	7.3	7.6	8.2	8.6	8.5	8.5
Effective interest rate (in percent) [4/]	9.3	7.3	7.4	8.0	8.2	8.1	7.7	7.6	7.6

As of October 31, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		219
5Y CDS (bp)		171
Ratings	Foreign	Local
Moody's	Baa1	Baa1
S&Ps	BBB-	BBB+
Fitch	BBB	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.2	3.3	3.1	2.9	2.6	1.9	1.4	1.6	1.0	11.3	
Identified debt-creating flows	0.0	3.4	4.0	2.8	2.4	1.7	1.3	1.4	0.8	10.4	
Primary deficit	-0.6	2.6	2.1	2.1	1.7	1.2	0.9	0.7	0.4	7.0	0.3
Primary (noninterest) revenue and grant	24.9	24.9	25.3	25.5	25.8	26.0	26.1	26.2	26.3	156.1	
Primary (noninterest) expenditure	24.3	27.5	27.4	27.6	27.6	27.2	27.0	26.9	26.8	163.0	
Automatic debt dynamics [5/]	-0.4	0.3	0.7	0.3	0.2	-0.1	-0.4	-0.4	-0.4	-0.8	
Interest rate/growth differential [6/]	-0.3	0.1	-0.2	0.3	0.2	-0.1	-0.4	-0.4	-0.4	-0.8	
Of which: real interest rate	0.8	1.0	0.6	0.9	1.2	1.1	1.0	1.0	1.0	6.1	
Of which: real GDP growth	-1.1	-0.9	-0.7	-0.6	-0.9	-1.2	-1.4	-1.4	-1.4	-6.9	
Exchange rate depreciation [7/]	0.0	0.2	0.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.0	0.6	1.2	0.5	0.4	0.6	0.8	1.1	0.8	4.2	
Privatization/Drawdown of Deposits (+	0.6	-0.7	-0.2	-0.2	-0.4	-0.3	-0.2	0.1	-0.3	-1.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Stock-flow adjustment	0.4	1.2	1.3	0.7	0.9	0.9	1.0	1.0	1.1	5.6	
Residual, including asset changes [8/]	0.2	-0.2	-0.9	0.1	0.2	0.2	0.2	0.2	0.2	1.0	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

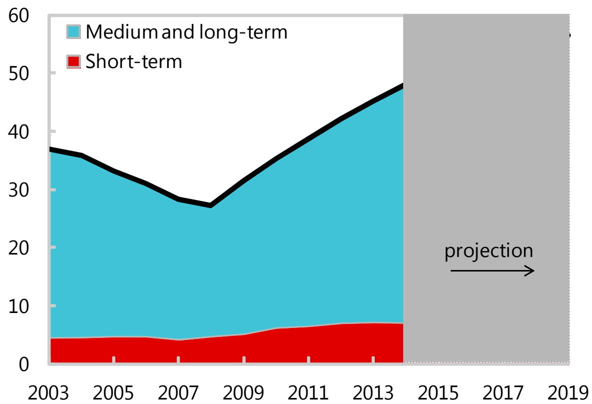
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

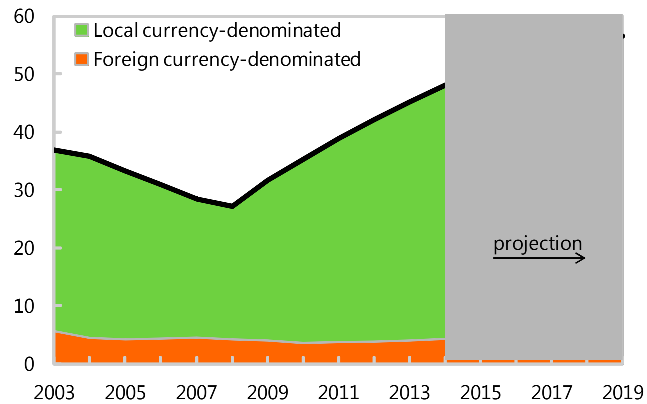
Figure 4. South Africa: Public Sector Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



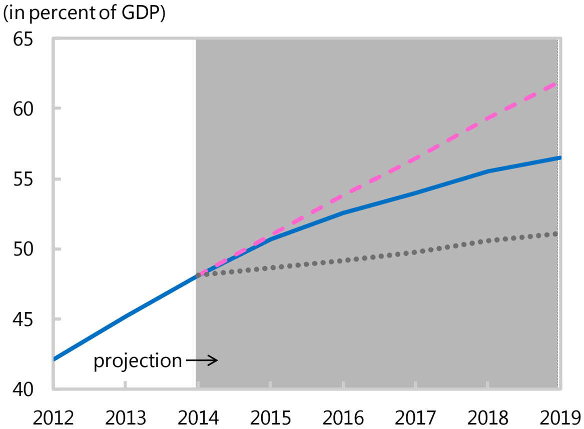
By Currency
(in percent of GDP)



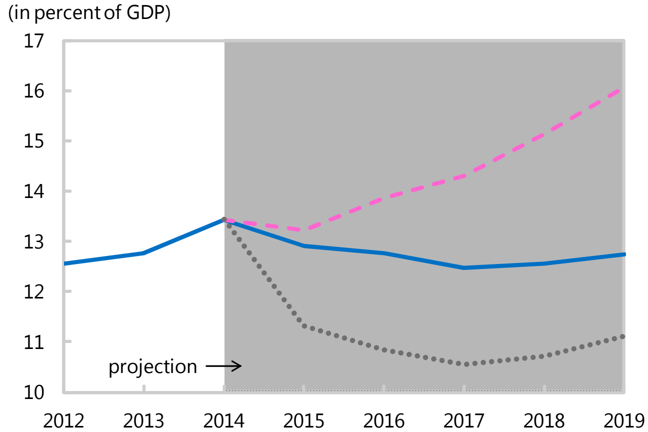
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

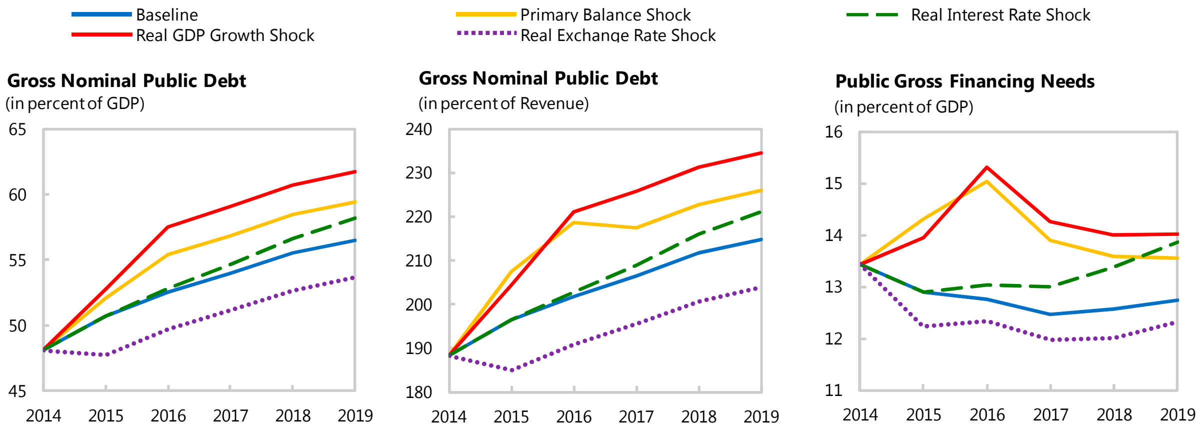
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary Balance	-2.1	-1.7	-1.2	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.2	8.1	7.7	7.6	7.6
Constant Primary Balance Scenario						
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary Balance	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	8.0	8.2	8.1	7.7	7.6	7.6

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	1.4	3.4	3.4	3.4	3.4	3.4
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary Balance	-2.1	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	8.0	8.2	8.1	7.7	7.5	7.5

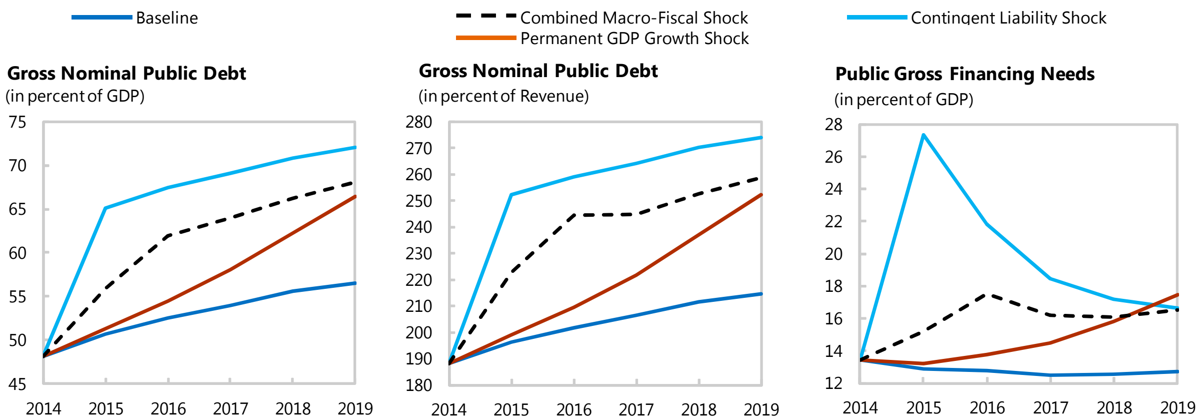
Source: IMF staff.

Figure 5. South Africa: Public Sector Debt Sustainability Analysis—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2014	2015	2016	2017	2018	2019
Primary Balance Shock						
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary balance	-2.1	-3.1	-2.6	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.2	8.1	7.8	7.7	7.7
Real Interest Rate Shock						
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary balance	-2.1	-1.7	-1.2	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.2	8.6	8.5	8.5	8.7
Combined Shock						
Real GDP growth	1.4	-0.1	0.3	2.8	2.8	2.8
Inflation	5.8	4.9	5.1	5.6	5.5	5.5
Primary balance	-2.1	-3.2	-3.3	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.9	8.9	8.6	8.7	8.9

	2014	2015	2016	2017	2018	2019
Real GDP Growth Shock						
Real GDP growth	1.4	-0.1	0.3	2.8	2.8	2.8
Inflation	5.8	4.9	5.1	5.6	5.5	5.5
Primary balance	-2.1	-2.5	-2.6	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.2	8.1	7.8	7.6	7.7
Real Exchange Rate Shock						
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	17.6	5.6	5.6	5.5	5.5
Primary balance	-2.1	-1.7	-1.2	-0.9	-0.7	-0.4
Effective interest rate	8.0	8.9	8.3	7.8	7.7	7.7
Contingent Liability Shock						
Real GDP growth	1.4	2.1	2.5	2.8	2.8	2.8
Inflation	5.8	5.4	5.6	5.6	5.5	5.5
Primary balance	-2.1	-12.1	-1.2	-0.9	-0.7	-0.4
Effective interest rate	8.0	17.3	8.9	8.1	8.0	8.1

Source: IMF staff.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

11. Increasing public indebtedness has contributed most to the build-up of external debt since 2011. Albeit from a low base, the stock of public external debt (including SOEs' debt) has increased nearly 8 percent of GDP points since 2011, reaching 21 percent of GDP at end-June 2014. The banking and corporate sectors also increased their external indebtedness, although to a lesser extent. Total external debt approached 42 percent of GDP at the end of 2014:Q2.

Breakdown of South Africa's External Debt, 2011-2014 1/

(In percent of GDP)	2011	2012	2013	2014
Total	29.2	37.1	38.9	41.9
Public authorities	10.1	14.4	14.9	16.0
SOEs	3.0	4.1	4.8	5.1
Monetary authorities	0.1	0.2	0.2	0.2
Banking sector	5.3	6.8	6.6	7.9
Others	10.6	11.6	12.4	12.7

Source: SARB; NT; Haver; and IMF staff estimates

1/ As of end-June, 2014.

12. South Africa's external debt is projected to increase to 52 percent of GDP by 2019. The rise in the external debt-to-GDP ratio over the medium term mainly reflects the elevated non-interest current account deficit (CAD), which is projected to average 2.7 percent of GDP during this period compared to an estimated debt-stabilizing non-interest CAD of 2 percent of GDP (Table 1).

13. The gradual normalization of global interest rates is expected to worsen the income deficit, but the stock of fixed-rate liabilities with long maturity provides some relief. Using WEO projections of global interest rates, we estimate a worsening of the net income balance by about ½ percent of GDP over the medium term. Existing public fixed-rate bonds with a long duration will help contain the impact of higher global rates on future debt service. Transfers to the Southern Africa Customs Union (SACU) are projected to remain slightly below 1 percent of GDP, in line with the historical average.

14. South Africa's gross external financing need (GEFN) is projected to average 18 percent of GDP in 2014-2019 compared to 13 percent of GDP in the past five years. Short-term external debt (on a residual maturity basis) is estimated to account for about 70 percent of the GEFN during the projection period, most of it in the form of banking and corporate loans which tend to have a shorter original maturity than public debt. With net FDI having averaged 0.8 percent of GDP in 2010-13, the GEFN is expected to be mostly financed by portfolio and other investment liabilities, in line with the recent past (each have averaged 1½ percent of GDP in 2010-13, while unrecorded transactions averaged 0.7 percent of GDP during the same period). The share of FX-denominated debt is projected to remain stable at 45 percent of total external debt.

15. Rising indebtedness and sizable rollover needs keep South Africa's external vulnerability elevated, but external debt rises only modestly under a number of shocks scenarios. Stress tests indicate that a 30 percent exchange rate depreciation would push the debt-to-GDP ratio above 67 percent (mainly due to a larger compression in the US$-denominated GDP than in the trade deficit). Other standard shocks applied in the external DSA—such as a further widening of the non-interest CAD, a growth deceleration, and an interest rate increase—would lead to a relatively mild increase in external debt. These shocks are partially contained due to the sizeable share of rand-denominated and fixed-interest-rate debt.

Table 1. South Africa: External Debt Sustainability Framework, 2009-2019

(in percent of GDP, unless otherwise indicated)

						Projections						
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
Baseline: External debt	29.0	30.5	29.2	37.1	38.9	**42.4**	**44.9**	**46.7**	**48.8**	**50.7**	**52.6**	**-2.0**
Change in external debt	1.6	1.4	-1.2	7.9	1.8	3.5	2.5	1.8	2.1	1.8	1.9	
Identified external debt-creating flows (4+8+9)	-2.3	-3.1	-0.3	4.4	4.0	3.3	1.9	2.0	2.1	1.8	1.8	
Current account deficit, excluding interest payments	3.0	1.1	1.1	3.9	3.8	3.5	3.2	2.9	2.6	2.1	1.8	
Deficit in balance of goods and services	0.9	-0.6	-0.4	1.9	2.8	3.2	2.7	2.4	2.2	1.9	1.7	
Exports	27.3	28.4	30.6	29.9	31.1	31.6	30.9	30.9	30.7	30.5	30.4	
Imports	28.2	27.7	30.2	31.8	34.0	34.8	33.7	33.4	32.8	32.4	32.1	
Net non-debt creating capital inflows (negative)	-5.0	-0.4	0.2	-0.2	-1.1	-1.9	-2.7	-2.1	-1.7	-1.5	-1.4	
Automatic debt dynamics 1/	-0.3	-3.8	-1.6	0.7	1.3	1.6	1.4	1.3	1.2	1.3	1.3	
Contribution from nominal interest rate	1.1	0.8	1.2	1.4	2.0	2.2	2.3	2.4	2.4	2.6	2.6	
Contribution from real GDP growth	0.4	-0.7	-1.0	-0.8	-0.8	-0.6	-0.9	-1.1	-1.2	-1.3	-1.3	
Contribution from price and exchange rate changes 2/	-1.8	-4.0	-1.8	0.1	0.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.0	4.6	-1.0	3.5	-2.2	0.2	0.5	-0.2	0.0	0.0	0.2	
External debt-to-exports ratio (in percent)	106.4	107.3	95.5	123.9	125.0	134.4	145.2	151.1	159.1	166.2	173.2	
Gross external financing need (in billions of US dollars) 4/	40.5	37.3	41.6	58.1	58.5	58.7	61.8	66.0	70.3	74.6	79.9	
in percent of GDP	14.2	10.2	10.3	15.2	16.7	17.3	17.7	18.1	18.4	18.6	18.9	
Scenario with key variables at their historical averages 5/						**42.4**	**42.9**	**43.1**	**43.6**	**44.1**	**44.7**	**-4.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	-1.5	3.1	3.6	2.5	1.9	1.4	2.1	2.5	2.8	2.8	2.8	
GDP deflator in US dollars (change in percent)	6.0	24.0	6.9	-7.7	-10.0	-4.7	0.8	1.8	2.2	2.1	2.3	
Nominal external interest rate (in percent)	4.1	3.7	4.3	4.5	5.0	5.5	5.5	5.5	5.5	5.5	5.5	
Growth of exports (US dollar terms, in percent)	-20.6	33.1	19.4	-7.6	-4.5	-2.1	0.8	4.5	4.2	4.3	4.7	
Growth of imports (US dollar terms, in percent)	-24.5	26.0	20.4	-0.2	-2.2	-1.1	-0.3	3.5	3.4	3.5	4.1	
Current account balance, excluding interest payments	-3.0	-1.1	-1.1	-3.9	-3.8	-3.5	-3.2	-2.9	-2.6	-2.1	-1.8	
Net non-debt creating capital inflows	5.0	0.4	-0.2	0.2	1.1	1.9	2.7	2.1	1.7	1.5	1.4	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation.

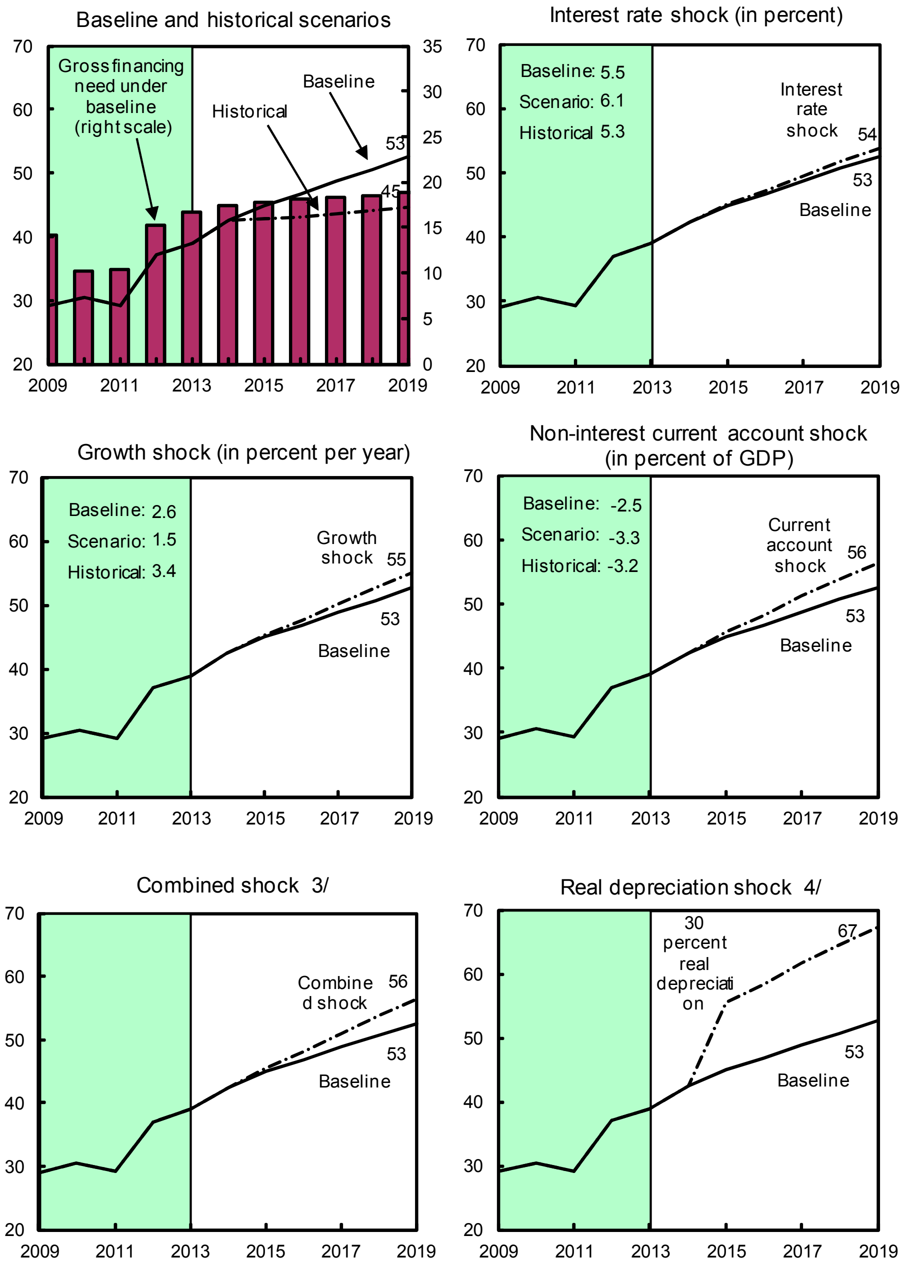
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 6. South Africa: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2015.

Statement by the Staff Representative on South Africa

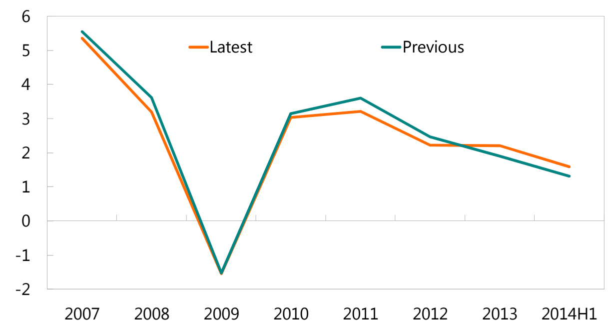
December 3, 2014

This statement contains information that has become available since the staff report was circulated to the Executive Board. This information does not alter the thrust of the staff appraisal.

1. **The latest national accounts data confirm that the economy is recovering from the strikes, though growth remains sluggish**. Real GDP growth increased to 1.4 percent q/q in 2014: Q3 from 0.5 percent in Q2 (seasonally adjusted and annualized), underpinned by improvements in wholesale and retail trade and mining, while manufacturing output still contracted. The new data are in line with staff projections of 1.4 percent growth for 2014, which will require a full recovery of the manufacturing and mining sectors from the disruptions in production that occurred earlier in the year.

2. The rebasing of the national accounts has lead to modest revisions to historical data, with no significant policy implications. The new national accounts data adopt the 2008 System of National Accounts and are rebased to 2010 from 2005, which occurs every five years. Nominal GDP is modestly higher than in previous estimates (by 4.4 percent for 2013). GDP in U.S. dollars rose to 366 billion for 2013 compared to 351 billion previously. This improves key ratios marginally, but trends remain broadly unchanged. While the growth rates for the years preceding the global financial crisis and in the immediate aftermath are slightly lower, the growth rates for 2013 and 2014 H1 were revised up (by 0.3 percentage points). The shares of government services and mining in the economy have increased, while those of manufacturing and financial services have declined.

Real GDP growth
(percent)



Source: StatsSA

Key economic ratios (2013)

(in percent of GDP)	Previous	Latest
Fiscal balance	-4.2	-4.0
Current account balance	-5.8	-5.6
Public debt	45.2	43.3
Total external debt	38.9	37.2

Source: StatsSA

3. Weaker-than-anticipated trade and budget balance data in October confirm that South Africa's twin deficits are likely to remain elevated. The October trade deficit increased to its highest level since 2010, mostly on account of a sharp increase in crude oil imports and declining commodity prices. The October increase in the national government budget deficit was driven by a drop in non-tax revenue and quarterly transfers to SACU countries. The new data are broadly in line with staff projections of a current account deficit around 5½ percent of GDP and fiscal deficit around 4¼ percent of GDP in 2014.

4. **Inflation pressures remain contained.** CPI inflation was flat at 5.9 percent y/y in October, staying inside the SARB's inflation band for the second consecutive month. Food inflation continued to fall and inflation momentum also moderated in sequential terms. These developments remain in line with staff projections.

5. **The South Africa Reserve Bank (SARB) kept the policy rate on hold in its November 20 Monetary Policy Committee Meeting.** Citing the lower trajectory of headline inflation, falling oil prices, and the continued weak state of the economy, the SARB concluded that risks to inflation are broadly balanced and reduced its 2015 inflation projection to 5.3 percent (staff 5.2 percent). It nevertheless reiterated that exchange rate depreciation and wage negotiations remain the main sources of upside risks to inflation. The SARB maintained that interest rates will have to normalize over time, and that the timing of future interest rate increases will depend on the evolution of inflation expectations, the speed of U.S. monetary policy normalization, and the state of the domestic economy.

Press Release No. 14/561
FOR IMMEDIATE RELEASE
December 11, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with South Africa

On December, 3, 2014, the Executive Board of the International Monetary Fund concluded the Article IV consultation[1] with South Africa.

South Africa has made substantial progress in its first 20 years of democracy, achieving much improved living standards for its citizens. But growth has slowed in recent years, specifically relative to other emerging markets. Although weak trading partners' growth contributed to the slowdown, increasingly binding structural constraints, such as protracted strikes and electricity constraints, have been important factors. Unemployment remains high at 25.5 percent.

Consumer Price Index (CPI) inflation declined to 5.9 percent in September after staying above the South African Reserve Bank (SARB)'s 3-6 percent band for six months, mainly driven by depreciation. The SARB has raised the repo rate by 75 basis points since January 2014.

South Africa's twin deficits remain elevated. Despite a 26 percent real effective exchange rate depreciation since 2010, the current account deficit remains high (5.8 percent of Gross Domestic Product (GDP) in 2013), reflecting persistent competitiveness problems, soft terms of trade, supply bottlenecks, and subdued external demand. Notwithstanding expenditure discipline, the general government budget deficit was 4.5 percent of GDP in 2013, and public debt rose to 45 percent of GDP from 27 percent in 2008. In the recently-announced Medium-Term Budget Policy Statement, the authorities have announced that they will take measures to improve the public finances.

The Financial System Stability Assessment (FSSA) concluded that financial sector risks are elevated but manageable. The financial system is large, highly interconnected, dependent on wholesale funding, and credit risk is rising due to sluggish growth and tighter financial

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

conditions. However, capital buffers are relatively high, financial regulation and supervision are strong, and capital controls limit liquidity risks.

The outlook is lackluster with considerable risks. Growth is projected to slow to 1.4 percent in 2014 and rebound only modestly to 2.1 percent in 2015 on improved industrial relations, while private consumption remains depressed under tighter financial conditions. Slowly easing infrastructure constraints and stronger external demand are expected to raise growth to 2.75 percent in 2016–19 but not enough to lower unemployment significantly. Fiscal and current account deficits are expected to fall moderately over the medium term. Inflation is projected to decline in 2015 on account of lower oil and food prices and tighter policies. Structural reforms are essential to generate more growth and jobs and to address the challenges of poverty, inequality, and unemployment.

Risks are tilted to the downside. A sharp surge in global financial market volatility could lead to capital flow reversals and trigger a disorderly adjustment in the current account deficit. Lower global growth and commodity prices, further delays in relieving electricity constraints, and more labor market disruptions are additional key risks.

Executive Board Assessment[2]

Executive Directors commended the authorities for the progress made in improving living standards and for maintaining macroeconomic stability in the last twenty years. However, against the backdrop of a weak external environment, the country is faced with the challenges from elevated external and fiscal deficits, rising public debt, and high unemployment and inequality. Directors agreed that strong and prudent policies and structural reforms are key to strengthening economic resilience, boosting inclusive and sustainable growth, creating jobs, and reducing poverty.

Given the risks facing the outlook and reduced policy space, Directors called for decisive structural reforms to unblock supply-side constraints, lift growth, and rebalance the economy towards exports and investments. They welcomed the ongoing infrastructure projects, especially in power supply, and encouraged greater private sector participation, supported by careful preparation and sound frameworks. Directors commended the government's enhanced focus on implementing the National Development Plan and promoting SMEs. They recommended that high priority be given to enhancing productivity and competitiveness by accelerating product and labor market reforms, reducing skill mismatches, and normalizing industrial relations.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed the envisaged fiscal consolidation in the 2014 Medium-Term Budget Policy Statement, and highlighted that containing the wage bill and raising taxes will be essential. They noted that further adjustment may be necessary to stabilize debt over the medium term, and in this context, underscored the importance of focusing on growth-friendly measures, including improvements in spending efficiency. They welcomed plans to increase state-owned enterprises' efficiency so as to limit contingent liabilities. A few Directors noted that a formal debt anchor could strengthen the fiscal framework.

Directors commended the South African Reserve Bank (SARB) for a finely balanced monetary policy stance. While recent declines in oil prices and the planned fiscal consolidation could allow the SARB to remain accommodative for some time, risks to the inflation outlook need continued careful monitoring. In general, Directors highlighted the importance of effective communication to help guide inflation expectations.

Directors viewed exchange rate flexibility and the favorable currency composition of external debt as effective buffers against volatile capital flows. To boost resilience, they generally encouraged the authorities to explore options to build reserves, while taking into account related costs. Directors noted the opportunities provided by robust growth in the rest of the continent and invited careful analysis of South Africa's spillovers to the region and potential spillbacks.

Directors noted the findings that the financial sector remains sound but is subject to vulnerabilities. To strengthen the sector's resilience, they encouraged timely implementation of the FSAP recommendations, in particular enhancing scrutiny of asset quality and liquidity risks, including through enhanced stress tests. Introducing deposit insurance and strengthening regulation of collective investment schemes could reduce liquidity risks and boost market discipline. Directors concurred that South Africa's deep and highly interconnected financial system requires group-wide supervision and better coordination among regulators. Directors noted that more competition could improve financial access and lower intermediation costs.

South Africa: Selected Economic and Social Indicators, 2010–15

Social Indicators

GDP		**Poverty**	
Nominal GDP (2013, billions of U.S. dollars)	351	Headcount ratio at $1.25 a day (2011, percent of population)	9.4
GDP per capita (2013, U.S. dollars)	6599	Undernourishment (2012, percent of population)	5.0
Population characteristics (2013)		**Income distribution (2011)**	
Total	53.2	Income share held by highest 10 percent of population	53.8
Urban population (percent of total)	64	Income share held by lowest 20 percent of	2.5
Life expectancy at birth (years), 2014	61	Gini index	65.0

Economic Indicators

	2010	2011	2012	2013	2014	2015
					Proj.	
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	3.1	3.6	2.5	1.9	1.4	2.1
Real GDP per capita	1.6	2.1	0.9	0.3	-0.2	0.5
Real domestic demand	4.4	5.2	3.9	2.5	1.2	1.8
GDP deflator	7.7	5.9	4.5	5.8	5.9	5.4
CPI (annual average)	4.3	5.0	5.7	5.8	6.1	5.2
CPI (end of period)	3.5	6.1	5.7	5.4	5.7	5.5
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.9	24.8	24.9	24.7	25.3	25.2
Average remuneration (formal nonagricultural, nominal)	13.5	7.2	7.5	7.6	6.8	7.1
Labor productivity (formal nonagricultural)	3.9	1.4	1.3	1.4	1.4	1.5
Unit labor costs (formal nonagricultural)	9.3	5.8	6.2	6.1	5.3	5.4
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	17.1	16.8	14.2	13.5	13.6	14.0
Public (including public enterprises)	-0.5	0.8	-0.9	-0.9	-0.9	-0.6
Private	17.6	16.0	15.1	14.4	14.5	14.6
Investment (including inventories)	19.1	19.1	19.4	19.4	19.3	19.4
Public (including public enterprises)	7.0	7.0	7.1	7.2	7.3	7.3
Private	12.1	11.8	11.8	12.1	12.3	12.3
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.5	27.9	28.3	28.9	29.2	29.5
Expenditure and net lending	32.4	31.9	32.6	33.1	33.7	33.8
Overall balance	-4.9	-4.0	-4.3	-4.2	-4.4	-4.3
Primary balance	-2.3	-1.3	-1.4	-1.1	-1.2	-0.9
Structural balance (percent of potential GDP)	-3.6	-3.8	-4.2	-3.9	-3.9	-3.7
Gross government debt 2/	35.3	38.8	42.1	45.2	48.1	50.5
Government bond yield (10-year, percent) 3/	8.5	8.3	7.6	7.3	7.9	…
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	6.9	8.3	5.2	5.9	6.4	7.6
Credit to the private sector	3.3	5.7	9.3	6.6	7.7	7.9
Repo rate (percent) 3/	5.5	5.5	5.0	5.0	5.8	...
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-7.2	-9.4	-20.0	-20.4	-19.4	-19.0
percent of GDP	-2.0	-2.3	-5.2	-5.8	-5.7	-5.4
Exports growth (volume)	9.0	6.8	0.4	4.2	2.6	3.5
Imports growth (volume)	11.0	10.0	6.0	4.7	1.8	2.3
Terms of trade (percentage change)	7.3	2.2	-2.2	-1.9	-1.8	-0.1
Overall balance	1.2	1.1	0.3	0.1	0.0	0.0
Gross reserves (billions of U.S. dollars)	43.8	48.9	50.7	49.6	49.6	49.6
percent of short-term debt (residual maturity)	145.8	151.6	133.2	130.2	126.1	115.7
Total external debt	30.5	29.2	37.1	38.9	42.4	44.9
of which short-term (residual maturity)	8.2	8.0	10.0	10.9	11.6	12.3
Nominal effective exchange rate (percentage change, end-period) 4/	11.3	-16.6	-5.4	-15.3	-7.3	…
Real effective exchange rate (percentage change, end-period) 4/	12.0	-4.7	-12.2	-12.4	-2.9	…
Exchange rate (Rand/U.S. dollar, end-period) 3/	6.6	8.1	8.5	10.5	10.9	…

Sources: South African Reserve Bank and National Treasury, Haver, Bloomberg, World Bank, IMF, INS database; and IMF staff estimates and projections.

1/ General government unless otherwise indicated.

2/ National government.

3/ For 2014, end-October data.

4/ For 2014, September data.

Statement by Ms. Kapwepwe and Mr. Todani on South Africa
December 3, 2014

In its past twenty years of democracy, South Africa has made remarkable progress in improving the welfare of its citizens. Access to education, health care and other services, has increased together with significant extension of income support to the most vulnerable. Social assistance now reaches 30 per cent of the population, while economic participation has increased.

Notwithstanding this progress, unemployment, poverty and inequality remain high. Real GDP growth is projected to be lower this year than previously anticipated and only a modest recovery is expected in the medium term, with the risks tilted on the downside. As a result of slow growth, tax revenue is below budget projection and the budget deficit and government debt are rapidly rising. This has created a challenging macroeconomic policy environment. My South African authorities are aware of these challenges and are taking appropriate policy actions, including appropriate structural reforms, to steer the economy back to a robust recovery.

Fiscal Policy

The South African authorities remain firmly committed to fiscal sustainability and are taking the necessary measures to achieve this objective while protecting core social and economic programs. In response to worsening budget deficit and debt outlook, the 2014 *Medium Term Budget Policy Statement* (MTBPS), although presented under fairly difficult macro-economic circumstances, proposes a comprehensive fiscal consolidation package to narrow the budget deficit, stabilize debt and begin to rebuild fiscal space. The package primarily reduces the expenditure ceiling and raises tax revenue over the next two years.

Specifically, some of the proposals include; lowering the 2014 Budget expenditure ceiling by R25 billion over the next two years; implementing measures to generate additional revenue of at least R27 billion over the next two years; freezing government personnel headcounts; and adopting a deficit-neutral approach to financing state-owned enterprises (SOEs). These measures will reduce the budget deficit and stabilize debt thereby creating the much needed fiscal space and enhance the sustainability of public finances.

My authorities are under no illusion that this is going to be an easy fiscal consolidation path. Reduction in expenditure ceiling and increases in taxes in an environment where there are so many pressing needs is going to be politically and socially challenging. Thus, in considering these proposals, my authorities will ensure that restraining expenditure growth will not compromise front-line services. Key social programs will be protected in order to render the measures socially acceptable. While expenditure ceilings are being lowered, the budget will continue to grow in real terms and in line with the medium-term strategic framework (MTSF), which gives expression to the National Development Plan (NDP).

Additional reforms are being undertaken to improve the efficiency of spending, including enhancing the planning capacity of the public sector - particularly at local government level, restructuring departments and agencies in order to eliminate inefficient resource allocation and overlapping mandates. Most importantly, my authorities are implementing measures to reinforce overall cost-containment. In this regard, financial accounting and control systems are being strengthened, resulting in improved reporting of unauthorized, irregular or wasteful expenditure.

Monetary Policy

Notwithstanding a 25 basis points increase in the South African Reserve Bank (SARB) monetary policy rate – the repurchase rate, on July 17, 2014, monetary policy remains relatively accommodative. The marked decline in international oil prices has had a significant and favorable impact on the medium term outlook for inflation in South Africa. As a consequence, inflation is now expected to slow further in 2015. At the same time, the projected slowdown in economic growth should ensure little or no excess demand pressures on the inflation outlook. These developments would imply that the accommodative stance of monetary policy may be sustained for longer.

The SARB is aware of the upward risks to inflation outlook. Despite its recent relative stability, the exchange rate remains vulnerable to changing perceptions of the timing of global monetary policy adjustments, and the slow pace of contraction in the current account deficit and this poses an upward risk to inflation outlook. A further upside risk to the inflation outlook comes from a possible increase in wage settlement rates in excess of inflation and productivity growth in the coming year. In this regard, the monetary authorities will remain vigilant and will continue to monitor developments closely. The timing of future interest-rate increases will be dependent on a range of factors, including the evolution of inflation expectations, the speed of normalization of monetary policy in the United States, and the state of the domestic economy.

My authorities note staff's advice that the central bank could consider enhancing its communications by "publishing inflation projections conditional on explicit interest rate and exchange rate assumptions, as some other inflation targeting central banks do". Since the adoption of the inflation targeting regime, the SARB has made several steps towards building a transparent monetary policy regime and they pay particular attention to the day-to-day communication with the financial markets and the public at large. However, my authorities are aware that determining the optimal level of communication is a complex task. They are of the view that staff advice could lead to reduced operational flexibility. However, the authorities remains committed and will continue to explores ways to enhance their communication and transparency practices.

Financial Stability

The South African financial sector remains sound. However, as noted in the Financial System Stability Assessment (FSSA), the operating environment for the South African financial sector is rather challenging and subject to vulnerabilities. My authorities are aware of these vulnerabilities, but the most important issue, in their view, is not vulnerabilities *per se* but the resilience of the sector should these vulnerabilities materialize. In this regard, the swift nature in which the recent event involving African Bank (a boutique lender catering mainly to low-income households, which was placed under curatorship after record losses from unsecured lending) was resolved without any contagion effects, demonstrate the robust resilience of the South African financial sector.

Notwithstanding the soundness of the financial sector there is no room for complacency. My authorities are continuing work to strengthen the financial sector in line with a series of reforms announced in the 2011 paper - *A safer financial sector to serve South Africa better* and they are committed to implement, to the extent possible, the 2014 FSSA recommendations. This year, draft regulations for over-the-counter derivatives, credit agreements, hedge funds and insurance were released. Substantial progress has been made with retirement reforms. In addition, the second draft legislation to implement a "twin-peaks" model of financial regulation has been completed and will soon be tabled in Parliament. A number of FSSA recommendations have already been taken into consideration in drafting this legislation.

The South African authorities continue to believe in the importance of exchange rate flexibility as a key adjustment mechanism to external shocks. In their view, this exchange rate regime has served South Africa well. Even at the height of the global financial crisis, unlike some emerging market economies, South Africa did not experience liquidity shortages as the country allowed the exchange rate to adjust to the availability of reserve currency liquidity. With regard to the accumulation of reserves, my authorities can only repeat what they said before, in that they agree with the desirability of higher reserves for precautionary purposes. However, this needs to be balanced against the cost of reserves build-up and management. They will continue to explore options to accumulate more reserves and are willing to consider any policy advice in this regard, provided that the potential benefits and costs are robustly established.

Structural Reforms

The MTBPS acknowledge that the current economic slowdown in South Africa has underscored the structural constraints in the economy. My authorities recognize that a number of factors that were perceived as temporary have now become embedded into expectations. These factors include tightness in electricity supply, labor tensions, skills shortages and transport constraints. The authorities realize that although important structural changes are occurring in major economic sectors, these need to be accelerated. Achieving faster growth and job creation will require growing private-sector investment, as well as structural reforms that enhance the labor-intensity of growth.

As detailed in the MTBPS, South Africa's longer-term economic prospects are tied to successful implementation of the reforms described in the MTSF and the NDP. Underpinning these reform initiatives is the recognition that the state must urgently step up the provision of critical services and infrastructure, and improve its capacity to plan, manage and maintain this infrastructure. These initiatives include large public-sector infrastructure investments in energy, transport and communication sectors. They also include expanded partnerships to encourage private-sector investment; special economic zones to boost exports; programs to encourage more dynamic, integrated cities; and other initiatives to improve the quality of education and skills development.

Finally, labor market reforms are continuing. In this regard, critical interventions over the medium term include, improving dispute-settlement mechanisms in labor relations and enabling immigration reform to encourage people with skills to work in South Africa.