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SOUTH AFRICA

July 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SOUTH AFRICA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with South Africa, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 1, 2016 consideration of the staff report that concluded the Article IV consultation with South Africa.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 1, 2016, following discussions that ended on May 4, 2016, with the officials of South Africa on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 15, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for South Africa.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
July 7, 2016

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with South Africa

On July 1, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with South Africa.

South Africa has made impressive economic and social progress in the past two decades. Yet, deep-rooted structural problems—infrastructure bottlenecks, skill mismatches, and harmful insider-outsider dynamics—are holding back growth and exacerbating unemployment and inequality.

South Africa's vulnerabilities are elevated. Despite a large currency depreciation and notwithstanding some correction, South Africa's current account deficit remains among the highest in emerging markets. A combination of rising government debt, albeit at a slower rate, low growth, financially-weak state-owned enterprises, and spending pressures has increased vulnerabilities in the real and fiscal sectors. Most private corporations' balance sheets remain strong, but financial indicators signal some deterioration ahead. Headline inflation at 6.1 percent in May 2016 was above the South African Reserve Bank's (SARB) 3–6 percent band, mostly due to base effects of fuel prices and rising food prices caused by drought.

Monetary and fiscal policy are on a tightening course. The SARB raised the policy rate by 50bps in 2015 and 75bps in 2016 to 7 percent, citing rising inflation and elevated risks. The 2016 budget envisaged significant deficit reduction for the years 2016 to 2017.

The outlook is sobering with considerable downside risks. Growth is projected to slow to 0.1 percent in 2016, with a weak recovery envisaged from 2017 (1.1 percent), approaching 2–2½ percent in the outer years, as shocks dissipate and new power plants are completed. The unemployment rate could rise further over the medium term. The current account deficit is forecast to narrow slightly in 2016, but rise to 4¾ percent of GDP in 2017–18 on weaker

[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.

terms of trade. Inflation is projected at 6.7 percent in 2016 before easing to 5.6 percent by end-2017.

Downside risks dominate and stem mainly from linkages with China, heightened global financial volatility, and domestic politics and policies that are perceived to harm confidence. Shocks could be amplified by linkages between capital flows, the sovereign, and the financial sector, especially if combined with sovereign credit rating downgrades to speculative grade. On the upside, the recent dialogue between social partners could catalyze reform implementation and invigorate growth.

Executive Board Assessment[2]

Executive Directors recognized the remarkable progress that South Africa has achieved in improving living standards, and the country's strong institutions and policy frameworks that have delivered macroeconomic stability in the past two decades. Directors welcomed the recent dialogue among social partners, but underlined the weak growth outlook, and the need to manage significant downside risks. In this context, Directors noted the likely impact of the recent U.K. referendum to leave the EU, China's transitions, tighter global financial conditions, and the effects of heightened policy uncertainty on growth. Directors also noted vulnerabilities and risks from linkages among capital flows, sovereign debt, and the financial sector, which could amplify the impact of shocks. Directors cautioned that unemployment and inequality remain high, while structural impediments continue to constrain growth and job creation.

Directors emphasized the need for wide ranging structural reforms as a sustainable way to boost growth, create jobs, lower inequality and reduce vulnerabilities. They recommended a comprehensive package of reforms, including greater product market competition, more labor market inclusiveness, better education and improved governance. Directors saw merits in an initial, focused set of tangible measures that can help generate reform momentum, and noted that such reforms could also provide near term benefits by increasing confidence, reducing uncertainty and signalling policy consistency. They welcomed progress in easing infrastructure bottlenecks.

Directors considered the 2016 Budget as appropriately ambitious but cautioned that additional measures might be required to stabilize debt over the medium term. They recommended measures to boost spending efficiency, including containing the public wage bill, and increasing private sector participation in state owned enterprises (SOEs). Should these measures not materialize, and if growth underperforms, Directors recommended

[2] At the conclusion of the discussion, the First Deputy 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.

implementing a package of growth-friendly fiscal consolidation measures, while protecting social spending. Directors also underscored the need to improve SOE performance and strengthen their governance.

Directors commended the South African Reserve Bank (SARB) for a balanced monetary policy stance. They suggested that the SARB consider holding interest rates steady unless core inflation or inflation expectations rise substantially, as the impact of past policy hikes is still filtering through, and the weak economy should keep inflation contained. Directors encouraged the SARB to consider ways to enhance its inflation targeting regime to guide expectations within the target band.

Directors viewed exchange rate flexibility, the favorable currency composition of external debt, and South Africa's net external creditor position as strengths. However, external competitiveness remains a concern, notwithstanding some adjustment in the current account deficit. Directors encouraged the authorities to seize opportunities to increase reserves.

Directors recognized the soundness of the financial sector, as noted in the SARB's recent stress tests. With rising pressures from the weak economy, tightening financial conditions and regulatory changes, Directors encouraged stepped up monitoring of financial sector risks and contingency planning.

South Africa: Selected Economic and Social Indicators, 2012–17

Social Indicators

GDP		**Poverty**	
Nominal GDP (2015, billions of U.S. dollars)	315	Headcount ratio at $1.90 a day (2011, percent of population)	16.6
GDP per capita (2015, U.S. dollars)	5727	Undernourishment (2012, percent of population)	5.0
Population characteristics		**Income distribution (2011)**	
Total, 2015	55.0	Income share held by highest 10 percent of population	51.3
Urban population (percent of total), 2014	64	Income share held by lowest 20 percent of population	2.5
Life expectancy at birth (years), 2014	57	Gini index	63.4

Economic Indicators

	2012	2013	2014	2015	2016 Proj.	2017 Proj.
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	2.2	2.3	1.6	1.3	0.1	1.1
Real GDP per capita	0.6	0.7	0.0	-0.4	-1.6	-0.6
Real domestic demand	3.5	3.3	0.6	1.6	-0.4	0.6
GDP deflator	5.3	6.6	5.7	4.0	6.5	6.1
CPI (annual average)	5.7	5.8	6.1	4.6	6.7	6.2
CPI (end of period)	5.7	5.4	5.3	5.2	7.0	5.6
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.9	24.7	25.1	25.4	26.1	26.7
Average remuneration (formal nonagricultural, nominal)	7.6	10.4	7.5	7.8	8.5	8.0
Labor productivity (formal nonagricultural)	1.1	-2.6	-0.3	2.3	2.8	2.8
Unit labor costs (formal nonagricultural)	6.4	13.5	7.7	4.9	5.5	5.1
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	15.0	15.3	15.3	16.4	15.8	14.9
Public (including public enterprises)	-0.9	-0.9	1.1	1.0	1.2	1.5
Private	15.9	16.2	14.2	15.4	14.6	13.4
Investment (including inventories)	20.0	21.0	20.7	20.7	19.9	19.7
Public (including public enterprises)	6.8	7.0	7.3	7.6	7.6	7.6
Private	12.5	13.3	13.2	13.0	12.3	12.2
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.3	27.6	28.2	29.6	30.1	30.2
Expenditure and net lending	31.4	31.5	31.9	33.5	33.8	33.8
Overall balance	-4.0	-3.9	-3.7	-3.9	-3.7	-3.6
Primary balance	-1.3	-0.9	-0.6	-0.6	-0.2	0.1
Structural balance (percent of potential GDP)	-3.8	-3.8	-3.4	-3.2	-2.8	-2.7
Gross government debt 2/	41.0	44.0	46.9	49.8	51.5	52.6
Government bond yield (10-year, percent) 3/	7.6	7.3	8.2	8.2	9.3	…
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	5.2	5.9	7.3	10.3	6.5	6.9
Credit to the private sector	9.3	6.6	7.2	8.3	6.5	6.9
Repo rate (percent, end-period) 3/	5.0	5.0	5.75	6.25	7.0	…
3-month Treasury bill interest rate (percent) 3/	5.3	5.1	5.8	6.1	7.0	…
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-19.7	-21.1	-19.1	-13.7	-11.0	-13.2
percent of GDP	-5.0	-5.7	-5.4	-4.3	-4.1	-4.8
Exports growth (volume)	0.7	3.6	3.3	3.6	2.4	2.9
Imports growth (volume)	4.2	5.0	-0.5	2.9	0.7	1.2
Terms of trade (percentage change)	-1.4	-5.4	-1.8	-0.5	-2.0	-3.3
Overall balance	0.3	0.1	0.4	-0.2	0.0	0.0
Gross reserves (billions of U.S. dollars)	50.7	49.6	49.1	45.8	45.8	45.8
percent of short-term debt (residual maturity)	133.2	130.2	123.8	134.8	122.8	118.0
Total external debt	35.7	37.3	41.3	39.4	50.6	51.4
of which short-term (residual maturity)	9.6	10.4	11.3	10.8	13.9	14.1
Nominal effective exchange rate (percentage change, end-period) 4/	-5.2	-15.4	-2.7	-16.6	-18.2	…
Real effective exchange rate (percentage change, end-period) 4/	-2.0	-12.5	1.4	-13.1	-14.0	…
Exchange rate (Rand/U.S. dollar, end-period) 3/	8.5	10.5	11.6	15.6	15.8	…

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 2016, May data.
4/ For 2016, April data.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 15, 2016

KEY ISSUES

Context. South Africa has made considerable economic and social strides since 1994, but faces significant challenges. Deep-rooted structural problems—infrastructure bottlenecks, skill mismatches, and harmful insider-outsider dynamics—have kept unemployment and inequality unacceptably high. Also, a confluence of external and domestic shocks, combined with heightened governance concerns and policy uncertainty, have weighed on confidence and growth. Though private balance sheets are still strong, vulnerabilities are elevated.

Outlook and risks. 2016 growth is projected at 0.1 percent. Only a muted recovery is envisaged from 2017, with rising unemployment. Downside risks dominate and stem mainly from China, heightened global financial volatility, and domestic politics and possible policy missteps. Shocks could be amplified by extensive macro-financial linkages, especially if combined with sovereign credit rating downgrades to speculative grade. On the upside, the recent dialogue between social partners could catalyze reform implementation and invigorate growth.

Structural reforms. Structural reforms are urgent and imperative to facilitate robust and inclusive private sector-led growth that creates more jobs and reduces inequality and vulnerabilities. The authorities are making some progress in addressing electricity bottlenecks. A comprehensive package of structural reforms—greater competition, more inclusive labor market policies, better training and education, and improved governance—remains the preferred option. An initial, focused set of tangible measures that lowers policy uncertainty and boosts confidence could help generate sustained reform momentum.

Fiscal and monetary policy. The 2016 Budget targets are appropriately ambitious, but could be challenging to achieve if staff's macro projections materialize. Maintaining debt sustainability is essential, but further adjustments need to be carefully designed to avoid pressuring an already-weak economy. Strengthening governance, private participation in SOEs, and greater spending efficiency are key interventions to improve SOE performance and public service delivery, protect the poor, and reduce contingent liabilities. After recent rate hikes, monetary policy may be able to remain on hold, though more tightening may be needed if core inflation or inflation expectations rise significantly.

Other policies to enhance resilience. The authorities are advancing key financial sector reforms and their stress tests suggest the financial sector remains resilient. Heightened monitoring of financial sector risks is warranted given the weak economy, tightening financial conditions, and regulatory changes. The SARB could seize opportunities to build international reserves, especially in case of large, lumpy, foreign direct inflows.

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Discussions took place in Pretoria, Johannesburg, and Cape Town, April 18–May 4, 2016. The staff comprised Ms. Papi (head), Ms. Chen, Messrs. Saxegaard, Wu (all AFR), Miao (MCM), and Morra (SPR). Mr. Schimmelpfennig (Senior Resident Representative) assisted the mission. Ms. Tshazibana and Mr. Sishi (OED) also participated in the discussions.

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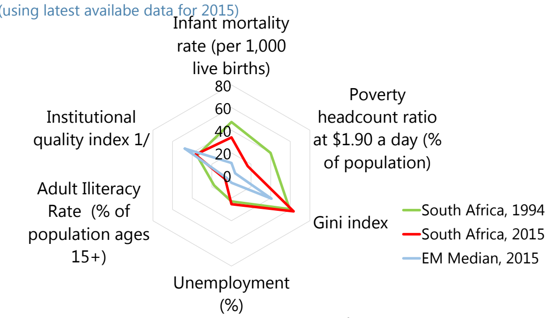
CONTEXT: CONFLUENCE OF SHOCKS ON TOP OF EXISTING STRUCTURAL CHALLENGES AND VULNERABILITIES

1. **South Africa has made considerable economic and social progress over the last two decades, but faces substantial challenges.** Annual per capita growth averaging 1.5 percent since 1994 and broadened access to social assistance and services have resulted in much improved living standards. Strong institutions and policy frameworks have contributed to macroeconomic stability. Globally-competitive corporates and a deep and sophisticated financial system have resulted in a globally-integrated economy. Yet, many South Africans have not sufficiently benefited from these improvements. Infrastructure bottlenecks, skill mismatches, and product and labor markets with harmful insider-outsider dynamics have left over a quarter of the labor force unemployed and income distribution among the most unequal in the world (Figure 1).

South Africa has made significant progress since 1994

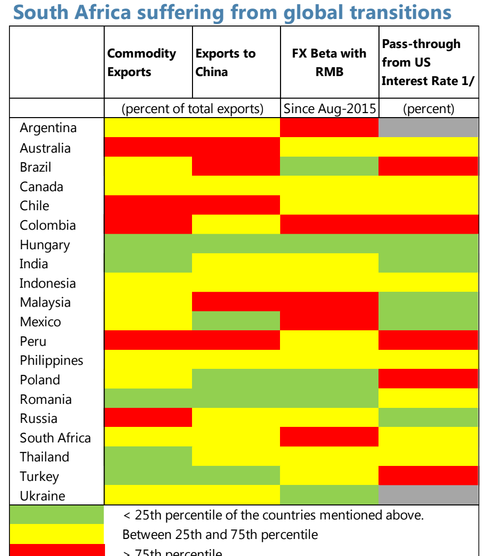
(using latest availabe data for 2015)



Note: Lower numbers represent better outcomes; a shift closer to the center indicates improvement. 1/ On a scale of 100, measures distance (in percent) away from the perfect score.
Sources: The Global Competitiveness Report, WEF; and WDI, World Bank.

2. **The global transitions—China's slowdown and rebalancing, weak commodity prices, and the U.S. monetary policy normalization—are taking a heavy toll on South Africa.** China's key role in the world economy and South Africa's high reliance on mining exports result in significant spillovers from China's transitions and the commodity price fall, despite the country being an oil importer (Box 1). China's growth now matters more for South Africa than the E.U.'s and the U.S.'s growth. Commodities are the main channel, closely followed by global financing conditions likely capturing confidence effects. The commodity channel is also likely operating via Sub-Saharan Africa (SSA)—now absorbing 30 percent of South Africa's exports and a major destination of South African corporates' large expansion abroad—and is reducing corporate profitability and incomes across the economy. In addition, South Africa's financing conditions are closely tied to those in the United States, though the two economies are moving in opposite directions. Outward spillovers to South Africa's immediate neighbors will be significant. Spillovers to the rest of SSA are rising but remain muted (Box 2).

South Africa suffering from global transitions



1/ Cummulative impulse response of domestic long-term rates after one year to 1 percent increase in federal funds rate.
Sources: UNCTAD and staff estimates.

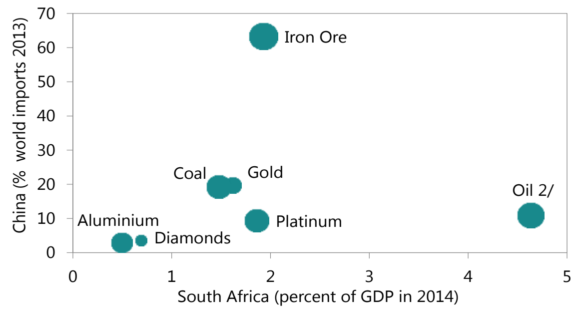
Box 1. Spillovers from Global Transitions

This box explores spillovers from the ongoing global transitions—China's rebalancing, lower commodity prices, and tighter global financial conditions—on South Africa. The results suggest China's growth matters more for South Africa than U.S.' and Europe's growth, with commodity prices and financing conditions the main transmission channels. The impact of commodity prices is amplified by inter-sectoral linkages. Tighter global financial conditions have a significant impact on South Africa, mainly though bond yields and equity prices.

Spillovers from China and lower commodity prices[1]

Rising trade linkages and reliance on commodities have increased spillovers from China. China absorbs 10 percent of South African exports, the most of any country. More importantly, it plays a key role in determining global demand for South Africa's commodity exports, which account for 34 percent of total goods exports (51 percent including manufactured commodities), and commodities imports including oil, which account for 16 percent of total goods imports.

China's role in South Africa's main commodities 1/



1/ The size of the bubbles represents the fall in real prices since end 2010
2/ South Africa is an oil importer
Sources: Bloomberg, UN Comtrade and MIT Observatory of Economic Complexity

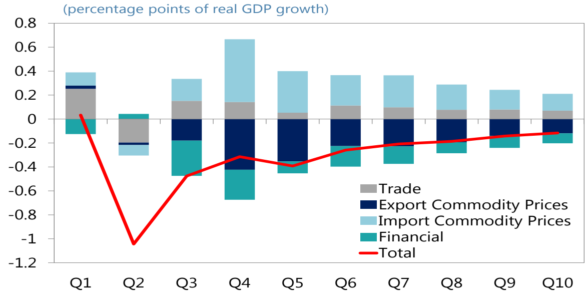
Staff analysis suggests China's growth now matters more for South Africa than that of the U.S. and the E.U. Using quarterly data from 2000, a VAR suggests that a one percentage point decline in China's real GDP growth would lower South Africa's growth by 0.3 percentage point (q/q sa annualized) after one quarter. This is smaller than the impact of a shock to the U.S. and the E.U. growth, and broadly consistent with estimates found in previous studies, including the World Bank's June 2015 Global Economic Perspectives. However, the impact of a shock to China's growth rises to 1 percentage point in the post-crisis sample, significantly exceeding the impact of shocks originating in the U.S. and the E.U. Though data limitations preclude a full analysis, the impact of a decline in China's secondary sector could be even greater.

Spillovers from the US, EU, and China to South Africa

	US	EU	China
	Latest sample (2010-15)		
Growth impact 1/	-0.3	-0.2	-1.0
	Full sample (2000-15)		
Growth impact 1/	-0.4	-0.7	-0.3

1/ Impact of a 1 percentage point negative growth shock on South Africa's growth after 1 quarter.

Impact of growth shock in China: Spillover channels
(percentage points of real GDP growth)



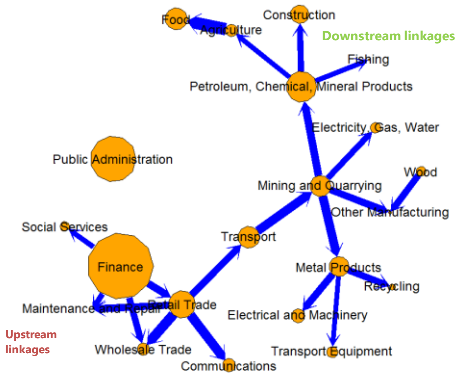
Source: Staff estimates.

Commodity prices and global financial conditions are the main transmission channels. A decomposition following Swiston and Bayoumi (2008) suggests the decline in South Africa's export commodity prices following a shock to China's growth has a large and persistent impact.[2] Financial spillovers (proxied by U.S. financial conditions), which likely capture global confidence effects, are also important. Spillovers through trade are small and positive, suggesting the impact of exchange rate depreciation on competitiveness outweighs the fall in global demand. Declining import commodity prices (mainly oil) provide a partial offset.

The impact of lower commodity prices is amplified by sectoral interlinkages. An analysis of input-output tables in South Africa suggests linkages between the commodity sector and the rest of the economy are significant. A sectoral structural VAR identified using multipliers from the input-output table suggests a 10 percentage point decline in export commodity prices would reduce real GDP growth by nearly 0.2 percentage points (q/q sa annualized) after two quarters, with most of the impact coming from downstream (e.g., construction) and upstream (e.g., transport) sectors including manufactured commodities. A Swiston and Bayoumi decomposition suggests that the main transmission channels are changes in corporate profitability and employment in the non-mining sector.

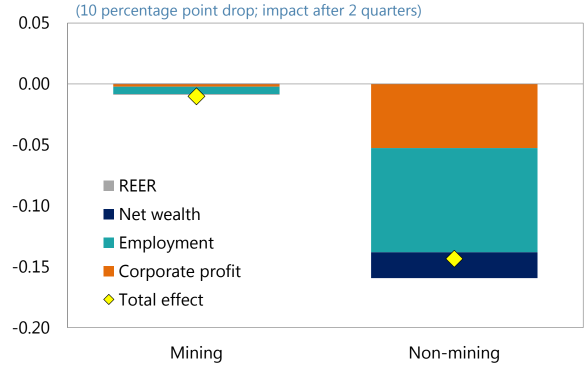
Box 1. Spillovers from Global Transitions (concluded)

Intersectoral linkages with the commodity sector



Sources: EORA MRIO Database and staff estimates.

Impact of shock to export commodity prices: Spillover channels
(10 percentage point drop; impact after 2 quarters)



Source: Staff estimates.

A shock to China's growth worsens South Africa's external and fiscal balances, but the impact on inflation is ambiguous. Mineral export growth declined to -7 percent in 2015 from an average of 19 percent in 2011–13 on lower demand and prices. The lower oil import bill is a partial offset, and the terms of trade are expected to remain negative over the next few years.[3] Fiscal revenues are affected mainly through growth, with corporate income tax growth down from an average of 10 percent between FY11/12-FY13/14 to an estimated 2.2 percent in FY15/16. Lower oil prices are fully passed through to retail prices, with petrol prices in early-2015 27 percent below their 2014 peak. However, this effect has been partly offset by depreciation. Anecdotal evidence points to a significant deflationary impact from overcapacity in China, which South Africa has partly offset through increasing tariffs by 10 percent on some steel imports (within the WTO bound rates). The overall impact on inflation in South Africa is therefore ambiguous.

Spillovers from tighter global financial conditions

High external financing needs and a large share of bond and equities held by foreign investors make South Africa vulnerable to spillovers from tighter global financial conditions. Almost half of South Africa's portfolio liabilities are held by U.S. investors. Estimates in Caceres et al. (2016) suggest a 100bps increase in the U.S. policy rate would increase South African long-term rates by 73bps after one year, above the EM average, but short-term rates are not significantly affected.[4] South Africa-specific estimates underlying the 2014 Spillover Report suggest a 0.2 percent decline in growth after one year following a 100bps rise in U.S. bond yields, with most of the spillovers coming from a 79bps increase in long-term bond yields and declining equity prices. Simulations using a broader set of countries in the 2015 Spillover Report and in Buitron and Vesperoni (2016) suggest that an unexpected tightening of monetary conditions that pushes up U.S. bond yields by 100 bps would spill over to bond yields in EMs and non-systemic advanced countries, result in capital outflows, and lower industrial production growth by 3½ percent per annum after one year.[5] Most EMs would also experience significant exchange rate depreciation, though South Africa is relatively shielded from negative balance sheet effects given low corporate leverage and limited FX mismatches.

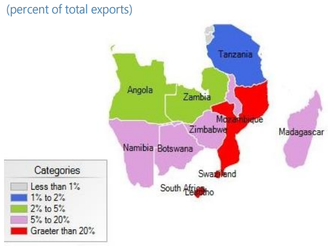
1/ Nose, Manabu, Magnus Saxegaard, and Jose Torres (2016), "The Impact of China's Rebalancing and Lower Commodity Prices on South Africa", IMF Selected Issues Paper.
2/ Swiston, Andrew and Tamin Bayoumi (2008), "Spillovers Across NAFTA", IMF Working Paper 08/3.
3/ This contrasts with the 2014 Spillover Report which found a positive impact on South Africa's trade balance from lower metal, energy, and food prices.
4/ Caceres, Carlos, Yan Carrière-Swallow, Ishak Demir, and Bertrand Gruss (2016), "U.S. Monetary Policy Normalization and Global Interest Rates", Forthcoming IMF Working Paper.
5/ Buitron, Carolina and Esteban Vesperoni (2015), "Big Players Out of Synch: Spillover Implications of U.S. and Euro Area Shocks", IMF Working Paper 15/215.

Box 2. Outward Spillovers to Sub-Saharan Africa

Outward spillovers from South Africa's growth to SSA are likely to have increased following South African corporates' expansion in the region and are significant for its immediate neighbors. Increased regional integration could also expose South Africa to reverse spillovers from the region.

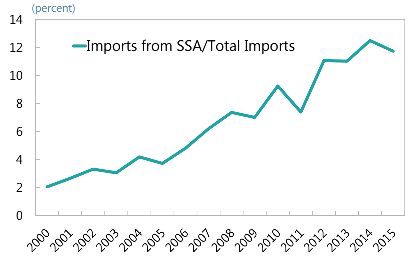
Past research suggests that, apart from its immediate neighbors, South Africa has limited spillovers to the rest of Africa, but these are likely to have increased. Several studies have shown that South Africa's growth has limited spillovers on SSA, once global growth is controlled for.[1] However, SSA's share in South Africa's imports has more than doubled over the last decade. South African companies in retail, banking, and telecommunications have established large networks in several sub-Saharan African countries. South Africa now represents an important export destination and source of FDI, especially for neighboring countries.

Exports to South Africa from neighboring countries, 2014
(percent of total exports)



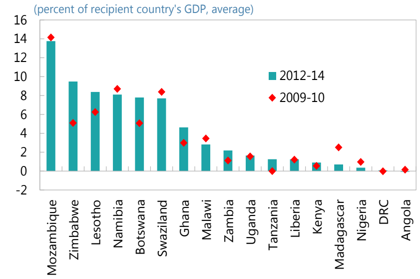
Sources: Country authorities, and staff estimates.

South Africa regional imports have increased
(percent)



Sources: IMF Direction of Trade Statistics

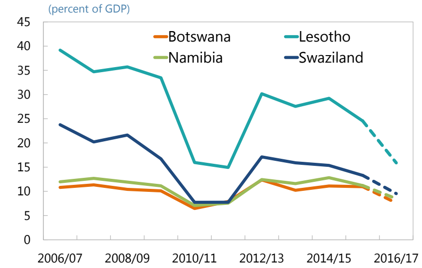
South Africa's outward FDI position
(percent of recipient country's GDP, average)



Sources: IMF Coordinated Direct Investment Survey and WEO.

Other countries of the Southern African Customs Union (SACU) will be the most affected by South Africa's slowdown. Besides the growth impact, SACU countries rely heavily on South Africa in their shared customs receipts, as South Africa accounts for about 85 percent of total SACU imports. With imports having declined in 2015 and low growth expected going forward, combined with the lags built in the SACU revenue formula, this vital source of revenue will decline markedly.

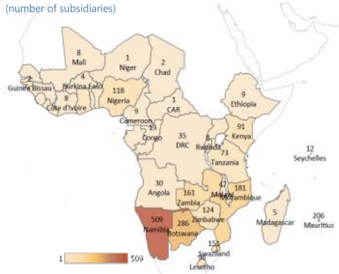
SACU revenue
(percent of GDP)



Sources: BLNS Authorities, and staff estimates.

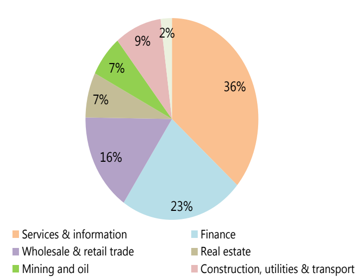
South African firms have many subsidiaries in SSA, which could dampen their profitability going forward. About 75 percent of African subsidiaries are in services, trade, and financial sectors. The 10 firms with the highest number of subsidiaries are some of the top listed companies. While African subsidiaries have contributed to South African corporates' high profitability in the past decade, the deteriorating performance of SSA could adversely affect profitability.

South African subsidiaries in Sub-Saharan Africa
(number of subsidiaries)



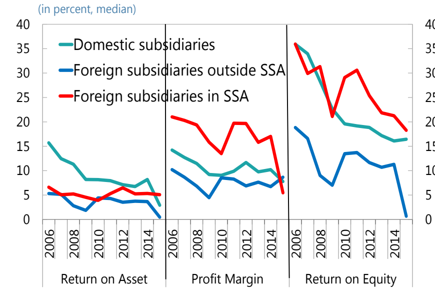
Sources: Orbis and IMF staff estimates

Industry breakdown of South African subsidiaries in SSA



Sources: Orbis, and staff estimates.

South African subsidiaries performance
(in percent, median)



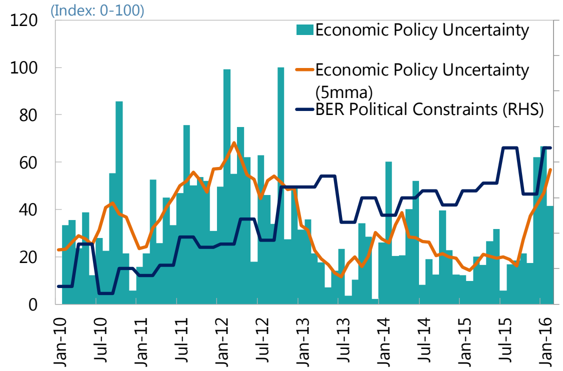
Sources: Orbis, and staff estimates.

1/ Basdevant, O., A. Jonelis, B. Mircheva, and S. Slavov (2014), "The Mystery of Missing Spillovers in Southern Africa: Some Facts and Possible Explanations," IMF African Departmental Paper 14/03; Canales-Kriljenko, J., F. Gwenhamo, and S. Thomas (2013), "Inward and Outward Spillovers in the SACU Area", IMF Working Paper 13/31; International Monetary Fund, 2012, "Nigeria and South Africa: Spillovers to the Rest of Sub-Saharan Africa," Chapter II, Regional Economic Outlook, Washington, (October).

3. Leadership changes at the National Treasury last December and subsequent political developments have heightened governance concerns and increased policy uncertainty. Changes in ministerial appointments at the Treasury in December 2015 shook investor confidence, with the subsequent recovery of financial markets not fully retracing the initial sharp losses. These and subsequent political developments have kept perceived political risks and policy uncertainty high, though the strength of South Africa's institutions has been affirmed. The President has announced that local elections will take place on August 3. General elections are due in 2019.

Rising economic policy uncertainty

(Index: 0-100)

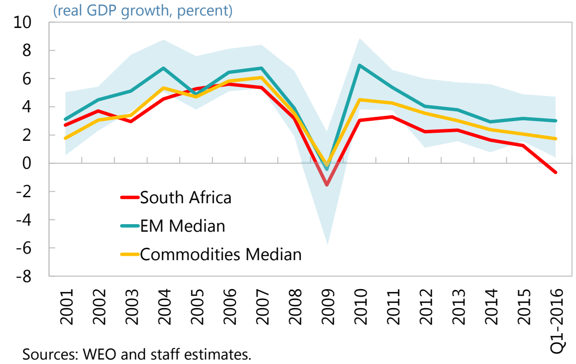


Sources: BER, Factiva, and staff estimates.

4. Growth and employment, which were already low, are faltering and continue to underperform peer countries.[1] Real GDP growth declined to 1.3 percent in 2015 versus 1.6 percent in 2014 (2½ percent adjusted for major strikes) (Figure 2).[2] Growth in 2015 was a post-crisis low and in the bottom quintile of emerging markets (EMs). Falling commodity prices played an important role (with the impact amplified by intersectoral linkages), as did electricity constraints and a severe drought, estimated to have directly detracted 0.5 and 0.2 percentage points from growth, respectively. Private consumption, which benefitted from fewer days lost to strikes, lower inflation, and a generous public wage increase, continued to underpin growth. Net exports contracted as imports recovered more than exports after the 2014 strikes.[3] Weak business confidence and policy uncertainty weighed on private investment. The economy weakened further in 2016Q1, with real GDP contracting by 1.2 percent (q/q, saar). Though mining played a big role, the weakening was across sectors and private consumption and investment fell. The unemployment rate also rose to 26.7 percent in 2016Q1, and the sluggish

Growth underperforming 1/

(real GDP growth, percent)



Sources: WEO and staff estimates.

1/ The light blue area represents the three center quintiles for other EMs.

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[1] Peer countries include EMs and commodity exporters. In turn, in this report EMs comprise: Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, Thailand, Turkey, and Ukraine. Commodity exporters comprise: Australia, Brazil, Canada, Chile, Colombia, Peru, and Russia.

[2] Statistics South Africa (StatsSA), which has been responsible for compiling GDP estimates by production, has recently also taken over the compilation of GDP estimates by expenditure from the South African Reserve Bank, and published revised 2010–15 GDP data in May 2016. Although the revisions to overall GDP are small (up by 0.3 percent for 2015), there were sizable changes to the GDP expenditure components: notably, 2015 exports were revised down and private consumption up.

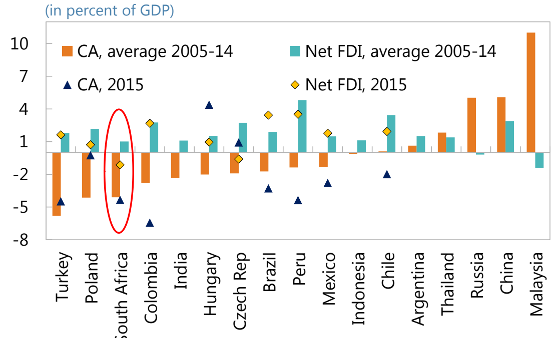
[3] During the 2014 strikes, exports held up better than production supported by inventory reductions. On the other hand, demand for imported inputs fell as well as for consumption goods.

employment growth since the global financial crisis has now turned into job losses in almost all sectors of the economy, with especially large retrenchments in mining and construction (Figure 3). Potential growth has declined in recent years and is expected to recover only moderately over the medium term.

5. Vulnerabilities remain elevated and have increased in the real and fiscal sectors.

- The current account has started adjusting, albeit mainly due to lower oil prices. Volume adjustment remains slow due to structural bottlenecks and policy uncertainty that result in low responsiveness of exports to currency depreciation despite some uptick in tourism, electronics, and automotives recently (Figures 4 and 5).[4] A shift to a positive net international investment position (IIP) in 2015, partly due to depreciation, is a source of strength, as is a favorable debt currency and maturity composition, and the fact that about 1 percent of GDP of the current account deficit consists of Southern Africa Customs Union transfers, paid in rand. Nevertheless, in the event of a shock, some foreign assets may be difficult to liquidate quickly, as 40 percent of total foreign assets are FDI. Hence, South Africa's still large current account deficit (4.3 percent of GDP), financed by non-FDI inflows, and gross financing needs (19 percent of GDP), and sizable gross external liabilities (139 percent of GDP, among the highest in EMs) remain a significant vulnerability.

South Africa has one of the largest current account deficits among EMs,financed by non-FDI flows
(in percent of GDP)



Sources: Haver, and SARB.

South Africa's Long-term Sovereign Ratings

	Foreign Currency Debt			Local Currency Debt		
	Moody's	S&P	Fitch	S&P	Moody's	Fitch
Rating	Baa2	BBB-	BBB-	BBB+	Baa2	BBB
Outlook	Negative	Negative	Stable	Negative	Negative	Stable
Date of last outlook change	Dec-15	Dec-15	Dec-15	Dec-15	Dec-15	Dec-15
Date of last rating change	Nov-14	Jun-14	Dec-15	Jun-14	Nov-14	Dec-15

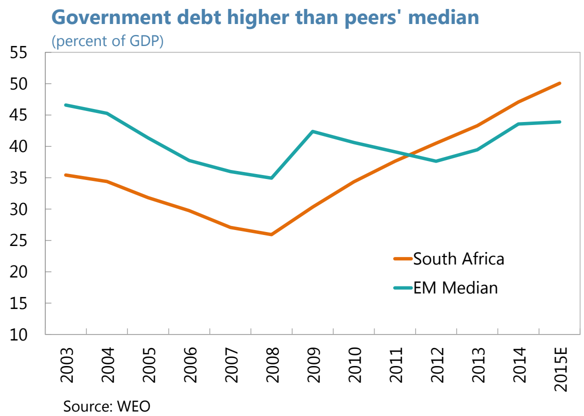
Sources: S&P, Moody's, and Fitch.

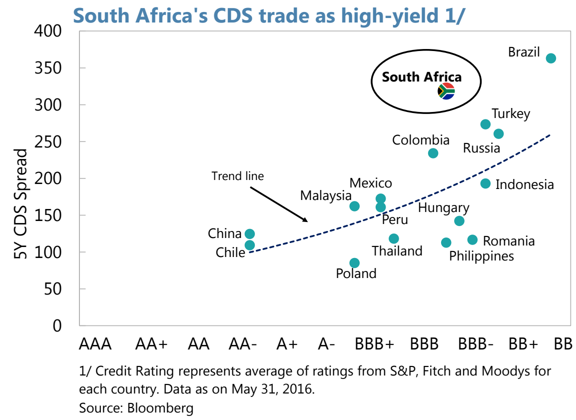
Note: Moody's does not differentiate between LC and FX credit risk. S&P allows a maximum difference of two notches.

- Though the rate of increase has slowed, as fiscal stimulus injected in response to the global financial crisis has been withdrawn, government debt continues to rise and is now above the EM median. This, coupled with low growth, sizable contingent liabilities from financially-weak state-owned enterprises (SOEs) reliant on government guarantees, and spending pressures, triggered an increase of vulnerabilities in the real and fiscal sectors. These trends are reflected in pressure

[4] Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), "South Africa's Exports Performance: Any Role for Structural Factors?", IMF Working Paper No. 16/24; and Hlatshwayo, Sandile, and Magnus Saxegaard (2016), "The Consequences of Policy Uncertainty: Disconnects and Dilutions in the South African Real Effective Exchange Rate-Export Relationship", IMF Working Paper No.16/113.

on the sovereign credit ratings, and South Africa's credit spreads now trade broadly in line with non-investment grade countries.



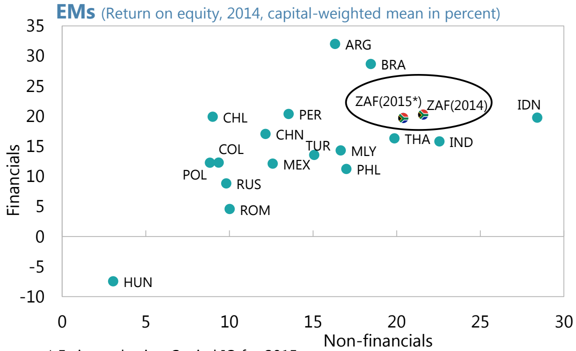


6. Monetary and fiscal policies are on a tightening course. After averaging 4.6 percent in 2015, headline inflation has started rising mostly due to base effects of fuel prices and food prices reflecting the drought (Figure 6).[5] In April 2016, headline and core inflation were at 6.2 percent and 5.5 percent y/y, respectively, versus the 3–6 percent target band. The South African Reserve Bank (SARB) raised the policy rate by 50bps in 2015 and 75bps in 2016 to 7 percent, citing rising inflation and elevated risks. Markets expect additional 80bps in hikes by end-2017. Fiscal consolidation, which started with the 2013 Budget, has resulted mostly in a contractionary stance, but the fiscal deficit has remained sticky as growth has underperformed (Figure 7).

7. Most private institutions' balance sheets remain strong, but financial indicators signal some deterioration ahead. Financial and corporate soundness indicators remain healthy, as South African firms have traditionally been run conservatively and benefit from market concentration (Figures 8 and 9). But a weaker labor market, higher interest rates and inflation, and a softening housing market are pressuring highly-indebted households. The corporate sector—historically highly profitable and with low leverage—is seeing lower profitability, with pockets of stress (e.g., mining, construction, steel, and agriculture). Equity prices of financial institutions and some corporates have declined markedly in the past year. Overall equity market performance has been in line with EMs due to a high share of foreign earnings and dual-listed firms.

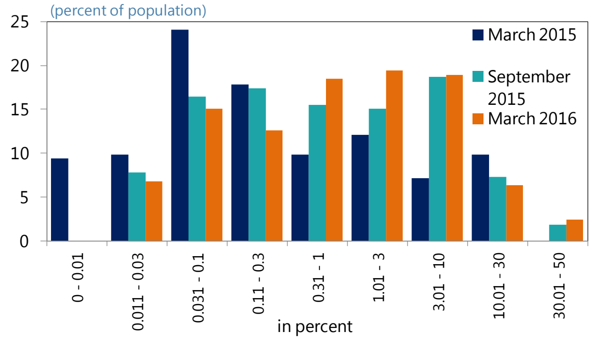
[5] The authorities approved a 34 percent increase in wheat-import duties in April 2016, which resulted from the existing variable import duty formula, based on international wheat prices and the exchange rate. The authorities are reviewing the formula on concerns about the higher tariff's effect on food prices.

South African firms are more profitable than most EMs (Return on equity, 2014, capital-weighted mean in percent)



* Estimated using Capital IQ for 2015.
Sources: Capital IQ and Corporate Vulnerability Utility.

The expected default frequency of non-financial corporates has increased
(percent of population)

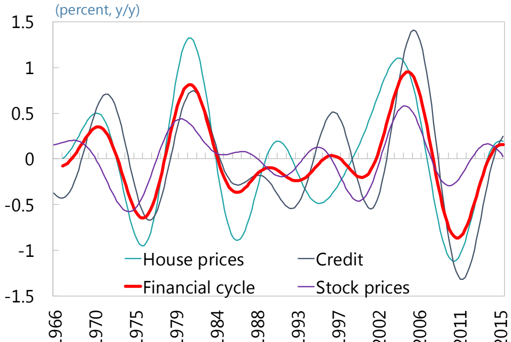


Source: SARB Financial Stability Reviews

8. Financial markets have weakened and financial conditions have tightened.

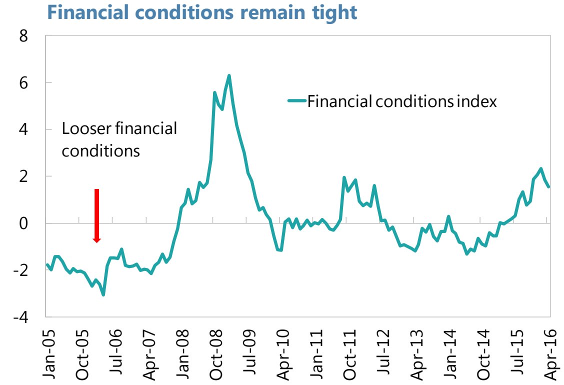
- In the first part of 2015, yields moved in line with other EMs and the nominal effective exchange rate was stable benefitting from lower oil prices and low dollar debt (Figure 10). But as China shocks hit, financial markets sold off markedly and more so after leadership changes at the Treasury. Portfolio outflows ensued, yields rose, and the rand depreciated 14 percent versus the dollar between October 2015 and February 2016 with rising volatility. Financial markets recovered some ground up to mid-June, as credit rating agencies maintained their ratings and global risk sentiment turned more positive toward EMs.

Financial cycle has peaked at a relatively low level
(percent, y/y)



Sources: Haver, SARB, and staff estimates.

Financial conditions remain tight



Sources: Bloomberg, L.P. and staff estimates.

- So far, growth in credit to corporates has remained buoyant, underpinned by activities in renewable energy and commercial property, investments abroad, and substitution for reduced bond financing. Credit growth to households is subdued. The financial cycle seems to have peaked at a relatively low level, and the SARB has determined that there is no need to activate countercyclical capital buffers for banks as the credit gap remains negative. Banks' funding costs are rising (partly due to regulatory changes), lending standards have become stricter, and overall financial conditions have tightened.

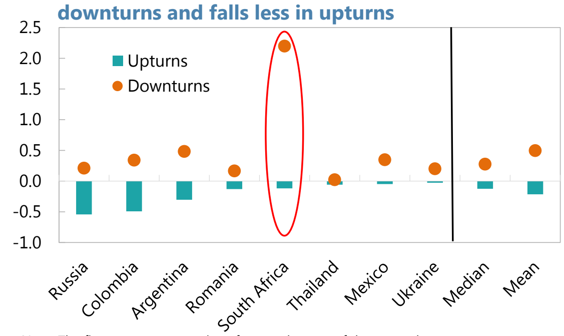
9. Keenly aware of the challenges, the authorities have devised plans to boost growth and achieve economic transformation, but implementation has fallen short. The authorities have articulated the NDP's 2030 vision in the Medium-Term Strategic Framework, successive Industrial Policy Action Plans, and more recently the Nine-Point Plan (Annex I). However, implementation has lagged and progress on past Fund advice in the structural area has been mixed. On the other hand, infrastructure bottlenecks, especially in electricity, have started easing, and macroeconomic policies have been broadly in line with previous Fund recommendations.

10. The 2016 Article IV consultation focuses on the recent shocks, risks, and the policy response. In particular, the consultation centers on: (i) the spillovers from global transitions and the macro-financial linkages that could amplify or buffer the impact of shocks; (ii) considerations that may help calibrate the macroeconomic policy mix to minimize the growth impact; and (iii) measures that can reduce policy uncertainty, and build confidence and trust.

SOBERING OUTLOOK AND ELEVATED DOWNSIDE RISKS

11. The near-term outlook is based on a projection of further deterioration before a muted recovery from 2017. The commodity price shock has yet to fully filter through to production and employment, the global recovery is fragile, macroeconomic policies and financial conditions are tightening, and high policy uncertainty persists. Against this backdrop, real GDP growth is projected to fall to 0.1 percent (-1.6 percent in per capita terms) in 2016. Private investment is expected to contract, consumption growth to weaken, while net exports are projected to contribute to growth. Electricity bottlenecks are less of a constraint on growth given the additional generation capacity and subdued demand in the electricity-intensive mining and manufacturing sectors. Only a feeble recovery is envisaged from 2017 (1.1 percent), approaching 2–2½ percent in the outer years, as shocks dissipate and new power plants are completed. South Africa's unemployment rate seems to respond more (less) strongly to changes in output during downturns (upturns) compared to EMs, suggesting unemployment may rise over the medium term. The current account deficit is forecast to narrow slightly to 4.1 percent of GDP in 2016, but rise to 4.8 percent of GDP in 2017 on weaker terms of trade before improving in the rest of the projection horizon. Inflation is projected at 6.7 percent in 2016, before easing to 5.6 percent by end-2017.

South Africa's unemployment rate rises more in downturns and falls less in upturns



Note: The figure represents ratios of mean changes of the unemployment rate to mean changes in real GDP per capita growth over all downturns (dot) and upturns (bar) for each country. Sources: ILO, WEO, and staff estimates.

12. Downside risks dominate. External risks, notably further shocks from China, a sharp increase in global financial volatility, and lower global growth weigh heavily on the outlook (Annex II). Domestic risks are equally prominent, especially from politics and policies perceived to harm confidence and from the realization of SOEs' contingent liabilities. All these risks would depress growth and asset markets and are amplified by South Africa's vulnerabilities. They would be particularly damaging if accompanied by downgrades of the sovereign credit rating to speculative grade. On the upside, the recent dialogue between government, businesses, and labor could catalyze reform implementation and boost activity.

13. The linkages between capital flows, the sovereign, and the financial sector could amplify the impact of shocks.

- Banks are intermediating a larger share of capital inflows and their ratings are linked to the sovereign (Box 3). Also, the country's financial cycle has become increasingly correlated with the U.S. financial cycle and appears linked to capital flows. In case of a capital outflow shock, import compression could follow and depress growth. As foreign investors and domestic non-bank financial institutions adjust their portfolios, large losses in bond and equity markets are likely, as is a reduction in wholesale funding for banks. Banks' funding profile would likely worsen, which combined with new regulatory requirements, could contribute to a significant rise in term funding premia. Banks' buffers are deemed sufficient to withstand a significant increase in non-performing loans (NPLs) on the households' unsecured credit and corporate books. A combined shock—higher funding costs, deteriorating asset quality, and reduced liquidity—could lower financial sector profitability, lead to a liquidity squeeze, induce banks to curtail lending, and further reduce growth, with sizeable implications for tax revenues: finance, real estate, and business services account for about half of personal income tax and one third of corporate income tax.[6]

- Sovereign downgrades could trigger capital outflows. The market appears to have mostly priced in a downgrade of the sovereign FX debt rating to speculative grade. The impact on the sovereign would be mitigated by the low level of government FX debt. However, the effect on SOEs and banks could be more significant, and countries with large SOEs and limited fiscal space face a stronger sovereign-corporate nexus. Furthermore, downgrades of South Africa's local currency sovereign debt rating to speculative grade could have significant consequences, given that foreigners hold a third of local currency government bonds and about a fifth of that is estimated to be rating-sensitive, though still two and three notches away and not in staff's baseline. In addition, equity flows have shown a high correlation with bond flows in times of stress, and foreign equity holdings at about 45 percent of GDP are high, though potential outflows would be mitigated by the fall in equity prices and depreciation. While large domestic financial institutions could provide a backstop in terms of availability of government financing, this could amplify vulnerabilities and linkages between capital flows, the sovereign, and the financial sector. Moreover, a speculative rating would also weaken the profile of the foreign investor base, making it more reliant on short-term oriented investors.

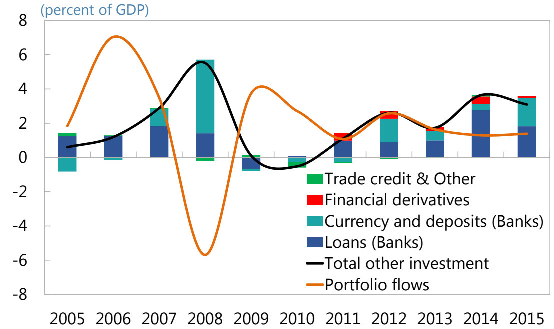
[6] A further breakdown is not available, but the financial sector accounts for a large share of this aggregate.

Box 3. Macro-Financial Linkages: Capital Flows, the Sovereign, and the Financial Sector[1]

Extensive macro-financial linkages could amplify shocks given South Africa's high reliance on external finance, high foreign ownership of local securities, and banks' increasing role in intermediating capital flows. Sovereign rating downgrades to speculative grade could trigger capital outflows and generate negative feedback loops.

Banks are intermediating a larger share of capital inflows. In recent years, South Africa's external financing has shifted from portfolio and FDI to other investment, mainly short-term bank flows, and unrecorded transactions. These inflows have played a stabilizing role as net FDI turned negative and portfolio flows moderated. Banks' liabilities, though accounting for only a quarter of total external debt, make up half of those due within one year. FX funding on average is about 10 percent of banks' liabilities, but it is higher for some banks. And while banks' FX position is small, it has risen and there could be some maturity mismatches as part of the FX assets is corporate loans to fund acquisitions abroad. Banks' credit rating outlook is tied to the sovereign and so are their funding costs. The outlook for strong inflows via banks is uncertain, also because particularly European banks (accounting for 76 percent of total external bank borrowing) are retrenching.

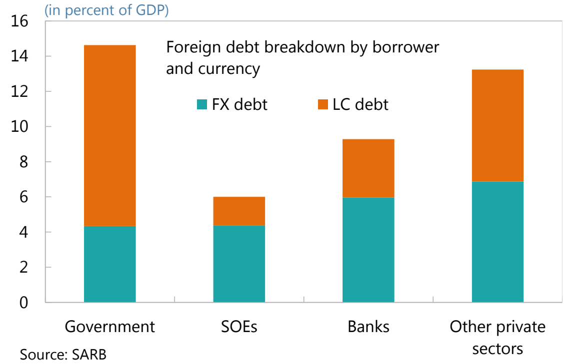
Other investment flows comprise primarily bank flows and are negatively correlated with portfolio flows
(percent of GDP)



Source: Haver

Shocks that cause sudden declines in capital inflows or a foreign investors' pullout from local assets could lead to sharp economic adjustments. The immediate impact would be a currency depreciation and declines in bond and equity prices. The floating exchange rate and limited original sin would mitigate the impact, and the large stock of external assets (157 percent of GDP) could provide a buffer. But 40 percent of FX assets are FDI which may be difficult to liquidate quickly, and financial institutions have 12 months to repatriate if regulatory limits are breached. In case of large outflows, growth could weaken sharply, as exports respond slowly to depreciation, while domestic demand would decline amid import compression and a forced adjustment of the current account deficit as financing becomes scarcer and costlier. Limited policy space would likely prevent counter-cyclical responses, as the authorities may have to hike rates to counter inflation if the depreciation is large and take measures to contain the fiscal deficit.

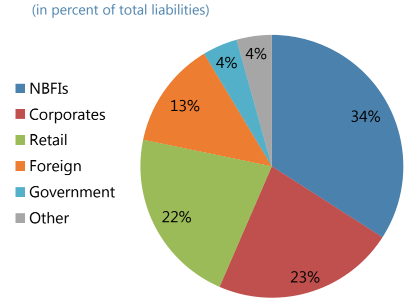
Limited original sin in external debt
(in percent of GDP)



Source: SARB

The financial sector is also vulnerable to large capital outflows, placing additional downward pressure on growth and public finances. South Africa has a large and highly-interconnected financial system, with assets three times GDP. While non-banks financial institutions (NBFIs, with assets of 210 percent of GDP) could backstop foreign sales and absorb new issuance, they would have to rebalance their portfolios away from other assets,

Banks rely heavily on domestic wholesale funding
(in percent of total liabilities)



Source: SARB

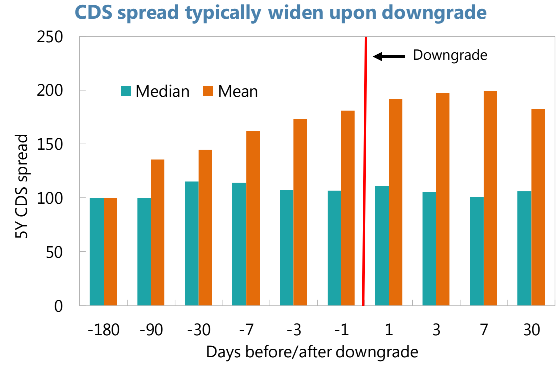
1/ Miao, Hui, Pablo Morra, and Yi Wu (2016), "Macro-Financial linkages: Capital Flows, Sovereign Ratings, and the Financial: Capital Flows Sovereign Ratings, and the Financial Sector Nexus," IMF Selected Issues Paper.

Box 3. Macro-Financial Linkages: Capital Flows, the Sovereign, and the Financial Sector (concluded)

e.g., equities and banks' certificates of deposits, which with corporate deposits and other funding from NBFIs and corporates account for close to 60 percent of banks' funding. This would lead to further equity price declines, tighter liquidity, and higher banks' funding costs. Though capital controls keep rand liquidity in the closed system, the deteriorating banks' funding profile would force banks to deleverage, at a time when firms face lower external and bond financing. NPLs would rise. Financial sector profitability would fall, significantly affecting fiscal revenue.

Impact of a FX sovereign debt downgrade to speculative grade. As other countries' experiences suggest, credit spreads could widen further if the downgrade materializes, driven by forced bond sales by investors with mandates restricted to investment grade securities. JP Morgan estimates such sales at round US$2 billion. The direct impact on government would likely be limited given very small FX issuance. SOEs are more reliant on FX borrowing. The subsequent deterioration in SOEs' balance sheets could feed back to the sovereign via credit guarantees or other financial support. For banks, credit rating downgrades could raise rollover and hedging costs, as syndicated loans for EM banks (and firms) are typically of 3-year tenor, at floating rates, with fees and credit spreads tied to their rating. Also, downgrades to speculative grade could trigger covenants, entailing reviews, cost escalations, or loans becoming callable.

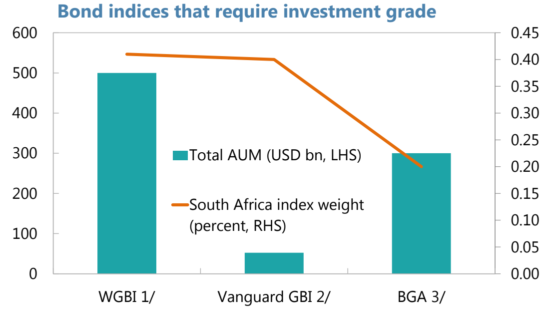
CDS spread typically widen upon downgrade



Sources: Bloomberg and staff estimates.

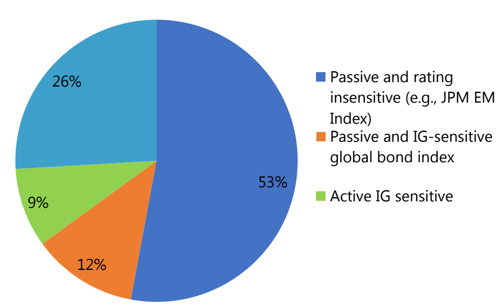
Impact of a potential downgrade of the LC debt to speculative grade. Non-residents hold 34 percent of South Africa's LC government bonds, 12.5 percent of GDP. Due to either index restrictions or investment mandates, staff estimate that a downgrade to speculative grade could trigger forced sales of about 2½ percent of GDP. Other bond investors might also sell anticipating price declines, and equity flows have displayed high correlation with bond flows in times of stress. With non-resident portfolio equity holdings at 45 percent of GDP, potential equity outflows could be large, though they would be mitigated by depreciation and price declines.

Bond indices that require investment grade



1/ Citigroup World Government Bond Index. 2/ Vanguard Government Bond Index. 3/ Barclays Global Aggregate.
Sources: Bloomberg and staff estimates.

Rating sensitivity of LC government debt investors



Sources: Bloomberg, National Treasury, and staff estimates.

Sovereign downgrades to speculative grade could reduce participation of long-term nonresident investors. Typically, real money investors, such as sovereign wealth funds, pension funds and insurance companies, are more rating-sensitive. Also, a GFSR (2014) study showed that institutional investors (currently the majority in South Africa) tend to take longer to return after a downgrade to speculative grade compared to retail investors. Hence, more short-term oriented investors (e.g., hedge funds and mutual funds) that tend to trade more could hold an increasing share of South Africa's bonds, possibly resulting in more volatile portfolio flows.

Authorities' views

14. The authorities broadly agree with the near-term outlook, but are more sanguine about South Africa's medium-term prospects than staff. They concur on the expected slowdown in private consumption and investment in the near term due to lower confidence and weaker commodity prices. They maintain a more positive medium-term outlook on investment and exports, expected to benefit from a gradual recovery in confidence and external demand, which will allow companies to capitalize on improved competitiveness from the exchange rate depreciation. The authorities believe that government and private sector initiatives aimed at expanding infrastructure, transforming cities, supporting SME development, and regional integration will boost growth and employment, although these are not included in the authorities' baseline forecast for 2016. They are confident about medium-term prospects in the rest of the African continent and the opportunities that those present for South African firms. They have identified agro-business and tourism, in addition to the value chains linked to mining and the auto industry, as sectors that can generate job-rich growth, and view their Broad-Based Black Economic Empowerment (B-BBEE) and Black Industrialists policy as likely to lead to significant progress on social transformation.

15. The authorities concur with the key risks and vulnerabilities, but emphasize that there are also upside risks. The concerted effort to raise cooperation between social partners to unblock growth can help leverage South Africa's strengths. Conservative export forecasts present further upside to growth. On the downside, the authorities note that prevailing global uncertainties complicate policy making and give more prominence to risks stemming from trading partners' lower growth, the impact of U.S. monetary policy normalization on financial markets and capital flows, and China's new growth model. While recognizing the significant impact of possible credit rating downgrades, the authorities view the risk of a local currency downgrade to speculative grade as remote at this stage. Finally, they emphasize the economy's resilience to capital outflows, the flexible exchange rate, low levels of FX debt, and deep financial and capital markets.

POLICIES

Boosting growth and job creation, thus reducing extremely high unemployment and inequality, and promoting social transformation remain South Africa's key challenges. In addition, the shocks that hit the economy in 2015 require immediate attention to maintain hard-won macroeconomic stability and restore confidence. Progress in the structural area is urgent given that global growth and commodity prices are expected to remain low for long, many of the problems are structural, and macroeconomic policies have to address vulnerabilities. Macroeconomic policies have to be designed and calibrated carefully: too little tightening and confidence could wane and debt could continue rising, but too much tightening could further weaken growth and become self-defeating. Recent country experience suggests that EMs that took more consistent and decisive action and complemented macroeconomic adjustment with structural reforms achieved the largest improvement in fundamentals and were more resilient to subsequent shocks.

A. Fiscal Policy

16. The 2016 Budget envisages additional consolidation aimed at stabilizing debt.

- High revenue buoyancy—partly the result of policy measures—and the withdrawal of a proposed reduction in social security contributions should yield a 3.9 percent of GDP deficit in FY15/16. With measures to cut compensation budgets and raise revenue, the authorities anticipate the deficit to fall to 2.4 percent of GDP by FY18/19 and debt to peak at 51 percent of GDP in FY17/18 and decline thereafter.

- The Budget emphasized slowing public sector hiring, greater spending efficiency, and less waste, mainly by blocking hiring for non-essential personnel in the central payroll system and more robust procurement processes. But the 2015 public wage settlement and rising interest rates mean interest and compensation absorb a rising expenditure share (46 percent).

17. In the baseline scenario, which includes staff's macroeconomic assumptions and the proposed Budget measures, achieving the authorities' targets will be challenging.

- The Budget projects higher growth and GDP inflation than staff. As a result, staff project the fiscal deficit to decline more slowly than in the Budget to 3.2 percent of GDP by FY2018/19. Debt would reach 53½ percent of GDP by FY2018/19 and continue rising, albeit slowly.

- As acknowledged in the Budget, the fiscal outlook is subject to significant risks: weaker growth and commodity prices, greater support for SOEs, and higher borrowing costs.[7] If contingent liabilities and permanently lower growth materialize, debt could reach 70–75 percent of GDP by 2021 (see accompanying Debt Sustainability Analysis). The mooted new nuclear power plants could pose considerable fiscal risks depending on scale and modalities. On the upside, buoyancy could continue exceeding expectations and the authorities' efforts to combat Base Erosion and Profit Shifting could widen the tax base.

18. Policies to maintain debt sustainability are critical for investor confidence, but need to be carefully chosen and calibrated to avoid pressuring an already-weak economy.

- The 2016 Budget is appropriately ambitious, though if staff's macroeconomic assumptions materialize debt may not stabilize at 51 percent of GDP in FY17/18 as envisaged by the

[7] Although revenue directly linked to the resources sector is only around 2 percent of total, lower commodity prices have an impact on other sectors of the economy and also lower the GDP deflator which matters for revenue, while expenditure is linked to CPI.

authorities.[8] The sharp adjustment required in a short period of time to keep debt at that level could reduce growth as much as -1½ percent. Instead, given that the weak economic outlook is the main reason behind the buildup of fiscal vulnerabilities and that growth is critical for confidence, implementation of pro-growth structural reforms (as outlined below) would be the best sustainable way to ensure an improved fiscal outlook over the medium term. Only if such reforms are not an option, should fiscal policy be tightened further and this should be done over a multi-year period to minimize the growth decline (which could render the consolidation self-defeating) and with a composition that protects the poor.

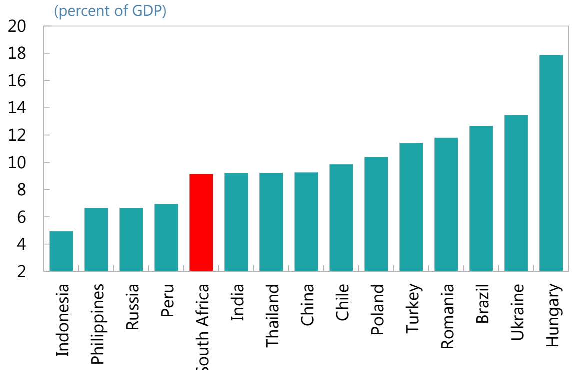
- Specifically, building on strengthened procurement processes and performance budgeting could reduce waste, freeing up resources to aid the consolidation without compromising service delivery and hence with minimal impact on growth and the poor. Asset sales could also reduce borrowing and arrest the debt rise, while contributing to growth, especially if combined with decisive SOE reforms (see below) and appropriate regulatory frameworks.

- Absent structural reforms and measures suggested above, additional spending or revenue measures to stabilize debt at the authorities' debt peak projection (51 percent of GDP) should be calibrated based on conservative estimates of the multiplier to ensure credibility, but phased over a longer period than the three-year budget horizon to smooth the adjustment. Over the longer term, reducing debt to 40 percent of GDP as recommended in the 2014 Article IV Consultation Staff Report would be advisable to leave space for shocks.

- Laying the groundwork for targeted expenditure cuts, including to the bloated government wage bill, while protecting social grants and investment, would avoid the need for across-the-board cuts that would be most damaging to growth and hurt especially the poor. If the need for fiscal consolidation is sizable or large spending projects (e.g., National Health Insurance) materialize, further revenue measures, notably raising consumption taxes toward the EM average, could be needed. Strong commitment to a fiscal anchor, besides the expenditure ceilings, lengthening the budget horizon, and communication about future fiscal policy could be instrumental in maintaining credibility, in addition to protecting South Africa's strong fiscal institutions.

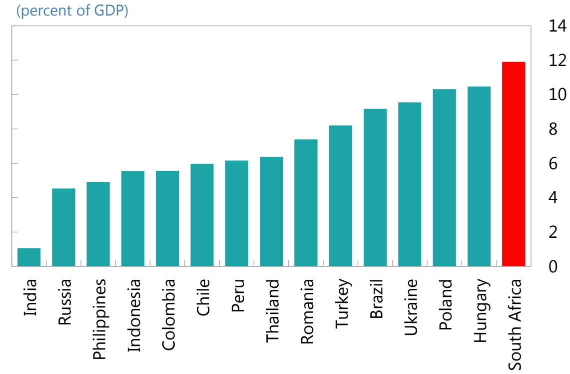
[8] Using the approach in Batini, Nicoletta, Luc Eyraud, Lorenzo Forni, and Anke Weber (2014), "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projects", the first-year fiscal multipliers in South Africa are estimated to be between 0.4–0.9. Achieving the authorities' debt peak projection of 51 percent of GDP in FY17/18 as envisaged by the authorities would likely require a further adjustment of ¾ to 1½ percent of GDP in FY16/17, depending on multipliers.

Relatively low consumption taxes
(percent of GDP)



Sources: OECD, and WEO.

Wage bill one of the highest among EM peers
(percent of GDP)



Source: WEO

19. Improving spending efficiency and composition is critical to maintain confidence, ensure public support for, and minimize the growth impact of the consolidation.

- As noted by the Auditor General, progress in strengthening procurement processes has contributed to a reduction in "irregular, fruitless, and wasteful and unauthorized expenditure" in the national and provincial governments by 28 percent in FY14/15 relative to FY13/14.[9] However, "irregular, fruitless, and wasteful and unauthorized expenditure" in municipalities increased by 30 percent during the same period and, despite a much smaller budget, is now similar in magnitude to that seen in national and provincial governments.[10] An eTender portal, central supplier database, and mandatory use of centrally-negotiated contracts should help increase the efficiency and effectiveness of government spending and, as the Chief Procurement Officer reported, reduce "the risk of fraud, corruption, and losses".[11] However, increased performance monitoring and consequences for poor performance (as recommended by the Auditor General) remain important to ensure that government receives value for money. At the same time, it is critical that the use of public procurement as a tool to advance social transformation does not undermine transparency surrounding procurement decisions.

- A generous public sector compensation favors insiders: civil servants represent 40 percent in the top 3 deciles of the income distribution.[12] Slowing growth in public wages, which at 184 percent of

[9] Auditor-General South Africa, "Consolidated General Report on the National and Provincial Audit Outcomes, 2014-15.

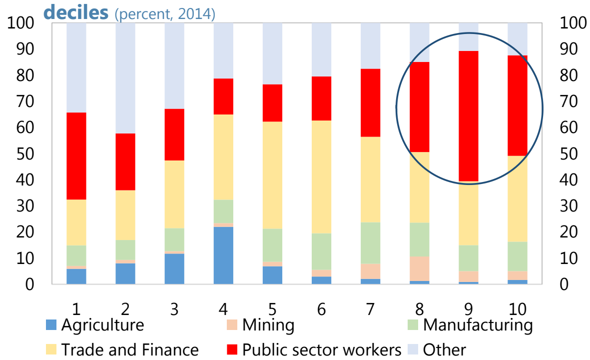
[10] Auditor-General South Africa, "Consolidated General Report on the Audit Outcomes of Local Governments", 2014-15.

[11] 2015 Public Sector Supply Chain Management Review, Chapter 8.

[12] The 2015 public sector wage settlement envisages a 10 percent increase in overall compensation (CPI+2 average wage increase and higher benefits) in FY2015/16, and wage increases of CPI+1 in the subsequent two years. The risks to these figures are skewed to the upside as sectorally-negotiated allowance adjustments and promotions are not

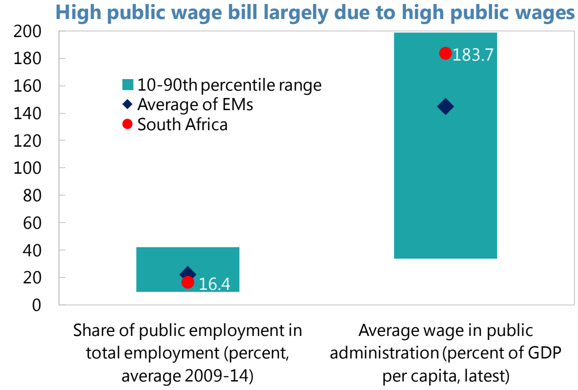
GDP per capita are high among EMs, will require stricter monitoring of wage and personnel decisions across all spheres of government, and a reassessment of the institutional structure for public wage negotiations.[13] A more rigorous process for selecting and costing investment projects is also important.[14]

Public employees represent 40 percent in top 3 earnings deciles (percent, 2014)



Sources: Labor Market Dynamics, StatSA, and staff estimates.

High public wage bill largely due to high public wages



Sources: Country authorities, and staff estimates.

20. Concrete steps to reform SOEs are needed to lower fiscal risks, and improve confidence and growth.

- The government's commitment that support to SOEs be budget neutral, and conditional on sound business plans and improved governance and operational efficiency, is welcome. However, as the recent report by the Presidential Review Committee on State-Owned Entities notes, SOEs' challenges require far-reaching reforms (Box 4).

- A strong governance framework, including transparency surrounding board appointments and remuneration of board members and management, and stronger accountability are essential to improve efficiency and ensure incentives are aligned with those of the country.

- Greater private participation—e.g. allowing private competition in some sectors, partial stock market listings, or management contracts to run certain parts of SOEs' operations—and effective regulators could help improve efficiency and service delivery, and free up resources for SOEs' investments. Clear mandates for every SOE that quantify the cost and address potential conflicts between commercial and developmental activities would facilitate benchmarking performance and contribute to greater accountability.

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taken into account, and because government is required to compensate for higher inflation but has historically been unable to claw back lower-than-anticipated inflation.

[13] IMF (forthcoming), "Managing Government Compensation and Employment" suggests potential measures to help control compensation budgets, including aligning public sector wage negotiations with the budget cycle, increasing National Treasury's role in wage negotiations, regular payroll audits to eliminate ghost workers, systematic annual comparisons between public and private wages, and differentiated pay scales to attract and retain staff in areas with skill shortages.

[14] See IMF (2015), "Making Public Investment More Efficient".

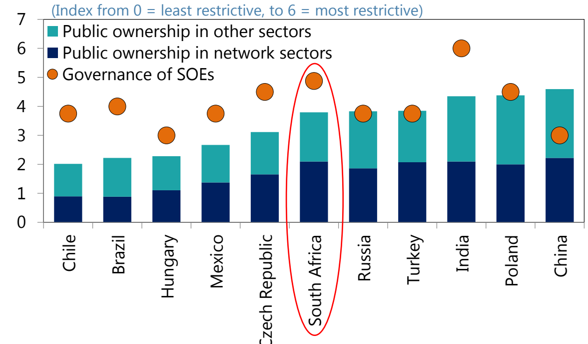
Box 4. State-Owned Enterprises in South Africa

SOEs' performance has deteriorated. Several SOEs suffer from inefficient operations, poor governance, and weak balance sheets. Far-reaching reforms are needed to ensure SOEs deliver essential economic and social services, hence supporting growth and the fiscal accounts.

South Africa's key SOEs play an important role in the economy. Most SOEs are small, but a few, notably Eskom (electricity), Transnet (ports, pipelines, and freight rail), South Africa Post Office (SAPO), South Africa Airways (SAA), SANRAL, and PetroSA, are large and/or several have a monopoly position in their sector. Moreover, because of their strategic position in network industries and their role in carrying out the government's infrastructure build program (over the next three years SOE account for 39 percent of total public infrastructure spending, equivalent to around 7 percent of GDP), SOEs are an important part of the enabling environment for the private sector. According to the Presidential Review Commission on State-Owned Entities (PRC), SOEs contribute in excess of 8 percent to overall GDP.

High public ownership in network sectors and weak SOE governance

(Index from 0 = least restrictive, to 6 = most restrictive)



Source: OECD Product Market Regulation

The financial performance of SOEs has deteriorated. Measures of profitability and leverage have worsened, though some SOEs (e.g., Transnet) perform well. Also, leverage measures have improved since the government's recapitalization of Eskom in 2015/16. As noted in the 2014 Financial System Stability Assessment (FSSA), reasonable shocks to borrowing costs and earnings could undermine SOEs' ability to service debt and require government intervention. Also, PetroSA, South African Airways (SAA), and the South African Post Office (SAPO) are loss making and (in the case of Eskom, SAA, SANRAL and SAPO) reliant on government guarantees which have increased to R553bn (14 percent of GDP) in FY2015/16 from R177bn (8 percent of GDP) in FY2007/08.[1] Auditors' concern with SAA's going-concern status means it has yet to finalize its FY14/15 financial statements.

South Africa: State-Owned Enterprise Performance (capital weighted mean) 1/

	FY09/10	FY10/11	FY11/12	FY12/13	FY13/14	FY14/15
Net profit margin (percent)	5.9	9.6	11.1	5.2	5.7	3.7
Return on equity (percent)	4.6	7.7	9.9	4.9	5.3	2.8
Return on assets (percent)	1.6	2.5	3.2	1.5	1.5	0.9
Debt to equity (percent)	112.0	146.4	141.0	149.1	168.0	152.6
Interest coverage ratio	7.5	3.9	4.3	6.7	3.6	2.4

1/ Major state-owned enterprises listed in Schedule 2 of the PFMA, excluding development finance institutions
Sources: National Treasury of South Africa and staff estimates.

The authorities are keenly aware that SOEs face a number of challenges that require far-reaching reforms. In addition to their poor financial position, the 2016 Budget Review maintains that many entities suffer from "internal weaknesses such as inefficient operations, poor governance, and weak balance sheets". The PRC found that "governance, ownership policy, and oversight systems", and "the quality of the board and executives' recruitment…and remuneration frameworks and practices" in SOEs were inadequate.

1/ This amount excludes R200bn in guarantees issued to independent power producers under power-purchase agreements with Eskom.

Authorities' views

21. The authorities affirmed their commitment to and confidence in meeting the budget targets. The authorities' core commitments are to expenditure limits, achieving a primary surplus over the medium term, and ensuring a stable national debt-to-GDP ratio. Even if growth were to develop as in staff's projections, they maintain that deficit targets are likely to be met in 2016/17—by which time the bulk of the consolidation will have been achieved. They point to a history of excellent budget execution (i.e., spending remaining within the expenditure ceiling), the budget's conservative tax buoyancy assumptions (relative to recent years), and savings from procurement reforms ensuring that the Budget's targets are met. The bulk of the spending reductions have been targeted at compensation budgets—an area of expenditure that has been a key driver of deficits over the past decade.

22. Underscoring their commitment to the debt sustainability principle, the authorities are committed to take additional measures, should debt stabilization be seriously at risk. They stress the dilemma that fiscal policy would face, if growth disappointed substantially: if necessary, they will consider additional reprioritization of spending and additional revenue options as appropriate to maintain confidence or stretch out the adjustment to minimize the growth impact. The authorities will balance these imperatives on the basis of data and analysis of fiscal and economic developments as they materialize over the medium term, but remain committed to the stabilization of debt.

23. The authorities are taking measures to improve SOEs' efficiency and governance. They monitor fiscal risks associated with SOEs on an on-going basis and associated contingent liabilities are reported in the Budget. The 2016 Budget outlined four broad areas of reform that will be overseen by the Deputy President, which include exploring ways to stabilize SOEs' financial performance, quantify the cost of developmental activities, improve transparency and governance by benchmarking boards' and executives' performance and compensation, and where appropriate, seeking greater private sector participation.

B. Monetary Policy

24. Inflation is projected to remain elevated, above the target band, but contained. Headline inflation is rising mostly due to base effects of fuel prices, higher food prices reflecting the drought, and currency depreciation. Though headline inflation will likely peak at about 7 percent in 2016Q4 and exceed the target band for the first half of 2017, core inflation is projected at 6 percent in 2016 and to ease to 5.6 percent in 2017. Staff expect inflation to remain contained for several reasons. The output gap is projected to widen (to 2¼ percent in 2017). Imported inflation is expected to remain negative in dollars. The FX pass-through seems unlikely to jump given a widening output gap and still-solid retailers' profits (Box 5). Unit labor costs are rising more moderately and job losses should keep them in check. Inflation expectations remain well-anchored, though slightly above 6 percent. The impact of the SARB's hikes is still filtering through, which takes up to six quarters, and regulatory changes being phased-in will likely tighten financial conditions further.

25. The SARB faces difficult trade-offs and uncertainty. While cutting interest rates would be unlikely to boost growth as policy uncertainty and reduced investor confidence will likely constrain private spending, additional monetary tightening would further depress growth.[15] And while inflation is above the band, it is mainly because of supply shocks, which are expected to subside in 2017. Core inflation is within the band. Moreover, there is considerable uncertainty surrounding inflation projections, especially due to the volatile exchange rate. Considering that additional monetary tightening would hurt an already-weak economy and the 2016 Budget envisages sizable consolidation, monetary policy could remain on hold for now. Consideration could also be given to whether greater specificity on the inflation target might help enhance communication and guide inflation expectations within the band.

Authorities' views

26. The SARB is concerned about inflation risks and remains focused on its inflation mandate. The SARB indicates that increases in food and fuel prices, the large exchange rate depreciation, real wage growth higher than productivity, and the threat of second round effects pose elevated inflation risks. Recent Monetary Policy Statements reflect concerns that inflation expectations are cemented at the upper end of the target band, which does not leave room for shocks. Also, the fact that inflation is projected to stay outside the band for a protracted period risks unhinging inflation expectations. The SARB views the impact of its actions on economic activity as limited, and reaffirms that its utmost contribution to growth is via ensuring price stability, which the existing flexible inflation targeting regime can deliver. The SARB reiterates that they view the real policy rate to be supportive of the economy, and that any further adjustments to the monetary policy stance would be informed by incoming data and the potential impact thereof on the inflation trajectory going forward, in the context of a flexible inflation targeting framework.

[15] Staff analysis suggests that a 100bp hike could lower output by 0.3 percent after one year and 0.5 percent after two years (cumulative), and could lower the price level by 0.6 percentage points after 3 quarters and 1 percentage point after 6 quarters (cumulative).

Box 5. Exchange Rate Pass-Through to Consumer Price Inflation

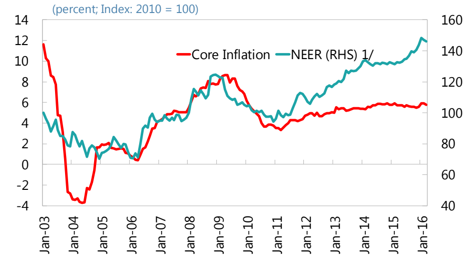
Our estimates indicate that the FX pass-through to inflation declined markedly in the early 2000s, but has declined only slightly in recent years when the global deflationary environment helped contain inflation. The pass-through is lower when the output gap is negative.

The FX pass-through has been moderate despite substantial depreciation since 2010. Core inflation's increase from 3.0 percent in 2011Q1 to 5.5 percent in April 2016 is moderate compared to the 48 percent depreciation of the nominal effective exchange rate (NEER). The global deflationary environment contributed to the apparently low pass-through. The substantial decline in oil prices in 2015 reduced headline inflation and helped contain core inflation. The rising share of imports from China (to about 20 percent of non-oil imports), where PPI has been declining for four years, contributed to the decline in total foreign PPI in 2014/15. As a result, despite the sizable depreciation of the rand, non-oil import price growth declined markedly in 2015.

Estimates of the FX pass-through to headline inflation in South Africa range from around 20 percent[1] to the low 10s.[2] The SARB has maintained its estimate of 20 percent, but some recent cross-country studies find smaller pass-through estimates. Gruss and Carriere-Swallow (2016) also finds a large decline in FX pass-through in recent years.

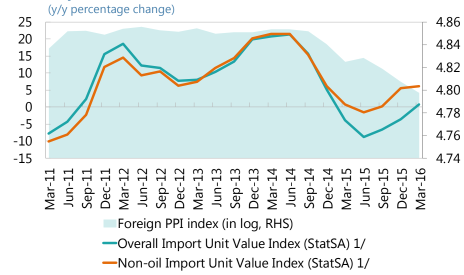
Our estimates suggest that the FX pass-through declined markedly in the early 2000s, while it declined only slightly in recent years. We focused on non-oil import prices and core inflation as there exists an automatic mechanism for complete pass-through of fuel prices. Following Chew et al. (2011)[3] and Kabundi and Mbelu (2016), we estimate the FX pass-through using an error correction model, focusing on non-oil import prices and core inflation using quarterly data for 1980–2015.[4] Average long-run first-stage pass-through from the NEER to non-oil import prices (controlling for foreign producer prices) is about 80 percent, with full pass-through occurring in six quarters. Average second-stage pass-through from import prices to core inflation (controlling for unit labor costs) is about 30 percent. Rolling 10-year window estimates show large declines in overall FX pass-through around the time of the introduction of the inflation targeting regime (2000), but only small declines in recent years, to 22 percent. The pass-through is found to be smaller when the output gap is negative. This study finds little evidence that the FX pass-through is related to the size of the depreciation or exchange rate volatility.

Core Inflation and NEER
(percent; Index: 2010 = 100)



1/ NEER is reversed so that a larger value represents a weaker exchange rate.
Source: Haver.

Import Prices (in Rand)
(y/y percentage change)

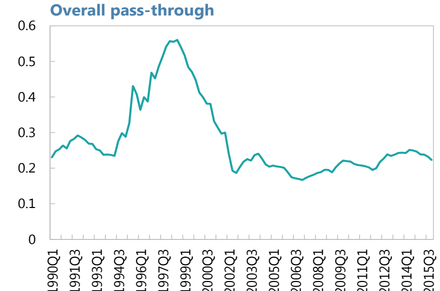


1/ Q1-2016 is an average of y/y percentage change for January and February, 2016.
Source: Haver.

Long-run relations (in log)	Non-oil import prices	Core inflation
NEER	-0.785***	
Foreign PPI	1.731***	
Non-oil import prices		0.308***
ULC		0.730***
R-squared	0.99	0.99
No. of Observations	144	144

Note: ***p<0.01. Variables are found to be co-integrated.

Overall pass-through



Source: Staff estimates

1/ A. Kabundi and A. Mbelu (2016), "Has the exchange rate pass-through changed in South Africa?" forthcoming SARB working paper; Albagli, E., A. Naudon, and R. Vergara (2015), "Inflation Dynamics in LATAM: A Comparison with Global Trends and Implications for Monetary Policy," Central Bank of Chile working paper No. 58; G. Gopinath (2015), "The International Price System," NBER WP 21646.
2/ Kolerus, C. and J. Menkulasi (2016), "Inflation Dynamics in EMs: The Role of Exchange Rate Pass-through and Oil Prices;" Gruss, B. and S. Carriere-Swallow (2016), "Exchange Rate Pass-Through: First- Versus Second-Round Effects," forthcoming IMF Working Papers.
3/ Chew, J., S. Ouliaris, and S. Tan, 2011, "Exchange Rate Pass-Through over the Business Cycle in Singapore," IMF WP 11/141.
4/ The analysis uses import-based NEER and foreign PPI (excluding oil exporting countries) with time-varying weights.

C. Structural Reforms

27. The authorities have made some progress on structural reforms, especially in infrastructure, but some other measures have been counterproductive.

- The bringing online of Medupi's first unit and some independent power producers (IPPs), maintenance improvements, and lower demand have reduced load-shedding. Private providers have expanded broadband, contributing to improving South Africa's ranking in the World Economic Forum's Global Competitiveness Index. But some freight transport projects are postponed, port tariffs remain among the highest in the world for manufactured goods, and the drought has exposed structural challenges in water supply.

- The use of Socio-Economic Impact Assessments is a positive step, though not all policy initiatives are covered. The Employment Tax Incentive Act has led to 270,000 youths being employed during its first year. The proposed national minimum wage could help reduce inequality, though depending on its level and modality, risks causing job losses, especially among the less-skilled, young, and SME workers. The Competition Commission's pro-active market inquiries in different product markets hold the promise of facilitating market entry for smaller businesses. Government, in collaboration with the private sector, is exploring ways to boost SMEs. Nonetheless, large businesses and labor unions maintain a stronghold on insider-outsider dynamics that contribute to above-market-clearing wage settlements that are binding on the entire sector and hinder SMEs' entry and development, and employment. Besides, complex business regulations are particularly damaging for SMEs.

- However, lack of clarity about pending legislation that would determine modalities for property expropriation and pricing of strategic minerals, as well as implementation of B-BBEEE codes in the mining sector are examples of policy uncertainty. In addition, stricter limits on temporary contracts have reduced employment especially for the low skilled. Stricter visa requirements hurt tourism and their reversal, though partial, is welcome. Finally, BER surveys report that more than 80 percent of responding firms in the manufacturing sector point to the general political climate as a constraint on their business.

28. A comprehensive package of structural reforms remains the preferred policy to increase growth, create jobs, and lower income inequality. In addition to closing infrastructure gaps, greater product market competition, more inclusive labor market policies and industrial relations, and improved education and training remain critical to promote growth and employment in the private sector.[16] Job creation, especially in SMEs, which are more labor intensive and hire a relatively high share of low-skilled workers, is the best way to ensure a sustainable reduction in inequality (lowest 20 percent only hold 2.5 percent of national income). These reforms will lower business costs, increase

[16] See IMF (2013 and 2014), "South Africa: Article IV Consultation Country Report"; OECD (2013 and 2015) South Africa Economic Survey; and OECD (2015 and 2016) "Going for Growth". Also, see World Bank (2016), "South Africa Economic Update (Eighth Edition)-Promoting Faster Growth and Poverty Alleviation through Competition" for recommendations about how to increase competition.

efficiency, boost employment and savings, and reduce the external gap, making the economy more resilient. Advancing these reforms will require building trust among stakeholders, ideally via a social bargain. Labor and businesses could agree on wage restraint in return for saving jobs and hiring commitments. Government could improve the functioning of SOEs, and the quality of government services, especially in education, and represent the interest of outsiders (the unemployed and SMEs).

29. An alternative option might be implementation of a focused set of tangible measures that can have some positive effects even in the short term and generate reform momentum.

- **Focus.** The severe effects of high unemployment on poverty, inequality, and social cohesion and analysis pointing to the critical importance of prior work experience suggest a need for a clear focus on jobs.[17] With fiscal space exhausted, the priority must be to boost private sector employment, including temporary and informal jobs.

- **Principles.** A centralized evaluation of all policy proposals should be done systematically to ensure that reforms, at a minimum, "do no harm" to growth and private employment. Reforms that reduce policy uncertainty and boost confidence and trust should be favored.[18]

- **Actions.** Improving governance and SOEs are key interventions to build confidence and trust. Clarifying the regulatory environment in mining would help lower policy uncertainty (Box 6). Reforms in the authorities' G20 growth strategy—including reducing business costs (e.g., port tariffs and spectrum allocation for broadband) and trade liberalization to promote regional integration—would further promote SMEs, and policies to reduce crime and transport costs could help the unemployed find jobs.[19]

[17] Anand Rahul, Siddharth Kothari, and Naresh Kumar (2016), "South Africa: Labor Market Dynamics and Inequality", forthcoming IMF working paper find that the probability of finding a job doubles with prior work experience, controlling for education attainment.

[18] OECD (2010), "Making Reform Happen, Lessons from OECD Countries", suggests that trust is a key ingredient to successful structural reforms.

[19] Chichello, Paul, Colin Almeleh, Liberty Ncube, and Morné Ooshuizen. (2011), "Perceived Barriers to Entry into Self-Employment in Khayelistha, South Africa: Crime, Risk, and Start-up Capital Dominate Profit Concerns" argue that crime is a key deterrent to micro-entrepreneurship, Ngarachu, Maria, Schimmelpfennig, Axel, and Volker Schöer, (2014), "The Costly Road To Work? Wages and Transport Costs in South Africa", forthcoming IMF Working Paper, finds that transportation costs take up significant share of workers' wages.

Box 6. The Role of Policy Uncertainty and Structural Bottlenecks. What's Holding Back Exports?

This box explores the role of policy uncertainty, using a new measure based on "news chatter". Our results suggest that policy uncertainty has a negative impact on South African exports and the responsiveness of exports to the exchange rate depreciation.

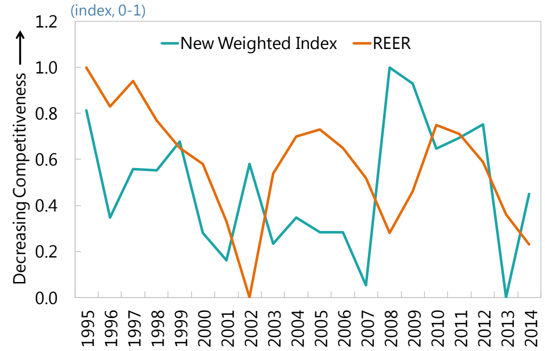
Policy Uncertainty

It is well known that investment and exports are subject to partially irreversible fixed costs that result in a real option value of delaying investments and hiring which increases with rising uncertainty. Baker et al. (2015), for example, find that increased policy uncertainty leads to diminished investment, employment, and output across 12 major economies.[1] To assess the importance of this channel for exports we follow Baker et al. (ibid) and construct a "news chatter" measure of economic policy uncertainty which tracks news articles that include words related to policy, economics, and uncertainty in South Africa.[2] The resulting index suggests uncertainty was high around 2012 when industrial relations in the mining sector reached a nadir, and has picked up in recent months after leadership changes at the Treasury.

Drivers of South Africa's Export Performance

We investigate the role of policy uncertainty in explaining South Africa's poor export performance by estimating a dynamic panel across 10 sectors. Our results suggest economic policy uncertainty has a statistically significant impact on the level of exports and the sensitivity of exports to movements in the REER. In particular, a one standard deviation increase in uncertainty would result in a drop in export volumes of 5 percent and a decline in the elasticity of exports to movements in the REER. Consistent with Anand et al. (2016), electricity shortages also adversely affect export volumes, while labor market disputes appear to be captured by the uncertainty measure itself.[3] The above results are also used to construct a measure of competitiveness that captures policy uncertainty and electricity constraints, as well as the REER. While the REER points to an improvement in competitiveness since 2010, the new competitiveness measure suggests competitiveness deteriorated in 2011–12 and in 2014. Both regression results and granger causality tests show that the new measure outperforms the standard REER in explaining export performance.

Alternative measures of competitiveness
(index, 0-1)



Source: Hlatshwayo, Sandile and Magnus Saxegaard (2016).

1/ Baker, Scott R., Nicholas Bloom, and Steven J. Davis (2015), "Measuring Economic Policy Uncertainty", NBER Working Paper No. 21633.
2/ Hlatshwayo, Sandile and Magnus Saxegaard (2016), "The Consequence of Policy Uncertainty: Disconnects and Dilutions in the South African Real Effective Exchange Rate-Export Relationship", IMF Working Paper WP/16/113.
3/ Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), "South Africa's Exports Performance: Any Role for Structural Factors?" IMF Working Paper WP/16/24.

- **Timing.** Research shows that reforms that increase wage flexibility are particularly important in bad times as they offer firms channels other than retrenchments to cut labor costs.[20] Therefore, the introduction of the proposed national minimum wage should be accompanied by reforms that increase wage flexibility, including exempting SMEs from collective bargaining outcomes, and the introduction of contracts where workers gradually accumulate benefits and job security. While the benefits from such reforms typically take time to materialize, they could lift growth in the short run if they boost confidence and signal policy consistency. Furthermore, these labor market reforms should be supported by product market reforms, such as lowering fees in telecommunications and transport, which could have large positive spillover effects to other sectors.

- **Momentum.** The authorities need to sustain reform momentum even as some impediments to growth are lifted and others become binding. Other countries' experience highlights the importance of publicizing successful reforms.[21]

Authorities' views

30. The authorities re-affirm the primacy of the National Development Plan and are committed to speeding up its implementation. The NDP (2012-2030) is being implemented through successive 5-year Medium Term Strategic Frameworks, which inform the expenditure framework on which the Budget is based. Based on short-term circumstances and risks, the authorities revisit policy priorities each year and monitor and evaluate departments' performance. The Nine-Point Plan is one such mechanism and puts forward immediate actions/priorities for government to boost growth and employment. Recognizing challenges to policy implementation at the sectoral level, the authorities are implementing the Malaysian style fast results framework, called Project "Phakisa," to unblock implementation challenges through work with social partners on sector-specific interventions.[22] To date, this style of intervention has been utilized to explore opportunities in the oceans economy, reforming education and primary health care, and transforming the mining industry.

31. The authorities highlight that cooperation with social partners and policy certainty are imperative for higher inclusive growth and are optimistic that results are forthcoming.

- The dialogue with social partners focuses on three key areas: (i) restoring confidence and reaffirming the country's investment grade rating; (ii) catalyzing employment growth in key sectors; and (iii) SOE reforms, including exploring opportunities for private sector participation. The interactions have already resulted in the creation of an SME venture fund, which includes not only finance, but also mentoring by seasoned business leaders for start-ups.

[20] Duval, Romain. and Davide Furceri, IMF (2016) "World Economic Outlook: Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies".

[21] OECD (2009), "The Political Economy of Reform: Lessons from Pensions, Product Markets, and Labor Markets in Ten OECD Countries".

[22] "Phakisa" means "hurry-up".

- To improve industrial relations, the government is finalizing a framework with social partners to reduce economic disruption caused by large, protracted strikes. Further, the national minimum wage will be an important tool in addressing income inequality: the modalities are being discussed, but the government will ensure that due consideration is given to minimizing possible adverse employment effects.

- The authorities point to bright spots of increased FDI in the automotive industry after the renewal of the support program till 2020 and of the Africa Growth and Opportunity Act till 2025, and higher numbers of tourist arrivals after the partial reversal of visa requirements: they hail these as examples of policy certainty.

32. The government is committed to infrastructure investments and is exploring ways to boost the economy with a range of interventions.

- The authorities highlight that energy supply is currently stable. They have stepped up efforts to partner with the private sector and the renewable energy independent power producer (IPP) program has begun to diversify South Africa' energy mix. Building on the success of these IPPs, the authorities have solicited bids for a coal-fired IPP. A similar process has been instituted for gas-fired IPPs. The BRICS New Development Bank recently approved a loan for electricity transmission lines.

- InvestSA is a one-stop shop that should facilitate FDI by coordinating and accelerating government departments' approvals. A Red Tape Impact Assessment bill dedicated to reducing red tape is with parliament and the authorities are assessing the ease of doing business across various municipalities to improve the business environment, especially for SMEs. Nine of the largest municipalities are undertaking a peer learning process based on a World Bank survey to roll out good practices. Government and businesses are working closely via the Presidential Business Working Group to address regulatory and licensing issues, and the Inter-Ministerial Committee on Investment will oversee progress and alleviate indentified obstacles.

- To enhance competition, the Competition Act amendment (into effect from May 1) classifies cartel behaviour as a criminal rather than a statutory offence.

- The authorities are confident that South Africa will soon ratify the World Trade Organisation Trade Facilitation Agreement, and that tangible progress is being made for the Tripartite Free Trade Zone between the East Africa Community (EAC), the Common Market for Eastern and Southern Africa (COMESA), and the Southern Africa Development Community (SADC) with the framework agreement completed and the Tripartite Free Trade Area launched in June 2015. The African Union Heads of State and Government also have commenced negotiations for the Continental Free Trade Agreement.

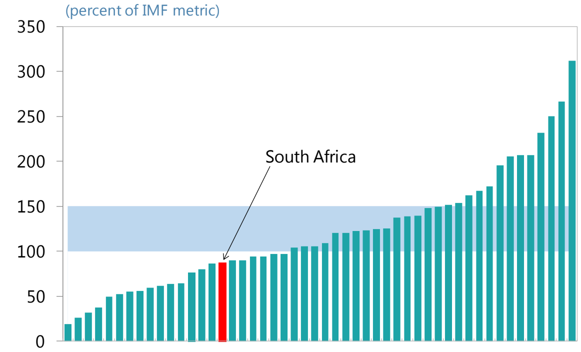
- The authorities also maintain that the recently-approved Protection of Investment Act will ensure that South Africa continues to provide protection to foreign investors in a manner consistent with Constitution and in accordance with international best practice and international customary law.

D. Other Policies to Manage Vulnerabilities and Strengthen Resilience

33. Despite the large currency depreciation, South Africa's external position is moderately weaker than desirable. The REER has depreciated by 32 percent since December 2010. But the current account deficit is still 1½–2½ percent of GDP wider than the estimated norm, though the gap is narrowing (Annex III). A low saving rate—reflecting inter alia low employment—is the root cause. The envisaged fiscal consolidation will help raise savings, but structural policies that can raise employment and eventually household savings remain essential for a sustained improvement, as well as to increase competitiveness (including via reducing business costs) and the responsiveness of the trade balance to exchange rate depreciation.

34. Higher reserves and measures to promote a stronger external financing mix would bolster resilience to shocks. Reserve coverage remains 4–15 percent (US$2-7bn) lower (more when including a buffer for commodity price shocks) than implied by the Fund's reserve adequacy metric and below most EMs'. The BRICS' Contingency Reserve Arrangement and the swap with the People's Bank of China can help bridge this gap. The SARB should seize opportunities, including those created by large FDI inflows, to increase reserves. The authorities also should agree on institutional responsibilities for funding FX purchases, and investigate the nature of unrecorded transactions. Many of the reforms outlined above to improve the business environment and reduce policy uncertainty, as well as facilitating highly-skilled immigration, would help attract FDI and boost South Africa's role as gateway to Africa.

Reserves still low compared to EM peers
(percent of IMF metric)



Source: Staff estimates.

35. Financial reforms are advancing.

- The Financial Sector Regulation Bill is expected to be promulgated in 2016. In line with the 2014 FSSA, it implements the Twin Peaks system, consolidates financial sector supervision at the SARB (including enhancing group-wide supervision), and creates the new Financial Sector Conduct Authority to improve consumer protection. A draft bill to introduce a resolution framework in line with the Financial Stability Board's Key Attributes of Effective Resolution is expected in 2016Q4 and will facilitate intervening failing institutions, discourage wholesale funding by clarifying the hierarchy of claims, and introduce a deposit guarantee scheme. Parliament is expected to consider the new Insurance Bill that would strengthen prudential regulation in 2016.

- The Liquidity Coverage Ratio (LCR) requirement has risen to 70 percent from January 2016, and will rise progressively to 100 per cent (of which up to 40 percent from the SARB's Committed Liquidity

Facility) in 2019 vs. the current 84 per cent. Requirements for Domestic Systematically Important Banks will be fully implemented in 2016 and risk-based capital will be fully implemented in 2019.

- Banks have started to reduce short-term wholesale funding and rely more on term funding and retail deposits in anticipation of the implementation of the Net Stable Funding Ratio (NSFR) from 2018. The SARB's application of national discretion has made the NSFR less challenging.[23]

36. Banks' asset quality and profitability are likely to deteriorate, requiring heightened monitoring. NPLs are likely to rise moderately with the weaker economy and employment outlook and tighter financing conditions. While higher interest rates initially boost banks' profitability, as most loans are at floating rates and re-price faster than banks' liabilities, this eventually reverses as credit costs rise. Banks' profitability is also pressured by higher funding costs as they source longer-term funding and increase capital. SARB's recent stress tests indicate that even in severe adverse scenarios with a protracted recession or high financial market volatility with significant depreciation, banks' average common equity tier 1 capital adequacy ratio remains above of the regulatory requirement.[24] However, banks' net open FX position (negative) has recently increased and there could be maturity mismatches in banks' FX portfolios. Also, rollover risks and higher hedging costs could rise at times of lower capital inflows. Given that risks are amplified by extensive macro-financial linkages, consideration could be given to combining the shocks analyzed in the stress tests with liquidity shocks associated with capital outflows, and planning measures that could address potential disorderly market conditions. Also, supervisors could consider examining banks' capital plans and the expected path with intensified scrutiny. If weaknesses are identified, additional reserves, higher provisions, or restrictions on dividends distribution might be needed. A strengthened crisis preparedness plan that involves both the SARB and the National Treasury would be helpful**.**

37. Recent country experience suggests that EMs that took consistent and decisive action became more resilient. Policy responses to external shocks since the taper tantrum varied, reflecting different fundamentals, policy space, and political constraints (Box 7). Like South Africa, most EMs allowed exchange rates to act as shock-absorber, hiked policy rates, and announced fiscal tightening. However, countries that achieved the most significant improvements in fundamentals and boosted growth also took structural reform measures, including steps to facilitate FDI, labor and product market reforms, actions to increase private sector participation in state-controlled sectors, and fuel subsidy reforms. As a result, these countries were more resilient during subsequent shocks.

[23] Given the existence of exchange controls on residents, the SARB has proposed an available stable funding (ASF) factor of 35 percent (instead of the standard 0 percent) to funding from financial corporate customers with a residual maturity of less than six months. On the other hand, the SARB's proposal of assigning a required stable funding (RSF) factor of 5 percent to minimum cash reserves (and 0 percent for any excess reserves) is more conservative than the Basel Committee on Banking Supervision, which assigns 0 percent to all central bank reserves.

[24] See SARB (2016) Financial Stability Review.

Authorities' views

38. The authorities concur that the current account deficit is somewhat high. They project the current account deficit to remain between 4 and 5 percent of GDP over the medium term. But they note positive developments in FDI and export prospects in the automotive sector, improving services balance, and the prospects of improvement in the long-standing income balance deficit as South African firms' outward FDI matures. The authorities are less concerned about increased banks' funding abroad as it is mainly matched by FX loans for offshore expansion to domestic firms on the strength of their South African balance sheets. They agree that the net creditor position is a source of strength, but indicate that it could change easily given high exchange rate volatility. Finally, the authorities note the difficulties in assessing the level of the REER given the many structural factors affecting South Africa's competitiveness.

39. The authorities remain committed to a flexible exchange rate regime. The floating exchange rate regime continues to be the key adjustment mechanism to external shocks, including capital account 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. Less than 10 percent of government debt is in FX. They concur with staff that large scale FDI inflows could present opportunities for reserve accumulation.

40. The authorities broadly share staff's assessment of the vulnerabilities, and remain confident about financial sector health. Since the 2014 FSAP, they have implemented several of the recommendations to enhance the regulatory architecture and are making good progress toward an upgraded resolution framework. They have completed their first top down stress test since the 2014 Financial Sector Assessment Program that attests to the soundness of the banking sector in severe stress scenarios, given large capital buffers and high profitability. The authorities appreciate staff's analysis of macro-financial linkages, though they see protracted low growth and the attendant asset quality deterioration as the most prominent risk rather than liquidity shocks. They also underscore mitigating factors, especially the depth and liquidity of the financial sector and a strong domestic investor base.

Box 7. Emerging Markets' Policy Responses to External Shocks in Recent Years

This box takes stock of policy responses and economic outcomes in selected EMs (Brazil, India, Indonesia, Mexico, Poland, Turkey, and South Africa) since May 2013. EMs that took decisive and consistent policy actions, including structural reforms, became more resilient to subsequent shocks.

EMs' policy responses varied, reflecting different fundamentals, policy space, and political constraints.

- *Exchange rates were allowed to absorb the brunt of the pressures*, with FX intervention used primarily to ensure orderly market conditions.

Summary of policy actions in selected EMs (2013-16)

	Brazil	India	Indonesia	Mexico	Poland	Turkey	S. Africa
Exchange rate flexibility	√	√	√	√	√	√	√
Foreign exchange intervention	√	√	√	√		√	
Monetary policy (tighten +/loosen -)	√ (+)	√ (+) (-)	√ (+) (-)	√ (-) (+)	√ (-)	√ (+) (-)	√ (+)
Fiscal measures (tighten +/loosen -)	√ (+)	√ (+)	√ (+)	√ (+)	√ (+)		√ (+)

Source: IMF Staff Reports.

- *Most countries hiked policy rates* (by 75-625 basis points bps). Once inflationary pressure subsided, some countries were able to reverse the tightening partially (Indonesia) or fully (India). Mexico eased initially, and tightened later on. Poland lowered rates since 2013.

- *Most countries announced fiscal tightening measures, with varying degrees of success*. India and Mexico introduced expenditure rationalization policies. Mexico approved a tax reform in 2013. South Africa announced further fiscal consolidation. In early 2015, Brazil announced a fiscal adjustment plan, but revised down its fiscal targets later on in view of weak revenue performance and political difficulties getting measures approved by Congress. Turkey maintained a neutral fiscal policy stance. Poland strengthened its fiscal position.

- *Some countries took structural reform measures*. India allowed higher FDI in multiple sectors, including infrastructure, and insurance. India and Indonesia undertook fuel subsidy reforms. Mexico allowed greater private sector participation in the energy sector, and undertook labor and product market reforms. Indonesia launched a series of economic packages, including trade liberalization measures, easier tourist visa regulations, actions to increase predictability and transparency in the labor market, actions to ease the process of business, and measures to facilitate private investment in infrastructure. Poland took actions to increase labor market flexibility, and ease administrative requirements for business start-ups and construction permits.

- *Other measures* included temporary import restrictions and mobilizing diaspora savings (India), easing of inflow CFMs (Brazil and Indonesia), and contingent credit lines.

Recent country experience suggests that EMs that took decisive and consistent structural reform actions became more resilient. Reforms varied by country, including steps to facilitate FDI, labor and product market reforms, actions to increase private sector participation in state-controlled sectors, and fuel subsidy reforms. In general, countries that undertook decisive reform efforts boosted confidence, were able to maintain robust growth and improve macro fundamentals, and were relatively less affected during subsequent shocks.

Key macroeconomic developments in selected EMs (2013-15)

	Brazil	India	Indonesia	Mexico	Poland	Turkey	S. Africa
Levels (average 2013-15 unless otherwise specified):							
Real GDP growth (percent)	-0.2	7.1	5.1	1.9	2.7	3.7	1.7
Inflation (percent)	7.2	6.3	6.4	3.6	-0.2	8.1	5.6
Inflation gap (inflation minus target), (2015, percent)	2.7	-0.6	-0.6	-0.4	-2.8	3.8	-0.5
Current account balance (percent of GDP)	-6.4	-1.5	-2.8	-2.3	-1.3	-5.9	-5.2
Structural fiscal balance (percent of GDP)	-7.1	-7.2	-2.1	-4.3	-2.9	-1.9	-3.7
Gross public debt (percent of GDP)	65.8	65.7	25.5	49.4	52.6	34.1	45.9
Changes (2015 minus 2013):							
Real GDP growth (percentage points)	-6.9	0.4	-0.9	0.9	2.4	-0.2	-0.9
Inflation (percentage points)	2.8	-2.8	-4.7	-1.4	-1.0	1.4	0.1
Current account balance (percent of GDP)	1.1	3.4	0.9	0.0	0.8	3.2	1.4
Structural fiscal balance (percent of GDP)	-4.7	0.4	-0.2	0.1	0.7	1.6	0.3
Gross public debt (percent of GDP)	13.3	-2.2	1.6	5.6	-4.7	-3.5	7.9

Source: WEO.

STAFF APPRAISAL

41. South Africa has achieved remarkable progress in two decades of democracy, but faces unacceptably high unemployment and inequality. Strong institutions and policy frameworks have contributed to macroeconomic stability and rising living standards in the democratic era. Yet, infrastructure bottlenecks, skill mismatches, and harmful insider-outsider dynamics have prevented many South Africans from benefiting from these improvements. On top of these deep-rooted impediments, the economy has been adversely affected by external shocks and domestic confidence shocks that have heightened governance concerns and policy uncertainty.

42. The outlook is sobering and downside risks prevail. Growth is projected to weaken further in 2016—the third year in which per capita incomes would fall. The muted recovery expected from 2017 is likely insufficient to address unemployment and inequality. The main risks stem from further shocks from China, tighter global financial conditions, lower growth, political risks, and SOEs' contingent liabilities. Vulnerabilities and linkages between capital flows, the sovereign, and the financial sector could amplify the impact of shocks, especially if combined with sovereign credit rating downgrades to speculative grade. The recent dialogue between government, businesses, and labor is welcome and could yield concrete results.

43. Structural reforms are urgent and imperative. With fiscal and monetary policy having to address vulnerabilities and given the many structural obstacles, structural reforms are the only sustainable way to boost growth, create more jobs, and reduce inequality. The authorities have made welcome progress in infrastructure, but action is urgently needed in other areas. Ensuring that the proposed national minimum wage is designed so as not to undermine job creation and the goal of reducing income inequality is important. While some structural reforms take time to yield positive growth effects, immediate benefits from a carefully-designed reform package can stem from confidence effects and signalling of policy consistency. A comprehensive package of reforms, ideally via a social bargain that includes greater product market competition, more inclusive labor market policies and industrial relations, and improved education/training remains the preferred option. An initial, focused set of tangible measures could help boost confidence and trust, lower policy uncertainty, and hence generate sustained reform momentum.

44. The 2016 Budget is appropriately ambitious, though additional measures might be needed to stabilize debt over the medium term. The buildup of fiscal vulnerabilities reflects lower-than-anticipated growth, not a lack of fiscal discipline. Growth-enhancing structural reforms, measures to boost spending efficiency, including by limiting the public wage bill, and greater private participation in SOEs are therefore the best sustainable ways to stop debt from rising. Asset sales could also be considered. But if growth underperforms and the measures above do not materialize, a package of fiscal measures that maintains medium-term debt sustainability while minimizing the negative growth impact and protecting the poor may be needed. Concrete progress on reforming SOEs is essential to improve governance and public services, and would boost private sector growth.

45. The SARB could consider holding interest rates unless core inflation or inflation expectations rise substantially. With the impact of past policy rate hikes still filtering through and financial conditions still expected to tighten, a widening output gap and sizable fiscal consolidation are expected to help contain inflation. This suggests that monetary policy might be able to remain on hold, unless inflation expectations or core inflation increase markedly, or external financing becomes problematic. The SARB could consider ways to enhance its inflation targeting regime to facilitate guiding inflation expectations within the band.

46. Advances in financial sector reforms are welcome and heightened monitoring of financial sector risks and contingency planning is warranted. Financial sector reforms are progressing and are in line with FSSA recommendations. The SARB's recent stress tests find that South Africa's financial system is well capitalized and can sustain large shocks. Nevertheless, stepping up the monitoring of financial sector risks and contingency planning is warranted given the rising pressures that the weak economy, tightening financial conditions, and regulatory changes are imposing on the financial system.

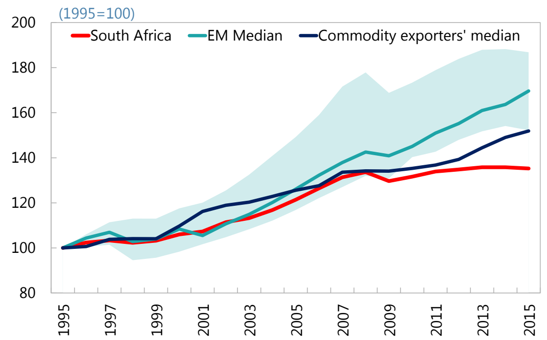
47. Higher reserves and attracting a stronger external financing mix would boost resilience. South Africa's strength includes a floating exchange rate, favorable currency and maturity debt structure, and a net external creditor position. The current account deficit remains higher than the estimated norm despite the large depreciation, though some adjustment is occurring. International reserves are below desirable levels, and the SARB should seize opportunities to increase reserves.

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

Figure 1. Improved Living Standards in the Democratic Era, but High Unemployment and Inequality Persist

Real GDP per capita increased by 35 percent since 1994, though the median EM's has increased by twice that rate.

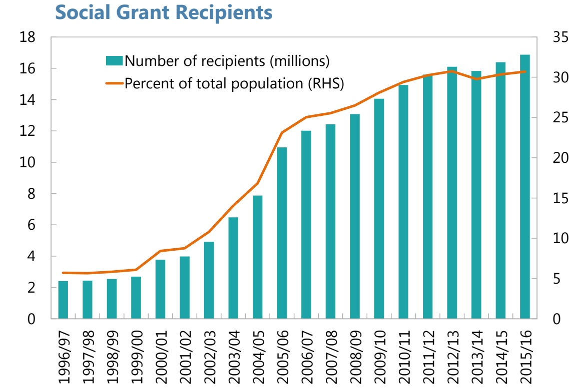
Real GDP per Capita



Note: The light blue area represents the three center quintiles for other EMs.

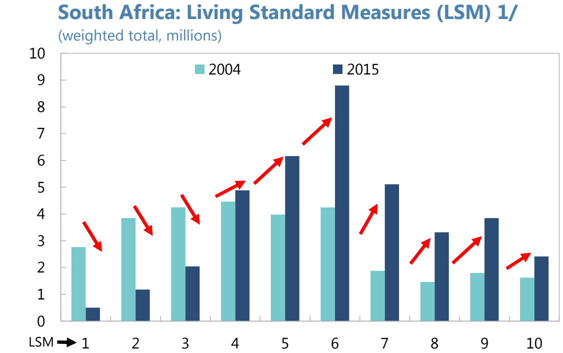
The social safety net has expanded significantly and now covers about a third of the population.

Social Grant Recipients



Living standards have improved substantially, ...

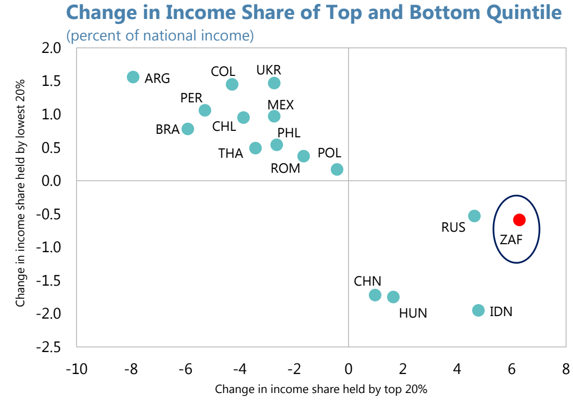
South Africa: Living Standard Measures (LSM) 1/



1/ The living standard measure groups individuals according to their living standards, using criteria such as degree of urbanization and ownership of cars and major appliances. It divides the population into 10 groups from 1 (lowest) to 10 (highest).

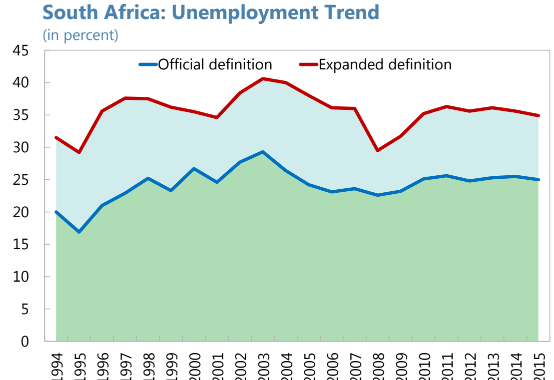
...but the gap between top and bottom income deciles has widened.

Change in Income Share of Top and Bottom Quintile



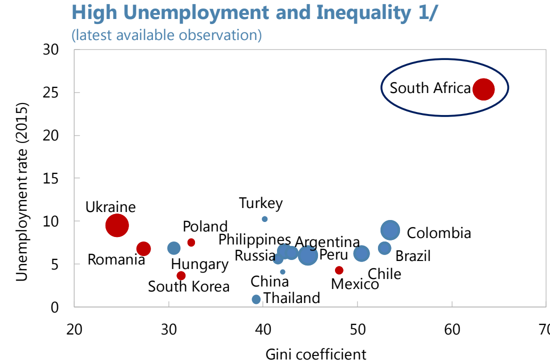
Unemployment has not improved, ...

South Africa: Unemployment Trend



... and inequality and unemployment are among the highest in EMs.

High Unemployment and Inequality 1/



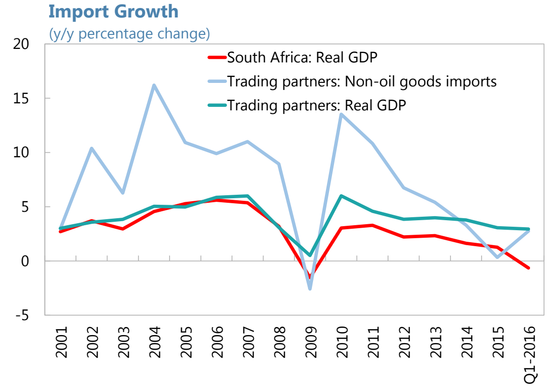
1/ Blue represents a decrease and red an increase in unemployment between 2008 and 2015. The size of the bubble illustrates the magnitude of the change in unemployment.

Sources: South Africa Audience Research Foundation, South Africa National Treasury, Social Security South Africa, WEO, World Development Indicators, and staff estimates.

Figure 2. Growth is Weakening Further

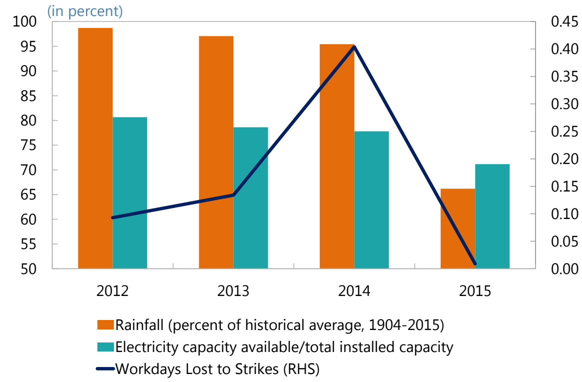
South Africa's growth continued to be below its trading partners'.

South Africa GDP Growth and Trading Partners' GDP and Import Growth



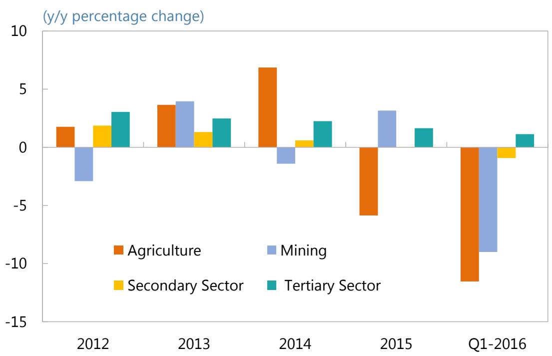
Although days lost to strikes dropped markedly in 2015, electricity constraints in the first half of the year and the drought weighed on growth…

Workdays Lost, Electricity and Rainfall



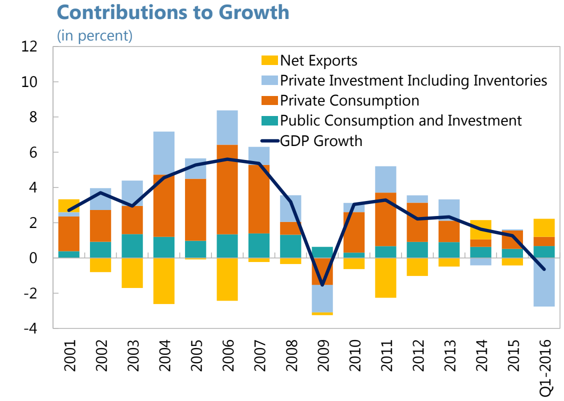
…which together with low commodity prices affected the agricultural and manufacturing sectors.

Sector-wise Growth



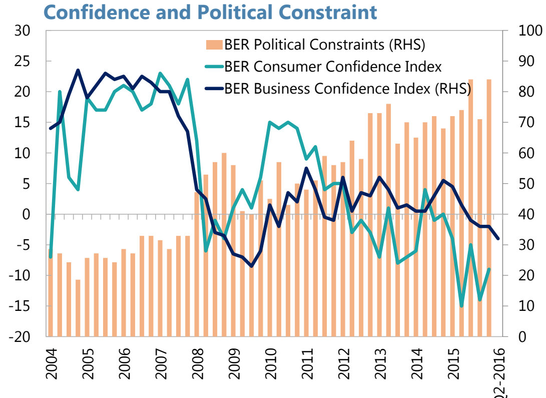
Net exports contracted in 2015 as imports recovered after the 2014 strikes, but improved in 2016Q1 as imports contracted. Private investment weakened in 2016Q1.

Contributions to Growth



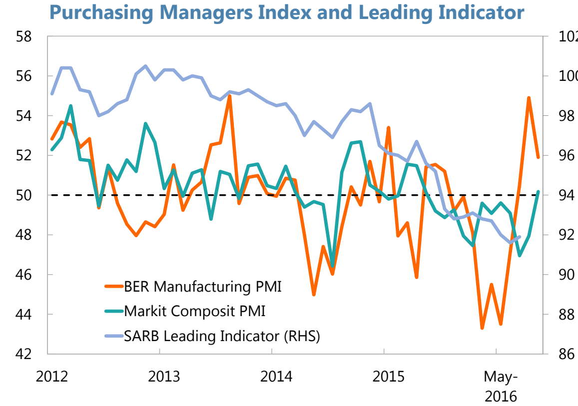
Business and consumer confidence are near record lows, and political constraints are at record high…

Confidence and Political Constraint



…though forward-looking indicators point to some recovery in the second quarter of 2016.

Purchasing Managers Index and Leading Indicator



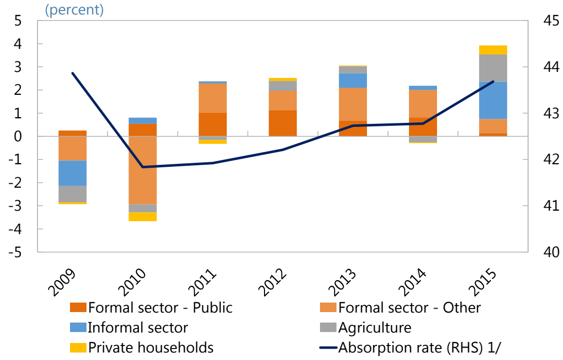
Sources: Andrew Levy Employment Publications, Haver Analytics, National Energy Regulator, SARB, South African Weather Service, and staff estimates.

Figure 3. Labor Market: Deteriorating Outlook Exacerbates High Structural Unemployment

Formal sector job growth has declined. Although informal jobs have increased, the absorption rate is still low …

Employment Growth: Contribution by Sector

(percent)

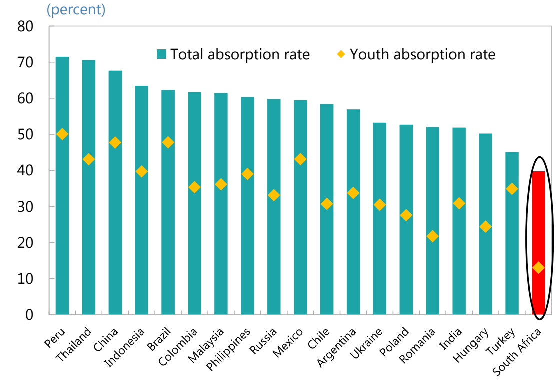


1/ Proportion of working-age population that is employed.

… and one of the lowest among EMs, especially for youth.

Absorption Rate, 2015

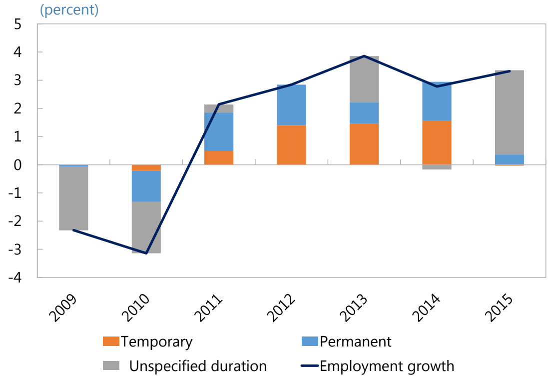
(percent)



Recent legislative changes restricting contract work have decimated temporary job growth, and permanent job growth is faltering.

Employment Growth by Contracts

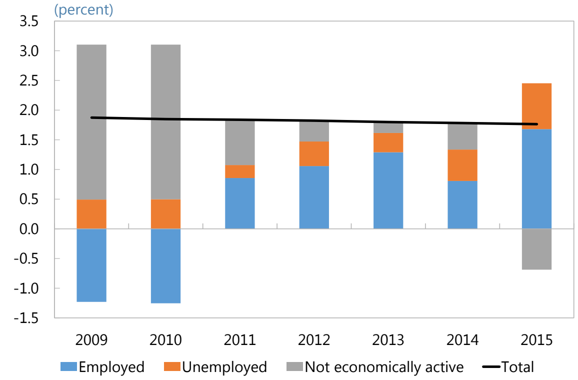
(percent)



As the working-age population is still growing substantially, …

Working-age Population Growth

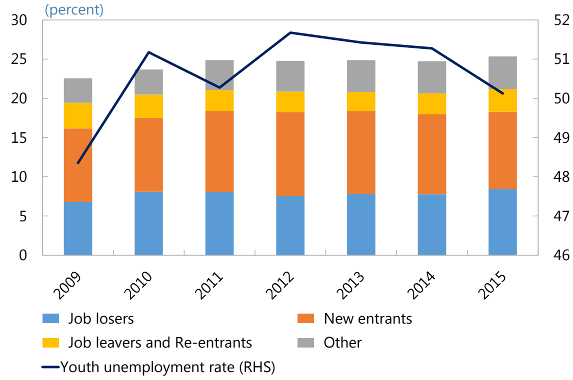
(percent)



… the unemployment rate remains high, comprising largely new entrants and job losers.

Unemployment Rate

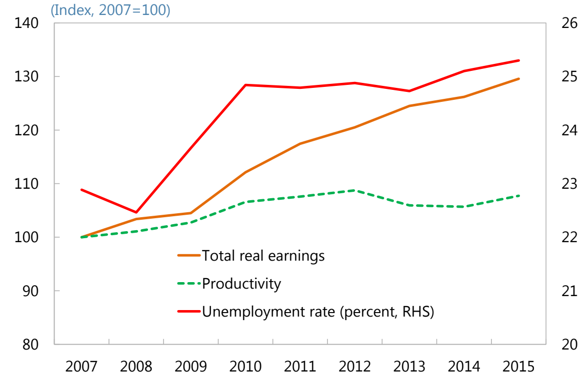
(percent)



Earnings have grown steadily despite high unemployment rates and sluggish productivity.

Total Earnings and Productivity

(Index, 2007=100)



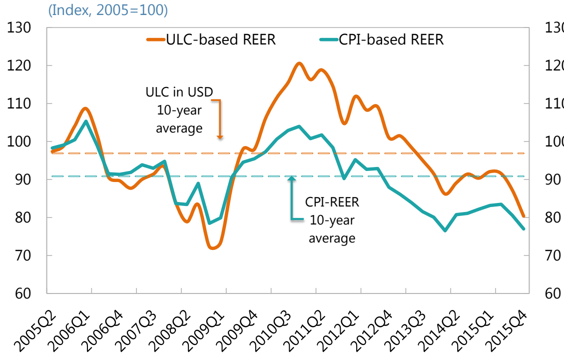
Sources: Haver Analytics, ILO, SARB, StatsSA, and staff estimates.

Figure 4. Lower Oil Prices Contributed to External Adjustment

The REER continued to depreciate in 2015 and relative ULCs have fallen…

South Africa: CPI-based and ULC-based REER

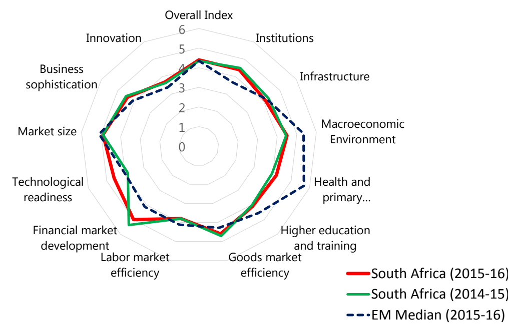
(Index, 2005=100)



…competitiveness has improved in some other dimensions too.

Global Competetiveness Scores

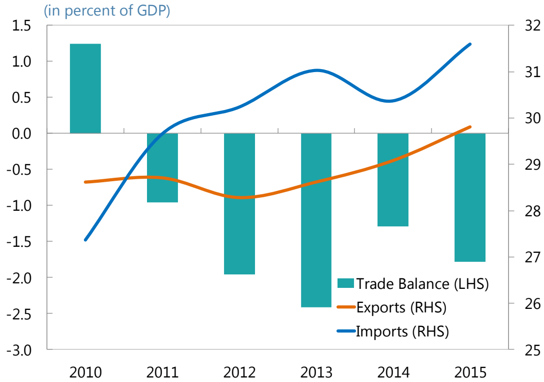
(1 - 7, 7 being highest quality)



The trade balance deteriorated in volume terms in 2015…

Trade Balance at 2010 prices

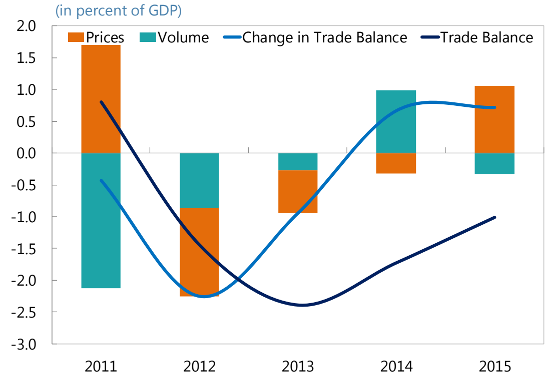
(in percent of GDP)



…but lower oil prices contributed to external adjustment.

Trade Balance at Current Prices

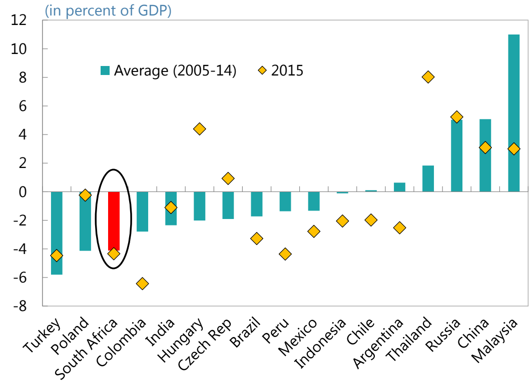
(in percent of GDP)



The current account deficit remains one of the largest among EMs…

Current Account Balance

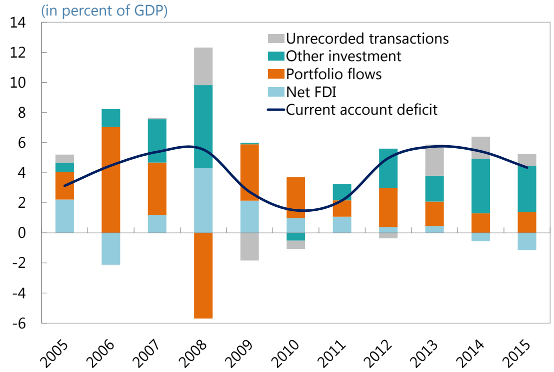
(in percent of GDP)



…financed by non-FDI flows and unrecorded transactions.

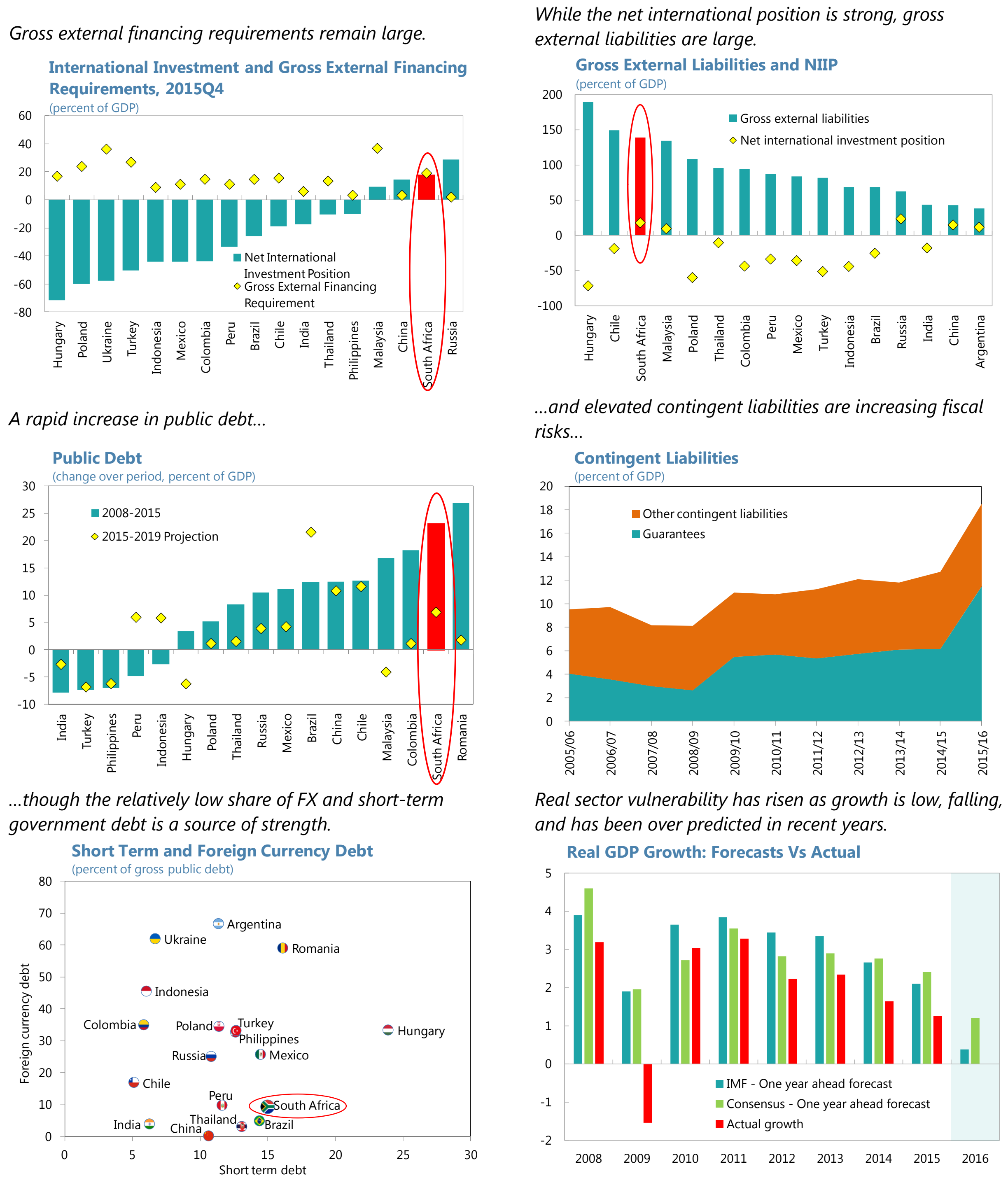
Financing of the Current Account Deficit

(in percent of GDP)



Sources: Haver Analytics, SARB, WEF, and staff estimates.

Figure 5. Elevated Vulnerabilities

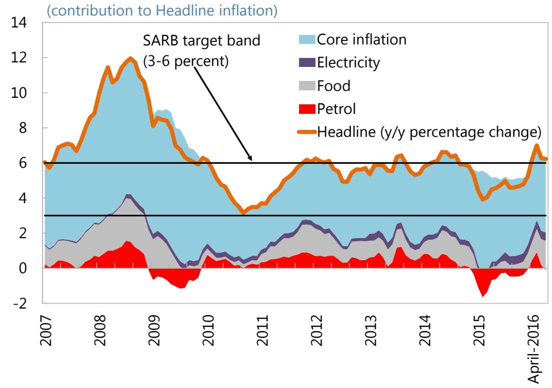


Sources: Capital IQ, Haver Analytics, National Treasury of South Africa, WEO, and staff estimates.

Figure 6. Monetary Policy is on a Tightening Course Though Demand Pressures Muted

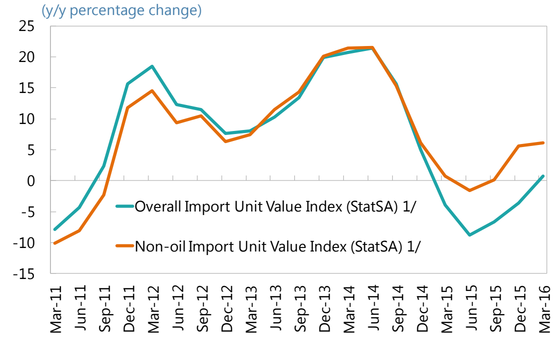
Inflation was below 5 percent in 2015, though has since risen above the top of the band due to fuel and food prices. Core inflation has increased less.

CPI Inflation Components
(contribution to Headline inflation)



Non-oil import price inflation fell substantially before some recent recovery.

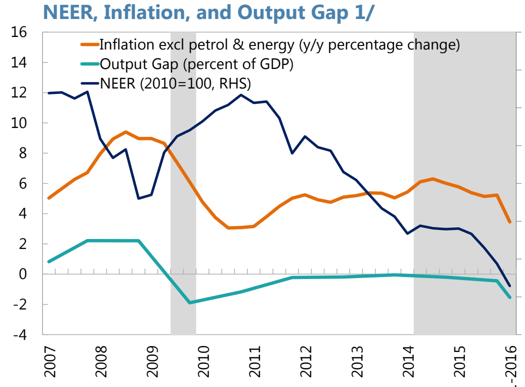
Import Prices (in Rand)
(y/y percentage change)



1/ Q1-2016 is an average of y/y percentage change for January and February, 2016.

With weak activity, exchange rate pass-through has been modest despite a 48 percent depreciation since 2011Q1.

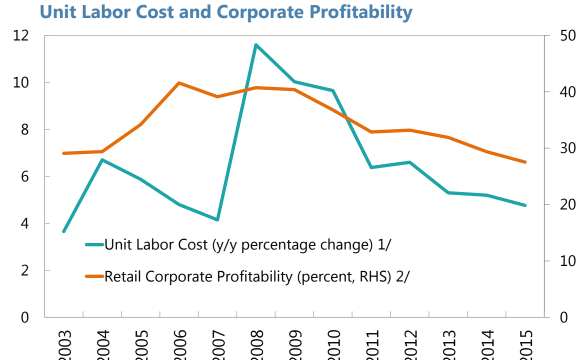
NEER, Inflation, and Output Gap 1/



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

ULC growth has moderated and retailers' profits remained high notwithstanding some decline.

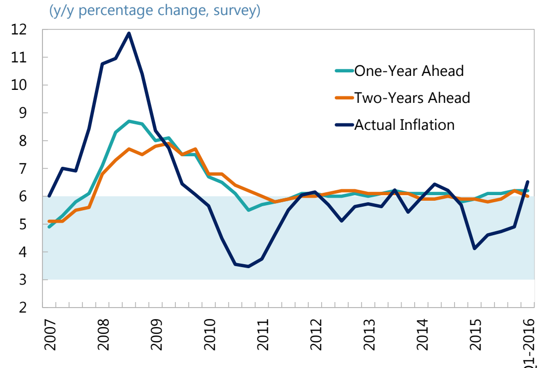
Unit Labor Cost and Corporate Profitability



1/ 2015 data is through September.
2/ Return on equity, weighted by market capitalization. 2015 is estimated.

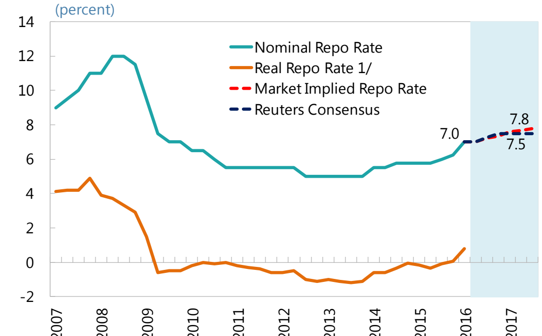
Inflation expectations remain broadly stable, though close to the target ceiling.

Inflation Expectations
(y/y percentage change, survey)



The SARB has hiked the policy rate by 200bps since December 2013, markets expect it to continue tightening.

Policy Rate
(percent)



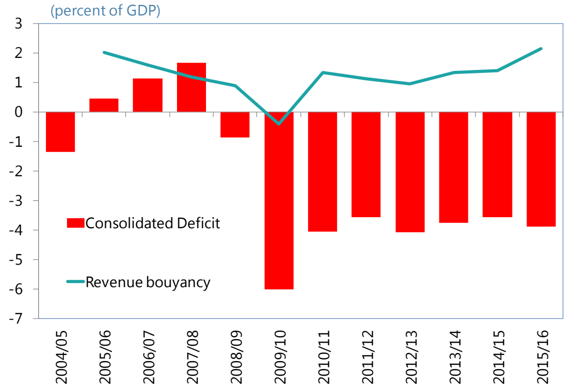
1/ Nominal rate deflated with one-year ahead inflation expectations.
The light blue are represnts the forecast period.

Sources: Bloomberg, L.P., Haver Analytics, Reuters, SARB, WEO, and staff estimates.

Figure 7. Despite Fiscal Consolidation, Fiscal Risks Rising

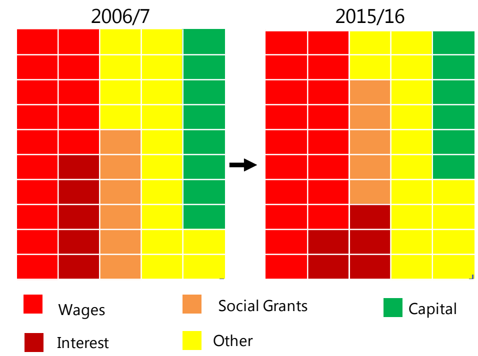
High revenue buoyancy prevented a sharp deterioration in the FY15/16 deficit…

Fiscal Deficit
(percent of GDP)



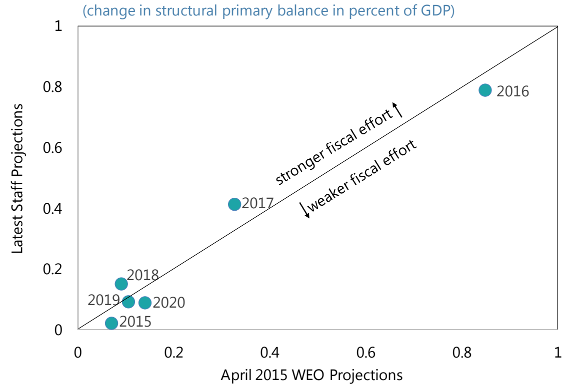
…but rising personnel and interest costs are crowding out more productive expenditure.

Government Spending
(1 block = 2% of total spending)



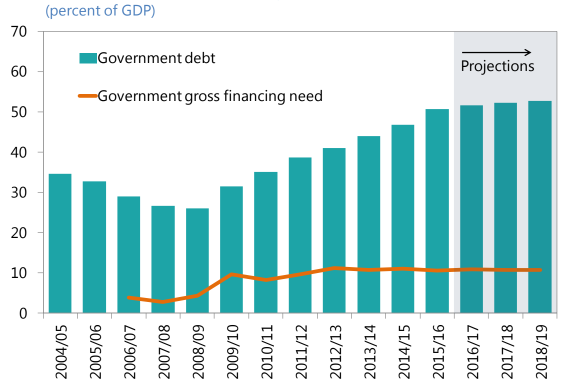
The fiscal effort in the 2016 Budget is broadly unchanged despite weaker growth…

Projected Fiscal Impulse
(change in structural primary balance in percent of GDP)



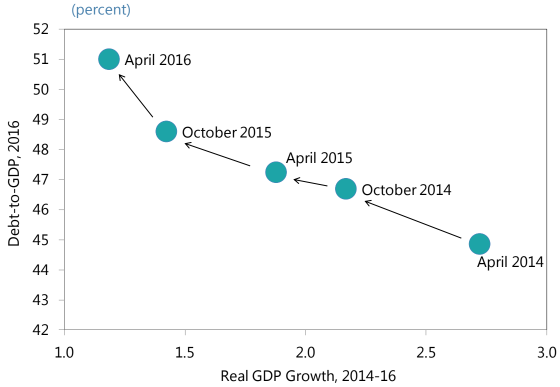
…but may be insufficient to stabilize debt and reduce the gross financing need.

Debt and Gross Financing Need
(percent of GDP)



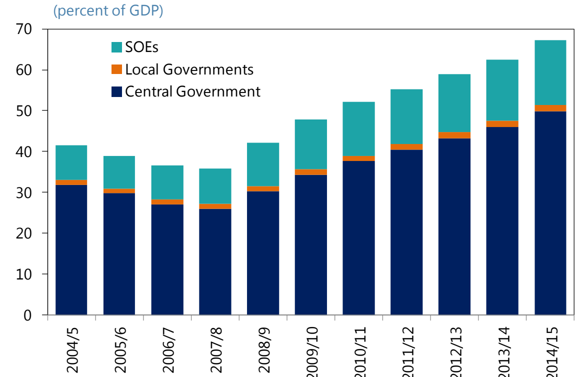
Downward revisions to growth are putting debt sustainability at risk.

Debt and Growth
(percent)



Fiscal risks are compounded by a significant increase in SOE debt and sizable contingent liabilities.

Public Sector Debt
(percent of GDP)

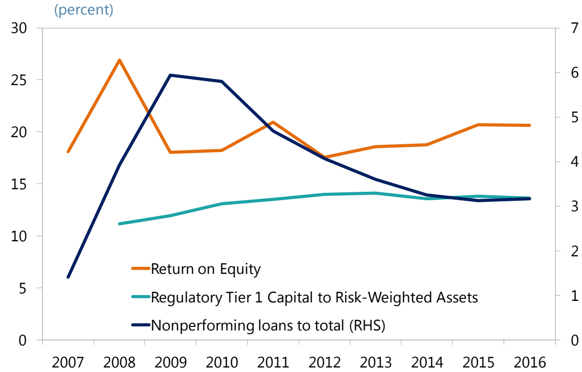


Sources: National Treasury of South Africa, SARB, WEO, and staff estimates.

Figure 8. Financial Sector Resilient, But Challenges Ahead

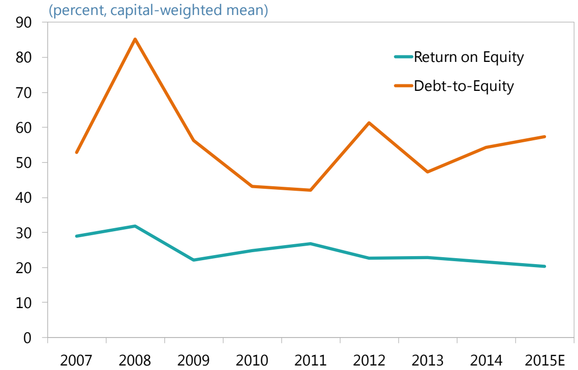
Banks' headline indicators continue to be good...

Banks' Financial Soundness Indicators 1/
(percent)



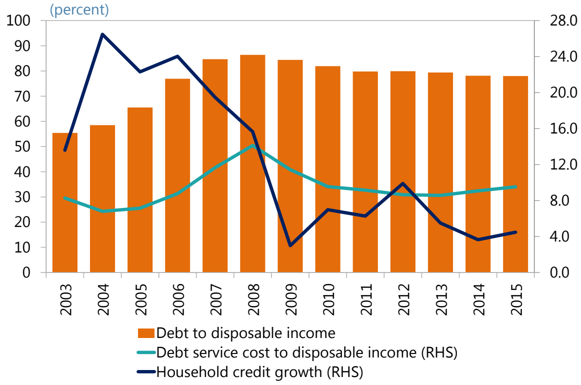
...but private corporates' profits, typically high, have softened while leverage is rising.

Private Non-financial Corporates' Leverage and Profits
(percent, capital-weighted mean)



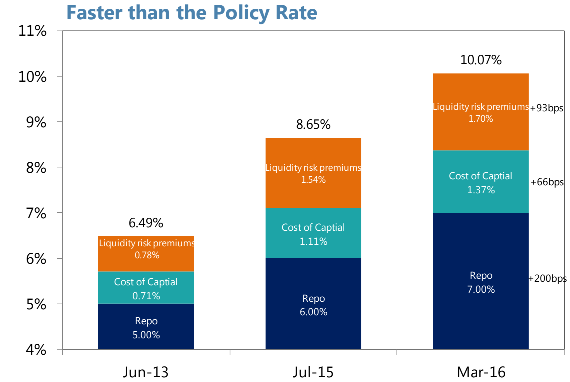
Households remain highly indebted, their debt service has risen, and credit growth slowed.

Households Financial Indicators
(percent)



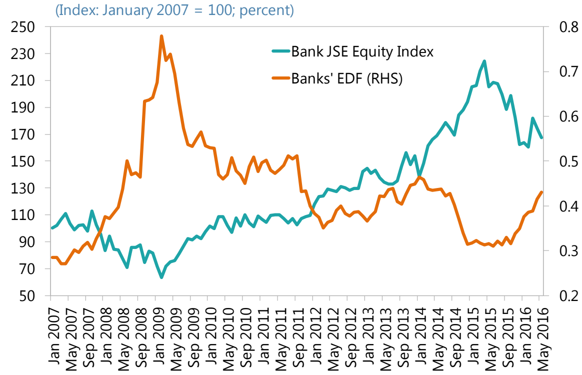
Banks' funding costs have risen more than the increase in the SARB's repo rate...

The Funding Cost and Capital Charge Increased Faster than the Policy Rate



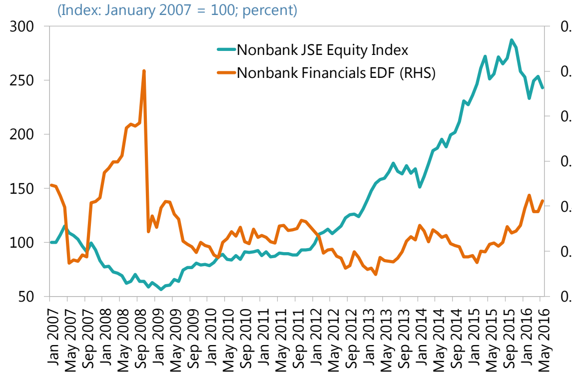
...and bank stocks tumbled in 2015, and expected default frequency (EDF) rose.

Banks
(Index: January 2007 = 100; percent)



Nonbank financial institutions were also hit.

Nonbank Financials
(Index: January 2007 = 100; percent)

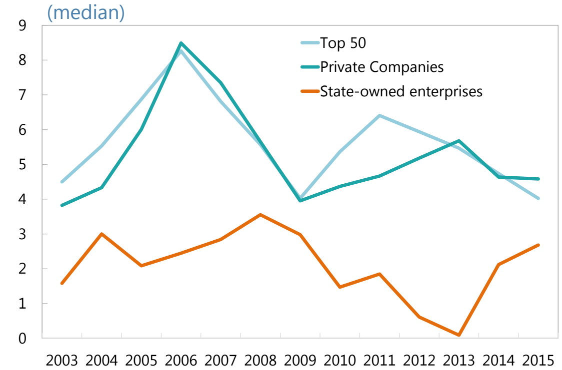


Sources: Bloomberg, L.P., Capital IQ, FirstRand Bank, IMF Financail Soundness Indicators database, Moody's CreditEdge, SARB Quarterly Bulletin, South Africa National Credit Regulator, and staff estimates.
1/ 2016 data is through February.

Figure 9. The Strong Corporate Sector Is Facing Some Headwinds

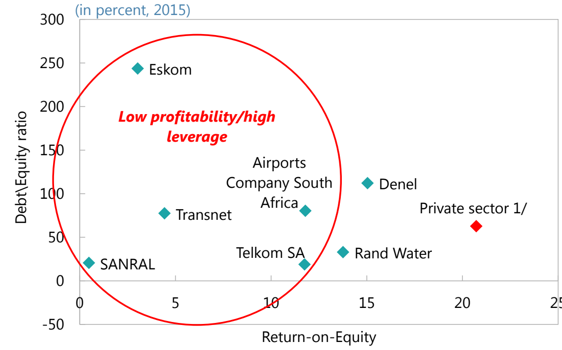
Private corporates remain relatively resilient…

South African Corporates: Interest Coverage Ratio
(median)



…but the financial situation of state-owned enterprises is weaker.

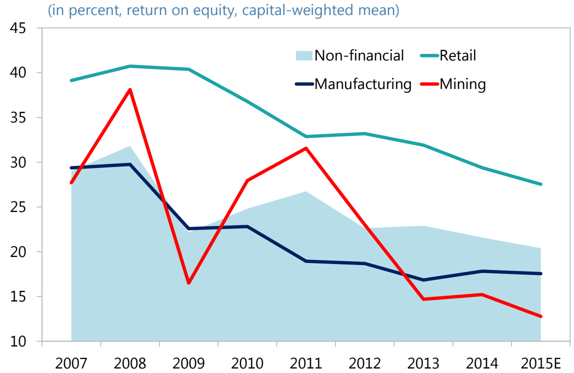
Financial performance of non-financial corporates
(in percent, 2015)



1/ Capital-weighted average.

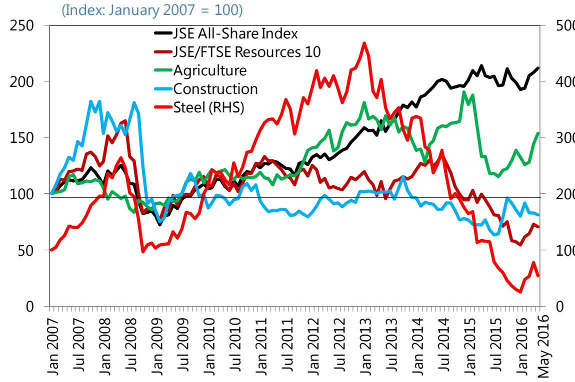
Corporate profitability has declined, particularly in the mining sector.

Corporate Profitability
(in percent, return on equity, capital-weighted mean)



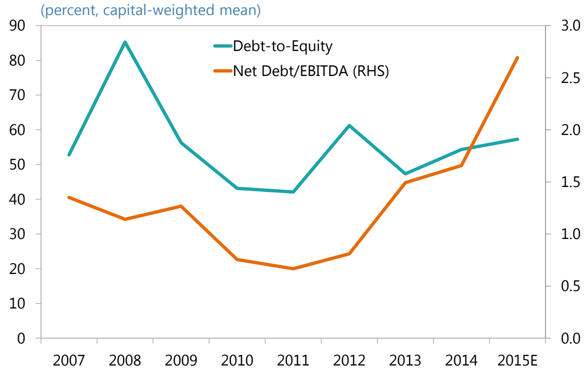
Other sectors under stress are steel, some manufacturing segments, construction, and agriculture.

Stock Performance
(Index: January 2007 = 100)



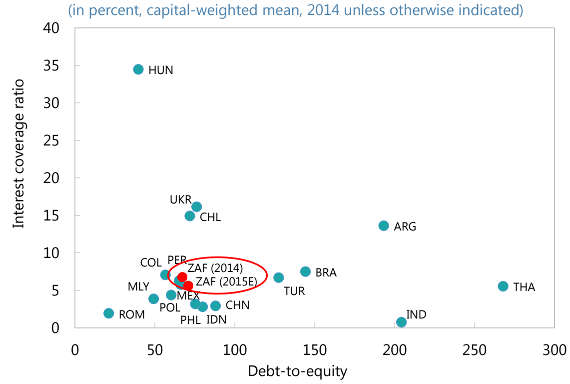
Firms' leverage has also risen…

Non-financial Corporate Leverage
(percent, capital-weighted mean)



…though private corporates leverage remains moderate and the ICR high compared with other EMs.

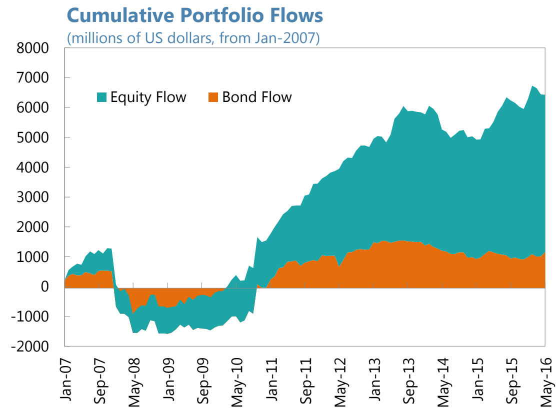
Corporate (non-financial) Profitability and Leverage
(in percent, capital-weighted mean, 2014 unless otherwise indicated)



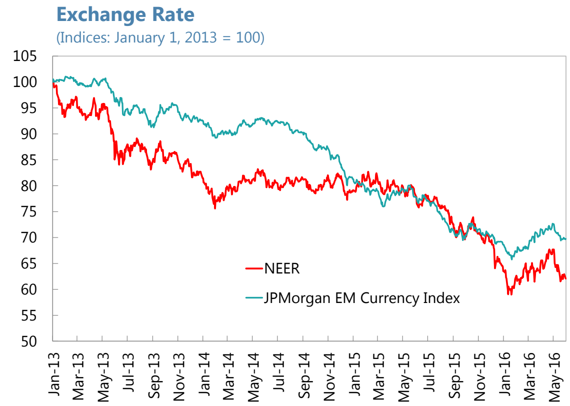
Sources: Bloomberg, L.P., Capital IQ, Corporate Vulnerability Utility, Haver Analytics, Orbis, SARB, WEO, and staff estimates.

Figure 10. Financial Markets Underperforming

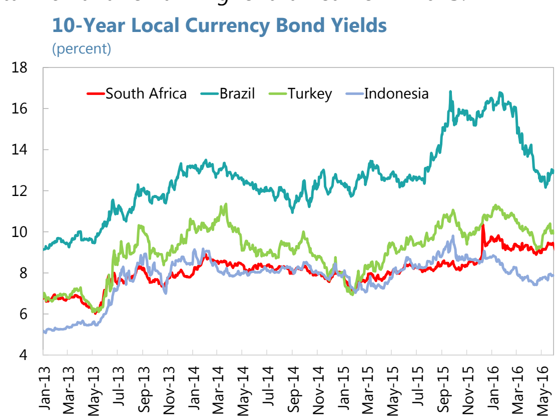
Large inflows after the global financial crisis started to reverse in 2013 and again from August 2015.



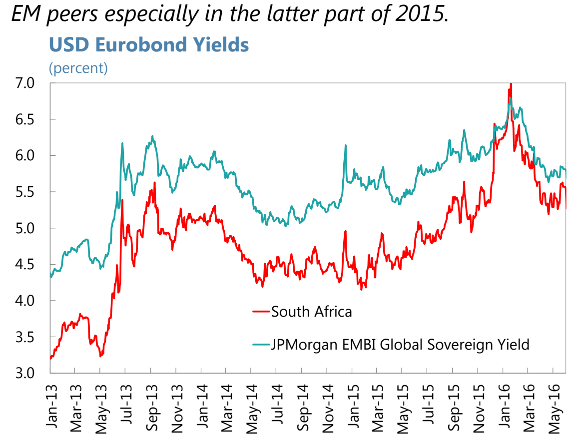
After staying broadly flat for one year, the NEER depreciated in 2015H2, especially in December, but recovered in the first half of 2016.



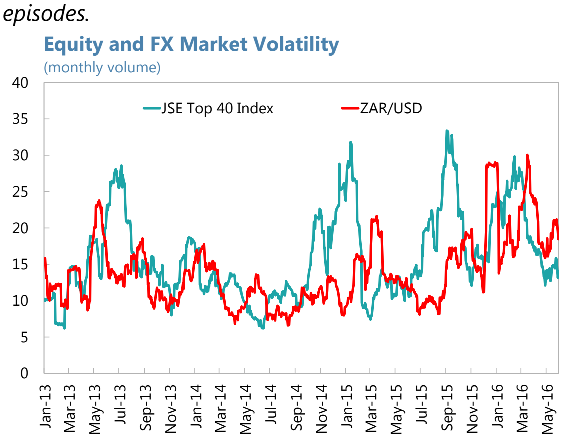
Local currency bond yields rose during the December 2015 turmoil and remain higher than earlier in 2015.



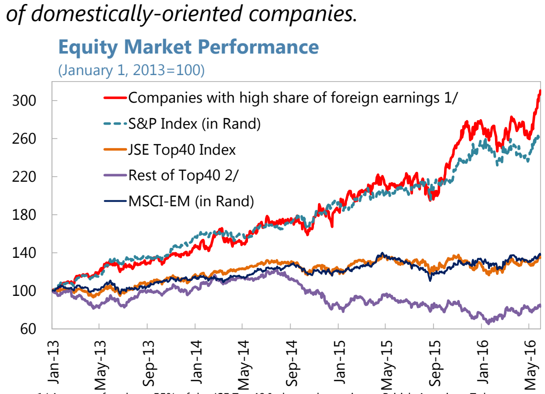
South Africa's external debt yields, which underperformed EM peers especially in the latter part of 2015.



Equity and FX markets experienced higher volatility in the second half of 2015 than during the taper tantrum episodes.



The equity performance of companies with a high share of foreign earnings continued to be much stronger than those of domestically-oriented companies.



1/ Accounts for about 55% of the JSE Top40 Index and constitutes British American Tobacco, SABMiller, Naspers, CFA, Steinhoff, MTN, Aspen Pharmacare, Mediclinic International, Intu Properties, and Netcare. 2/ Constitutes remaining companies in JSE Top40 Index.

Sources: Bloomberg, L.P., EPFR, Haver Analytics, S&P, and staff estimates.

Table 1. South Africa: Selected Economic and Social Indicators, 2012–17

Social Indicators

GDP		**Poverty**	
Nominal GDP (2015, billions of U.S. dollars)	315	Headcount ratio at $1.90 a day (2011 PPP) (percnet of population)	16.6
GDP per capita (2015, U.S. dollars)	5727	Undernourishment (2012, percent of population)	5.0
Population characteristics		**Inequality (2011)**	
Total (2015)	55.0	Income share held by highest 10 percent of population	51.3
Urban population (percent of total), 2014	64	Income share held by lowest 20 percent of population	2.5
Life expectancy at birth (years), 2014	57	Gini index	63.4

Economic Indicators

	2012	2013	2014	2015	2016	2017
					Proj.	
National income and prices (annual percentage change unless otherwise indicated)						
Real GDP	2.2	2.3	1.6	1.3	0.1	1.1
Real GDP per capita	0.6	0.7	0.0	-0.4	-1.6	-0.6
Real domestic demand	3.5	3.3	0.6	1.6	-0.4	0.6
GDP deflator	5.3	6.6	5.7	4.0	6.5	6.1
CPI (annual average)	5.7	5.8	6.1	4.6	6.7	6.2
CPI (end of period)	5.7	5.4	5.3	5.2	7.0	5.6
Labor market (annual percentage change unless otherwise indicated)						
Unemployment rate (percent of labor force, annual average)	24.9	24.7	25.1	25.4	26.1	26.7
Average remuneration (formal nonagricultural, nominal)	7.6	10.4	7.5	7.8	8.5	8.0
Labor productivity (formal nonagricultural)	1.1	-2.6	-0.3	2.3	2.8	2.8
Unit labor costs (formal nonagricultural)	6.4	13.5	7.7	4.9	5.5	5.1
Savings and Investment (percent of GDP unless otherwise indicated)						
Gross national saving	15.0	15.3	15.3	16.4	15.8	14.9
Public (incl. public enterprises)	-0.9	-0.9	1.1	1.0	1.2	1.5
Private	15.9	16.2	14.2	15.4	14.6	13.4
Investment (including inventories)	20.0	21.0	20.7	20.7	19.9	19.7
Public (incl. public enterprises)	6.8	7.0	7.3	7.6	7.6	7.6
Private	12.5	13.3	13.2	13.0	12.3	12.2
Fiscal position (percent of GDP unless otherwise indicated) 1/						
Revenue, including grants	27.3	27.6	28.2	29.6	30.1	30.2
Expenditure and net lending	31.4	31.5	31.9	33.5	33.8	33.8
Overall balance	-4.0	-3.9	-3.7	-3.9	-3.7	-3.6
Primary balance	-1.3	-0.9	-0.6	-0.6	-0.2	0.1
Structural balance (percent of potential GDP)	-3.8	-3.8	-3.4	-3.2	-2.8	-2.7
Gross government debt 2/	41.0	44.0	46.9	49.8	51.5	52.6
Government bond yield (10-year, percent) 3/	7.6	7.3	8.2	8.2	9.3	...
Money and credit (annual percentage change unless otherwise indicated)						
Broad money	5.2	5.9	7.3	10.3	6.5	6.9
Credit to the private sector	9.3	6.6	7.2	8.3	6.5	6.9
Repo rate (percent, end-period)	5.0	5.0	5.75	6.25	7.0	...
3-month Treasury bill interest rate (percent) 3/	5.3	5.1	5.8	6.1	7.0	...
Balance of payments (percent of GDP unless otherwise indicated)						
Current account balance (billions of U.S. dollars)	-19.7	-21.1	-19.1	-13.7	-11.0	-13.2
percent of GDP	-5.0	-5.7	-5.4	-4.3	-4.1	-4.8
Exports growth (volume)	0.7	3.6	3.3	3.6	2.4	2.9
Imports growth (volume)	4.2	5.0	-0.5	2.9	0.7	1.2
Terms of trade (percentage change)	-1.4	-5.4	-1.8	-0.5	-2.0	-3.3
Overall balance	0.3	0.1	0.4	-0.2	0.0	0.0
Gross reserves (billions of U.S. dollars)	50.7	49.6	49.1	45.8	45.8	45.8
percent of short-term debt (residual maturity)	133.2	130.2	123.8	134.8	122.8	118.0
Total external debt	35.7	37.3	41.3	39.4	50.6	51.4
of which short-term (residual maturity)	9.6	10.4	11.3	10.8	13.9	14.1
Nominal effective exchange rate (percentage change, end-period) 4/	-5.2	-15.4	-2.7	-16.6	-18.2	...
Real effective exchange rate (percentage change, end-period) 4/	-2.0	-12.5	1.4	-13.1	-14.0	...
Exchange rate (Rand/U.S. dollar, end-period) 3/	8.5	10.5	11.6	15.6	15.8	...

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/ May for 2016.

4/ April for 2016.

Table 2. South Africa: Consolidated Government Operations, 2012/13–2018/19[1]

	2012/13	2013/14	2014/15	2015/16	2016/17		2017/18		2018/19	
				Est.	Auth.	Staff	Auth.	Staff	Auth.	Staff
					billions of rand					
Total revenue and grants	907.6	1,008.1	1,100.0	1,223.1	1,324.3	1,310.6	1,436.7	1,414.2	1,571.6	1,537.0
Tax revenue	771.7	856.6	934.6	1,018.7	1,135.3	1,125.7	1,245.4	1,225.5	1,371.8	1,339.9
Non-tax revenue	28.5	30.6	30.9	55.8	26.7	26.6	18.9	18.9	16.9	16.9
Provinces, social security, and other entities	107.4	120.8	134.5	148.5	162.3	158.2	172.4	169.9	182.9	180.1
Total expenditure	1,043.4	1,144.1	1,237.7	1,380.9	1,463.3	1,465.3	1,572.1	1,576.1	1,695.2	1,699.2
Current expenditure	919.6	1,006.5	1,086.0	1,188.3	1,283.0	1,285.0	1,377.5	1,381.5	1,481.5	1,485.5
Wages and salaries	376.3	408.2	437.0	476.8	516.8	516.8	551.5	551.5	590.9	590.9
Other goods and services	162.9	174.2	187.5	193.7	204.7	204.7	221.9	221.9	236.6	236.6
Interest	93.3	109.6	121.2	135.3	154.3	156.3	168.7	172.7	185.6	189.6
Transfers	287.1	314.6	340.2	382.5	407.2	407.2	435.4	435.4	468.4	468.4
Capital expenditure	118.7	133.3	146.1	163.0	169.0	169.0	179.4	179.4	193.7	193.7
Payment for financial assets	5.1	4.2	5.6	29.7	5.2	5.2	5.2	5.2	5.1	5.1
Contingency	0.0	0.0	0.0	0.0	6.0	6.0	10.0	10.0	15.0	15.0
Primary balance	-42.6	-26.4	-16.6	-22.6	15.4	1.6	33.4	10.8	62.0	27.4
Overall balance	-135.9	-136.0	-137.8	-157.9	-139.0	-154.7	-135.3	-161.9	-123.6	-162.3
Structural primary balance	-34.7	-22.2	-10.1	-2.1	n.a.	35.9	n.a.	52.2	n.a.	62.9
Gross government debt	1,366	1,585	1,799	2,056	2,234	2,249	2,423	2,468	2,607	2,690
					percent of GDP					
Total revenue and grants	27.3	27.8	28.5	29.9	30.2	30.1	30.2	30.3	30.4	30.5
Tax revenue	23.2	23.6	24.2	24.9	25.9	25.9	26.2	26.2	26.6	26.6
Non-tax revenue	0.9	0.8	0.8	1.4	0.6	0.6	0.4	0.4	0.3	0.3
Provinces, social security, and other entities	3.2	3.3	3.5	3.6	3.7	3.6	3.6	3.6	3.5	3.6
Total expenditure	31.4	31.6	32.0	33.8	33.3	33.7	33.1	33.7	32.8	33.7
Current expenditure	27.7	27.8	28.1	29.1	29.2	29.5	29.0	29.6	28.7	29.5
Wages and salaries	11.3	11.3	11.3	11.7	11.8	11.9	11.6	11.8	11.4	11.7
Other goods and services	4.9	4.8	4.9	4.7	4.7	4.7	4.7	4.7	4.6	4.7
Interest	2.8	3.0	3.1	3.3	3.5	3.6	3.6	3.7	3.6	3.8
Transfers	8.6	8.7	8.8	9.4	9.3	9.4	9.2	9.3	9.1	9.3
Capital expenditure	3.6	3.7	3.8	4.0	3.9	3.9	3.8	3.8	3.8	3.8
Payment for financial assets	0.2	0.1	0.1	0.7	0.1	0.1	0.1	0.1	0.1	0.1
Contingency	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.3	0.3
Primary balance	-1.3	-0.7	-0.4	-0.6	0.4	0.0	0.7	0.2	1.2	0.5
Overall balance	-4.1	-3.8	-3.6	-3.9	-3.2	-3.6	-2.8	-3.5	-2.4	-3.2
Structural primary balance (percent of potential GDP)	-1.0	-0.6	-0.3	-0.1	n.a.	0.8	n.a.	1.1	n.a.	1.2
Gross government debt 2/	41.1	43.7	46.6	50.3	50.9	51.7	51.0	52.8	50.5	53.4
Memorandum items:										
National budget primary balance (percent of GDP)	-2.3	-1.6	-1.3	-1.1	-0.2	-0.4	0.1	-0.3	0.5	-0.1
National budget overall balance (percent of GDP)	-5.0	-4.4	-4.3	-4.2	-3.6	-3.9	-3.3	-3.9	-2.9	-3.7
Fiscal year GDP (billions of rand)	3,323	3,624	3,863	4,087	4,388	4,353	4,751	4,673	5,161	5,036
Fiscal year real GDP growth (percent)	2.2	2.4	1.7	0.5	1.2	0.5	1.9	1.2	2.5	2.2

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 2016 Budget.

2/ National government.

Table 3. South Africa: Balance of Payments, 2013–21

	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Proj.			
				In billions of U.S. dollars					
Balance on current account	-21.1	-19.1	-13.7	-11.0	-13.2	-13.4	-12.0	-11.9	-12.1
Balance on goods and services	-8.3	-6.5	-3.2	-3.4	-5.2	-4.7	-3.2	-2.5	-2.5
Exports of goods and services	113.4	109.4	96.7	96.3	97.5	101.3	106.6	111.4	115.8
Imports of goods and services	-121.8	-115.9	-99.9	-99.7	-102.7	-106.0	-109.8	-114.0	-118.3
Balance on income	-9.6	-9.4	-7.9	-6.1	-6.4	-6.5	-6.4	-6.9	-7.1
Income receipts	6.7	7.6	7.7	6.8	8.0	9.7	11.3	11.8	12.6
Income payments	-16.3	-16.9	-15.6	-12.9	-14.4	-16.1	-17.7	-18.7	-19.7
Balance on transfers	-3.2	-3.2	-2.6	-1.5	-1.7	-2.2	-2.4	-2.5	-2.5
Capital flows (including errors and omissions)	21.6	20.6	13.0	11.0	13.2	13.4	12.0	11.9	12.1
Balance on capital and financial account	14.0	15.4	10.5	11.0	13.2	13.4	12.0	11.9	12.1
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	14.0	15.4	10.4	11.0	13.2	13.4	11.9	11.9	12.1
Direct investment	1.7	-1.9	-3.6	-1.1	-0.8	-0.6	-0.3	0.0	0.3
Liabilities	8.3	5.8	1.8	1.1	1.7	2.3	3.0	3.7	4.5
Assets	-6.7	-7.7	-5.4	-2.1	-2.5	-2.9	-3.3	-3.7	-4.2
Portfolio investment	6.0	4.5	4.3	1.6	1.1	1.1	1.2	1.2	1.3
Liabilities	7.2	6.8	8.3	3.2	2.8	2.9	3.0	3.1	3.2
Assets	-1.2	-2.2	-3.9	-1.6	-1.7	-1.7	-1.8	-1.9	-1.9
Financial derivatives	0.8	1.5	0.4	0.3	0.3	0.3	0.4	0.4	0.4
Liabilities	-19.5	-18.0	-25.2	-21.4	-22.0	-22.8	-23.8	-24.9	-25.9
Assets	20.3	19.5	25.5	21.7	22.3	23.1	24.2	25.3	26.3
Other investment	5.6	11.2	9.3	10.1	12.6	12.5	10.7	10.3	10.1
Liabilities	5.2	13.7	5.5	6.3	8.8	8.6	6.9	6.5	6.3
Assets	0.3	-2.4	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Errors and omissions	7.6	5.2	2.5	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	0.5	1.5	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (end of period)	49.6	49.1	45.8	45.8	45.8	45.8	45.8	45.8	45.8
				In percent of GDP					
Balance on current account	-5.7	-5.4	-4.3	-4.1	-4.8	-4.7	-4.0	-3.8	-3.7
Balance on goods and services	-2.3	-1.9	-1.0	-1.3	-1.9	-1.7	-1.1	-0.8	-0.8
Balance on goods	-1.9	-1.8	-0.9	-0.8	-1.5	-1.5	-1.0	-0.7	-0.6
Balance on services	-0.3	-0.1	-0.1	-0.4	-0.3	-0.2	0.0	-0.1	-0.1
Exports of goods and services	30.8	31.1	30.7	36.0	35.4	35.5	35.8	35.8	35.7
Imports of goods and services	-33.1	-33.0	-31.7	-37.3	-37.3	-37.2	-36.9	-36.6	-36.5
Balance on income	-2.6	-2.7	-2.5	-2.3	-2.3	-2.3	-2.2	-2.2	-2.2
Balance on transfers	-0.9	-0.9	-0.8	-0.5	-0.6	-0.8	-0.8	-0.8	-0.8
Capital flows (including errors and omissions)	5.9	5.9	4.1	4.1	4.8	4.7	4.0	3.8	3.7
Balance on capital and financial account	3.8	4.4	3.3	4.1	4.8	4.7	4.0	3.8	3.7
Balance on capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on financial account	3.8	4.4	3.3	4.1	4.8	4.7	4.0	3.8	3.7
Direct investment	0.4	-0.5	-1.1	-0.4	-0.3	-0.2	-0.1	0.0	0.1
Portfolio investment	1.6	1.3	1.4	0.6	0.4	0.4	0.4	0.4	0.4
Financial derivatives	0.2	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other investment	1.5	3.2	3.0	3.8	4.6	4.4	3.6	3.3	3.1
Errors and omissions	2.1	1.5	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance of payments	0.1	0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (end of period)	13.5	14.0	14.5	17.1	16.6	16.1	15.4	14.7	14.1
Memorandum items:									
Total external debt	37.1	41.3	39.4	50.6	51.4	52.0	52.2	52.3	52.5
International investment position (net)	-4.3	-8.0	17.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
GDP at current prices (US$ billion)	367.8	351.6	314.7	267.3	275.2	285.1	297.7	311.3	324.0

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

Table 4. South Africa: Monetary Survey, 2012–16

	2012	2013	2014	2015	2016 March
			billions of rand		
Monetary Survey					
Net Foreign Assets	504	641	600	785	754
Net Domestic Assets	1,869	1,872	2,097	2,190	2,313
General government	-4	-94	-87	-180	-170
Public Nonfinancial Corporations	34	30	46	49	55
Nonfinancial Private Sector	2,233	2,381	2,552	2,764	2,842
Other items net	-394	-445	-415	-443	-413
Broad Money	2,373	2,514	2,697	2,975	3,067
Central bank					
Net Foreign Assets	402	486	528	668	642
Net Domestic Assets	-228	-295	-323	-444	-425
General government	-246	-318	-352	-484	-497
Public Nonfinancial Corporations	1	1	1	1	1
Nonfinancial Private Sector	0	0	0	0	0
Depository institutions (banks)	38	39	45	51	84
Other items net	-21	-18	-17	-13	-13
Monetary base	174	191	205	224	217
Currency in circulation	112	119	131	138	131
Reserves and others	62	72	74	86	87
			annual percentage change		
Memorandum items:					
Broad money growth	5.2	5.9	7.3	10.3	10.2
Monetary base growth	11.2	9.8	7.3	9.0	9.4
Credit to private sector	9.3	6.6	7.2	8.3	7.5
Broad money multiplier	13.6	13.2	13.1	13.3	14.1

Source: South African Reserve Bank.

Table 5. South Africa: Financial Soundness Indicators, 2012–16

	2012	2013	2014	2015	2016 1/
Capital adequacy					
Risk-weighted capital adequacy ratio	15.9	15.6	14.8	14.2	13.7
of which Tier 1 capital	14.0	14.1	13.6	13.8	13.6
Capital to asset ratio	7.8	7.9	7.6	7.0	7.1
Asset quality					
Nonperforming loans (percent of outstanding loans)	4.0	3.6	3.2	3.1	3.2
Nonperforming loans net of provisions (percent of regulatory capital)	21.5	18.1	16.3	16.5	18.1
Earnings, profitability, and efficiency					
Return on assets	1.5	1.4	1.4	1.5	1.5
Return on equity	20.5	18.6	18.8	20.7	20.6
Interest income (percent of gross income)	41.3	48.1	53.3	49.7	55.9
Trading income (percent of gross income)	8.9	7.8	2.8	2.0	11.9
Non-interest expenses (percent of gross income)	55.0	56.3	53.5	47.8	61.1
Personnel expenses (percent of non-interest expenditure)	38.7	47.3	50.7	41.4	48.8
Liquidity					
Liquid assets (percent of total assets)	16.2	16.6	17.6	17.7	18.4
Liquid assets (percent of short-term liabilties)	33.0	33.0	33.5	35.0	35.4
Customer deposits (percent of total non-interbank loans)	52.2	53.1	53.5	54.3	60.6
Exposure to FX risk					
Effective net open FX position (percent of regulatory capital)	0.5	0.3	0.3	-0.3	-2.8
Foreign-currency-denominated loans (percent of outstanding loans)	8.3	8.7	10.1	11.3	12.0
Foreign-currency-denominated liabilities (percent of total liabilities)	5.7	6.3	8.1	9.4	9.6
Sectoral distribution of loans and advances					
Residents	90.5	89.2	88.2	87.4	87.5
Central Bank and other financial corporations 2/	12.7	12.3	12.2	13.8	9.4
General government	0.8	0.7	0.7	0.6	0.6
Nonfinancial corporations	31.0	31.1	32.2	32.4	32.1
Households	46.0	45.1	43.1	40.6	39.7
Nonresidents	9.5	10.8	11.9	12.6	12.5
Derivatives (percent of regulatory capital)					
Gross asset position in financial derivatives	88.6	70.4	64.5	113.7	91.9
Gross liability position in financial derivatives	87.6	75.4	69.5	129.2	103.8
Real Estate Market					
Residential real estate prices (annual percentage change)	7.4	8.6	9.1	5.4	5.8
Residential real estate loans (percent of total loans)	30.3	28.5	26.6	24.8	24.2
Commercial real estate loans (percent of total loans)	9.1	8.8	9.1	9.2	9.0
Household debt					
Household debt (percent of GDP)	47.7	46.3	45.8	46.2	…
Household debt (percent of disposable income)	76.3	78.8	77.8	77.8	…
Household debt service (percent of disposable income)	7.7	8.6	9.3	9.7	…

Source: South African Reserve Bank.

1/ 2016 data is for February.

2/ Including interbank loans.

Table 6. South Africa: Medium-Term Macroeconomic Framework, 2013–21

	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Proj.			
National income and prices (annual percentage change)									
Real GDP	2.3	1.6	1.3	0.1	1.1	2.0	2.4	2.4	2.4
CPI (annual average)	5.8	6.1	4.6	6.7	6.2	5.5	5.5	5.5	5.5
Output gap (percent of potential real GDP)	-0.09	-0.3	-0.5	-1.9	-2.3	-1.9	-1.4	-0.9	-0.5
Labor market (annual percentage change)									
Unemployment rate (percent of labor force, annual average)	24.7	25.1	25.4	26.1	26.7	26.9	27.0	27.1	27.2
Savings and Investment (percent of GDP)									
Gross national saving	15.3	15.3	16.4	15.8	14.9	15.1	15.9	16.3	16.5
Public (incl. public enterprises)	-0.9	1.1	1.0	1.2	1.5	1.8	1.9	2.0	2.1
Private	16.2	14.2	15.4	14.6	13.4	13.3	14.1	14.3	14.4
Investment (including inventories)	21.0	20.7	20.7	19.9	19.7	19.8	20.0	20.1	20.2
Public (incl. public enterprises)	7.0	7.3	7.6	7.6	7.6	7.5	7.5	7.5	7.4
Private	13.3	13.2	13.0	12.3	12.2	12.3	12.4	12.5	12.6
Fiscal position (percent of GDP) 1/									
Revenue, including grants	27.6	28.2	29.6	30.1	30.2	30.4	30.5	30.5	30.5
Expenditure and net lending	31.5	31.9	33.5	33.8	33.8	33.8	33.7	33.5	33.4
Overall balance	-3.9	-3.7	-3.9	-3.7	-3.6	-3.4	-3.2	-3.1	-2.9
Primary balance	-0.9	-0.6	-0.6	-0.2	0.1	0.4	0.6	0.8	1.0
Gross government debt 2/	44.0	46.9	49.8	51.5	52.6	53.3	53.7	53.9	54.0
Balance of payments (percent of GDP unless otherwise indicated)									
Exports (volume, annual percentage change)	3.6	3.3	3.6	2.4	2.9	3.2	3.4	3.4	3.4
Imports (volume, annual percentage change)	5.0	-0.5	2.9	0.7	1.2	2.3	2.4	2.7	2.7
Current account balance (billions of U.S. dollars)	-21.1	-19.1	-13.7	-11.0	-13.2	-13.4	-12.0	-11.9	-12.1
percent of GDP	-5.7	-5.4	-4.3	-4.1	-4.8	-4.7	-4.0	-3.8	-3.7
Overall balance	0.1	0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (billions of U.S. dollars)	49.6	49.1	45.8	45.8	45.8	45.8	45.8	45.8	45.8
percent of short-term debt (residual maturity)	130.2	123.8	134.8	122.8	118.0	112.6	107.2	102.4	98.1
Total external debt	37.1	41.3	39.4	50.6	51.4	52.0	52.2	52.3	52.5

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, 2012–16

	2012	2013	2014	2015	2016
					Proj.
Financial indicators					
Gross government debt (percent of GDP)	40.6	43.1	45.8	49.6	51.5
Broad money (annual percentage change)	5.2	5.9	7.3	10.3	6.5
Private sector credit (annual percentage change)	9.3	6.6	7.2	8.3	6.5
91 day Treasury bill yield (percent, end-period) 1/	5.3	5.1	5.8	6.0	7.2
91 day Treasury bill yield (real, percent, end-period) 2/ 3/	-0.4	-0.6	-0.3	1.5	0.7
External indicators					
Exports (annual percentage change in U.S. dollars)	-8.2	-3.9	-4.2	-11.8	-0.1
Export volume (goods and services, annual percentage change)	0.1	4.6	3.3	3.6	2.4
Imports (annual percentage change in U.S. dollars)	2.0	-0.6	-4.7	-14.7	-0.6
Import volume (goods and services, annual percentage change)	6.0	1.8	-0.5	2.9	0.7
Terms of trade (annual percentage change) 4/	-1.4	-5.4	-1.8	-0.5	-2.0
Current account balance (percent of GDP)	-5.0	-5.8	-5.4	-4.3	-4.1
Capital and financial account balance (percent of GDP)	5.3	3.7	3.9	3.2	4.0
of which: Net portfolio investment (debt and equity)	2.6	1.6	1.3	1.4	0.6
Other investment (loans, trade credits, etc.)	2.2	1.5	3.2	3.0	3.8
Net foreign direct investment	0.4	0.5	-0.5	-1.1	-0.4
Gross international reserves (billions of U.S. dollars) 1/	50.7	49.6	49.1	45.8	46.1
in months of imports of goods and services	4.9	4.9	5.1	5.5	5.5
in percent of broad money	18.2	20.7	21.1	24.0	23.3
in percent of short-term debt, residual maturity	133.2	130.2	123.8	134.8	123.6
Net international reserves (billions of U.S. dollars) 1/	47.9	45.5	42.7	40.7	40.5
Foreign currency forward position (billions of U.S. dollars) 1/	5.2	3.6	2.0	1.4	1.6
Total external debt (percent of GDP)	35.7	37.3	41.3	39.4	50.6
percent of export earnings	114.3	113.6	132.6	128.3	140.6
External interest payments (percent of export earnings)	4.4	4.9	5.2	6.3	5.4
External amortization payments (percent of export earnings)	26.9	31.1	35.5	38.8	36.2
Exchange rate (Rand/U.S. dollar, period average) 5/	8.2	9.7	10.8	12.8	15.5
Real effective exchange rate (annual percentage change, period average)	-5.4	-10.5	-6.3	-0.6	n.a.
Financial market indicators					
Stock market index (end-period) 1/	39,250	46,256	49,771	50,694	53,905
Net purchases of bonds by nonresidents (billions of U.S. dollars)	10.8	0.2	-6.4	-1.5	n.a.
Net purchases of shares by nonresidents (billions of U.S. dollars)	-0.4	0.0	1.2	-0.4	n.a.

Sources: Haver and Fund staff estimates and projections.

1/ For 2016, May data.

2/ For 2016, April data.

3/ Nominal yield adjusted deflated by current CPI inflation.

4/ The terms of trade include gold.

5/ For 2016, January through May average.

Text Table 1. Key Legislative Measures[1]		
Legislation	**Key Features**	**Status**
Legislation related to labor markets		
The Labour 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; facilitates unionization of workers, expands definition of dismissal, and limits fixed term contracts to 3 months.	Came into effect on January 1, 2015.
The Employment Services Act	Regulates private recruitment services, provision for public recruitment services, promotes employment for persons with disabilities, and drives productivity in the workplace through new state owned entity, Productivity South Africa.	Came into effect August 9, 2015.
Continuing Education and Training Act: National policy on community colleges	Provides education to about 12-million adults and youth with a qualification lower than a Grade 9 by opening Community Education and Training Colleges (CETC).	Came into effect July 1, 2015
Legislation Related to Land		
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.	Came into effect August 1, 2015.
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.	Awaits presidential approval.
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.	Awaits presidential approval.
The Electronic Deeds Registration Bill	Intends to reform land administration and standards of governance.	Submitted to Parliament.
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.
[1] Ongoing key legislative initiatives approved or under consideration since January 1, 2015.		

Text Table 1. Key Legislative Measures (concluded)		
Legislation	**Key Features**	**Status**
Strengthening the Relative Rights of People Working the Land (50:50 proposal)	Requires farmers to hand 50% of their farms to their workers, whose share will be allotted proportional to their contribution and tenure. State buys 50% of the farm that will be allocated to the farm workers with proceeds put into an investment and development fund (IDF), jointly owned by the parties constituting new ownership regime. Use funds to develop managerial and production capacity of new entrants to land ownership, reinvest into farm and buy out people.	In first phase pilot test
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.	Submitted to Parliament.
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.	Draft bill approved by Cabinet.
	Other Legislation	
Disaster Management Amendment Bill	Aims to streamline the country's approach to planning for and responding to disasters, including the drought. Transfers the function of disaster management from national government to municipalities.	Passed by Parliament.
The Mineral and Petroleum Resource Development Act 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. Re-introduced bill includes the establishment of an independent Mineral and Mining Development Council.	Rejected by President, re-introduced to National Assembly in May, 2016.
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.	Signed by President, awaiting enactment.
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.	Came into effect May 1, 2015.
Reviewed Broad Based Socio-Economic Empowerment Charter for the South African Mining and Minerals Industry (Mining Charter)	Requires a "minimum target of 26% ownership per mining right to […] black people"[2] at all times, even if those stakes are subsequently sold. Introduces scorecard system aligned with B-BBEE codes. Targets for higher rate of black representation at management level and more local procurement from black companies.	Issued for public comments by the Department of Mineral Resources, April, 2016.

[2] According to Government Gazette, April 15, 2016, "'Black people' […] means Black Africans, Coloureds and Indians" (http://www.gov.za/sites/www.gov.za/files/39933_gon450.pdf).

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 long-term plan. The NDP provides 2030 targets for investment, growth, and employment creation. 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] 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 2016/17–2018/19, 8th annual edition)*** (Department of Trade and Industry, http://www.thedti.gov.za/editmedia.jsp?id=3726) focuses on government interventions and trade policy to stimulate industrial development and diversify exports. It plans to increase public procurement to promote local production and localized supply chains. Special focus is devoted to the following sectors: textiles, agro-processing, automobiles, business processing services, and the ocean economy.

- ***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 (five million jobs by 2020). The NGP starts by identifying where employment creation is possible. The sectors identified are: infrastructure, the agricultural and mining value chains, the green economy, manufacturing (metal fabrication, machinery and equipments etc.), tourism, and certain high level services. It combines macroeconomic and microeconomic interventions.

- ***Nine-Point Plan* (*2016)*** (State of the Nation Address, http://www.gov.za/issues/nine-point-plan) highlights the following areas to achieve faster growth, job creation, and radical economic transformation: agriculture, increasing value added to minerals, more effective industrial policies, SMEs, resolving the energy challenge, stabilizing the labor market; scaling up private investment, and SOEs.

[1] The ANC manifesto (http://www.anc.org.za/2014/anc-manifesto/together-we-move-south-africa-forward/) states that achieving these goals require "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 NGP, National Infrastructure Plan and IPAP."

Annex II. Risk Assessment Matrix 1/

Nature/Source of Threat	Likelihood and Time Horizon	Expected Impact on Economy	Policy Responses
Tighter or more volatile global financial conditions	*M/H; ST*	*H.* Depreciation and asset price declines. Capital flow reversals could trigger disorderly adjustment of the current account deficit, especially if accompanied by credit rating downgrades and spillovers to the financial system. Higher inflation, lower growth, and higher fiscal deficit.	Increase policy rate. Provide FX liquidity if dollar shortages appear. Tighten fiscal policy further if financing becomes problematic, but protect social grants to minimize impact on the poor.
Significant slowdown in China and further suppressed commodity prices	*L in ST and M in MT*	*H.* Depreciation and asset price declines. Further deterioration in growth, employment, and twin deficits. Could also lead to capital flow reversal as above.	Take some structural measures that promote growth. If external financing becomes problematic, tighten monetary and fiscal policy and provide FX liquidity if shortages appear.
Weaker than anticipated growth	*H; S-MT*	*M. Higher fiscal deficit, and worse banks' asset quality. Higher current account deficit, especially* if accompanied by lower global growth and commodity prices. Asset price declines and capital flow reversal.	Structural reforms needed to drive growth. Take additional fiscal measures to ensure debt stabilization over medium term. . Step up risk analysis and financial institutions monitoring. In case of capital outflows, package of measures as below needed.
Domestic political developments, policy missteps, or events that reduce market confidence	*M/H; S-MT*	*H.* Depreciation and asset price declines. Capital flow reversal, especially if combined with downgrades to speculative grade. Import compression, recession, wider fiscal deficit, and rising financial risks.	Announce package of measures, including measures to improve governance and to reduce deficit (but protect poor); asset sales and greater private participation in SOEs; tighter monetary policy. Provide FX liquidity if shortages appear. Step up risk analysis and financial institutions monitoring.
SOEs' contingent liabilities materialize	*M; S-MT*	*H.* Wider fiscal deficit. Higher interest rates. Lower growth, capital outflows, especially if combined with downgrades to speculative grade. Import compression, recession. Rising financial risks.	Announce package of measures focused on SOEs' better governance/ performance and including fiscal measures to reduce deficit (but protect poor); asset sales; tighter monetary policy. Provide FX liquidity if shortages appear. Step up risk analysis and financial institutions monitoring.
Further delays in the completion of power plants	*L; MT*	*M.* Lower investment, growth, and employment, with adverse implications for the twin deficits.	Explore options to ration electricity demand more efficiently, introduce greater private participation.
Extensive labor market disruptions	*L/M; S-MT*	*M.* Weaker growth, worse twin deficits, lower investor confidence, and layoffs.	Intensify dialogue with social partners.

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. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. External Sector Assessment

South Africa		Overall Assessment
Foreign asset and liability position and trajectory	**Background**. South Africa's net international investment position shifted to 18 percent of GDP as of end-2015 from -8 percent of GDP at end-2014, driven primarily by currency depreciation. Total gross external liabilities amounted to 139 percent of GDP,[1] up from 130 percent of GDP at end-2014. Gross external debt, which rose rapidly from 26 percent in 2008, stood at 39½ percent of GDP as of end-2015, of which 14½ percent of GDP was short-term (residual maturity). **Assessment**. Large gross external liabilities, including large holdings of local-currency denominated bonds by nonresidents, pose risks. These risks are mitigated by a large external asset position, totaling 157 percent of GDP as of end-2015 (of which 40 percent are hard-to-liquidate FDI assets), and majority large share of external debt (50½ percent) being in rand.	**Overall Assessment**: *The external position in 2015 was moderately weaker than implied by desirable policy settings and medium-term fundamentals. Lower oil prices contributed to the external adjustment.* In 2015, the current account deficit gap declined. However, South Africa remains highly reliant on non-FDI flows to finance its still relatively high CA deficit. Despite the REER depreciation of recent years, structural constraints result in a slow pace of CA adjustment. High gross external liabilities and large gross external financing requirements pose risks. A reduction in capital inflows would complicate the financing of the CA deficit and, if severe, could lower growth markedly. Subsequent developments as of May 2016 point to a broadly unchanged current account position, and do not alter the assessment of the external position. **Potential policy responses**: Structural reforms are key to accelerate the external adjustment and boost domestic savings. Implementation of the authorities' National Development Plan, especially upgrades in infrastructure and education/skills, would help improve competitiveness over the medium term and increase employment and savings, but reducing policy uncertainty and additional labor and product market reforms are also essential. Fiscal consolidation will help reduce the current account deficit and alleviate external vulnerabilities. A build-up of reserves would strengthen the country's ability to deal with FX liquidity shocks.
Current account	**Background.** The current account (CA) deficit narrowed to 4.3 percent of GDP in 2015 from 5.4 percent in 2014, as a result of lower oil prices, while the trade deficit widened in volume terms. The deterioration in the trade balance in volume terms seen in 2015, however, may not be a good indication of underlying trends in the external accounts, as it was partly due to a rebound in imports from a depressed level in 2014 when protracted strikes reduced demand for intermediate and consumption imports. The CA deficit is projected to narrow slightly to 4.1 percent of GDP in 2016. **Assessment.** The CA regression model estimates a CA norm of -1.4 percent of GDP, and a CA gap of -2½ percent of GDP for 2015, down from -3½ percent of GDP in 2014. The CA gap is largely explained by the regression residual, reflecting structural factors that are not captured by the model. Staff assesses the CA to be 1½ to 2½ percentage points weaker than implied by medium-term fundamentals and desirable policy settings in 2015.[2] Addressing structural rigidities remains key to accelerate the pace of adjustment.	
Real exchange rate	**Background.** The CPI- and ULC-based REERs were broadly unchanged on average in 2015, following a depreciation of about 30 percent since 2010. While the CPI-based REER has already reversed the 2009-10 appreciation, the ULC-based REER remains about 12 percent more appreciated than at end-2008. As of April 2016, the REER has weakened by about 15 percent relative to the 2015 average **Assessment**. Consistent with the assessment of the CA gap, staff assesses a REER overvaluation of 0-10 percent for 2015, down from 5-20 percent in 2014.[3] The magnitude of the REER misalignment relies on estimates of the elasticity of the CA to the REER.[4] The REER overvaluation would come down if structural rigidities currently hampering the pace of external adjustment were addressed.	
Capital and financial accounts: flows and policy measures	**Background.** Net FDI declined to -1.1 percent of GDP in 2015, from -0.5 percent of GDP in 2014. Portfolio, other investment flows (mainly bank flows), and unrecorded transactions financed the CA deficit. Gross external financing needs totaled 19 percent of GDP in 2015. **Assessment.** High reliance on non-FDI flows and high nonresident holdings of local financial assets pose risks. These are mitigated by a floating exchange rate, the fact nonresident portfolio holdings are mainly denominated in local currency, and a large domestic institutional investor base subject to capital controls.	
FX intervention and reserves level	**Background**. South Africa has a floating exchange rate regime. Foreign exchange intervention is rare. Reserves cover 96 percent of gross external financing needs and over five months of imports, but are below the IMF's composite adequacy metric (at 87 percent of the metric without considering capital flow management measures, and 96 percent of it considering them). **Assessment**. As conditions allow, reserve accumulation is desirable to strengthen the external liquidity buffer, subject to maintaining the primacy of the inflation objective.	

Technical Background Notes	1/ Of the 139 percent of GDP in total external liabilities as of end-2015, 47 percent were portfolio investment liabilities, 35 percent were direct investments, and the remainder 18 percent were financial derivatives and other investments. Total external assets amounted to 157 percent of GDP as of end-2015, of which 40 percent were direct investments, 36 percent were portfolio investment assets, 11 percent were reserve assets, and the remainder 13 percent were financial derivatives and other investment assets. 2/ 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 EM peers' benchmark (-35 percent of GDP). According to this approach, to stabilize South Africa's net IIP at the peers' level, South Africa's CA deficit would need to be 2½ percent of GDP, compared to staff's projection of a CA deficit of about 3½ percent of GDP over the medium term, thus resulting in a CA gap of about -1½ percent of GDP. The CA regression approach yields a gap for 2014 of -2½ percent of GDP. Hence, the staff's gap range for 2015 is centered on -2 percent of GDP. 3/ The EBA REER regressions (which use the CPI-based REER) point to undervaluation for 2015. The EBA REER Index regression gives an undervaluation of 23 percent, while the REER Level regression estimates an undervaluation of 4 percent for 2015. Gauging the appropriate REER for South Africa is challenging due to its structural changes since 1994 and high REER volatility. 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 that use CPI-based REERs are very likely to point to undervaluation, unless they can link the full downward trend of the REER to deteriorating fundamentals. Also, the sensitivity of trade flows to the exchange rate movements appears lower than implied by long-run elasticities, as structural impediments, including electricity shortages, prolonged strikes, and concentrated product markets, hamper adjustment. 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 fully explain this shift. Other indicators, including the EBA CA regression model and South Africa's declining share in world's exports, suggest overvaluation. 4/ Using the CA gap range and applying a long-run elasticity estimate would suggest a REER overvaluation of about 5-8 percent. However, considering the uncertainty regarding the elasticity, possible lags for REER adjustment to have effects on the current account balance, and signs that some volume adjustment is in train, staff assesses REER overvaluation in the order of 0 to10 percent.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 15, 2016

Prepared By

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

CONTENTS

RELATIONS WITH THE IMF

As of April 30, 2016

Membership Status

Joined: December 27, 1945

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

General Resources Account	**SDR Million**	**%Quota**
Quota	3,051.20	100.00
IMF holdings of currency (Exchange Rate)	2,630.74	86.22
Reserve Tranche Position	420.49	13.78
Lending to the Fund		
New Arrangements to Borrow	340	

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	1,785.42	100.00
Holdings	1,492.53	83.60

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				
	2016	2017	2018	2019	2020
Principal					
Charges/interest	0.10	0.21	0.21	0.21	0.21
Total	0.10	0.21	0.21	0.21	0.21

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 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.

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

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[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.

supervision, and away from a rigid system of quantitative controls.

Article IV consultation

The 2014 Article IV consultation was concluded by the Executive Board on December 3, 2014. South Africa is on the standard 12-month Article IV consultation cycle.

Technical assistance

Fiscal Affairs Department (FAD) technical assistance (TA) missions

In April 2013, an FAD 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). As part of the technical support for the Davis Tax Committee, an FAD mission on VAT gaps took place in August 2014 and January 2015, and missions on natural resource taxation took place in January and November 2015. An FAD mission visited Pretoria in March 2015 on public sector balance sheets. In December 2015, an FAD mission conducted a workshop on wage bill management and PBO analysis. In March 2016, an FAD mission followed up on the review of mining and petroleum fiscal regimes.

Monetary and Capital Markets Department (MCM) technical assistance (TA) missions

In May 2014, an MCM mission took place to conduct the training on banking sector stress test for the SARB. In August 2015, an MCM mission conducted seminars on stress testing.

Legal Department (MCM) technical assistance (TA) missions

In January 2015, a LEG mission provided technical assistance on fiscal law of the extractive industries in conjunction with FAD's mission on national taxation.

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. Guang Zhe Chen (country director) in April 2016, to discuss macrocritical structural issues and to coordinate the two teams' work for April, 2016–May, 2017.

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, and macroeconomic stability.

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 April, 2016–May, 2017.

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, May 2016-April 2017

Title	Products	Expected Delivery Date
1. World Bank Work Program[1]	▪ $3.75b IBRD Eskom operation	Ongoing
	▪ Ongoing $250m CTF renewable (solar and wind) operation	Ongoing
	▪ Isimangaliso Wetland Project (GEF) $9.0 m	Ongoing
	▪ Carbon Capture and Storage Development TA, US$14 million	Ongoing
	▪ Land Bank Financial Intermediation Loan (US$100m)	Due to Board in August 2016
	▪ 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	Completed
	▪ Economic Updates	Semiannual
	▪ Systematic Country Diagnostic	2017
	▪ National Health Insurance TA	Ongoing (Knowledge Hub)
	▪ TB and HIV/AIDS Program	Ongoing (Knowledge Hub)
	▪ PETS-QSDS in Gauteng Province	2016
	▪ Financial sector stability, including financial inclusion dialogue	Ongoing
	▪ Monitoring and Evaluation technical assistance	Ongoing
	▪ TA on helping the NT and the relevant stakeholders decide on how to improve the secondary market architecture	Ongoing
	▪ Analysis of productivity trends in South Africa	Ongoing
	▪ Analysis of the impact of the power deficit on countries in southern Africa, including South Africa	2017
	▪ Analysis of effect of potential downgrade to sub-investment grade on public borrowing costs	Ongoing
	▪ Analysis of effective tax rates and efficacy of tax incentives	Ongoing

Table 1. South Africa: Bank and IMF Planned Activities in Macrocritical Structural Reform Areas, May 2016-April 2017 (concluded)		
	▪ 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 ▪ Private Investment Program	Ongoing Ongoing
2. IMF Work Program	▪ Spillovers from China's transitions and commodity prices	Ongoing
	▪ Policy uncertainty and exports	Completed
	▪ Labor markets dynamics and inequality	Forthcoming
	▪ Policy uncertainty and investment ▪ Macro-financial linkages: capital flows, ratings, and the financial sector nexus ▪ Outward spillovers ▪ Exchange rate pass-through to import prices ▪ Fiscal policy under elevated vulnerabilities and low growth	All Ongoing
3. Joint products in the next 12 months	No joint products planned at this time	
1/ Missions are ad hoc, but generally occur twice a year.		

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

Reporting of real sector data for International Financial Statistics (IFS) is timely. Statistics South Africa, which has been responsible for compiling GDP data by production, has now also taken over the compilation of GDP data by expenditure from the SARB. The revised 2010−15 GDP data were published in May 2016. GDP data are compiled according to SNA2008, with a base year of 2010.

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 (QLFS) was launched in January 2008 based on major revisions to the old Labour Force Survey that was in existence since 2000. Since 2015, a new Master Sample has been now introduced based on the 2011 census data. The new Master Sample should improve the level of precision in the estimates produced compared to the prior Master Sample which was only based on the prior census in 2001.

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 are compiled with December 2012=100.

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 and international investment position data are broadly consistent with the sixth edition of the Balance of Payments Manual (BPM6). The authorities have improved the coverage of trade flows within the Southern African Customs Union (SACU) in 2013. Work is needed to improve the reliability and accuracy of balance of payments data with the aim of reducing errors and omissions.

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.

Table 2. South Africa: Table of Common Indicators Required for Surveillance (as of May 31, 2016)

	Date of Latest Observation	Date Received[7]	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of Publication[8]	Memo Items: Data Quality – Methodological Soundness[9]	Memo Items: Data Quality – Accuracy and Reliability[10]
Exchange rates	5/26/2016	5/26/2016	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[1]	3/31/2016	4/29/2016	M	M	M		
Reserve/base money	3/31/2016	4/29/2016	M	M	M	O, O, LO, O	LO, O, O, O
Broad money	3/31/2016	4/29/2016	M	M	M		
Central bank balance sheet	3/31/2016	4/29/2016	M	M	M		
Consolidated balance sheet of the banking system	3/31/2016	4/29/2016	M	M	M		
Interest rates[2]	5/26/2016	5/26/2016	D	D	D		
Consumer Price Index	4/2016	5/18/2016	M	M	M	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	FY15/2016	2/24/2016	Y	Y	Y	O, O, O, O	O, O, O, O
Revenue, expenditure, balance and composition of financing[3]–central government	12/2015	3/8/2016	M	M	M		
Stocks of central government and central government-guaranteed debt[5]	12/2015	3/8/2016	M	Q	Q		
External current account balance	Q4 2015	3/8/2016	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
Exports and imports of goods and services [6]	3/31/2016	4/29/2016	M	M	M		
GDP/GNP	Q4 2015	5/23/2016	Q	Q	Q	O, LO, LO, LO	LO, O, O, O
Gross external debt	Q4 2015	3/31/2016	Q	Q	Q		
International investment position	Q4 2015	3/31/2016	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] Reflects the latest information released by the IMF Statistics Department by 5/26/2016.
[8] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[9] 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).
[10] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.

INTERNATIONAL MONETARY FUND

SOUTH AFRICA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

June 15, 2016

Approved By
Anne-Marie Gulde-Wolf and Vivek Arora

Prepared by the Staff Representatives for the 2016 Article IV Consultation with South Africa

The increase in government debt to 50 percent of GDP in FY2015/16 from 27 percent of GDP in FY2008/09 has raised fiscal risks. Recognizing this fact, the 2015 and 2016 Budgets announced fiscal measures aimed at narrowing the deficit and stabilizing debt. Notwithstanding these measures, this debt sustainability analysis (DSA) suggests that the debt ratio may continue to rise over the projection horizon if staff's macroeconomic projections materialize, albeit more slowly than in recent years. Also, further negative shocks represent a significant risk to the debt and financing outlook. In particular, permanently low growth or a realization of large contingent liabilities from state-owned enterprises (SOEs) could push debt above the DSA's 70 percent of GDP high-risk threshold, and the debt-to-GDP ratio could exceed 65 percent if the economy were buffeted by a standard combined macro-fiscal shock. In addition, South Africa's gross financing needs 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 2014 Article IV consultation, and if staff's macroeconomic assumptions materialize, further measures will likely be required to ensure South Africa's debt remains sustainable.

PUBLIC DEBT SUSTAINABILITY ANALYSIS[1]

1. **Macroeconomic assumptions.** Real GDP growth is projected at 0.1 percent in 2016 but is expected to increase to 1.1 percent in 2017 and 2 percent in 2018 as a result of some easing of electricity constraints. Over the medium term, growth is projected at around 2-2½ percent. The GDP deflator is expected to average close to 6 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 FY2016/17 national government primary fiscal deficit is projected to improve to 0.4 percent of GDP from a deficit of 1.1 percent of GDP in FY2015/16 as a result of fiscal measures in the 2015 and 2016 Budgets—the yield from these measures is as assumed in the Budget. The primary deficit is expected to continue to improve over the medium term as a result of additional fiscal measures and a gradual improvement in growth. The amount of consolidation is, however, not expected to be sufficient to stabilize the debt-to-GDP ratio, which is projected to rise to 54 percent of GDP by 2021. Consistent with the 2016 Budget, the projections include stock-flow adjustments to capture discounts on new issuance of existing benchmark bonds as well as valuation effects on inflation-linked dbonds. The projections do not assume any additional fiscal measures that the 2016 Budget signaled could be taken to fulfill the government's medium-term budget deficit targets.

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 (central government). While this coverage excludes provincial governments, social security funds, and extra-budgetary institutions, these entities are not allowed to incur debt. Even though municipalities are allowed to incur debt, 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. **A higher-scrutiny debt sustainability analysis is warranted given South Africa's elevated gross financing needs.** Gross financing needs (GFN) are estimated at 10.8 percent of GDP in 2015 and expected to reach 11.2 percent in 2021, above the 10 percent of GDP high-scrutiny trigger based on a conservative assessment of early-warning results.

5. **Consistent overestimation of real GDP growth over the past 4 years poses risks.** Between 2012-15, the median real GDP forecast error was -1.4 percentage points, broadly in line with other surveillance countries. Although neither the primary balance nor GDP inflation projections were systematically biased, the persistent overprojection of real GDP growth poses an upside risk to the debt-to-GDP forecasts.

[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.

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 (1.3 percent of GDP) as well as the maximum three-year level of the cyclically-adjusted primary balance (1.8 percent of GDP) is moderate when compared to the experience in market-access countries.

7. **Fiscal consolidation in recent years has reduced the national government deficit though debt has continued to rise.** Substantial fiscal stimulus during the global financial crisis contributed to high fiscal deficits and a near-doubling of the debt-to-GDP ratio since 2008, to nearly 50 percent of GDP in 2015. Fiscal consolidation, which started with the 2013 Budget, has reduced the national government deficit from 6.3 percent of GDP in FY2009/10 to 4.2 percent of GDP in FY2015/16. Rising interest costs means the national government primary deficit has adjusted even more, from 4.1 percent in FY2009/10 to 1.1 percent in FY2015/16. However, largely due to lower-than-anticipated growth this consolidation has not been sufficient to stabilize the debt-to-GDP ratio and reduce the GFN, which at 10.8 percent of GDP is above the EM average despite a favorable maturity and currency structure.

8. **As acknowledged in the 2016 Budget, the fiscal outlook is subject to several downside risks.** Lower-than-anticipated growth or higher borrowing costs would put upward pressure on the fiscal deficit. Depending on scale and modalities, 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 support, while higher-than-anticipated fiscal multipliers could put further downward pressure on growth and render the fiscal consolidation self-defeating.

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 54 percent by 2021. This is 28 percentage points higher than in 2008, but below the 70 percent high-risk threshold.

- The projected debt level in 2021 increases to around 57 percent of GDP if none of the envisaged fiscal consolidation materializes and the primary balance remains unchanged, and to near 60 percent of GDP with a one-standard-deviation temporary shock to growth.

- 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

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

primary balance) and an exchange rate shock (consistent with the maximum movement over the 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 66 percent.[3]

- A customized shock entailing a permanent reduction in growth—growth remains at the 2016 level (0.1 percent) throughout the projection horizon—results in debt increasing to around 73 percent of GDP—above the high risk threshold—by 2021 and continuing to rise.

- A contingent liability shock where 75 percent of the government's guarantee exposure—estimated at 10 percent of GDP in FY2015/16—is realized would push debt above the high-risk threshold of 70 percent of GDP by 2021. 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 aforementioned stress tests, with the former suggesting there is a 10 percent chance that the debt-to-GDP ratio reaching 67½ percent of GDP by 2021.

10. The heat map suggests that despite its low share of foreign currency and short-term debt, South Africa faces risks from lower growth, contingent liabilities, and tighter global financial conditions. A realization of SOE contingent liabilities, permanently low growth, or a combined macro-fiscal shock could all push South Africa's GFN above the high risk benchmark, indicating an increased risk of financing difficulties. Permanently low growth or a shock to contingent liabilities could also push South Africa's debt level above the threshold often associated with debt distress in other countries. South Africa's local currency bond spread, high external financing requirements, 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 2014 Article IV consultation, even after taking into account the consolidation measures announced in the 2015 and 2016 Budgets.

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

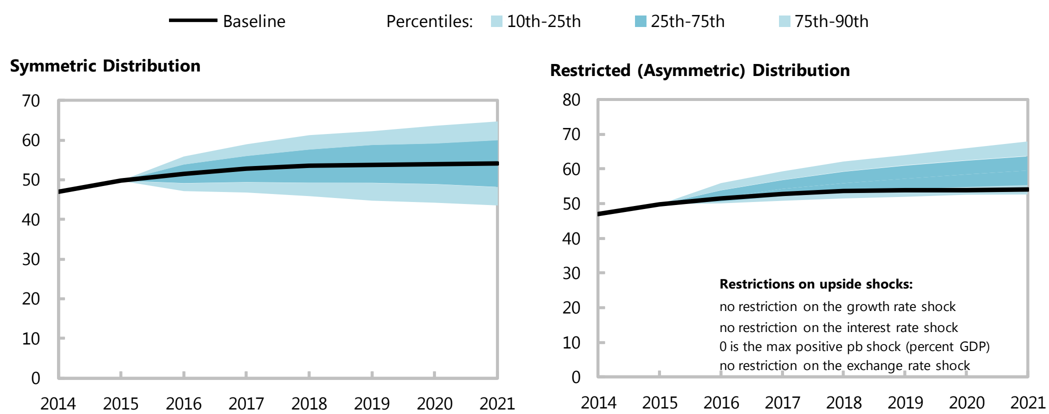
Figure 1. South Africa: Public Sector Debt Sustainability Analysis—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Real Exchange Rate Shock	Permanent GDP Growth Shock	Contingent Liability Shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Real Exchange Rate Shock	Permanent GDP Growth 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	

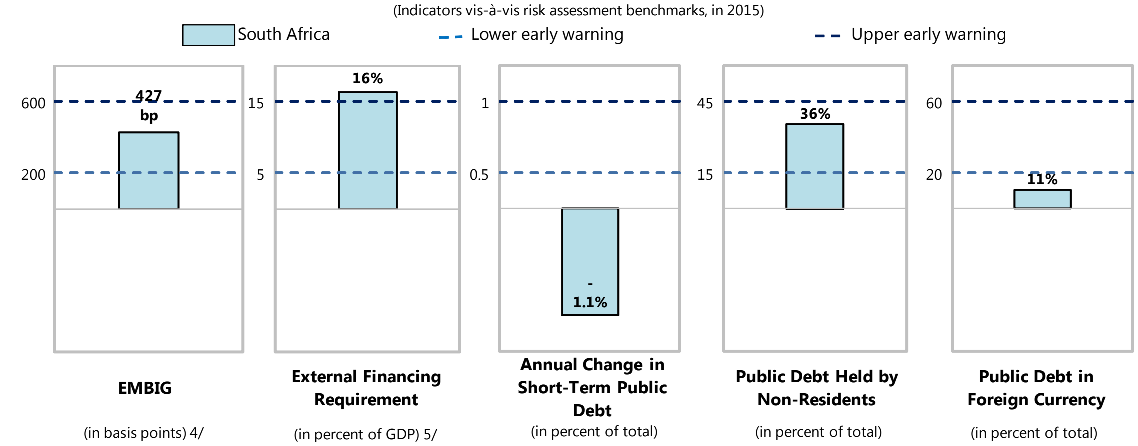
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



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.

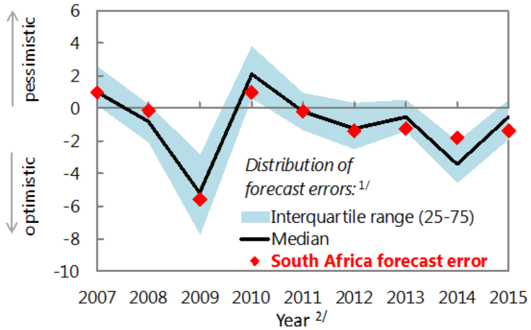
4/ EMBIG, an average over the last 3 months, 02-Mar-16 through 31-May-16.

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.

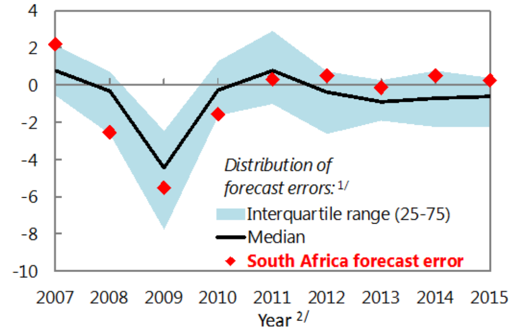
Figure 2. South Africa: Public Sector Debt Sustainability Analysis—Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

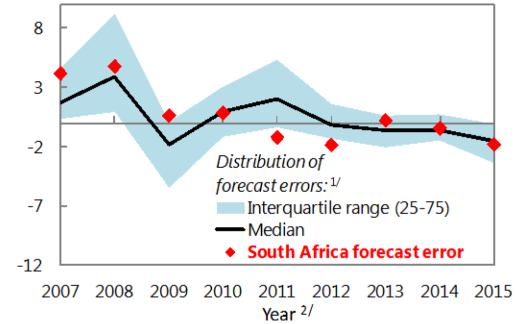
Real GDP Growth
(in percent, actual-projection)
South Africa median forecast error, 2007-2015: -1.23
Has a percentile rank of: 19%



Primary Balance
(in percent of GDP, actual-projection)
South Africa median forecast error, 2007-2015: 0.26
Has a percentile rank of: 77%

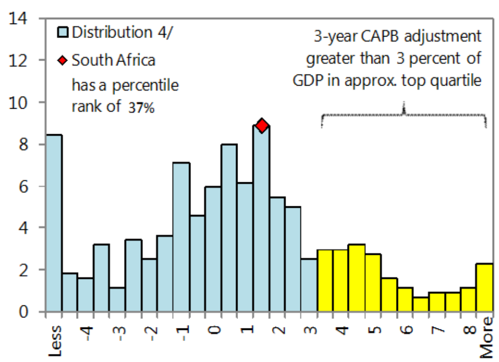


Inflation (Deflator)
(in percent, actual-projection)
South Africa median forecast error, 2007-2015: 0.19
Has a percentile rank of: 53%

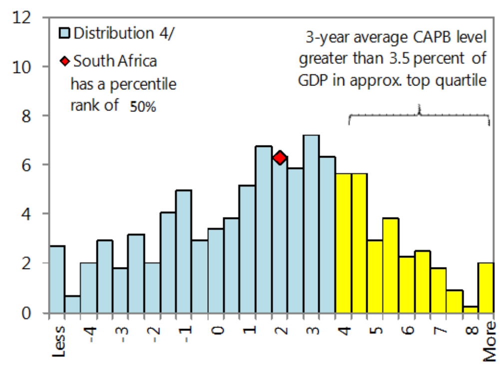


Assessing the Realism of Projected Fiscal Adjustment

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

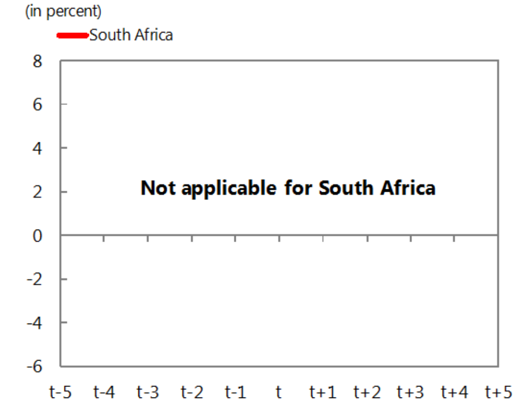


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



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)

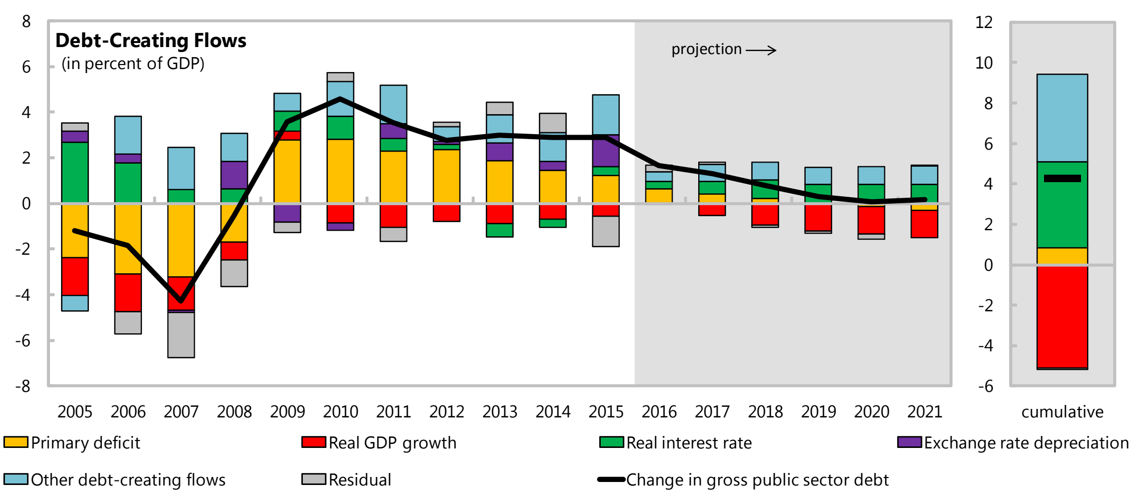
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	34.0	46.9	49.8	51.4	52.7	53.5	53.8	53.9	54.0
Public gross financing needs	7.3	10.9	10.8	10.9	11.1	11.0	11.2	10.9	11.2
Real GDP growth (in percent)	3.2	1.6	1.3	0.1	1.1	2.0	2.4	2.4	2.4
Inflation (GDP deflator, in percent)	6.8	5.7	4.0	6.5	6.1	5.6	5.6	5.6	5.6
Nominal GDP growth (in percent)	10.3	7.4	5.3	6.6	7.2	7.7	8.1	8.1	8.1
Effective interest rate (in percent) [3/]	8.7	7.1	7.0	7.2	7.3	7.4	7.4	7.4	7.5

As of May 31, 2016		
Sovereign Spreads		
EMBIG (bp)		421
5Y CDS (bp)		318
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB-	BBB+
Fitch	BBB-	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.1	2.9	2.9	1.6	1.3	0.8	0.3	0.1	0.2	4.3	
Identified debt-creating flows	1.5	2.1	4.2	1.4	1.2	0.9	0.4	0.3	0.2	4.3	
Primary deficit	0.2	1.5	1.2	0.6	0.4	0.2	0.0	-0.1	-0.3	0.9	0.5
Primary (noninterest) revenue and grants	24.4	24.7	26.0	26.4	26.6	26.8	26.9	26.9	26.9	160.4	
Primary (noninterest) expenditure	24.6	26.2	27.2	27.1	27.0	27.1	26.9	26.7	26.6	161.3	
Automatic debt dynamics [4/]	0.2	-0.6	1.2	0.3	0.0	-0.1	-0.4	-0.3	-0.3	-0.9	
Interest rate/growth differential [5/]	-0.1	-1.0	-0.2	0.3	0.0	-0.1	-0.4	-0.3	-0.3	-0.9	
Of which: real interest rate	0.9	-0.4	0.4	0.4	0.6	0.8	0.8	0.8	0.9	4.2	
Of which: real GDP growth	-1.0	-0.7	-0.6	0.0	-0.5	-1.0	-1.2	-1.2	-1.2	-5.1	
Exchange rate depreciation [6/]	0.3	0.4	1.4	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.1	1.3	1.8	0.4	0.8	0.8	0.7	0.8	0.8	4.3	
Privatization/drawdown of deposits (negative)	0.4	0.2	-0.1	-0.2	0.0	0.0	-0.1	-0.1	-0.1	-0.4	
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 [7/]	0.7	1.1	1.9	0.6	0.8	0.8	0.8	0.9	0.9	4.7	
Residual, including asset changes [8/]	-0.4	0.8	-1.3	0.3	0.1	-0.1	-0.1	-0.2	0.0	-0.1	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

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

4/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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).

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

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

7/ Includes inflation-linked bond revalulation adjustments and discounts on government bonds.

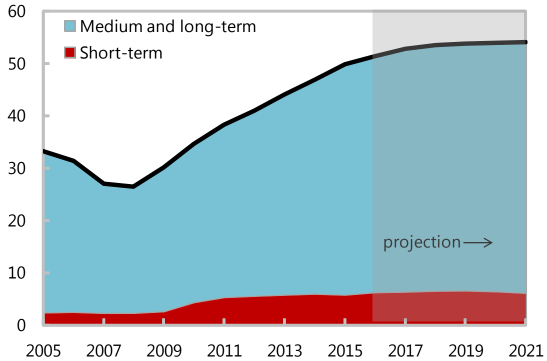
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

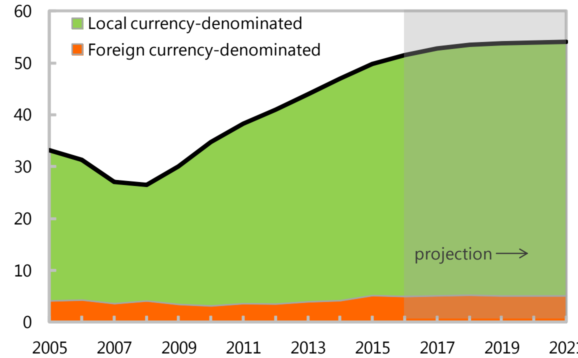
Figure 4. South Africa: Public Sector Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



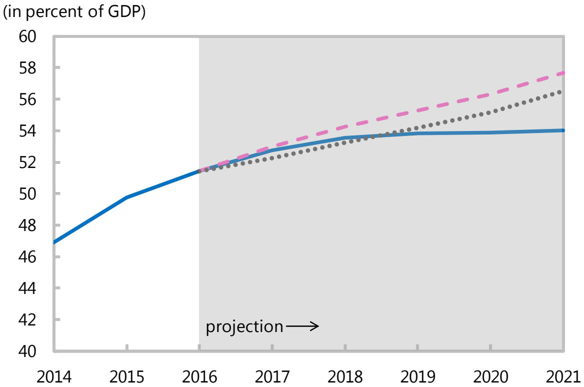
By Currency
(in percent of GDP)



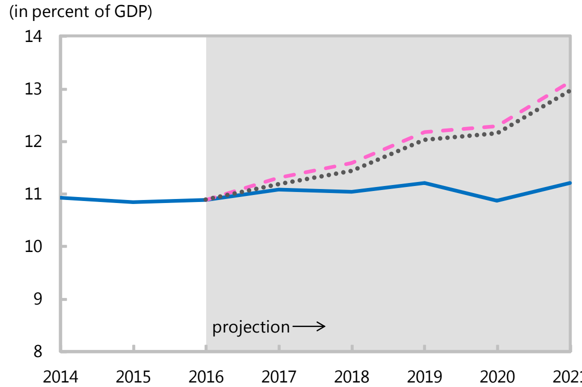
Alternative Scenarios

Baseline Historical Constant Primary Balance

Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

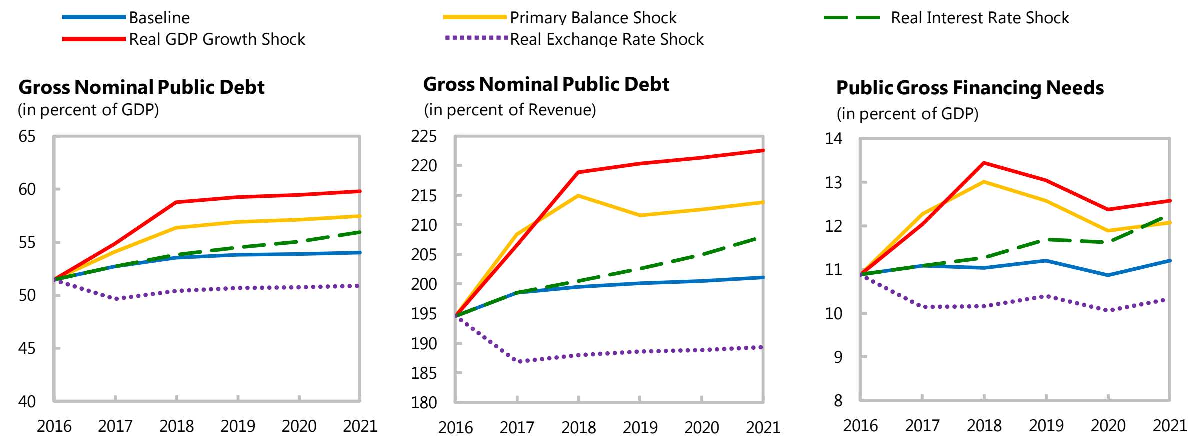
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary Balance	-0.6	-0.4	-0.2	0.0	0.1	0.3
Effective interest rate	7.2	7.3	7.4	7.4	7.4	7.5
Constant Primary Balance Scenario						
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary Balance	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	7.2	7.3	7.4	7.4	7.5	7.5

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.1	2.6	2.6	2.6	2.6	2.6
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary Balance	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	7.2	7.3	7.4	7.4	7.5	7.5

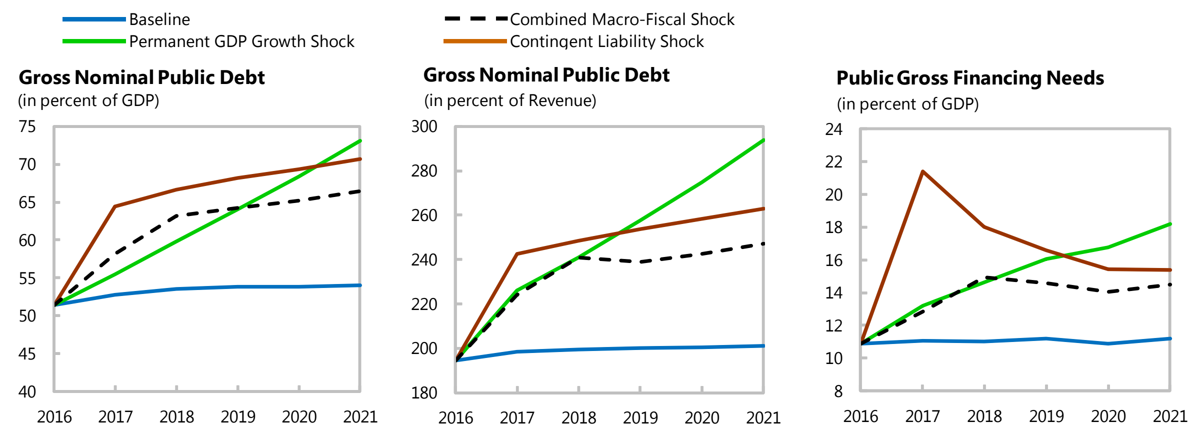
Source: IMF staff.

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

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary balance	-0.6	-1.6	-1.4	0.0	0.1	0.3
Effective interest rate	7.2	7.3	7.5	7.5	7.6	7.6
Real Interest Rate Shock						
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary balance	-0.6	-0.4	-0.2	0.0	0.1	0.3
Effective interest rate	7.2	7.3	7.8	8.1	8.3	8.5
Combined Shock						
Real GDP growth	0.1	-1.0	-0.1	2.4	2.4	2.4
Inflation	6.5	5.6	5.1	5.6	5.6	5.6
Primary balance	-0.6	-1.7	-2.2	0.0	0.1	0.3
Effective interest rate	7.2	7.6	7.8	8.0	8.3	8.5

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	0.1	-1.0	-0.1	2.4	2.4	2.4
Inflation	6.5	5.6	5.1	5.6	5.6	5.6
Primary balance	-0.6	-1.1	-1.6	0.0	0.1	0.3
Effective interest rate	7.2	7.3	7.4	7.5	7.5	7.6
Real Exchange Rate Shock						
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	18.3	5.6	5.6	5.6	5.6
Primary balance	-0.6	-0.4	-0.2	0.0	0.1	0.3
Effective interest rate	7.2	7.6	7.3	7.2	7.3	7.3
Contingent Liability Shock						
Real GDP growth	0.1	1.1	2.0	2.4	2.4	2.4
Inflation	6.5	6.1	5.6	5.6	5.6	5.6
Primary balance	-0.6	-10.8	-0.2	0.0	0.1	0.3
Effective interest rate	7.2	7.3	8.5	8.4	8.4	8.4

Source: IMF staff.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

11. External debt fell in 2015 for the first time since 2011. South Africa's external debt fell to 39.4 percent of GDP in 2015 from 41.3 percent of GDP in 2014. The decline was due to the effect of currency depreciation on local currency-denominated external liabilities and interrupted the significant build-up of external debt that took place in 2012-14. Such build-up was primarily driven by the public sector and banks.

Breakdown of South Africa's External Debt, 2011-15

(In percent of GDP)	2011	2012	2013	2014	2015
Total	**28.3**	**35.8**	**37.1**	**41.3**	**39.4**
Public authorities	9.8	13.9	14.2	15.0	12.7
SOEs	2.9	4.0	4.5	4.8	5.5
Monetary authorities	0.1	0.2	0.2	0.3	0.2
Banking sector	5.1	6.5	6.3	9.0	8.9
Other	10.3	11.2	11.9	12.2	12.0

Source: Haver

12. Gross external financing needs (GEFN) are projected to average 18½ percent of GDP in 2016-2021, compared to 14½ percent of GDP in the past five years. The rise would be due to higher reliance on short-term external debt (comprising primarily bank liabilities, which tend to have a shorter tenor than public debt). With the current account deficit projected at 3¾ to 5 percent of GDP range in 2016-21, short-term external debt would account for about 75 percent of the GEFN.

13. External financing is projected to come primarily from other investment flows during the projection period. In recent years, South Africa's external financing mix shifted from foreign direct investment (FDI) and portfolio flows towards other investment flows (primarily bank loans) and unrecorded transactions. These averaged 2½ percent and 1½ percent of GDP, respectively, in 2013-15, financing the bulk of the current account deficit. With net FDI projected to remain negative or very low during the projection period and portfolio flows to moderate as US monetary policy normalizes, the GEFN is projected to be mostly financed by other investment flows, in line with recent years.

14. The external debt is projected to increase to 52½ percent of GDP by 2021. The external debt is projected to rise sharply to over 50 percent of GDP in 2016 as a result of the effect of the depreciation of the rand in late 2015 on GDP denominated in US dollars.[4] From 2017 onwards, the rise in the external debt-to-GDP ratio is relatively slow and reflects the non-interest current account deficit, which is projected to average 1¾ percent of GDP during the forecast period compared to an estimated debt-stabilizing non-interest current account deficit of 1¼ percent of GDP (Table 1).

15. Rising external debt and sizable GEFN would keep South Africa's external vulnerability elevated. Stress tests indicate that a 30 percent currency depreciation would push the external debt-to-GDP ratio above 60 percent. Other standard shocks simulated in the external debt sustainability analysis —such as a widening of the non-interest current account deficit, a deceleration in real GDP growth, and an increase in the interest rate on public debt—would lead to relatively moderate increases in external debt. These shocks would be mitigated by the high share of rand-denominated and fixed interest rate debt.

[4] The depreciation of the rand of late 2015 first reduced the external debt-to-GDP ratio as of end-2015 as rand-denominated liabilities declined in US dollar terms. However, as US dollar GDP declines in 2016 as a result of the depreciation, the external debt-to-GDP ratio will rise.

Table 1. South Africa: External Debt Sustainability Framework, 2011-2021

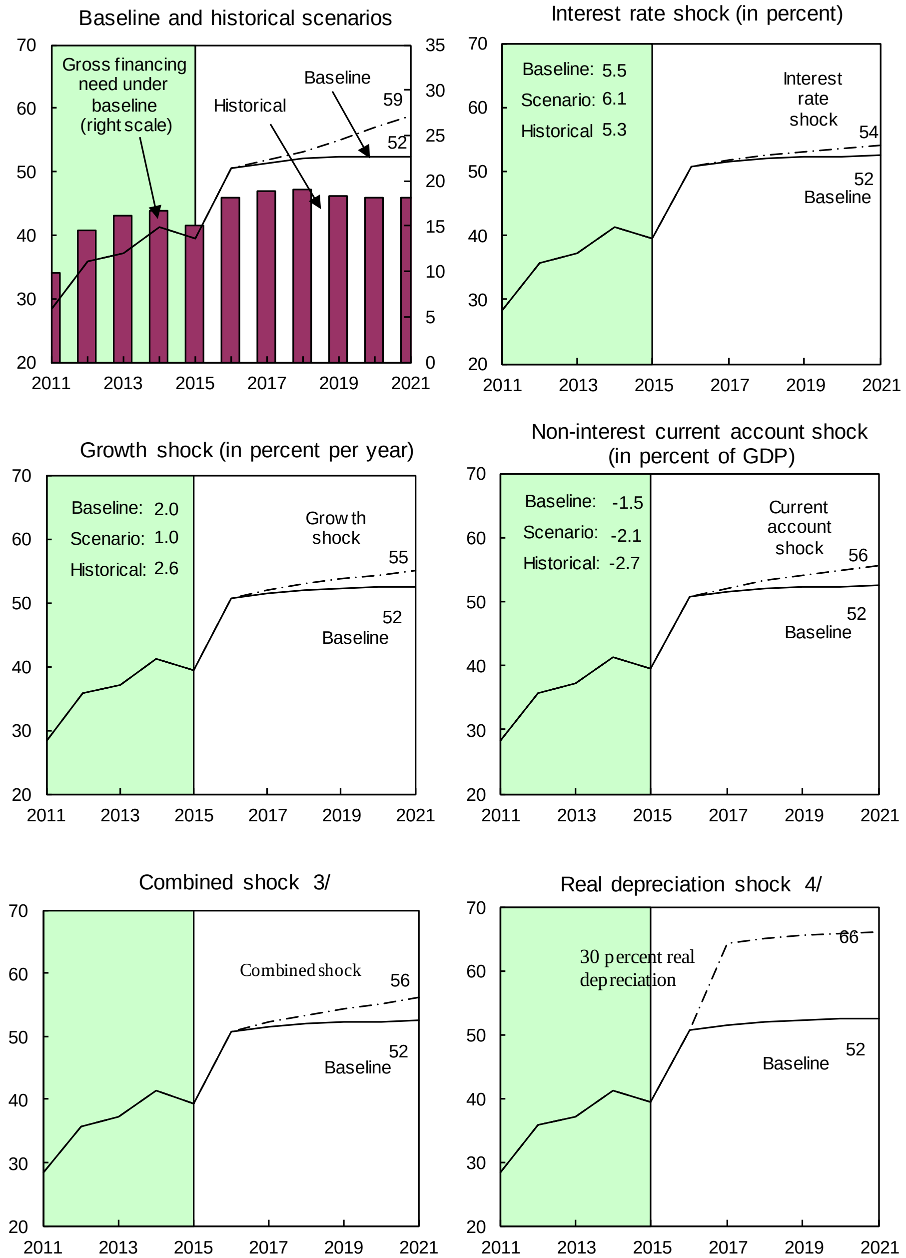
(in percent of GDP, unless otherwise indicated)

	2011	2012	2013	2014	2015	Projections 2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
Baseline: External debt	28.3	35.8	37.1	41.3	39.4	**50.6**	**51.4**	**52.0**	**52.2**	**52.3**	**52.5**	**-1.3**
Change in external debt	-1.3	7.4	1.3	4.1	-1.8	11.2	0.8	0.6	0.2	0.1	0.1	
Identified external debt-creating flows (4+8+9)	-0.5	3.9	3.2	2.3	1.7	1.8	2.6	2.3	1.6	1.4	1.3	
Current account deficit, excluding interest payments	1.0	3.6	3.8	3.3	1.8	1.6	2.1	2.0	1.3	1.1	1.0	
Deficit in balance of goods and services	-0.9	1.3	2.3	1.9	1.0	1.3	1.9	1.7	1.1	0.8	0.8	
Exports	30.5	29.8	30.8	31.1	30.7	36.0	35.4	35.5	35.8	35.8	35.7	
Imports	29.6	31.1	33.1	33.0	31.7	37.3	37.3	37.2	36.9	36.6	36.5	
Net non-debt creating capital inflows (negative)	0.2	-0.2	-1.1	-1.8	-2.7	-2.3	-1.7	-1.5	-1.2	-1.3	-1.3	
Automatic debt dynamics 1/	-1.7	0.5	0.5	0.8	2.6	2.5	2.2	1.8	1.5	1.5	1.6	
Contribution from nominal interest rate	1.1	1.3	1.9	2.1	2.5	2.5	2.7	2.7	2.7	2.7	2.8	
Contribution from real GDP growth	-0.9	-0.7	-0.9	-0.6	-0.6	0.0	-0.5	-1.0	-1.2	-1.2	-1.2	
Contribution from price and exchange rate changes 2/	-1.9	-0.1	-0.6	-0.7	0.7	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.8	3.5	-1.9	1.8	-3.6	9.4	-1.8	-1.7	-1.3	-1.3	-1.1	
External debt-to-exports ratio (in percent)	93.1	120.0	120.3	132.6	128.3	140.6	145.1	146.3	145.8	146.2	146.8	
Gross external financing need (in billions of US dollars) 4/	41.2	57.8	59.2	58.7	47.6	48.3	52.0	54.1	54.7	56.6	58.8	
in percent of GDP	9.9	14.6	16.1	16.7	15.1	18.1	18.9	19.0	18.4	18.2	18.1	
Scenario with key variables at their historical averages 5/						**50.6**	**51.8**	**53.1**	**54.9**	**56.9**	**58.9**	**-1.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.3	2.2	2.3	1.6	1.3	0.1	1.1	2.0	2.4	2.4	2.4	
GDP deflator in US dollars (change in percent)	7.5	-7.0	-9.3	-5.9	-11.6	-15.1	1.8	1.6	2.0	2.1	1.6	
Nominal external interest rate (in percent)	4.3	4.5	5.0	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	
Growth of exports (US dollar terms, in percent)	18.2	-7.0	-4.0	-3.5	-11.6	-0.4	1.2	3.8	5.3	4.5	3.9	
Growth of imports (US dollar terms, in percent)	20.1	-0.1	-1.2	-4.8	-13.9	-0.1	3.0	3.2	3.6	3.8	3.8	
Current account balance, excluding interest payments	-1.0	-3.6	-3.8	-3.3	-1.8	-1.6	-2.1	-2.0	-1.3	-1.1	-1.0	
Net non-debt creating capital inflows	-0.2	0.2	1.1	1.8	2.7	2.3	1.7	1.5	1.2	1.3	1.3	

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 2016.

Statement by the Staff Representative on South Africa

June 27, 2016

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

U.K. referendum

1. **South African financial markets weakened in the immediate aftermath of the U.K. referendum to leave the E.U.** The rand depreciated by 8 percent against the dollar in the early hours of trading immediately following the referendum results, but recovered nearly 2 percent by June 27: this was among the largest depreciations in emerging markets. In the same time period, the benchmark 10-year sovereign bond yield rose 25 basis points, and the stock index fell 6.5 percent. The market decline was orderly, underscoring the depth of South Africa's financial markets.

2. **The U.K. referendum has increased downside risks for South Africa, as there are sizable financial linkages between the two countries and trade linkages with the E.U. as a whole.**

- *Financial linkages.* U.K. banks account for about 70 percent of total external bank lending to South Africa. The U.K. also accounts for about 10 percent of nonresident bond and equity investment holdings in South Africa. A number of major South African financial institutions have linkages with the U.K. In addition, the U.K. is the largest FDI source country, accounting for 45 percent of the total inward FDI stock (18 percent of GDP), and the third largest destination of outward South African FDI (3.7 percent of GDP). Finally, revenue from the U.K. is estimated at about 5 percent of total revenue of listed companies.

Trade linkages. While the U.K. accounts only for 4 percent of South Africa's goods exports, exports to the E.U. (excluding the U.K.) account for about 15 percent. Further, about a fifth of tourists to South Africa come from the U.K. On the other hand, potentially higher gold prices and lower oil prices could be partial, positive offsets on the current account balance.

Other recent developments

3. **Inflation edged down.** Headline inflation eased marginally to 6.1 percent y/y in May (from 6.2 percent in April), underpinned by lower food inflation (10.8 percent). Core inflation was unchanged at 5.5 percent.

4. **The South African Reserve Bank's lending indicator continued to decline.** The indicator dropped 5.5 percent y/y in April to its lowest level since November 2009, dimming the hope for a robust recovery after the weak Q1 GDP reading.

5. **The state electricity company, Eskom, has made progress in enhancing electricity supply.** The fourth and last unit of the Ingula power station, a pumped storage facility, was synchronized on June 16 (ahead of schedule), a major step for full commercial operation. The first Ingula unit was declared commercial a week earlier, and the three remaining units are on track for commercial operation by January 2017. The facility will add 1,332 megawatts (4 percent of 2015 available capacity) to the national grid. It will also help secure overall grid stability.

**Statement by Fundi Tshazibana, Alternate Executive Director,
Edgar Sishi, and Felicia Dlamini–Kunene, Senior Advisors
to the Executive Director for South Africa
July 1, 2016**

The South African authorities thank staff for the constructive engagement during the 2016 Article IV Consultation, and welcome the detailed assessment of the economy and analysis of relevant policy issues. Staff's analysis is broadly in line with the authorities' view of economic challenges, vulnerabilities and risks. The authorities are also concerned that the protracted period of low growth has resulted in declining per capita incomes. They agree with staff that structural reforms are imperative to raise potential growth and that they should implement tangible measures to boost confidence and enhance resilience.

Much progress has been made since 1994 to reverse the legacy of the past, yet the challenges remain. During this period of low growth and rising public debt, and as articulated in the National Development Plan (NDP), the authorities are placing emphasis on rebalancing the economy through structural reforms. Rebalancing will require difficult trade-offs and stronger cooperation with social partners. Reducing imbalances, including narrowing the budget deficit and consolidating the debt ratio, will provide a sound and predictable basis for achieving structural reforms. In this context, the authorities are focused on three key areas: restoring confidence and boosting investment, including minimizing regulatory obstacles to doing business; removing obstacles to faster employment creation; and strengthening state-owned entities (SOEs).

Recent Economic Developments and Outlook

GDP growth has decelerated from 1.6 percent in 2014 to 1.3 percent in 2015 due to external and domestic factors. In addition to lower commodity prices, electricity supply constraints were more binding in 2015, with adverse effects on mining and manufacturing production. A severe drought has also resulted in lower crop yields, while business and consumer confidence remained weak.

Official growth projections are reviewed bi-annually by the authorities. The current growth projection of 0.9 percent, tabled in February 2016, will be updated in October 2016. The authorities are aware that their current projections are higher than staff's projection of 0.1 percent, and that for these growth projections to materialize, GDP would have to grow at around 3 percent for the remaining quarters of the year. The authorities' new growth projections will, like staff, take into account the 1.2 percent GDP contraction in the first quarter of 2016 and second quarter data. Although downside risks prevail over the medium term, some upside risks are evident, including the resolution of electricity supply constraints, marginally lower inflation, some recovery in business confidence, and the likely finalization of mining legislation. The authorities estimate that resolution of energy constraints could add between 0.8 and 1 percentage points to the country's growth. For this reason, the authorities expect growth to recover from 2017.

The South African Rand depreciated sharply against major currencies during 2015. The weighted exchange rate of the rand depreciated by 19.7 percent in 2015, and the real effective exchange rate (REER) fell to its lowest level since 2001. While the current exchange value of the rand is supportive of domestic-export growth, higher input costs and slower economic growth in South Africa's main export trading-partner countries may erode potential gains from the depreciation, in addition to other inflationary and negative balance sheet effects. Gross gold and other foreign reserves provided import cover of 5.6 months during the first quarter of 2016. The authorities are committed to take every opportunity to build more reserves in order to bolster resilience against future shocks.

Inflation remained firmly within the target range of 3-6 percent during the course of 2015, with headline inflation averaging 4.6 percent for the year. However, due to rising food prices, which are expected to peak at 12 percent in the final quarter of 2016, and the recent upward revisions in the international oil price, headline inflation has breached the upper band of the inflation target range. While core inflation has remained relatively stable at 5.5 percent, recent data on firm profitability, proxied by gross operating surplus, also indicates a build-up of inflationary pressures. The South African Reserve Bank (SARB) expects core inflation to peak in the fourth quarter of 2016 and moderate in late 2017.

Fiscal Policy and Public Debt Management

Given the overall outlook for growth and heightened fiscal risks, the authorities are committed to pursuing a prudent and sustainable fiscal policy trajectory. In October 2015, the authorities strengthened the fiscal framework by reaffirming their commitment to a fiscal guideline that sets the expenditure ceiling in the outer years of every fiscal framework. Over the long term, the guideline is meant to maintain spending as a stable share of national income. This is complemented by a capital budgeting framework, which includes new appraisal tools for capital projects, strengthening of procurement regulations and more transparency on the full life cycle costs of large capital projects. The authorities also utilize an on-going process of expenditure reviews, which reconciles budget allocations with intended program outcomes, to inform decisions on expenditure reprioritization and improving program efficiency.

The 2016 Budget sets a course for more rapid fiscal consolidation and stabilizing the growth of public debt while carefully weighing the impact of the consolidation on domestic output. The authorities have proposed gross tax revenue increases of 1.5 percent of GDP and expenditure reductions amounting to 0.5 percent of GDP. The budget deficit is thus projected to close from an estimated 3.2 percent of GDP in 2016/17 to 2.4 percent in 2017/18, with net debt projected to stabilize at 46.2 percent of GDP in 2018/19. A primary surplus will be achieved in 2016/17. The Tax Review Committee, which was set up in 2014, continues its work on assessing the optimal tax composition to support growth and the authorities' developmental objectives. Almost all of the expenditure reductions are being targeted at the public wage bill, and extracting more value for money in the other recurrent spending items.

The authorities are cognizant of the main risks to their borrowing program and actively manage these risks. In this regard, the authorities continue to reconcile the outlook with the debt sustainability targets, and clarified in the budget documents that they would take additional measures to achieve the above fiscal targets if conditions warrant. The medium term borrowing program is underpinned by strategic benchmarks for refinancing, interest, inflation and currency risks. The debt portfolio remains well within prudent limits. In addition to benchmarking, the borrowing strategy includes measures to manage refinancing risk by adjusting the composition and maturity of the debt portfolio.

SOEs and other public sector institutions are an important element of the authorities' strategy for development and inclusive growth. In this context, the authorities are continuously monitoring the financial position of SOEs through a formal fiscal risk mechanism, and contingent liabilities are reported in the annual Budget. The 2016 Budget outlines four areas of reform that are intended to strengthen the ability of SOEs to support the NDP; namely, financial and operational stabilization, coordination and collaboration among different entities, rationalization and consolidation, and the enactment of a new governance framework.

Monetary Policy

Monetary policy in South Africa continues to confront the risks of rising inflation. In addition to rising food prices, currency weakness and volatility pose a risk to inflation. The substantial rand depreciation could generate higher inflation over the forecast period, if it persists. While the pass-through from the exchange rate to inflation has been low in recent years, there are indications that this may be increasing. The SARB estimates the pass-through to currently be half its long term average of about 20 percent. However, the authorities note that with substantial depreciation and falling corporate profits, even low levels of pass-through still generate meaningful amounts of inflation and there remains a risk that pass through may return to more normal levels.

Although the Monetary Policy Committee (MPC) has increased the policy rate by a total of 200 basis points since January 2014 and most recently by 25 basis points at the March 2016, the policy rate was kept on hold in the May 2016. The authorities indicated that monetary policy remains focused on its price stability mandate while sensitive to the state of the economy, within a flexible inflation targeting framework. Future monetary policy actions will be subject to data outcomes.

The authorities indicate that despite recent interest rate increases, monetary policy remains accommodative as the policy rate is low from a historical perspective and is near or below policy rates in peer countries. Therefore, with growth continuing to undershoot potential, monetary policy is still providing stimulus to help absorb surplus capacity. The pace of tightening has also been gradual relative to previous hiking cycles. The authorities are of the view that modest tightening of policy should keep inflation expectations in check.

Financial Sector Policy

The South African financial sector is well regulated and continues to attract global investment flows. The SARB actively monitors the compliance of the banking sector with the country's regulatory framework and also monitors the fundamental capacity of financial institutions to deal with economic headwinds and regulatory changes. The banking system remains resilient, with the authorities' stress tests indicating that even under severe adverse scenarios, capital adequacy for the participating banks remains above the regulatory requirements. Total banking assets exceeded 120 percent of GDP in 2015, with a combined total capital adequacy ratio of 14.19 percent. The level of NPLs is low, at around 3 percent of gross loans and advances at the end of 2015, and level of impaired advances to total loans and advances was 3.12 percent at the end of 2015. Therefore, the authorities view the risk management frameworks of the banks as being robust.

Since the completion of the 2014 FSAP, the authorities have initiated significant financial regulatory architectural reforms. The Financial Sector Regulation Bill, the enabling legislation for shifting to a Twin Peaks model of financial sector regulation, is expected to be enacted towards the end of 2016. Under the Twin Peaks model, two regulators will be established, a Prudential Authority within the SARB and a Financial Sector Conduct Authority. The Prudential Authority will focus on institutional soundness (including prudence and solvency), while the Financial Sector Conduct Authority will focus on business conduct or consumer protection. A "shadow" Prudential Authority structure was established in the SARB at the end of May 2016. The Bill will also address two areas of concern raised in the FSAP, namely conglomerate supervision and strengthening oversight of over-the-counter derivatives.

Progress is being made on a comprehensive resolution framework for banks based on lessons learnt from the successful resolution of African Bank. The ultimate objective of these reforms is to significantly reduce the state's contingent liability relating to the financial sector. In August 2015 the authorities published a Resolution Framework Policy Paper. This policy paper outlines an approach that is closely aligned to the FSB's Key Attributes for Effective Resolution Regimes for Financial Institutions. Its main features are the introduction of a depositor guarantee scheme, a bail-in framework, and a creditor hierarchy in line with the key attributes. Legislation to give effect to this policy is expected to be introduced to parliament during the fourth quarter on 2016.

Macro-Financial Linkages

The authorities welcome the assessment of macro-financial linkages in staff documents. They reiterate that South Africa's reliance on foreign flows must be viewed within the context of the depth and liquidity of domestic financial markets, and the flexible exchange rate. In line with trends in other emerging markets, net out-flows from equities continued during the first few months of 2016, with year-to-date net sales by non-residents amounting to R48.5 billion.

However, there have been net purchases of domestic bonds by offshore investors amounting to R13.4 billion as of May 31, 2016.

The authorities' welcome staff's detailed assessment of global and regional spillovers, in particular the growing importance of China's growth for South Africa through the commodity trade channels. The authorities are also carefully monitoring spillovers. Overall, the SARB assesses financial stress as emanating from five sources; namely: a possible sovereign rating downgrade to non-investment grade (especially local currency), spillovers from excessive volatility and risk aversion in global financial markets, protracted period of slow economic growth in the Euro region and lengthy rebalancing of growth, low domestic economic growth and fragility of global banks.

The authorities agree that a combination of commodity-price driven macro-fiscal shocks and declining growth rates in Sub-Saharan economies will negatively affect firms' profitability and South Africa's economy. They are also cognizant that while the largest outward spillover of lower growth to the rest of Africa maybe limited, for countries in the Southern African Customs Union the slowdown in the South Africa economy has a significant impact.

Structural Reforms

Economic inclusion remains a key challenge for South Africa. The authorities are committed to raising growth and creating jobs over the medium and long term. In this regard, they recognize the urgent need to build partnerships between the state, the private sector, the labor movement and civil society in order to realize the goals of the NDP. The Cabinet has approved a Nine-Point Plan, which is an implementation program for the NDP to prioritize sectors with high potential to boost employment and growth. The authorities have proposed measures to support small businesses, manufacturing, tourism and revitalization of the agricultural value chain.

The authorities believe that government and private sector initiatives aimed at expanding infrastructure, transforming cities, supporting SME development and regional integration will boost growth and employment. The authorities are working with business to identify measures that will restore confidence, boost private sector investment, remove obstacles to employment creation in key sectors and identify regulatory hurdles to doing business. In partnership with the private sector, the authorities have established a Small-Business Innovation Fund, with over R1 billion already committed, to support the development of small enterprises. Work is also ongoing to put in place measures to minimize protracted strikes and review the employment effects of compensation agreements and the introduction of a national minimum wage.

Interventions already in the 2016 Budget include the implementation of a public infrastructure investment program for which R865.4 billion has been allocated; as well as greater support for the country's eight metropolitan areas to transform the urban landscape and incentives to the automotive industry. The Presidential Infrastructure Coordination Commission continues to coordinate public infrastructure project plans across spheres of government and identify skills gaps and mechanisms to speed up project delivery.

The Renewable Energy Independent Power Producer program is a major initiative by the authorities to increase the country's energy supply capacity, but also significantly boosting private investment in the sector, while also facilitating further upstream investments. To date, 92 projects amounting to over $13 billion have been approved. The authorities intend to use the program to boost electricity capacity by 17 000 MW by 2022 and will expand it to include other technologies.

Conclusion

The authorities recognize that South Africa faces exceptionally difficult global and domestic economic conditions over the near and medium term and difficult choices and tradeoff are necessary. As recognized in the staff report, appropriate policy choices have been made in managing fiscal, monetary and financial sector policy.

The authorities do, however, realize that monetary and fiscal policy are not sufficient to respond to the negative outlook for growth, and the need to raise potential output and aggregate demand in the near to medium-term. The authorities are focusing on building on the strengths of some positive fundamentals that characterize the South African economy and are placing urgency on effective implementation of existing plans.

Finally, the authorities look forward to the Executive Board's conclusion of the 2016 Article IV Consultation and appreciate the engagements with the Fund on the critical goal of achieving inclusive growth for the South African economy.