Country Study

South Africa

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South Africa has made substantial economic progress since the end of apartheid in 1994, notably in the form of a significant rise in real GDP growth and a reduction in macroeconomic imbalances. A sustained improvement in the public finances has been accompanied by a strengthening in the external position, and monetary policy has been bolstered by the adoption of an inflation-targeting regime in 2000. The economy nevertheless faces major challenges: relatively low growth compared with many successful emerging market countries, persistently high unemployment, and the spread of HIV/AIDS. This article provides an overview of recent IMF research on some of the key features of economic developments in South Africa and the associated policy implications.

A general strand of research has focused on issues related to the central longer-term economic challenge for South Africa of further raising growth and reducing unemployment. Success in meeting these goals depends in large part on maintaining a sound and stable financial environment, which will be supported by implementing the inflation-targeting strategy, maintaining fiscal restraint, and rebuilding international reserves; on following through with the structural reforms, including privatization and trade liberalization; and on addressing the spread of HIV/AIDS. These would improve growth performance both by their direct impact and by attracting foreign investment. Labor market reforms that reduce the statutory costs of doing business would help to ensure that investment absorbs labor.

The annual growth rate of real GDP in South Africa has risen from 1 percent on average during 1980–93 to 2¾ percent in 1994–2001. Arora, Bhundia, and Bagattini (2003) suggest that the growth pickup reflects a substantial increase in total factor productivity (TFP) growth rather than greater factor accumulation.[1] TFP growth may have increased in part due to the greater efficiency associated with increased openness to trade and greater private sector participation in the economy.[2] Jonsson and Subramanian (2001) show that trade liberalization and openness raised TFP growth significantly during the 1990s.[3]

The increase in growth has occurred against the background of prudent macroeconomic policies. The central government fiscal deficit declined from 9 percent of GDP in 1993/94 to 1½ percent in 2001/02 through a significant increase in the primary balance, in line with what Fajgenbaum and others (1996) anticipated was needed in order to avoid a public debt "trap" (an upward spiral in the public debt to GDP ratio).[4] Using an analysis that examines the primary surplus, the interest-growth differential, other debt determinants, and the sensitivity to macroeconomic shocks, Barnett (2003) concludes that South Africa's debt dynamics are manageable.[5] This conclusion is supported by several of the alternative indicators proposed by Jacobs (2002) and Jacobs, Schoeman, and Van Heerden (2002) to gauge the stance and sustainability of fiscal policy.[6]

The monetary policy regime has gained credibility with a reduction in inflation from the very high rates prevailing through the early 1990s, the adoption of an inflation-targeting framework, and reduced external vulnerability. Jonsson (2000) argues that South Africa has the main prerequisites for an inflation-targeting regime, including an independent central bank and relatively well-developed capital markets.[7] Bhundia (2003) and Jonsson (2001) find that a stable long-run relationship exists among prices, broad money, real income, and interest rate (the conventional "money-demand relationship"), which underscores the importance of continuing to monitor the rate of money growth in seeking to meet the inflation target.[8] External confidence, as reflected in sovereign risk spreads, has been bolstered by the virtual elimination of the central bank's net open forward position in foreign exchange, which was a key source of external vulnerability in the past.[9] Empirical analysis by Vocke (2003) suggests that monetary policy credibility has contributed to the reduction in spreads between South Africa and comparator countries.[10]

Notwithstanding the general improvement in confidence, the exchange rate has fluctuated significantly, depreciating by over a third vis-à-vis the U.S. dollar in 2001 and early 2002, before recovering subsequently. Bhundia (2002) attributes the depreciation in part to an easing of monetary policy.[11] MacDonald and Ricci (2003) find evidence of "overshooting" and estimate that the rand was 25 percent below its long-run real equilibrium value in early 2002. They estimate an equilibrium path for the real exchange rate of the rand, which is found to depend mainly on commodity prices, productivity and real-interest-rate differentials vis-à-vis trading partners, openness, and the fiscal and net foreign asset positions; it does not, however, take into account the qualitative impact on confidence of factors such as unemployment and HIV/AIDS.[12] While the rand is influenced by commodity prices, Cashin, Céspedes, and Sahay (2002) find that it does not appear to be a "commodity currency" in the sense that commodity price movements alone cannot explain a significant portion of real exchange rate fluctuations in South Africa during 1980–2002.[13] Aron and Muellbauer (2002) find that, in the short run, nominal exchange rate shocks have a much smaller impact on real output than do monetary shocks, but their influence appears to be increasing with greater openness.[14]

The favorable overall macroeconomic performance since 1994 has not been reflected in jobs, with the unemployment rate at nearly 30 percent in 2002. Fajgenbaum and others (1997) and Alleyne (2000) discuss, respectively, the role of wage inflexibilities and the labor legislation, particularly collective bargaining agreements, in influencing unemployment.[15] Although South Africa mainly trades with advanced countries, it is a net exporter of capital-intensive goods and a net importer of labor-intensive goods. Alleyne and Subramanian (2001) suggest that this surprising trade pattern indicates that domestic labor market institutions may not be functioning properly.[16]

Fajgenbaum and others (1996) estimate that in order for long-term real GDP growth to rise to a level that is consistent with declining unemployment, fixed investment would need to increase by nearly 10 percent of GDP.[17] The increased investment would need to be accompanied by policies to reduce labor costs relative to capital costs so that it absorbs rather than displaces labor. For financing this investment, Fajgenbaum and others discuss the potential role of government saving, whose effect is estimated to be blunted by a significant Ricardian offset, and of foreign saving, which would depend on continued macroeconomic stability and policy credibility. There is scope for greater foreign direct investment, which in comparator countries is significantly influenced by infrastructure, trade liberalization, skills, and potential market size, according to an empirical study by Arvanitis (2003).[18] Long-run economic prospects also depend importantly on the HIV/AIDS outlook.[19]

[1]Vivek Arora, Ashok Bhundia, and Gustavo Bagattini, "Potential Output and the Sources of Growth," *South Africa: Selected Issues,* IMF Staff Country Report No. 03/18, January 2003.

[2]José Fajgenbaum, Trevor Alleyne, Gunnar Jonsson, Arvind Subramanian, Enrique de la Piedra, Timothy Muzondo, and Martin Parkinson, "Growth Accounting," *South Africa—Selected Issues,* IMF Staff Country Report No. 98/96, October 1998.

[3]Gunnar Jonsson and Arvind Subramanian, "Dynamic Gains from Trade: Evidence from South Africa," *IMF Staff Papers,* Vol. 48, No. 1 (2001), pp. 197–224.

[4]José Fajgenbaum, Benedict Bingham, Peter Doyle, Judith Gold, Sayuri Shirai, and Andrew Wolfe, "Accelerating Growth and Fiscal Policy," *South Africa—Selected Issues,* IMF Staff Country Report No. 96/64, July 1996.

[5]Steven Barnett, "Government Debt Dynamics," *South Africa: Selected Issues,* IMF Staff Country Report No. 03/18, January 2003.

[6]Davina Jacobs, "Suggestions for Alternative Budget Balances for South Africa," IMF Working Paper 02/110, 2002; Davina Jacobs, Nicolaas Johannes Schoeman, and Jan Horn van Heerden, "Alternative Definitions of the Budget Deficit and Its Impact on the Sustainability of Fiscal Policy in South Africa," *South African Journal of Economics,* Vol. 70, No. 3 (2002), pp. 543–59.

[7]Gunnar Jonsson, "Inflation Targeting as a Monetary Policy Framework in South Africa," *South Africa: Selected Issues,* IMF Staff Country Report No. 00/42, March 2000.

[8]Ashok Bhundia, "Real Money Demand, Consumer Prices, and the Real Exchange Rate in South Africa," *South Africa: Selected Issues,* IMF Staff Country Report No. 03/18 (January 2003); Gunnar Jonsson, "Inflation, Money Demand, and Purchasing Power Parity in South Africa," *IMF Staff Papers,* Vol. 48, No. 2 (2001), pp. 243–65.

[9]Gunnar Jonsson, "The Forward Book of the South African Reserve Bank," *South Africa: Selected Issues,* IMF Staff Country Report No. 00/42, March 2000.

[10]Matthias Vocke, "Sovereign Risk Spreads Under Inflation Targeting," *South Africa: Selected Issues,* IMF Staff Country Report No. 03/18, January 2003.

[11]Ashok Bhundia, "An Empirical Investigation of Exchange Rate Pass-Through in South Africa," IMF Working Paper 02/165, 2002.

[12]Ronald MacDonald and Luca Ricci, "Estimation of the Equilibrium Real Exchange Rate for South Africa," IMF Working Paper, forthcoming, 2003.

[13]Paul Cashin, Luis Céspedes, and Ratna Sahay, "Keynes, Cocoa, and Copper: In Search of Commodity Currencies," IMF Working Paper 02/223, 2002.

[14]Janine Aron and John Muellbauer, "Interest Rate Effects on Output: Evidence from a GDP Forecasting Model for South Africa," *IMF Staff Papers,* IMF Annual Research Conference, Vol. 49 (2002), pp. 185–213.

[15]José Fajgenbaum, Peter Doyle, Judith Gold, Gunnar Jonsson, Godfrey Kalinga, David Orsmond, and Julio Santaella, "Unemployment and Employment Issues," *South Africa—Selected Issues,* IMF Staff Country Report No. 97/82, October 1997; Trevor Alleyne, "Labor Legislation in South Africa," *South Africa: Selected Issues,* IMF Staff Country Report No. 00/42, March 2000.

[16]Trevor Alleyne and Arvind Subramanian, "What Does South Africa's Pattern of Trade Say About Its Labor Market?" IMF Working Paper 01/148, 2001.

[17]Fajgenbaum et al., "Accelerating Growth and Fiscal Policy," n. 4 above.

[18]Athanasios Arvanitis, "Determinants of Foreign Direct Investment in South Africa," *South Africa: Selected Issues,* IMF Staff Country Report No. 03/18, January 2003.

[19]Markus Haacker, "The Economic Consequences of HIV/AIDS in Southern Africa," IMF Working Paper 02/38, 2002.

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