

South Africa—Locomotive for African Growth?

South Africa fared better than most developing economies in 2001 despite the global slowdown and the economic woes of other emerging market economies (such as Argentina and Turkey). The relative resilience of its economy was due primarily to sound financial regulation, low external borrowing, and depreciation of the rand (ZAR). Indeed, a significant increase in South Africa's competitiveness slowed growth in imports and raised exports, contributing to a current account surplus in the first half of 2001. This was mirrored by a small but positive net inflow of capital through the financial account.

Growth in real GDP picked up from an annualized rate of 2.0% in the first quarter of 2001 to 2.5% in the second quarter. The terrorist attacks on the United States dampened prospects for the second half of the year, however, and economic growth in 2001 is estimated to be 2.5%, down from a pre-September 11 forecast of 3.0%.

Macroeconomic fundamentals remained sound in 2001. Consumer price inflation declined to within the target band of 3–6% in August and September. Prime lending rates and government bond yields fell sharply. And monetary easing has resulted in real interest rates that compare well with those in other emerging market economies. The sound macroeconomic conditions are reflected in lower household debt, a credit upgrade, and higher tax revenues at lower tax rates.

The rand fell sharply against major currencies, ending the year 40% lower than its initial level. The slump in the currency will push up the price of imported basic necessities, particularly oil, which in turn could raise the cost of commuting for the poor. On the positive side, the depreciation of the rand contributed to a substantial boost in exports, with the trade surplus for 2001 at ZAR 29.1 billion, up from ZAR 14.4 billion in 2000.

Private and government investment increased, with investment rising by 5.6% in the first half of 2001. Household spending continued to rise, but at a more moderate pace than in 2000. Total employment, however, continued its declining trend.

The budget deficit is expected to be 2.3% of GDP for 2002/03, with real increases in non-interest spending averaging 3.7% over the period 2002–05. Declining bond yields have reduced government borrowing costs to their lowest levels in four decades.

In the medium term fiscal adjustment and monetary easing in the face of a weaker global environment, and the more competitive cost structure of the South African econ-

Fiscal adjustment and monetary easing should accelerate economic activity

omy, should accelerate economic activity and raise the cyclical and potential growth rates of the economy. Raising growth rates and sustaining poverty reduction will also require appropriate microeconomic and institutional reforms to complement macroeconomic adjustment. As the largest economy in Africa—accounting for a fifth of regional GDP—South Africa has the potential to be the locomotive for African growth.

“Sustaining poverty reduction will require appropriate microeconomic and institutional reforms”

Recent economic developments—from currency crises to stabilization programme

Two issues have dominated macroeconomic policy and performance in South Africa since 1995. First, the rand went through three currency crises—in the first half of 1996, in mid-1998, and in the second half of 2001. Second, and partly in response to the first of these crises, in June 1996 the government announced a stabilization programme—the Growth, Employment, and Redistribution (GEAR) programme—which defined policy instruments and objectives for the five years until 2001. In announcing the programme government officials stressed both its “home grown” nature and its close parallels with the standard approach of the international financial institutions.

Despite the frequent currency crises, South Africa’s macroeconomic policy performance has been solid. The government has met its key fiscal and monetary policy targets, bringing the fiscal deficit under control and keeping inflation stable throughout the period. In addition to macroeconomic policy interventions, the government has undertaken structural reforms, including liberalizing tariffs and strengthening tax collection, that have supported the strong macroeconomic performance.

Nonetheless, economic growth has been disappointing. GDP growth averaged 2.6% a year from 1995 to the third quarter of 2001. With population growth estimated at just over 2.1% a year, annual GDP per capita growth averaged a mere 0.5%.

This persistently poor performance in growth is due in large part to poor performance in investment, especially private investment. The country has been unable to sustain the post-apartheid “honeymoon,” which led to greater investor confidence in the early years. Moreover, the government appears not to fully appreciate the links between its positions on socio-economic and geo-political issues and the trends in markets. There seems little doubt that its failure to take strong positions on such issues as HIV/AIDS and regional political and economic instability, particularly in the period since 1998, have had an adverse effect on capital flows and contributed to the currency instability over the past three years.

Some factors in the collapse of investor confidence have been unrelated to domestic policy, however. In particular, volatile capital flows resulting from the collapse of confidence among portfolio investors worldwide have affected the exchange rate and the money market and reduced the confidence of domestic producers and foreign direct investors.

Box 2.1

Adjusting to slowing world growth

The U.S. and world economies are expected to rebound in the second half of 2002. But the effects of the deflation on economic growth may be felt longer in many parts of the world. Falling prices and household spending, combined with declining investment and output, send signals to policy-makers everywhere that greater fiscal and monetary easing is in order. The poor global economic environment is expected to affect South Africa primarily through slower growth in exports and weaker confidence and consumption.

Some precautionary easing has occurred in South Africa's monetary stance in 2001, and the exchange rate has weakened. Government spending has strengthened, and a steady recovery in public capital spending is under way. Fiscal and monetary policy adjustments are helping to sustain the economic growth momentum despite the unfavourable international environment.

The inflation target for 2003 will remain 3–6% (for consumer prices minus mortgage interest costs, or CPIX inflation). With a declining trend in inflation, bond yields and interest rates will have room to continue falling, lowering the cost of doing business.

The budget deficit for 2002/03, which was expected to be 2.3% of GDP, is now expected to reach 2.6% of GDP as social spending increases and tax cuts take effect. Deficits for 2003–05 will similarly be adjusted, by around 0.3% of GDP. A declining trend in the deficit will be maintained, however, to ensure that borrowing costs continue to fall, freeing up additional fiscal resources.

The proposed adjustments are aimed at ensuring that South Africa is well placed to take advantage of growing economic activity in the rest of the world in 2002.

Source: Economic Commission for Africa.

Indeed, economic performance in 2001 was shadowed by global developments (box 2.1). The weakening of the international economy contributed to a slowdown in output growth in South Africa in the first quarter of 2001. But unlike in the global economy, in the domestic economy growth picked up, from an annualized rate of 2.0% in the first quarter of 2001 to 2.5% in the second quarter.

The resilience of the South African economy in the first half of 2001 can be attributed in part to the fact that the potential benefits of the rand's depreciation were not eroded by higher inflation, as has happened so often in the past. Investment and output growth in manufacturing, construction, trade, and services have also contributed to the economic resilience. Investment and growth in these sectors are expected to strengthen in the next few years as lower production costs raise profitability in export-oriented sectors.

The service sector has become increasingly important for the broader economy and a large contributor to employment. In the first two quarters of 2001 wholesale and retail trade grew by an average 3.3%, and financial services by 4.1% (seasonally adjusted and annualized growth). The transport, storage, and communications sector grew by an average 4.5%.

Agriculture—output sliding, exports up

Agricultural output continued to decline in the first half of 2001, at a seasonally adjusted and annualized rate of 3.1%. Agriculture's share of total value added is expected to be 4.2% in 2001, largely unchanged over the past five years.

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The country is self-sufficient in most agricultural commodities and not dependent on imports for its domestic food supply. Imports of agricultural products have fallen both as a share of GDP (from 1.3% in 1995 to 1.1% in 2000) and as a share of merchandise imports (from 7.7% in 1995 to 5.4% in 2000).

Agricultural exports have increased slightly as a share of GDP, rising from 1.7% in 1995 to 2.1% in 2000, but declined slightly as a share of merchandise exports, from 9.5% in 1999 to 7.9% in 2000. Sugar, wine, and fruits were the most important export products by value in 2000. The largest market for South Africa's agricultural exports is the European Union, which accounted for 27.9% of total exports by value in 2000.

Despite South Africa's abundant labour, agriculture is largely capital intensive, accounting for only 11% of formal employment. In the former homelands an estimated 2.2 million people are employed in agriculture, 37% as subsistence farmers. The rest are small-scale farmers who sell at least some of their produce, or farm workers employed on commercial farms.

Poverty is significant in the sector. Of those employed in agriculture, 69% are among the lowest income earners—those with monthly incomes of ZAR 500 or less—compared with 22% among all other employed people.

At the end of the apartheid period the agricultural sector was marred by inequity and inefficiency, which constrained production to below optimal levels. The sector was effectively split in two—one white-owned, capital-intensive, and large-scale segment and one black-owned, labour-intensive, and subsistence segment. The second, concentrated in the former homelands, produced output at levels below subsistence for the total homeland population, while white, large-scale farmers produced 90% of the total value added of the sector. Policy distortions, such as subsidized credit for white farmers, resulted in capital-intensive production and farms that were larger than the efficient size.

Once elected in 1994, the African National Congress (ANC) government embarked on an ambitious programme of land reform, rural financing, and deregulation of agricultural marketing (box 2.2). Policy reforms introduced since 1995 are perhaps too recent to show significant results, however. Low productivity growth, stagnant export revenues, and limited absorption of labour remain serious policy challenges in the sector. Moreover, reforms have not been smooth. Land redistribution and restitution tend to take time. And some controls were not abolished immediately.

On the positive side, the number of enterprises operating in agriculture increased significantly between 1990 and 1998, with new registrations growing by an average 16% a

Box 2.2

Agricultural reforms—to correct historical injustices

After taking office in 1994, the ANC government embarked on an ambitious programme of agricultural reforms aimed at undoing the effect of 80 years of inequality and discriminatory practices. The programme focuses on land reform, deregulation of agricultural marketing, and rural financing.

Land reform

The land reform programme, initiated in 1995, aims to transfer 30% of all agricultural land in 15 years. A redistribution programme provides grants and technical assistance to the landless poor. A restitution programme returns land that was lost or otherwise compensates victims of the 1913 Land Act, which awarded white settlers rights to 87% of South Africa's arable land and relegated blacks to so-called homelands. And a tenure reform programme is creating a validated system of landholding, including recently approved legislation (the Extension of Security of Tenure Act) aimed at protecting vulnerable farmers who do not own their land. Other goals include improving the incomes and nutrition of the rural poor, reducing congestion in overcrowded former homeland areas, and expanding opportunities for women and young people who stay in rural areas.

Deregulation of agricultural marketing

Since 1995 the government has deregulated previously strictly controlled markets. It removed price controls, and by early 1998 it abolished all agricultural control boards (transferring their assets to industry trusts to support marketing and export services). These policies led to the disappearance of official "single channel" markets. The deregulation efforts have reduced government-induced distortions in South Africa to much lower levels than ever before.

Restructuring of rural finance

During the apartheid regime disadvantaged people had poor access to rural finance. To rectify this situation, the government abolished the Agricultural Credit Board, which had provided subsidized credit to large farmers, and gave a new mandate to the government-owned Land Bank, which had served a similar purpose. Now the Land Bank provides credit to historically disadvantaged farmers, a capacity in which it has already done much to redress the imbalances of the past. In addition, the government has removed many other subsidies, such as funding options for fencing, irrigation facilities, and on-farm infrastructure. And it has amended the tax regime, eradicating implicit subsidies for capital equipment provided through rapid depreciation schemes.

Source: ANC 1994; statistics South Africa and South Africa, National Department of Agriculture 2000.

year. Capital productivity is improving, suggesting that the capital-intensive bias of the sector is being addressed. Prices for agricultural products have largely stabilized, thanks in part to the establishment of a futures and options market for agricultural commodities in 1995. The abolishment of the control boards and reduction in the anti-export bias in agriculture have led to a marked increase in the production of export crops, especially fruit and vegetables and, to a lesser extent, in livestock production.

Industry—weak domestic demand

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Industry (mining, manufacturing, and construction) contributed around 29.0% of GDP (in gross value added terms) in 2000. This share has fallen steadily from 31.1% in 1995. Manufacturing output fell by 0.7% in real terms between 1995 and 2000. Since export growth was strong, the decline probably reflects weak domestic demand. Manufacturing output edged upward in the first half of 2001, however, growing by 1.2% on a seasonally adjusted and annualized basis. Mining production fell by 1.9% from June 2000 to June 2001, largely as a result of a sharp decline (around 9.1%) in gold production. Platinum production continued to rise in 2001, achieving an annual growth rate of 6.2%. Platinum output is likely to continue to expand as investments come on stream.

In 1995 industry accounted for 32% of formal employment in South Africa. Between 1995 and 2001, however, employment in the sector fell by around 14%, compared with a drop in total non-agricultural employment of around 10%. Employment fell by as much as 37% in construction and 30% in mining over the same period. In construction the drop in formal employment may reflect a shift towards casual labour.

Industrial exports grew at an average annual rate of 16.8% between 1995 and 2000, responding rapidly to new opportunities emerging after international sanctions were lifted. The composition of industrial exports has changed slightly in favour of basic processed goods and machinery and equipment. That shift, combined with a decline in mineral exports as a share of merchandise exports (from 27.0% in 1995 to 21.9% in 2000), suggests that downstream manufacturers are becoming more successful exporters.

The manufacturing subsectors of basic metals and “rubber, glass, plastic, non-metals, and minerals” show a particularly strong export orientation, with the ratio of exports to output in these sectors at 57.0% and 24.2% in 2000. The export orientation in mining, historically extremely strong in South Africa, was as high as 77.2% in 2000.

Imports of industrial merchandise goods also increased between 1995 and 2000, rising from 17.4% of GDP to 21.0%. The composition of merchandise imports has shifted away from machinery and equipment and towards mineral imports. The relative decline in machinery imports may be due to the depreciation of the rand along with weak domestic demand. At the aggregate level the textile and apparel industries do not appear to have suffered from the huge inflow of inexpensive imports that critics of the trade liberalization expected, although it is possible that the exchange rate depreciation has temporarily postponed the effects on these sensitive industries.

Accelerated trade liberalization aimed at introducing competitive pressures from imports was central to the industrial policy developed by the ANC government. The government also introduced a powerful competition policy, including a revamped Competition Act (1998) and independent enforcement authorities. In addition, the government embarked on an ambitious programme of privatizing state-owned enterprises and introduced spatial development initiatives aimed at overcoming the spatial legacy of apartheid and refocusing economic activity away from import substitution and towards production for global markets.

The competitive pressures resulting from import liberalization, competition policy, foreign investment, and privatization—combined with supply-side incentives and export opportunities—were expected to kick-start a deep restructuring of domestic manufacturing and lead to internationally competitive and outward-oriented industries.

In the past two years the industrial policy has shifted towards a greater focus on knowledge-intensive sectors and human resource development, placing less emphasis on comparative advantage based on natural endowments. The industrial policy now being developed will include sectoral strategies based on creating competitive advantages in knowledge-intensive manufacturing (box 2.3).

“*The public sector has not taken up the ‘slack’ in investment demand*”

Domestic consumption and investment—flat

Household consumption has remained stable as a share of GDP since 1995 (table 2.1). The private investment rate peaked in 1997, then fell with the onset of recession in 1998 and has remained well below the peak even with a small rise in 2001. Thus while the 1994 elections were associated with an improvement in investor confidence, the effect was quite modest and also fragile. The small growth in private investment was halted by the first foreign exchange crisis in 1996, and punctured by the second two years later. Even though the GEAR policy was intended precisely to improve policy credibility among investors, it did not lead to any noticeable improvement in the investment rate, even before the 1998 collapse of the rand.

The public sector has not taken up the “slack” in investment demand. The only substantial increase in public investment was that linked to the one-time rise in telecommunications investment in 1998 required as a condition of the purchase by a U.S.-Malaysian consortium of a 30% strategic partnership stake in the government-owned fixed line operator in 1997. Infrastructure investment by the government (beyond that by public corporations) has remained almost flat in real terms through most of the post-apartheid period, with the government focusing most of its fiscal policy attention on bringing the deficit under control. The government signalled an intention to increase investment spending in its (March) 2001 budget, however, and restated this commitment in the November 2001 medium-term budget policy statement looking ahead to the 2002 budget.

More recent developments in aggregate demand are positive, with consumption and investment patterns pointing to a potential for the economy to pick up in 2002. Real household consumption spending rose by around 2.3% in the first two quarters of 2001. Real government consumption spending rose by 1.5% in the first half of 2001 and is expected to grow by an annual average of 2.5% in 2002–03.

Investment performance improved in almost all sectors in the first half of 2001. Gross domestic fixed investment increased to 15.3% of GDP. Private corporations and the public sector contributed to a 5.6% average rise in investment, while the government’s contribution to gross capital formation grew by 1.8%.

Box 2.3

Principles of the new industrial strategy

Don't rely on the old ways

A large share of South Africa's manufactured products—particularly exports—rely heavily on inputs of raw materials and energy. But access to cheap raw materials has become increasingly less important and it no longer provides a firm foundation for a competitive position—for producers that are now competitive or for the manufacturing sector as a whole.

Don't bank on cheap labour

Many have argued that policy should aim at reducing the cost to employers of unskilled labour and increasing flexibility in the market for unskilled and semi-skilled labour. This is a complex issue with clear political and economic considerations. But the trajectory of industrial development does not support these goals as the basis for a sustainable industrial policy.

As globalization proceeds, a combination of factors appears to be raising the demand for skilled labour and reducing the demand for unskilled and semi-skilled labour. That phenomenon is evident in South Africa. Thus lowering the cost and increasing the flexibility of unskilled and semi-skilled labour will not provide a sustainable basis for most manufacturing in South Africa.

Forget protection

Privileged market position similarly is no basis for a sustainable industrial strategy. The South African government is committed to continued trade liberalization. This entails more bilateral trade agreements and possibly additional offers within a new round of negotiations in the World Trade Organization. Consequently, manufacturers will face ever more competitive markets, both domestically and internationally.

Pay attention to innovation

Manufacturing firms in South Africa generally spend little on innovation. While increasing innovation activities will be an important policy effort, new technology will continue to come mainly through transfers from abroad—technology similarly available to producers elsewhere.

Enhance knowledge capacities

As the structure of world trade shifts away from commodity production and simple, raw material-intensive manufactured goods and towards increasingly knowledge-intensive goods and services, the traditional sources of competitive advantage for South African manufacturers will decline. Their ability to compete will increasingly turn on their capacity to master information technology, to innovate, and to meet the precise needs of their customers. These activities are all highly knowledge intensive. The industrial strategy will need to reflect this important shift.

Source: South Africa, Department of Trade and Industry 2001a.

The rise in investment growth since the first half of 2000 has been unusually widespread across sectors. Economy-wide and sector-specific factors—such as declining relative costs and platinum prices—have contributed to the improvement. Investment in mining, manufacturing, and financial services accelerated somewhat in 2001. Investment also grew in the construction industry in 2000 and 2001, possibly signalling an end to the

Table 2.1
Components of GDP, South Africa, 1995–2000
 (percentage of GDP)

Component	1995	1996	1997	1998	1999	2000
Household consumption	62.6	62.3	63.0	63.4	63.3	63.6
Private investment	11.6	11.7	11.8	11.3	10.5	10.7
Public investment ^a	4.3	4.4	4.5	5.5	4.7	4.2
Government consumption	18.3	19.4	19.8	20.0	19.4	18.4
Exports	23.0	24.5	24.6	25.9	25.9	29.1
Imports	22.1	23.2	23.5	24.7	23.1	26.1
Change in inventories plus residual	2.3	0.8	-0.3	-1.2	-0.6	0.1
GDP (millions of 1995 dollars)	151,117	157,390	161,318	162,426	165,471	170,572

a. Public investment data include both general government and public corporations.

Source: South Africa Reserve Bank.

long shakeout in that industry. The broader shift in the economy towards greater export production is expected to feed through into non-tradable and import-competing sectors. Even so, deeper problems related to investor confidence remain serious constraints to economic growth.

Employment and remuneration

The long-term decline in employment in the non-agricultural formal sector continued in the first quarter of 2001, while private sector wages continued to rise modestly. The moderate wage increases, combined with strong productivity growth (related in part to the drop in employment), led to a further slowdown in the growth of nominal unit labour costs. In the medium to longer term this trend may lead to stronger international competitiveness for domestic producers—and thus to stronger growth in exports, employment, and the economy.

Data from the 2001 Labour Force Survey suggest that employment losses in older sectors of the economy have been partly offset by employment gains in newer sectors, the informal sector, and outsourcing. These shifts reflect changes in the composition of demand for South African products, with little net change in effective demand. Currency depreciation and heightened competitiveness have also played a part in the shifts in employment, by contributing to employment creation in export industries. Nonetheless, at around 20%, the unemployment rate remains a major problem in South Africa.

Productivity growth remained strong in 2000 and the first quarter of 2001, resulting in moderate increases in real unit labour costs, lower domestic price inflation, and healthy corporate earnings. Over the past two years productivity has risen faster than real wages, reducing labour market disequilibria and setting the stage for employment growth in the medium term. Growth in real disposable household income remained healthy in 2001, averaging around 2.5% in the first half of the year.

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“South Africa has managed to bring its fiscal deficit under control”

Fiscal policy and the budget framework

South Africa has managed to bring its fiscal deficit under control. After escalating to 10.1% of GDP in 1993, the deficit fell to well below 3.0% by 1998, surpassing the target set by the ANC government in 1994. As part of its fiscal reform programme, the government had established a series of annual targets to lower the fiscal deficit to 3.0% of GDP by 1999. The deficit remained well below the GEAR target of 3.0% of GDP in 1999 and 2000, was projected at 2.0% of GDP for 2000/01, and is expected to increase to 2.3% of GDP in 2001/02 and 2.6% in 2002/03 before falling to 2.2% by 2003/04.¹

Fiscal reforms have also been aimed at improving the revenue collection performance of the South African Revenue Services by increasing its autonomy from the Department of Finance. The resulting growth in direct (income) taxes has increased total government revenue as a share of GDP by nearly 2 percentage points since 1995 (table 2.2). The improved revenue collection has enabled the government to meet its deficit targets with relative ease, at least since 1998. The government has used its extra fiscal “room” to move towards higher public investment spending. Despite the moderate increase in the budget deficit expected in 2001/02, debt will continue to fall as a share of GDP and debt service costs will continue to decline as a share of government spending, releasing resources for productive uses.

Despite the improved fiscal control, the government has been unable to reduce its total current spending as a share of GDP (table 2.3). Part of the reason is the rise in interest rates in 1996 and again in 1998, related to the foreign exchange crises of those two years. But current consumption spending also has risen, largely because of the growth in social spending as a share of the budget and of GDP (all three components of social spending—education, health, and welfare—increased as a share of GDP). To help offset these increases, the government has reduced spending on subsidies and transfers.

The government has thus met the promise made in its GEAR policy to increase the redistributive focus of its expenditure programmes. But the higher spending has not been fully reflected in government *output*—that is, improved service delivery to the public. And significant improvements in the *outcomes* of government social programmes—such as in basic skill levels or the population’s health status—remain some way off.

Against this background the minister of finance, Trevor Manuel, presented the 2002 medium-term budget policy statement to Parliament on 20 October 2001. The proposed budget reflects a fiscal policy stance that takes into account the slowdown in the international economy and the sluggish growth in South Africa. Designed to support a projected recovery in growth and building on a sound fiscal foundation since 1994, the medium-term budget policy statement outlines a programme of further tax relief and strong real growth in non-interest spending, averaging 3.7% over the next three years. The proposed 2002 budget framework signals:

- Priority for reducing poverty and vulnerability.
- Increased spending on health services and social grants, municipal infrastructure and housing, improved police and justice services, and critical administrative services for citizens.

Table 2.2

Government revenue, South Africa, 1995–2000
(percentage of GDP)

Item	1995	1996	1997	1998	1999	2000
Direct taxes on income and wealth	12.4	13.4	13.8	14.9	14.9	14.4
Indirect taxes on production and imports	11.7	11.3	11.1	11.5	11.5	11.5
Total other revenue ^a	1.3	1.5	1.4	1.3	1.3	1.3
Current income ^b	25.4	26.2	26.3	27.6	27.7	27.1
Budget deficit	-4.2	-5.0	-4.7	-3.5	-2.6	-1.8

a. Transfers receivable and income from property.

b. Government revenue less interest on public debt, subsidies, and transfers.

Source: South African Reserve Bank.

Table 2.3

Government expenditure, South Africa, 1995–2000
(percentage of GDP)

Item	1995	1996	1997	1998	1999	2000
Interest on public debt	5.9	6.3	6.1	6.3	6.2	5.9
Subsidies	1.5	1.4	1.2	1.2	0.9	0.8
Current transfers to households	3.4	3.5	3.4	3.1	3.1	3.1
Transfers to the rest of the world	0.5	0.5	0.6	0.6	0.7	0.8
Final government consumption expenditure	18.3	19.4	19.8	20.0	19.4	18.4

Source: South African Reserve Bank.

- Strengthening of programmes that address the impact of the HIV/AIDS epidemic.
- A step-up in the electrification programme and support for the restructuring of the post office and the unemployment insurance fund.
- Strong growth in transfers to municipalities, recognizing their critical role in extending basic services to underserved communities and households.

In addition, a range of new infrastructure projects are envisaged that will contribute to social and economic development in the years ahead, such as telecommunications investments, water supply schemes, a toll road concession, industrial development zones, and a gas pipeline from Mozambique to South Africa. These projects will be largely self-funding and thus are outside the main budget. In some of these projects private investors will provide funding through direct equity participation or public-private partnerships. In others, funds will be raised against the balance sheets of public corporations. Even with these investment plans, the consolidated public sector borrowing requirement is expected to remain modest, rising from an estimated 1.6% of GDP in 2002 to around 2.4% by 2004.

Against the background of the substantial tax reforms over the previous two years, the 2002 budget will herald a period of consolidation in tax policy. The personal income tax

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structure will again be lightened, with relief particularly for low- and middle-income wage earners, and the tax treatment of retirement savings will receive a thorough review. Investment incentives amounting to ZAR 3 billion will take effect over the next four years. In addition, shortcomings in the income tax treatment of the banking sector will be addressed, and effective tax rates in other sectors reviewed. And work will continue with other southern African countries on customs administration, tax incentives, tax reform lessons, and effective revenue administration. All this work notwithstanding, the broad parameters of the tax law are now in place.

Monetary policy—M3 ahead of targets

The rapidly changing international environment and relatively favourable domestic economic conditions have made decisions on an appropriate monetary policy stance challenging. Until 1999 the Reserve Bank set growth targets for broad money supply (M3), adopting what it termed an “eclectic” monetary policy approach in which the nominal exchange rate was sometimes also implicitly targeted. But the M3 growth rate greatly exceeded the targets as a result of the large gross inflows of foreign portfolio capital associated with the liberalization of the capital account. These large inflows were a central factor in the Reserve Bank’s decision to abandon its approach to targeting money supply growth.

In February 2000 the government established an inflation targeting regime in which the minister of finance sets a formal target for consumer prices minus mortgage interest costs (CPIX) and the Reserve Bank is responsible for meeting it. The initial target is a range of 3–6%, to be reached by 2002 (box 2.4).

Monetary aggregates

Since 1994 growth in the money supply has fluctuated with a series of innovations and structural changes in the financial sector, contributing to a breakdown in the relationship between M3 and inflation. Since inflation targeting began, growth in M3 is no longer used as an intermediate target for monetary policy. Nevertheless, money supply and credit continue to provide useful information about spending plans and inflationary pressures. Recent trends have been encouraging. M3 growth has accelerated noticeably, but largely as a result of strong growth in long-term deposits (which may reflect fears of losses on equity investments more than intentions to spend in the future).

Bank credit to the private sector has continued to grow briskly, with much of the expansion in credit going to the corporate sector. Over the past year fixed capital formation has been growing at a solid pace in that sector, laying the foundation for future economic growth. The credit expansion also reflected reasonably buoyant consumer demand. The net claims of the banking sector on the government sector declined quite sharply in the first half of 2001, slowing the growth in total bank credit extension to a low rate.

Box 2.4

New inflation targets

The government announced an inflation targeting framework to guide monetary policy in the 2000 budget, with an initial target band of 3–6% for CPIX inflation in 2002. Since monetary authorities need lead time to adjust policy—because of the time lag between a policy change and its impact on CPIX—the cabinet decided that the target will remain at 3–6% for 2003.

A critical factor in lowering inflation is how the targeting framework affects the expectations of producers, financial markets, and labour market agents about future inflation. To influence these expectations, the Reserve Bank has opened the monetary policy-making process to public scrutiny and explained the benefits of lower inflation to the public.

To further enhance the transparency and credibility of the framework, the cabinet has announced the inflation target for 2004 and 2005—an average of 3–5%. This target band represents an intention by South Africa to achieve inflation rates similar to those of its major trading partners and thus will help to maintain the economy's competitiveness.

In addition, the framework has been adjusted to make the “escape clause” more concrete. This clause provides for flexibility in the event of exogenous and supply-side shocks to the economy, such as drought, a sharp rise in international oil prices, or international financial contagion that causes major changes in the exchange rate unrelated to domestic economic fundamentals and monetary policy. When it is expected that the CPIX inflation target will not be met, the Monetary Policy Committee will set out the path and time horizon for bringing inflation back in line with the target. This flexibility will be critical in avoiding costly losses in jobs and output.

Source: *South African Reserve Bank 2000.*

Inflation

The slower growth in nominal unit labour costs and the lower international oil prices were reflected in lower year-on-year price inflation in the first half of 2001. Price pressures at the production level have started to ease in recent months, and consumer price inflation has also started to decline.

Domestic producer prices rose by 7.8% in the year to September but are expected to decline as the prices of imported goods stabilize in the years ahead. Consumer price inflation as measured by CPIX peaked in 2000 and has declined since, reaching 6.0% in August 2001 and 5.8% in the year to September 2001. Slower growth in food and oil prices was the primary factor in the easing of consumer price increases.

Although administered prices continue to grow more rapidly than CPIX, the rate of growth is slowing. Medical and transport costs, for example, grew by 11.9% and –3.6% in the year to August 2001, down from 16.1% and 10.1% in March and January. Rates of increase in administered prices will moderate as these sectors, particularly health and transport, adjust more fully to changes in market conditions, regulatory and industry structures, and legislation.

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**South Africa's real
interest rate compares
well with those in other
emerging market
economies**
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Between the first and second quarters of 2001, however, there were signs of acceleration in endogenously generated inflation. For example, prices of domestically produced goods and non-food consumer goods rose more rapidly in the second quarter than in the first. Moreover, although growth in overall inflation was curbed by smaller increases in the prices of imported goods and a decisive slowdown in the prices of consumer services during the first half of the year, the drastic slide in the rand since September 11—which again put pressure on import prices—heightens inflationary pressures and may call for increases in domestic interest rates.

Interest rates

Confident that an upturn in the growth of aggregate demand in the second half of 2001 would not jeopardize inflation prospects, the Reserve Bank cut the repurchase rate in June 2001 from 12% to 11%, resulting in a decline in the prime rate from 14.5% to 13.5%. A subsequent rate cut in September, in addition to a technical change in how the repurchase market functions, led to a further decline in the repurchase rate to 9.5%. The prime rate fell to 13%. Lower short-term interest rates were accompanied by a large decline in long-term interest rates. All these rate adjustments were consistent with the policy objective of lowering inflation to within the upper region of the 3–6% target range in 2002.

Real interest rates declined from an average of around 12% in 1995–98 to around 6% in 2001. South Africa's real interest rate compares well with those in other emerging market economies.

Exchange rate developments—rand under pressure

The external value of the rand is and has been under considerable pressure, mainly from developments outside South Africa that affect not only the rand but also many other currencies. Despite these pressures, the Reserve Bank did not sell dollars in the foreign exchange market to strengthen the exchange rate of the rand. The bank regards such intervention as undesirable because it is effective only if it signals a change in underlying policies, if it is strongly supported by participants in the foreign exchange market, and if the central bank is prepared to intervene repeatedly and decisively.

In fact, the Reserve Bank continued to buy small amounts of dollars in the market to gradually reduce the net oversold open position in foreign exchange. Its objective is to gradually close down the net open position, amounting to \$4.8 billion in 2001, to eliminate the risk involved in carrying such a position and the negative influence it has on the perceptions of potential market participants. The net open position is expected to reach zero sometime in 2002.

Reducing the net open position in foreign exchange may also lead to depreciation of the rand or prevent the rand from appreciating when an overall surplus is recorded on the balance of payments. Consequently, transactions aimed at reducing the position that are based on portfolio and short-term capital flows could provide speculators with a one-way

bet. To counter such speculation, the Reserve Bank buys dollars in the foreign exchange market only under exceptional circumstances, such as when large direct investments or more permanent capital flows are received.

The Reserve Bank's oversold forward book has an important influence on the management of the country's foreign reserves. No less than 85% of the Reserve Bank's foreign exchange holdings were in U.S. dollar-denominated assets on 31 July 2001 because the oversold forward book is denominated largely in U.S. dollars. Although liquidity is still an important focus of reserve management, risk returns are also taken into account. The Reserve Bank's risk management strategy also aims at prudence, risk aversion, capital preservation, and reciprocity with counterparts that extend credit to the bank.

The Reserve Bank continued to follow a conservative approach to borrowing funds that would support the level of reserve holdings. On 31 July 2001 the bank's outstanding foreign loans amounted to \$2.5 billion and the available facilities to \$1.1 billion.

External debt and foreign borrowing—interest payments remain low

South Africa's foreign currency debt is around \$25 billion, equal to 19.7% of GDP and 64.1% of exports. Interest payments remain low, falling from 8.6% of export earnings in 1999 to 6.2% in 2000.

In 1985, after facing a serious foreign exchange crisis, South Africa declared itself unable to repay its foreign creditors. Debt standstill agreements entered into with creditors allowed South Africa to freeze its debt repayments. On 15 August 2001 the government issued final authorization for repaying all outstanding capital on loans in the standstill net, bringing to an end an unfortunate chapter in South African history. Throughout that period, however, South Africa meticulously honoured all the capital redemption schedules and interest payments on this debt in accordance with the standstill agreements.

South African bonds remain well priced on international markets, despite an increase in the average cost of issuing new debt in most emerging markets. South Africa's favourable status among emerging market economies allows the country to borrow abroad at relatively low interest rates. Moreover, Moody's upgraded South Africa's credit ratings in November 2001. It raised the country ceiling for foreign currency bonds from Baa3/Not Prime to Baa2/Prime-2, and the rating for foreign currency-denominated bank deposits from Ba1/Not Prime to Baa2/Prime-2. In addition, it raised the rating for local currency bonds from Baa1 to A2.

Sales of government bonds by non-residents in 2001 did little to slow a rally in the bond market predicated on lower government borrowing and declining inflation. The public sector borrowing requirement fell from 4.8% of GDP in 1997 to an expected 1.1% of GDP in 2001, contributing to a sharp drop in long-term government bond yields. Domestic and foreign borrowing will remain moderate in 2002–03.

“ **South Africa meticulously honoured all the capital redemption schedules and interest payments in accordance with standstill agreements** ”

Gross official reserves improved marginally in 2001, rising from \$7.51 billion in January to \$7.53 billion in September. Net reserves, however, declined from \$4.92 billion to \$3.54 billion as dollar proceeds from a syndicated loan were used to reduce the forward book.

“Trade reforms led to considerable real growth in trade in 1995–2000”

Trade policy and global developments—integrating with the world

South African trade policy has been characterized by accelerated trade liberalization and an outward orientation since 1994. The lifting of international sanctions beginning in the early 1990s provided new opportunities for South African exports and reintegration with the world economy.

Trade liberalization

In response to the new opportunities, the ANC government adopted several major trade policy changes. First, South Africa joined the Southern African Development Community (SADC) in 1994, a step towards regional re-integration. Second, the country acceded to the World Trade Organization (WTO) and became a signatory to the Uruguay Round agreement so as to reap the benefits of the lifting of sanctions. Third, it negotiated a free trade agreement with the European Union in 1999, to increase access to strategic markets.

South Africa has also made tremendous progress in rationalizing its once very complex tariff regime and reducing nominal and effective protection. It reduced the number of tariff bands by almost half by 1997, lowered average tariffs in all categories to below the bound levels under the General Agreement on Tariffs and Trade (GATT), and eliminated import surcharges. These changes reduced the average nominal tariff from 27.5% in 1990 to 7.0% by 1997. By July 2000 nearly 60% of South Africa's imports faced a zero tariff. Despite the tariff rationalization, as many as 1,941 non-ad valorem tariffs still existed in 2001. But almost all remaining quantitative restrictions on imports have been abolished. And on at least four occasions the government has accelerated the WTO programme of trade liberalization.

The South African government further reduced industrial protection by phasing out its demand-side export subsidy scheme in 1997. To cushion the effect of reduced tariff protection and to stimulate exports, the government introduced supply-side measures such as import duty rebates, export credit guarantees, and an export marketing assistance scheme. Improved access to markets, including the SADC and the European Union, further stimulated exports. The continuing depreciation of the rand has helped to sustain the trade liberalization, and to accelerate it in 1996, by providing protection from import competition and stimulating exports.

The trade reforms led to considerable real growth in trade in 1995–2000. Imports grew on average by 8.2% a year, up from an average 2.1% over the previous four years. And exports grew by 7.9% a year, up from an average 0.5% (table 2.4).

Table 2.4

Balance of payments, South Africa, 1995–2000
(percentage of GDP)

	1995	1996	1997	1998	1999	2000
Exports						
Merchandise exports	15.8	16.8	17.3	18.4	18.9	21.9
Net gold exports	4.1	4.3	3.8	3.5	3.1	3.1
Service receipts	3.1	3.5	3.6	4.0	3.9	4.0
Factor income receipts	0.8	0.8	0.9	1.0	1.2	1.7
Total exports of goods and services	24.0	25.0	26.0	27.0	27.0	31.0
Imports						
Merchandise imports	18.1	19.2	19.5	20.5	18.8	21.6
Payments for services	4.0	4.0	4.0	4.2	4.3	4.5
Factor income payments	2.7	2.9	3.0	3.3	3.6	4.3
Total imports of goods and services	24.7	26.1	26.5	28.0	26.8	30.4
Current transfers ^a	-0.4	-0.5	-0.5	-0.6	-0.7	-0.7
Balance on current account	-1.5	-1.3	-1.5	-1.8	-0.4	-0.3

Note: Export and import values are f.o.b. (free on board).

a. Net receipts.

Source: South African Reserve Bank.

Global events

Despite all the trade reform efforts, the recent performance in South Africa's external sector has been determined largely by exogenous events. In the United States in 2001 investment spending on information technology declined sharply, which spilled over into other areas of the economy. Equity prices on the New York Stock Exchange declined sharply. For small open economies worldwide, the investment collapse unwinding in the United States and in Europe has depressed growth and trade. Industrial production in the Republic of Korea, Malaysia, Singapore, and Taiwan (China) declined by around 10% in August 2001 from a year earlier. The terrorist attacks on the United States led to further turbulence in financial markets and capital flows.

For South Africa, the impact of these global developments is reflected in the current and financial accounts of its balance of payments. South Africa has fared better than most other developing economies, primarily because of its sound financial regulation and low external borrowing and export competitiveness.

Current account

The current account of the balance of payments moved into a surplus in the fourth quarter of 2000 and fared reasonably well in the second quarter of 2001—with a slightly smaller ZAR 6.3 billion surplus—despite the slowdown in the international economy. This positive trend was due primarily to the much-improved competitive position of South African exports. Despite weaker global demand, South African manufacturing

“South Africa has fared better than most other developing economies”

Box 2.5

The effect of depreciation on the economy

Exchange rate depreciation can affect an economy in different ways, depending on the size of the depreciation and the price-setting response by firms, unions, importers, and exporters. Depreciation of the rand has benefited the South African economy, mainly by encouraging greater exports and offsetting the adverse effect of declining commodity prices on exports.

In addition, depreciation shifts domestic demand towards domestically produced rather than imported goods. Together with rising demand for South African exports, this raises effective demand and leads to greater profitability and more rapid growth. And rising demand for South African products in foreign countries leads to increasing demand for the rand and thus to exchange rate appreciation.

Most emerging market currencies depreciated against the U.S. dollar in 2001. The rand is estimated to be undervalued by around 30% against the dollar.

Source: *Economic Commission for Africa.*

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Strong exports and moderate imports resulted in a cumulative trade surplus of 25.1 billion rand
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and services exports have responded well to the increased competitiveness of the rand (box 2.5).

Merchandise export volumes recovered somewhat from the slight weakness in the first quarter of 2001. Nominal export earnings showed impressive growth, bolstered by the increase in domestic prices caused by the depreciation of the rand.

The increase in import prices that followed the depreciation of the rand in 1999–2000, helped by a decline in inventory investment, discouraged imports of goods and reinforced the trade surplus in the second quarter of 2001. This healthier trade balance was offset by a considerably higher deficit on the services and income account, reflecting the steady increase over the past eight years in non-residents’ ownership of shares in domestic companies. As a consequence, the current account surplus fell back slightly in the second quarter of 2001.

Strong exports and moderate imports resulted in a cumulative trade surplus of ZAR 25.1 billion for the first half of 2001. Imports are likely to grow with the expected acceleration in economic activity in 2002. Meanwhile, exports are expected to benefit from the U.S. African Growth and Opportunity Act that came into effect in 2001. Exports are likely to strengthen further if the current gap between returns to exports priced in dollars and rand-denominated production costs is maintained. This fundamental improvement in competitiveness may accelerate the relocation of export industries to South Africa from developed economies.

Changes in the services and income account of the balance of payments in 2001 came primarily from dividend outflows by foreign-listed companies with domestic operations. Between the first and second quarters of 2001 dividend outflows on foreign direct investments increased by a seasonally adjusted and annualized ZAR 22.8 billion, and those on

portfolio investments by ZAR 8.7 billion. The change in dividends on inward non-direct investment was also large, rising by a seasonally adjusted and annualized ZAR 12.5 billion from the first to second quarter of 2001.

Concerns about emerging markets and the uncertainties about the recession in Europe, Japan, and the United States in 2001 led to sharp reversals in capital flows and considerable currency volatility in many emerging market economies. In South Africa, by contrast, non-residents continued to make substantial purchases of listed shares in the first half of the year, although they were net sellers of bonds.

Capital flows were dominated by a restructuring of the shareholding in the De Beers mining company. In part as a result of this transaction, FDI into South Africa rose from a net outflow of ZAR 6.4 billion in the first quarter of 2001 to a net inflow of ZAR 93.8 billion in the second quarter. The matching component of the De Beers transaction resulted in a large net portfolio investment outflow as shareholders received shares in a non-resident company (Anglo American Corporation) in return for the delisting of their De Beers shares. The net outflow of portfolio investment amounted to ZAR 60.8 billion in the first half of 2001, compared with an outflow of ZAR 13.8 billion in 2000.

On a net basis other investment flows declined by ZAR 5.7 billion in the first quarter of 2001 and by ZAR 19.3 billion in the second quarter as South African firms repaid cross-border loans and extended trade finance. South Africa's financial account recorded a small cumulative net surplus of ZAR 1.6 billion in the first half of 2001.

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South Africa's financial
account recorded
a small cumulative
net surplus in the first
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Human development—wide disparities between rich and poor

Many of the human development challenges in South Africa reflect its history of apartheid, which left a legacy of disparities in access to good quality education and health care. Poverty rates remain high, in part because of such disparities.

Population and employment

The South African population was estimated at 44 million in 2000, with an average annual growth rate of 2.1% between 1995 and 2000. Average life expectancy is 58 years, although this composite figure conceals differences in life expectancy across population groups (black and white South Africans have different life expectancies).

Both the population growth rate and life expectancy are expected to fall dramatically as a result of the HIV/AIDS pandemic. Population growth may fall to zero by 2010, and some estimates suggest that life expectancy could be as low as 40 years by 2008, compared with a potential 65 years without the epidemic (Lewis 2001).

The labour force accounts for 25.7% of the population, reflecting the large share of South Africans who are below the age of 15 (women account for 35.6% of the labour force).

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The gap between rich
and poor in South
Africa is among the
largest in the world”

Still, only 19.6% of the population was employed in 1995. The high unemployment means a dependency ratio of more than five people for every employed person.

As a result of apartheid policies, the South African labour market is highly segmented, with large differences in unemployment rates among unskilled, semi-skilled, and skilled workers. And employment does not necessarily ward off poverty: around a third of South Africans who are employed earn incomes below the poverty level (Indicator South Africa 2000).

Poverty

South Africa is not among the world's poorest nations in GDP terms. Yet because of the extreme inequalities, half the population is poor. In fact, the gap between rich and poor in South Africa is among the largest in the world, with the Gini coefficient of inequality estimated at 59.3 in 1993–94 (Indicator South Africa 2000; UNDP 2001).

Whether people are poor in South Africa is determined by the province in which they live (the population of the industrial heartland, Gauteng, is best off; that of the rural Northern Province worst off), by their racial group (60% of black South Africans are poor, compared with 30% of those of mixed race, 5% of Indians, and 1% of whites), and by their gender (nearly twice as many female-headed households as male-headed households are poor). Women are more likely to be unemployed, and the average wage in female-headed households is a third that in male-headed households. Children are particularly affected by poverty, with 60% living in poor households (Indicator South Africa 2000).

Education

Before 1994 South Africa's education sector was marked by apartheid policies. The country had two distinct education systems with different levels of funding and quality. The “Bantustan” system, underdeveloped and with insufficient resources, provided education for more than 70% of all children. The other, highly developed and with rich resources, served exclusively white South Africans.

These disparities have left a legacy of challenges in education. The country's literacy rate was 84.9% in 1999 (UNDP 2001), though illiteracy continues to decline. Gross primary enrolment is around 88%. Some sources estimate net primary enrolment in 1995–97 at 96% (with female primary enrolment at 89%), and net secondary enrolment at 56% (UNDP 2000). A large gap in quality remains between historically disadvantaged institutions and historically white and private schools.

Between 1994 and 2000 a major shift took place in education policy, reflected in a constitutional amendment making education (in all 11 of the country's official languages) a basic human right. The new education policy aims at providing 10 years of compulsory, free education, revising the curriculum, reducing class sizes, and instituting adult basic education and training programmes. But despite the change in policy and the subsequent real increases in education spending, government spending on education has not grown dramatically as a share of GDP or as a share of the budget.

Health

The South African health sector was characterized by a similar dichotomy in funding and quality before 1994. One health system, underdeveloped and underfunded, stretched to provide even primary health care. The other, a state-of-the-art, highly developed, well-funded system, provided secondary and tertiary health care to the privileged.

Nevertheless, in recent years health indicators have shown progress on some fronts. The fertility rate in 1999 was 4.2 births per woman, down from 4.6 in 1997. The infant mortality rate has been falling—declining from 66.6 per 1,000 live births in 1997 to 63.0 in 1999—although it is expected to rise again with the increase in HIV/AIDS in pregnant mothers. Children in poor households continue to die from curable diseases such as measles, typhoid, diarrhoea, and tuberculosis. Nonetheless, the infant mortality rate for South Africa compares well with those for East Asia and Latin America—though the average for the country hides considerable disparities among provinces and racial groups (UNDP 2000).

The greatest health and socio-economic challenge in South Africa is AIDS. Recent estimates indicate that the AIDS epidemic has cost the lives of more than 500,000 South Africans. And projections suggest that by 2015 this figure will increase to more than 10 million (ING Barings 1999, 2000). Because the disease typically affects those of prime working age (25–45 years old), the epidemic will put great pressure on the health care system and social services as many heads of household become unable to work, require care, and eventually die.

The AIDS epidemic has had a disproportionate effect on children. As early as 1994, 2.3% of babies in South Africa were HIV-positive and as many as 10.7% of reported AIDS cases were children. And the number of AIDS orphans is growing steadily.

The government's health policy objective is to shift the emphasis of the health system from curative services to primary health care, providing free medical services at state facilities for children under six and for pregnant women. Despite the policy change and the subsequent real increase in health spending, government spending on health has not increased as a share of GDP and has risen only slightly as a share of the budget (from 10.0% in 1995 to 11.1% in 2000).

Public spending on social services

Over the past five years the government has devoted roughly the same share of its spending to social services, with a one-time increase in 1997. Social spending amounted to 14.3% of GDP and 47.5% of the main budget in 2000/01 (table 2.5).

The share of spending on social services is large by international standards. Japan directs 37.5% of its central government spending to social services, and the United States only 28.5% (Indicator South Africa 2000). South Africa's comparatively high level of spending can be explained by several factors. First, the country is working to redress the inequalities of apartheid. Second, poverty rates are much higher in South Africa than in

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Government spending
on health has
not increased as a
share of GDP
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Table 2.5**Government spending on social services, South Africa, 1995/96–2000/01**

Type of social service	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
Education						
As share of GDP	6.7	7.0	7.1	6.5	6.4	6.5
As share of main budget	21.3	22.1	22.0	21.6	21.4	21.5
Health						
As share of GDP	3.1	3.3	3.6	3.4	3.3	3.3
As share of main budget	10.0	10.4	11.3	11.1	11.2	11.1
Social security and welfare						
As share of GDP	3.0	2.9	3.7	3.6	3.6	3.7
As share of main budget	9.7	9.3	11.6	11.9	12.2	12.4
Housing and community development						
As share of GDP	0.6	0.3	1.1	0.8	0.7	0.6
As share of main budget	1.9	0.9	3.4	2.6	2.2	2.1
Total social services						
As share of GDP	14.5	14.5	15.6	14.4	14.1	14.3
As share of main budget	46.0	45.9	48.6	47.6	47.5	47.5

Note: All data refer to the fiscal year ending 31 March.

Source: South Africa, National Treasury.

many other countries. Third, social spending has limited impact in a situation of high and growing unemployment. And fourth, as a share of GDP, South Africa's national budget is smaller than that of developed countries.

Spending on social security increased from 9.7% of the main budget to 12.4% between 1995/96 and 2000/01, while spending on health rose from 10.0% to 11.1%. Spending on housing increased sharply in 1997/98 and 1998/99, reflecting the changing priorities of the new administration. Surprisingly, education spending has retained largely the same share of the total budget (rising only from 21.3% in 1995/96 to 21.5% in 2000/01), although the distribution of the funds has changed as the post-apartheid government has sought to rectify the past imbalances in spending. As a share of GDP, education spending has dropped and health spending has increased slightly.

Even without sizeable increases in the share of the budget devoted to social spending, South Africa achieved a number of social objectives between 1994 and 1999 (UNDP 2000):

- It extended access to water supply from 70% of the population to 80%.
- It expanded the electricity infrastructure grid from 40% of the population to 63%.
- It extended the landline telephony infrastructure from 24% of the population to 33%.
- It launched a primary school nutrition programme serving 5 million children.
- It built and repaired 10,000 classrooms.
- It extended free medical care to children under six and pregnant women.

- It built 638 health clinics.
- It constructed 1 million low-cost houses (by 2000).

The 2002 budget signals the government's continuing commitment to addressing the poverty and social vulnerability that affect most South Africans. Spending on social services will account for around 50% of consolidated non-interest expenditures.

Medium-term outlook and policy challenges— 3% growth expected in 2002

Despite relatively sound macroeconomic fundamentals, the South African economy has performed well below its potential. Economic growth has been slow since the 1970s, averaging 3.2% in that decade, 2.2% in the 1980s, and 1.3% in the 1990s. The effects of the slow growth have been intensified by the sharply declining labour absorption capacity in the economy. A relatively low savings ratio and high net outflow of capital have typified the stagnating growth performance over the decades. Perhaps the only factor defying the slow growth has been the steady growth in exports, due primarily to the constantly depreciating rand.

The slow economic growth has exacerbated the country's huge socio-economic disparities, which have developed over time as a result of many economic, socio-economic, political, and institutional factors. Another policy challenge has been the HIV/AIDS pandemic. Many economists have predicted a significant downward trend in total and per capita GDP as the epidemic leads to reductions in labour supply and total factor productivity and shifts in household and public spending. By 2010 GDP could decline by 19%, or 8% per capita, compared with a "no AIDS" counterfactual (Lewis 2001).

One obstacle to improved economic performance lies in the lack of investor confidence, which appears to be related largely to political and socio-political issues rather than purely macroeconomic concerns. Among the reasons for the lack of confidence:

- Delays in formulating a telecommunications policy contributed to a delay in the initial public offering of South Africa's national telecommunications company, Telkom, and few now believe that the listing can proceed before the middle of 2002. Despite signs that further postponement is likely, the government insists that the offering is on track for the current fiscal year (2001/02). Adverse market conditions are part of the problem. But there are also indications that the privatization and liberalization process in South Africa has lost its way because of competing economic and social demands. Indeed, the country's telecommunications policy had to be redrafted no less than four times after a series of interventions by vested interests. Less government interference in the drafting of the policy would probably have allowed an earlier listing of Telkom, despite less than ideal market conditions.
- The South African labour market remains severely overregulated, a disincentive to foreign direct investment.
- The investment environment in South Africa is unattractive. Investors must contend with massive red tape and high start-up costs. Corporate taxes are high, and firms face

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Slow economic growth
has exacerbated the
country's huge
socio-economic
disparities”

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The economy is
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hidden taxes in the form of levies. And human resource departments need dedicated teams to monitor all the relevant laws and regulations.

- Attempts to rectify the social imbalances created by apartheid constrain liberalization, and in the privatization process policy implementation often appears to sabotage policy directives. Both these problems undermine the macroeconomic environment.

What is the immediate outlook for South Africa? The economy is expected to achieve growth of around 3% in 2002. The currency will continue to be vulnerable to external shocks, which could stem from further troubles in other emerging market economies and from deteriorating political and economic conditions in neighbouring Zimbabwe. But the rapid depreciation of the currency during the second half of 2001 and the improved global economic conditions in 2002 will give a major impetus to exports. The trade agreement with the European Union may provide another significant boost.

Inflation is expected to continue to be low in 2002 (averaging 5.5%), thanks mainly to the Reserve Bank's resolve to pursue a tight monetary policy. New targets set for 2003 and 2004 are designed to ensure a declining path for inflation as well as stability in real household income in coming years. The budget deficit is expected to rise slightly to 2.6% of GDP in 2002/03—with real increases in non-interest spending averaging 3.7% over the period 2002–05—and to fall to 2.2% of GDP in 2003/04. As a result, the consolidated public sector borrowing requirement is expected to remain modest in the years ahead, rising from an estimated 1.6% of GDP in 2002 to around 2.4% by 2004.

South Africa faces important choices relating to its future growth and development performance. Most critical will be putting in place the necessary conditions for achieving 5–6% growth. That effort must include narrowing the large and growing gap between the modern core economy and the peripheral economy. While greater integration with the global economy is often correlated with a reduction in unemployment, this correlation does not seem to hold in South Africa. One possible reason for this is that the benefits of globalization are largely confined to South Africa's sophisticated and industrially developed core economy, while the peripheral economy surrounding it has no real functional links to that core nor any link to global markets.

Narrowing the gap between the modern and peripheral economies will require economically empowering those in the periphery through training, job opportunities, and better social services. Only then will the economy allocate scarce resources more efficiently and thus move onto a higher growth path. Until then, South Africa may not fulfil its potential as the locomotive for regional growth.

Note

1. South Africa's fiscal year ends on 31 March. However, to be consistent with the rest of the report, fiscal data are reported for the calendar year whenever possible. When data for the calendar year are not available, fiscal year data are used.

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