I. THE ECONOMIC ENVIRONMENT

(1) Major Features of the Economy

1. Located on the southern most tip of the African continent, the Republic of South Africa has a coastline of nearly 3,000 kilometres along the South Atlantic and Indian Oceans and a landmass of over 1.2 million square kilometres. In 1997, the population was 37.9 million, of which some 60% was between 15 and 64 years old, and nearly 51% was urbanized (Table I.1). The major urban concentrations are the Cape Peninsula with Cape Town as South Africa's legislative capital, Johannesburg/Randburg, Durban/Pinetown, Pretoria (the administrative capital), Port Elizabeth/Uitenhage and Bloemfontein (the judicial capital). Some 29% of the economically active population is unemployed; this situation results from various factors including a recent increase in the urban population (spurred by the 1994 political change), the high percentage of the population being of working age, and a shortage of skilled labour.

Table I.1
Socio economic indicators, 1992-96

Area: 1.22 million square kilometres
Population: 37.9 million in 1997
Urban population: 50.8% of the total
Population growth rate: 2% a year
Life expectancy (years): 64.2
GNP per capita: US$2,918 in 1996

	1992	1993	1994	1995	1996
GDP (US$ billion)[a]	108.4	105.9	108.4	118.7	112.6
Exchange rate (Rand/US$)	2.9	3.3	3.5	3.6	4.3
Share of real GDP[a,b,c]			(Per cent)		
Agriculture	4.2	5.1	5.5	4.6	5.7
Mining and quarrying	10.0	10.1	9.6	9.0	8.6
Manufacturing	24.4	24.1	24.1	25.2	24.5
Electricity gas and water	4.6	4.8	4.8	4.8	4.9
Construction	3.2	3.0	2.9	2.9	2.9
Services	53.6	53.1	53.1	53.4	53.5
			(Per cent)		
Share of employment (as of year end)[c]					
Agriculture, forestry and fishing	...	...	11	8	7
Mining and quarrying	...	...	8	11	11
Manufacturing	...	...	25	28	27
Services	...	...	53	53	55
			(US$ million)		
Exports	23,987	27,129	24,966	28,626	29,120
of which, gold	6,800	7,246	6,668	6,214	6,120
Imports f.o.b.	18,194	18,327	21,481	27,009	27,075
Merchandise trade /GDP (per cent)	35.1	36.3	38.3	41.6	44.9

... Not available.

a At factor cost.
b At constant 1990 prices.
c The components may not add up to 100 because of statistical discrepancies.

Source: Data provided by the South African authorities.

2. The South African economy is relatively capital intensive, supported by various incentive schemes including interest rate subsidies and duty concessions on imports of capital goods. The capital intensity is compounded by poor labour skills and rigidities in the labour market, which have resulted in shortages of working capital and high production costs in almost all sectors of the economy.

3. South Africa is a world leader in terms of both supply and known reserves for a wide range of minerals. The mining and quarrying sector, which also supplies inputs directly into manufacturing, is the backbone of the economy; it contributes over 8% of real GDP and accounts for more than 40% of exports.[1] Gold is the main mineral export. However, the share of mining and quarrying in GDP is down from over 10% in the 1980s, largely due to the depletion of mineral reserves, gold in particular. The share of the manufacturing sector in South Africa's real GDP has been around 24.5% since 1992.

4. Under normal weather conditions, South Africa is a net exporter of agricultural products. Depending on harvests, agriculture contributes between 8 and 10% to South Africa's exports of goods, and around 5% to its real GDP; agriculture is also a source of inputs for the manufacturing sector, mainly food processing industries. The share of agriculture in South Africa's GDP has been on a downward trend since the mid-1980s; droughts, topographical factors and declining investments have contributed to this decline.

5. Services account for almost 54% of real GDP, with construction contributing a further 3%. Financial services are a major part of the services sector; South Africa has a modern financial system supervised by a constitutionally independent central bank, the South African Reserve Bank (SARB). In 1996, the services sector was the largest employer in the economy (55% of total formal employment), followed by manufacturing (27%), mining and quarrying (11%), and agriculture, forestry and fishing (7%).

6. With a gross national product (GNP) per capita of US$3,160 in 1995, the Republic of South Africa is an upper-middle-income developing country.[2] This level of GNP per capita is misleading since several decades of apartheid led to a concentration of economic power and very distorted and unequal income distribution. Adopted in September 1994, three months after the elections, the Reconstruction and Development Programme (RDP) is aimed at the socio-economic development of the majority of the population (Chapter II(3)) and provides the framework for South Africa's economic policies. In line with the RDP, the Government has formulated phased and cautious reforms, based on a social consensus. Unemployment, basic health care, education, and housing for the growing population are at the centre of the Government's socio-economic concerns. The effectiveness of socio-economic policies is seen as a central element in efforts to reduce crime and violence in South Africa.

(2) <u>Evolution of the Economy</u>

(i) <u>Developments up to 1994</u>

7. South African real GDP grew at an average rate of less than 1% a year in the decade commencing 1985; this followed ten years of modest growth, of some 2.6% a year. The Government's continued use of an import-substitution strategy for much of the period served to raise

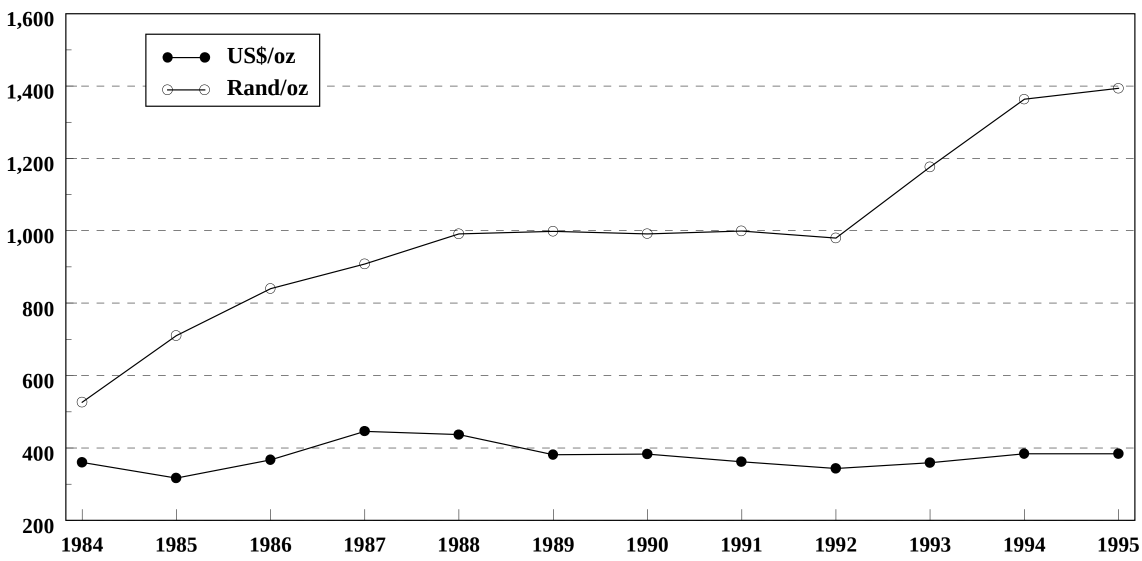
---

[1] The share of the mining and quarrying sector does not include gas, electricity (partially produced from coal) and water, representing together almost 5% of GDP.

[2] World Bank (1997). The 1996 GNP per capita was estimated at US$2,918 by the South African authorities.

costs and exacerbate financial constraints. Corporate profits, savings and investments were negatively affected, a situation made worse by the tightening of international sanctions in the second half of the 1980's; there was disinvestment in the latter period. Hesitant metal prices, particularly gold (Chart I.1), aggravated the situation and contributed to sluggish export performance. In addition, South Africa underwent a severe drought in the early 1990s, such that agricultural output declined by a quarter in 1992 and manufacturing production was down by over 3%. In 1992, real GDP was down by over 2% (Table I.2). A return to a more normal harvest and a pick-up in demand, particularly by the Government in 1993 and investors in 1994, helped the economy regain modest growth of 1.3 and 2.7% in 1993 and 1994, respectively.

Chart I.1
Average gold price per fine ounce on the London market, 1984-95



Source: South African Mining Industry, Statistical Tables, 1995.

8. The Government sought to help local producers by strengthening incentive schemes. In particular, the General Export Incentive Scheme (GEIS) was introduced in April 1990. Also, in March 1992 the Government reduced the tax burden on local companies, with a slight reduction in the rate of corporate income tax; a value-added tax, at 10% replaced a 13% sales tax.[3] Some liberalization initiatives were also undertaken, especially in agriculture where a review of the pricing mechanism, control boards and border measures was started in 1992.[4]

[3] The rate of the VAT was increased to 14% on 7 April 1993.

Table I.2
Recent economic performance, 1992-96

	Share of 1996 GDP (per cent)	1992	1993	1994	1995	1996
	(Current prices)	(Annual percentage change; at 1990 prices)				
GDP at market price[a]	100.0	- 2.2	1.3	2.7	3.4	3.2
Private consumption	61.0	- 1.4	0.3	3.1	4.7	3.9
Government consumption	20.4	1.9	3.6	3.1	-1.4	6.0
Gross fixed investment	17.2	- 5.3	- 2.8	8.7	10.3	6.8
Inventory investment	1.0	0.2	1.2	1.5	0.7	- 1.2
Exports of goods and nonfactor services	26.5	2.5	4.8	1.0	9.3	7.8
Imports of goods and nonfactor services	25.7	5.3	7.0	16.1	16.6	7.5
		(Percentage change)				
Consumer prices[b]		13.9	9.7	9.0	8.5	7.4
Real effective exchange rateb,[c]		1.8	- 4.4	- 3.0	0.2	- 8.3
Nominal effective exchange rateb,[c]		-4.8	- 9.2	- 9.3	- 5.7	- 13.0
Money supply (M3)		8.0	7.0	15.7	15.2	13.6
		(Per cent)				
Discount rate		14.0	12.0	13.0	15.0	17.0
Ratio of external debt to exports of goods and nonfactor services		104.8	94.5	95.7	97.4	...
Gross international reserves (months of imports)		1.9	1.3	1.2	1.4	1.3
		(Per cent of GDP)				
Government revenue		24.7	25.8	26.4	26.7	27.8
Government expenditure		32.7	32.4	32.2	32.1	33.6
Balance		- 8.0	- 6.6	- 5.7	- 5.4	- 5.7
Trade balance		5.3	8.3	3.2	1.4	1.8
External current account		1.5	1.6	- 0.3	- 2.1	- 1.6
Net domestic savings		2.3	3.1	3.4	3.2	3.2
Net domestic investment		0.9	1.5	3.7	5.3	4.9

... Not available.
a The components may not sum up to 100 because of statistical discrepancies.
b Period average.
c Negative sign indicates depreciation; Index: 1990=100.
Source: Data provided by South African authorities.

9. Monetary policy was relatively conservative during the period but inflation nevertheless averaged 14% a year in the decade to 1994; continued limitations on increases in the money supply helped bring the rate below 10% by 1993. The fiscal deficit rose to some 8% of GDP by 1992, both because of increases in administrative, security and social expenditure and because the share of mining in government revenue fell from over 12 to about 5% in the period 1986 to 1992. A slight revenue recovery and expenditure restraint helped to lower the deficit to under 6% of GDP by 1994.

---

[4]Foreign pressures and the costs of South Africa's import-substitution strategy had contributed to intermittent liberalization during the 1970s and 1980s.

(ii) Recent economic developments

10. Following the 1994 elections and coincident with the conclusion of the Uruguay Round, the Government adopted certain trade reforms. In consequence of its Uruguay Round commitments, South Africa bound some 98% of its tariff lines and tariffied agricultural quantitative restrictions.[5] In addition, a five-year (exceptionally eight-year) trade liberalization programme, with some export bias, was adopted. The programme is aimed at reducting the overall level of protection on manufactured and agricultural products, simplifying and rationalizating the tariff structure through the Tariff Rationalization Process (TRP) and restructuring incentive schemes for local companies. In line with the programme, tariffs on a number of inputs and on goods not produced, and without substitutes in South Africa have been abolished. However, the effect of the TRP may be to increase escalation and effective protection for manufacturing. In line with reform, import surcharges were completely eliminated in October 1995, and the General Export Incentive Scheme (GEIS), an export subsidy was abolished on 11 July 1997.

11. Among other measures, the Government adopted a four-year reform programme aimed at amending legislation on labour and promoting training: thus a new Labour Relations Act was enacted in November 1996 and a bill on Basic Conditions of Employment was drafted and released in early 1997. In keeping with the Government's Reconstruction and Development Programme (RDP), a medium-term fiscal plan was adopted in 1994 to reduce public expenditure and reorient it towards the underprivileged population. Under the programme, the public deficit (net of borrowing and debt repayment) was to be reduced by 0.5% of GDP a year, to 3.5% in fiscal year 1998/1999. Measures adopted under the programme include: the establishment of the South African Revenue Service (SARS); reduction of the rate of the secondary tax on companies from 25 to 12.5%; increases in excise duties, the fuel levy and the rates of estate duty and donations tax; and the restructuring of public service, including both a reduction in the number of employees by 300,000 over three years and an improvement in conditions of service.

12. Expenditure on RDP projects contributed to a slight increase in the public deficit during the fiscal year 1996/1997, which at 5.7% of GDP nevertheless remained below its pre-1994 level; nearly half of government expenditure was devoted to education, health, welfare, housing and related services. The situation was exacerbated by the increase in central government expenditure following the implementation of a three-year civil service rationalization programme from July 1996; this provides both termination benefits and civil-service wage increases. The restructuring of State assets came under review in 1996; revenue from sales of such assets partially finances RDP projects.[6] Also, extraordinary revenue from the sale of the strategic oil stock partially offsets the effect of increases in public expenditure on the deficit. However, the effect of the abolition of incentives such as the Regional Industrial Development Programme (RIDP) and, more recently, the General Export Incentive Scheme (GEIS), on public finance is ambiguous since it has been followed by the enhancement of existing incentives and/or the introduction of new ones.

13. In 1996, several reform programmes were reformulated and actions were taken to improve tax and duty collection. In April 1996, the Inland and Customs Revenue Services were merged into the autonneneomous South African Revenue Service (SARS). The number of international airports clearing cargo is to be reduced from 35 to ten (if the identified airports meet the regulatory criteria set by the SARS) and the number of commercial border posts from 52 to 19. In addition, various

[5]Except on black tea (Chapter III(2)(iii)(b)).

[6]The RDP Office was closed down in 1996.

incentive schemes and financial liberalization reforms, including easing of exchange controls and reduction of taxes on investment earnings, both aimed at promoting exports of more processed products, were reformulated or strengthened.

14. On 13 March 1995, the Government abolished the dual exchange rate system, and South Africa now maintains a managed float for the exchange rate of the rand, the national currency. In this context, the Government is phasing out exchange controls (Annex I.1). In 1996, political and economic uncertainties were factors in the depreciation of the average nominal and real effective exchange rates of the rand by 13 and 8%, respectively. The extent of the depreciation and the release by the Government of its medium-term macroeconomic strategy on Growth, Employment and Redistribution (GEAR) on 14 June 1996 (section (4)), helped to bolster investor confidence.

15. Overall, the various reform programmes contributed to an increase in net domestic investment, which averaged 4.6% of GDP during the period 1994-96, compared to 0.9% in 1992 and 1.5% in 1993. Over the same period, real GDP grew at an average rate of almost 3.1% a year. In 1996, good weather conditions contributed to a growth of 29% in agricultural output, a recovery from the drought induced 15% contraction experienced in 1995; however, growth in other sectors slowed, limiting GDP growth to 3.2%, compared to 3.4% in 1995. An increase in imports, especially of capital equipment and intermediate goods, and the decline in gold exports, has contributed to the deterioration of the current account since 1994. In 1996, the level of gross international reserves represented 1.3 months of imports, compared to 1.9 in 1992.

(3) Trade Performance and Foreign Investment

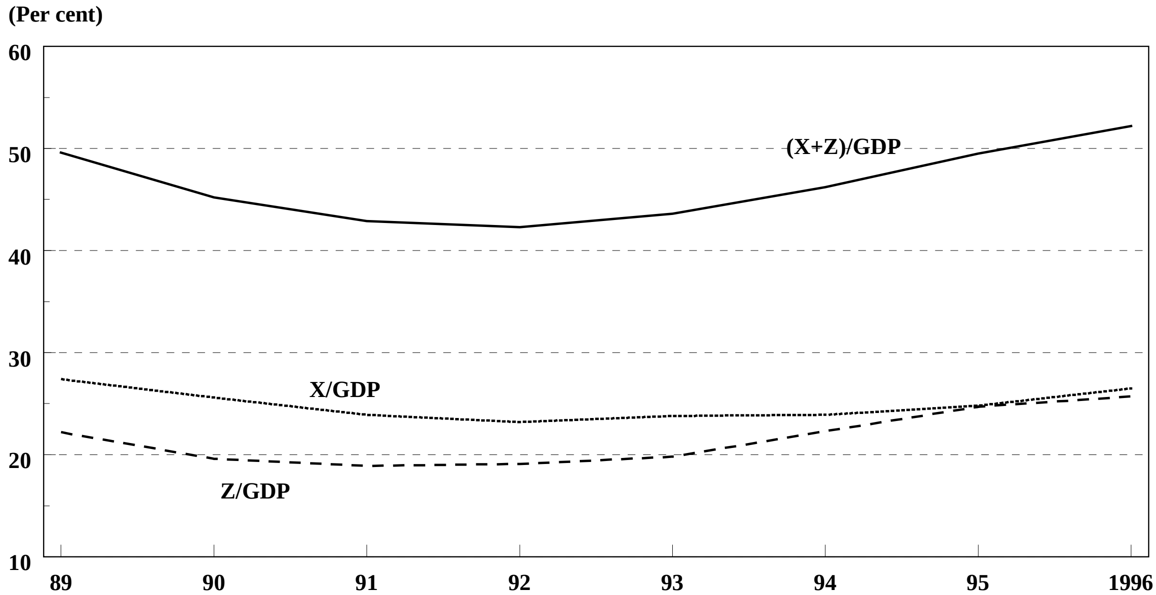
16. Since 1992, there has been an increase in South Africa's share of trade to GDP, from just over 40% to over 50% (Chart I.2). South Africa typically runs a merchandise trade surplus but this has contracted since 1994, with import growth outstripping that of exports. In consequence, South Africa's traditional service imbalance has not been offset, and there have been current account deficits since 1994.

(i) Trade in goods and services

17. As a result of South Africa's improved economic performance, and the lifting of sanctions, since 1994 merchandise imports have risen, especially imports of capital and intermediate goods such as machinery and electrical equipment. The share of machinery and mechanical appliances in total imports increased from 27% in 1993 to some 32% in 1994 and 1995 (Chart I.3). In 1996, the volume of imports of capital and intermediate goods slowed with the stagnation of manufacturing activities; the depreciation of the rand contributed to the rise in import value without seriously affecting volume, the price elasticity of non-oil imports being low in South Africa (-0.85).[7] There was a decline in the share of capital and intermediate imports in total imports to about 30% in 1996.

[7] S.A.R.B. (1996a) No. 200, June.

Chart I.2
Trade in goods and non-factor services as a percentage of GDP, 1989-96 [a]



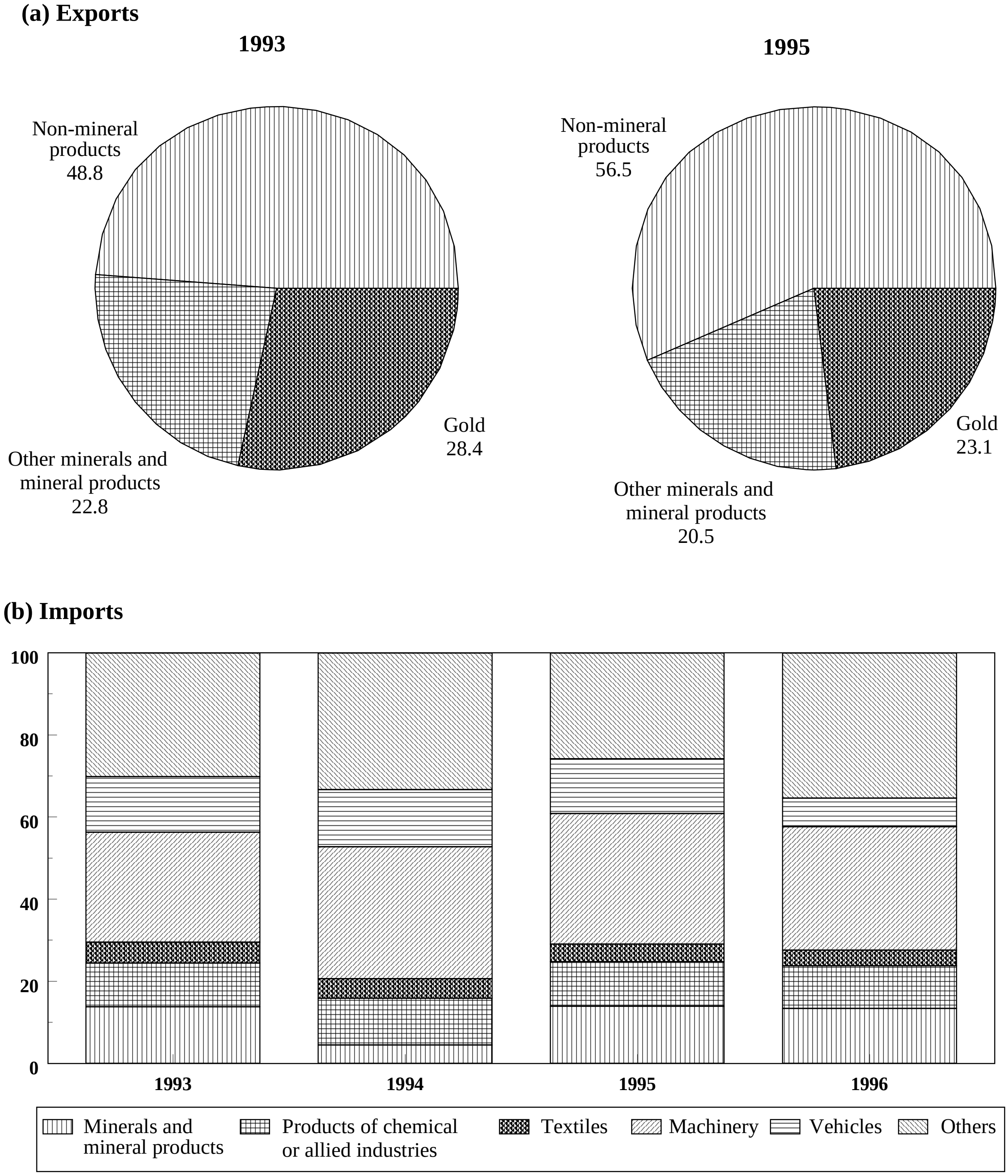
a X - exports of goods and non-factor services; Z - imports of goods and non-factor services.

Source: South African Reserve Bank, Quarterly Bulletin, June 1997.

18. South Africa's exports remain dominated by minerals and mineral products, especially gold. Agricultural exports have been negatively affected by droughts, particularly in 1992 and 1995. The share of non-mineral exports in total exports rose from 48.8% in 1993 to 56.5% in 1995 mainly because of the increase in exports of manufactured products and the decline in the production of gold. Increases in both volume and prices contributed to the rise in earnings from merchandise exports in 1995 and 1996; the reintegration of South Africa into the world economy and the resultant increase in its access to foreign markets also played its part. The depreciation of the rand, a good agricultural performance and the coming into production of new export-oriented manufacturing projects such as Columbus, which produces stainless steel, boosted exports of goods in 1996; in addition to manufactured goods, exports of mineral products, such as coal, ferrochrome and nickel, also rose.[8]

[8] The price elasticity of exports of manufactured goods are estimated at 1.40; these products are also sensitive to international business conditions (SARB, 1996a).

Chart I.3
Breakdown of trade, by main commodities, 1993-96
(Per cent)



<u>Source</u>: **Data provided by the South African authorities.**

19. South Africa's trade (both imports and exports) with Asian and European countries increased between 1992 and 1995 (Chart I.4); its exports to African countries have also increased. Manufactured products, such as machinery, motor vehicles and fertilizers, constitute the bulk of South Africa's exports to African countries. South Africa imports raw materials, including agricultural products (e.g. cottonnene, tobacco, wood and red meat), and minerals (e.g. diamonds and crude petroleum oils) from Africa. South Africa exports minerals, mineral products and agricultural products, such as fruit and wine, to developed countries, and imports capital and intermediate goods from these countries. Italy, Japan, the United States, Germany and the United Kingdom were the largest markets for South Africa's exports; each of these countries bought between 5 and 8% of South Africa's exports in 1995. In the same year, the main suppliers of imports to South Africa were Germany, the United Kingdom, the United States and Japan; each of them supplied between 9 and 16% of total imports.

20. South Africa is a net importer of broad categories of services. Net payment of investment income is the principal source of deficit in the services account, with such scheduled payments accounting for over 55% of the services deficit in 1992 and for around 50% in 1995 (Chart I.5). The decline in the share of net income payments abroad in South Africa's services deficit resulted from the rise in net freight and insurance payments abroad, with the latter rising in line with increased merchandise imports. The increase in service payments abroad has not been offset by the rise in net receipts that has resulted from the surge in international arrivals, both for business and tourism, especially from outside Africa.

(ii) Foreign investment

21. South Africa's reintegration into the international capital markets and its financial reforms have contributed to the growing participation of foreigners in its financial markets. Portfolio and short-term investments have represented the largest part of capital inflows to South Africa since the 1994 political change. The short-term structure of capital inflows has enhanced the vulnerability of South Africa to changes in market sentiment. Compounded by uncertainties in the South African foreign exchange market and the depreciation of the rand from mid-February 1996, this structure favoured large speculative capital outflows in March and April 1996.

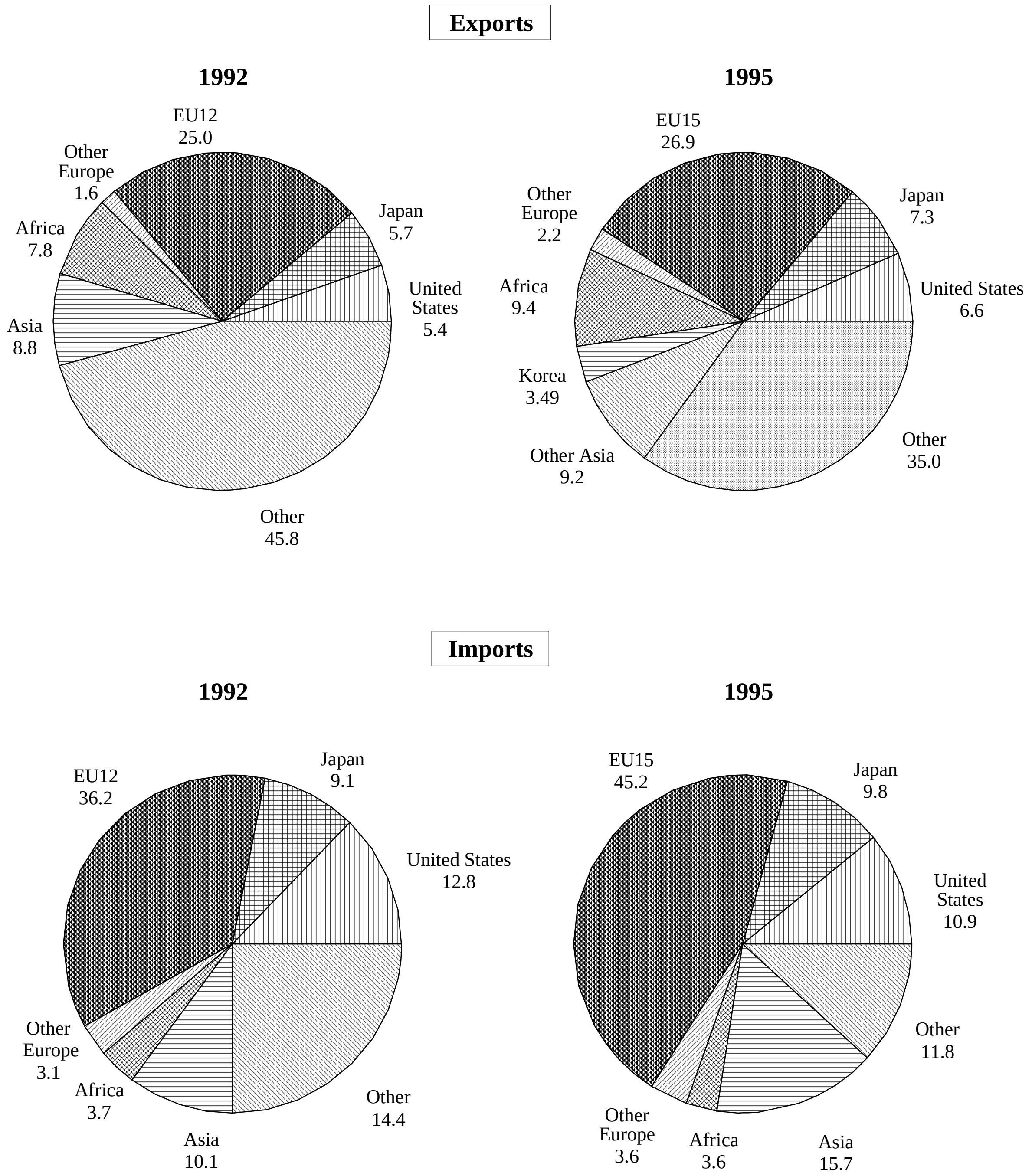
22. Foreign direct investment (FDI) into South Africa was some R 59 billion at the end of 1996 compared with about R 21 billion in 1989. About 80% of FDI into South Africa is from Europe (Chart I.6).[9] The United Kingdom is the largest single source, followed by Germany and the United States. More than 40% of FDI into South Africa was for activity in manufacturing, mainly food and beverages, motor industry, and electronics and information technology. The bulk of FDI consists of equity positions in existing businesses. FDI in financial and business services represent some 30% of the total.

23. Outward FDI by South Africa has been mainly, into Europe (Chart I.7), which received 90% of the total of nearly R 115 billion in 1996, as against some R 33 billion in 1989.

[9] Charts I.6 and I.7 are based on the latest available complete data.

Chart I.4
Trade by partner, 1992 and 1995

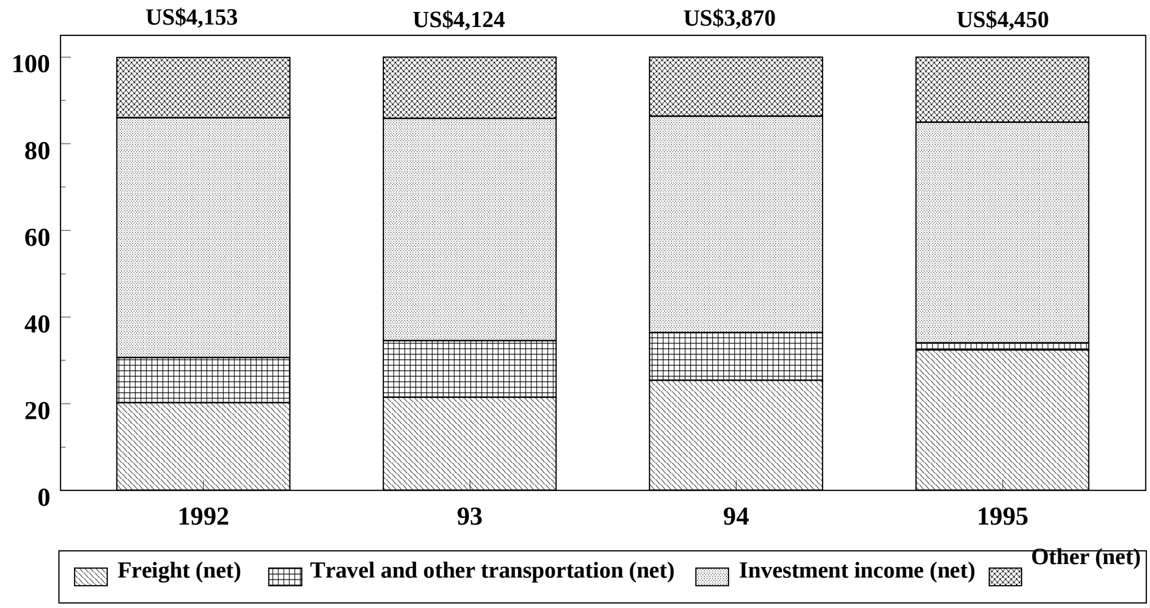
(Per cent)



Source: International Monetary Fund, Direction of Trade Statistics, Yearbook 1996.

Chart I.5
Deficit in trade in services, 1992-95

(Per cent and US$ million)



Source: Data provided by the South African authorities.

(4) Outlook

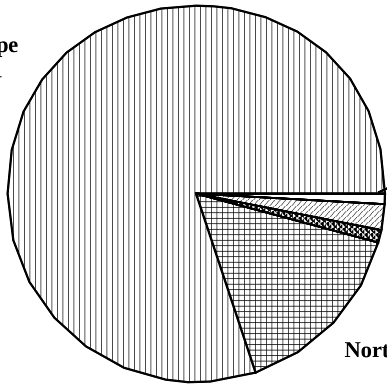
24. The 1996 macroeconomic strategy on Growth, Employment and Redistribution (GEAR) is aimed at achieving high export-led economic growth and creating employment on a sustainable basis and in a stable macroeconomic environment.[10] In keeping with the goals set in the Reconstruction and Development Programme (RDP), the GEAR provides for the pursuance of a tight monetary policy, aimed at the attainment of long-term stability of the real effective exchange rate and the reduction of inflation; fiscal consolidation will also contribute to containing inflationary pressures. The gradual liberalization of exchange controls will be pursued and tariff reforms will be accelerated. The restructuring of incentive schemes, tariff reforms and moderate wage increases are aimed at promoting export-oriented manufacturing activities (with emphasis on labour-intensive industries and small, medium and micro enterprises) by making them more cost competitive.

[10] Government of South Africa (1996a).

Chart I.6
Origin and sectoral distribution of foreign direct investment into South Africa, 1994

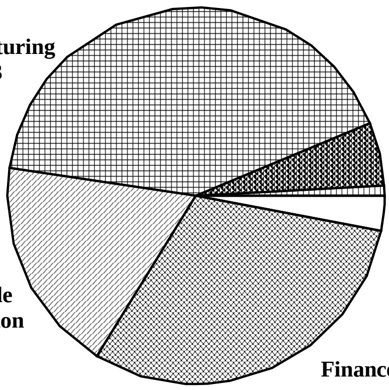
(Per cent)

(a) Origin



Total FDI: R 36,024 million

(b) Sectoral distribution



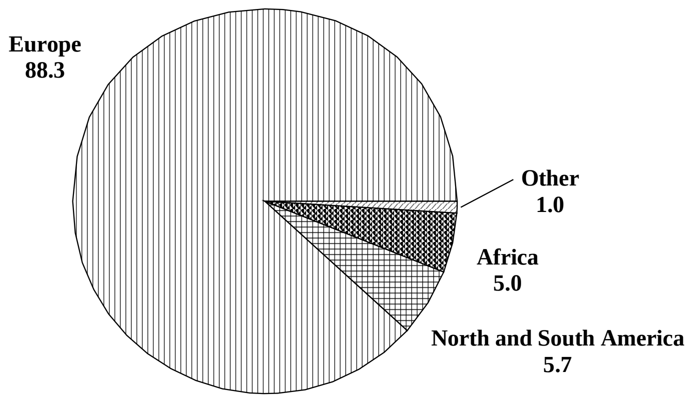
Total FDI: R 36,024 million

a Including construction (53.3%); transport, storage and communication (43.3%); and community, social and personal services (3.3%).

Source: South African Reserve Bank, Quarterly Bulletin, March 1997.

Chart I.7
Destination of South Africa's outward foreign direct investment, 1994

(Per cent)



Total FDI: R 74,896 million

Source: South African Reserve Bank, Quarterly Bulletin, March 1997.

25. The implementation of the measures provided for by the GEAR strategy is expected to result in a progressive rise in economic growth to around 6% in the year 2000 (Table I.3). By maintaining the ratio of tax to GDP at around 25% and reducing the ratio of real government consumption to GDP from nearly 20% in 1996 to some 18% in the year 2000, the authorities intend to reduce the fiscal deficit to 3% of GDP by 1999. GEAR envisages an acceleration of employment growth to 409,000 jobs per year (largely in the private sector) in the year 2000. The volume of manufactured exports is projected to increase by annual rates of around 10% in the period to 2000. However, because of the higher growth rates of imports that would result from economic growth and the related services payments abroad, the ratio of the external current account deficit to GDP is projected to rise from around 1.5% in 1996 to around 3% in the year 2000. A gradual increase in capital inflows, mainly inward FDI, is expected to offset the rise in the external current account deficit.

Table I.3
Macroeconomic projections, 1997-2000

	1997	1998	1999	2000	Average
Fiscal deficit (% of GDP) (fiscal year)	4.0	3.5	3.0	3,0	3.7
Import weighted average tariff	8.0	7.0	7.0	6.0	7.6
Average real wage growth, private sector	1.0	1.0	1.0	1.0	0.8
Real effective exchange rate (% change)	-0.3	0.0	0.0	0.0	-1.8
Real bank rate	5.0	4.0	3.0	3.0	4.4
Real non-gold export growth	8.0	7.0	7.8	10.2	8.4
Real export growth, manufacturing	12.2	8.3	10.5	12.8	10.8
Additional foreign direct investment (US$ million)	365	504	716	804	509
GDP growth	2.9	3.8	4.9	6.1	4.2
Inflation (CPI)	9.7	8.1	7.7	7.6	8.2
Non-agricultural formal employment growth	3.0	2.7	3.5	4.3	2.9
External current account deficit (% of GDP)	2.0	2.2	2.5	3.1	2.4
Gross private savings (% of GDP)	21.0	21.2	21.5	21.9	21.2

Source: Government of South Africa (1996), Growth, Employment and Redistribution - A Macro-economic Strategy.

Annex I.1 Foreign exchange regime

26. Established in 1961, abolished in 1983 and reintroduced in 1985, South Africa's dual exchange rate system comprising a commercial and a financial rand was terminated on 13 March 1995. Since then South Africa has maintained a managed floating exchange rate system, with no margins in respect of exchange transactions. The U.S. dollar is the intervention currency. There are no taxes or subsidies on purchases or sales of foreign exchange.[11] South Africa accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Agreement of the International Monetary Fund on 15 September 1973. The South African rand is convertible for external transactions in goods and services; restrictions apply to some capital movements and transfers, mainly by residents.

27. For the purpose of exchange control, all countries outside the Common Monetary Area (CMA), which consists of Lesotho, Namibia, South Africa and Swaziland, constitute the non-resident area and their currencies are foreign currencies; exchange restrictions do not apply to the other CMA members (Chapter II(5)(ii)(b)). Exchange for permitted imports is made available by the authorized dealers to whom the South African Reserve Bank has delegated some of the exchange licensing powers that it exercises on behalf of the Treasury. Exporters and companies must repatriate their foreign currency earnings within 30 days of accrual.

28. The annual authorized travel allowances are R 80,000 for adults and R 25,000 for children. Non-residents' access to domestic credit is limited to amounts equivalent to their shareholders' equity. Currency transfers for investment abroad are limited to R 30 million per project for approved new investments and to R 50 million to non-CMA members of the Southern African Development Community (Chapter II(5)(ii)(c)).

[11]IMF (1996).