South Africa

key figures

• Land area, thousands of km²	1 221
• Population, thousands (2002)	44 759
• GDP per capita, $ (2002)	2 376
• Life expectancy (2000-2005)	47.7
• Illiteracy rate (2002)	14.0

South Africa

TEN YEARS AFTER THE END OF APARTHEID, South Africa has achieved budgetary discipline and contained inflation, but still faces the daunting task of reducing inequalities and enhancing growth performances.

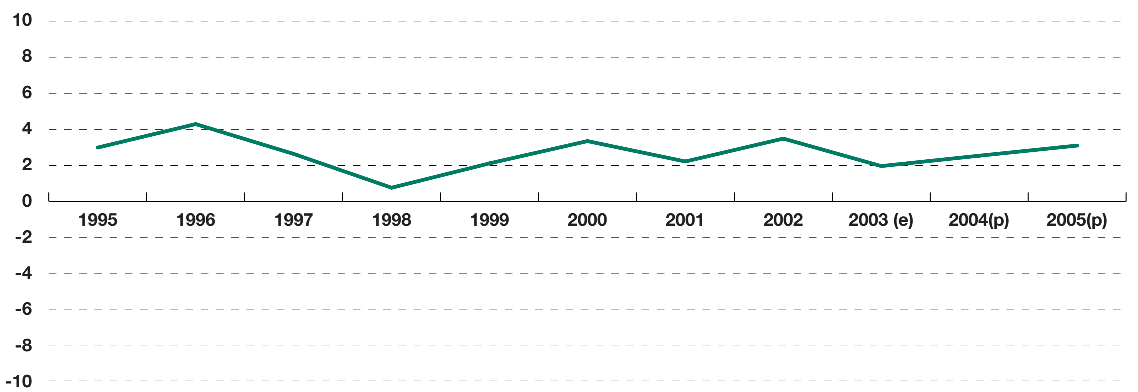
The pace of recovery, which started in 1998 and culminated with a 3.6 per cent growth in 2002, lost momentum in 2003 owing to the strong appreciation of the rand and the 2002/03 drought that led growth to fall to 1.9 per cent. Growth is expected to resume in 2004 and 2005 at average rates of 2.5 and 3.1 per cent, supported by lower interest rates and a weakening rand.

Despite a positive outlook, both investment and output growth are still below the levels necessary to reduce unemployment — which stood at 31 per cent in 2002 — and to achieve more equitable income distribution. Moreover, the country is faced with major social challenges including poor management of social and education systems, principally reflecting poor spending, a high prevalence of HIV/AIDS infection (20 per cent of adult population), and a high level of crime.

In late 2003, the government released a "Ten Year Review" to evaluate the progress and shortcomings of the first ten years of democracy in South Africa. The review identifies the leadership's new priorities, laying out plans to improve social inclusion (by fostering Black Economic Empowerment programmes), encourage skill development, and improve health care. Specifically, in November 2003 the government launched a National Antiretroviral Programme that will triple funding for HIV/AIDS from ZAR3.3 billion to ZAR12 billion (from $437 million to $1.6 billion) over the next three years. This decision, which marks a gradual shift in the South African policy for dealing with the epidemic, has been widely applauded. The success of the programme will however depend on the government's effective political commitment and the ability of provinces to take initiative. The uneven quality of spending and limited absorptive capacity, especially at provincial and local levels, may prove to be impediments to the effective roll-over of the treatment.

Ten years after the end of Apartheid, South Africa still faces major social challenges such as wide income inequality, high unemployment rates and poor quality of spending.

Figure 1 - **Real GDP Growth**

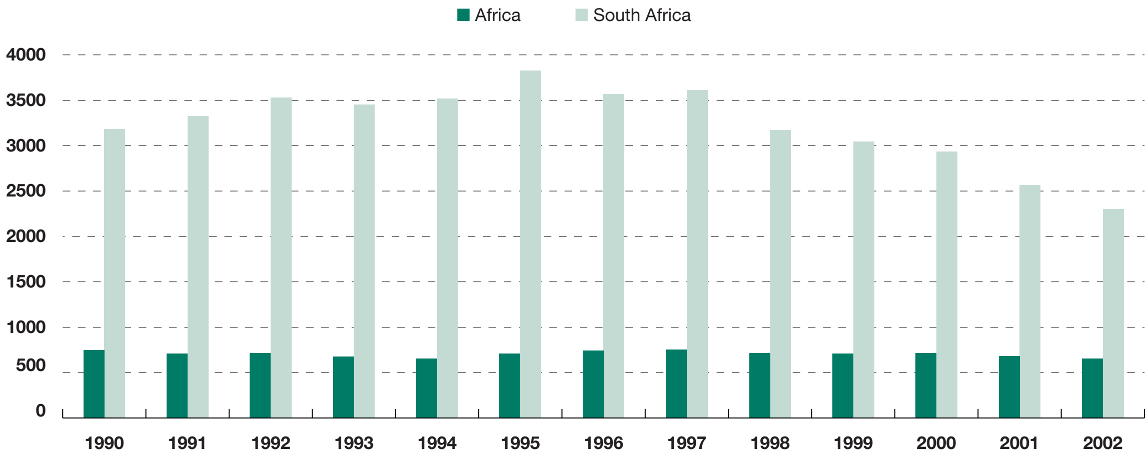


Source: South African Reserve Bank data; projections based on authors' calculations.

Recent Economic Developments

The South African economy inevitably suffered with the slowdown of the global economy, but supported by strong macroeconomic management and a highly competitive exchange rate, it began to recover in 1998, and growth reached a peak of 3.6 per cent in 2002. This performance resulted in an overall strengthening of

Figure 2 - **GDP Per Capita in South Africa and in Africa** (current $)



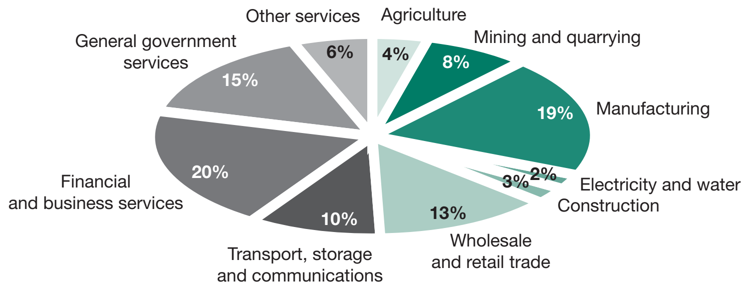
Source: IMF.

confidence in the economy and South Africa's long-term foreign currency debt was upgraded to BBB in May 2003. However, the pace of recovery dropped off in 2003. The 28 per cent appreciation of the rand against the dollar in 2003, as well as feeble international growth, had a severe impact on domestic exports. Combined with a sharp decline in agricultural production as a result of adverse weather conditions, estimated growth for 2003 was 1.9 per cent, significantly below the original target of 3.3 per cent.

Whereas the manufacturing sector strongly benefited from the depreciation of the rand in 2001 and 2002, the rebound of the currency at the end of 2002 constrained both export-oriented industries and the import-competing sector in 2003. The global economic slowdown is also partly responsible for the poor performance of the manufacturing sector. In 2003, increased import competition resulted in a significant contraction in the production of radio, television and communications equipment, basic metals, and chemical products, with a marked effect on employment in local companies. Only the automotive industry continued to perform well in 2003. On the back of a 40 per cent annual increase in vehicle and transport equipment exports between 1996 and 2003, manufactured goods doubled as a percentage of total exports, from 12 per cent in 1996 to 24 per cent in 2003. This is mainly attributed to the Motor Industry Development Programme (MIDP) that was introduced in 1995. It promotes the selective production of vehicle models by granting import duty rebates on the component parts of exported vehicles. The cost competitiveness of the South African automotive industry is threatened however, by the recent appreciation of the rand, rising labour costs and growing competition from South East Asia.

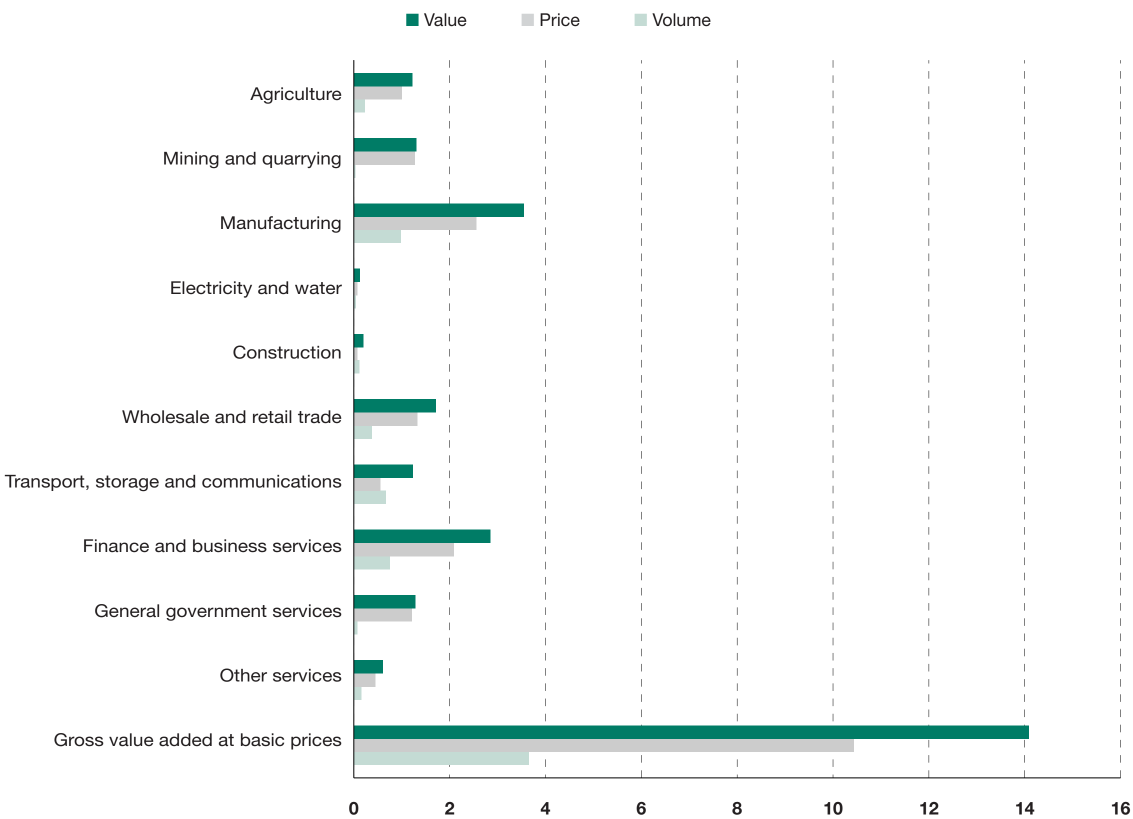
The mining sector registered mixed performance in 2003. The continuous slow decline in gold production (which fell by 2 per cent in 2003) was offset by robust growth in platinum, coal and diamond output. In particular, platinum volumes increased by 14.9 per cent in 2003, driven by automotive industry demand for its use in catalytic converters. Despite real growth in output, the mining sector has been adversely affected by the appreciation of the rand. This led to a 14 per cent contraction of mining revenues in 2003 over 2002 when they stood at around ZAR160 billion ($15.2 billion). Reduced revenues and a rising domestic cost base have put industries under increasing cost pressure. In particular, a 10 per cent increase in mining wages following tense negotiations with the National Union of Mineworkers in 2003, and administrative price setting by *parastatals* are responsible for increasing operating costs (water and electricity prices increased by 18 per cent and 8.5 per cent respectively in 2003), while rail tariffs increased by 35 per cent in the year.

Figure 3 - **GDP by Sector in 2002**



Source: Authors' estimates based on South African Reserve Bank data.

Figure 4 - **Sectoral Contribution to GDP Growth in 2002**



Source: Authors' estimates based on South African Reserve Bank data.

The new Mineral and Petroleum Royalty Bill (under discussion in early 2004) will further undermine the industry's cost base, according to which the state will claim an extra 2-8 per cent revenues on various minerals. Mining companies strongly oppose the proposed bill, which should cost the industry about ZAR5 billion ($662 million), arguing that royalties should be charged on profits rather than turnover. The Chamber of Mines has claimed that lower revenues and higher costs have transformed the country from the world's least expensive large-scale gold producer to the most expensive in the course of 2003. As a result, a number of mines are losing money, with 70 000 of the sector's total 120 000 employees facing retrenchment. Many mines have cut capital expenditure, with clear negative implications for future production. In particular, Angloplat, the leading producer of platinum, has reduced its investment provisions for the 2000-2006 period by 28 per cent, also contracting its output objectives for 2006 by about one-third. Platinum output is forecast at only 2.9 million ounces in 2006 (from 2 million ounces in 2002), compared to 3.5 million ounces originally forecast by the Chamber of Mines. Companies are therefore trying to focus on productivity enhancement and cost competitiveness and are negotiating a forward-looking perspective on inflation-linked wage increases with the government.

Over the past two years, some progress has been achieved in promoting economic empowerment for blacks in the mining sector, in line with that sector's empowerment charter, which calls for 15 per cent non-white ownership of mining companies' local assets within five years (increasing to 26 per cent in ten years). In late 2003, the merger of three companies, African Rainbow Minerals, Anglovaal and Harmony Gold Mining, created South Africa's largest black-controlled mining company. Following the merger, 43 per cent of the company — called ARM — will be black-owned.

The tertiary sectors continued to expand throughout 2002 and 2003, recording 3.1 per cent growth in both years. Growth of real output in the retail and motor trade sub-sectors, reflecting lively consumer demand for durable goods, more than offset the decrease in foreign tourism (accommodation and catering) experienced in 2003. While a record number of non-residents visited South Africa in 2002, the recovery of the rand, the general uncertainty linked to the war in Iraq, as well as fear about the spread of SARS were important factors in reducing the number of tourists. With the rand expected to resume a downward trajectory, tourism should rebound in 2004.

Over the same period, the transport, storage and communication sector grew by an estimated 6.2 per cent. Growth was spurred by continued expansion in the telecommunications industry, as the introduction of a third cellular telephone operator – Cell C – in 2001 remained an impetus to growth, compensating for the transport sector's weakened activity linked to reduced export volumes in 2003. Affected by the global downturn, the financial intermediation, insurance, real estate and business services sector decelerated steadily from 6 per cent in 2000 to about 3.5 per cent in 2002 and 2.7 per cent growth in 2003. This was due to lower trading volumes on the JSE Security Exchange of South Africa, but was partly counterbalanced by the good performance of the real estate sector, reflecting a solid housing market.

Agriculture's share of total output is about 4 per cent of real gross value added. However, it remains an important sector in terms of employment, accounting for 10 per cent of the country's jobs. Growth in agriculture is extremely volatile and relies upon output prices and weather conditions. The pronounced decline of 2001 was followed by a strong recovery in 2002. In contrast to many Southern African countries, which suffered from widespread crop failures due to drought in 2002, agricultural output in South Africa grew by 6.5 per cent. However, poor weather conditions in 2003 caused a contraction in output by an estimated 5.9 per cent. The maize harvest, which is the most important field crop (white maize, in particular, is the staple food for millions of people in South Africa), decreased to 9.7 million tonnes in the 2002/03 season compared to 10.1 million tonnes in 2001/02. As a result, the country will be obliged to direct its large food reserves towards meeting internal demand therefore sharply reducing its capacity to send relief to other countries in the region. Maize output is likely to contract further in the 2003/04 season as the dry spell in the South African maize belt in autumn 2003 affected the planting season, causing 20 per cent less land to be planted compared to the previous season. Total maize harvest is estimated around 7.2 million tonnes. Dry conditions have also pushed prospects for wheat production in 2003/04 to below normal levels: the expected wheat crop for 2003/04 is 1 478 thousand tonnes, compared to 2 390 thousand tonnes in the 2002/03 season.

Table 1 - **Demand Composition** (percentage of GDP)	1995	2000	2001	2002	2003(e)	2004(p)	2005(p)
Gross capital formation	**18.1**	**15.7**	**14.9**	**16.1**	**15.7**	**17.1**	**18.2**
Public	4.3	4.0	3.7	3.9	4.3	5.0	5.6
Private	13.8	11.6	11.2	12.2	11.4	12.1	12.7
Consumption	**81.0**	**81.6**	**81.5**	**80.5**	**81.6**	**79.5**	**78.6**
Public	18.4	18.8	19.0	18.8	19.5	19.5	19.4
Private	62.6	62.7	62.4	61.8	62.1	59.9	59.2
External Sector	**0.9**	**2.8**	**3.6**	**3.3**	**2.7**	**3.4**	**3.2**
Exports	23.0	28.6	30.6	33.3	28.4	29.5	29.8
Imports	-22.1	-25.8	-27.0	-29.9	-25.7	-26.0	-26.6

Source: South African Reserve Bank data; projections based on authors' calculations.

Compared to other emerging economies, South Africa is still characterised by low levels of investment. The investment/GDP ratio decreased from 18 per cent in 1995 to 16 per cent in 2002. Despite government emphasis on the need for public investment as a boost to economic growth, public sector investment has not expanded at a significant pace in the last five years. However, since 2002, gross fixed capital formation has steadily increased, reflecting the higher level of government spending on expanding infrastructure to improve service delivery. On the other hand, growth of private sector capital formation has been spurred by several factors: an exchange rate conducive to importing goods, a lowering of the cost of borrowing, rising prices on international commodity markets, and finally, greater inflationary stability. Such positive developments remain fragile however, as further strengthening of gross fixed capital formation depends both on the government's ability to improve its record in delivering big projects, and on the capacity of the private sector to withstand increasing pressures from slower growth in 2003 and wage increases.

Sustained by above inflation wage increases, and a reduction in income tax and interest rates, private consumption remained buoyant in 2003. Real government consumption also increased over the same period, in line with the moderately expansionary stance of the 2003/04 budget.

The contraction of exports in 2003 as a percentage of GDP reflects the strengthening of the rand over the period. Expectations that the rand will weaken during 2004, especially against the euro, suggest that export performance will gradually recover. On the other hand, rising imports will mirror the acceleration in spending on capital goods.

Macroeconomic Policy

Fiscal and Monetary Policy

Since the start of the democratisation process, South Africa's macroeconomic policy has been directed with the goal of enhancing the government's credibility by demonstrating to the international community its commitment to stabilise the macroeconomic environment. Over the past ten years, South Africa has made tremendous progress in stabilising macroeconomic fundamentals. Since 1994/95, when the budget deficit was about 5.5 per cent of GDP, public finances have substantially improved and consolidated, resulting in fiscal contraction in real terms.

A gradual transition from fiscal austerity to a growth-oriented policy has taken place since 2001/02. However, despite growing emphasis on reducing poverty and increasing social spending, the fiscal outcomes have retained a conservative stance. Deficit ratios in the past three fiscal years have been below target, reflecting measures aimed at broadening the tax base and improving tax collection via the increased efficiency of the South Africa Revenue Service (SARS), the poor quality of social spending, and the limited absorptive capacity of the provinces and local governments, to which about 60 per cent of expenditure is channelled. Despite the government's spending re-orientation, the impact on poverty has been limited. Enormous social needs remain unmet and a large segment of the population is excluded from the formal economy — as highlighted by the high unemployment rate — and has limited access to services. In order to face these pressing social challenges, the Medium Term Expenditures Framework (MTEF) for the period 2003/04 to 2005/06 prioritises strengthening investment, increasing capital spending on economic infrastructure and social services, and promoting tax relief to create an environment more conducive to rapid growth and job creation.

Expenditures are focused on poverty-reduction measures, including social grants targeting children in need, labour-based public work programmes and skill training for the unemployed.

Overall spending on social and economic infrastructure, human capital and administrative services, is projected to grow by 5.7 per cent in 2004/05, and at a rate of 4.4 per cent over the MTEF period. Public-sector capital expenditure on urban renewal projects, roads, ports and hospital revitalisation is expected to increase in real terms from 2.4 per cent in 2002/03 to 6 per cent in 2005/06, and will be mainly channelled through an Expanded Public Works Programme. Other priority areas include increasing expenditure on healthcare, following the approval of a National Antiretroviral Programme in November 2003 that will triple funding for HIV/AIDS from ZAR3.3 billion to ZAR12 billion (from $437 million to $1.6 billion) over the next three years, and the extension of income support through the social grant system channelled through provinces. The provinces and local governments are slated to receive a 5.6 per cent real increase in their resource envelope in 2004/05. This is intended to strengthen service provision, accelerate the roll out of free basic electricity, water and sanitation services, as well as distribute school materials and initiate the antiretroviral (ARV) treatment programme.

These ambitious government plans have several shortcomings that may pose challenges to their effective implementation. Despite receiving increased resources, provinces have a very little or no discretion in deciding how the funds transferred to them by the national government should be allocated. The intergovernmental fiscal system remains highly centralised, limiting the scope for an efficient and equitable allocation of resources according to each province's needs. Moreover, although the government launched capacity-building programmes and initiatives to link expenditures to measurable programme objectives in 2003, improving the quality of spending remains a major challenge. Efficient service delivery at central, provincial and local levels is hampered by a series of bottlenecks, originating in an increasing shortage of skilled staff, as well as management deficiencies and inadequate systems for monitoring and evaluating performance.

On the revenue side, the main elements of the MTEF include: the introduction of personal income tax relief and a cut in tax rates on retirement funds (from 25 per cent to 18 per cent) corresponding to 1 per cent of GDP. The MTEF also includes measures to encourage research and development, and investment in productive assets, including tax deductibility for start-up costs. These measures operate in tandem with tax reforms targeted at broadening the tax base and the South African Revenue Services' redoubled efforts to improve collection. The tax burden is expected to remain above 24 per cent of GDP over the forecast period.

Deficits are therefore expected to stay within affordable levels in the medium term. In 2003/04, the overall deficit is estimated at 1.9 per cent, against a target of 2.4 per cent. Revenues were lower than budgeted, as corporate profitability, particularly in export sectors such as mining, fell in response to the economic slowdown and appreciation of the rand in 2003. These factors were also responsible for a fall in customs revenues. The drop in revenues however, was compensated by a lower than budgeted capital expenditure and a reduction in interest payments due to the lower cost of borrowing. A moderate increase in capital expenditure should lead to deficits in 2004/05 and 2005/06 of 2.7 and 2.8 per cent of GDP respectively. However, these figures are still below the government targets of 3.1 per cent of GDP for 2004/05 and 3 per cent of GDP for 2005/06.

Table 2 - **Public Finances**[a] (percentage of GDP)

	1995/96	2000/01	2001/02	2002/03	2003/04(e)	2004/05(p)	2005/06(p)
Total revenue and grants [b]	**22.5**	**23.6**	**24.7**	**24.8**	**24.4**	**24.5**	**24.8**
Tax revenue	22.0	23.2	24.2	24.4	24.0	24.1	24.4
Total expenditure and net lending [b]	**27.5**	**25.6**	**26.1**	**26.0**	**26.2**	**27.2**	**27.6**
Current expenditure	25.3	25.2	25.2	25.3	24.8	25.0	25.1
Excluding Interest	*20.1*	*20.2*	*20.5*	*21.1*	*21.1*	*21.3*	*21.5*
Wages and salaries	10.3	10.0	9.8	9.9	10.0	9.9	9.8
Interest	5.2	5.1	4.7	4.2	3.7	3.7	3.7
Capital expenditure	2.4	1.4	1.8	2.2	2.3	2.7	3.0
Primary balance	**0.2**	**3.1**	**3.3**	**3.0**	**1.8**	**1.0**	**0.9**
Overall balance	**-5.0**	**-2.0**	**-1.4**	**-1.2**	**-1.9**	**-2.7**	**-2.8**

Notes: a: Fiscal year begins 1 April.
b: Only major items are reported.
Source: South Africa National Treasury Statistics; projections based on authors' calculations.

In South Africa, the exchange rate is flexible and therefore cannot be used by the national authorities for inflation control purposes. Since 2000, the South African Reserve Bank has adopted inflation targeting as its general monetary policy objective and uses interventions on the monetary market (i.e. indirect pressures on interest rates) to restrain inflationary trends.

On 20 December 2001, the South African rand reached its lowest historic level against the US dollar (13.84: 1). Since then, the rand rebounded strongly against both the dollar and (to a lesser extent) the euro. Between the end of December 2001 and early January 2004, the South African currency appreciated in nominal terms by 105 per cent against the dollar and 50 per cent against the euro.

This substantial appreciation of the rand reflects more than the currency's mere recovery following the 2001 overshooting of the exchange rate; other factors such as a weak dollar, strong real interest rate differentials between South Africa and other financial centres (primarily the US) and an increased appetite among global investors for emerging market bonds since mid-2002 also underpin its recovery. Furthermore, the rand appreciation has been supported by the fundamental drivers of sustained commodity prices (gold and platinum prices increased by 52 and 70 per cent respectively since the end of 2001), and a shift in market perception regarding South Africa's country and currency risk. The South African Reserve Bank has indeed achieved a breakthrough in reducing its rand Net Open Forward Positions (i.e. the component of the forward book not covered by gold and hard currency reserves) to zero, thereby eliminating a major source of vulnerability for the currency and the government fiscal stance.

For all this underlying strength, the surge in the rand exchange rate may be regarded as fairly puzzling in light of the ongoing sluggishness of foreign capital flows to the country in 2003 (including portfolio investment). The strength of the rand might actually be driven largely by a surge in offshore transactions in rand derivatives (especially swaps), as reflected by the high level of unrecorded transactions in the financial account of the balance of payments. In the third quarter of 2003, these stood at more than ZAR14 billion ($1.85 billion), financing the current account deficit more than threefold. The latter development may reflect the widespread use of the South African currency to hedge transactions on commodities, just as it may equally point to intense speculation on the rand. Given this, it is possible to question the durability of the rand's present strength and to retain a view of the currency as highly volatile and susceptible to sudden shifts in market sentiment.

Inflation, as measured by the CPIX index (the consumer prices minus interest costs on mortgage bonds), peaked in October and November 2002 (reaching 11.3 per cent), mainly propelled by the lagged effect of the collapse of the rand in the latter part of 2001, and the poor performance of the agricultural sector (food accounted for 5.3 percentage points of the October 2002 peak). Since then, the country registered a dramatic drop in inflation, still strongly driven (downward this time) by food prices and to a lesser extent, by oil prices and housing costs. The 12-month CPIX index fell below the upper boundary of the inflation target from September 2003. In November 2003, it even receded to below the mid-point of the target range when it reached 4.1 per cent. While the dramatic recovery of the rand after December 2002 has been the overriding driver of the inflation rate from mid-2003 onward, other factors have been instrumental in keeping prices under check; subdued worldwide inflation (oil prices, though volatile, have remained until recently by and large within the OPEC range) and weak external demand both enabled the country to import disinflation.

With the improvement of the inflation outlook, the Monetary Policy Committee began to lower interest rates from the middle of the year. The Repo rate was cut by 150 basis points in June, by 100 basis points in August and September, by 150 basis points in October and 50 basis points in December. This resulted in what would appear to be an aggressive lowering of interest rates, amounting to a total reduction of 550 basis points in seven months.

Although nominal rates are at 1980s' levels, the 6 per cent inflation rate experienced in 2003 is significantly lower than the rates prevalent at that time. Real interest rates have doubled from 4 per cent in 1980 to 8 per cent in 2003. As a result, the South African Reserve Bank has been heavily criticised for having been too conservative in cutting rates and for not intervening more aggressively in the foreign exchange market. Some analysts have suggested that the bank missed an opportunity to stem the appreciation of the rand at the same time as replenishing the central bank's hard-currency reserves.

Despite the reduction of short-term interest rates in 2003, the prime objective of the Reserve Bank remains the attainment of the inflation target. Though positive, the outlook for inflation still bears some risks. Unit labour costs have been on a vigorous upward trend in 2003, mirroring high inflation expectations and thereby

Figure 5 - **Rand Performance versus the US dollar and the Euro**

Source: South African Reserve Bank.

acting as an impediment to the disinflation process. Moreover, allowing for the delayed impact of interest rate moves, monetary authorities are already fixing their attention on the 2005 inflation outlook. Their cautiousness is similarly underpinned by the currency's strong volatility. The central bank is seemingly concerned about avoiding any possible move that might trigger a new sharp depreciation of the rand. Overall, CPIX inflation is expected to average 5.1 per cent in 2004 and 4.4 per cent in 2005.

External Position

Although the September WTO ministerial conference in Cancun failed to achieve much in terms of reversing the unbalanced multilateral trade relations for less developed countries and middle-income countries alike, the latter, including South Africa, can claim some progress with the formation of the informal G20+ block. Although somewhat loose, the creation of this group — including Brazil, China and India — is one of the most important outcomes of the Cancun trade talks. With the potential to form alliances with certain developed countries, especially those in the Cairns Group, on specific issues such as agriculture, this group is likely to become more vocal and powerful in the future.

This alliance also paves the way for increasing South-South trade rather than concentrating on further penetrating South Africa's traditional markets, in which tariffs are already relatively low. Establishing closer trade relations with the G20+ group has now therefore been added to the agenda of South African trade policy makers, with Brazil, India and China being identified as likely partner candidates.

The effects of South Africa's free trade agreements are beginning to be felt in the external sector. Over the past four years, South Africa has concluded Free Trade Agreements (FTAs) with the EU and Southern African Development Community (SADC) and has undertaken engagements with new trading partners, particularly focusing on South–South trade.

In terms of the current FTAs, trade between the EU and South Africa has continued to grow since the conclusion of the Free Trade Agreement (FTA) in January 2000. The EU is South Africa's largest trading partner, accounting for 34 per cent of exports and more than 40 per cent of imports in 2002. The EU agreement is heavily in favour of South Africa.

As far as the SADC Free Trade Agreement, launched in 2000, is concerned, South Africa has undertaken to fast track the abolition of import tariffs on goods from the SADC region. Tariffs on 65 per cent of imports have been lifted in 2000 while 95 per cent of imports from the region will be duty free by 2005. However, South Africa still enjoys a significant trade surplus with the rest of the region, owing to the size of its economy. The export to import ratio between South Africa and the rest of the region has moved from around 5:1 in 1999 to 9:1 in 2002.

South Africa has also benefited from the Africa Growth and Opportunity Act (AGOA), passed by the US in 2000. The major sectors to benefit from AGOA include motor vehicles, clothing and textiles, as well as some agricultural chemicals and basic metals. Duties on South African exports to the US are very low and manufacturing accounts for an increasing share. South

Table 3 - **Current Account Balance** (percentage of GDP)

	1995	2000	2001	2002	2003(e)	2004(p)	2005(p)
Trade balance	1.8	3.4	4.2	4.1	0.5	1.1	0.8
Exports of goods (f.o.b.)	19.9	24.8	26.7	29.1	21.9	22.8	22.9
Imports of goods (f.o.b.)	-18.1	-21.4	-22.5	-25.0	-21.4	-21.7	-22.2
Services	-0.9	-0.6	-0.6	-0.8			
Factor income	-1.9	-2.4	-3.2	-2.5			
Current transfers	-0.4	-0.7	-0.6	-0.5			
Current account balance	**-1.5**	**-0.4**	**-0.3**	**0.3**			

Source: : South African Reserve Bank data; projections based on authors' calculations.

Africa's clothing and textile exports to the US rose by more than 30 per cent to almost ZAR2 billion ($190 million) in 2002. An emerging problem with the AGOA agreement however, is that the US government holds discretionary power to change tariff margins should South Africa's exports to the US start making dramatic inroads in its market. AGOA will expire in 2008, hence there is some urgency among South African policy makers to explore a US-SACU free trade agreement.

The product composition of major exports has remained substantially unchanged over the past ten years although some signs of diversification in the export base are beginning to emerge. Among the top ten export categories, gold and diamonds have declined considerably from 37 per cent in 1992 to 22 per cent, while coal and other ores remained stable with a 3 per cent share. In terms of manufacturing products, resource heavyweights iron and steel also maintained their share (9 per cent), but machinery and motor vehicles have increased theirs to 7 per cent from 2 per cent in 1992.

There is also limited diversity in export markets, with the United Kingdom, United States, Switzerland and Germany consistently figuring as the top four destinations for South African products. SADC countries, the rest of the African continent, India and China have only recently become more prominent on the horizon of South African exporters, while Mercosur has diminished in importance.

The depreciation of the rand boosted trade performance in 2001 and the current account deficit narrowed to 0.3 per cent of GDP. South Africa's trade performance remained robust during 2002, despite the appreciation of the exchange rate beginning in the second half of the year. Foreign earnings were supported by manufacturing exports – especially vehicles, transport equipment, machinery and electrical equipment, and by gold exports, spurred by a rise in the average price of gold. Nevertheless, the skyrocketing rand in 2003 seriously affected export earnings. In the mineral sector — which is the major foreign export earner, accounting for 20 per cent of total foreign earnings — the recovery of the currency more than offset gains from higher US dollar commodity prices, causing rand prices to fall substantially compared to 2002. Rand gold, platinum, and coal prices declined by 16, 9 and 5 per cent respectively in 2003, neutralising the increase in volumes of exported metals.

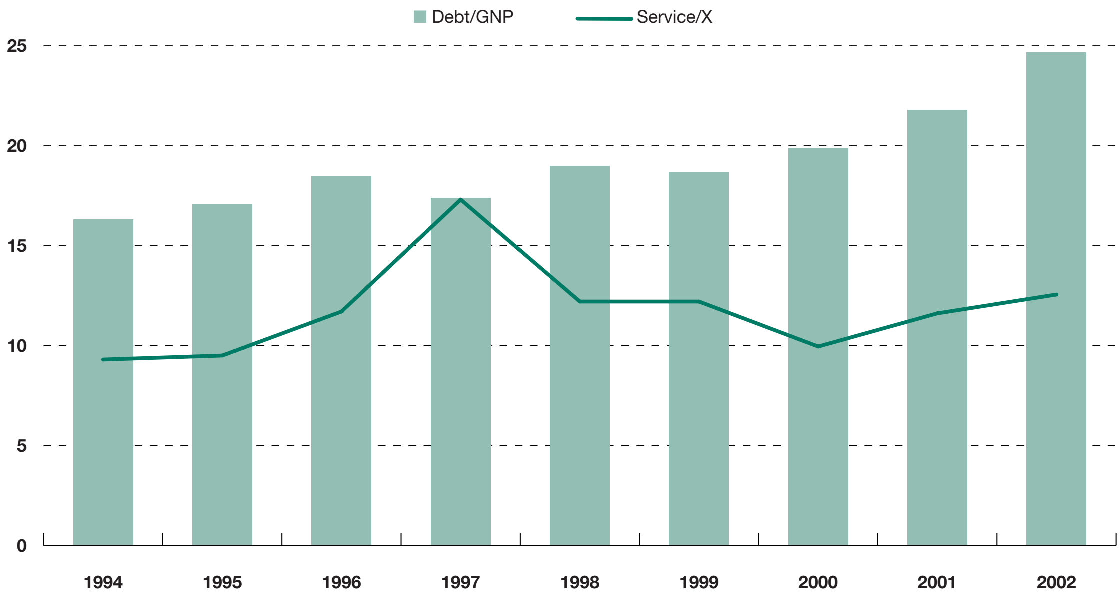
According to an analysis carried out by Trade and Industrial Policies Strategies (TIPS), the export performance picture of non-minerals is somewhat mixed. While sectors such as machinery, electrical machinery, and chemicals appear to have suffered major reductions in their real exports, other industries such as motor vehicles, food, clothing, furniture and plastics have been less affected. It is possible that these latter industries have been more flexible, expanding supply in order to compensate for lower rand denominated prices. It should also be pointed out that in order to remain competitive, some exporters have squeezed profit margins, without reducing export volumes.

The price reduction of imported goods has also been responsible for increasing merchandise imports by 2 per cent in the first half of 2003. Imports of capital goods, such as machinery, vehicles and transport equipment have dominated the surge, accounting for over three-quarters of total imports. The import penetration ratio has increased from 18.5 per cent in the third quarter of 2002 to 20.1 per cent in the third quarter of 2003.

The outcome is that after recording a surplus of 4.1 per cent of GDP in 2002, South Africa's trade balance is estimated at 0.5 per cent of GDP in 2003. Export growth is likely to pick up in 2004 and 2005, on the back of a depreciation of the rand particularly against the euro, that should boost manufacturing exports towards the euro zone. Firmer commodity prices will contribute to higher gold and platinum exports. On the other hand, imports are also expected to continue to rise, mirroring the increasing trend of private and public investments.

Foreign direct investment in South Africa remains meagre. Few transactions such as the privatisation of Telkom in 1997, as well as the restructuring of the corporate relationship between Anglo American

Figure 6 - **Stock of Total External Debt** (percentage of GNP) **and Debt Service** (percentage of exports of goods and services)



Source: World Bank.

corporation and the De Beers mining company boosted inflows in 1997 and 2001. However, if these deals are discounted, the level of inward investments has been more or less flat since 1994. In 2002, FDI inflows amounted to $754 million. Conversely, South Africa is the main source of outward FDI in Africa (they amounted to $401 million in 2002). South Africa's transnational corporations have traditionally targeted mining and breweries, largely within the region, but some also invested significantly in telecommunications in 2002.

South Africa's foreign currency denominated debt increased to $25 billion at the end of December 2002 from $24 billion in 2001. The national government's foreign borrowing on international capital markets through bond issues, as well as loans to finance the arms procurement programme, are largely responsible for this increase.

Structural Issues

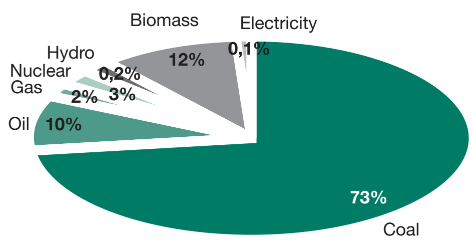
During the 1990s, the government launched a restructuring programme of state-owned enterprises (SOEs) focused primarily on the key economic sectors of telecommunications, energy, defence and transport. SOE-reform was motivated by several objectives: improving the access of historically disadvantaged sections of the population to services such as telecommunications and electricity; increasing efficiency and reducing costs; and reducing public debt through revenues gained from privatisation. One of the pillars of the restructuring programme, discussed in fuller detail below, was to encourage black economic empowerment (BEE) through the sale of discounted shares and preferential procurement.

In the process of restructuring state assets and liberalising markets previously controlled by state monopolies, new regulatory systems have been established, specifically in the transport, telecommunications and energy sectors.

A 1998 White Paper on Energy Policy set the basis for that sector's restructuring programme, which aims to unbundle and privatise the national electricity company, ESKOM. The impact of the envisaged power sector reform and the crucial role played by ESKOM is best understood in the context of the country's energy system.

South Africa's very large coal reserves account for more than 70 per cent of its primary energy. It is relatively cheap by international standards, and coal for electricity production in particular, is among the cheapest in the world. With negligible gas and oil reserves, most of South Africa's liquid fuel requirements are imported in the form of crude oil. In terms of renewable energy, the country possesses good conditions for solar and wind power though hydro potential is very limited. Biomass, mainly used for cooking and heating, accounts on average for 12 per cent of South Africa's primary energy supply. Much of the primary energy is transformed into final energy, such as electricity and liquid fuels. South Africa's final energy demand in 2000 was composed of: electricity (20 per cent); coal (32 per cent); liquid fuel (31 per cent); biomass (13 per cent); other fuels (3.7 per cent); and natural gas and renewables (less than 1 per cent).

Figure 7 - **Structure of Domestic Energy Supply in 2001**



Source: International Energy Agency.

ESKOM supplies about 96 per cent of South Africa's electricity requirements, equalling more than half of the electricity generated on the African continent. The company owns 24 power stations, including several coal-fired power stations, gas turbines and one nuclear power station with a total nominal capacity of 40 585 MW. The national company is among the top seven utilities in the world in terms of generation capacity and among the top ten in terms of sales. It is also one of the cheapest electricity producers due both to the immense capacity of its plants and the relative size of its investment needs. Built in the 1980s, ESKOM's plants have not required capital investment for several years and the cost of older plants has mostly been amortised. However, it is anticipated that by 2007 ESKOM will reach its maximum production capacity and new power stations will have to be brought on-line. In order to support these investments, prices will have to rise.

Some 26 461 km of transmission lines owned by ESKOM span South Africa and carry power to neighbouring countries. However, their stretch poses certain transmission loss and supply quality problems. About 60 per cent of the company's electricity output is delivered directly to customers, with the remainder distributed by about 240 municipal distributors. Domestic consumers account for just 18 per cent of electricity consumption, with the remaining bulk being absorbed by the mining sector. According to 2002 figures, two-thirds of households have access to electricity. The biggest challenge remains to bring power to the immense formal and informal settlements. Distance makes some isolated rural areas difficult to connect to the grid.

The average price of electricity for rural and residential customers is $0.28kWh though this does not cover the full cost of supply. The total annual internal cross-subsidy to these customer categories exceeds $132 million. Moreover, many municipalities face the combined problems of non-payment by a substantial portion of their low-income consumers, resultant debt to ESKOM, inefficiency, and a lack of technical and managerial capacity.

Although ESKOM's performance appears highly efficient when judged by African standards, a series of problems would seem to justify a reform process. Chief among these is the imminent exhaustion of current capacity and the necessity of investing in new power plants. An additional reform imperative is the need to improve the poor performance of many municipalities. In order to avoid excessive price increases, it will be crucial to create a competitive environment that can invest in generation capacity while sustaining the delivery and expansion of affordable electricity services.

Over the past decade, the pace of the reform has been slow. A "managed liberalisation" plan proposed in 2001 called for 10 per cent of ESKOM's existing generation capacity to be sold to BEE, followed shortly thereafter by the sale of an additional 20 per cent to a strategic equity partner in order to secure foreign direct investment. In the medium term, transmission (wires, system and market operations) would remain an ESKOM subsidiary before becoming an independent state-owned company. On the distribution side, six regional electricity distributors owned by both ESKOM and the municipalities would be established. This unbundling programme was scheduled to commence in 2003, but it incurred delays and is now expected to take place over the next two years.

Within this framework, private investment opportunities in the sector are at the moment primarily focused on generation. The Department of Public Enterprises is currently studying how to allocate the ESKOM plants so that no single company will obtain excessive market power and each generation cluster is financially viable. Significant obstacles to foreign investment in the sector exist beyond generation; first, in order to gain investor confidence, it is imperative that an independent transmission network be created. Regarding distribution, it remains unclear who will bear the risks associated with the cost of restructuring and how municipalities will be compensated for the loss of electricity reticulation. Furthermore, until the regional electricity distribution networks are operational, significant private investment in this area will not take place.

No major privatisation took place in 2003, with the exception of the final disposal of Aventura Resorts and the listing of Telkom, the State Telecommunications Company.

The further sale of 28 per cent stake in Telkom[1] reduced the government's shareholding to 39 per cent. The sale involved a primary listing on the Johannesburg Stock Exchange and a secondary listing on the New York Stock Exchange on 4 March. The weak state of the global telecommunications market led to some disappointment with the IPO however; it netted the government around 0.4 per cent of GDP, compared to a target of one per cent. Telkom's IPO was implemented in accordance with the government's black economic empowerment objectives, promoting equity ownership, procurement and skill transfers. This took place via a two-tiered offering targeted to favour historically disadvantaged sections of the population. However, Telkom continue to retain its stranglehold on the sector. Competition, which was legally supposed to commence on 7 May 2002, with Telkom losing its statutory monopoly on basic services is being delayed. The Second National Operator (SNO) and the under-serviced area licences had not been issued as of February 2004.

Restructuring (in the true sense of the word rather than a synonym for divestiture) however, proceeded with a new management team in place at Transnet, the state transport company, and laid the groundwork for the concession of ports operations. During 2003, the Department of Public Enterprises' efforts to restructure the transport sector were directed at raising the efficiency and delivery capacity systems, responding to raising criticism and concerns about passenger security and cargo service predictability.

However, progress in restructuring Transnet has been slower than anticipated. Its largest division, Spoornet, which is responsible for rail freight and long-distance passenger services, operated without a permanent CEO for most of 2002 and 2003. This had obvious implications for impeding the pace of its quality and efficiency reforms. In addition, Spoornet's

1. A stake of 30 per cent of Telkom's shares was sold in 1997 to Thintana (a consortium of Malaysia Telkom and Southern Bell Corporation, U.S.), a further 3 per cent of Telkom's shares were subsequently sold to BEE company Ucingo in 2001.

recapitalisation needs and capacity problems posed another major challenge over the period. Although some critical upgrades and refurbishments were completed to maintain current capacity levels, the bulk of recapitalisation is not expected before the end of 2004. Delays in the restructuring process were further hampered by the suspension of the concession for Spoornet's luxury train service, following a fire on one of the trains in early 2003.

In contrast, port restructuring has made good progress. A proposal to establish an independent National Port Authority responsible for infrastructure provision and managing the public port estate was submitted to Parliament in March 2003. In addition, a strategic plan to concession the Durban Container Terminal is being drawn up in an attempt to mitigate the severe congestion problems experienced with container handling there. The plan envisages attracting private operators in order to increase productivity, mobilise private-sector capital for port terminal infrastructure, and accelerate black economic empowerment.

In January 2004, President Thabo Mbeki signed the Black Economic Empowerment Act into law. The policy, aimed at helping historically disadvantaged sections of the black, coloured, and Indian populations (particularly women, the disabled, youth and rural communities), is part of the government's ongoing efforts since 1994 to reverse the legacy of apartheid. The legislation brings together the aims of increasing black ownership of economic resources, human resource development (through greater managerial participation) and indirect empowerment (through preferential procurement). The programme provides for companies and sectors to be evaluated on how well they achieve these three core elements of BEE via "balanced scorecards". As an incentive to promote BEE, the government will take private companies' scorecards into account when granting licenses and concessions, selling state assets and forming public private partnerships. Though there is a measure of flexibility built into the scorecard, permitting it to be adapted to the particular circumstances of specific sectors and companies, it introduces a degree of standardisation to BEE measurement and definition.

Other key policy instruments of BEE include: offering discounted shares in privatisation offerings to encourage black ownership, giving preference to black empowered enterprises in procurement bids, offering institutional support in implementing the strategy as well as creating partnerships and drafting charters with the private sector.

Though the BEE programme will be partly financed through state funds (the 2003/04 budget envisages that over the next five years ZAR10 billion — 0.2 per cent of annual GDP — will be devoted to the programme), the commercial risks associated with it will remain with the private sector. In addition to the mining charter discussed earlier, the financial sector and the Ministry of Finance jointly subscribed to a new charter in line with BEE in October 2003. This requires that by 2010, 25 per cent of the banking sector's capital and assets be black owned.

Most privatisation transactions carried out in 2002 and 2003 envisaged some degree of BEE. Thus far, the programme has met with some success, notably in the forestry sector in which black ownership has increased markedly, bringing benefits to adjacent communities. The liberalisation of the telecommunications market also indirectly furthered the programme. The creation of Cell C, a 40 per cent black-owned company, both increased competition in the industry and furthered empowerment objectives.

On the negative side, difficulties in increasing the number of black people in executive and senior management positions remain, primarily due to a lack of managerial capabilities. In addition, poor financial management practices and reluctance among financial institutions to give start-up capital to entrepreneurs hinder the development of black-owned businesses.

Political and Social Context

South Africa's third democratic legislative and presidential elections took place on 14 April 2004. About 140 political parties registered with the Independent Electoral Commission (IEC), jostling for positions at the provincial and national levels or both.

The electoral campaign was marked by mounting tensions in the KwaZulu Natal province between the ruling African National Congress (ANC) and the InKatha Freedom Party (IFP), which has traditionally enjoyed strong support amongst the Zulu ethnic group. Despite pre-election tensions, the voting process in the region and in the country as a whole was declared free and fair by the IEC and regional observers.

As forecasted by analysts and media, the result of the elections turned out in a significant victory of the ruling party. Securing about 70 per cent of the votes (compared to 66 per in 1999), the ANC obtained its first two-third majority in parliament, with Mr. Mbeki retaining the presidency. The opposition Democratic Alliance (DA), a traditionally white dominated party, came second nationally with about 12 per cent of the votes compared to just below 10 per cent in 1999. The Zulu-based IFP came in third at the polls, with nearly 7 per cent of the votes, mainly concentrated in the KwaZulu Natal province. The ANC obtained outright control in 7 out of 9 provinces. In the Western Cape Province, ANC is expected to continue a coalition govermnent with the New National Party, successor of the ruling party during the apartheid era and now almost entirely limited to the province. A coalition government is also expected in the hotly contested KwaZulu Natal province, where the ANC secured 46 per cent of the votes, compared to 37 per cent for IFP and 8 per cent for DA, IFP's alliance partner. The dominant position of the ANC reflects the lack of a strong parliamentary opposition. The main challenge for the country is therefore the creation of significant political alternatives, beyond the current primarily white opposition party. The re-elected party is faced with the difficult task of balancing the interests of two very different constituencies: the white and new black business community, and the vast community of poor, against the backdrop of a still fragile democracy and high levels of economic inequality.

In late 2003, the government initiated a "Ten Year Review" aimed at evaluating the progress of the first ten years since South African democratisation. If the ANC's prudent economic management is widely recognised as its greater achievement, this has however, been accompanied by a high level of social exclusion. South Africa continues to face formidable challenges with unemployment averaging 31 per cent in 2002[2], 20 per cent prevalence in HIV infection rates and a widening income inequality (the Gini coefficient is 0.59 per cent). Compared to other middle income countries, South Africa performs poorly on many indicators of human development such as life expectancy, infant mortality and poverty (averaging 45 per cent in 2000). Those indicators also vary widely by race group and geographical location.

The high level of unemployment and in particular the decline in formal sector employment is arguably a major challenge facing the government to curb poverty. Factors that contribute to the unemployment problem include the chronic skills imbalances inherited from the apartheid practises, as well as obstacles to labour market flexibility that have kept labour cost relatively high in the formal sector. Among the government intervention for job creation, the most efficacious seem to be the public work programmes, aimed at providing income to poor communities by granting short-term jobs in social service to unemployed people. The main limitation to these programmes is their limited scale. In 2002, the total number of active jobs was about 45 000, only about 1.5 per cent of total unemployed. Nevertheless, the 2004 budget channelled additional resources to the Expanded Public Work Programme, projecting that over the next 5 years at least onemillion beneficiaries will be provided with employment, income and training. The success of this initiative depends on the joint efforts of the national government, provinces and private sector, and on establishing the means to monitor the progress regularly.

The acceleration of land redistribution represents another priority to reduce poverty and promote rural employment. Although progress has recently been made in restoring land to dispossessed owners during the apartheid practices, the pace of the reform is still disappointingly slow.

2. When discouraged workers are included it averages 41 per cent.

When the ANC came to power in 1994, it promised that, through voluntary means, over 30 per cent of white-owned farmland would be handed over to non-whites within five years. Ten years later, only 2 per cent has been transferred and 80 per cent of commercial farmland is still owned by some 50 000 white producers.

On the basis of annual surveys of women attending prenatal clinics, it is estimated that 20 per cent of South African adults aged 15-49 years are HIV-positive in 2002, compared to about one per cent a decade earlier.

Since the epidemic began, the government has been criticised for its failure to take concrete action to alleviate the human and economic suffering associated with the disease. The lack of a comprehensive response and co-ordination within the government, and between the government and NGOs has been exacerbated by President Mbeki's controversial antiretroviral stance. Despite a court ruling in July 2002 that requires the government to provide antiretroviral for HIV transmitted from mother to child nationwide, the government has been slow in meeting its obligations. Treatment and prevention measures have been primarily led by charity and international aid organisations, pressure groups and increasingly, private-sector companies, of which about 68 per cent currently have an internal HIV/AIDS strategy.

Several studies have pointed out the adverse economic impact of HIV/AIDS in South Africa through declines in labour force, in savings and investment. A World Bank study, published in July 2003, projected complete economic collapse within three generations in the absence of prompt government intervention. In particular, the report forecast a fall of GDP per head from current levels of $2 300 to only $1 000 by 2080.

International and internal pressure, as well as the political imperative of the 2004 election has compelled the government to act more concretely. In November 2003, the government announced a National Antiretroviral Programme which would triple funding for HIV/AIDS over the next three years, marking a gradual shift in the battle against the epidemic.

The government has set a target of training 24 000 new HIV/AIDS support workers by 2005/06 and of setting up 356 additional treatment sites with co-ordination provided by a regional centre in each of the provinces. Once this system is in place, the goal is to make antiretroviral drugs available to 50 per cent of the country's AIDS patients by 2008, or a total of around 600 000 people. The announcement of the initiative has been widely applauded, yet progress on roll-out will depend on leadership within each province and the province's ability to take the initiative from the national Department of Health. The process is therefore expected to take a long time to be implemented, and access to ARVs risks being very uneven across the country as provinces face different challenges, including insufficient human resources, lack of training of health care workers, lack of treatment literacy, delays in the procurement of the drugs, and the need for specialised equipment. Moreover, many commentators have questioned the degree of political commitment to the plan. There is still some reluctance in parts of the government to act on HIV/AIDS with appropriate urgency, and this more than anything else could determine the programme's success.

In the education sector, near-universal primary school enrolment and major gains in realising equity per learner expenditure have been achieved. Gross primary school enrolment remained steady at around 95.5 per cent between 1995 and 2001. Gross secondary school enrolment was 85 per cent in 2002, indicating a 15 per cent increase from 1992. The learner-facility ratio also declined with classroom sizes reducing from 43:1 in 1996 to 38:1 in 2001, suggesting that students are getting better access to classroom facilities.

Despite these successes, progress both in terms of advancing the quality of education and expanding the range of further education options has been slower. On this front, the country's major challenge remains developing its skill base. The Growth and Development Summit, which took place in June 2003, bringing together representatives from government, business, labour and communities, was an important initiative to address the daunting skills problem.

The agreements arising from this summit focused on promoting literacy, learnerships, strengthening the Sector Education and Training Authorities (SETAs) and broadening access to quality education and basic services. With funding from the SETAs and the National Skills fund, business and government have undertaken to draw up a register of least 72 000 unemployed learners by May 2004. Beyond this, several departments have already embarked on major learnership drives. In early 2004, more than 26 000 learners had registered. The SETAs also focus on promoting basic literacy skills to ensure that 70 per cent of workers attain basic levels of numeracy and literacy.

