'LETTER OF INTENT' - SA + IMF/[redacted] CONFIDENTIAL

Statement of Policies

1. South Africa stands at an historic watershed. The first multiracial elections are scheduled for April 27, 1994; the Transitional Executive Council (TEC) was set up on [date] and began operations on [date]. The United Nations lifted its economic sanctions on [date].

2. The progress on political and constitutional issues in South Africa occurred against a backdrop of difficult domestic economic circumstances and an increasingly severe balance-of-payments constraint. The year through June 1993 saw large drought-related maize imports, export receipts depressed by the drought and by low prices of gold and other metals, and a sharp loss of foreign exchange reserves. The Government and the political parties that make up the TEC are determined that the political transition not be allowed to founder on economic developments. Therefore, the macroeconomic strategy of the Government, with the concurrence of the TEC, is aimed at a resumption of investment and growth, preventing increases in a consolidation of the progress against inflation, and a sustainable balance of payments. In support of these policies South Africa intends to request a purchase under the CCFF in an amount equivalent to SDR 614 million, (45 percent of quota) with respect to an excess in cereals imports and an export shortfall. Recent developments in the economy and the South African policies are outlined below.

3. Macroeconomic developments in South Africa have been disquieting. The recession, which began in 1989, has been more harsh than any other since the 1930s. Real per capita GDP is now more than 15 percent lower than in the early 1980s, and more than 40 percent of the labor

force is unable to find work in the formal sector. Equally troubling, from the perspective of growth prospects over the medium term, has been the drop decline in gross saving and investment ratios in 1992, fixed investment was barely sufficient to replace depreciating capital. On the positive side, inflation has been reduced: the underlying inflation rate is currently around 7 1/2 percent per annum compared with an average rate of about 15 percent during 1985-1991.

4. In part the present dire circumstances are related, both directly and indirectly, to the historical system of apartheid, the national and international reaction to it, and uncertainties associated with the ongoing political transformation. Severe race-based distortions in the labor market and disparities in education and training under apartheid were exacerbated in recent years by the breakdown of segments of the educational system. Since 1985, financial sanctions in the form of the cessation of international lending have compelled South Africa to restrain demand in order to make payments on its international debt. At the same time, rising uncertainty resulting from the political transition and the upsurge of violence has persuaded domestic and foreign entrepreneurs to adopt a wait-and-see attitude to investments in South Africa. Exogenous factors have exacerbated matters further. The 1992 drought reduced real agricultural production by 25 percent, and South Africa's terms of trade have deteriorated steadily throughout the recession.

5. The external balance of payments position worsened in 1992 and 1993 owing to drought-related maize imports, low export receipts reflecting the effects of the drought and unfavorable metals prices, an unwillingness on the part of domestic enterprises to refinance external debt at the prevailing margins, and a bunching of principal repayments. Gross official gold and foreign exchange reserves have dropped by US$2.1 billion since August 1992; their current level is US$2.7 billion, equivalent to only 5 weeks of imports of goods and services.

6. Government finances came under increasing pressure in the early 1990s. Revenues were reduced by the weak cyclical position. At the same time it proved difficult to contain spending: expenditures on social services-- education, health, and the social pension--were increased as part of a drive toward correcting racial disparities in per capita spending and special budgetary allocations were necessitated by the 1992 drought. In 1992/93 these factors contributed to a budget deficit equivalent to an unprecedented 8½ percent of GDP. In 1993/94 the deficit is budgeted to fall to a little under 7 percent of GDP, chiefly as the result of an increase in the VAT and the end of the drought.

7. Monetary policy has carried much of the burden of South Africa's adjustment during the 1990s. In the last four years real interest rate have generally been high & positive, rising above 5 percent in late 1992, and the growth of broad money and credit have been negative in real terms. In 1993, in light of the low level of foreign exchange reserves, continued monetary stringency has been pursued (necessary) to moderate downward pressure on the rand resulting from political developments. An easing of policy would have brought sharper depreciation and risked (that would have risked) a further undermining of confidence and a resurgence of inflation. The tight monetary policy has played a major role in reducing inflation. although the costs in terms of loss of employment & output have been high. The 12-month rate of consumer price inflation fell steadily from more than 16 percent in December 1991 to less than 10 percent in December 1992. The underlying rate at present is somewhat lower: some 2 percentage points of the 9 1/2 percent inflation in the twelve months through August are attributable to the increase in the VAT. Also, the rand depreciated by 12 percent in nominal terms during the first 9 months of the year, and by nearly 7 percent in real effective terms through August.

8. In order to redress the social backlogs that are the legacy of decades or apartheid and its predecessor policies, South Africa's economic policies must be driven by the objective of durable

growth in which all can share equitably. This will require political stability and a package of macroeconomic and structural policies that addresses the problems of high unemployment and weak investment, respects financial constraints, and promotes confidence in the economic management of the country. The outlines of this package are sketched in the following paragraphs.

9. On fiscal policy, despite the pressures for additional expenditure that will arise in the social and political transition that South Africa is now embarked upon, there is widespread understanding that increases in the government deficit would jeopardize the economic future of the country. At the same time it is recognized that unless social needs are addressed in a responsible manner, socio-political and economic stability would be difficult to obtain and sustain.

10. Fiscal policy in 1994/95 will aim at lowering non-interest recurrent expenditures to 22½ of GDP (as against 23 percent in the 1993/94 budget) and reducing the Central Government

a) deficit to about 6 percent of GDP. This fiscal framework will seek to continue the process involved in the reduction of the budget deficit--from 8 1/2 percent of GDP in 1992/93 to a projected 7% in 1993/94--but, (in light of the importance of maintaining a competitive tax structure,) will emphasize

the reallocation of existing expenditure & increased efficiency in revenue raising, rather than the introduction of new taxes

b) expenditure containment rather than raising taxes. The budgetary situation will be helped by a post-Apartheid fiscal bonus--the ending of wasteful duplication and extra layers of bureaucracy that was part of the legacy of the system--although these savings will be small in relation to total

total

expenditure. Also, the Government is committed to containing the civil service wage bill ~~consistent~~

c) ~~with no real increase in wage rates.~~

11. The attainment of the quantitative fiscal objectives will require further reordering of government priorities, both between and within functional categories. Steps to reallocate expenditure away from defence would be continued as far as is feasible and could be supplemented

be set so as to accommodate real growth, projected at 1 1/2 percent and a further slight drop in the inflation rate. (These targets will remain under review during the year: stronger than projected economic activity and an easing of the external constraint--as evidenced by a build-up in reserves and a strengthening of the rand--would warrant a more accommodating stance.) The influence of the monetary targets on interest rates, the exchange rate, and the real economy will depend on a variety of factors: most importantly, ~~wage developments~~, fiscal policy, and confidence in the economy as reflected in capital flows and exchange rate expectations. With realistic wage settlements, a realization of fiscal objectives, and a restoration of confidence, the monetary targets will be consistent with lower interest rates and higher investment.

13. Maintaining the competitiveness of the South African economy is fundamental to the objective of durable growth of output and employment. Competitiveness is influenced by a combination of internal developments--~~wage rates and~~ productivity growth--and by exchange rates. The beneficial effects of a nominal depreciation can be easily offset by the reaction of domestic factor

prices leading to a spiral of depreciation and inflation. On the other hand, internal adjustment can promote employment and investment in a noninflationary environment. An understanding of these issues has been fostered by the National Economic Forum, a tripartite body (employers, unions, and government) that has assumed a greater role in the discussion of policy options and the formulation of policies.

14. The South African labor market is distorted by enormous inequities in the distribution of education and job skills. At present levels of productivity, it will be impossible to absorb the vast number of unemployed workers at even a modest living wage. The medium-term solution, of course, is to boost productivity by improving education and training--this is a national priority in which government and business will have to participate equally. For the immediate future, the Government and the social partners are already embarked on a discussion of policies designed to

bargaining with

couple wage restraint and training in order to foster investment and promote employment. The role

promoting training & restructuring

of Government will depend chiefly on moral suasion and on leadership in ~~setting civil service wages~~

public sector wages.

~~that are sensitive to the magnitude of unemployment.~~

15. The balance of payments position will remain difficult in 1994. Even assuming that trade credits and short-term Reserve Bank credits can be rolled over, repayments will amount to some 2 percent of GDP (US$ 2.1 billion) and official reserves have already been substantially depleted. The relatively low stock of foreign debt (16 percent of GDP) should make it possible, with the lifting of sanctions, for South Africa to benefit from capital inflows. A sustained capital inflow would ease the resource constraint, reduce the pressure on external reserves, and eventually facilitate an ending of capital controls and the financial rand mechanism. But a spontaneous surge in capital inflows cannot be counted on in the initial stages of the transition as investors may continue to be hesitant to commit resources to South Africa. In the meantime, therefore, the

financial rand mechanism will be retained as a buffer against foreign disinvestment, ~~and the authorities will refrain from net intervention in the financial rand market.~~ The strategy, starting immediately, is to restore confidence by a showing evidence of political stability and financial discipline and by regularizing the external debt situation.

16. The third interim debt agreements expires in December 1993, at which point some US$5 billion of principal will remain past due. South Africa and the commercial banks have negotiated an agreement under which this amount will be repaid over eight years. Under the terms of the proposed agreement 10 percent of the debt will be paid in February 1994 with another 60 percent back-loaded to the three years 1999-2001. The maturity structure meshes with a sharp fall in other debt service obligations in 1998-99; this will help to smooth out the amortization schedule.

17. Finally, trade and industrial reform liberalization will be an important part of the restructuring of the South African economy. The ~~objective is a shift~~ from an inward-looking economy (isolated by sanctions) ~~to an export-oriented economy~~ with world demand providing an engine for growth. ~~Correspondingly, regulatory intervention will have to give way to greater~~ reliance on market forces. Specifically, the protection system will be simplified and rationalized. Import licensing and non-tariff barriers will continue to be phased out. The revised tariff structure offered to GATT in the context of the Uruguay Round involves a substantial reduction in the number of tariff lines (from more than [12,000] to about [1,000]), a significant cut in the average level of protection (from ... percent to ... percent), and greater uniformity and stability of the system. Formula duties will be phased out as new anti-dumping legislation becomes effective and the restructuring of the economy progresses. Provided the balance of payments situation is under control, the import surcharge will be eliminated by [mid-1994]. With respect to export promotion, ~~over time the system will move~~

~~toward reliance on~~ a duty drawback scheme that will allow exporters unrestricted access to imported inputs at international prices. will be investigated. ~~Once a more streamlined duty drawback scheme in place, the~~ Government will review the option of substantially reforming or abolishing the General Export Incentive Scheme (GEIS) and other export subsidy programs.

September 30, 1993