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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1995 CONSULTATIONS WITH THE REPUBLIC OF SOUTH AFRICA

1. The WTO Committees on Balance-of-Payments Restrictions and the GATT 1947 Committee on Balance-of-Payments Restrictions consulted jointly with South Africa on 29-30 May 1995. The consultations were held in accordance with the WTO Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994 and with the 1979 Declaration on Trade Measures Taken for Balance-of-Payments Purposes (BISD 26S/205). The consultations were held under the Chairmanship of Mr. P. Witt (Germany). The International Monetary Fund was invited to participate in the consultation, in accordance with Article XV of the General Agreement.
2. The Committees had the following documents before them:

Basic Document for the Consultation	WT/BOP/1
Background Paper by the Secretariat	WT/BOP/W/2
IMF, <u>Selected Economic Issues</u> , 17 January 1995 and	
<u>Supplementary Background material for the WTO</u> , 17 May 1995	
3. The opening statement of the representative of South Africa (Mr G. Croeser) is attached as Annex I.
4. The statement of the IMF representative is attached as Annex II.
5. The Committees commended South Africa for the trade and financial reforms undertaken since the last consultation, including the abolition of the financial rand system and the progressive abolition of the import surcharge. At the same time, they recognized that, because of the volatility of capital flows, the overall balance-of-payments situation remained tenuous, with a low level of international reserves. The Committees welcomed the statements made by South Africa concerning economic adjustment and the normalization of external economic relations, and noted the importance of appropriate macroeconomic policies.
6. The Committees welcomed South Africa's commitment to fully abolish the import surcharge on 1 October 1995 and to disinvoke the balance-of-payments provisions of the General Agreement on Tariffs and Trade.

ANNEX 1

Opening statement by the representative of South Africa to the GATT/WTO Committee on Balance-of-Payments Restrictions - 29 and 30 May 1995

I am happy to appear before you again today on this historic first joint meeting of your committee. On the previous occasion in 1993, I still had a formal responsibility for the administration of the import surcharge and you were then a committee of the GATT. Today you are a committee of both the GATT and the new WTO and I no longer have any policy responsibility for the surcharge. It nevertheless provides me much satisfaction to explain the motivation for the demise of the last remnants of the surcharge from 1 October 1995.

I do not wish to repeat the information already before you in the form of the 1993 Basic Document and Opening Statement in which the background to the original implementation of the import surcharge was clearly described, together with the balance of payments problems that precluded the earlier abolition of this surcharge. Furthermore, the subsequent economic developments are also set out in the new Basic Document prepared by the South African Government for this meeting. I therefore rather wish to focus this Opening Statement on the implementation of some of the economic policy measures of the Government of National Unity, especially regarding restrictions on balance of payments transactions, as well as the main considerations why the total abolition of the surcharge on imports will only take effect in October 1995.

As stated in the Preamble to the Reconstruction and Development Programme (RDP), the South African Government of National Unity believes that the only way to generate the resources needed to effectively address the problems of poverty and inequality in the South African society, would be if we can again place the South African economy on the path of high and sustainable economic growth. To this end the Government regards it as essential to create a stable economic environment conducive to economic growth that would strengthen domestic and foreign business confidence in the South African economy.

In its Reconstruction and Development Programme, the Government of National Unity has set various economic policy objectives, including among others:

- financial and monetary discipline in order to finance the Reconstruction and Development Programme, reprioritize public sector activity, facilitate industrial restructuring and establish fair and equitable user charges;
- the establishment of an economic environment conducive to economic growth; and
- trade and industry policies designed to foster a greater outward orientation so as to sustain high employment levels and levels of participation in the economy.

In order to achieve these objectives, various measures that created distortions in the South African economy and inhibited investment, trade, competitiveness and productivity needed to be addressed. These include amongst others exchange controls, relatively high levels of direct taxation, high import tariffs, the surcharge on imports, to name but a few. However, all of these measures had to be dealt with within a stable financial environment, with fiscal and monetary discipline. Consequently the Government decided to adopt a realistic but sustainable programme to address these problems gradually

(instead of a "big bang" approach) to limit serious disruption in the South African economy which could have a negative impact on business confidence and economic growth - especially as the country is already undergoing major change in a number of fields.

During the previous discussion of South Africa's import surcharge before your Committee in July 1993, reference was made to the low level of foreign reserves, when the level of gross reserves was only sufficient to cover about six weeks of imports. The uncertainty about the outcome of the elections and future political stability led to a further deterioration of our reserve position during the nine months following that meeting and prior to the South African elections in April 1994. In fact, at the time of the elections, South Africa had no net foreign reserves (including gold) and its gross reserves consisted exclusively of short-term facilities utilized by the South African Reserve Bank. This left the newly elected Government with virtually no room to implement its declared policies of abolishing exchange controls, as well as to open up the South African economy to greater competition, among others through the abolition of the import surcharge. Despite the balance of payments problems faced at the time of the 1994 Budget in June last year, as well as the very difficult fiscal challenge of reducing the budget deficit while addressing some of the social expenditure backlogs, the Government none the less demonstrated its commitment and goodwill by abolishing the import surcharges on both capital and intermediate goods.

Regarding the timing of the abolition of the remaining 15 per cent surcharge on so-called "white goods" and 40 per cent on so-called "luxury goods", I wish to refer to especially two major considerations of the Government in its decision to abolish these remaining surcharges only with effect from 1 October 1995. The first concerns continued balance of payments limitations, and the second fiscal constraints:

Following the elections and the favourable acceptance of the first budget of the Government of National Unity, business confidence and demand in the economy started to improve, with real annualized GDP growth rates of 4 per cent and 6½ per cent recorded in the third and fourth quarter of 1994 respectively. According to preliminary figures for the first quarter of this year, it is evident that the economy has started to slow down, mainly due to the decline in production in the agricultural and gold mining sectors. Of more significance, however, was the strong increase in gross domestic fixed investment in South Africa since the middle of last year with real annualized growth rates of 18 per cent and 19½ per cent in GDFI being recorded in the third and fourth quarter of 1994 respectively. This strong investment growth was mainly due to private sector fixed investment, which is of course crucial for the expansion of production capacity and job creation in South Africa.

Since South Africa still has to rely largely on imported machinery and equipment for much of its new production capacity, this increase in fixed investment has unfortunately also led to a sharp increase in the volume and value of imports. In the Basic Document prepared for this meeting, reference is made of the increase in the volume of imports of 11 per cent in 1994. In analysing the Government's considerations in its decision on the abolition of the import surcharge, it is important to also look at the more recent trends in the balance of payments, especially since the middle of 1994. In fact, during the second half of last year import volumes increased on an annualized basis by as much as 30 per cent, compared to an increase of only 14 per cent in export volumes. In value terms, imports rose by 36 per cent in the second half of 1994, compared to a 17 per cent increase in the value of exports, with the result that the current account of the balance of payments moved from a surplus of R2.6 billion, on an annualized basis, in the second quarter of 1994, to a deficit of R7 billion in the fourth quarter, and initial indications are that a similar deficit was again recorded in the first quarter of this year. In fact, in March this year South Africa experienced its first negative monthly trade balance since August 1984.

Simultaneously, however, the improvement in South Africa's political and economic situation and increased foreign credit lines to South African financial institutions, led to a turnaround on the capital account of the balance of payments with a net capital inflow of almost R9 billion during the second half of 1994 - a trend that also continued in the first quarter of this year. Initially the inflow was mostly short-term, but recent inflows have been of a more medium-term nature. The fact that the capital inflow exceeded the deficit on the current account naturally led to an improvement in our net foreign reserves and enabled the central bank to reduce its short-term liabilities. South Africa's gross reserves are however still at the relatively low level of less than 6 weeks of import cover.

In order to further stimulate foreign investment - especially direct investment - in South Africa, the Government of National Unity immediately after the elections committed itself to the abolition of exchange controls on non-residents (via the dual currency system) as well as on South African residents as soon as circumstances would permit. Some of the most important considerations for the abolition of the financial rand was a more adequate level of foreign reserves, re-access to international capital markets (which was achieved in December 1994 with the Government's US\$750 million global bond issue) and the narrowing of the discount between the financial and commercial rand exchange rates. Following the improvement in net reserves and the narrowing of the financial rand discount to only 3 percent, the Government and monetary authorities decided to abolish the dual currency system with effect from 13 March 1995 - two days before the 1995 Budget was presented.

Given the uncertainty at the time of the Budget (15 March 1995) about how the South African financial markets would react in the medium-term to the abolition of the financial rand, especially following the impact of the Mexico crisis on emerging markets (into which category South Africa has unfortunately been classified), the rapidly growing current account deficit, and the need to ensure financial stability to provide a favourable climate of investment in South Africa, the Government deemed it prudent not to add further unnecessary pressure on the balance of payments by immediately abolishing the import surcharge. In line with its general approach to avoid sudden shocks to the economy but rather to adopt a gradual but sustainable approach to economic policy adjustments, it was deemed advisable to rather postpone the abolition of the surcharge on imports till October 1995.

As far as fiscal policy is concerned, the Government has also committed itself, among others, to a reduction in the budget deficit as part of its programme to ensure fiscal discipline and to eliminate dissaving by the Government. In this regard the Government has set itself a target of reducing the budget deficit to a level of not more than 4.5 per cent of GDP by the end of the current term of the GNU (1999). Given the social expenditure backlogs in South Africa, the relatively modest economic growth at present, as well as its commitment not to increase the overall tax burden in the economy, this is indeed a very difficult process. Furthermore the scope to raise compensatory tax revenue from other sources is also very limited, with the relatively high rates of direct taxation already considered as a disincentive by foreign investors.

Notwithstanding these problems, the Government accepted the need to visibly encourage foreign trade and investment, among others by abolishing the remaining surcharge on imports as well as the tax on dividend earnings of non-residents. The immediate abolition of these two taxes would have meant a loss of tax revenue of R1.7 billion, compared to a loss of revenue of only R0.7 billion if the abolition was postponed for six months. This R1 billion smaller sacrifice of tax revenue enabled the Government to reduce the budget deficit from 6.4 per cent in 1994/95 to 5.8 per cent for the current fiscal year (compared to 6 per cent if these two taxes would have been abolished from the beginning of April 1995). This more than one half percentage point reduction in the budget deficit was very important in illustrating the Government's commitment to fiscal discipline and that its target of a deficit not exceeding 4.5 per cent of GDP by 1999 was indeed attainable.

Against the background of the balance of payments constraints, the commitment to clearly reduce the budget deficit, and the need to maintain financial stability, it was therefore decided to abolish the surcharge on imports, but only with effect from 1 October 1995.

Mr Chairman and members of this Committee, I wish to conclude by again referring to the extensive transition that South Africa is currently undergoing where economic and social distortions built into our economy and society over many years have to be addressed as speedily as possible. Although the surcharge on imports was originally implemented as a short-term measure, circumstances precluded an earlier removal of this in-built distortion in the South African economy. In order to build confidence in the Government's ability to effectively manage this very challenging reconstruction of the economy, and to encourage both domestic and foreign investment in South Africa, it is crucial that this transition takes place in an environment of fiscal and monetary discipline and to avoid as far as possible any sudden and avoidable shocks to our economy. Furthermore, a fine balance has to be achieved between stimulating economic growth and especially fixed investment, on the one hand, and managing the increasing current account deficit, on the other hand. In this regard it is perhaps pertinent to direct the Committee's attention to the concluding comments by the representative of the International Monetary Fund during your deliberations in 1993.

"In the immediate future, the need to maintain an adequate level of international reserves will remain a basic constraint on economic policy. Any sharp tightening of financial policies, however, would risk further depressing production, employment, and investment. Therefore, the management of aggregate demand and international reserves will require a delicate balance of all the available policy instruments: in particular, a steady reduction in the fiscal deficit, a careful relaxation of monetary conditions, and a supportive exchange rate will be important in the period ahead. At the same time, early and steady movement toward structural reforms, including a liberalization of the exchange and trade system, should help lessen supply constraints, restore trade flows, and strengthen the underlying balance of payments position. South Africa's access to foreign markets in both products and capital will be crucial throughout this process."

Despite many of these problems still being prevalent in the South African economy, especially the continued low level of foreign reserves, much progress has already been made in the liberalization of our exchange and trade system through tariff reduction and rationalization, the abolition of the dual currency system, and now with the final abolition of the import surcharge on 1 October 1995. Thank you Mr Chairman.

ANNEX II

Statement by the Fund Representative to the WTO Balance of Payments Committee

The new Government faces the enormous challenge of rebuilding an economy damaged by decades of apartheid and years of sanctions. Apartheid has left huge backlogs in areas such as education and training, housing and social infrastructure, and health care. At the same time, the restrictive, inward-looking policies adopted in response to sanctions have weakened the economy and its ability to redress social backlogs quickly while still respecting basic fiscal and external constraints. Indeed, renewed growth has underscored the fundamental weaknesses in the economy and the balance of payments: a still fragile political situation and high labor costs which impede much needed foreign direct investment, levels of domestic saving and investment that are inadequate to achieve the high growth needed to reduce unemployment, and a long-sheltered, uncompetitive industrial sector.

The lifting of trade and financial sanctions has eased the constraints on growth. Real GDP grew by 1 percent in 1993, largely reflecting a recovery of agricultural production from drought. In 1994, growth faltered initially, owing to uncertainties surrounding the political transition as well as labor unrest, but rebounded in the second half of the year. Moreover, real GDP growth in 1994 was broadly-based. Generally restrictive monetary policies in 1990-93 had reduced inflation below 10 percent in 1993 and early 1994; however, late in 1994, inflation rose back up to its current level of around 10 percent (12-month rate). Despite a further rise in unemployment, unit labor costs in manufacturing continued to rise relative to producer prices during 1993 and the first half of 1994. The real effective exchange rate of the rand depreciated by 6½ percent (INS index) between end-1992 and end-1994, partly offsetting the loss of international competitiveness that has occurred since 1990.

A sharp rise in real domestic expenditures during 1994--led by investment--was reflected in an external current account deficit (0.5 percent of GDP) for the first time since the imposition of financial sanctions in 1985. In the second half of 1994 the current account deficit rose to 1½ percent of GDP, at an annual rate, owing to strong import demand, especially for capital, intermediate, and durable goods, and a weakening of export growth--particularly gold exports. Data for the first quarter of 1995 indicate that the trade balance continued to decline at a rapid pace, and it is expected that for 1995 the current account deficit could be 1½ to 2 percent of GDP. On the capital account, illegal capital flight surged in 1993 and the first part of 1994 but subsided following the April 1994 election. Since mid-1994, capital inflows have been more than sufficient to finance the current account deficit, and net official reserves (including liabilities to the IMF), which were negative before the election, increased to R 3 billion by the end of 1994, but this provides a mere 1½ weeks of import cover. The major source of capital inflow in 1994 was short-term borrowing by commercial banks, although some longer-term funds were raised in December with South Africa's successful return to international capital markets. In the first quarter of 1995, net international reserves rose to R 5 billion (2 weeks of import cover) and gross reserves, to R 12 billion (4.8 weeks of imports). Nevertheless, reserve levels remain inadequate.

The new Government has continued the policy of fiscal consolidation initiated in 1993. In fiscal year 1992/93 (begins April 1), the fiscal deficit had risen to 8 percent of GDP, from 2.5 percent of GDP in 1990/91, mainly as a result of drought-related expenditures and increased social spending. The deficit was brought down to 6½ percent of GDP in 1994/95 by improved revenue performance and by reducing recurrent expenditures in real terms. The 1995/96 budget has been formulated within a medium-term framework that aims to cut the fiscal deficit from 5.8 percent of GDP in 1995/96 to

4½ percent by 1998/99, primarily by further reducing recurrent expenditures in real terms. On the basis of current macroeconomic assumptions, the debt-to-GDP ratio is expected to decline to about 50 percent of GDP in 1998/99. Within the overall expenditure limits, it is intended to increase capital spending significantly over this period, which together with the reduction in current outlays, would improve government saving. While fiscal policy is on a potentially sustainable path, the credibility of the fiscal framework has yet to be established. Uncertainty remains concerning the re-prioritization of expenditures within announced spending limits and issues related to fiscal devolution. Furthermore, the Central Government's borrowing requirement--6 percent of GDP in 1995/96--remains large, placing the burden of adjustment on monetary policy in the short term.

In 1994, the resurgence of domestic demand and inflation indicated that monetary policy was insufficiently restrictive. To target lower inflation and to strengthen reserves, monetary policy was tightened in the latter part of 1994, and again in February 1995, when the bank rate was raised by one percentage point to 14 percent, the cash reserve requirement on banks was raised, and guidelines were adopted for the growth of M3 and of credit to the private sector. This progressive tightening by the Reserve Bank formed the backdrop for the successful abolition of the financial rand on March 13, 1995. The authorities are prepared to tighten monetary policy further as necessary to curb inflation and pressures on the balance of payments.

The Government is committed to the normalization of international relations and the liberalization of South Africa's exchange and trade regimes. Important steps have already been taken in this direction, and further liberalization is planned to open the economy to foreign competition, reduce the anti-export bias of the complex trade regime, attract foreign direct investment, and support economic growth. The recent unification of the exchange rate was carefully planned and smoothly implemented. With this step, South Africa eliminated the single remaining exchange restriction on current account transactions. The Government is committed to further capital account liberalization when the balance of payments position strengthens further.

In the trade area, South Africa has embarked on a medium-term trade reform program--in part related to commitments under the Uruguay Round--to simplify and lower the tariff structure, to eliminate import surcharges, and to improve the system of customs duty rebates for exporters. The system of import surcharges, which was reintroduced in 1985 to protect the balance of payments, is being progressively dismantled, and the 1995/96 budget announced the elimination in October 1995 of the remaining import surcharges. As part of the simplification of the import tariff structure, formula duties are being replaced by the anti-dumping and countervailing provisions of the Uruguay Round agreement. This year, a new agricultural tariff schedule will replace existing quantitative restrictions, and a new industrial tariff schedule will be completed which will sharply reduce the number of tariff lines and standardize tariff rates into six bands.

On the export side, the General Export Incentive Scheme (GEIS) introduced in 1992, which is a direct export subsidy scheme, is to be eliminated over the next three years pursuant to the Uruguay Round agreement. It will be replaced by WTO-consistent duty drawback and export pre-financing schemes. In 1995, GEIS payments were made tax-free effective March 1, and GEIS benefits on agricultural products were withdrawn on April 1. The GEIS scheme will terminate by December 31, 1997.

The Government is also moving forward on structural policies, particularly in areas of labor market reform and competition policy which are essential to foster investment and growth. A new draft labor relations act that aims to encourage less adversarial relations between workers and employers is expected to be introduced in Parliament by September 1995. The authorities are also working on

programs of privatization of public enterprises and restructuring of public assets that could stimulate foreign investment and a more competitive business environment.

The Fund welcomes the unification of the exchange rate and the Government's commitment to an open trade regime and the elimination of remaining import surcharges. With the lifting of trade and financial sanctions, South Africa should be able to address its balance of payments objectives by relying on appropriate macroeconomic policies. Further capital account liberalization would be desirable, but a cautious approach is recommended in view of the potential shocks to the balance of payments and the low level of reserves. The steps being taken to address competitiveness issues are also welcome, but they are unlikely to yield quick results. In the meantime, wage restraint will be essential to encourage investment, stronger growth, and employment gains.