SOUTH AFRICA: Staff Concluding Statement of an IMF Staff Visit

November 19, 2018

1. **Following the leadership transition, the government stepped up its efforts to improve governance and enhance the dialogue with the private sector, but reform implementation has faced headwinds**. Markets reacted favorably to the government's efforts aimed at fostering an environment more conducive to private investment, growth, job creation, and social inclusion. However, some of the initial optimism has dissipated as growth remains stuck in low gear and reform implementation has faced constraints. Economic reforms in a number of areas, in particular, strengthening the finances of state-owned enterprises (SOEs), reducing the cost of doing business, and increasing competition are proceeding, albeit slowly. The recent investment conference between government and businesses —domestic and international—on unlocking the vast investment opportunities is welcome.

2. **Some of the negative effects of the changing external environment are already being felt in South Africa despite its economic resilience**. Amid deepening global trade tensions and capital outflows from most emerging markets, nonresident investors have been selling South African assets, more than reversing the large inflows that followed the change in government, although the country has not been as badly hit as some emerging markets. The rand has depreciated, and its volatility increased. Bond yields have risen, lifting the government's financing costs. Despite important mitigating factors, such as the freely floating exchange rate, sophisticated financial and corporate sectors, and favorable currency and maturity profiles of the sovereign debt, there is no room for complacency.

3. **Against this backdrop, growth continues to lag, and economic vulnerabilities are rising**. As acknowledged in the 2018 Medium-Term Budget Policy Statement (MTBPS), on

current policies, growth will likely be insufficient to increase per-capita income and make a meaningful dent in poverty and inequality. Public debt and contingent liabilities are expected to continue rising in line with expenditure trends on wages and the interest bill and the fragile financial positions of several SOEs, particularly Eskom. Weak growth and deteriorating public finances could trigger additional capital outflows, potentially creating adverse spillovers through the interconnected financial system. Space for continuing monetary policy support is narrowing, as inflation expectations get closer to the upper end of the 3 to 6 percent target band and U.S. monetary policy tightens. Rising unemployment and inequalities could accelerate calls for populist initiatives.

4. **This is therefore a critical time to implement stalled reforms to restore confidence, attract investment, support growth, and rebuild buffers to deal with a challenging environment by**:

- ***Addressing remaining governance issues and improving the business models of SOEs***. Enforcement of existing good laws and regulations needs to be stepped up and effectiveness of anti-corruption institutions bolstered. Well-defined participation of the private sector in key segments of the economy should be secured, with the modalities carefully assessed to maximize benefits for the population. More efficient service provision by SOEs would lower input costs for households and businesses, and reduce fiscal risks.

- ***Revisiting labor market practices to help unlock job creation and reduce the cost of doing business***. Wage negotiations should ensure that salary increases are aligned with productivity gains. Small and medium-sized enterprises (SMEs) should not be subject to the outcomes of centralized negotiations that may negatively affect their cost structure and competitiveness. There is need to further reduce hiring and firing restrictions and facilitate the settlement of labor lawsuits. To reduce skills mismatches, basic education outcomes and vocational training need to be improved over time. Considerations should be given to easing visa restrictions to help mitigate skill shortages and support the tourism industry.

- ***Promoting competition in all sectors of the economy to boost business opportunities***. For instance, a competitive regulatory framework is needed to enhance South Africa’s attractiveness as a viable mining investment destination. While the revised Mining Charter represents an improvement from a previous version, costs and barriers for investors remain above those in competing destinations. The process of allocating broadband spectrum should be executed expeditiously to promote an efficient and competitive telecommunications sector with significant positive spillovers for the rest of the economy.

- ***Reducing uncertainty by clarifying some recent policy proposals***. Guided by lessons from international experience, land reform should focus on enhancing agricultural productivity and strengthening tenure security, including in urban areas where most South Africans live. At the same time, potential negative effects of land reform should be mitigated, particularly those related to the security of property rights and the health of bank balance sheets. Similarly, the proposals to nationalize the South African Reserve Bank (SARB) should be reconsidered, especially at this juncture, as they represent an unnecessary distraction with a potentially sizable fiscal cost.

5. **The authorities need to continue implementing sound macroeconomic policies to complement the reform efforts**.

- ***With the fiscal space being limited and public debt reaching uncomfortable levels, fiscal policy needs to be gradually tightened.*** The 2018 Medium-Term Budget Policy Statement (MTBPS) candidly acknowledged the difficult growth outlook, but by keeping nominal primary expenditure ceilings unchanged this implies a further increase in public debt. The 2019 main budget provides an opportunity to signal the government's commitment to debt sustainability while improving the efficiency of spending. Expenditure should be gradually rationalized by containing wages, targeting education subsidies to the most vulnerable, and reducing transfers to state-owned enterprises and entities. The impact of public infrastructure investment on growth should be enhanced by improving project selection and implementation capacity within the budget framework, while avoiding the creation of new extra-budgetary funds. Equally important, tax administration needs to be bolstered by enhancing the South African Revenue Services' (SARS) capacity to collect taxes especially from large businesses. A debt anchor could be usefully introduced in the fiscal framework to signal the government's commitment to debt reduction, and complement the existing nominal expenditure ceiling—a tool with favorable cyclical properties but with weak debt stabilization characteristics.

- ***Monetary policy should focus on anchoring inflation expectations at the mid-point of the target band to help preserve price stability and central bank credibility***. Monetary policy is not an effective tool to address structurally-induced low economic activity. With inflation expectations remaining close to the upper end of the target band, the accommodative monetary policy stance is running out of space, risking the central bank falling behind the curve.

- ***Financial sector policy should continue to be mindful of pockets of vulnerability and of the need to improve financial inclusion***. The introduction of a new financial sector regulatory model promises a welcome overhaul of the regulatory framework. Vulnerabilities in the banking system should continue to be monitored closely, including by further upgrading stress-testing capabilities, paying greater attention to governance issues and oversight of external auditors, and responding proactively to early distress signals. Efforts to enhance financial inclusion should also continue, for instance, by promoting banking competition, including through Fintech solutions.

6. **Stepping up reform implementation would help reduce policy uncertainty**, **supporting a recovery in confidence and investment which is critical in the challenging external environment**. Absent reform, macro-fiscal risks will continue to grow, making subsequent adjustments larger and more difficult. Growth could be severely compromised over the medium term, with attendant further increases in unemployment. Confidence is likely to return quickly if policies provide opportunities for entrepreneurs and innovators to generate new value and boost jobs. The economy has enormous potential supported by its diversified structure, abundant natural resources, deep capital markets and sophisticated financial system, and strong economic institutions. Renewed investment and job creation would increase living standards for all and foster greater social inclusion.