South Africa: Staff Concluding Statement of the 2024 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – November 26, 2024: An International Monetary Fund (IMF) team led by Delia Velculescu visited South Africa on November 11-25 to hold meetings with the economic authorities and other counterparts from the public and private sectors for the 2024 Article IV annual consultation. Discussions focused on policies to ensure macroeconomic stability and the structural reforms needed to durably lift potential growth, create jobs, reduce poverty and inequality, and facilitate the transition to a greener economy.

Context, Macroeconomic Outlook, and Risks

The Government of National Unity (GNU), in place since June 2024, represents an opportunity to put South Africa's economy on a path toward higher and more inclusive growth. The GNU faces massive long-standing challenges: eroding standards of living, unacceptably high levels of unemployment, poverty, and inequality, lower life expectancy relative to peers, and rising public debt and debt servicing costs, which crowd out critical spending needs. At the same time, South Africa's diversified economy, abundant mineral wealth, flexible exchange rate, credible inflation-targeting framework, deep financial markets, and ability to issue domestic-currency debt are sources of strength. The fresh mandate of the GNU offers an historic opportunity to build on these strengths and pursue ambitious reforms to safeguard macroeconomic stability and address impediments to growth to achieve higher standards of living for all.

The outlook is improving. Activity is recovering following a challenging 2023 marked by power shortages and severe logistics disruptions. Real GDP growth is projected to accelerate to 1.1 percent this year and 1.5 percent in 2025, driven by recovering domestic demand supported by renewed post-election confidence, improved power generation (with no loadshedding since end-March), and declining interest rates. Having fallen to 2.8 percent (year-on-year) in October, headline inflation is expected to average 4.5 percent in 2024 and 4 percent in 2025. The medium-term outlook critically depends on the GNU's ability to fully implement structural reforms addressing impediments to growth. Under the IMF baseline, growth is projected to reach 1.8 percent by the end of the decade, as investment recovers gradually on the back of ongoing electricity and logistics reform efforts.

Risks are tilted to the downside. A further deepening of geoeconomic fragmentation and intensification of protectionist policies, an escalation of ongoing conflicts, a deeper slowdown in key trading partners (e.g. China), or slower global disinflation could lead to exchange-rate, commodity-price, and capital flow volatility, dampening confidence, exports, and growth in South Africa. Domestically, resistance to and delays in the implementation of needed reforms could weaken confidence, increase financing costs, and erode growth. On the upside, faster and more ambitious reform implementation under the new GNU, or stronger global growth, could contribute to domestic confidence, lower financing costs, and higher exports and growth.

Policies to Safeguard Macroeconomic Stability

Fiscal policy

The mission welcomes the GNU's commitment to reducing fiscal deficits and stabilizing public debt, as indicated in its October 2024 Medium-Term Budget Policy Statement (MTBPS). The MTBPS aims to arrest the increase in public debt by containing public spending growth while safeguarding growth-enhancing public infrastructure investment. Under the IMF baseline, public spending is projected to decline more gradually given ongoing support to State-Owned Enterprises (SOEs) and insufficiently well specified consolidation measures in the MTBPS. As a result, absent additional reforms, public debt is expected to continue to rise over the medium run.

A more-ambitious-than-envisaged fiscal consolidation is necessary to place public debt on a sustained downward path. The mission recommends a consolidation effort of 1 percent of GDP per year over the next three years to achieve a primary surplus sufficient to lower debt to around 60-70 percent in the next 5-10 years. This could be achieved by cutting inefficient public spending on subsidies, curtailing transfers to SOEs, improving procurement processes (by judiciously implementing the new procurement bill), and rationalizing the public-sector wage bill (by limiting wage increases to below-inflation adjustments and incentivizing early retirement, as planned), while protecting vulnerable groups. Financing additional public investment and other social or health initiatives in a budget neutral way would likely require additional revenue measures, such as continuing ongoing efforts to strengthen tax administration, broadening tax bases, and raising other taxes to finance health insurance.

A fiscal rule anchored in a prudent debt ceiling can help underpin the consolidation and support policy credibility. Lower debt is essential to increase capacity to support the economy when shocks occur and reduce debt-service costs to make space for other critical spending. Cross-country experience suggests that well designed fiscal rules in support of clear debt-reduction objectives can help bolster credibility and reduce financing costs. The mission recommends an enhanced fiscal framework including a long-term prudent debt anchor (of around 60 percent of GDP, in line with that of peers), a credible fiscal rule (building on the existing expenditure ceiling), and an independent body to assess compliance. In the absence of a fiscal rule, the recommended consolidation would need to be more frontloaded to safeguard credibility. The resilience of the public finances can be further strengthened by bolstering public-financial and expenditure frameworks, enhancing fiscal reporting, and improving the effectiveness of public-investment management and governance.

Monetary policy

The mission welcomes the SARBs' September and November 2024 decisions to lower the policy rate by a cumulative 50 basis points. These actions have been appropriate, given that headline inflation has fallen well below the mid-point of the target range and inflation expectations have declined. As risks to inflation remain, including from slower-than-expected global disinflation and geopolitical tensions, as well as from concerns related to domestic administered prices, wages, and food inflation, the central bank should continue to carefully manage the normalization of the policy rate towards its neutral level, remaining flexible and data-driven on the pace and duration of the easing cycle.

The inflation-targeting framework has served South Africa well. However, inflation expectations have stayed above SARB's midpoint of the target range, putting pressure on inflation, which disproportionately affects the poor. The inflation differential with main trading partners also puts pressure on the exchange rate, further eroding purchasing power. Shifting from the current target band to a lower point target at an appropriate time could help lower expectations and inflation, supporting medium-term macroeconomic stability. Careful design and gradual implementation will be key to minimize potential near-term output costs. A well-calibrated tolerance band can help provide flexibility given the volatile and shock-prone global environment. Close coordination between the Treasury and the SARB and clear communication of policy plans will be critical to support credibility and anchor expectations.

A robust policy implementation framework, strong central-bank balance sheet, and transparent practices are key to supporting the effectiveness of monetary policy. The new monetary policy implementation framework is working well, supporting monetary-policy transmission. While the new GFECRA framework and recent distributions adequately safeguard the SARB's balance sheet and policy solvency, they should not substitute for needed fiscal consolidation. Going forward, the SARB's balance sheet stress-testing exercise should help guide potential distributions of realized gains while preserving the SARB's financial strength. The transparency of the monetary policy framework is strong, and the authorities are encouraged to continue to build on the progress achieved so far.

Financial sector policies

The financial sector has been resilient, and the supervisory authorities are making commendable progress toward safeguarding its stability. The implementation of the new banking-resolution framework and the new deposit insurance scheme are important milestones to safeguard the system against future shocks. The decision to impose a positive neutral countercyclical capital buffer and new loss-absorbing capacity requirement will further enhance banks' ability to deal with shocks.

Looking forward, the authorities should stay vigilant and address risks preemptively. While mitigating risks from the sizable exposure of banks to government debt primarily requires fiscal consolidation and structural reforms, continued vigilance and stress testing are key. Should risks build up, prudential measures could also be considered as needed**.** The authorities should continue to monitor non-performing loans. Harmonizing supervisory approaches between banks and non-bank financial institutions can help mitigate potential contagion and regulatory arbitrage. The SARB's plans to bolster staffing should help enhance supervisory capacity, which can be used to improve the intrusiveness of supervision, including by increasing on-site examinations.

The mission welcomes the progress toward strengthening the anti-money laundering and counter-financing of terrorism (AML/CFT) framework. The authorities have addressed 16 out of 22 action items recommended by and agreed with the Financial Action Task Force (FATF). Looking forward, efforts should continue to implement remaining items to facilitate removal from the "grey list" in 2025.

Structural reforms to bolster job-rich, inclusive, and green growth

The mission welcomes the progress made under "Operation Vulindlela" to address key sectoral bottlenecks to growth. A critical electricity reform is underway, unbundling generation, transmission and distribution and allowing for private sector participation in the sector, which has helped improve generation capacity, including renewables. In the logistics sector, freight-rail operations and infrastructure are being separated, and a policy framework for private sector participation in the freight-rail sector is being developed. Progress has also been made with the completion of the auction of high-demand spectrum, streamlining digital-telecommunications regulations and water licensing, and modernizing the eVisa system.

The authorities are encouraged to implement their agenda ambitiously, prioritizing electricity and logistics reforms, which pose binding constraints on growth:

- ***Electricity***: Efforts should continue to develop the competitive wholesale electricity market, establish a fully independent transmission system operator, and put in place regulatory frameworks for transmission and distribution. Expanding the transmission network is essential to allow connecting new renewable energy capacity to the grid. Private-sector participation in transmission can be facilitated by advancing with planned Independent Power Transmission projects, streamlining the regulatory framework, and exploring innovative financing options to de-risk investments. Eskom's financial viability must be bolstered by boosting operational efficiency, improving procurement processes, and rationalizing its wage bill, alongside efforts to recover municipal payment delays.
- ***Logistics:*** Ongoing reforms must be accelerated to attract private-sector participation in freight rail and ports, including by establishing fully independent transport and ports regulators, finalizing the legal framework for a competitive rail sector, and ensuring competitive and transparent concession processes. Transnet should improve revenue generation through the disposal of non-core assets and recovery of volumes on strategic and profitable corridors, while rationalizing wages and strengthening security.
- ***Other ongoing reforms:*** Efforts should also continue with improving water infrastructure, including by establishing an independent regulator and ensuring strong governance of the new Water Infrastructure Agency. The authorities' initiative to digitalize the payments system and public services, including by implementing a Digital ID, will foster financial inclusion, increase efficiency, and enhance tax and AML/CFT compliance. Completing the eVisa reform can help address critical skills gaps.

To unlock the economy's full growth potential, additional business-environment, governance, and labor-market reforms are needed. Such reforms, particularly focused on small and medium-sized enterprises (SMEs) as a source of growth and jobs, will not only increase output, but can also reduce inequality and poverty, alleviate policy tradeoffs, and support the green transition. Their success depends on careful prioritization, sustained implementation, clear communication, and efforts to mitigate potential adverse impacts on vulnerable groups.

- **Business environment*:*** Streamlining procedures to start a business, where South Africa lags its peers, by reducing red tape and administrative requirements can help support firm entry, investment, and employment. Strengthening cooperation between the Competition Commission and other regulators and ensuring that SMEs and micro enterprises have fair access to markets can also support competition and job growth and lead to lower prices.
- **Governance:** Further strengthening efforts to fight corruption and organized crime and tackling governance weaknesses is paramount to supporting activity, enhancing safety, and rebuilding trust in public institutions. Building on the State Capture Commission's recommendations, the authorities should continue to promote whistleblower protection, further strengthen the financial and operational independence of the National Prosecuting Authority, and bolster the autonomy of the Public Service Commission. Legislating transparent, merit-based selection and appointment of SOE boards is key to bolstering their efficiency.
- **Labor market:** Addressing labor market rigidities is essential to durably lower South Africa's high unemployment rate. Revisiting zoning regulations and improving public transportation can reduce commuting costs, especially for low-wage earners. Incentivizing apprenticeships, fostering university-business partnerships, and making job search more effective and linked to benefit provision can support employment, especially for youth. While Employment Protection Legislation (EPL) provides important legal protection against discrimination, streamlining dismissal processes, shortening dispute-resolution procedures, and providing more EPL flexibility for SMEs can help support employment. Exempting SMEs from collective-bargaining agreements could enhance their ability to create jobs.

The authorities are also encouraged to continue to enhance trade integration. The ongoing implementation of the African Continental Free Trade Area (AfCFTA)--bringing substantial benefits to exports and growth—requires finalizing negotiations on remaining tariffs and protocols on competition, investment, and digital trade. Lowering non-tariff barriers and upgrading customs systems can further promote foreign direct investment and trade. Industrial policies should focus on targeted objectives and addressing well-defined market failures, relying on horizontal structural reforms to support development objectives. The authorities are encouraged to avoid discriminating between domestic and foreign producers to prevent distorting trade and investment decisions and mitigate the risk of retaliatory responses from trading partners.

Reducing carbon emissions is essential to support greener growth. The mission welcomes the 2024 Climate Change Act, which empowers the government to set carbon budgets. Aligning the new framework with the country's climate targets, together with a more ambitious increase in the effective carbon tax (including by rationalizing allowances and exemptions) and a faster transition to renewable energy—supported by ongoing electricity reforms, private-sector investment, and concessional financing—will be key to achieving climate goals. Targeted support to affected groups and communities is essential to mitigate the impact of higher carbon prices and of shifting from coal to renewable energy sources, while ensuring that the latter's benefits are broadly shared.

The IMF mission team thanks the South African authorities and all other interlocutors for the candid discussions and their hospitality.