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Redefining South Africa's economic trajectory

How structural reform can lift South Africa from its slump

We are often asked what is needed to lift South Africa's growth trajectory from our current 'just below 2%' medium-term view. People expect a complicated answer, but it does not have to be.

With the appropriate policy choices, South Africa does not need miracles or fairy tales for a better outcome. We need sustained *implementation* of existing structural reform plans. Taking Operation Vulindlela (OV) as a starting point, this note explores what would be needed to lift South Africa's trajectory to a faster, stronger growth path. Importantly, this means that, at this stage, no new initiatives are required as many of the building blocks are in place. Many of the reforms aim to improve the South African business environment. If implemented successfully, the anticipated improvement in business confidence and private sector investment will also play an important role in tilting South Africa's trajectory upward. This would improve the lives of all South Africans.

The BER's macroeconometric model

The details of the BER's modelling process fall outside this note's scope, but we'll highlight some features. The BER's core macroeconometric model is a medium-sized semi-structural demand-orientated model with specific supply-side elements. In layman's terms, we estimate GDP from the expenditure side (by adding up household and government spending, investment and net trade). These components are determined by several interlinked model relationships, which in turn, are sometimes based on an assumption (i.e. we take a specific view on a forecast figure) or other times based on model outcomes (i.e. the model produces a forecast figure). The interlinked nature means that changing one thing impacts everything else (for example, assuming a weaker rand → higher inflation → higher interest rates → lower consumption → lower growth → stronger rand → lower inflation, etc). This is important because it ensures we stay consistent.

There is one important caveat: the model is not designed to capture the feedback loops like an economy-wide Computable General Equilibrium (CGE) model would. Such a model would also test how economic actors change their behaviour in response to policies. In short, this means that we are likely underestimating the positive impact of pursuing these policies on growth, potentially significantly so. Furthermore, CGE models allow you to disentangle what policy 'does what' to growth – see this paper by the National Treasury for such an exercise. The paper is from 2019 and thus may seem somewhat dated, but the core structure of the economy has not changed much since, and a repeat of the study is likely to result in similar outcomes.

Assumptions

STARTING POINT

We used the BER's quarterly forecast for May as a baseline that relies on a set of assumptions we made around the global and domestic economy[1]. We then tweaked some of the domestic assumptions made in the baseline (unpacked below) to study the impact over time. For example, what if we see an improved energy availability factor (EAF) and logistics become more efficient and enable more exports than assumed in our baseline? Sometimes, there was a clear lever to pull in the model (for example, there is an assumption for the EAF, which impacts investment, exports, etc.), but other times, we had to assume how a policy change would impact the model. Importantly, we have not changed the global backdrop for this exercise. This means that the positive outcome is solely on improvements to domestic assumptions. In reality, the global economy can help lift growth or work against us. This is important for growth forecasts but also impacts the currency.

We took Operation Vulindlela (OV) as a starting point for the structural reform measures required to lift South Africa's growth trajectory. OV aims to accelerate economic growth through structural reforms. The programme focuses on key areas such as energy, digital infrastructure, transport, and water to stimulate investment, improve service delivery, and enhance the competitiveness of the South African economy. OV seeks to streamline regulatory processes, remove bureaucratic obstacles, and promote public-private partnerships to drive economic development and create opportunities for all South Africans.

There is no need to reinvent the wheel. Our scenario uses OV because it is an existing plan that has already booked successes and is well supported within the public and private sectors. OV came into being during the pandemic and aimed to address the long-standing constraints that have held back the economy. Significant progress has been made on some fronts (specifically on the energy front), with OV reporting that 89% of the initial identified projects in Phase I are on track or completed. However, more work remains to be done. Our scenario models the successful implementation of the remaining structural reforms and continued progress within the four network industries—energy, railways, ports, and infrastructure—outlined by OV (and the Economic Recovery and Reconstruction Plan, ERRP).

Another important focus of OV has been on the visa system to encourage tourism growth and attract the skills needed to grow the South African economy. It is difficult to pinpoint a lever in our model that captures this, but it would further boost sentiment and aid with much-needed export earnings. Our model likely underestimates this: a sensible visa framework would boost growth beyond what we have estimated below.

[1] The modelling was done before the release of the 2024Q1 GDP data, which includes some revisions for 2023. At first glance, the steep further decline in private sector fixed investment (excluding machinery and equipment) is worrying and means that we might revise down our 2024 GDP forecast.

FUNDAMENTAL ASSUMPTIONS

The assumption that the South African constitution and Rule of Law are maintained overarches everything. Also important is that the judiciary remains independent. A more committed and speedy pursuit of the recommendations by the Zondo Commission would go above and beyond this and does not form part of this scenario. This would give a positive boost to sentiment throughout.

It is also important that the South African Reserve Bank (SARB) remains independent and can pursue its mandate without fear of interference.

The assumptions on the fiscal front are trickier. Due to the nature of the national account calculation, any form of government spending can be positive for GDP growth over the short term. However, spending on infrastructure and current line items do not have the same long-term impact on potential growth. The markets will also view them differently, with ill-advised spending resulting in higher bond yields and debt (repayments) over time. We assume that fiscal discipline remains intact, with a commitment to bring down government debt to GDP levels over time. This would include prudent funding decisions around implementing the National Health Insurance (NHI) or a Basic Income Grant (BIG). There needs to be revenue to fund such endeavours over time and, with the NHI in particular, the appropriate systems and infrastructure. This is not the case currently, but a faster economic growth rate would mean that we can implement versions of these initiatives much faster – but not now and not in the current form.

We assume policy uncertainty diminishes as reform momentum gathers pace. From a modelling perspective, this means bringing down the model's measure of uncertainty to the level of uncertainty in 2014 – a time before it started to trend higher. This is a reasonable and attainable assumption. Reduced uncertainty stimulates investment and consumption, laying a favourable foundation for economic activity. This also involves a continued willingness of the public sector to engage with the private sector, even in projects where the government leads the way.

Budging on any of these assumptions would have a significant negative impact on the economy.

REFORMS TO ACCELERATE GROWTH

This scenario models the successful implementation of structural reforms in the four network industries—energy, railways, ports, and infrastructure—outlined in Operation Vulindlela (and the ERRP), contributing to a bullish outlook for South Africa.

We assume significantly better electricity outcomes. This is achieved by leveraging private sector generation to supplement Eskom's efforts. Eskom's recent Generation Adequacy Report showcases a remarkable surge in rooftop solar energy. Higher private sector generation lowers the demand for Eskom's energy. Proper maintenance will further increase Eskom's EAF. This will support economic activity while bolstering potential growth through higher production capacity.

Apart from a stable energy supply, a finance model for transmission, including private sector participation, allows for the implementation of Eskom's transmission capex plan. Local electricity distribution needs to be reorganised too. Allowing privately generated power to be transmitted across the national grid further aids in creating more sustainable energy availability, cementing improved sentiment and stronger investment and productivity outcomes.

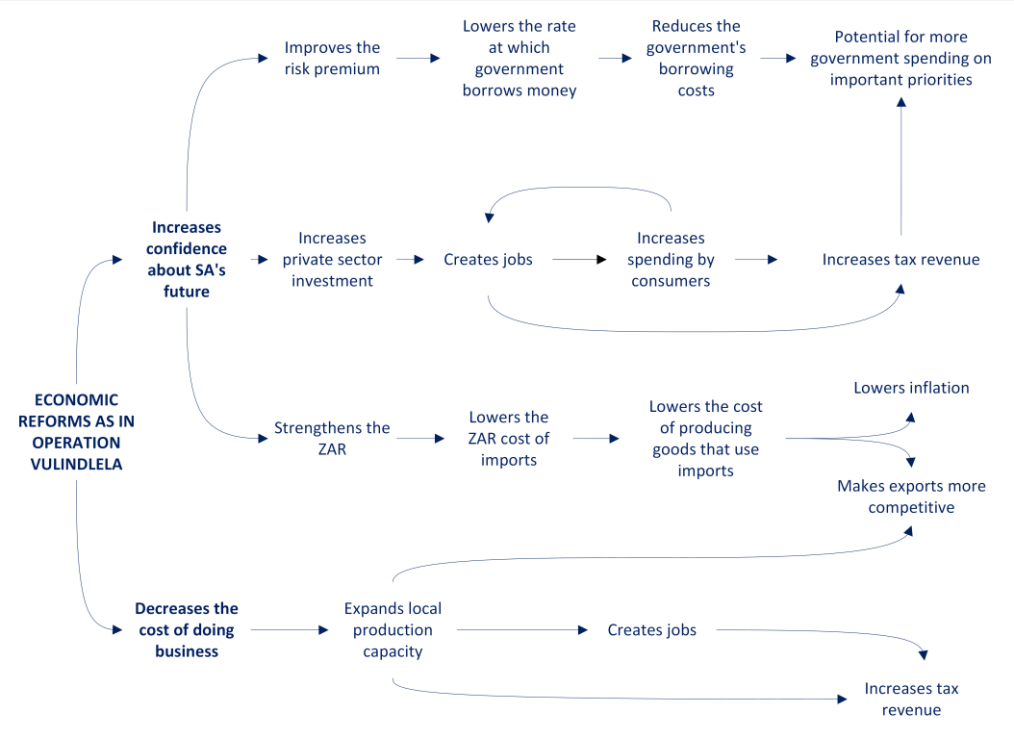
Water security concerns are addressed by expanding water infrastructure at the municipal level, overseen by an independent authority. Implementing licensing for local governments as water entities will streamline water management and ensure the efficient delivery of water services to communities. These measures aim to enhance infrastructure, ultimately contributing to sustainable water resource management and improved access to water.

The scenario also sees a reformed logistics network driven by public and private sector collaboration, particularly in rail and ports. Examples include a successful partnership between the Durban container pier and a private sector operator, a new National Ports Authority that operates the ports independently from Transnet, an independent economic regulator, and the conclusion of the 25-year concession on the City Deep/Durban line. The private sector's involvement in logistics improves operational efficiencies and enhances SA's export capabilities. Assuming railways and ports were operating at full capacity, stronger tax receipts from higher exports would contribute to the fiscus, allowing for more productive expenditure.

In our model, much also hinges on sentiment—both from businesspeople operating within the country and from investors (local and domestic) towards investing in the country. An improvement on this front helps to reduce the risk premium in the economy, boosting house prices and improving household income. This also leads to banks being less risk-averse, resulting in less tight credit standards and higher demand for credit. This lifts household consumption (especially on durable goods and services) and investment (particularly private investment).

High-level view of how economic reforms filter through to the rest of the economy

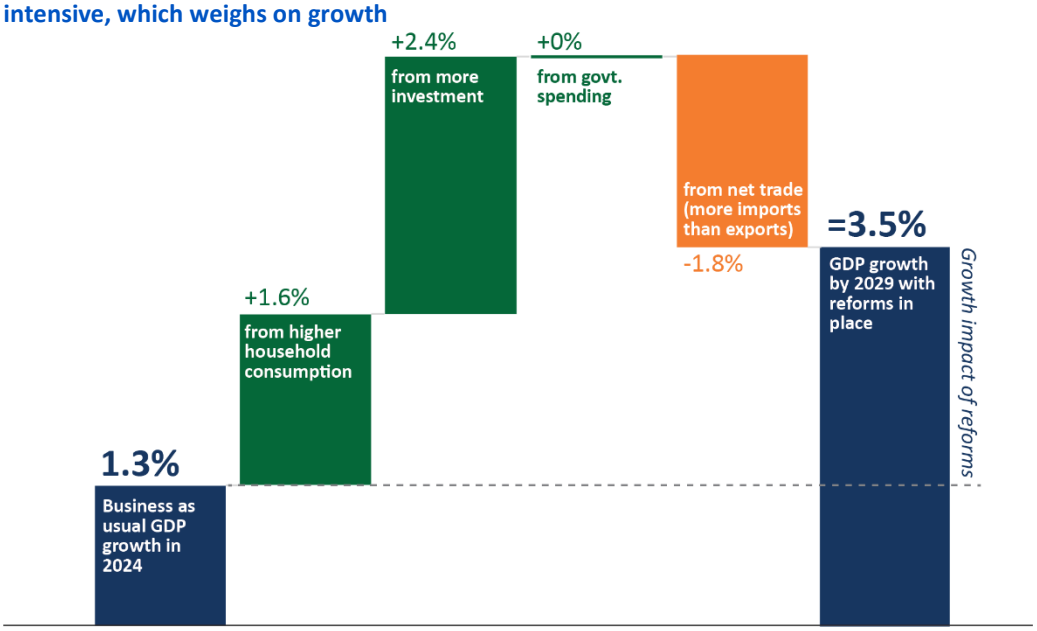
Suitable economic reforms increase sentiment (confidence about the South African economy) and reduce the cost of doing business. They also create jobs, increase tax revenue, improve international competitiveness, and more. The schema below provides a high-level view of these linkages.



Outcomes

Implementing these reforms can boost real GDP growth by 1.5 percentage points (% pts) by 2029: 3.5% vs. the 2% modelled in our baseline. The largest driver of this improvement in the growth trajectory stems from fixed investment, which is 4% pts higher by 2029, underpinned by robust private fixed investment. Given the improved energy availability and access to ports and railways, exports perform much better, reaching growth of almost 5% in 2029 vs. 3% modelled in the baseline.

Figure 1: Real GDP growth is boosted by private sector participation (investment) in energy and other infrastructure and improved sentiment that lifts consumer spending, but it is import intensive, which weighs on growth



Source: BER

However, relative to the baseline, the faster investment growth (largely import-intensive) leads to higher imports, limiting the boost to GDP growth. Higher investment and household consumption pushes import growth to 6.6% by 2029 (compared to 3.6% in the baseline). This detracts from growth. However, successfully lowering the cost of doing business in South Africa would make local production more competitive and result in even faster GDP growth than we have forecast as the production capacity expands and the need for imports declines. At the moment, higher imports also keep our current account in a relatively large deficit, which holds back the potential gains for the rand exchange rate.

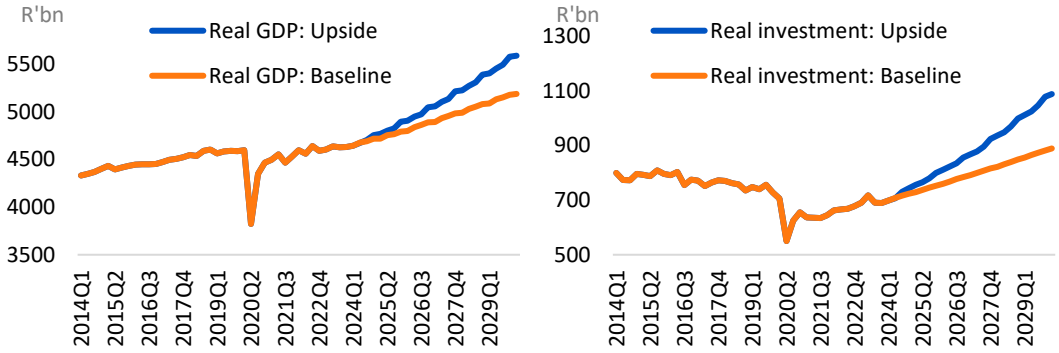
Table 1: Additional growth in expenditure components (% pts)

	Short term 2024	Medium term 2025-2026	Long term 2027-2029	Average 2024-2029
Real household consumption expenditure	0.3	1.3	1.6	1.3
Real private fixed investment	0.2	3.4	4.5	3.4
Real gross domestic expenditure	0.4	1.4	1.8	1.5
Total real exports	0.5	1.7	1.6	1.4
Total real imports	1.0	2.5	2.9	2.5
Real gross domestic product	0.2	1.1	1.4	1.1

Source: BER

The differences may seem small, but they significantly impact the level of GDP and investment over time. In this scenario, real GDP is R399.6bn (+7.7%) higher than in the baseline, and investment is a staggering R196.7bn (+22.3%) higher by 2029.

Figure 2: Successive implementation of reforms has a large impact on GDP and investment over time



Source: BER

Importantly, this scenario assumes that fiscal discipline remains intact and public debt dynamics improve due to lower borrowing costs. With a functional developmental state, the government's efforts to maintain fiscal prudence result in borrowing at better rates due to a reduced risk premium. Consequently, lower bond yields free up fiscal space, allowing for increased productive expenditure without exacerbating debt levels. The debt-to-GDP ratio ends about 2% pts lower than the baseline, while the budget deficit remains largely in line with the baseline.

The rand trades about R1/$ stronger by 2029 relative to the baseline owing to improved sentiment towards South Africa and a lower risk premium. Importantly, though, the currency could end up a lot stronger than modelled in this scenario, with spillover implications for trade, capital flows, inflation and interest rates. However, we are mindful that global factors (such as the timing of global monetary policy changes, changes in the fair value of other emerging market currencies, etc.) also feed through into the rand.

The stronger rand exchange rate, among other positive spillovers, contributes to lower price increases, while administrative prices ease with lower electricity prices. This means that generally speaking, inflationary pressures are expected to ease, outweighing any inflation caused by increased demand. As a result, headline inflation is anticipated to moderate faster than expected in the latter half of this year already, falling below the midpoint target of 4.5% by the end of the year. This creates scope for the SARB to cut by 75 basis points (bps) more in 2024 than the baseline. Over the longer term, the SARB cuts by a cumulative 125bps more than in the baseline, implying the terminal rate ends at 5.75% instead of 7%. The lower inflation and reduced interest rate outcomes lead to a more favourable credit environment. This boosts consumer and business confidence, increasing household spending, business investment, and overall economic activity.

Table 2: Summary comparison of main macroeconomic variables

	Average 2016-2022	2023	Average 2024-2029	
Main economic indicators	Actuals		Baseline BER forecast	Positive Scenario
Rand/US dollar (level)	14.76	18.45	18.40	17.58
CPI inflation	5.0	5.9	4.6	3.6
Real prime interest rate (%)	4.2	5.5	6.2	6.1
Real private fixed investment	-0.4	4.9	4.6	8.0
Real gross domestic expenditure (GDE)	0.8	0.8	1.9	3.4
Total real exports	0.9	3.5	2.9	4.4
Total real imports	1.3	4.2	3.3	5.8
Real gross domestic product (GDP)	**0.7**	**0.6**	**1.8**	**2.9**

Source: BER

Conclusion

The scenario presented is just one of the ways the coming years could play out and the next few weeks are critical. At this stage, it is easy to tell a much more negative story than presented in our baseline. Still, we can also (easily) be more positive about the economy than presented here. We have remained prudent in our assumptions, and as mentioned, our model cannot capture the changes in behaviour that would come from policy changes, which would further boost the economy. Even in this more positive scenario, South Africa still faces a huge challenge in overcoming structural unemployment and vast inequality. This cannot be solved quickly in any realistic, medium-term scenario.

Still, a committed pursuit of OV and a general dedication from all stakeholders to bringing down the cost of doing business in South Africa would improve our competitiveness. This will enhance South Africa's potential for success.

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Please refer to the glossary on the **BER website** for explanations of technical terms.