AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

COUNTRY FOCUS REPORT 2024

SOUTH AFRICA

Driving South Africa's Transformation

The Reform of the Global Financial Architecture

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ADB/AfDB	African Development Bank
ACRA	African Credit Rating Agency
AEO	African Economic Outlook
AfCFTA	African Continental Free Trade Agreement
ANC	African National Congress
BRICS	Brazil, Russia, India, China, and South Africa. Expanded in 2024 to include Iran, Egypt, Ethiopia, and the United Arab Emirates
DFI	Development Finance Institution
EAP	Energy Action Plan
Eskom	Electricity Supply Commission
G20	Group of Twenty of the world's largest economies, as well as the African Union and the European Union.
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
GFA	Global Financial Architecture
ICT	Information and Communications Technology
IFI	International Financial Institution
JET-IP	The Just Energy Transition Investment Plan
JETP	The Just Energy Partnership
MDB	Multilateral Development Bank
MtCO2-eq	Metric Tons of Carbon Dioxide Equivalent
NDC	Nationally Determined Contribution
NDP	National Development Plan
ODA	Official Development Assistance
PPP	Public-Private Partnership
R&D	Research and Development
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South Africa Reserve Bank
SDG	Sustainable Development Goal
SDR	Special Drawing Rights
SME	Small and Medium-Size Enterprise
SOE	State-Owned Enterprise
SSA	Sub-Saharan African
UMIC	Upper Middle-Income Country
USD	United States Dollar
ZAR	South African Rand

EXECUTIVE SUMMARY

The economy of South Africa has faced a series of challenges, exacerbated by the COVID-19 pandemic and subsequent economic shocks. The initial strong recovery in 2021 was a positive sign, but the deceleration in growth rates to 1.9% in 2022 and 0.6% in 2023 highlights the persistent structural issues within the economy. The constraints posed by infrastructure deficits, public sector inefficiencies, and regulatory barriers have been significant impediments to sustained growth. The fiscal pressures, with a high deficit and debt-to-GDP ratio, further complicate the economic landscape. Looking ahead to 2024-2025, the forecasted average GDP growth of about 1.5% suggests a cautious optimism, underpinned by anticipated improvements in energy infrastructure and a revival across various economic sectors. The potential decline in inflation could indeed provide a much-needed boost to household consumption and credit extension, thereby supporting economic activity. However, the risks cannot be overlooked, particularly those associated with electricity supply, logistics, and the financial health of state-owned enterprises.

A mix of policies in the short, medium and long terms could help South Africa navigate its challenges and put the economy back on the path of sustainable development. An adaptable monetary policy and a balanced fiscal policy are crucial to respond to economic fluctuations and to ensure that economic growth does not come at the expense of fiscal health. Structural reforms to improve the business environment and ensure energy security are key to achieving inclusive growth and sustainable development. In the long term, policies and public investment could be directed towards enhancing the quality of education, infrastructure, and fostering innovation.

South Africa's economy has navigated a complex landscape of transformation and challenge. The post-apartheid era brought about a surge in GDP growth (averaging 3.6% during 2000-2009), but the subsequent decade saw a deceleration (1.7% during 2010-2019). This slowdown reflects broader global economic trends and the shift towards a service-oriented economy, factors that have led to a redistribution of labor and productivity across sectors. Despite these challenges, South Africa has seen a diversification in its export composition, moving away from traditional reliance on mining, to a more varied portfolio including agriculture, manufacturing, and services. This shift is supported by the nation's commitment to good governance and macroeconomic stability, which are crucial for navigating global financial volatility. The country's economy is marked by a dynamic private sector that is integral to its growth and productivity. The information and communication technology sector in particular, has seen substantial growth. Infrastructure development has made significant strides, contributing to the overall progress. However, challenges such as climate change threaten to undermine infrastructure and productivity, while resource allocation remains a critical issue. The informal sector, vital for economic inclusivity, confronts hurdles in transitioning to more modern, productive sectors. Small and medium-sized enterprises, despite their resilience and sophistication, often find it difficult to secure credit due to stringent requirements by formal financial institutions.

To foster rapid economic transformation, the government's role in establishing robust institutions and formulating policies that capitalize on the nation's comparative advantage cannot be overstated. Equally important is the development of human capital through investments in education and skills training, tailored to the nation's needs and developmental goals. Fiscal policy enhancement, tax reform, and public sector efficiency are pivotal in fostering a conducive environment for private sector growth. The private sector's proactive involvement is vital for rapid economic transformation, aligning with government policies to stimulate innovation, sustainability, and competitiveness. Additionally, harnessing trade agreements like the African Continental Free Trade Area (AfCFTA) can unlock new markets and export opportunities, promoting economic diversification and integration. Development Finance Institutions and Multilateral Development Banks can also play a significant role in driving sustainable economic growth in developing nations by adopting sustainable lending practices and offering innovative financial solutions to attract private sector investment and mitigate risks.

The South African economy's journey towards structural transformation amidst the challenges of climate change is a multifaceted endeavor, requiring significant external financing. The African Economic Outlook reports (AEO2022, AEO2023, and AEO2024) provide a framework for understanding the financial needs and gaps that must be addressed by South Africa (and other African countries) to expedite this transformation and fund climate action by 2030. A critical aspect of this financial strategy involves increasing the tax-to-GDP ratio, which is a pivotal move to bridge the financing gap and support the country's developmental goals. The ongoing discourse on the reform of the international financial architecture is a testament to the global recognition of the need for a more inclusive and resilient financial system.

The African Development Bank's call for an overhaul to transform African economies further underscores the urgency of these reforms. The proposal to establish an African Credit Rating Agency (ACRA) marks a pivotal move towards enhancing Africa's financial autonomy and resilience. The re-channeling of Special Drawing Rights (SDRs) through MDBs is a pivotal proposal that could significantly enhance concessional finance for Africa's structural transformation, potentially multiplying the impact of these resources. The push for increased African representation in the International Financial Institutions (IFIs) is crucial to ensure that the continent's perspectives are integrated into global financial governance. These reforms are not just about creating favorable borrowing conditions; they are about laying the foundation for sustainable growth, equitable development, and robust integration into the global economy, aligning with the Sustainable Development Goals and climate action initiatives. The path to a reformed Global Financial Architecture is complex, but the collective efforts and discussions signify a promising direction towards a more equitable financial future for developing nations and the world at large.

1

MACROECONOMIC PERFORMANCE AND OUTLOOK

KEY MESSAGES

- The South African economy continued to slowdown mainly on account of worsening power cuts and transport logistics bottlenecks, compounded by several other long-standing structural and policy-related challenges. GDP growth decelerated to 0.6% in 2023 from 1.9% in 2022. Per capita GDP growth turned negative, from 1.1% in 2022 to -0.3% in 2023. Manufacturing and construction outputs remained stagnant, at 0.5% and 0.6%, respectively, in 2023, while the agricultural sector lost momentum from 0.9% in 2022 to -12.2% in 2023.
- The fiscal position has deteriorated in recent years, with the deficit estimated at 4.9% of GDP in FY23/24, influenced by the economic downturn and reduced corporate profits, coupled with a higher public sector wage bill, state-owned enterprises (SOE) bailouts, and increased debt-service costs.
- Due to higher borrowing levels, the public debt-to-GDP ratio soared to an estimated 73.9% in FY23/24. The main factors behind the higher public debt are higher interest rates, a weaker exchange rate, and elevated public spending.
- Monetary policy remains tight amid inflationary pressures. Annual inflation eased to 6% in 2023 from 6.9% in 2022, but inflationary pressures remain elevated.
- The external sector's performance in South Africa is currently facing challenges. The current account deficit widened to 1.6% of GDP in 2023, after temporarily shifting to a surplus. This trend reflects a combination of factors such as impact of rising oil prices, increased imports for renewable energy projects, and persistent supply-side constraints in the export sector such as the effects of electricity and logistics constraints, coupled by lower export commodity prices.
- The economic outlook for 2024 and 2025 presents a cautiously optimistic scenario, with GDP growth projected to recover by 1.3% and 1.6%, respectively. Growth is expected to be bolstered by a boost in construction activities linked to energy infrastructure projects and a gradual resurgence in various economic sectors as the energy supply situation improves. Additionally, a decline in inflation could potentially support household consumption and credit extension, contributing positively to the economy.
- However, risks to the domestic outlook are significant and include ongoing challenges in electricity supply, freight rail, and port operations, as well as fiscal vulnerabilities arising from SOE bailouts. Furthermore, the economy's high susceptibility to climate change-induced shocks, adds another layer of uncertainty to the outlook.
- South Africa's status as an upper middle-income country belies the persistent vulnerabilities it faces, such as high poverty rates and large inequalities, which are particularly pronounced in the townships. These issues are compounded by the impacts of globalization and regional economic dynamics, which expose the economy to both external and internal shocks. They are worsened by the dual nature of the economy and the weak structural growth and transformation.

1.1 Introduction

This chapter presents an updated analysis of South Africa's economic performance for 2023, including medium-term growth projections over the period 2024-2025. It assesses trends in, among others, key macroeconomic indicators, fiscal and monetary policies, and changes in domestic and international financial flows, investment, and public debt. The chapter discusses main downside and upside risks to the outlook and provides policy options to foster high and resilient growth; supporting macroeconomic stability and economic transformation, and deal with shocks that have continued to buffet the country economy.

1.2 Growth Performance

The South African economy continued to face significant challenges in 2023, with real gross domestic product (GDP) growth decelerating to 0.6%. While the economy recovered strongly from a deep COVID-19 pandemic-induced recession, growing strongly by 4.9% in 2021, recovery was short-lived as growth decelerated to 1.9% in 2022. The primary sector, particularly agriculture, experienced a notable contraction due to energy shortages impacting irrigation and farm operations, alongside an avian influenza outbreak affecting livestock. Despite a robust field crop and harvest, these factors, compounded by inefficiencies at ports, led to a sharp 12.2% contraction in the sector in 2023.[1] The secondary sector saw modest growth, partly due to a temporary reduction in power cuts, with manufacturing and construction witnessing a slight uptick of 0.5% and 0.6%, respectively. The tertiary sector, however, provided a silver lining, contributing a full percentage point to the overall GDP growth, with expansions in transport, finance, and personal services. The transport sector, in particular, emerged as a strong performer, expanding by 4.3%, driven by land and air transport services. Conversely, the wholesale and retail trade sectors were hampered by stagnant demand, and increased borrowing costs. Persistent logistical challenges, including deteriorating port operations and disruptions in rail services due to maintenance, theft, and vandalism, continued to hinder economic activity and exacerbate the effects of load-shedding.

On the demand side, South Africa's economic landscape of 2023 presented a mixed picture. Household consumption remained under pressure, growing by a mere 0.7% compared to the robust 2.5% in 2022. This downturn was more pronounced in the non-durables sector, where the impact of inflation increased borrowing costs, and declining real incomes led to weakened consumer confidence. In contrast, private sector investment in machinery and equipment, especially for energy self-generation, continued to bolster gross fixed capital formation, although the growth rate slightly dipped to 4.2% from 4.8% in 2022. The latter part of the year saw a diminishing growth momentum, indicating potential headwinds driven by high borrowing costs and low business confidence. Public corporations reduced their capital expenditures, with spending levels falling behind levels seen in 2019, reflecting the financial difficulties faced by major state-owned enterprises (SOEs).

1.3 Other recent macroeconomic and social developments

1.3.1 Monetary Policy

South Africa's monetary policy stance has been marked by a careful balancing act between fostering economic growth and containing inflation. The South African Reserve Bank (SARB) has navigated through a complex economic landscape, marked by external shocks such as Russia's invasion of Ukraine and subsequent geopolitical tensions. These events have had a ripple

[1] SARB 2024.

effect, causing a surge in global oil and food prices and impacting domestic inflation. The SARB's decision to initially lower the repo rate to 3.5% in July 2020 was a strategic move to stimulate economic activity in a low-inflation environment. However, facing heightened inflation risks, the SARB shifted gears towards a tightening cycle. This cycle, which began in November 2021, saw a series of ten incremental increases in the repo rate aimed at containing inflation, bringing it to 8.25% in May 2023. This level, sustained since then, represents the highest since June 2016, underscoring the SARB's commitment to its primary mandate of maintaining price stability even amidst the challenges of low economic growth and high unemployment.

The inflationary trend in South Africa has experienced significant fluctuations over the past few years.

The average inflation rate, which stood at 4.5% in 2021, was significantly impacted by the global increase in oil and food prices, pushing it to 6.9% in 2022. Despite the challenges posed by power cuts, currency fluctuations, and an avian flu outbreak, 2023 saw a return to the target inflation range (of 3%-6%) with a rate of 4.7% in July. Yet, the year concluded with a rate of 6%, indicating persistent inflationary pressures. As of April 2024, the inflation rate has been reported at 5.2%, a slight decrease from the 5.3% in March, with the main contributors being food and non-alcoholic beverages, housing and utilities, and transport costs. This ongoing inflationary pressure is largely attributed to sustained increases in domestic fuel prices, a ripple effect of the continued rise in global crude oil prices. The SARB's monetary policy stance will likely continue to adapt to these dynamic conditions, striving to achieve a delicate equilibrium between economic support and inflation control.

1.3.2 Fiscal Policy

South Africa's fiscal position has deteriorated, marked by a widening fiscal deficit and uncertainties in tax revenue projections. The fiscal deficit widened from 3.6% of GDP in FY22/23 to an estimated 4.9% in FY23/24. Total revenue as a percentage of GDP declined to 27.3% in FY23/24 from 28.2% in the previous fiscal year, reflecting the impact of an economic downturn, which led to reduced corporate profits and mining taxes. However, the country's tax-to-GDP ratio (which averaged 24.2% during FY20/21-23/24), remains above the African average of 15.6% in 2021,[2] a testament of the efficiency of the South African Revenue Service (SARS). On the spending side, total expenditure increased to 32.2% of GDP in FY23/24 from 31.9% in FY22/23, driven by factors such as a 7.5% increment effected on the public-service wage bill, social protection programs, bailouts for SOEs including the government provision of a debt relief to the Electricity Supply Commission (Eskom) of ZAR254 billion (USD14 billion) announced in the 2023 budget, and rising debt-service costs compounded by economic and fiscal uncertainties, tighter global monetary conditions, and a depreciating South African rand (ZAR). The government's strategy for fiscal consolidation is focused on fostering economic growth, rebuilding fiscal buffers, and enhancing the performance of SOEs to minimize the need for financial support. This approach requires a delicate balance

[2] AEO 2024.

between domestic and external borrowing while maintaining sustainable debt levels to ensure long-term economic stability.

The public debt stock has risen rapidly due to the growing deficit financing needs. The public debt-to-GDP ratio soared to 73.9% in FY23/24 from 70.9% in FY22/23. The main factors behind the higher public debt were higher interest rates, inflationary pressures, a depreciating currency, and increased public spending. Despite these challenges, the government has managed to keep its external public debt within the statutory limits, adhering to a ceiling of 15% of the total public debt. However, the external debt has risen in recent years from 6.6% of GDP in FY21/22 and to about 10% in FY23/24 due to an unprecedented increase in financing from International Financial Institutions (IFIs) to help address urgent financing needs from the COVID-19 pandemic. Interest payments on the debt likewise steadily rose to 4.9% of GDP (19.4% of total revenue) in FY23/24 from 4.6% of GDP (18.2% of total revenue) in FY22/23.[3] The Debt Sustainability Analysis for South Africa conducted by the International Monetary Fund (IMF) in January 2022 highlighted the precarious nature of South Africa's economic recovery and pointed out the risks associated with debt sustainability. These include global financial tightening, additional fiscal pressures, and substantial liabilities from SOEs. In January 2024, Fitch Ratings affirmed South Africa's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB-' with a Stable Outlook, reflecting a balance between the country's economic challenges (low GDP growth, high inequality, and a rising public debt-to-GDP ratio) and its strengths (a favorable debt structure, strong institutional frameworks, and a credible monetary policy).

1.3.3 External Position

South Africa's external sector's performance is currently facing challenges. The current account deficit widened to 1.6% of GDP in 2023 from 0.5% in 2022, after temporarily shifting to a surplus of 2% in 2020 (the first surplus since 2002). This deterioration stems from a combination of factors, including the global rise in oil prices, increased imports for renewable energy projects, and persistent supply-side constraints in the export sector such as the effects of electricity and logistics constraints, coupled by lower export commodity prices. Despite the pressures, the country's gross international reserves have shown resilience, rising to USD 62.5 billion (5.7 months of import cover) as of December 2023 from USD 60.6 billion in December 2022. This increase reflects official financing from IFIs and a higher US dollar gold price. The electricity crisis, transport and logistics constraints hampering South African exports, poor governance (especially in SOE and local governments), and South Africa's "grey listing" by the Financial Action Task Force (FATF) eroded investor confidence and triggered large non-resident portfolio outflows in 2022 and early 2023. As a result, the South African rand weakened significantly against major trading currencies, depreciating against the USD, British Pound and Euro by 12.8%, 14.2%, and 16.7%, respectively, in 2023. The strong US dollar, driven by global monetary tightening, also contributed to the rand's depreciation.

[3] National Treasury (February 2024).

Table 1 - Macroeconomic Indicators

	2019	2020	2021	2022	2023(e)	2024(p)	2025(p)
Real GDP Growth (%)	0.3	-6.3	4.9	1.9	0.6	1.3	1.6
Real GDP Growth per Capita (%)	-1.0	-7.6	3.9	1.1	-0.3	0.3	0.6
Inflation (%)*	4.1	3.3	4.5	6.9	6.0	4.8	4.5
Overall Fiscal Balance, Including Grants (% GDP)*	-5.3	-9.8	-5.1	-4.6	-4.6	-4.3	-4.2
Primary balance (% GDP)*	-1.6	-5.5	-0.7	-0.9	-0.7	-1.1	-1.8
Current Account (% GDP)	-2.6	1.9	3.7	-0.5	-1.6	-2.9	-3.2
Total Population (million)	58.1	58.8	59.4	59.9	60.4		
Life Expectancy at Birth (years)	66.2	65.3	62.3	61.5	62.9		

*Source: AfDB Statistics Department, April 2024. Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. Note: *Data in fiscal year 1 April (n-1)/ 31 March (n)*

1.4 Social Developments

Poverty. South Africa continues to struggle with significant socio-economic challenges, including high levels of poverty, unemployment, and inequality. The country's poverty headcount ratio, as reported by Statistics South Africa's Living Conditions Survey (LCS 2014/15), saw an increase from 53.2% in 2011 to 55.5% in 2015,[4] with a notable portion of the population living in extreme poverty.[5] The upcoming Living Conditions Survey, scheduled to be completed in the third quarter of 2024, will provide updated insights into these issues. The economic growth rate remains low, and access to quality employment is uneven, contributing to the persistence of poverty. About 12.2% of the population live in informal settlements and townships, often lacking access to formal infrastructure and essential services. This situation is further compounded by the duality of the economy, characterized by a divide between advanced sectors and traditional low-skill industries, leading to rising unemployment and socio-economic disparities. South Africa remains one of the most unequal countries globally although its Gini coefficient has shown a slight improvement from 0.648 in 2005 to 0.63 in 2016. The decline in life expectancy from 66 years in 2019 to 63 years in 2023 is another cause of concern. Factors such as the energy supply issues, the COVID-19 pandemic and environmental pressures exacerbate these socio-economic challenges, underscoring the need for inclusive policies and development strategies to address the root causes and promote stability and growth. The government allocates a large share of the national budget to Social Relief Distress (SRD) grants. In FY22/23, social protection expenditure accounted for about 11% of the total budget, reaching about 18.6 million people in need. By targeting the support more effectively, the government can ensure that the funds reach those who need them the most, while also managing the national budget responsibly.

[4] Most recent data.

[5] South Africa uses the food poverty line (FPL), lower bound poverty line (LBPL) and upper bound poverty line (UBPL) measures based on monthly household income levels. In 2015, 25.2% of South Africans (14m) lived in extreme poverty or below the national food poverty line of ZAR441 per person per month, while 55.5% of the population (31.4m) lived below the national upper bound poverty line of ZAR992.

[6] Comprising child support, old age, disability, foster care, care dependency, grant-in-aid, and social relief grants.

Unemployment. The labor market situation improved slightly at the end of 2023, with the official unemployment rate decreasing to 32.1% from 32.7% at the end of 2022. However, this overall measure masks the persistent inequalities in employment and income opportunities among different segments of the society, especially women and youth. At the end of 2023, the unemployment rate among women was 35.2%, and 59.4% among youth aged 15-24.[7] In addition, 35.5% of 10.3 million young people (15-24 years old) were not in employment, education, or training (NEET) and, therefore, were socially excluded from any social and economic interventions. The level of education plays a crucial role in determining the chances of finding a job. Most of the jobless (39.1%) did not have a matric certificate, while 34.5% had matriculated and only 11.8% had a degree. The main drivers of youth unemployment included low economic growth, lack of technical and employability skills as well as skills mismatches.[8] This underscores the need for robust economic policies and targeted interventions to foster job creation and skills development.

“Accelerating implementation of a comprehensive and well sequenced set of structural reforms to tackle long-standing constraints such as infrastructure gaps, public sector inefficiencies, regulatory barriers, market concentration, and skills mismatches is key to strengthening South Africa’s economic outlook and achieving long-term growth.”

Resilience to shocks and institutional fragilities: South Africa faces a number of vulnerabilities that undermine its efforts to achieve equitable, resilient, and sustainable socio-economic development. The country's status as an upper middle-income country (UMIC) belies the persistent vulnerabilities it faces, such as high poverty rates and stark inequalities, which are particularly pronounced in the townships. These issues are compounded by the impacts of globalization and regional economic dynamics, which expose the economy to both external and internal shocks. They are worsened by the dual nature of the economy and the weak structural growth and transformation. Addressing these multifaceted challenges requires innovative approaches to development policy, with a focus on job creation, especially for the youth, and a concerted effort to bridge the inequality gap.

1.5 Macroeconomic Outlook and Risks

1.5.1 Outlook

“Accelerating implementation of a comprehensive and well sequenced set of structural reforms to tackle long-standing constraints such as infrastructure gaps, public sector inefficiencies, regulatory barriers, market concentration, and skills mismatches is key to strengthening South Africa’s economic outlook and achieving long-term growth.”

South Africa’s medium-term economic outlook reflects both challenges and opportunities. The projected real GDP growth of 1.3% in 2024 and 1.6% in 2025, while modest, signals a gradual recovery, contingent upon successful supply-side reforms. The investment in renewable energy and Eskom's maintenance initiatives and improving the efficiency of rail and port operations are critical, potentially triggering spillover effects to other sectors of the economy. These include improved household consumption and employment rates, supported by declining inflation rates projected at 4.8% in 2024 and 4.5% in 2025, contingent on the stability of global economic factors and the absence of new economic shocks. The fiscal consolidation efforts appear to be bearing fruit, as evidenced by the projected narrowing of the fiscal gap to 4.3% of GDP in FY24/25 and 4.2% in FY25/26. These are primarily driven by revenue increases due to higher economic growth and improved efficiency on

[7] Statistics South Africa (2024).

[8] Technical skills are a set of specialized skills, knowledge or know-how needed to perform specific duties or tasks. They are practical, and often relate to mechanical and professional skills such as driving, teaching, engineering, medical and legal etc. On the other hand, eemployability skills are a set of skills which enable people to gain, keep and progress in employment, including skills in the clusters of work readiness and work habits, interpersonal skills and learning, thinking and adaptability skills.

revenue collection. The economy's susceptibility to electricity shortages and logistical challenges underscores the urgency for comprehensive reforms in these sectors to ensure long-term stability and growth. In addition, the rising public debt-to-GDP ratio, expected to reach 74.1% in FY24/25, before stabilizing at about 75% from FY25/26, remains a significant concern, highlighting the need for sustained economic growth and prudent fiscal management. The 2024 Budget Review indicates that the gross borrowing requirement is projected to decrease from ZAR553.1 billion (USD 30.5 billion) in FY23/24 to R428.5 billion (USD 28.8 billion) in FY26/27.Gross loan debt is expected to stabilize at 75.3% of GDP in 2025/26. The drawdown of ZAR150 billion (USD 8.3 billion) from the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) held by SARB is a strategic move to manage debt levels. The projected increase in the current account deficit to 2.9% and 3.2% of GDP in 2024 and 2025, respectively, due to rising imports for renewable energy projects and higher oil prices further complicates the economic outlook, necessitating a balanced approach to navigate these complexities. The balance between these various factors will be crucial in determining the trajectory of South Africa's economic resilience and growth.

1.5.2 Risks

Risks to South Africa's medium-term economic outlook remain elevated. The economy is still grappling with external risks such as volatile commodity prices and tightening global financial conditions. Other related risks include the spike in oil and food prices caused by geopolitical tensions, the rise in interest rates as the world's central banks tighten monetary policies, market volatility after elections, associated with coalition governance uncertainties, and extreme weather events whose frequency is rising because of climate change. These issues are further intensified by domestic factors like the reliability of electricity, logistical constraints in transportation, and fiscal vulnerabilities exacerbated by SOEs' bailouts and wage bill. Additionally, the prolonged lackluster economic performance in South Africa arising from these challenges has implications for the Southern African Customs Union (SACU), potentially reducing their imports and revenues. To mitigate these risks and foster sustainable growth, the government is prioritizing macroeconomic stability, structural reforms, and enhancing state capability. The success of these measures is crucial for enhancing the fiscal situation, boosting confidence, and stimulating investment and job creation, which are essential for accelerating economic growth. While the path ahead is fraught with potential pitfalls, targeted reforms and investments in critical sectors like energy and transport, could pave the way for a more robust and resilient South African economy.

1.6 Policy Options to Foster High and Resilient Growth: Supporting macroeconomic stability and economic transformation

A mix of policies is needed in the short-, medium- and long-term to address South Africa's macroeconomic challenges and put the economy back on the path of higher growth and sustainable development.

In the short term:

- The SARB's inflation targeting framework has been instrumental in managing inflation expectations and steering the economy towards stability. By adjusting the repo rate in response to economic indicators, SARB has been able to gradually reduce monetary policy accommodation, ensuring minimal disruption to the economy. This approach, coupled with a commitment to transparency and effective communication, has helped to maintain trust and credibility in the financial system. The ability to adapt monetary policy to both local and global economic changes remains key in fostering a resilient economic environment in South

Africa.

- South Africa's adherence to a flexible exchange rate regime has been a significant aspect of its economic policy, allowing the Rand value to be determined by market forces. While this policy exposes the economy to the volatility of global markets, with adverse implication on inflation and the cost of imports and exports, it aligns with the country's commitment to market-driven economic principles. This has been instrumental in managing the balance of payments in a dynamic global market.
- Despite the country's self-sufficiency in major agricultural products, there are pressing challenges that need to be addressed to stabilize food prices and promote inclusive growth. The disparities in resource allocation, innovation, and services within the agricultural sector often exclude poor black rural communities, who are disproportionately affected by constraints in land ownership. Addressing these disparities is essential for enhancing agricultural productivity and ensuring equitable access to the benefits of the sector. Moreover, tackling energy shortages and improving regulatory frameworks remains crucial for the sector's advancement.
- Accelerating governance reforms is not only important for mitigating the public debt burden, but also important in fostering an efficient allocation and utilization of loaned funds towards sectors that spur growth, such as technology, renewable energy, and infrastructure. Such investments will ultimately contribute towards unlocking South Africa's full economic potential and fostering long-term prosperity and job creation.

In the medium and long term:

- South Africa’s public debt, being one of the highest among emerging markets, limits fiscal space to respond to economic shocks, necessitates a strategic approach to enhance domestic resource mobilization. Effective debt management strategies are essential to optimize the cost and risk profile of the government's debt portfolio, while combating illicit financial flows is imperative to the safeguard of integrity of the financial system and in ensuring the retention of domestically generated resources.
- As South Africa continues to navigate its developmental path, external financial flows (such as FDI, portfolio investment, and remittances) will be crucial for the country’s transformation, supplementing domestic resources. A robust and transparent institutional framework will continue to enhance the impact of external flows, while continued financial openness will spur economic transformation by boosting domestic savings, lowering capital costs, and enabling technology transfer.
- Accelerating implementation of a comprehensive and well sequenced set of structural reforms to tackle long-standing constraints—such as infrastructure deficits, public sector inefficiencies, regulatory barriers, market concentration, and skills mismatches—is essential for strengthening the economic outlook and achieving long-term growth. These concerted efforts are crucial for the country to navigate post-pandemic recovery and establish a resilient and competitive economy.

TAKING STOCK OF SOUTH AFRICA’S STRUCTURAL TRANSFORMATION PROGRESS

2

KEY MESSAGES

- The end of apartheid in 1994 heralded an era of relatively strong growth, marking a significant turnaround in the nation's economic trajectory. However, challenges emerged during 2010-2019, with average GDP growth slowing to 1.7%. Consequently, real per capita GDP growth has been modest over the past four decades.
- The economy, which is a structurally developed country, has undergone significant transformation over the past decades, mirroring a global shift towards a service-driven economy. However, it is marked by a stark contrast in sectoral productivity and employment distribution. The shifting of employment opportunities from traditional labor-intensive industries to services reflects broader trends in economic development and structural change.
- The evolution of labor productivity trends in South Africa, reflects the dynamic nature of its economy and structural transformation. Comparatively, South Africa's labor productivity trajectory offers a distinct perspective against other regions, where structural change often drives productivity.
- The advancement of the economy is reflected in the changing composition of its exports. While the mining sector has seen a decrease in the share of domestic value added in exports, there has been a notable increase in agriculture, manufacturing, and service sectors.
- South Africa’s commitment to good governance and the strengthening of institutions has been instrumental in fostering a stable macroeconomic environment conducive to structural change. A flexible exchange rate policy, in tandem with inflation targeting, is a strategic tool that helps mitigate the impact of global financial volatility.
- The country has a vibrant private sector, although navigating through a number of challenges that impede its growth and productivity remains a major concern. The information and communication technology sector has experienced significant growth, reflecting a dynamic trend reflected in many emerging economies, and the country’s infrastructure development has shown remarkable progress.
- Structural transformation is impacted by climate change, which disrupts infrastructure, skews productivity, and complicates resource allocation; the informal sector, which encounters obstacles in reallocating resources efficiently from traditional to modern sectors and from low to high productivity sectors; and the formal financial sector’s stringent requirements for credit history and collateral that often leave small and medium-sized enterprises (SMEs) at a disadvantage.
- To accelerate transformation, the government's commitment to creating a favorable environment for structural change is crucial, including through strengthening institutions and accountability. The private sector's involvement is vital for rapid economic transformation, aligning with government policies to stimulate innovation, sustainability, and competitiveness. Furthermore, regional bodies, development finance institutions, and multilateral development banks are instrumental in backing South Africa's transformation goals, offering essential financial support to manage the intricacies of economic and political dynamics.

2.1 Introduction

This chapter presents a comprehensive overview of recent progress in South Africa's economic transformation amid a changing world The chapter identifies key trends in characteristics of, and provides financing estimates to fast-track structural transformation in South Africa. The chapter takes both a historical perspective and a forward-looking approach on structural transformation to inform policy options. It compares South Africa's performance with that of African and other peer countries, and draws lessons for the future.

2.2 Taking Stock of economic performance and transformation of South Africa

"The evolution of labor productivity in South Africa reflects the dynamic nature of structural transformation, with the reallocation of labor from agriculture, where productivity is below the national average, to services, where productivity is above national average."

South Africa is an upper middle-income country. With a per capita gross domestic product of USD 6,022 (constant 2015 GDP) and a nominal GDP of about USD 405 billion in 2022, it stands as the second-largest economy in Africa.[9] The country's mixed economic model supports a thriving private sector, particularly in mining, tourism, and finance, while the government maintains a regulatory role and operates key state-owned enterprises (SOEs) in vital sectors like energy, water, and transportation. This strategic balance is designed to promote economic growth and stability while ensuring equitable distribution of wealth and resources across the population.

The South African economy has faced numerous challenges over the past decades, with growth rates fluctuating and often falling behind those of its regional and global peers. During the apartheid regime, which lasted from 1948 to 1994, the country implemented discriminatory policies that not only segregated the population based on race, but which stunted economic growth and integration with the global market. The policies restricted economic opportunities for the majority of South Africans, particularly black citizens. The racial divide hindered innovation and productivity, coupled with limited foreign investment, trade and access to global markets due to international sanctions that were imposed on the country. Therefore, South Africa's real GDP growth rates during the final decades of the 20th century reflect the impact of these policies. Growth averaged 1.7% and 1.4% during 1980-1989 and 1990-1999, respectively, falling below those of many regional and global and regional peers, such as Brazil, Egypt, India, Mauritius, Morocco, Nigeria, Turkey, UMICs, and sub-Saharan African (SSA) countries (Figure 2.1).

The end of apartheid in 1994 heralded an era of a relatively strong growth in South Africa, marking a significant turnaround in the nation's economic trajectory. The African National Congress (ANC) government's policies were pivotal in fostering a conducive environment for growth and development. Key reforms that spurred economic activity included the liberalization of trade, which expanded access to international markets, and infrastructure investments that modernized the country's capabilities, with positive impact on productivity (Figure 2.5). The natural resource sector, particularly mining, alongside tourism and services, played a substantial role in driving growth. Moreover, a focus on education and skills development aimed to equip the population with the tools necessary for a competitive economy. These strategic initiatives resulted in a notable period of growth, with the real GDP climbing by an average of 3.6% annually between 2000 and 2009. However, South Africa's average growth was modest when compared to the growth rates of UMICs (6.3%) and regional and global peers such Egypt (5.0%), India (5%), Mauritius (4.5%), Morocco (5.2%), Nigeria (7.4%), Turkey (4.0%), and SSA countries (5.1%) (Figure 2.1).

9 World Development Indicators as of May 2024

The period from 2010 to 2019 presented significant economic challenges for South Africa, with average GDP growth slowing to 1.7% (Figure 2.1). A combination of domestic issues, such as infrastructure shortcomings—especially in electricity and transport—governance deficiencies (especially in SOE and local government), regulatory hurdles, and labor market inflexibility, severely impacted productivity and competitiveness. These were exacerbated by external factors, including the aftermath of the 2008-2009 global financial crisis and climate change impacts. The COVID-19 pandemic further exacerbated the situation, causing a steep 6.3% contraction in GDP growth for 2020. Although a recovery of 4.9% followed in 2021, growth slowed again to 1.9% in 2022. Over these three years, the average GDP growth was a mere 0.2%, placing South Africa at one of the lowest growth rates compared to its peers. Despite ongoing stimulus efforts, the economy's recovery has been hampered by persistent pandemic effects, geopolitical conflicts such as Russia's invasion of Ukraine, and long-standing structural and policy barriers. Consequently, South Africa continues to face the formidable task of enhancing investment, fostering innovation, and improving productivity to build resilience and achieve a more robust economic growth path.

South Africa's economic trajectory over the past four decades has been marked by modest real per capita GDP growth. The high population growth rate, averaging 1.7% during 1980-2022, juxtaposed with low economic growth has led to relatively stagnant per capita income levels. This is highlighted by the minimal 11% increase in real per capita GDP from 1980 to 2022. In comparison, many of South Africa's regional and global peers have seen their per capita GDP at least double or triple in the same period (except for Brazil, Nigeria and SSA countries) (Figure 2.2), contributing to significant poverty reduction. South Africa's real per capita GDP growth has experienced considerable fluctuations, contracting by 1.3% and 0.4% during the decades of 1980-1989 and 1990-1999, respectively. It then expanded by 2.6% in 2000-2009, followed by a modest increase of 0.4% in 2010-2019. As a result, per capita GDP, measured in constant 2015 USD, decreased from USD 5,410 in 1980 to USD 4,589 in 1999, before rising to USD 5,911 in 2009 and USD 6,189 in 2019. The post-COVID posed additional challenges, leading to the contraction in per capital GDP growth by an average of 0.8% during 2020-2022. South Africa's modest real per capita GDP growth over the last forty years reflects the ongoing struggle to enhance investment, drive innovation, and improve productivity. The country's economic trajectory underscores the need for strategic initiatives to stimulate a more dynamic economy that can thrive in the face of global and domestic challenges.

Figure 2.1: South Africa's real GDP growth v African and Peer Countries (%), 1980-2022

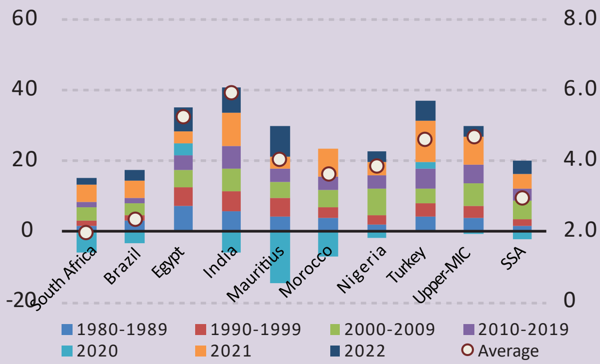
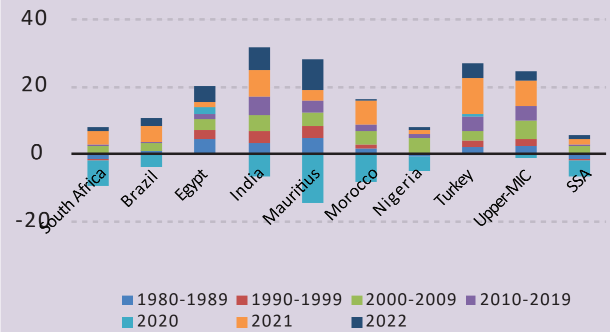


Figure 2.2: South Africa's real GDP per Capita growth v African and Peer Countries (%), 1980-2022



Note: Decades are based on simple averages.
Source: AfDB Statistics, IMF and WDI.

"The evolution of labor productivity in South Africa reflects the dynamic nature of structural transformation, with the reallocation of labor from agriculture, where productivity is below the national average, to services, where productivity is above national average."

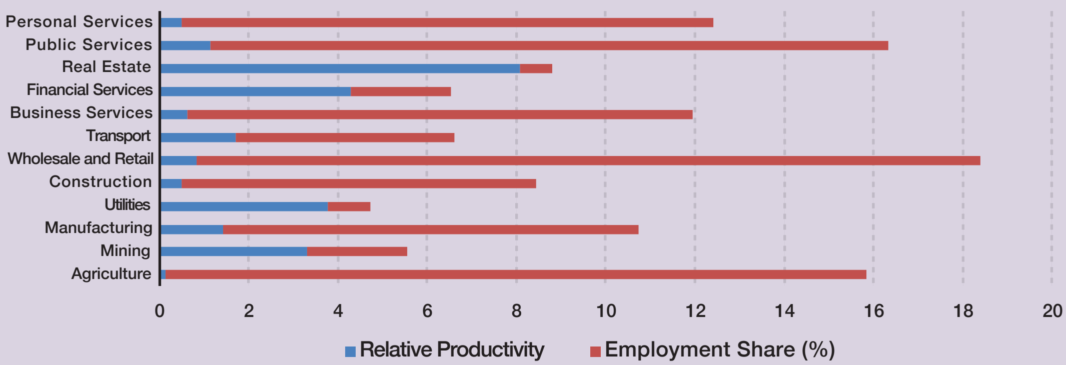
2.3 South Africa's Structural Transformation: Drivers, bottlenecks, opportunities

2.3.1 South Africa's structural/economic transformation

"The evolution of labor productivity in South Africa reflects the dynamic nature of structural transformation, with the reallocation of labor from agriculture, where productivity is below the national average, to services, where productivity is above national average."

South Africa's economy has undergone significant transformation over the past decades, mirroring a global shift towards a service-driven economy. South Africa is one of nine African countries classified as structurally developed. Its tertiary sector's expansion at the expense of industry and agriculture has been a double-edged sword, offering diversification and presenting challenges in job creation and inclusive growth. The decline in the industry's share of GDP from 35.6% in 1990 to 24.7% in 2022, mainly driven by the halving of manufacturing's contribution to GDP from 23.7% to 12.3% in the same period, is indicative of broader global trends of de-industrialization, often linked to trade liberalization and globalization. The growth of the services sector, which in 2022 constituted 62.3% of the GDP from 52.4% in 1990, were driven by financial services, real estate, and transport, suggests a dynamic shift towards a knowledge and service-based economy. This transition, coupled with technological innovation and productivity improvements, could be pivotal for South Africa to break free from stagnant growth and move towards becoming a high-income country. The moderate recovery in agriculture's GDP contribution to 2.8% in 2022, after dropping from 3.7% in 1990 to 1.9% in 2013, points to the potential for balanced sectoral development. Overall, the South African economy's evolution reflects a complex interplay of factors, where strategic policy interventions and technological advancements could play a crucial role in shaping its future trajectory.

Figure 2.3. **South Africa: Relative sectoral productivity and employment shares in South Africa, 2018**



Source: Staff calculation using the Economic Transformation Database (Kruse et al. 2023)

The South African economy is marked by a stark contrast in sectoral productivity and employment distribution. Figure 2.3 shows the relative labor productivity of the country's 12 main sectors and the employment share of each sector.[10] Agriculture, employing a significant portion of the workforce (15.7% of the workforce) in 2018, shows a relative productivity of just 0.15, reflecting the sector's vulnerability to climate change and dual structure, with a modern and competitive commercial segment and a large number of subsistence and smallholder farmers relying on traditional farming methods. This low figure underscores the ongoing challenges in land reform and the need for increased mechanization and resilience against environmental impacts. In sharp contrast, sectors such as mining, utilities, financial services, and real estate, though employing a smaller fraction of the workforce, boast high productivity levels (with relative sectoral productivity of 3.3, 3.8, 4.2 and 8.1, respectively), indicating a more capital-intensive nature of operations. The middle ground is occupied by transport (1.7), manufacture (1.4) and public services (1.1), with moderate productivity. This highlights the disparities in the economy in terms of productivity and points to potential areas for policy intervention and development to balance sectoral growth and employment opportunities.

The shifting of employment opportunities in South Africa reflects broader trends in economic development and structural change. The gradual decline in the proportion of people employed in the agricultural sector from 23.2% to 15.7% and in manufacturing from 13.5% to 9.3% between 1990 and 2018 signals a move away from traditional labor-intensive industries (Figure 2.4). Meanwhile, the tertiary sector has become the main driver of employment, with the share of people employed in services rising sharply from about half of total employment in 1990 to 63.7% in 2018.[11] The rise in tradable services (such as transport, financial services and utilities) employment, from 5.8% to 7% in the same period, reflects a growing demand for specialized skills and suggests a pivot towards higher productivity sectors. The

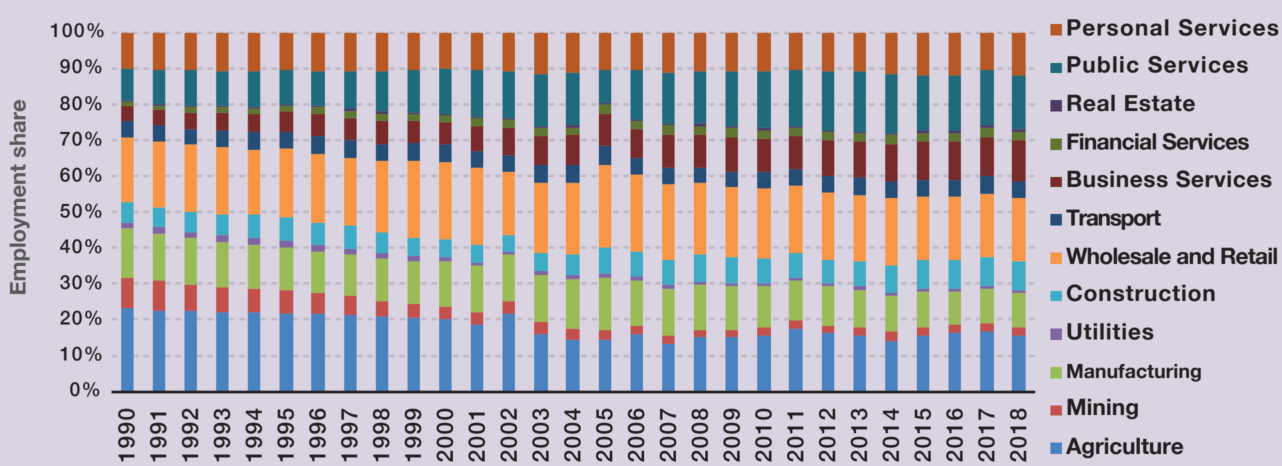
[10] Relative productivity is calculated as the ratio of each sector's labor productivity to the average labor productivity of the economy. A value less than one, suggests the sector exhibits below-average labor productivity, and vice versa.

[11] WDI

expansion of public services, employing 15.2% of the workforce in 2018 from 9% in 1990, underscores the country's evolution towards a service-based economy.

The structural change of the South African economy presents a complex picture of labor distribution and productivity. While 45% significant portion of the workforce is engaged in sectors like agriculture, personal services, and wholesale and retail (2018 data), these are areas with low productivity (with relative productivity of less than one as depicted in figure 2.3). Thus, the challenge lies in enhancing the productivity of these sectors or facilitating the transition of workers to more productive sectors. However, the capacity of high-productivity sectors to absorb low-skilled labor is limited, which necessitates a strategic approach to workforce development and job creation. Upskilling the workforce and creating opportunities within the high-productivity sectors could be pivotal. Additionally, fostering entrepreneurship and small business development in lower-productivity sectors might spur growth and employment. The decrease in agricultural employment and the subsequent shift to other sectors underscores the need for a robust support system for workers transitioning between sectors, to prevent job loss and mitigate income inequality (Figure 2.4). A balanced reallocation of labor, coupled with targeted skill development, could potentially unlock growth and reduce unemployment in the South African economy. For the manufacturing sector, a nuanced strategy is required, recognizing the distinct needs of labor-intensive industries (food processing and textiles) versus capital-intensive ones (chemicals, pharmaceuticals and motor vehicles). Investment in research and development (R&D), coupled with the adoption of advanced technologies, can help maintain the sector's competitiveness. Ultimately, a balanced and inclusive economic strategy that fosters innovation and skill development across all sectors will be crucial for sustainable growth and social equity in South Africa.

Figure 2.4: South Africa: Sectoral employment shares in South Africa, 1990-2018



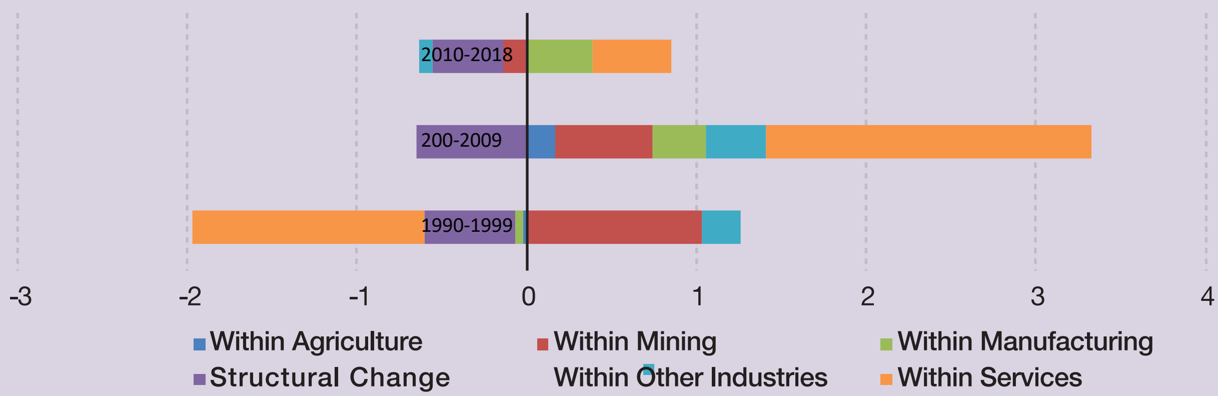
Source: AfDB

2.3.2 Unpacking South Africa's structural transformation through labor productivity decomposition

The evolution of labor productivity trends in South Africa, as depicted in figure 2.5, reflects the dynamic nature of the country's economy and its structural transformation. The reallocation of labor in the country from agriculture, where productivity is below the economy's average, to services, where productivity is above that average, has been a key factor in South Africa' structural transformation. Despite this, the fluctuating labor productivity growth rates over the decades—declining by an average of 0.7% in the 1990s, rebounding by 2.7% in the 2000s, and stagnating by 0.2% in the 2010s—indicate ongoing challenges in achieving consistent productivity growth. Figure 2.5 shows the decomposition of labor productivity in South Africa following the methodology of McMillan and Rodrik (2011). While productivity growth due to structural change has remained negative in all the three decades, almost 100% of average productivity came from within-sector productivity growth. The initial surge in productivity within the mining sector, which was responsible for driving productivity growth in the 1990s, followed by a more diversified within-sector productivity growth in the 2000s due to government reforms and investments, highlight the importance of policy innovation and sustained infrastructure investments that modernized the country's capabilities. Yet, the slowdown in the last decade underscores the need for continued policy innovation, particularly in modern sectors like manufacturing and services, to overcome infrastructure and skill-related challenges and to keep up with the pace of Africa's structural transformation.

Comparatively, South Africa's labor productivity trajectory shows a distinct perspective against other regions and across African countries, where structural change often drives productivity. The resilience shown by South Africa, particularly during the 2000s with notable within-sector productivity gains, suggests a complex interplay of factors influencing economic progress and the need for tailored strategies to sustain growth. The absence of structural change over the past decades also suggests that the economy could benefit from a more dynamic reallocation of resources across sectors. Addressing the long-standing structural challenges is crucial to exploit the potential of within-sector productivity and to catalyze broader structural changes. Such reforms are crucial for South Africa's integration into the global economy and for enhancing its competitive edge on the international stage.

Figure 2.5: South Africa: Structural Change in South Africa and Africa, 1991-2018

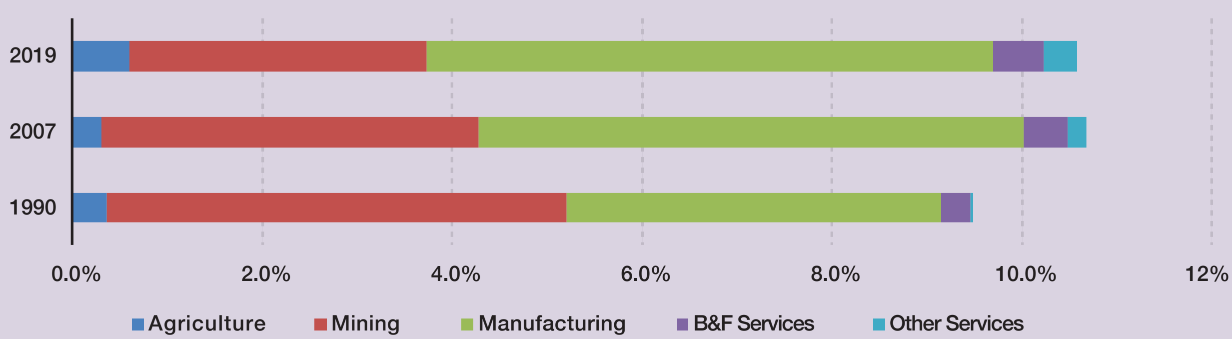


Source: AfDB staff calculations

2.3.3 Rapid growth in income and jobs embodied in export: new evidence

The evolution of the South African economy is reflected in the changing composition of its exports (Figure 2.6). While the mining sector has seen a decrease in the share of domestic value added in exports, there has been a notable increase in the sectors of agriculture, manufacturing, and services. This shift is particularly pronounced in business and financial services, which, along with other service sectors like arts, entertainment, and recreation, have grown significantly since the 1990s. These trends align with the broader structural changes observed across African nations, where the service industry has become a key driver of economic transformation. Contrary to the pattern identified by Mensah and de Vries in their 2024 study, which noted a rise and subsequent fall in the share of domestic value added in manufacturing, South Africa's manufacturing sector, especially export-oriented industries such as chemical, pharmaceutical, metal, rubber and plastic products, and motor vehicles, has sustained its growth. This growth is largely attributed to the capital-intensive nature of these industries, which is consistent with within-sector productivity gains that have been observed in manufacturing as discussed above. South Africa's exports of medium and high-tech activities (as a share of manufactured exports), rose from 45.7% in 2010 to 50.6% in 2016, before stabilizing at an average of about 45.9% during 2018-2021. This share is above the average for Africa and global median of 14.9% and 30.3% in 2021, respectively, but comparable to other regions such as Europe and Central Asia (46.2 percent).[12]

Figure 2.6: Sectoral domestic value added embodied in exports (% of GDP), 1990, 2007 and 2019



Source: Author's calculations from Mensah and de Vries (2024)

2.3.4 Drivers to accelerate structural transformation

Governance: South Africa's commitment to good governance and the strengthening of institutions has been instrumental in fostering a stable macroeconomic environment conducive to structural change. The country's progress is reflected in its rankings on international indices; for instance, Transparency International's 2023 Corruption Perception Index places South Africa as the 12th least corrupt nation in Africa, and 83rd out of 180 countries globally. South Africa scored 67.7/100 on the 2022 Ibrahim Index of African Governance (sixth-best

[12] AEO 2024.

performing in Africa) and is higher than the African (48.9) and Southern African regional (54.2) averages. The Public Finance Management Act remains a pivotal element of South Africa's governance, ensuring public funds are managed with efficiency, transparency, and accountability. Despite these advancements, the challenges posed by SOEs and state capture underscore the need for robust governance mechanisms. The establishment of the Judicial Commission of Inquiry into Allegations of State Capture exemplifies the government's proactive approach to reinforcing governance and addressing systemic issues.

- **Exchange rate policy:** South Africa's flexible exchange rate policy, in tandem with inflation targeting, is a strategic tool that helps mitigate the impact of global financial volatility. By allowing the value of the rand to fluctuate, the policy acts as a shock absorber, contributing to economic stability. It is a balancing act that requires careful monitoring to prevent potential overvaluation, which could affect export competitiveness. The success of this policy is integral to the nation's broader economic goals, including re-industrialization and diversification, which hinge on the synergy between monetary strategies and addressing other structural impediments .

- **Trade policy:** South Africa's trade policy is a delicate balance between opening up to international markets while protecting local industries. The focus is on creating jobs and supporting local sectors while embracing global trade opportunities. Recent shifts towards market-based strategies reflect a move to promote output and employment growth in higher-productivity sectors to stimulate economic growth. However, challenges such as the structure of the export basket and high business costs have historically hindered export performance. The National Development Plan (NDP) and other strategies highlight the need for structural change to foster growth and job creation, supported by international trade. Addressing investment costs and trading barriers, revising policies, and updating negotiations are seen as vital steps to promote higher productivity sectors. Moreover, navigating the complex tariff system, especially in protected sectors, is essential for businesses entering South Africa's market.

- **Business environment:** South Africa has a vibrant private sector, generating about 75% of GDP. However, the country is navigating a number of challenges that impede its growth and productivity. Infrastructure deficits, particularly in energy and transport, are significant hurdles, with strategic SOEs like Eskom and Transnet struggling to perform efficiently. This underperformance has a ripple effect, diminishing the private sector's productivity and competitiveness. The situation is further strained by complex industrial relations and restrictive labor regulations that limit labor mobility, which pose additional barriers to the country's industrialization and the performance of SMEs. Innovation is another area where South Africa lags, as reflected in its Global Innovation Index ranking and modest R&D investments. The scarcity of highly skilled workers, along with issues like unequal land distribution, limited spatial connectivity, and the looming threat of climate change, compound these development challenges. In response, South Africa is focusing on diversifying its economy, particularly towards skill-intensive manufacturing and service sub-sectors.

- **Urbanization:** The urbanization trend in South Africa reflects a complex interplay of historical, economic, and social factors. The migration towards urban centers, with over 68% of the population residing in urban areas as of 2022, is driven by the search for better opportunities, yet it often results in increased strain on infrastructure and services. The dual economy, a vestige of apartheid, exacerbates inequality, with a significant portion of the population still residing in informal settlements and townships with limited access to resources. This urban dichotomy presents unique challenges that require innovative policy approaches and sustainable development strategies. Addressing these issues necessitates a multifaceted approach that includes investment in education and skills development, expansion of the formal economy to include informal sectors, and the creation of a more inclusive urban planning framework that considers the needs of all residents.

Technology and physical capital:

- **South Africa's Information and Communication Technology (ICT) sector has experienced significant growth, reflecting a dynamic trend seen across many emerging economies**. The increase in smartphone subscriptions (from 42.1 million in 2017 to 65.3 million in 2021) and the shift towards fiber internet (from 280,097 to 1.8 million in the same period) underscore a rapid technological evolution, driven by both consumer demand and infrastructural advancements. However, the challenge of equitable access remains, especially in less urbanized areas. The high cost of mobile data also presents a barrier. However, the proactive measures taken by the government, such as the auction of broadband spectrum and the drafting of new by-laws, indicate a commitment to addressing these issues. These initiatives could catalyze further advancements in the ICT sector, ensuring that the benefits of technological progress are shared more widely across all the sectors of the economy.

- **South Africa scored 81.7 out of 100 on the 2022 Africa Infrastructure Development Index.** The country's strategic investment in electricity infrastructure, with an installed capacity of 54 GW in 2021 (the highest in sub-Saharan Africa), along with significant improvements in electricity access (87% in 2022), underscores its commitment to energy development, with a focus on renewable sources (Box 2.1). The expansion of water supply coverage (84.7% in 2021) further illustrates the nation's dedication to enhancing the quality of life for its citizens. Moreover, the extensive transport network (with a road network of about 750,000 km, ranking as the 11th largest globally and the largest on the continent) facilitates domestic connectivity and enhances South Africa's integration into regional and global value chains. However, the persistent infrastructure gaps, particularly in energy supply and transport logistics, highlight the critical need for sustained investment and governance reforms.

- **Human capital development: South Africa's commitment to education is evident in its investment surpassing 6% of GDP.** However, the return on this investment, as measured by the Human Capital Index, has not met expectations. The nation's score of 0.43 falls short when compared to countries like Brazil, China, India, Mauritius, and Mexico, which spend less but achieve higher outcomes. The challenge lies in the tertiary education system's low transition and completion rates, leading to a skills mismatch in the workforce. This gap hinders economic growth, stifles innovation, and limits business productivity. Addressing this issue requires a strategic shift in focus towards technical and vocational education, aligning with the market's needs. Integrating entrepreneurship skills into the curriculum can empower the workforce, drive innovation, and enhance business productivity. Such a shift promises to reduce the high structural unemployment rate and positions South Africa to realize its full economic potential, fostering stability and growth.

Box 2.1: Potential and existing investment opportunities in renewable energy and transport sector

South Africa's energy and transport sectors are facing significant challenges and transformations. The energy crisis, characterized by load-shedding and economic impacts, is being addressed through the Energy Action Plan (EAP). This plan includes a comprehensive strategy to fix existing power plants, enable private investment, and add new generation capacity from diverse sources, aiming to end load shedding and achieve energy security. The country's policies have been fostering such investments, particularly with the lifting of licensing requirements for large-scale generation projects and efforts to address the electricity crisis. The Renewable Energy Independent Power Producer Procurement Program (REIPPP) has been successful in attracting private sector finance, with over ZAR 53 billion (USD2.9 billion) invested and 93 projects either operational or in the pipeline, showcasing policy stability and a strong regulatory environment. The Just Energy Transition Partnership (JETP) and the commitments under the Paris Agreement further underscore the country's dedication to a sustainable energy future. The transport sector, facing issues with road maintenance, public transport reliability, and rail network governance, is also experiencing reforms. The National Rail Policy White Paper is set to restructure the railway sector, promoting competition and private sector involvement, which is expected to revitalize the transport system and contribute to economic growth. These initiatives reflect South Africa's commitment to improving infrastructure and services, which are crucial for the nation's development and prosperity.

South Africa's role in the Southern African Development Community (SADC) and the Southern African Customs Union (SACU) is underscored by its large contribution to intra-regional trade. The ratification of the African Continental Free Trade Agreement (AfCFTA) demonstrates South Africa's commitment to regional economic integration. However, South Africa's exports are still dominated by primary products, indicating need for diversification and improving technological capabilities to move up the economic complexity index. Addressing the energy and transport gaps, and improving cross-border trade efficiency by eliminating non-tariff barriers and streamlining customs processes are crucial for South Africa to fully benefit from the growing regional market.

2.3.5 Key bottlenecks to fast-paced structural transformation

South Africa's journey towards sustainable development and structural transformation is fraught with systemic challenges. They include demographic shifts, such as a rapidly growing population; climate change; the persistence of an informal sector, political issues, and financing constraints. Addressing these challenges requires a multifaceted approach that includes policy innovation, investment in human capital, and strengthening institutions to create a resilient and inclusive economy.

Demographic challenges: South Africa is navigating complex demographic issues marked by a significant shift towards a larger working-age population, which presents both opportunities and challenges. The nation's working-age population is expected to grow by another 9 million in the next 50 years, offering a potential demographic dividend that could propel economic growth and improve living standards. However, this advantage is currently hindered by high unemployment rates, with the unemployment rate standing at 32.4% in 2023, disproportionately affecting women and youth. As noted, South Africa grapples with one of the highest inequality rates in the world, and poverty was estimated at 55.5% in 2015. Addressing these issues requires a multifaceted approach, including improving job creation rates, enhancing knowledge and knowledge management, education and skills training, and ensuring that the benefits of a growing working-age population are fully realized.

Climate change: Climate change has a profound impact on South Africa's infrastructure, productivity, and resource allocation. In recent years, South Africa has experienced increased frequency and intensity of droughts, heatwaves, and severe flooding. These extreme weather events are damaging critical infrastructure and disrupting agricultural and industrial productivity, which are a cornerstone of the South African economy. The two devastating episodes of severe flooding which occurred in 2022 and 2023 displaced over 40,000 people, damaged more than USD 1.5 billion worth of infrastructure, crops and livestock, among other things.

Informal sector: The informal sector in South Africa faces significant challenges in the transition of resources from traditional to modern sectors and from low to high productivity sectors. The country continues to be characterized by a dual economy, a manifestation of the legacy of apartheid. A world-class developed segment of the economy coexists with a developing and largely informal segment, serving mainly impoverished communities living in townships, informal settlements, and rural areas. Despite being linked to the formal economy and providing essential services, the informal sector often operates with simple and adapted technologies, which are sometimes viewed as responsible for its static nature. The sector is recognized as an alternative to combat growing unemployment, especially among the youth and the poor, yet it remains socio-economically excluded from basic service provisions, such as reliable energy sources, which hinders its productivity and growth. Furthermore, the relationship between the informal sector and local government is often marked by exclusion and negligence, leading to a lack of engagement and support for the sector's development. The path to a more equitable economy is complex and requires multifaceted approaches, including policy reforms, investment in education, knowledge management and the dismantling of systemic barriers that perpetuate inequality. There is a need for inclusive policies that recognize the value of the informal sector, consider the livelihoods of those involved, and facilitate their transition into more productive and modern economic activities.

Political issues: South Africa's economic transformation is complex and complicated, with political issues deeply intertwined with economic policies and outcomes. One of the key challenges is the operational and financial crises of SOEs like Eskom and Transnet, which have been linked to broader political controversies and governance issues associated with allegations of "state capture" during previous administration. These crises have led to significant disruptions in economic activity due to power outages and transport logistics bottlenecks, hindering structural transformation efforts. Additionally, the political landscape is increasingly marked by a struggle to maintain coalitions within the ruling ANC and its allies, amidst persistent racialized inequalities and a misalignment between economic and political power. This has necessitated a delicate balance between redistribution, nation-building, and economic policy. The political dynamics in South Africa are characterized by long-standing contestations over the control of rents and policy direction, reflecting deeper tensions within the post-apartheid political economy. This leads to incoherent distributional pressures and institutional constraints, coupled with weaknesses in public services and policy consistency. Addressing corruption, improving governance, and maintaining coherent economic policies are crucial for South Africa’s economic transformation.

Financial constraints: South Africa's financial sector is a robust and integral component of its economy, showcasing a high degree of sophistication and resilience. The sector's structure is diverse, encompassing a wide range of institutions, comprising 18 registered commercial banks, five cooperative banks, four mutual banks, 13 local branches of foreign banks, and 28 other financial intermediaries, which cater to the financial needs of various segments of the economy. The dominance of five major commercial banks indicates a strong concentration of market power, which has both benefits and drawbacks. On one hand, it suggests stability and the ability to manage systemic risks effectively. On the other hand, it points to potential challenges in terms of competition and innovation. Most of the population is banked, with about 87% of the adult population owning an account with a bank or with a mobile-money-service provider in 2021, reflecting successful financial inclusion initiatives. Yet, SMEs in the country struggle to obtain credit from the formal financial sector, which is cautious and requires a positive credit history and collateral that SMEs often do not have. The main commercial banks have units for SMEs, but they only lend a small percentage of their portfolio to SMEs. Moving forward, fostering an environment that supports SME growth and diversifying the financial services landscape could further enhance the sector's robustness and its contribution to the broader African economy.

2.4 Finance to fast-track South Africa’s Structural Transformation: How much is at stake? South Africa’s commitments to structural change

2.4.1 South Africa’s structural change strategy

South Africa's National Development Plan (NDP) Vision 2030 is an ambitious program aimed at eradicating poverty and reducing inequality by 2030. The plan's strategic priorities focus on stimulating economic growth, job creation, improving education and skills development, fostering innovation, and enhancing the state's capacity for developmental governance. Critical to these are three identified phases: aligning long-term departmental plans with the NDP, policy coherence, and evidence-based monitoring and evaluation. Leadership at various governmental levels is essential to drive these initiatives forward. However, the Medium-Term Strategic Framework (MTSF) reports from 2019 to 2024 indicate significant challenges in achieving these targets. Economic growth has been sluggish, unemployment rates have soared, and investment has fallen short of expectations, highlighting ongoing structural constraints and subdued investor confidence.

In response to these challenges and the impact of the COVID-19 pandemic, the South African government introduced the Economic Reconstruction and Recovery Plan (ERRP). The ERRP is structured around three phases: engaging and preserving public health, recovering and reforming the economy, and reconstructing and transforming towards a sustainable, resilient, and inclusive economic future. By focusing on key areas such as energy security, industrial growth, employment programs, infrastructure development, and green economy initiatives, the ERRP seeks to catalyze long-term growth and job creation, thereby aligning with the broader objectives of the NDP Vision 2030.

2.4.2 Financing needs and financing gaps

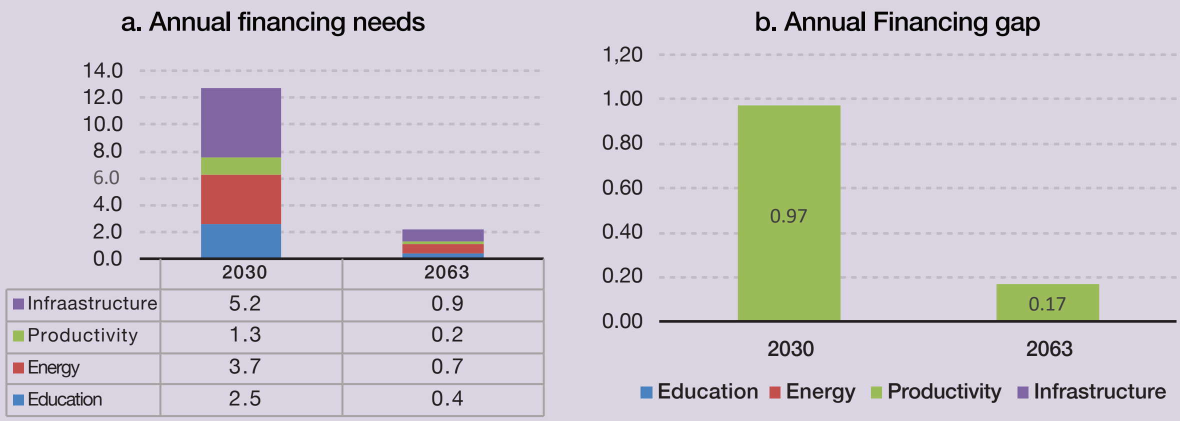
The African Development Bank (AfDB) estimates point to a financing gap of USD 0.97 billion annually by 2030 to fast-track South Africa's structural transformation and catch up to high-performing developing countries from other regions. The Bank recognizes the key role of the Sustainable Development Goals (SDGs), particularly quality education (SDG 4), sustainable energy (SDG 7), productivity (SDG 8), and industry, innovation, and infrastructure (SDG 9) as well as Africa's Agenda 2063 in driving structural transformation. For each African country, the Bank calculates annual financing needs and the associated financing gap under both the 2030 Agenda and Agenda 2063.[13]

Using this benchmarking methodology, the Bank estimates that South Africa would need USD 12.8 billion annually until 2030 to accelerate its structural transformation process and put it at par with high-performing developing countries.[14] When the deadline for Agenda 2063 is used as a reference, the annual financing needs fall to USD 2.2 billion. The bulk of these resources are in road infrastructure (40.4% of the total), highlighting the dearth of current investment in the sector, followed by energy (29.2%), education (19.9%), and productivity-enhancing research and development (10.4%) (Figure 2.7a). Given the current country performance levels on these critical sectors and their projected values, which are assumed to change in line with GDP per capita, the annual financing gap to fast-track structural transformation is estimated at almost USD 1 billion (or about 1.2% of South Africa Africa's 2024 GDP) under the SDGs framework and USD 0.17 billion (0.2% of GDP) under Agenda 2063 deadline, with a longer time horizon and spread of investment across each SDG target. Productivity, aimed at enhancing economic growth and decent work, is the only main contributor to South Africa's financing gap (Figure 2.7b).

[13] The approach estimates how much African countries need to spend—and the financing gap to be filled—if they target reaching the same level of performance as other developing countries in sectors critical for structural transformation. The African Economic Outlook 2024 report estimates the annual financing gap at US$402 billion to fast-track Africa's structural transformation and align with global counterparts. This underscores the urgency for reforms in the global financial architecture to facilitate sustainable and inclusive resource allocation to finance Africa's development goals.

[14] The World Bank's current country classification by income level is used: developing countries are defined as those with a gross national income (GNI) per capita below $13,846, and high-income countries as those with a GNI per capita of $13,846 or more

Figure 2.7: Estimated annual financing needs and gaps to fast-track structural transformation in South Africa by 2030 and 2063 (USD billion)



	2030	2063
Infraastructure	5.2	0.9
Productivity	1.3	0.2
Energy	3.7	0.7
Education	2.5	0.4

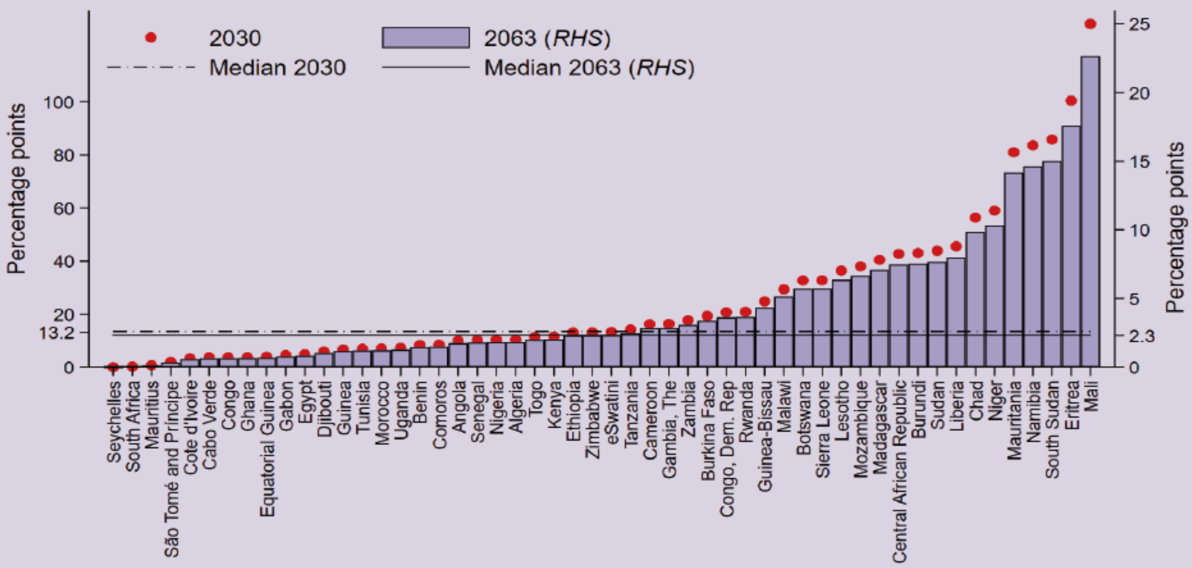
Source: AfDB

2.4.3 Closing the financing gap through domestic resource mobilization

The challenge of closing financing gaps in African countries is indeed a multifaceted issue that requires a concerted effort to enhance domestic resource mobilization. The average tax-to-GDP ratio in Africa was 15.6% in 2021, which is below the threshold needed to finance the SDGs. Despite some countries showing improvements, with Botswana and South Africa witnessing significant increases in their tax-to-GDP ratios, the overall picture remains one where additional efforts are necessary. While the primary responsibility for financing structural transformation lies with African countries themselves, there is a clear need for policies to boost tax revenues and address the structural factors limiting revenue collection, such as the size of the informal sector and economic diversification. This approach, coupled with international support, including the Bank (Box 2.2), could pave the way for sustainable financing of development goals on the continent.

Figure 2.8 displays the fiscal adjustments required by African countries to their tax-to-GDP ratios to meet their development financing needs by 2030 or 2063. These countries will need to increase this ratio by a median of about 13.2 percentage points—bringing the current median ratio to 28% of GDP—to close their financing gap by 2030, assuming that all the mobilized additional tax revenues are efficiently deployed and allocated to that objective. A smaller median increase of 2.3 percentage points will be required to close the financing gap by 2063, allowing for a more gradual fiscal expansion. In 17 African countries, the required increase in tax effort for structural transformation is estimated at less than 5 percentage points for the SDGs deadline of 2030, or 38 countries for Agenda 2063 deadline. South Africa stands out as a model, requiring only a minimal increase in its tax-to-GDP ratio, estimated at 0.25% and 0.04% to close its financing gap by 2030 or 2063, respectively. This reflects its robust tax system, thanks to the effectiveness of the South African Revenue Service in tax collection and administration. South Africa has consistently maintained a high tax-to-GDP ratio (averaging 24.2% during FY20/21-23/24) above the Africa's average in 2021. The contrast in the required tax effort highlights the diverse economic landscapes within the continent and underscores the importance of tailored fiscal strategies to achieve structural transformation and sustainable growth.

Figure 2.8: Required increase in tax-to-GDP ratio to close the estimated annual financing gap in Africa



Source: Staff calculations based on database from African Development Bank statistics, Sachs et al. (2023), UNESCO, CIA, NASA, IMF, and World Bank.

Box 2.2: Bank's support to economic transformation in South Africa

The Bank's new Country Strategy Paper (CSP) 2023-2028, which was approved by the African Development Bank Board of Directors on October 24, 2023, is well aligned with South Africa's efforts in this direction to tackle structural and policy challenges that constrain industrialization and inclusive growth for sustainable poverty reduction. The CSP focuses on two interrelated Priority Areas: (1) Enhance Governance and Private Sector Development; and (2) Quality Infrastructure Development for Inclusive Growth.

The Bank's approach covers two aspects: policy advice and project design. The Bank will leverage its credibility as a "trusted" partner to assist in tackling the economic governance issues that affect the quality and sustainability of infrastructure projects and the business environment for private sector actors. In collaboration with its development partners, the Bank will leverage its expertise, resources and networks to help South Africa address some of the key priorities for its recovery and transformation.

2.5 Concluding remarks and policy recommendations

The following recommendation are proposed to accelerate South Africa’s transformation.

- It is crucial for South Africa to craft and implement robust development plans that leverage the nation's unique strengths. These plans should be deeply rooted in the understanding of local economic and sociocultural landscapes, ensuring that they resonate with both national aspirations and global economic dynamics. The success of such strategies hinges on unwavering political will and the collective resolve of its citizens, fostering an environment where policy consistency catalyzes structural transformation and economic stability, thereby attracting investment and propelling the nation towards its development goals.
- South Africa needs to urgently scale up investments to build requisite human capital suited to local realities, circumstances and development priorities, including providing adequate skills training to prepare the workforce for the present and future. Tailoring education and skills training to the country's needs, particularly in science, technology, engineering, and mathematics (STEM), will facilitate the movement of labor to the high-productivity sectors and prepare its citizens for the demands of the global economy. The creation of innovation centers, in collaboration with educational institutions, is a critical step in cultivating a labor force ready for the fourth industrial revolution and the expanding ICT sector. Such strategic partnerships are key to aligning academic achievements with market needs, promoting sustainable development and economic growth.
- The strategic development of national and regional markets within South Africa and across the African continent is pivotal for economic resilience and growth. The AfCFTA promises to unify Africa into a single market for goods, services, capital, and labor, bolster intra-African trade and shield it against global economic fluctuations, with spillover effects on South Africa. The Pan-African Payment and Settlement System (PASS) is a crucial component of this integration, as it seeks to address the challenges of cross-border payments and reduce the dependency on foreign currencies. In South Africa, strengthening property rights, expanding financial services, and aligning legal frameworks are essential steps that can enhance the country's financial market infrastructure. These efforts, combined with policies that encourage labor mobility and technological collaboration, have the potential to harness Africa's abundant resources, promote industrialization, and drive sustainable development across the continent.
- South Africa's National Infrastructure Plan 2050 is a strategic initiative aimed at driving the country's development through a comprehensive infrastructure overhaul. By strengthening institutional frameworks, aligning regional agendas, and innovating in financing, the plan seeks to catalyze structural transformation. Enhancing the civil construction sector and establishing transparent monitoring systems are critical to the implementation of the plan.
- Strengthening fiscal policy, implementing tax reforms, and boosting public sector efficiency can create a favorable climate for private sector growth in South Africa. Enhancing the credibility of monetary policy and integrating risk management with strategic planning are key to building economic resilience. Transparent governance remains essential to these efforts, ensuring sustainable economic advancement.
- The active engagement of the private sector is crucial for economic development. By aligning with government

policies and incentives, private companies can foster innovation, boost productivity and competitive edge. Investing in the development of skills and capabilities is crucial for sustaining a competent workforce, which is the backbone of any thriving economy. Furthermore, leveraging trade agreements such as the AfCFTA can help to open up new markets and opportunities for exports, fostering economic diversification and integration.

- The IFIs need to continue supporting inclusive growth in developing countries by scaling up sustainable lending and offering innovative financing solutions like guarantees and blended finance to mitigate perceived risks and catalyze private sector investment. The IFIs need to support countries such as South Africa to access additional climate funds to implement key initiatives to bolster economic and climate change resilience.

3

FINANCING STRUCTURAL TRANSFORMATION IN SOUTH AFRICA: THE NEED FOR REFORMS OF THE INTERNATIONAL FINANCIAL SYSTEM ARCHITECTURE

KEY MESSAGES

- The South African economy's journey towards structural transformation amidst the challenges of climate change is a multifaceted endeavor, requiring significant external financing.
- The African Economic Outlook reports (AEO2022, AEO2023, and AEO2024) provide a framework for understanding the financial needs and gaps that must be addressed to expedite this transformation and fund climate action by 2030. A critical aspect of this financial strategy involves increasing the tax-to-GDP ratio, which is a pivotal move to bridge the financing gap and support the country's developmental goals.
- Moreover, the call for reforms in the international financial architecture underscores the necessity for a more equitable and effective global financial system that can support developing nations like South Africa in their quest for sustainable growth and resilience against climate adversities.
- These reforms are essential for South Africa and the broader international community, as they aim to create a financial environment conducive to addressing the pressing issues of our time, including climate change and economic inequality.
- The proposed changes to the international financial architecture could lead to more favorable borrowing conditions for developing countries, ensuring that they have the necessary resources to invest in health, education, social protection, and climate mitigation and adaptation strategies.
- The accelerated structural transformation of South Africa and the broader African continent hinges on a robust and reformed global financial architecture that can mobilize resources effectively and on favorable terms. The ongoing discussions and proposals for reforming the Global Financial Architecture are critical for Africa's economic development and integration into the global economy.
- The proposal to establish an African Credit Rating Agency is a significant step towards enhancing the continent's financial sovereignty and reducing dependency on external credit rating agencies, which often impose higher interest rates due to perceived risks. Additionally, the re-channeling of Special Drawing Rights (SDRs) through MDBs could provide much-needed concessional finance for Africa's structural transformation, aligning with SDGs and climate action initiatives.
- Moreover, increasing Africa's representation and voice in MDBs and IFIs is essential to ensure that the continent's growing economic and demographic significance is reflected in global financial decision-making processes. These reforms could pave the way for a more equitable and sustainable global financial system that supports Africa's aspirations for development and integration.

3.1 Introduction

This chapter presents the financing needs for South Africa to achieve structural transformation while dealing with the threat of climate change. It uses the Bank's estimates on financing needs and gaps to fast-track structural transformation (AEO2024) and finance climate actions (AEO2022 and 2023), respectively, by 2030. The chapter examines South Africa's capacity to increase the tax-to-GDP ratio to close the financing gap to fast-track structural transformation by 2030 and 2063 and motivates the need for reforms to the international financial architecture.

South Africa is a respected member of the international community of nations and plays an important leadership role in the global and regional affairs as well as support for peace missions across the region. South Africa is a member of the African Union, and the only African country that is a member of the G20[15] (and will chair the group in 2025) which aims to address major global economy issues including international financial stability, climate change mitigation and sustainable development. It is a member of the BRICS[16] , the AfCFTA, and the Southern Africa Development Community (SADC)[18] .

"Accelerating structural transformation in South Africa and the rest of Africa hinges on a robust and reformed global financial architecture that can mobilize resources effectively and on favorable terms."

3.2 South Africa's stand on the Need to Reform the International Financial Architecture

South Africa's drive to unlock its growth potential and achieve structural transformation requires enhancing governance, strengthening institutions, and increasing public sector efficiency. Regulatory frameworks that foster competition, innovation, and entrepreneurship are equally important to stimulate economic activity and attract investments. The commitment to significant investments in critical infrastructure, human capital, climate action, and technology is essential to enhance productivity to catalyze growth and ensure that the benefits of economic expansion reach all segments of society. The pursuit of comprehensive reforms, supported by development partners and IFIs, reflects a proactive approach to overcoming the challenges of limited fiscal space and elevated public debt levels. By seeking innovative and tailored solutions from the global community, South Africa aims to meet its financing needs, ensuring that efficient interventions and investments contribute to sustainable development and inclusive growth. The country's dedication to maintaining debt sustainability, even as it navigates fiscal pressures, is a testament to its commitment to long-term economic stability and prosperity.

South Africa, like many emerging and African economies, continues to encounter challenges in attracting international capital under favorable credit terms. Specifically for South Africa, internally, issues such as energy insecurity, with frequent power cuts known as "load-shedding," and the exposure of corruption within state entities like Eskom, have eroded investor confidence. These factors contribute to the perception of a high-risk environment, leading to higher credit costs. Externally, South Africa's geopolitical stance, particularly its balancing act between alliances with Western economies and BRICS

[15] Members include: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States, the European Union and the African Union

[16] Group of major emerging economies with influence on regional and global affairs: Brazil, Russia, India, China and South Africa, now expanded to include Iran, Egypt, Ethiopia, and the United Arab Emirates.

[18] Comprising of 16 members: Angola, Botswana, Comoros, Democratic Republic of Congo, Eswatini, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Tanzania, Zambia and Zimbabwe, SADC aims to promote economic growth and development, peace and security, alleviate poverty and enhance the quality of life of the people of Southern Africa.

nations like Russia and China, creates uncertainty, which can deter investment and affect credit terms. Additionally, the country's struggle with massive economic inequalities and the resultant social imbalances put pressure on its strong political institutions, potentially threatening their integrity and further complicating the investment climate. These internal and external challenges, coupled with the global economic context, shape the terms under which South Africa can access international capital. The complexity of the global financial circumstances necessitates a nuanced strategy for South Africa to navigate these challenges effectively.

South Africa has been a strong advocate for the reform of the global financial architecture, emphasizing the need for a system that allows developing countries to participate equally in the decision-making processes. The importance of addressing the challenges faced by developing economies and reform of the mandates of multilateral development banks, asserting the principle of country ownership and the alignment of projects to the development priorities and climate commitments has been made. The need for innovation in private sector engagement and a re-evaluation of credit ratings for developing economies to be based on economic fundamentals rather than subjective assessments has been stressed.

“Accelerating structural transformation in South Africa and the rest of Africa hinges on a robust and reformed global financial architecture that can mobilize resources effectively and on favorable terms.”

The call for Global Financial Architecture (GFA) reform is a pivotal step for South Africa and other African economies seeking to navigate the global financial system more effectively. The current architecture, established in the post-World War II era, while now structured to support the SDGs in Africa and other developing, is increasingly seen as inadequate to address the complex challenges of today's world, including climate change, systemic risks, and social inequalities. It presents a high cost of sovereign borrowing for African nations relative to their global counterparts. The accelerated structural transformation of South Africa and the broader African continent, therefore, hinges on a robust and reformed global financial architecture that can mobilize resources effectively and on favorable terms. Such reforms could potentially provide more equitable access to external financial resources, which are crucial for driving structural transformation. By advocating for a more inclusive and fair global financial system, South Africa aims to secure lower-cost credit and attract investment that is aligned with its developmental goals. The motivation for seeking such reforms often stems from the challenges faced in the current system, where developing countries, including South Africa, may encounter high borrowing costs, stringent conditions, and limited access to finance. Reforms could lead to a more balanced distribution of power within international financial institutions, ensuring that the voices of emerging economies are heard, and their interests represented. This, in turn, could facilitate the implementation of policies that support sustainable economic growth and reduce vulnerabilities to financial shocks. South Africa's pursuit of GFA reform is driven by the need to create a financial environment that supports its vision for economic advancement and resilience.

3.3 Mobilizing Additional Resources for South Africa’s Structural Transformation

In recent years, the South African economy has been bolstered by significant external financial flows, including Official Development Assistance (ODA), Foreign Direct Investment (FDI), portfolio investment, and remittances. These inflows were pivotal in stabilizing the economy and fostering growth amidst the aftermath of the COVID-19 pandemic and the global downturn triggered by geopolitical tensions. However, for UMICs like South Africa, ODA represents a smaller proportion of GDP compared to lower-income nations. ODA to South Africa amounted to about USD 1.0 billion (only 0.25% of GDP) in 2022. The steady declining trend in ODA as a percentage of South Africa's GDP from 0.36% in 1999 can be attributed to several factors, including the country's evolving economic status, which affects its eligibility for aid, and the changing priorities and economic conditions of donor countries. It also reflects the shifting landscape of international relations and economic partnerships in the global context. Despite this, ODA remains a valuable source of funding for specific sectors and projects, particularly those aimed at social development and infrastructure improvements.

South Africa attracted significant FDI in 2022, directed particularly towards renewable energy projects. Net FDI inflows rose to USD 9.19 billion (27% of global Sub-Saharan Africa and about 2.7% of the country's GDP) in 2022 from USD 5.11 billion in 2019.[19] According to the United Nations Conference on Trade and Development's World Investment Report 2023,[20] the total stock of FDI in the country stood at USD 173.5 billion in 2022, representing about 42.8% of the GDP. FDI from major global economies (European countries, the US, Japan, China, and Australia) is predominantly channeled into key sectors such as financial services, energy, mining, and manufacturing, which are cornerstones of South Africa's diverse economy. South Africa offers a dynamic demography, a diverse and advanced economy, abundant natural resources, a transparent legal system, and political stability, making it an attractive destination for investors. However, challenges such as corruption, labor unrest, and persistent electricity shortages, have been deterrents to investment in recent years. Despite these challenges, SARB reported FDI inflows of ZAR 53.8 billion (around USD 2.8 billion) in the second quarter of 2023, showing a positive trend in investment.

Portfolio investment flows into South Africa have become highly volatile in recent years, reflecting a myriad of economic and geopolitical influences. In 2022, the nation saw a significant reduction in portfolio investment inflows, which amounted to USD 4.2 billion compared to USD 8.9 billion recorded in 2019.[21] This decline can be attributed to a range of factors, such as economic policies, domestic macro weaknesses, ongoing economic recovery efforts, political dynamics, and global market conditions, which led to net disinvestment in 2023. The composition of portfolio investments in the country typically includes a diverse range of assets such as equities, stocks, bonds, and other securities held by foreign investors in the country. These investments play a crucial role in capital flows and economic development, with investors typically allocating their funds across various sectors including mining, finance, telecommunications, and industrial companies to spread risk and capitalize on growth opportunities within the country's emerging market. However, portfolio investment trends have become increasingly volatile in South Africa, which underscores the importance of a diversified portfolio across various sectors to mitigate risks and leverage growth opportunities in the emerging market. Investors continue to be watchful of the evolving economic landscape, balancing the potential for high returns against the backdrop of a volatile and complex investment climate.

The remittance inflows into South Africa present a unique case within the SSA context. South Africa received USD 872.9 million in 2022, accounting for 0.2% of its

[19] World Development Indicators viewed in May 2024.

[20] https://unctad.org/system/files/official-document/wir2023_en.pdf.

[21] World Development Indicators, 2024.

GDP, which is relatively low compared to the total remittances to SSA countries of USD 53 billion. As a share of GDP, the inflows to South Africa are much lower compared to countries like Ghana (5.2%), Rwanda (3.6%), Kenya (3.5%), and Uganda (2.8%).[22] This could be indicative of various economic factors, including the relative strength of South Africa's economy, which might rely less on remittances as a source of income, or it could reflect the patterns of migration and diaspora communities from these countries. Policymakers need to delve into the complexities of remittance flows and their implications on South Africa's economy to harness their potential for economic development and support the financial stability of the recipient families.

South Africa's economic development is shaped by various capital financial flows, including ODA, FDI, portfolio investments, and remittances. However, the volatility of these flows poses a challenge to the nation's goal of achieving structural transformation and economic growth. To address this, South Africa could adopt a multifaceted approach. Firstly, establishing robust regulatory frameworks can bolster investor confidence and reduce the risk of abrupt capital withdrawal. Secondly, reinforcing economic fundamentals with consistent policy execution may attract more stable capital flows. Thirdly, diversifying the economy and enhancing the business climate could increase FDI and remittances. Clear communication with investors and contingency planning for global financial volatility are also crucial in managing and stabilizing capital flows. Collaboration with international financial institutions and credit rating agencies can provide valuable guidance and support. The downgrade of South Africa's long-term credit rating to 'junk' by the major credit rating agencies has been a concern.[23] While the effects of financial flows on economic growth can be complex, they are generally considered essential for development if managed effectively. Thus, improving the business environment and investing in infrastructure, human capital, and technology are key strategies for South Africa to attract and optimize these financial flows, ultimately contributing to the country's economic prosperity.

3.4 Dealing with South Africa's debt

Public debt management in South Africa is strong with good planning and rigorous oversight to facilitate economic stability and growth. The country's public debt dynamics have been a focal point of economic discussions, reflecting the broader challenges of balancing fiscal responsibility with growth. The National Treasury's 2022/23 Debt Management Report[24] outlines the government's approach to managing borrowing requirements, domestic and foreign borrowing, and the associated costs of servicing the debt. It emphasizes the importance of maintaining a balance between stimulating economic growth through public investment and the need to manage debt sustainably to avoid excessive financial burdens. The report also highlights the significance of the South African debt capital market, detailing activities in both primary and secondary markets, and the use of electronic trading platforms. Furthermore, the government's debt portfolio and risk metrics are carefully analyzed to assess sovereign risk and ensure that the maturity profile of the debt aligns with the country's long-term financial strategy. This comprehensive approach to debt management is crucial for South Africa to navigate the complexities of the global financial landscape and to harness public debt as a tool for develop-

[22] World Development Indicators, 2024.

[23] The downgrade reflects concerns about the country's economic challenges, including high public debt, low growth, and inequality. These factors contribute to a cautious approach by foreign investors and adversely impact FDI inflows.

[24] National Treasury (2022/23).

ment and social progress.

South Africa's government debt has seen a significant increase, with the debt-to-GDP ratio reaching nearly 73.9% in 2023. This rise reflects the challenges of managing fiscal deficits and the impact of contingent liabilities from SOEs. The country's fiscal rule has been instrumental in keeping external debt within manageable limits, but the recent uptick to about 10% of GDP indicates a shift in borrowing dynamics. Domestic debt increased from 28.6% of GDP in 2010 to 65.8% in 2023 and is a major contributor to the overall debt burden (Figure 3.1). The growing debt service costs are exerting pressure on the government's budget, limiting the ability to fund critical public services and posing a hurdle to fiscal consolidation efforts. Prudent fiscal management and policy measures, as well as recourse to financing from IFIs, remain crucial for South Africa to navigate this challenging financial situation and ensure sustainable economic growth.

The structure of a country's national debt is a critical factor in maintaining fiscal financial stability. In South Africa, the government's debt portfolio is diversified across various maturities, which is a prudent approach to debt management. Long-term bonds, which make up a significant portion of the debt, offer the advantage of stability and predictability, as they typically carry fixed interest rates and longer maturities, reducing the need for frequent refinancing. On the other hand, short-term debt can offer flexibility and may be less expensive due to lower interest rates, but requires more frequent rollovers, which can increase refinancing risk, especially during periods of market volatility. This can introduce volatility and uncertainty into the government's fiscal planning. Therefore, a balanced mix of long and short-term debt is essential to mitigate risks and ensure that the government can meet its financial obligations without compromising its long-term fiscal health. By carefully managing the maturity profile of its debt, South Africa can navigate the complexities of public finance and support sustainable economic growth.

South Africa's public debt sustainability is a complex issue, reflecting the intricate interplay of economic dynamics and policy choices. The government's commitment to fiscal consolidation is evident in its efforts to stabilize the debt-to-GDP ratio through a judicious mix of spending cuts and broadening the tax base. The 2024 Budget Review's focus on achieving a primary budget surplus by FY25/26 underscores a strategic approach to fiscal management. The gradual implementation of reforms, as outlined in the fiscal consolidation plan, is designed to support growth while avoiding a debt crisis. The IMF's recommendation to introduce a debt ceiling complements the existing fiscal rule, potentially increasing expenditure efficiency and bolstering long-term fiscal sustainability. Nonetheless, the challenge of rising debt service costs, which now consume a larger share of revenue, cannot be overlooked. These costs are crowding out spending on critical public services, highlighting the delicate balance needed between debt management, economic growth, and fiscal prudence. The country's monetary autonomy, marked by a flexible exchange rate and an autonomous central bank, offers a degree of protection against debt distress. Continuous monitoring of these economic indicators is crucial for evaluating the resilience of South Africa's economy and the effectiveness of its fiscal policies.

3.5 Financing Climate Action

South Africa's juxtaposition as an upper middle-income country with high susceptibility to climate change highlights the complex challenges faced by African nations striving for development while

grappling with environmental vulnerabilities. The 2023 Notre Dame Global Adaptation Initiative Index, which ranks South Africa at 95th out of 182 countries, underscores the nation's need for robust adaptation strategies.[25] The country's recent experiences with increased frequency and intensity of extreme weather events, such as droughts, heatwaves, and severe flooding, have not only caused tragic loss of life and extensive damage to infrastructure but have also had profound economic repercussions, thereby impacting South Africa's progress on structural transformation. The agricultural sector, a key component of the country's economy, has been particularly affected, with the drought between 2015 and 2018 leading to substantial declines in crop exports and associated revenue losses, estimated at ZAR12 billion (USD 0.67 billion), as well widespread job losses across different sectors of the economy. The severe flooding in KwaZulu-Natal in 2022 and across several provinces in 2023, which led to over 400 deaths, displaced over 40,000 people and damaged infrastructure worth more than USD 1.5 billion and various forms of economic activities, further accentuates the urgency for enhanced resilience. These events underscore the urgent need for South Africa to prioritize climate change mitigation and adaptation measures, integrating them into its broader economic and social policies, to foster structural transformation and ensure the well-being of its people.

South Africa's approach to climate change integrates both mitigation and adaptation to reduce emissions and to cope with the impacts. The country's National Climate Change Adaptation Strategy of 2020 and the updated Nationally Determined Contribution (NDC) of 2021 demonstrate its alignment with global efforts like the Paris Agreement. These commitments are crucial as South Africa transitions from its coal-dependent energy sector, which has made it the 16th largest emitter of greenhouse gas (GHG) in the world and the highest in Africa, emitting 534.53 of metric tons of carbon dioxide equivalent (MtCO2-eq) (accounting for 0.99% of global emissions) in 2022.[26] The Climate Change Bill of 2022 and partnerships within the Southern African Development Community (SADC) are pivotal in fostering regional cooperation for climate resilience. By setting emission targets for 2025 and 2030, South Africa is actively working towards a sustainable future. The government's pledge to transform into a low-carbon and climate-resilient society by 2050 highlights the long-term vision required to address the complicated challenges of climate change.

South Africa's Just Energy Transition Investment Plan (JET-IP) is a strategic framework designed to harmonize the nation's economic development with environmental sustainability. With a comprehensive budget of USD 98 billion, the plan is set to cover the period 2023-2027, focusing on the decommissioning of coal-fired power plants and the expansion of renewable energy infrastructure. This aligns with South Africa's updated NDC and its Long-term Low-Emissions Development Strategy of 2020. The JET-IP is not just an environmental strategy; it is a socio-economic blueprint that addresses the broader socio-economic challenges of poverty, inequality, and unemployment, resonating with the NDP. The plan's equitable approach ensures that the transition safeguards the interests of vulnerable workers and communities. The international support, evidenced by the Just Energy Transition Partnership (JETP) and the pledged of USD 8.5 billion from the International Partners Group (comprising the USA, the UK, France, Germany, and the EU), underscores the global confidence in South Africa's commitment to sustainable development. This initiative positions South Africa as a pivotal player in the global climate action arena, demonstrating a balanced pursuit of

[25] (https://gain.nd.edu/our-work/country-index/rankings/.

[26] https://unctad.org/system/files/official-document/wir2023_en.pdf.

ecological integrity and economic viability.

South Africa's energy transition is an opportunity for the country to drive industrial development, innovation, and economic diversification, thereby fostering structural transformation. The JET-IP, which outlines investments required for decarbonization in line with South Africa's NDC, is a call to action for both local and international investors to support the country's commitment to the Paris Agreement. The transition encompasses a multi-sectoral investment in climate mitigation and adaptation, emphasizing the importance of securing financial support from the international community to complement domestic resources. This is crucial for the successful implementation of the JET-IP and for meeting the broader SDGs. The introduction by government of a carbon tax in 2019, which has been incrementally adjusted to ZAR144/MtCO2-eq by 2022, serves as a fiscal measure to reduce greenhouse gas emissions and encourage a shift towards greener technologies. As South Africa prepares for the second phase of the carbon tax in 2026, the focus remains on balancing economic development with environmental sustainability, ensuring that the transition does not negatively impact society, jobs, and livelihoods. The country's proactive stance on climate finance reform and its efforts to mobilize adequate funding are essential in driving the global financial architecture towards supporting climate action and structural transformation.

3.6 Policy recommendations

The accelerated structural transformation of South Africa and the broader African continent hinges on a robust and reformed global financial architecture that can mobilize resources effectively and on favorable terms. Implementing the following policy recommendations to the global financial architecture could be a transformative step towards achieving financial stability and inclusive economic progress, where South Africa and the African continent can actively participate in global resource allocation decisions:

Reform of the global financial architecture:

- South Africa's advocacy for rechanneling of IMF Special Drawing Rights (SDRs) to Multilateral Development Banks (MDBs) can significantly boost resources for Africa's structural transformation, and for robust replenishment of the African Development Bank's African Development Fund (ADF) and the World Bank's International Development Association (IDA) will further enhance their capacity to support low-income countries across the continent. By also advocating for favorable terms and exploring innovative financing, such as debt-for-nature swaps, South Africa is not only addressing its immediate financial needs but also contributing to a sustainable future.
- South Africa's active engagement in international financial forums and collaboration with other African nations could significantly influence the reform of the global debt architecture. South Africa could leverage its position as chair of the G20 in 2025 to amplify its voice and that of Africa to champion the reform of the global financial architecture that supports sustainable development and climate goals, reflecting the collective aspirations of the continent.
- South Africa's strategic position as a leading African economy gives it leverage to advocate for the reform of global financial architecture that ensures that African nations have fair representation in international financial discussions. Collaborative efforts with other African countries to propose new financing

mechanisms and sustainable policies could further strengthen the continent's voice.

- The initiative to establish an African Credit Rating Agency, backed by South Africa, will help to enhance the continent's financial sovereignty and reduce dependency on external credit rating agencies, which often use subjective assessments due to perceived risks. The support of the African Union and the United Nations Economic Commission for Africa is needed to underscore the collective desire for a system that better serves the development aspirations of African countries.

Climate action financing:

- South Africa's strategy of blending global best practices with local expertise through its active participation in the Partnership for Action on Green Economy (PAGE), is a model for integrating economic growth with environmental stewardship. This commitment not only advances South Africa's own green economy but also contributes significantly to the global effort, promoting policies that are both inclusive and resilient.

- South Africa's commitment to climate justice and transformation is evident in its strategic approach to financial mobilization. The establishment of a regulatory environment that encourages private climate finance, along with the development of comprehensive NDC plans, demonstrates the country's dedication to attracting vital investments for sustainable development. Credit enhancement mechanisms and capacity building are crucial in advancing projects to financially viable stages, and the introduction of innovative financing options, such as green bonds, is set to further stimulate funding. By aligning its development objectives with climate goals and enhancing governance, South Africa is indeed charting a course towards a resilient and equitable future.

- The development and implementation of frameworks for green growth and climate action in South Africa requires robust coordination between the government, the private sector, and international financial institutions. Strengthening regulatory clarity by addressing policy gaps, adapting legislation and capacity building are needed to support the design of bankable climate projects and to incentivize climate finance from private entities.

- Bolstering support for blended finance vehicles and pioneering innovative financial tools are crucial steps towards mobilizing necessary resources for initiatives like the JET-IP. These financial instruments should aim to mitigate risks and overcome market barriers, thereby attracting private investment into high-risk sectors. Integrating green growth into national policies and strategies is essential to ensure that these frameworks are effectively implemented to drive South Africa towards a sustainable and resilient future.

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