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South Africa: Economic Realities and Political Choices

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An Intelligence Assessment

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South Africa: Economic Realities and Political Choices [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Southern Africa Division, ALA [redacted]
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South Africa: Economic Realities and Political Choices 25X1

Key Judgments

Information available as of 1 November 1984 was used in this report.

South Africa's economic performance, in our judgment, will limit the pace of Pretoria's racial reform process. Nonetheless, Pretoria must sustain the momentum of reform if the new constitution granting limited political rights to Coloreds and Indians is to gain legitimacy among these nonwhite minorities. Moreover, we believe that, in order to satisfy the demands of Colored and Indian representatives, the government must also improve conditions for the black majority. The leader of the majority Colored party has already threatened that his party will pull out of the new system unless substantial new reforms that benefit all nonwhites are instituted in the next five years. 25X1

The economy is ill poised to shoulder the financial burden associated with major new programs for the nonwhite population in general, including blacks. Economic austerity measures imposed during 1984 to reduce a large current account deficit, as well as a persistent 12-percent inflation rate, will limit real economic growth to about 2 to 3 percent in 1985, in our judgment. Growth could be even lower if the price of gold falls, if the three-year drought continues through this growing season, or if the world economic recovery grinds to a halt. Moreover, we believe that South Africa's average annual rate of real economic growth during the remainder of this decade will be no more than 3 percent, and will continue to inhibit programs for nonwhites. 25X1

For their part, whites, already hit hard by inflation, recent tax hikes, and credit restrictions, are likely to be unwilling to foot the bill for costly racial reforms that would erode their privileged position. Even a speculative surge in gold prices would be unlikely, in our view, to induce the Botha government to enact massive new spending programs for nonwhites, largely because Pretoria would not want to be saddled with the added burden during subsequent economic downturns. Moreover, we believe that if economic conditions deteriorate severely—which we consider possible but not probable—Pretoria would move to protect the interests of whites at the expense of nonwhites. 25X1

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We believe that Pretoria will move on reforms that do not cost very much but are designed to have symbolic value to nonwhites, such as ending the ban on interracial marriages and relaxing job, business, and residency restrictions for all nonwhites. Such reforms also would reflect a new, implicit recognition by Pretoria that a large and settled urban black population is a permanent fixture in South Africa. Although the government's reform program in the near term will not improve the lives of blacks living in white areas enough to avoid periodic flareups of black unrest, it may be enough to maintain the participation of Colored and Indian members of parliament who will have a vested interest in the new political dispensation. 25X1

The effect of South Africa's mediocre economic prospects on US interests in southern Africa would probably be mixed. Slow economic growth in South Africa would compound the economic difficulties of Pretoria's neighbors and would lead them to look to the West—including the United States—for additional economic aid. Botswana, Lesotho, Swaziland, and Zimbabwe are especially dependent on South Africa as a market for their products and a source of employment. 25X1

On the other hand, budgetary constraints have made Pretoria sensitive to the economic drain of maintaining its control over Namibia. While we do not believe that financial considerations alone would determine South Africa's attitude toward a possible Namibian settlement, the increasing cost of Namibia probably will reinforce US peace initiatives in the region. 25X1

Aside from Namibia, we do not expect that South Africa's economic troubles will give Washington much leverage over Pretoria's domestic or foreign policies. South Africa most likely will continue to plead for patience for its gradualist approach to racial reform, citing among other factors the economic constraints on the reform process. In the event of a serious economic decline, however, Pretoria may implicitly ask Washington to acknowledge its cautious reform policies by assenting to another IMF standby loan—this would provide Washington with some new leverage. 25X1

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Contents

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Figure 1
South Africa's Black Homelands and Industrial Areas

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South Africa: Economic Realities and Political Choices

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Introduction

The recent outbreak of violence in black townships that coincided with the implementation of South Africa's new constitution, as well as the splits within the Colored and Indian communities over the new multiracial political system, has lent urgency to the government's efforts to gain legitimacy for the new constitution among these nonwhite minorities. The state of the economy is an important limiting factor on how far the government can move on reforms that the white electorate may perceive as a threat to white control and privilege. This paper assesses South Africa's economic prospects and the linkage between its economic health and the likely direction that President Botha's reform process will take.[1]

Recent Economic Performance

South Africa's economy is buffeted by the wild swings of world gold prices and the government's attempts to keep current account deficits within manageable bounds. In the past five years, the price of gold, which accounts for some 40 percent of South Africa's foreign earnings, has ranged from under $300 per ounce to over $600. During the same period, annual real economic "growth" has ranged from a negative 3 percent to a positive 7 percent (see figure 2). The record shows that Pretoria has not been particularly successful in balancing the surge in growth and imports that follows a gold price upturn against the inevitable current account deficits that follow a price decline (see table). Most recently, the government has struggled with a current account deficit that, in our view, was caused by Pretoria's unfulfilled expectations of higher gold prices and an end to the southern African drought, and by debt-financed consumer purchases.[2]

As it had in the past, Pretoria reacted to the recent current account deficit—as well as continued high inflation and a fall in the exchange value of the rand—by ratcheting down the economy. Banks boosted the prime lending rate from 20 percent in January 1984 to 25 percent in August. Pretoria increased the general sales tax from 6 to 7 percent in January, and to 10 percent in July. Credit restrictions also were tightened in August. Government policies were mixed, however, as a seemingly nonexpansionary budget presented last March has been largely undermined by spending that has run well above planned amounts.

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The economic downturn began in March as consumers apparently realized that the hoped-for sustained economic recovery was not in the offing. Retail sales slumped to 15 to 20 percent below business expectations in early September, according to press reports. In addition, the low exchange value of the rand fueled inflation, which has climbed back to an annual rate of 12 percent after slowing somewhat in late 1983. 25X1

Based on the sketchy data available—and on estimates by private US and South African economic forecasters—we believe that real growth for South Africa will be only about 1.5 percent in 1984. The current account deficit—that had been running at a seasonally adjusted, annual rate of $2.2 billion in the first quarter of 1984—probably will total nearly $1 billion for the entire year 25X1

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Economic Prospects for 1985 and Beyond

End of the Downturn?

In our view, the South African economy is set to turn around next year. Assuming an average gold price of $370 per ounce, growth of export demand of about 3

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[1] This paper focuses on South Africa's economic prospects for 1985.

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[2] Except where otherwise noted, all data are from South African Government sources.

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South Africa: Riding an Economic Rollercoaster

The South African economy is influenced to a large extent by factors that Pretoria cannot control: the price of gold, world economic conditions, and the amount of rainfall in South Africa's corn-growing region. Beginning in 1979, South Africa enjoyed a period of robust economic growth that was fueled by an unprecedented jump in the world price of gold. The increase from an average of less than $200 per ounce in 1978 to more than $600 in 1980 produced record current account surpluses that averaged $3.5 billion in 1979 and 1980 , and real economic growth of 7.3 percent in 1980.

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The Contraction of 1981-83

South African consumers bumped into limits on their ability to borrow, and began to reduce their spending by early 1981. This slowdown in private consumption triggered an economic downturn that was amplified by a plunge in world gold prices and the onset of recession in the United States and other Western countries. Gold prices slid steadily from an average of $560 an ounce in January 1981 to just $400 by the end of that year, cutting 1981 gold sales by $3.5 billion. Nongold exports dropped 12 percent in response to the recession in the West.

Pretoria responded to the prospect of rising current account deficits by boosting domestic interest rates in an effort to slow the economy further and reduce imports. South Africa was forced to cover a record current account deficit of $4.6 billion in 1981 and another $3.0 billion in 1982. It increased short-term borrowing from West European banks and drew down gold and foreign currency reserves by $1.8 billion in 1981. In 1982, South Africa obtained a $1 billion loan from the IMF, although steady increases in the price of gold during the latter half of the year eased the foreign payments difficulties. 25X1

The Untimely Miniboom

A temporary rise in gold prices from less than $300 per ounce in June 1982 to more than $500 per ounce in January 1983 triggered an economic upswing from April 1983 to March 1984, despite a third consecutive year of drought. Even after gold prices dropped back by more than $100 per ounce in the second half of February 1983, the boom continued; in our view, consumers—in the expectation of a sustained recovery and higher inflation rates—increased spending by borrowing more and saving less. The ratio of savings to aftertax income fell from over 11 percent in 1980 to only 3 percent in 1983. We believe that government miscalculations about the weather and gold prices also contributed to the false recovery because Pretoria did not clamp down on the economy by raising interest rates or reducing government spending. 25X1

Strong consumer spending and drought-induced corn purchases pushed imports up 21 percent in the fourth quarter of 1983. This rise in imports—and a further drop in gold prices from $410 to $388 per ounce—caused a current account deficit of $844 million in that quarter. The current account surplus for all of 1983 was only $246 million—far below predictions by South African economists at the beginning of the year that it would reach $2 billion. 25X1

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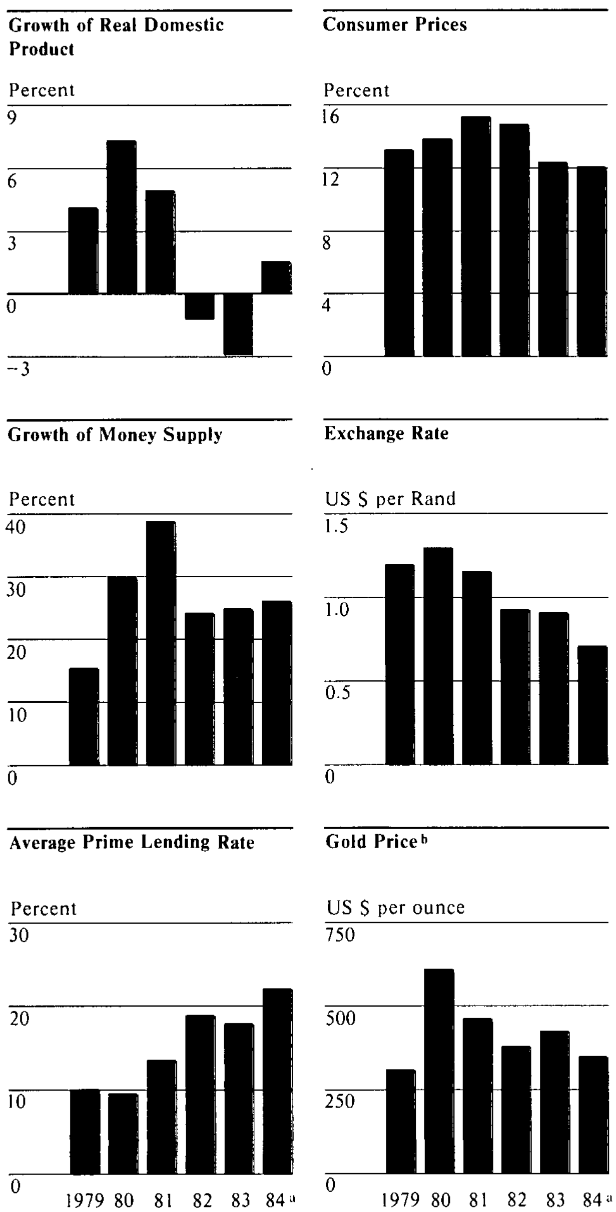
percent, and a normal corn harvest,[3] we project that Pretoria will be able to relax its economic restraints enough to allow 2- to 3-percent real growth in 1985 while generating a small current account surplus.[4]

Based on similiar assumptions, some private economic forecasters in South Africa and the United States expect a slight reduction in the rate of inflation to about 10 to 11 percent in 1985—1 to 2 percentage points lower than the rate we estimate for 1984. 25X1

[3] Past drought cycles suggest that three years of serious drought may be followed by several years of mild drought, but the limited data available make this pattern largely speculative. 25X1

[4] Some private US economic forecasters have projected a 4-percent real growth rate and a $600 million current account deficit for South Africa in 1985. Although we acknowledge that this performance is possible, we believe that Pretoria will keep interest rates near current record-high levels in order to avoid a too rapid economic expansion that would generate this large current account deficit. 25X1

Figure 2
South Africa: Selected Economic Indicators, 1979-84



[a] Projected.
[b] London average daily fixing price.
Sources: IMF, *International Financial Statistics;* South African Reserve Bank, *Quarterly Bulletin.*

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Economic growth greater than 3 percent would require a more rapid upswing than we expect in South Africa's revenues from gold and other mineral sales abroad. Most private economic forecasters project that a high demand for dollars will keep gold prices in the $300 to $400 per ounce range, with an average gold price for 1985 of about $370.[5] According to public statements by representatives of the South African mining industry, gold production probably will increase only slightly in 1985. Likewise, although the value of South Africa's nongold mineral exports may continue to grow, we expect that a gradual slowing of the world economic recovery will limit the real growth of revenues from mineral sales to about 3 percent. 25X1

Most South African economists argue that avoiding another economic downturn through 1985 and beyond—in the absence of higher gold prices—probably will depend crucially upon keeping the economy from expanding too rapidly, which would again lead to untenable deficits. In particular, these economists contend that excessive government spending could trigger another increase in inflation and new foreign payment problems that again would lead the government to clamp down on economic growth. Otherwise, Pretoria may be forced to increase foreign or domestic borrowing in order to cover current account deficits. 25X1

Based on public statements and past "pay as you go" practices, we believe that Pretoria will attach considerable importance to avoiding sustained, heavy borrowing. South African officials probably already are concerned about the increase in the country's foreign debt—which has risen from about $7 billion in 1980 to more than $15 billion at present, according to data published by the Bank for International Settlements. Moreover, increased government borrowing from banks within South Africa would tend to raise already high interest rates, and thus slow economic growth. 25X1

[5] Factors that might drive gold prices higher than expected would include a major intensification of the Iran-Iraq war, default by one or more of the major debtor nations, a significant reduction in Soviet gold sales, major purchases of gold by governments or international agencies, or a sharp economic downturn in the United States. 25X1

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South Africa: Balance of Payments *Million US $*

	1979	1980	1981	1982	1983	1984 [a]
Current account balance	**3,422**	**3,622**	**−4,567**	**−2,962**	**246**	**−1,000**
Merchandise trade balance	−1,100	−5,647	−9,804	−7,255	−5,067	−5,000
Merchandise exports, f.o.b.	10,469	12,553	11,006	9,359	9,290	9,600
Merchandise imports, f.o.b.	11,569	18,200	20,810	16,614	14,357	14,600
Net gold output	7,131	13,035	9,583	7,961	8,927	7,700
Net services	−2,803	−4,143	−4,771	−3,981	−3,940	−4,000
Net transfers	194	377	425	313	326	300
Total reserves, yearend [b]	**5,176**	**7,695**	**4,380**	**3,970**	**4,084**	
Long-term capital movements	−1,216	−614	623	2,236	−394	
Change in liabilities related to reserves [c]	−476	1	2,103	305	997	
Other short-term capital movements [d]	−1,709	−2,325	686	336	123	
Gold valuation adjustments and SDR allocations	2,419	1,258	−624	148	−388	
Change in gross gold and other foreign reserves	2,438	1,942	−1,779	62	586	

[a] Projected on the basis of an average gold price of $345 an ounce, 690-ton gold production, 3-percent growth in export demand, and 1.5-percent real domestic economic growth.
[b] Total reserves are not the sum of changes in reserves and the previous year's total reserves because of year-to-year changes in exchange rates.
[c] Liabilities related to reserves are short-term foreign liabilities of the South African Reserve Bank and short-term foreign obligations of the central government and commercial banks.
[d] Includes supplier credits and errors and omissions.

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Longer Term Prospects

Based on our earlier analysis of South Africa's export potential, we believe that the country's annual rate of real economic growth in 1986-90 will average no more than 3 percent. In our judgment, gold production will probably continue to stagnate, with nongold exports being insufficient to offset expected increases in import costs and to allow for economic growth. Most of South Africa's remaining gold ores are at extreme depths and of low grade, according to South African mining experts. These experts do not foresee major new discoveries. Thus, although gold production may rise in 1985, we believe that this is only a temporary development, and Pretoria over the remainder of the decade probably will continue periodically to constrain economic growth in order to cut imports and reduce the need for foreign borrowing. 25X1

The Impetus of Racial Reform

Against this backdrop of only modest economic performance that we expect to prevail for at least the next several years, President P. W. Botha is pursuing a program of gradual racial reform. The most visible element of this program is a new constitution that provides for separate parliamentary chambers for Coloreds and Indians, but that excludes the country's black majority. We believe, however, that in order to satisfy the demands of Colored and Indian representatives, the government must also improve conditions for the black majority. 25X1

South Africa: Good as Gold

The South African economy remains critically dependent on its foreign gold sales, despite Pretoria's efforts to diversify exports. Cyclical swings in South Africa's economic performance mirror swings in the world gold price. A $100 per ounce gold price change equates to a $2.1 billion change in export receipts, or 12 percent of earnings we project for 1984. Moreover, a $100 change in the gold price affects government revenues by about $400 million.

Our projection of 2- to 3-percent economic growth for 1985 is based on an assumed average gold price of $370 per ounce, which many economists expect for 1985. Other assumptions about gold prices will affect economic growth projections. For example, we believe that an average gold price of $450 in 1985 would enable Pretoria to boost economic growth to about 3 to 4 percent, and still maintain a current account surplus. On the other hand, in our view, an average gold price below $300 [a] would result in an economic contraction and a substantial current account deficit.

[a] *In our view, the gold price would be unlikely to fall below about $270 per ounce because we believe that many gold mines would become unprofitable at that price, thus reducing the supply of newly mined gold.*

Colored and Indian Demands

We believe that the government must sustain momentum in its reform process if the new constitution is to gain legitimacy among the Colored and Indian populations. Less than one-fifth of eligible Coloreds and Indians voted in elections held last August for the nonwhite chambers in Parliament.[6] Moreover, Colored and Indian parliamentarians will be particularly anxious to belie the charge of having "sold out" South Africa's black majority, and will demand reforms that would benefit South African blacks as well. For example, Alan Hendrickse—leader of the Labor Party, which won 76 of the 80 seats in the Colored elections—pushed for the government to lift the Colored labor preference in the western Cape Province that makes it difficult for blacks to compete for jobs there; Botha recently announced that this change would be implemented. 25X1

The government probably will continue to be sensitive to Colored and Indian demands because its program of gradual racial reform largely hinges on the viability of the new constitution. Hendrickse already has threatened that the Labor Party will pull out of the new system unless substantial new reforms that benefit all nonwhites are instituted in the next five years. 25X1

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Reforms for Blacks

Although South Africa has taken no actions that have weakened white control of either the government or the economy, several recent reforms seem to signal an important shift in Pretoria's policies toward improving the condition of blacks residing in urban areas. Until recently, Pretoria's apartheid policy has been built on the premise that all blacks could express political rights only in their assigned tribal homelands. The government now has recognized, if only implicitly, 25X1 that a large and settled urban black population in white areas is a permanent fixture on the South African scene. This new realism is reflected in the introduction in the late 1970s of a 99-year leasehold system that allows urban blacks to lease land in white 25X1 areas. A recent regulation goes further and allows blacks to renew these leases automatically on expiration or at the time of sale; Pretoria, in effect, has granted land title to blacks in areas of the country previously reserved for whites. 25X1

This acceptance of a permanent urban black population in white areas has led the government to other changes, including several intended to address the need for additional black housing and improved facilities in the affected urban areas. The government has:

- Initiated programs to provide electricity, street lighting and paved sidewalks, sewerage, and shopping centers to Soweto and some other major black townships, according to press reports.

[6] In our view, the low turnout was the result of cynicism about government intentions, as well as apathy, intimidation by opponents to the constitution, and Pretoria's last-minute crackdown on those opponents.

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Government Reforms in Perspective

The government's reform program in the near term probably will improve only marginally the lives of blacks living in white areas and will have even less impact on those in impoverished tribal homelands. Today, almost every aspect of daily life of blacks living outside of the homelands is regulated by a complex structure of discriminatory laws designed to maintain white privilege and control.

Political Rights
Apartheid envisions that blacks will exercise political rights only in the tribal homelands. When a homeland becomes "independent," South African blacks belonging to that tribal group lose their South African citizenship whether or not they were born in, or reside in, the homeland. Outside of the homelands, black political representation is limited to local councils that most blacks resent for cooperating with the white government.

Residence
Blacks living outside of the homelands are allowed to live only in designated black townships, which have poor or inadequate housing and services, and which are located far from jobs in white cities.

Travel
Movement of blacks outside of the tribal homelands is severely restricted, often entailing separation of family members. Blacks must carry an identification "pass book" and legally can only stay in white areas for 72 hours unless they have a job or have gained residing rights.

Education
Separate and unequal educational facilities are maintained for the various racial groups, and black teachers often lack a high school diploma themselves. The government spends an average of seven times as much to educate a white child as it does on schooling for a black.

- Called upon the private sector to play a major role in providing and financing black housing.
- Decided to sell—on generous terms—a large stock of urban houses in black townships that had previously been available only as rentals.
- Lowered building regulation standards and promoted self-housing programs.

Moreover, for blacks residing in urban areas, Pretoria has opened new job opportunities, increased spending on education, and legalized labor unions. Incentives have been introduced for additional black training by the private sector. According to press reports, Pretoria even plans to impose school fees on the families of white students to help fund increased educational expenditures for the other racial groups. Despite these reforms, however, the lives of blacks living in white areas are unlikely to improve enough in the near term to avoid periodic flareups of black unrest.

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The Costs of Reform

Following through on these reforms would require substantial government expenditures. For example, according to data reported in the press, parity in education for all ethnic groups in South Africa would increase recurrent annual expenditures on education by about $4 billion per year, about 16 percent of total government expenditures. We estimate that even the more modest goal of raising expenditures per black student outside of the homelands to one-half the average level enjoyed by white South African students would increase recurrent annual expenditures by nearly $500 million.

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Outlook

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So far, Botha's reform program appears to have the support of the majority of white South Africans, based on results of the white referendum on the new constitution. Slow economic growth during the remainder of this decade, however, probably would

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increase the political difficulty of further racial reforms that involved significant budgetary outlays. Pretoria's efforts to reduce public-sector borrowing by containing government spending implies that any significant increase in expenditures on nonwhites would come at the expense of whites. Moreover, many farmers and middle-class consumers hit hard by high interest rates and inflation probably already attribute the recent tightening of credit restrictions to excessive government social spending.

Given South Africa's lukewarm economic prospects and Pretoria's fiscal conservatism, we believe it unlikely that the government will undertake new reforms that involve significant additional government spending on nonwhites. Even a speculative surge in gold prices would be unlikely, in our view, to induce South Africa to enact massive new spending programs for nonwhites, largely because Pretoria would not want to be saddled with the added burden during subsequent economic downturns.

Pretoria no doubt recognizes that nonwhites are unlikely to be satisfied with the limited economic reforms being considered. According to press reports, the government, however, is considering several relatively inexpensive measures:

- New incentives to encourage the promotion of blacks into managerial positions in the private sector.
- Admission of more blacks to white colleges, universities, and technical schools.
- Relaxation of regulations on business activities of blacks in central city areas, as well as other restrictions on nonwhite businessmen.
- Elimination of bans on interracial marriages and sex—a step of great symbolic importance, especially for Coloreds.

While we judge that there is little likelihood of new or greatly expanded programs for nonwhites, we also believe that Pretoria would avoid significant cuts in existing programs unless the economy were severely depressed. Even if, for example, gold prices failed to rise above $340 per ounce, and Pretoria faced the usual cycle of current account deficits and constraints on growth, it has considerable financial resources to cover short-term adjustments without risking either a strong white reaction or backsliding on nonwhite reforms.

Under a worst case scenario—which we believe is possible but not probable—South Africa would face falling gold prices, perhaps combined with a fourth year of drought in 1985, divestiture of foreign-owned investments, and—as in 1976—an outflow of capital as a result of continued black violence. According to press reports, a private South African economic forecaster has projected that, if real interest rates in the United States remain at their current high levels, by 1987 the price of gold would fall to less than $200 per ounce. In this event, Pretoria would be forced to raise the prime lending rate to over 35 percent in order to prevent massive current account deficits, according to this forecast. We believe that the economy would enter a protracted depression, and that the living conditions of both whites and nonwhites would deteriorate. We expect Pretoria—under this extreme duress—would move to protect the interests of whites by cutting spending on nonwhites.

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Implications for the United States

The effect of South Africa's relatively poor economic prospects on US interests in southern Africa probably will be mixed. Slow economic growth in South Africa will limit economic recovery among neighboring states with which it has strong economic ties. For example, some 18 to 20 percent of Zimbabwe's exports go to South Africa, including 70 percent of its manufactured exports. Likewise, Lesotho and other black states that earn significant foreign exchange from the remittances of "guest workers" they send to South Africa will feel the pinch caused by a very limited growth of mining employment and wage rates. Such developments will compound the economic difficulties that these countries are experiencing and may lead them to look to the West—including the United States—for additional economic aid.

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On the other hand, budgetary constraints have made Pretoria more sensitive to the economic drain caused by financial and military support for Namibia. Although we do not believe that financial considerations

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alone would determine South Africa's desire for a Namibian settlement, we expect that the increasing financial drain of Namibia will reinforce US peace initiatives in the region.[7] 25X1

We do not expect that South Africa's economic troubles will give Washington much leverage over Pretoria's domestic or foreign policies. South Africa most likely will continue to plead for patience and understanding of Pretoria's gradualist approach to racial reform, citing among other factors the economic constraints on the reform process. However, as a result of recent US legislation requiring that US support for an IMF loan to South Africa be contingent upon expected benefits for South Africa's blacks, Washington may gain some new leverage should South Africa approach the IMF for another standby loan—which Pretoria almost certainly would do in the event of serious economic decline. 25X1

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