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South Africa: Short-term Economic Prospects

Summary

The South African economy, like those of industrializing countries, is divided between modern and traditional sectors, but its dualism is more pronounced and corresponds closely to racial divisions. Apartheid and its impact on South Africa's international status deny Pretoria the option of addressing its economic challenges without reference to broader political issues. Sustaining this year's likely recovery through 1987 probably will require successful negotiations with foreign creditors to reschedule $14 billion in suspended debt repayments. Even with a debt agreement and a relaxation of international pressure, we believe that the average annual growth rate is unlikely to exceed 3 to 4 percent for the remainder of this decade--a rate too low to keep black unemployment from rising. The growth outlook would prove even worse if internal political developments intensified external pressures that economically isolated South Africa from the industrial world. Economic reforms that might eventually boost manufactured exports and raise South Africa's economic growth potential would require massive foreign investment that is unlikely so long as the unrest continues. [redacted] 25X1

This typescript was prepared for the Secretary of State's Advisory Committee on South Africa by [redacted] the Office of African and Latin American Analysis. It has been informally coordinated with counterparts at State, Treasury, Commerce and DIA, all representatives of the Interagency Information and Coordination Group on South Africa. Comments and queries are welcome and should be addressed to the Chief, Africa Division, Office of African and Latin American Analysis, [redacted] 25X1 25X1

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Despite having many accoutrements of a modern economy--an advanced telecommunications system, well-developed transport infrastructure, and a wide array of consumer goods--South Africa is an industrializing nation with most of the characteristics associated with developing economies, such as a sharp division between modern and traditional sectors, a dependence on commodity exports, and a legacy of heavy government intervention.* The economy has been buffeted in recent years by numerous shocks--drought, lower-than-anticipated export prices, and a debt crisis that threatens to isolate it from international credit markets. As a result of these shocks, real economic growth has averaged less than 1 percent per year since 1981, a rate insufficient to keep per capita income from declining. We believe that the brunt of this mediocre economic performance has fallen on blacks, and, in our view, has contributed significantly to the serious unrest of the past 16 months. In an effort to boost economic growth and coopt urban blacks, Pretoria has publicly commited itself to liberalizing its economic policies. 25X1

Modern Versus Traditional Sectors

Academic studies and government data show that South Africa's 5 million whites enjoy an average per capita income and lifestyle similar to that of Western Europe. By contrast, the 13 million blacks who live in the rural "homelands" lead lives of grinding poverty. Conditions for them are generally not much different from those in the poorest African countries. Most of the other 11 million blacks, along with the 4 million Indians and mixed-race Coloreds, provide cheap labor for the modern economy, mostly in the urban area. They have an average per capita income closer to that found in middle-income countries, such as Turkey. The differences between living conditions are reflected in infant mortality rates that are 7 times higher for blacks than for whites, according to government data. 25X1

The disparity in economic development also manifests itself in food production and population growth. The output of commercial white agriculture has grown at a rate of 4 percent per year compared to a white population growth rate of under 2 percent, according to government data. For blacks, however, food production has stagnated, while population growth has averaged 3 percent per year. As a result, the black homelands have become increasingly dependent on food aid or purchases from white commercial agriculture. 25X1

A rising unemployment rate among semiskilled and unskilled workers coexists with a shortage of skilled manpower, according to an IMF study of South Africa. In mid-1985, registered unemployment among whites, Coloreds, and Indians was relatively low--for example, white unemployment was less than 2 percent--and was limited largely to the

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* With a population of 33 million and a GDP of $74 billion, the South African economy is roughly comparable in size and per capita income to the economies of South Korea and Argentina, according to IMF data. 25X1

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semiskilled. On the other hand, a number of academic studies have estimated that black unemployment is running at 25 to 30 percent; and, in parts of the eastern Cape Province, US Embassy sources calculate the figure exceeds 50 percent. 25X1

<u>Urbanization</u>. The large gap between the average per capita incomes of blacks living in the homelands and those in major urban centers acts as a strong magnet encouraging migration to "white" South Africa. As a result, the percentage of all blacks living in urban areas is expected to grow from 38 percent in 1980 to 60 percent in 2000, according to an academic study. 25X1

South African economists generally view the movement of blacks to the cities as essential for the country's economic development, but Pretoria--in common with the governments of most developing nations--clearly regards uncontrolled migration to the cities as a potential security threat. The government has admitted that the so-called influx laws have failed to stem black urbanization, and has promised to replace these laws with controls based more directly on the availability of employment and housing. White fears that sprawling slums of discontented blacks would threaten white rule probably will keep Pretoria from eliminating all controls on the movements of blacks to the cities. 25X1

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<u>Freeing the Black Economy</u>. We believe that the Botha government wants to improve the living conditions of urban blacks in an attempt to coopt them into accepting his program of limited racial reforms, but that it will not jeopardize its carefully crafted consensus for reform within the white electorate by massively redistributing income in the face of poor economic growth. Pretoria thus has only gradually dismantled economic apartheid to provide new opportunities for black advancement. According to government statements and US Embassy reporting, for example:

-- Expenditure for black education has risen sharply during the 1980s, although spending for whites on a per student basis remains seven times larger.

-- Pretoria in 1979 gave black labor units official recognition and the right to participate in collective bargaining.

-- Nonwhites working in white areas as executives, managers, or technical or administrative employees are no longer subject to the legislative "color bars" that restricted them to jobs where they worked under the fulltime supervision and control of a white employer.

-- Pretoria has announced that it will promote the development of small businesses by reducing government red tape, providing low-cost loans, and opening parts of some central business districts to all races; cumbersome licensing procedures, legal impediments and limited access to finance currently stifle black business initiative.

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Although these measures will help some blacks in the short run, Pretoria probably believes that over the long haul only higher GDP growth rates will create the larger economic pie necessary to make income redistribution more palatable to whites. 25X1

According to a recent South African government study, the economy's real GDP growth potential over the remainder of this decde is 3.6 percent per year in the absence of new foreign capital inflows or a sharp rise in world gold prices. The study held that economic growth will be constrained by stagnant gold production, limited prospects for further import substitution, and only fair-to-good opportunities to increase traditional commodity exports 25X1

While 3.6 percent real growth would represent an improvement over the economy's recent performance, many private and government economists in South Africa consider it disturbingly low. Although a 3.6 percent real growth would slightly raise per capita incomes--the overall population growth rate is estimated to be 2.3 percent per year--it is insufficient to provide jobs for all new entrants to the job market. According to a recent academic study, a real economic growth rate of at least 5.4 percent per year would be needed to absorb new job-seekers into formal sector employment. Erasing current black unemployment levels of 25 to 30 percent, of course, would take much higher growth rates. 25X1

Dependence on Commodity Exports

According to official trade statistics and our estimates, South Africa depends heavily upon raw mineral and agricultural exports, which together with semiprocessed minerals and food products account for 87 percent of the country's export revenues (see Figure 1). Overall, the economy is fairly export intensive. Total export earnings in 1984 were $20 billion, equivalent to 27 percent of GDP. These funds are used to purchase vital imports, especially oil and capital goods (see Figure 2). 25X1

Mining. The backbone of South Africa's exports--and its economy--is the mining industry, which accounts for some 76 percent of export revenues. Gold alone accounts for nearly half of total export revenues. The country's mineral exports are important not only to its own economic development, but also to world markets. Based on international statistics and data from the US Bureau of Mines:

-- South Africa accounts for 60 percent of world gold production, and is a major source of gem diamonds.

-- It is the major non-Communist supplier of several strategic minerals, including more than 90 percent of Western production of platinum group metals, some 60 percent of vanadium, one-half of

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Figure 1: Estimated South African Exports by Commodity Group, 1984

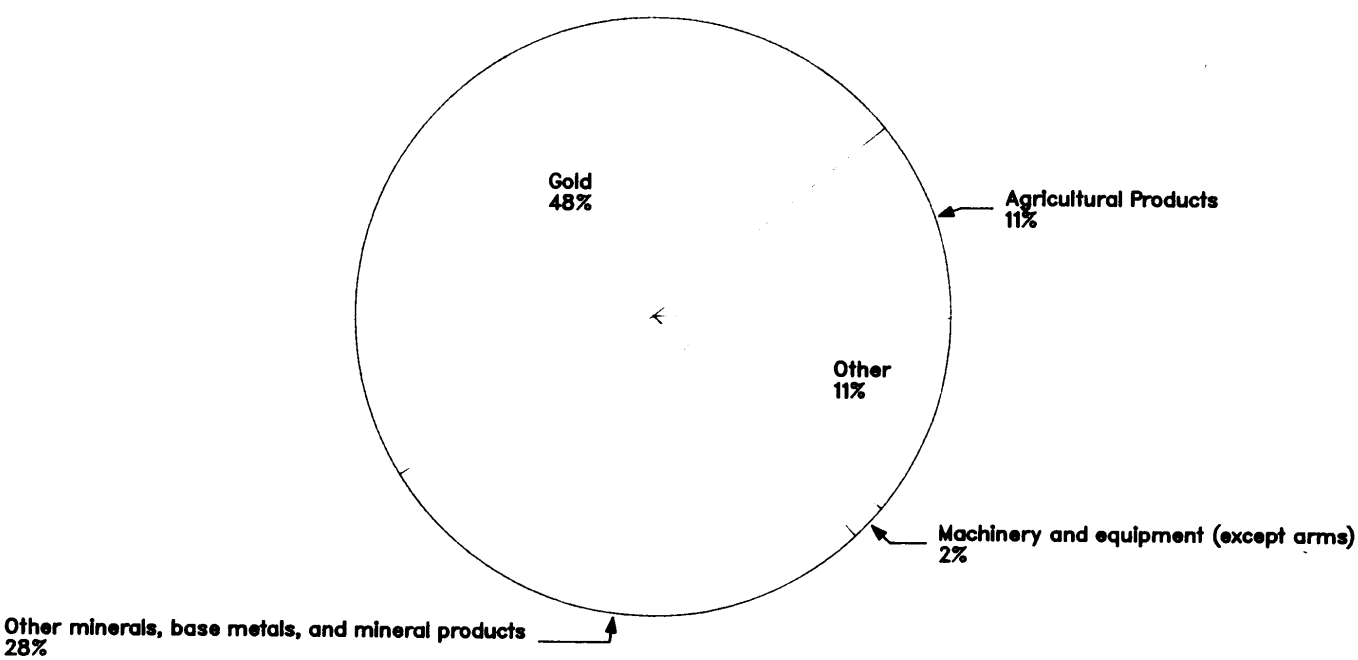

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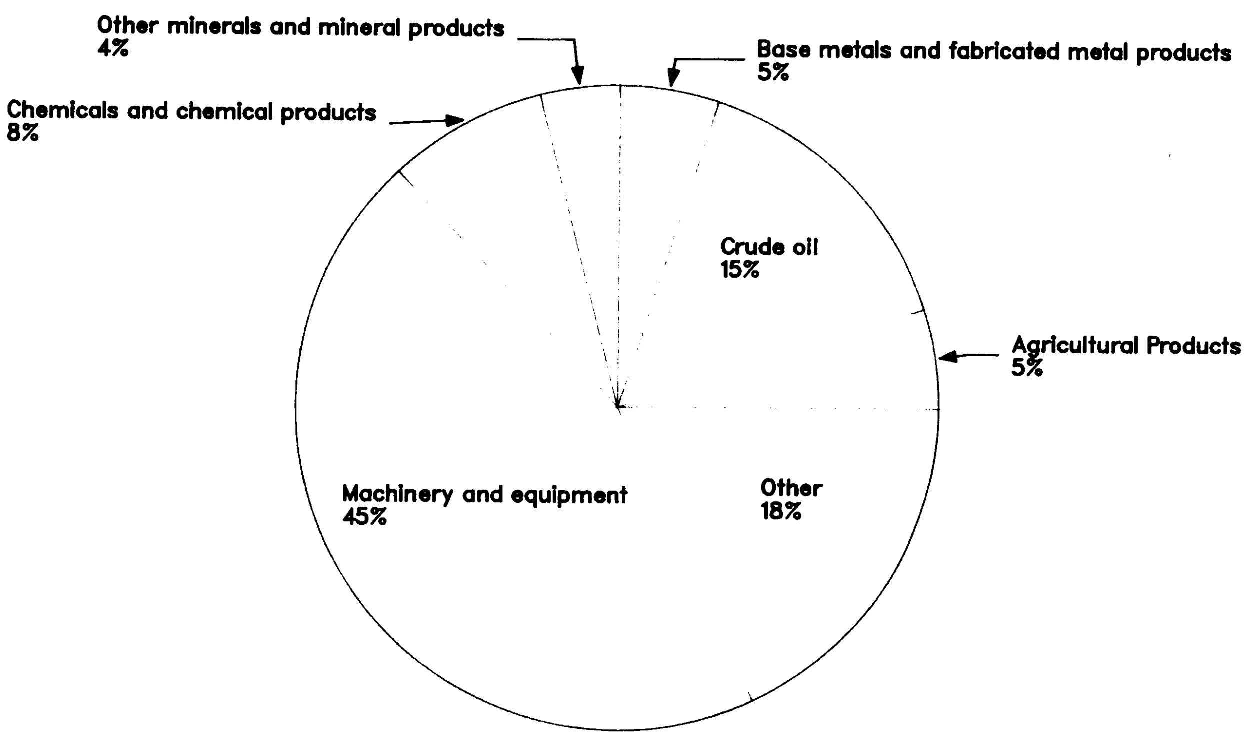
Figure 2: Estimated South African Imports by Commodity Group, 1984



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chromium, and one-fourth of manganese.

-- It is a major source of industrial minerals such as antimony, asbestos, fluorspar, vermiculite, andalusite, and titanium.

-- It is the world's third largest producer of uranium and a major coal producer.

Processing of minerals--particularly the production of ferro-alloys--has progressed significantly, and processed minerals now account for some 40 percent of nongold mineral exports by value. 25X1

In contrast to other parts of the economy where South Africa depends almost entirely on imported technology, the country is an acknowledged world leader in deep-mining technology. Expertise developed in the country's gold mines, which extend as far as 2 miles or more below surface level, has given South African mining corporations the wherewithal to invest in mining operations in southern Africa, the United States and Latin America. 25X1

Agriculture. Although the agricultural sector makes a much smaller contribution to GDP and export earnings than does mining, academic studies note that South Africa is one of a handful of African countries that are food self-sufficient in nondrought years, and that it supplies grains to much of southern Africa. South African farmers, however, do face significant problems. Rainfall is unreliable, and the country suffers from recurring and prolonged droughts. Moreover, the financial press reports that the severe drought that gripped South Africa's major grain-producing region from 1982 to 1985 and high interest rates have left the country's corn and wheat farmers overburdened with debt. Even with good rains, we believe it may be years before the country can match its record grain harvest of 1981. 25X1

A Legacy of State Intervention

The South African Government openly advocates market-oriented principles and is decidedly anti-Communist, yet its actions demonstrate a penchant for statist solutions to the country's social and economic challenges. This interventionist approach is notorious for the limits it has placed on black economic activity, but white businessmen, farmers and consumers also have been affected. Examples of government intervention include state-run corporations and markets, and policies intended to channel private-sector industrial development. 25X1

State-Run Companies and Markets. According to South African data, state-owned companies dominate several industries and hold some 15 percent of the country's physical capital. The South African Transport Services (SATS) operates the country's railroads, major airline, largest road freight service, and harbors. The South African Broadcasting Corporation (SABC) and post office dominate the communications field, operating television, radio, telephone, and postal services. The Iron and Steel Corporation (ISCOR) is by far the largest producer in its market. Other monopolies owned wholly or

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partially by the government include ESCOM (electricity), FOSKOR (phosphate), ALUSAF (aluminum), UCOR (uranium enrichment), SOEKER (oil exploration), Atlantis Diesel Engines, and ARMSCOR (weapons). 25X1

Even when government companies do not dominate an industry, Pretoria often sets the price or markets the product, according to US Embassy reports. Some academic studies have estimated that approximately one-third of South Africa's consumer price index consists of prices controlled by the government or its companies. The government also is the sole overseas purchasing agent for South African oil companies, and regulates domestic energy prices. Some 70 percent of farm output is sold to 29 agricultural marketing boards. The central bank markets gold overseas on behalf of the mining companies, and is heavily involved in the local foreign currency market. Overall, we estimate that the government sells more than half of the country's exports, and buys more than one-quarter of its imports. 25X1

Relations with Private Sector. Despite significant government intervention, academic studies and IMF reports indicate that the economy has a healthy private sector with a small, but reasonably sophisticated, financial market. The Johannesburg Stock Exchange is dominated by a handful of corporate groups, most notably Anglo American Corporation and Barlow Rand, which are involved in South African mining, property, manufacturing, and insurance. Foreign-based multinational corporations also play an important role in the economy, often in joint ventures with local corporations. 25X1

The Afrikaner-dominated government often has had cool relations with the business community, which is dominated by English-speaking South Africans and foreign companies. In fact, the Afrikaner leaders historically have used their control over the country's political system to improve the economic lot of their people. Based on public statements, this attitude seems to have changed somewhat in recent years as more Afrikaners have moved up in South African business, and as the National Party has sought business sector support for its racial reform program. Nonetheless, a mutual wariness is still the norm in government-business relations. 25X1

Import Substitution. As with many developing nations, the South African Government has sought to guide private-sector industrial development towards strategic, as well as economic, goals. In particular, it has used stiff tariffs and import controls to promote local production of goods previously imported. Import substitution probably has made South Africa less vulnerable to certain types of economic sanctions, but it also has created a manufacturing base that is largely uncompetitive in world markets, especially in industries where high technology and long production runs are important in keeping costs down. As a result, much of South Africa's manufacturing industry consists of high-cost companies producing consumer or industrial goods for domestic use under the protection of tariffs that exclude cheaper foreign substitutes (see Figure 3). Only 15 percent of the country's industrial output is exported. 25X1

The automobile industry provides good example of the problems facing South African manufacturing. According to the financial press, the industry grew rapidly during the 1960s and 1970s under heavy government protection from foreign competition. The

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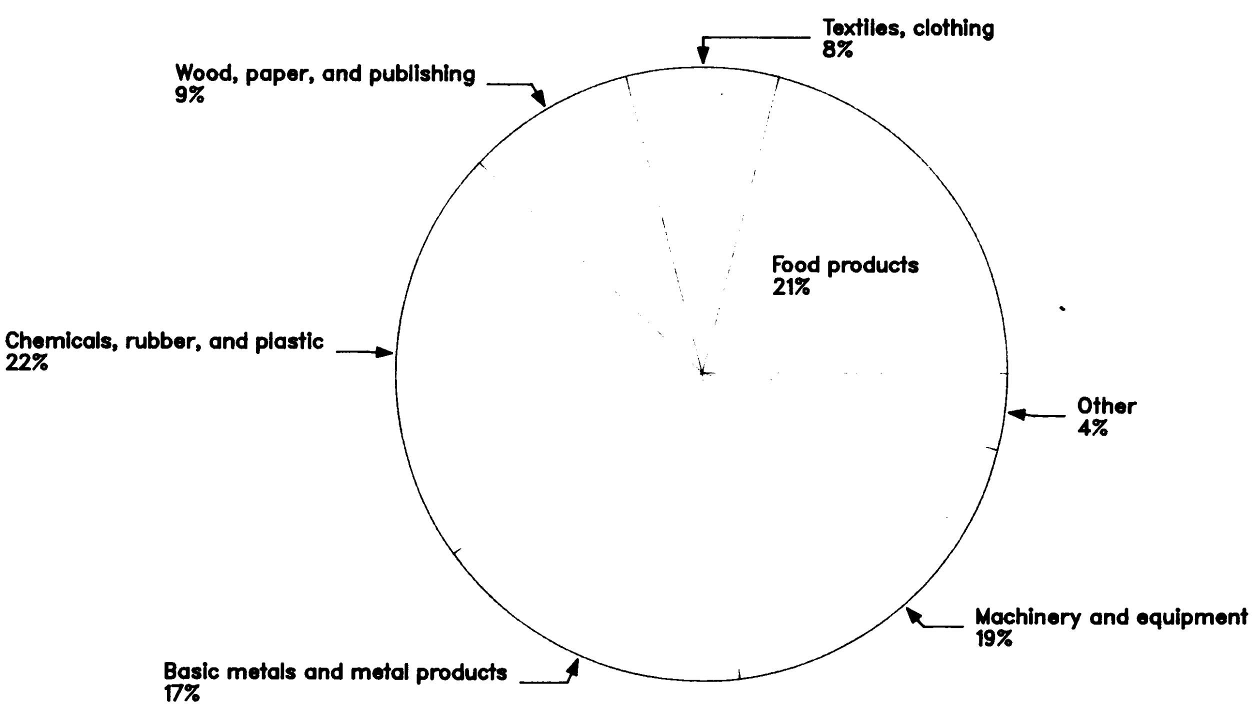
Figure 3: South Africa Manufacturing Sector Sales, 1984



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rising affluence of whites and government ceilings on interest rates created a ready market that numerous companies entered. More recently, however, saturation of the automobile market for whites--combined with recession and high interest rates--has triggered a precipitous decline in sales. The industry is operating at less than 50 percent of capacity, and more than 30,000 workers have been laid off during the past two years. Although there are some minor exports of motor vehicle parts to West Germany, the industry is too high-cost to expand its potential market through exports. A painful series of mergers and withdrawals of producers has begun and appears likely to continue. [redacted] 25X1 25X1

Pretoria's policy of import substitution has not been without its successes, most notably the three synthetic crude oil facilities, which use domestic coal reserves as feedstock to produce about 40 percent of South Africa's liquid fuel needs, according to academic studies. The first coal-to-oil plant began operation in 1955, and has been expanded over the years to a capacity of about 14,000 barrels per day of synthetic petroleum products. The second and third plants started operation in 1980 and 1982, respectively, and each has a capacity of about 45,000 barrels per day. Although the construction of these facilities initially was undertaken by the government for strategic reasons, a subsequent rise in world oil prices and fall in the value of the rand has made the facilities profitable, and they are now privately owned, receiving only a small subsidy in the form of a tax break. [redacted] 25X1

Prospects for further import substitution generally are poor, in our judgment. Two or three additional synthetic crude oil facilities are planned, including one that would use natural gas as a feedstock, but they probably will do little more than offset the growth in energy demand that will have occured by 1991 when the new facilities are expected to be in operation. Some import substitution for capital equipment may well occur, but the small domestic market will not permit the scale of operation enjoyed by high-volume foreign producers, which will lead to high unit costs that must be offset by government subsidies or passed on as higher prices. [redacted] 25X1

We believe concern over the country's mediocre long-term growth prospects has been reflected in Pretoria's effort since 1979 to liberalize its economic policies in order to promote manufacturing exports, and boost domestic savings. attract new foreign investment. A key element in this strategy has been the removal of selected import and foreign currency controls that were intended to protect high-cost domestic industry from foreign competition. In addition to allowing the rand to float against foreign currencies, the monetary reforms eliminated ceilings on domestic interest rates. Some selective promotion of exports also is envisaged, but as a signatory to the General Agreement on Tariffs and Trade, South Africa is limited in the types of export subsidies that it can use. [redacted] 25X1

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The Debt Crisis

Pretoria usually has practiced conservative foreign debt management to assure continued access to credits despite foreign criticism of its racial policies. The country's economic record shows that on several occasions the government has clamped down hard on growth to reduce import demand. South African economic performance thus has risen and fallen in response to swings in export prices, especially as a result of fluctuations in the world price of gold. In the past seven years, the annual average price of gold has ranged from under $300 per ounce to over $600 (see Figure 4). During the same period, real economic "growth" has ranged from a negative 3 percent to a positive 7 percent. 25X1

Origins of Debt Troubles. In our view, the most recent economic upturn--which lasted roughly from April 1983 to July 1984--stemmed from Pretoria's expansionary policies that were based on expectations of higher gold prices and of an end to the southern African drought, and from consumer purchases that ultimately were funded by short-term trade credits. By the middle of last year, it was becoming clear that the country's trade balance was getting out of hand (see Table 1). As it had in the past, Pretoria reacted to a $1 billion current account deficit for the first 9 months of 1984--as well as continued high inflation and a fall in the exchange value of the South African rand--by clamping down hard on the economy. As a result, the current account jumped back into surplus in late 1984, and real GDP fell by 2.5 percent between second quarter 1984 and second quarter 1985, according to government data. 25X1

Although the growth in debt relative to GDP during the 1983-84 miniboom was not unprecedented, South Africa became more vulnerable to a cutoff in foreign credits. According to Bank for International Settlements data, the maturity of the foreign commercial debt shifted from 38 percent short-term debt in 1979 to 66 percent in 1984--a trend which meant that a larger fraction of the debt needed to be paid off or reborrowed each year. Meanwhile, Pretoria's foreign currency and gold reserves fell relative to imports. Whereas these reserves were sufficient in 1980 to pay for 5 months of imports, by 1984 they could buy only 2 months worth. 25X1

According to the financial press, growing international nervousness over South African political uncertainties led some foreign banks to trim their credit lines in the first half of 1985, causing significant downward pressure on the rand. With floating exchange rates, the rand plummetted as South African companies scrambled for foreign currency commitments to cover future transactions in the self-fulfilling expectation of further declines. From an average of $1.30 in the first quarter of 1980, the rand sank to $0.40 in the third quarter of 1985. Political events, such as the declaration of a state of emergency in major black townships in July 1985 and a hardline speech by President Botha in August, triggered near-panic runs on the rand. 25X1

Pretoria suspended trading on South African foreign currency and stock markets for four days in August 1985, pointing publicly to the slide in the value of the rand, an acceleration of the withdrawal of foreign credit lines, and an apparent bunching of foreign debt repayment commitments as key reasons behind the decision. Pretoria then

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TABLE 1

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South African Balance of Payments, 1980-1985

	1980	1981	1982	1983	1984	1985 a/
Current Account Balance	3.6	-4.6	-3.0	0.2	-0.7	3
Merchandise Trade Balance	-5.6	-9.8	-7.3	-5.1	-5.7	-2
Merchandise Exports, F.O.B.	12.6	11.0	9.4	9.3	9.1	11
Merchandise Imports, F.O.B.	18.2	20.8	16.6	14.4	14.8	13
Net Gold Output	13.0	9.6	8.0	8.9	8.1	8
Net Services and Transfers	-3.8	-4.3	-3.7	-3.6	-3.1	-3
TOTAL RESERVES, YEAREND b/	7.7	4.3	4.0	4.1	3.1	
Long-term Capital Movements	-0.6	0.6	2.2	-0.4	1.9	
Change in Liabilities Related to Reserves c/	0.0	2.1	0.3	1.0	0.4	
Other Short-term Capital Movements d/	-2.3	0.7	0.3	0.1	-2.1	
Gold Valuation Adjustments and SDR Allocations	1.3	-0.6	0.1	-0.4	0.9	
Changes in Gross Gold and Other Foreign Reserves	1.9	-1.8	0.0	0.6	0.2	

a/ Estimated.

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 commercial banks.

d/ Includes errors and omissions and supplier credits.

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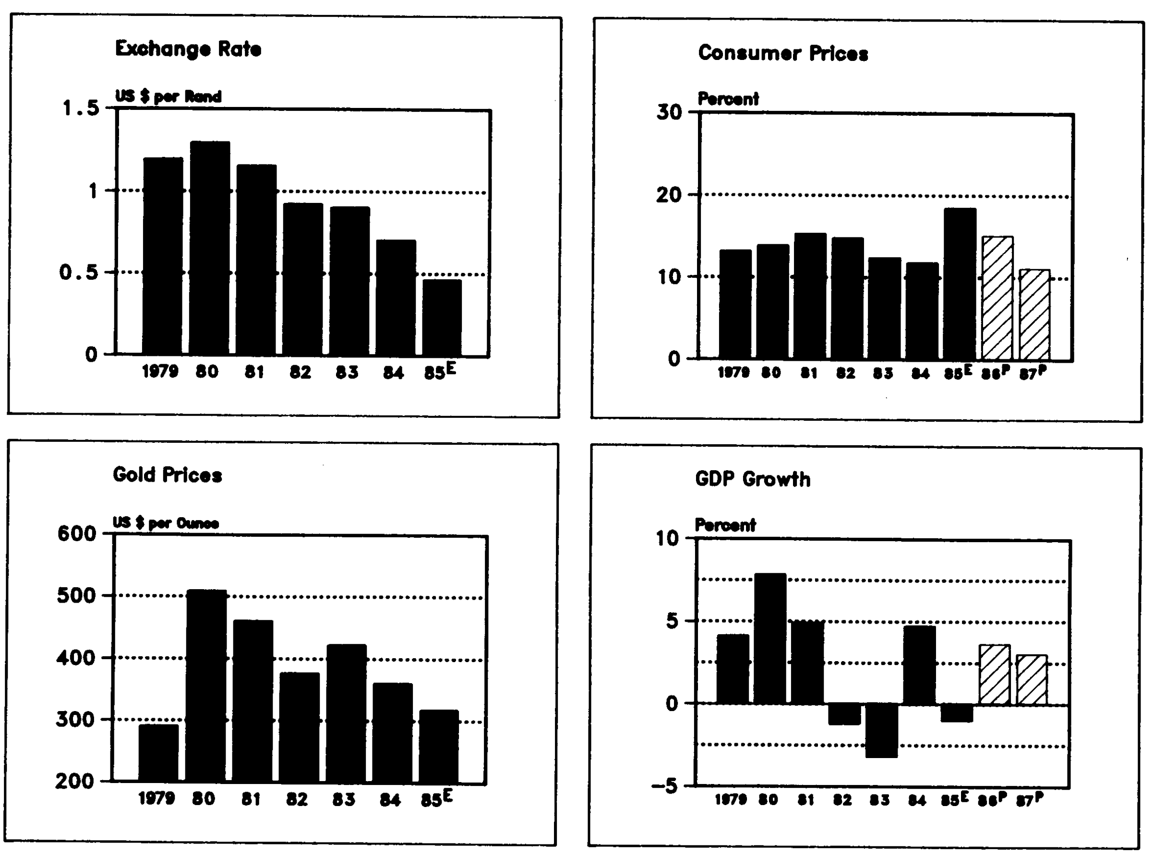
Figure 4: Selected Economic Indicators



E Estimated

P Predicted

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announced on September 1 a four-month suspension of principal repayments on $14 billion of South Africa's $24 billion in foreign debts. Foreign currency controls also were tightened in an effort to slow the capital outflow, reversing its previous policy of economic liberalization. [redacted] 25X1

Negotiations with foreign creditors so far have not yielded a debt rescheduling agreement, and the moratorium has been extended to 31 March. According to press reports, Pretoria has proposed to major creditor banks that the moratorium be extended to 1990. Not surprisingly, the initial creditor reaction to the proposal has been unfavorable. In addition to the economic considerations, foreign banks also face the dilemma of balancing a solution to South Africa's financial crisis against a desire to avoid being viewed as cooperating with Pretoria. [redacted] 25X1

Implications. Failure to resolve the debt crisis amicably would reduce significantly South Africa's future access to foreign capital, in our view. Not only would overseas commercial banks be unlikely to make major new loans, but retention of the tighter foreign currency controls recently reimposed also would discourage foreign investment. [redacted] 25X1

The short-run impact of a decline in foreign investment should not be overstated. According to government data, South Africa's industrial development has received little financial help in recent years from foreign investment and has been funded largely through domestic savings of revenues earned through the export of gold and other commodities. Indeed, government data reveal that net foreign capital inflows, including loans and investment, have accounted for only 12 percent of gross domestic investment since 1977. [redacted] 25X1

Although foreign capital inflows have played a comparatively small role in South Africa's recent economic growth, over the long haul the loss of foreign capital from loans and investment would hurt the country's ability to diversify exports and boost black employment prospects. Based on our review of past periodic episodes of heavier foreign investment and borrowing, we believe that capital inflows have served principally either to fund major development projects or to sustain temporarily an economic upswing at times when the gold price has declined unexpectedly:

-- In the mid-1970s, state-run corporations undertook major infrastructural projects that required foreign funds, including port development and improvements, expansion of iron and steel plants, establishment of television service, and more rapid electrification.

-- By contrast, 1981 and 1982 were years of little new investment, but South African banks and the central government borrowed abroad to finance current account deficits totaling $7.5 billion; gold prices had fallen from an average of $608 per ounce in 1980 to $460 in 1981 and $376 in 1982, according to IMF data. [redacted] 25X1

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In the absence of new capital inflows--and especially if sanctions cut markedly into export earnings--we believe that Pretoria will be unable over time to boost South Africa's economic growth potential significantly above 3.6 percent despite its economic liberalization drive. According to an academic study, the country over the next five years will need capital to fund proposed infrastructural projects such as the two proposed synthetic petroleum facilities, as well as normal expansion of productive capacity. Internal sources of funds exist, but without inflows of foreign capital the capacity of the economy to buy the imports that it needs for growth soon will be reached, according to US Embassy analysis. Even the sale of state-owned companies will have limited benefit as these corporations tend to be unprofitable. 25X1

Despite the potential implications of the debt crisis for the future availability of funds to South Africa, the government has reacted to the debt crisis by easing its credit policies. Banks have lowered the prime lending rate from 21 percent at the time that the debt moratorium was declared to a prevailing 15.5 percent, and restrictions on consumer borrowing have been relaxed. In our view, Pretoria chose to ease credit in order to boost domestic business confidence and promote a gradual economic recovery that would reduce tensions in black townships. 25X1

Prospects for 1986 and Beyond

South Africa is poised for a modest economic recovery this year. Our economic model forecasts roughly 3.5-percent real GDP growth, around a 15-percent yearend inflation rate, and a little over a $1 billion current account surplus. This compares with private sector forecasts of South African economic growth which in general are in the low 3-percent range. In our judgment, the recovery would be export-led, with the domestic economy remaining fairly depressed and black unemployment rising slightly. As a result, we expect private investment in plant and equipment to decline further. Key assumptions that underlie our forecast include a continuation of current heavily-expansionary policies, an average gold price of $350 per ounce, continued good rains though February in the corn-growing region, progress in the debt negotiations (though not necessarily a final resolution), and little significant change in foreign economic sanctions against South Africa. 25X1

Sustaining the upswing beyond 1986, in our view, will require at a minimum successful negotiations with foreign creditors to reschedule the $14 billion in debts that are now frozen. Failure to do so, or to avert tougher sanctions, will lower growth prospects in 1987 and beyond. Although political developments in South Africa may derail the debt talks, we believe that at least a tacit one-year debt rescheduling is likely--if not a formal, multi-year agreement. The banks have little to gain by breaking off debt talks as long as public pressure is manageable and South Africa remains current on its interest payments. On the other hand, creditors probably believe that a one- or two-year rescheduling would have the advantage of appearing to keep Pretoria on a tight leash. Pretoria, for its part, probably recognizes bankers' political sensitivities and may be willing to negotiate on the basis of a one- or two-year rescheduling. 25X1

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In the absence of major new political reforms, we expect South Africa's economic isolation to increase over time. Continued unrest is likely to spark new calls for tougher Western economic sanctions. These sanctions, in turn, probably would push growth below 3 percent in 1987 and beyond, and seriously erode any current account surpluses. By contrast, economic reforms intended to boost manufactured exports eventually may raise South Africa's economic growth potential, but the necessary infusion of foreign investment implies some internationally-accepted resolution of the country's political dilemma--an unlikely scenario--which, in any case, would take years to affect significantly economic growth. [redacted] 25X1

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SUBJECT: **South Africa: Short-Term Prospects**

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