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August 29, 1990

Mr. Tebogo Mafole
Chief Representative
African National Congress
Observer Mission to the U.N.
801 Second Avenue
Suite 405
New York, New York

Dear Mr. Mafole:

Enclosed is a revised version of the draft memorandum I sent you. Please give me a call when you are ready to discuss it.

Regards,

David Ferreira

/d1/3h/17875/OOZ/MEMOQO/restructuring
DRAFT: August 29, 1990
Memorandum to: Working Group
- (See attached list)
Re: Restructuring of the
South African Economy

In this memorandum I have outlined, in very basic terms, an approach to several key issues that will have to be addressed in the restructuring of the South African economy that will necessarily take place in the post-apartheid era. In so doing, I have attempted to describe the context in which a South African Development Bank (the "Bank") will be required to operate. The memorandum is intended to provide a rudimentary starting point for discussion among members of the working group, rather than to state any definitive position.

I have made no attempt at completeness in raising topics for discussion. Any document prepared for prospective subscribers will have to be not only more detailed in its treatment of the subjects that appear in this memorandum, but will have to address a variety of related matters.

1. The Current Situation

The South African economy contains an extreme structural mix. Its make-up ranges from "first world" development, through the informal sector characteristic of most developing economies, to squalid urban shanty towns and primitive rural subsistence agriculture that rank with the worst areas of "third world" poverty anywhere.

In the easier times of the 19605, when bouyant world demand for South African metals and minerals ensured almost continuous export-led growth, and in the gold booms of 1973-4 and 1979-81, the country was able to achieve substantial economic growth. But, as growth in the major Western economies was disrupted by oil shocks and belated anti-inflation drives, and latterly as sanctions took their toll, South Africa slumped to an average real economic growth rate of less than 2% in the 19803.1 This is below the rate of population growth, causing a secular decline in per capita living standards.

The adverse effect of weak growth has been exacerbated for most South Africans by the concentration of wealth and income in a small segment of the population. The average black per capita income is thought to be between 9 and 13% of the white income level.

On the other hand, the country has a wealth of natural resources, a highly advanced spread of mining and manufacturing activities, a sophisticated financial service industry and a long established entrepeneurial business culture. It therefore has the potential for striking economic success.

2. The Goal of Restructuring

The central medium to long term goal in restructuring the economy is a reversal of the trend to declining per capita income, accompanied by increasing equality in the distribution of wealth and income.

To put the issue of growth in perspective, it should be noted that growth of over 4% a year in income per capita over two decades has been achieved, for example, by China, Indonesia, Thailand, Botswana, Brazil, Malaysia and South Korea. Growth at 4% doubles income per capita in 18 years.

Significant redistribution of resources has to take place, not only as a matter of equity, but also for sound economic reasons: Skills have to be more widely dispersed for the effective management of the economy. Income (and thus effective demand) must be more evenly distributed to allow the growth potential of many industries to be realized. Productive resources (like land) must be far more widely accessible, to facilitate their optimal use.

At the same time, this process must take place over time, to ensure that it is well managed, that it takes plaoe in accordance with the requirement of growth in the economy, that foreign investment is encouraged to the fullest extent possible and, most importantly, that the changes in the economy are permanent and fundamental, rather than short term. Economic analysis shows that direct redistribution often shows fairly modest short term benefits and potentially disastrous longer term results.

Consequently, it is useful to consider a realistic time frame when assessing the feasibility of achieving development goals. For example, if one asks how a significant and lasting compression in the distribution of income and wealth can be achieved, one should probably be looking at how this can be done within twenty years; when one is considering affirmative action to redress racial inequalities in the management of firms, a far shorter time horizon is appropriate.

3. Population Growth

South Africa’s population is growing at 2.5% a year. The black population is growing at close to 3%. There is a 7.5% growth rate in black urbanization and a 20% growth rate in the number of black school leavers. At present, over 40% of black people are under the age of fifteen. The government estimates that a real economic growth rate of 5% a year is required merely to absorb the 1,000 daily new entrants to the workforce. These figures have to be viewed against the backdrop of black unemployment rate estimated to be as high as 30%. (White unemployment is virtually non-existent.)

Public information programs and social services will have to be directed towards achieving more sustainable population growth. Experience shows that mothers' schooling and employment and access to child schooling and health facilities are important factors in reducing the number of births desired by families.

4. Mobilizing Foreign Resources

An arguably positive benefit of sanctions, in the economic sense, is that South Africa is not affected by the debt crisis which burdens much of the developing world.1k Exclusion of South Africa from international capital markets since 1985 has, however, constrained growth. In order to finance its international debt, which stood at $23.65 billion

8 Total foreign debt is estimated to have fallen to $20.6 billion in 1989 from $21.2 billion in 1988. Of this total 43.2% is accounted for by public medium and long term debt, 40.8% by short term debt, and the remaining 16% by private medium and long term debt. Based on its repayment schedule, South Africa's total debt is projected to fall to $18.8 billion, or 16.9% of GDP, by 1991.

in 1985, the government has had to run sizeable current account surpluses. In practice thus has placed a 3% ceiling on economic growth. Because the South African economy depends heavily on imports of capital goods, economic growth translates into higher import bills and thus greater claims on the economy’s foreign exchange reserves. At the same time, financial and investment sanctions constrain South Africa’s access to new foreign capital, and trade sanctions limit its export opportunities, rendering these reserves inelastic. With foreign debt repayment schedules already making heavy claims on foreign reserves, an expansion in production related business activity, with its accompanying increase in capital goods imports, rapidly produces a potential balance of payments crisis. As a result, the government has adopted tough monetary and fiscal policies in order to reduce domestic consumption growth.

Foreign aid in the form of official development assistance (i.e. aid from governments and multilateral agencies and not from individuals and charities) has to be treated with caution. It is sometimes tied to purchases from donor countries. Conditionalities on policies to be pursued by recipients are increasingly popular amongst both multilateral and national agencies. Governments such as the United Kingdom’s appear to be linking their own aid to conditionalities applied by the World Bank in their packages, which often involve tight control of public expenditure and liberalization of trade policies. Management and monitoring of official development assistance is thus important.

The flow of aid from charities and non-governmental bodies is much smaller, but such aid can often be extremely productive. Agencies such as Oxfam have a good record in pioneering innovative projects which involve initiative and training and, particularly, helping weaker groups in direct action to help themselves.

Private foreign investment in the South African economy is indispensable if sufficient growth is to be generated.

Foreign investment is often discouraged by sheer red tape. Zimbabwe has recently established a one-stop investment center to guide foreigners through ministries that must endorse new projects. Such an option should be seriously considered.

Substantial incentives may be necessary to encourage new foreign investment. Among the reasons behind this thought is that South Africa is perceived as a relatively mature market. In other words, foreign corporations may see the investment choice as being between buying an existing business or sacrificing profitability while becoming established.

5. Mobilizing Domestic Resources

Foreign capital cannot be a substitute for domestic savings. It has to be viewed essentially as a supplement to such savings. The capital market does not currently direct investment into many potentially productive activities or infrastructural development, nor into projects designed to meet basic needs, expand development, redistribute incomes and provide increased social services. Such investment will initially have to come primarily from foreign capital raised by the state and institutions like the Bank, and from taxes. Even though South Africa collects a relatively small proportion of its GDP (roughly 27%, compared to 42% in Britain) in taxes, there is not much room for increases in tax rates. Low tax receipts reflect a narrow tax base; rates are already fairly high. The top marginal rate applied to individuals is 44% and the corporate tax rate is 50%. Tax reform requires considerable analysis and must incorporate consideration of public sector pricing, since one can regard differences between price and marginal cost in a public sector firm as a form of taxation. The design of any tax system will have to take account of its administrative feasibility, problems of manipulation and evasion, and political acceptability, together with an assessment of how far it squares with basic considerations of revenue requirements, incentives and distribution.

To some extent resources can be redirected from wasteful uses, such as apartheid’s parallel bureaucracies and much military expenditure. This requires, amongst other things, shrinkage in the overall size of the bureaucracy. Overall government expenditure cannot increase.

Central government spending, at 65 billion South African rands, represented about 32% of GDP in 1989, compared to 25% a decade earlier. The government dissaves, i.e. it borrows to finance current expenditures, and this absorbs an increasing proportion of the country’s scarce savings. The deficit before borrowing, as a percentage of private savings, increased from 37% in the 19705 to 46% in the 1980s and had reached 78% by 1988.

The ratio of personal savings to disposable income is exceptionally low. At present, it is only the large volume of contractual savings that is preventing a sharp fall into a negative trend. For the first quarter of this year the ratio, on an annualized basis, was 0.5%, and in 1989 it was 0.8%. In an attempt to address this, the government has made it known that it intends in the next budget he make all interest income subject to a maximum withholding tax of between 10 and 12%.

Exchange controls are an important component of the current government's strategy to retain domestic savings in the country. They would probably have to be kept in place in the short term to prevent capital outflow.

6. Structural Adjustment and Stabilization; Monetagy and Fiscal Policy

Stabilization programs refer to attempts to correct balance of payments deficits and excess demand by changing the real exchange rate, liberalizing trade and tightening fiscal policy. Orthodox programs of this nature, usually associated with the IMF and the World Bank, have often failed in macroeconomic terms and had a sharply negative impact on living standards.

Fortunately, South Africa does not require shock therapy in the form of austerity measures. If foreign debt can be kept at low levels and government expenditure redirected to more productive uses, there is room for moderately expansionary macroeconomic policy accompanied by policies intended to preserve employment, improve social sector efficiency and protect entitlements of vulnerable groups.

South Africa does require macroeconomic policies to address a high rate of inflation (currently around 14%) and balance of payments problems. While the current account shows a surplus, there is a deficit in the capital account. There is no reason to rely only on monetary and fiscal policy. Nor is there that much room to maneuver, especially on the part of the Reserve Bank, right now. For example, prime lending rates, which are set by agreement with the Reserve Bank, are at the 21% mark. Tight fiscal and monetary policy, designed to restrict domestic demand, curb imports and reduce inflation, act as a brake on growth. The European experience in, for instance, regional development programs and incomes policies, demonstrates the potential for the effective use of more imaginative economic management.

7. State Ownershig and Nationalization

Both state intervention and the free market are susceptible of failure. The problems of the market are particularly acute in the areas of health, infrastructure (roads, communications, power, water and so on), education and social security. Those of planning appear most strongly when the government gets heavily involved in production activities outside the infrastructure. The intention expressed in the Freedom Charter to transfer "to the ownership of the people as a whole" the mines, the banks and monopoly industry, will have to be critically assessed in the light of relevant experience. Or, in the more colorful words of Joe Slovo of the African National Congress, any sharing of wealth has to steer clear of the "false panacea" of the market and the "ossified and badly implemented" statism elsewhere in Africa.

8. Trade and Industrial Policy

South Africa remains reliant on the primary sector for export earnings. Gold accounts for just under 40% of export revenue, and earnings from diamonds, coal, other precious metals and agricultural produce provide another 35%. Although the economy has a manufacturing sector representing 23.6% of GDP (1988), expansion of the domestic economy remains dependent on imports of capital and intermediate goods.

Industrial growth has been extremely uneven. Unemployment is high, demand is severely skewed (and capacity utilization in industry consequently often poor) and there is a poor technological and organizational bridge between producing for the narrow segment of rich at the apex of the population and the majority with low incomes.

Interestingly, the current president's Economic Advisory Council, in its Central Economic Strategy, advocates "inward industrialization". The idea is that by paying special attention to advancing labor intensive industries with particular relevance to the black population -- such as low cost housing -- economic growth can be encouraged with less threat to the balance of the payments, via a high marginal propensity to import, than is the case in the developed sector. The emphasis for the developed sector is placed on exports, particularly through increased local processing of exported raw materials and the establishment of downstream industry through the associated forward linkages.

The Japanese and Koreans have state-led industrial policies which target key sectors and enable shifts in resources from declining to growing sectors. These are worthy of emulation. Manufacturing production must be diversified beyond the minerals sector. Resources will have to be shifted from the military sector.

There are indications that the Development Bank of Southern Africa (an existing South African institution) has abandoned an ideological (i.e. "homelands"-based) industrial development incentive strategy and is moving towards a "nodes of growth" approach. This merits investigation.

International linkages will no doubt be improved with the lifting of sanctions, but there remains the necessity of being competitive in international markets. This is not simply a price (i.e., exchange rate and manufacturing cost) issue, but also one of quality. Price competition is now less important than the ability to innovate and to produce to high levels of quality with short lead times and high levels of predictability. A prerequisite for attaining these goals is a Japanese-style attitude to training and development of workers as a resource.

Microenterprise must be encouraged, not only to create employment, but also to produce basic wage goods.

More competitive markets and deconcentration of industrial ownership should be systematically encouraged.

9. The Mining Sector

The mining industry creates many jobs, earns large amounts of foreign exchange and supplies numerous important raw materials. Investment of venture capital in new mines should be encouraged. The state could consider making strategic investments in mines.

Gold mining is not a growth area. Output has dropped fairly steadily in recent years and some estimates put the potential job losses in the industry at 70,000 out of a total of 500,000 over the next five years.

Mineral prices are volatile and, in many cases, declining. Consideration will have to be given to the formation of cartels and joint marketing agreements with other countries.

Industries which add value to mineral production will have to be encouraged. The manufacture of mining machinery is an example. There are various methods to encourage this, among them tax incentives, government funding of R&D, import tariffs and loans on favorable terms.

10. Economic Concentration

Monopolies should be discouraged and dismantled where possible. This could be accomplished by encouraging competition, e.g. through anti-trust legislation, rather than through direct state intervention. Although these measures do not go far enough, it should be noted that the government has recently given new powers to the Competition Board to block mergers where it believes such action to be in the public interest, and to force the dismantling of market sharing agreements and the like.

11. Agricultural Strategy and Rural Development

Changes in the traditional agricultural sector can be a major factor in the long-run processes of economic development. The experience of the Green Revolution has provided many lessons both on the way in which rural economies may function and on government policy.

Agriculture in South Africa is underdeveloped in the black rural areas, where farming is currently aimed largely at subsistence. Land distribution is extremely unequal. There will undoubtedly have to be land reform, but this could take place without large-scale dispossession of white farmers. Co-operatives and joint ventures could be established to farm land which is currently state-owned or which may be bought from white farmers. Technical support, infrastructural development and training could be redirected.

South Africa should, for political and economic reasons, avoid extracting surplus from the rural areas to subsidize development of urban areas and industry.

The rural economy is not an agricultural economy only. It contains small to medium sized towns, mining, manufacturing and services. Linkages between different aspects of the rural economy and between the rural and urban sectors should be developed.

12. Human Resources Development

Existing labor legislation will have to be amended to extend to agricultural laborers, domestic workers and public sector employees.

Affirmative action programs will have to be followed in education, training and throughout the economy. Interestingly, some such programs are already being actively promised by private enterprise. It would be interesting to see how First National Bank’s Black Advancement Programme has performed to date.

Women have been particularly exploited and thus especially underdeveloped as a resource. Legislation, training and social services (such as child care) will have to be directed toward redressing this issue.

Public works programs, particularly in infrastructure and housing creation, need to be investigated as productive employment creation possibilities.

European-style representation by employees on boards of directors and similar bodies could be required by law.

13. Basic Goods and Services

Large amounts of finance are going to be required to meet basic social needs, such as welfare, housing, health and education. This is true even if the current inequalities in social spending are eliminated.

Of the basic goods and services, all of which are in short supply, housing is the scarcest. The black housing shortage is thought to total 1.8 million units at present. Adequate housing for all cannot be provided within any reasonable time frame. The current government’s site-and-service policy will have to be extended. But there is also room for skills training, provision of information, experimentation with cheaper building materials, land policies aimed at freeing up land for housing construction, financing of community controlled non-profit housing development projects and similar strategies to encourage low cost housing initiatives.

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I look forward to discussing these and related issues with the working group. Please do not hesitate to call me if you have any queries regarding this memorandum.

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