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SOUTH AFRICA

Debt Rescheduling and Potential for Financial Sanctions

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National Security and
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February 16, 1990

The Honorable Paul Simon
Chairman, Subcommittee on
African Affairs
Committee on Foreign Relations
United States Senate

The Honorable Edward M. Kennedy
United States Senate

On November 2, 1989, you requested that we analyze South Africa's financial situation and the U.S. options for imposing further financial sanctions against that country. As agreed with your office, we are providing an interim report analyzing South Africa's debt, loan rescheduling arrangements, and the feasibility of excluding South Africa from funds transfer systems that facilitate international trade and payments.

Background

In 1985, because of political pressure, American banks refused to extend existing short-term credit lines to South Africa. Other international banks followed, and a financial crisis occurred.

Because no short-term credit was made available, South Africa did not have the resources to pay off its short-term debt when it came due. As a result, South Africa continued to pay interest on this debt but in 1985 unilaterally froze repayment of much of the principal. In subsequent years, South Africa announced, after limited negotiation with its creditors, a series of three loan rescheduling arrangements to gradually pay off part of the frozen loans.

In response to South Africa's policy of racial segregation, the U.S. Congress passed the Comprehensive Anti-Apartheid Act of 1986 that imposed economic sanctions against that country, including selective import and export bans, a prohibition on new lending and investment, and restrictions on air transportation between the United States and South Africa. Subsequently Congress has debated whether more financial sanctions should be imposed.

Results in Brief

Since 1985, South Africa's debt has declined by about $4.7 billion because of repayments on some loans and the reluctance of international banks to make new loans.

Differing opinions exist about the extent to which the third rescheduling arrangement, announced in October 1989, puts financial pressure on South Africa. South Africa had to reschedule its debt because it could not pay. However, there are some groups who believe that the duration of the agreement should have been shorter, and the amount to be repaid should have been greater. Our review indicated the arrangement was particularly favorable to South Africa because it allowed the country to smooth out its debt services burden by increasing repayments of the frozen short-term debt only as scheduled payments on other debt decreased.

Two major systems for facilitating international payments that are critical to international commerce include an electronic dollar transfer system and a communication system. South African banks have been directly excluded from the electronic dollar transfer system, but it would be difficult to effectively exclude South Africa from participating indirectly through other nations' banks. It would be difficult formally to exclude South African banks from the second system because it is a private system based in a foreign country. Even if South Africa could be effectively excluded from these major systems, it could use other means to facilitate trade and payments.

South Africa's Foreign Debt

At the end of 1988, South Africa had a debt of $21.2 billion, according to South Africa's Reserve Bank. About two-thirds of this debt was owed to international banks, and the majority of the balance consisted of bonds owed to holders outside South Africa.

Debt Profile

The Bank for International Settlements, an organization of central banks of industrialized nations, reported that about $14.6 billion was owed to international banks at the end of 1988. Approximately 83 percent of this debt (or $12.5 billion) was owed to banks of five nations. The nations and their lending exposures are listed in table 1.1.

Table 1.1: South Africa's Bank Debt and Major Creditors

Dollars in billions

Creditor	Lending Exposure (yearend 1988)
United Kingdom	$4.1
United States	2.5
France	2.6
West Germany	1.9
Switzerland	1.4
All other countries	2.1
Total	**$14.6**

Of the $2.5 billion owed to U.S. banks, about 39 percent comes due in 1 year or less, 25 percent in 1 to 5 years, and 36 percent in longer than 5 years. About 74 percent of debt to the United States is owed by the South African private sector, and the balance is owed by South African government entities.

Changes in the Debt

South Africa imposed a moratorium on repayment of the principal on many of its short-term debts in 1985. Since that time, South Africa's outstanding bank debt has declined by about $4.7 billion. Outstanding U.S. loans to South Africa have also declined from a high of about $5 billion in September of 1984 to $2.4 billion in September 1989.

The two primary reasons for the decline were:

- South Africa has repaid debt that was not subject to the moratorium, principally bonds and debt guaranteed by the South African government, and a small portion of the debt covered by two rescheduling agreements.
- With the exception of short-term credit to facilitate trade and some extensions of existing loans, most international banks have been reluctant to provide new loans to South Africa.

The Nature of South Africa's Financial Difficulties

According to international bankers we interviewed, South Africa's financial difficulties are different from those of nations with heavy debt burdens. South Africa has a liquidity problem because most of its debt comes due in the short term, and it cannot obtain new loans to help make payments.

Unlike other nations with debt problems, South Africa gets few new loans because of foreign perceptions of increased lending risks associated with its political situation and the potential for turmoil.[1] South Africa has also been excluded from access to loans from international organizations, such as the International Monetary Fund. Therefore, it must repay existing debt by running a current account surplus.[2] To do this, it has had to restrict the money supply and slow its economy to reduce imports while attempting to increase exports in the face of international boycotts of its products. In sum, receiving no new loans slows the South African economy.

South Africa's liquidity problem contrasts with the difficulties of other nations heavily in debt, whose economies cannot support the burden. In fact, some bankers have said that for a gross domestic product of its size, the South African economy is "underborrowed." South Africa's special situation is illustrated by the fact that South Africa's debt is sold for a much higher price on the secondary market than the debt of most countries with heavy debt burdens. According to Salomon Brothers Inc's Indicative Prices for Less Developed Country Bank Loans, in December 1989, South Africa's debts sold for about 70 on an index of 100, while Mexico's sold for about 36, Brazil's about 23, and Argentina's about 13.

South Africa's Debt Rescheduling

After South Africa declared a moratorium on repayment of principal in 1985, which eventually froze payment of about $14 billion, it negotiated debt repayment with its principal international creditors. An interim arrangement, lasting 15 months (from April 1986 to June 1987), provided that South Africa would repay about $500 million. A second arrangement, lasting 36 months (from July 1987 to June 1990), provided that South Africa would pay about another $1.3 billion. The second arrangement also provided creditors with the option of taking 10-year exit loans, which convert frozen shorter-term loans to unfrozen longer-term loans with a higher priority of repayment, although repayment does not begin for several years. Over $4 billion in moratorium debt was converted to exit loans, which will leave about $8 billion in frozen debt at the expiration of the second arrangement.

[1] South Africa is experiencing political turmoil because of its apartheid system.

[2] The current account is exports of goods and services plus dividends and interest (earned from overseas investments and lending) minus imports of goods and services and dividends and interest (paid to overseas entities).

A third interim arrangement was reached in October 1989 and will last 42 months (from July 1990 to December 1993). The arrangement provides for repayment of about another $1.5 billion. All three interim arrangements allow creditors up to 1 percent additional interest payments above a loan's current interest rate.

The payment schedule estimate for the third rescheduling arrangement is shown in table 1.2.

Table 1.2: South Africa's Payment Schedule Estimate Under the Third Rescheduling Arrangement

Payment		Percent of remaining principal	Dollars (in millions)
1990:	December	1.5%	$120
1991:	February	2.5	197
	August	3.0	230
1992:	February	3.0	224
	August	3.0	217
1993:	February	3.0	210
	August	3.0	204
	December	1.5	99
Total		**20.5%**	**$1,502**

South Africa's overall payment schedule for frozen debt and other debt is shown in table 1.3.

Table 1.3: South Africa's Overall Payment Schedule

Dollars in Millions

Type of Payment	1990	1991	1992	1993
Principal payments on frozen debt	$240[a]	$427	$440	$513
Principal payments on other debt	1,400	700	700	600
Total payments	**$1,640**	**$1,127**	**$1,140**	**$1,113**

[a]Includes last payment of the second interim arrangement on June 15, 1990.

In December 1993, at the end of the third interim arrangement, about $6.5 billion will still remain frozen and need rescheduling.

The third interim arrangement favorably affects South Africa by smoothing its payments over time, increasing payments on frozen debt only when payments on other debt decrease. In particular, the arrangement requires a lower payment for frozen debt in 1990, a year when other debt payments are the highest. South Africa has about $1 billion in bonds maturing in 1990, most of it held by institutions and individuals in European countries. These bonds could not easily be rescheduled, making it important to South Africa to minimize repayment of principal on frozen debt in 1990, so funds will be available to retire the bonds.

South Africa's payments also have been smoothed and delayed by some creditors' opting to take 10-year exit loans under the second interim arrangement. These lenders obtain higher priority repayment by converting frozen debt to longer-term loans that are not frozen, but payments do not begin until 5 years after the conversion. Payment in full by installments is received in the subsequent 5-year period. Over $4 billion, or a little less than one-third of the original $14 billion caught in the moratorium, has already been converted from frozen debt to exit loans. In the third interim arrangement, South Africa tightened exit loan provisions so that creditors taking 10-year exit loans would be paid during the first 3 1/2 years at the same rate as lenders still having frozen loans. For the next 4 years there is a grace period free from payments. In the final 2 1/2 years, South Africa would resume payments.

There are several advantages for a lender in taking an exit loan rather than having its loan remain frozen: (1) repayment of exit loans is not frozen and is thus a higher priority for South Africa; (2) a higher interest rate can be negotiated; (3) payment could actually be attained sooner because of the slow rate of payment associated with frozen loans; and, (4) a bank will no longer be pressured by anti-apartheid groups because it is no longer party to the rescheduling negotiations on frozen debt. Disadvantages to the lender include the initial bad publicity and the possibility of higher rates of repayment for frozen debt if South Africa's financial situation improves.

International bankers we interviewed stated that South Africa unilaterally declared what it would pay on principal owed on frozen debt. But they also acknowledged that the banks had some negotiating leverage because it is very important to South Africa to maintain some standing with the international financial community so that it might eventually get new loans. Unlike some other problem debtors, South Africa has honored the payment schedules as promised under debt rescheduling arrangements.

Differing opinions exist about the extent to which the third interim rescheduling arrangement, announced in October 1989, puts financial pressure on South Africa. South Africa had to reschedule its debt because it could not pay. However, there are some groups who believe that the duration of the agreement should have been shorter, and the amount to be repaid should have been greater. American church groups, prominent members of the anti-apartheid movement, believe the third interim arrangement, announced in October 1989, was reached too early. To maintain uncertainty in South Africa's financial situation, they would have preferred that the third arrangement not have been completed until the second interim arrangement, expiring in June 1990, had almost elapsed.

These groups also wanted only a 1-year arrangement with a $1.6 billion repayment, instead of a 3 1/2-year arrangement with a cumulative repayment of $1.5 billion. They preferred to keep pressure on the new South African President to reform the political system in 1990. The church groups believe, based on their projections of South Africa's current account balance derived from making assumptions about the gold price, that South Africa could have paid more than the bankers projected. In contrast, most bankers said that it was in their business interest to get South Africa to pay as much as it could without going into default. They believe they achieved this solution in the third arrangement. The bankers argue that the arrangement will make South Africa pay more over a shorter period than the country originally wanted.

Because South Africa is concerned about its standing in the international financial community, it will more than likely honor the third arrangement as it did the first two. If revenues from exports (primarily through increases in the price of gold and increased exports resulting from further depreciation of South Africa's currency) do not generate enough surplus on the current account to make debt repayments, South Africa will probably create the surplus by slowing its economy to reduce imports. Thus, the more debt repayments South Africa is required to make, the more likely economic growth will be restrained.

If Western nations demanded immediate payment of all debt coming due because of government sanctions or action by the banks, South Africa would probably refuse to pay. If this happened, South Africa's balance of payments would be helped in the short term by ending the drain of loan repayments, but it would probably further erode its standing in the international financial community. This additional loss of standing might further dim any prospects for new loans in the future. In any case, South Africa would probably continue interest payments to avoid being declared in technical default.

International bankers we interviewed also want to avoid declaring a nation in default because of the legal complexities. It is difficult for international bankers to seize assets of a defaulting nation because they must sue the debtor for each loan separately and can effectively seize only the debtor's assets that are actually in the bankers' countries — for example, a visiting airliner. Furthermore, bankers want to avoid the precedent of declaring a nation in default. No nation has been declared in default since the worldwide depression in the 1930s. Even during the recent debt crisis for lesser developed countries, banks avoided declaring the nations in default.

Feasibility of Excluding South Africa From Fund Transfer Systems

The two primary systems used to facilitate international trade and payments are the Clearing House Interbank Payments System (CHIPS), operated by the New York Clearing House Association, and the SWIFT telecommunications system, operated by the Society for Worldwide Interbank Financial Telecommunication, S.C. CHIPS has been in existence since 1970 and is the primary electronic funds transfer system for processing U.S. dollar transfers between the United States and international banks. The SWIFT system is a major international message and communications processing system used by banking institutions worldwide to transmit information that is critical to initiating international electronic funds transfers.

Banks use the SWIFT system to give instructions to other banks about sending payments, while the actual dollar transfer is sent through the CHIPS system. Approximately 80 percent of CHIPS dollar transfers are initiated by SWIFT messages. Although other systems exist, the international financial community considers CHIPS and SWIFT to be the most efficient and largest systems of their kind.

CHIPS is a private sector system that links depository institutions and branch offices and acts as a conduit for moving dollar transactions, including letters of credit, collections, reimbursements, foreign exchange transactions, and the sale of short-term Eurodollar funds. In 1988, CHIPS served 139 national and international depository institutions and processed about 34 million transfers valued at $165 trillion.

The SWIFT telecommunications system, operational since 1977, is owned and operated by a Belgian cooperative society. As of December 1988, the system provided more than 70 types of messages, including international payment orders and other messages associated with international financial transactions. In 1988, SWIFT served 2,537 financial participants and processed 255 million messages.

Advocates of placing further financial sanctions against South Africa have proposed excluding it from international trade and payments systems. The possible impact of imposing these sanctions is discussed below.

Effects of Excluding South Africa From CHIPS

South Africa no longer is a member of CHIPS. Nedbank, a South African bank, was admitted in 1984 but was asked to leave in 1986. South Africa now participates indirectly in the system through other countries' member banks. South Africa is able to continue to use CHIPS because other member banks maintain its accounts and act as intermediaries by processing its dollar transactions.

It would be difficult to stop South Africa from using CHIPS in this way because the ultimate beneficiary of a financial transaction is usually unknown. Transfers between banking institutions may pass through a number of banks in the course of a transaction, and the ultimate beneficiary is rarely identified. During a CHIPS transaction, only the participating banks performing the transaction are identified. South Africa could use intermediaries if it wanted intentionally to hide its transactions to continue participation in CHIPS. These intermediaries would most likely be European banks.

Even if South Africa were somehow excluded from using CHIPS altogether, there are still a number of other mechanisms available to it to move dollars. Although these other dollar clearinghouse systems are much smaller in dollar volume than CHIPS, alternatives currently exist in London and Tokyo, and more could be created.

South African exports consist mostly of primary products, which are traded in dollars. If South Africa were to be cut off from CHIPS, the largest of the dollar clearinghouse systems, it might choose to do its transactions in other currencies. Even though this option may cost more because currency conversions from dollars to other currencies would be needed, there are a number of nondollar clearinghouse systems available in other countries, including the United Kingdom, Japan, Switzerland, and Germany.

It also appears that U.S. banks hold and handle South African dollar accounts to clear dollars. U.S. banks expressed concern that if they were not allowed to handle South African dollar accounts, they would be giving business to Europe.

Effects of Excluding South Africa From SWIFT

Because SWIFT is a privately owned foreign company and is considered to be apolitical, the U.S. government might have difficulty in trying to persuade it to stop doing business with South Africa.

Banks, rather than countries, are members of SWIFT. Seventeen South African banks belong to SWIFT. If U.S. banks moved to expel South African banks from SWIFT, they would need the cooperation of banks from other countries. Procedures exist to remove a member bank from SWIFT for violation of its articles of association. Expelling a bank would require a majority of shares voted to ratify such action if it were taken by a majority of SWIFT's 24-member board. Two U.S. banks and one South African bank are members of the board.

Even if the United States could exclude South African banks from SWIFT, there are several alternatives to SWIFT that are only slightly slower and more costly. Messages facilitating payments could be sent by using telex, fax, and mail instead of using SWIFT. Telex and mail were the common methods of facilitating payments before SWIFT.

Even though it would be difficult to effectively exclude South African banks from SWIFT and CHIPS, barring them from these systems might have the symbolic effect of excluding South Africa from yet another international system.

Scope and Methodology

In developing a profile and analysis of South Africa's debt and debt rescheduling, we interviewed and obtained documentation from representatives of the major banks involved in lending to South Africa in New York, London, and Frankfurt, and from independent researchers and other knowledgeable private sector sources. We obtained information on international trade and payments systems from representatives of the New York Clearing House Association, a member of the Society for Worldwide Interbank Financial Telecommunication, S.C. (SWIFT), and a member of the SWIFT board of directors. In addition, the above sources provided information on the potential impact of excluding South Africa from international trade and payments systems.

Our review was conducted between November 1989 and February 1990. As agreed, we did not obtain agency comments on this report.

Unless you announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to the Secretaries of State and Treasury, the Director of the Office of Management and Budget, congressional committees responsible for overseeing implementation of the act, and to other interested parties upon request.

This report was prepared under the direction of Allan I. Mendelowitz, Director, International Trade and Finance Issues. He can be reached on (202) 275-4812 if you or your staff have any questions. Other GAO staff members who made major contributions to this report were Steven Sternlieb, Project Director, Ivan Eland, Project Manager, and Alison Pascale, Staff Member.

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