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Report to Congressional Requesters

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SOUTH AFRICA

Relationship With Western Financial Institutions

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National Security and
International Affairs Division

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

The Honorable Edward M. Kennedy
United States Senate

This report responds to your November 2, 1989, request that we provide a profile of South Africa's debt, an analysis of trade credits to South Africa and the economic impact on South Africa of denying trade credits, and an analysis of the implications of excluding South Africa from the American Depositary Receipt system. On February 16, 1990, we issued a report entitled South Africa: Debt Rescheduling and Potential for Financial Sanctions (GAO/NSIAD-90-109BR), which contained information on South Africa's debt and the implications of excluding it from international payments systems.

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, Director of the Office of Management and Budget, congressional committees responsible for overseeing implementation of the Comprehensive Anti-Apartheid Act, and to other interested parties. Copies will also be made available to others upon request.

This report was prepared under the direction of Allan I. Mendelowitz, Director, Trade, Energy, and Finance Issues. He can be reached on (202) 275-4812, if you or your staff have any questions. Other major contributors are listed in appendix I.

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Executive Summary

Purpose

In 1986, in an effort to change South Africa's policy of racial segregation, the Congress passed the Comprehensive Anti-Apartheid Act that prohibited certain transactions and trade in selected items with that country.

At the request of Senator Paul Simon, Chairman, Subcommittee on African Affairs, Senate Committee on Foreign Relations, and Senator Edward M. Kennedy, GAO analyzed South Africa's financial situation, trade credits being provided to that country and the economic impact on South Africa of denying such credits, and the implications of excluding South Africa from the American Depositary Receipt system.

Background

The Comprehensive Anti-Apartheid Act of 1986 bans new investment that includes new loans; however, the ban excludes short-term credits associated with trade, which allow importers to pay for goods over a period of time. Before recent steps toward negotiation in South Africa, some advocates of sanctions had proposed imposing additional measures. Among these were banning all credits associated with trade and excluding South Africa from the American Depositary Receipt system. An American Depositary Receipt is a negotiable certificate issued by an American bank, representing ownership of the stock of a foreign company, that simplifies and aids the purchase of such stock by U.S. citizens.

South Africa faced a financial crisis beginning in 1985, when American banks refused to extend existing short-term credit lines because of political pressure, and other international banks followed suit. Because short-term credit then became unavailable, South Africa did not have the resources to pay off its debt when it came due. As a result, South Africa continued to pay interest on this debt but unilaterally froze repayment of much of the principal. Since 1985, South Africa has announced, after limited negotiation with its creditors, a series of three loan rescheduling arrangements to gradually pay off part of the frozen loans.

Results in Brief

Although South Africa has managed to significantly reduce its large debt repayments that fall due in 1990, its most critical barrier to sustained long-term economic growth is still a shortage of capital. This shortage is due to capital outflow and the unwillingness of international banks to make new, long-term loans. South Africa is able to get credits associated with trade to partially compensate for the lack of new bank lending, but the inflow of credits is small compared to the large outflows of total debt repayment and capital flight by cautious investors.

If the Western nations decide that additional economic sanctions are needed, a multilateral ban on credits associated with trade would probably have a significant economic effect by compelling the cash-short South African economy to pay cash for imports or resort to barter trading. South Africa would likely have to further restrict imports and increase exports in order to generate hard currency to make up for the reduced credits. However, a unilateral U.S. ban would have a limited effect, because many U.S. banks have already voluntarily stopped giving credits associated with trade.

Excluding South Africa from the American Depositary Receipt system would have a small impact on South Africa's economy because under the Comprehensive Anti-Apartheid Act, the receipts cannot be used to make new U.S. investments in South Africa. Furthermore, U.S. investors could still purchase underlying shares of South African companies issued before the statute's enactment and might take advantage of new offshore markets that would give them the same advantages as the American Depositary Receipt. But forcing U.S. investors to divest themselves of South African American Depositary Receipts might have some negative effect on South Africa's business climate and make it slightly more difficult to raise capital.

GAO's Analysis

South Africa's Financial Situation

South Africa has the resources to pay the interest costs on its international debt, but because it is virtually frozen out of world capital markets, it is unable to get new medium- and long-term loans to repay the principal on existing loans as it comes due. The problem is exacerbated by capital flight linked to its unstable political climate.

South Africa faced particularly large payments due in 1990 but has managed to reduce these by "smoothing" its payments and pushing them into the future. This smoothing was achieved through a new, favorable debt rescheduling arrangement for the largely short-term credit frozen in 1985 and by extending repayment periods for the largely longer-term loans and bonds not affected by or removed from the arrangement. Yet, even with the improved climate for political negotiations, most international creditors are still unwilling to make new, medium- and long-term loans because of the uncertain political situation and because South Africa is a problem debtor. This situation, combined with the debt repayment and capital flight problem, results in a substantial capital outflow for the South African economy. Such an outflow slows economic growth and remains South Africa's most critical economic problem.

Credits Associated With Trade

South Africa is able to get some medium- and long-term credits associated with trade to partially make up for international banks' reluctance to offer new, conventional loans. Thus, a South African company that is closed off from international lending for general purposes or for a specific development project may buy capital equipment for the project and receive credits associated with the purchase. South Africa's debt owed to foreign banks declined $2.8 billion from June 1986 to June 1989, while its medium- and long-term credit associated with trade increased by a maximum of $1.1 billion. However, such inflows are small compared to South Africa's overall capital outflow of at least $6.5 billion during that same period.

A multilateral ban on credit associated with trade to South Africa could significantly impede South Africa's trade by compelling that country to pay cash for its imports. To make up for the reduced credit, South Africa would be required to decrease imports and increase exports. The alternative to paying cash would be to barter its exports for imports.

In contrast to the significant effect of a multilateral ban, a unilateral U.S. ban on such credit to South Africa would have a limited effect; indeed, many U.S. banks already are voluntarily refraining from providing credits to South Africa because of the economic and political risks of doing so. The ban would mainly affect American companies that are still selling to South Africa and extending credit of up to 1 year on the sales. Such companies might then be at a competitive disadvantage relative to international competitors who could continue to provide such credits.

Excluding South Africa From the American Depositary Receipt System

Most financial analysts GAO interviewed stated that South African companies were more or less indifferent to participation in the American Depositary Receipt system and would feel minimal effect if excluded. If South Africa were excluded from the American Depositary Receipt system, there would be little effect on South Africa's economy; Americans cannot currently use the receipts to buy new South African shares. American Depositary Receipts can only be used as surrogates for shares issued prior to passage of the Comprehensive Anti-Apartheid Act. Thus, Americans who hold the receipts cannot provide new capital to South Africa. Requiring Americans to divest their South African receipts would only result in a transfer of ownership between investors. As American investors divest, they may have to sell at reduced prices; thus, the price of the underlying shares may fall in the short-term. Divestiture also could cause a marginal downturn in the business climate in South Africa, thus slightly impairing South Africa's ability to raise capital in the future.

Recommendations

GAO is making no recommendations.

Agency Comments

As requested, GAO did not obtain agency comments on the report.

Contents

Abbreviations

ADR	American Depositary Receipt
GAO	General Accounting Office
OECD	Organization for Economic Cooperation and Development

Introduction

In response to South Africa's policy of apartheid, the United States has imposed economic sanctions on selected products and transactions. In 1985, the President issued Executive Orders 12532 and 12535, which, among other things, administratively banned imports of South African Krugerrands (gold coins); exports of computers to apartheid-enforcing agencies; exports of nuclear goods and technology; and new loans to the South African government. Subsequently, the Comprehensive Anti-Apartheid Act of 1986 legislatively banned selected transactions and trade in selected products, including

- imports into the United States of South African coal, textiles, uranium, agricultural products, iron and steel, and products from South African government-owned or -controlled entities;
- exports of oil, arms, nuclear goods and technology, and computers to apartheid-enforcing agencies; and
- new U.S. loans and investment in South Africa.

Since 1986, debate in Congress has focused on the effectiveness of these existing sanctions and whether more should be imposed.

Objectives, Scope, and Methodology

We were asked by the Chairman, Subcommittee on African Affairs, Senate Committee on Foreign Relations, and Senator Edward M. Kennedy to provide a profile of South Africa's financial situation, to analyze the level and type of trade credits currently believed to be provided to South Africa, and to assess the economic impact on South Africa of denying trade credits. We were also asked to provide an analysis of the implications of excluding South Africa from the American Depositary Receipt (ADR) system and from international electronic systems used to facilitate trade. On February 16, 1990, we issued an interim report containing information on South Africa's debt and the implications of excluding it from international payments systems.[1]

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 in New York, London, and Frankfurt involved in lending to South Africa and from independent researchers and other knowledgeable private sector sources.

[1]South Africa: Debt Rescheduling and Potential for Financial Sanctions (GAO/NSIAD-90-109BR, Feb. 16, 1990).

We interviewed officials from South African banks, securities firms, insurance companies, the Department of Finance, the South African Reserve Bank, and private economists to obtain information about the country's financial situation.

We obtained information and documentation on credits associated with trade to South Africa from officials at the U.S. Export-Import Bank, the Treasury Department's Office of Foreign Assets Control, the Japanese and Taiwanese governments, and independent researchers. We also used information derived from the Berne Union, an association of international credit and investment insurers. We also interviewed representatives of seven major U.S. companies that trade with South Africa and one Japanese trading company to obtain information about trade financing arrangements.

We obtained information and documentation on the American Depositary Receipt system from international securities firms, a major gold mutual fund with large investments in South Africa, and Treasury's Office of Foreign Assets Control. In addition, the above sources provided their views on the potential impact of excluding South African shares from the ADR system and banning credits associated with trade to South Africa.

We also retained the services of an expert consultant to provide us with technical assistance on all issues.

We conducted our work from November 1989 to April 1990, in accordance with generally accepted government auditing standards. As requested, we did not obtain agency comments on this report.

South Africa's Financial Situation

According to international bankers we interviewed, South Africa's financial difficulties are different from those of other nations with heavy debt burdens. Unlike these other nations, whose economies cannot support the large amount of debt owed, South Africa has a liquidity problem. South Africa has the resources to pay the interest on its international debt, but cannot repay all principal obligations as they come due because most are short term, and it cannot obtain new loans. South Africa's special situation is illustrated by the fact that its debt is sold for a much higher price on the secondary market than the debt of most countries with heavy debt burdens.

South Africa gets few new loans because other countries perceive lending risks associated with the country's political situation, a potential for turmoil, and a problem with loan repayment. 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.[1] South Africa's economic policy is driven primarily by the need to generate these funds for debt repayment to improve its standing with the international financial community; South Africa eventually hopes to get new loans from international bankers.

South Africa's Debt Rescheduling

Our review indicated that South Africa's third and latest debt payment arrangement, which will take effect in 1990, was particularly favorable for the country. It allowed a smoothing out of the debt service burden by increasing repayments of the frozen short-term debt only as scheduled payments on other debt decrease. South Africa's overall payment schedule for frozen debt and other debt is shown in table 2.1.

Table 2.1: South Africa's Overall Debt Repayment 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 arrangement on June 15, 1990.

[1]The current account is defined as exports of goods and services, including dividends and interest (earned from overseas investments and lending) minus imports of goods and services, including dividends and interest (paid to overseas entities).

The third and latest arrangement requires a lower payment for frozen debt in 1990, a year in which payments on unfrozen debt are the highest. South Africa has about $1 billion in unfrozen debt maturing in 1990, most of it held by institutions and individuals in European countries. According to an economic officer in the U.S. embassy in South Africa, about one-fourth to one-third of the $1 billion are bonds issued by ESCOM, the South African state-owned electric utility. Originally, the country had about $2 billion of repayments on unfrozen debt due in 1990, which made it important to minimize repayment of principal on frozen debt during that year. Indications are, however, that South Africa has been able to renew about half of this unfrozen debt, thereby extending repayment, and thus significantly reducing the payment squeeze in the critical year 1990.

South Africa's payments also have been smoothed out and delayed because some creditors have opted to take 10-year exit loans under the second debt rescheduling arrangement. Creditors who take exit loans obtain higher priority repayment by converting frozen debt to longer-term loans that are not frozen, but payments on principal 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 payment freeze, has already been converted from frozen debt to exit loans. In the latest rescheduling arrangement, South Africa tightened provisions for taking 10-year exit loans, making them less attractive for creditors than did the provisions of the second arrangement. According to a South African Reserve Bank official and independent financial analysts from South African securities firms, the Reserve Bank is actively managing the granting of exit loans to smooth payments so that a payment bulge similar to that in 1990 does not recur in later years.

Prospects for New Capital Infusions Into South Africa

According to financial experts we interviewed in South Africa (including a senior South African Reserve Bank official, financial analysts in banks, and representatives from securities firms), international banks and investors are reluctant to make medium- and long-term loans to and investments in South Africa, even with the improved political climate there. They are waiting to see what, if any, changes are made in the political system and what effect they will have on the business climate. Even if there were a rapid change to a post-apartheid government, the holders of international capital would wait to assess the political stability of the new government and its economic policy.

In addition, because of past problem loans to Third World countries, increased opportunities for lending to emerging democracies elsewhere in the world, and new requirements for higher levels of capital, international banks may have less capital to lend to South Africa.

Because little new capital is flowing into South Africa, and its debt repayments are substantial, the net capital outflows it has experienced since 1985 will probably continue. From January 1985 to June 1989, at least $10.8 billion has flowed out of South Africa. Of this, $3.7 billion has been loan repayment to banks; $7.1 billion has been other debt repayments and capital flight by cautious investors. These figures probably understate capital outflow because some capital flight is unrecorded by the official statistics. Such capital outflow has contributed to the low level of investment by South Africans in their own economy.

Net capital outflows are South Africa's most critical economic problem because they slow economic growth over the long term. At its stage of development, South Africa should be running a current account deficit to import capital goods and technology needed for development and should finance it by inflows of capital. Instead, a current account surplus is needed to finance capital outflows. Nevertheless, despite the capital outflow, the South African economy has been able to grow at an average of 1.5 percent per year since 1985. This growth rate, however, does not keep pace with the rate of population growth.

Prohibiting Credits Associated With Trade

South Africa is able to get credits associated with trade to partially compensate for the lack of new bank lending, but the inflow of credits is small compared to the large outflows of total debt repayment and capital flight by cautious investors. If political negotiations fail and the Western nations find that additional economic sanctions are needed, a multilateral ban on credits associated with trade would probably have a significant economic effect by compelling the cash-short South African economy to pay cash for imports or resort to barter trading. South Africa would likely have to further restrict imports and increase exports in order to generate hard currency to make up for the reduced credits. However, a unilateral U.S. ban would have a limited effect, because many U.S. banks have already voluntarily stopped giving credits associated with trade.

Background

Trade financing plays an important role in international trade by allowing firms to import goods and services while paying for them over a period of time. Short-term credits, extended for 30 to 180 days, are given for commodities and consumer and manufactured goods. Medium-term credits of 1-5 years are generally employed to finance the supply of industrial and agricultural capital equipment. Long-term credit arrangements, lasting up to 10 years, apply to major engineering or construction projects.

The most common credits associated with trade are export credits, which are extended to the importer by the exporter, on behalf of the exporter by commercial banks, or by government export credit institutions in the exporting country. These credits help an exporter to sell its goods more competitively by providing reasonable financing for the importer. If an importing company did not have access to credits, it would have to pay cash for the imported goods or resort to the barter system. Longer-term credits associated with trade can provide a limited substitute for the hard currency normally obtained through conventional loans. Such hard currency is needed by South Africa to meet existing debt repayment obligations.

The Comprehensive Anti-Apartheid Act prohibits new lending to South Africa but does not prohibit short-term credits associated with trade.[1] The regulations define short-term credits as those lasting 1 year or less. Proponents of further sanctions believe that restricting credits would impair trade with South Africa and decrease capital flow to that

[1] The prohibition also does not apply to firms owned by black South Africans.

country at a time when it already has a capital shortage. Such a sanction would impose substantial economic pressure on South Africa.

The Nature of Credits Going to South Africa

The United States provides only short-term credits associated with trade to South Africa. The situation in other countries is different, however. According to both foreign official statistics and statements by the Governor of the South African Reserve Bank, longer-term credits associated with trade may occasionally be made available to South African clients by credit agencies outside the United States.

Worldwide data on credits associated with trade are extremely limited, and there is little information about both the level and the origin of credits to South Africa. In addition, the South African government does not publish figures specifically on the amounts of trade credit its companies raise on international markets. However, some information on credits can be derived indirectly.

The only published data on trade credit flows into South Africa are for credits guaranteed or insured by governments of countries that are members of the Organization for Economic Cooperation and Development (OECD). The OECD is a group of 24 major industrialized countries that promotes the economic growth of its members. The figures for guaranteed trade credits to South Africa do not include any U.S. credits because the U.S. Export-Import Bank does not guarantee credits to South Africa either directly or through banks.

As table 3.1 shows, the level of bank-provided loans declined between June 1986 and June 1989, while government-guaranteed trade-related credits increased during the period.

Table 3.1: Net Flow of Total Bank Lending and Guaranteed Trade-Related Credits

Dollars in millions

	Total bank lending	Total guaranteed trade-related credits
June 1986 through June 1989	- $2,787[a]	+ $1,066[b]

[a]Does not include government-guaranteed bank credits.

[b]Includes government-guaranteed bank credits.

Source: GAO analysis of OECD's Statistics on External Indebtedness.

These guaranteed trade credits, however, represent only a portion of the total trade credits going into South Africa because there may be many credits that are not guaranteed.

Nevertheless, we believe that guaranteed credits are an important measure of the medium- and long-term credits entering South Africa because governments guarantee the preponderance of medium-and longer-term credits associated with trade with South Africa. The $1.1 billion represents a maximum for increases in medium- and long-term credits associated with trade and may include some government-guaranteed short-term credits and conventional loans.

Total bank lending has declined over time as South Africa has repaid its existing debt and has been able to get few new loans from international banks. It does appear from the guaranteed trade-related credits portion of table 3.1, though, that South Africa may be having some success in attracting medium- and long-term credits associated with trade. These credits are mainly provided by large corporations or trading companies doing business with South Africa. This financing may be permitting South Africa to substitute medium- and long-term credits associated with trade for the lack of medium- and long-term conventional lending. For example, a South African business entity might get a credit associated with a purchase of capital equipment for a construction or engineering project because it could not receive a conventional loan covering the entire project. In this regard, the current Governor of the South African Reserve Bank has alluded in public statements to the potential use of trade financing as a source of new credit for South Africa. The Governor has also encouraged South African companies to take advantage of lines of trade-related credits that are currently not being used.

The substitution of medium- and long-term trade credit for conventional lending may offer South Africa some relief from its balance of payments problem, but it does not fully compensate for the scarcity of conventional bank lending. These relatively small inflows have not made up for the drain in South Africa's capital stock of at least $6.5 billion from June 1986 to June 1989. This capital outflow is due to the repayment of international debt owed to creditors other than commercial banks (such as the International Monetary Fund), redemptions by foreign private bond holders, repayment of foreign government-guaranteed loans, and to capital flight that has continued unabated over this same 3-year period. The figure may understate capital outflow because some capital flight is unrecorded by official statistics.

Western Credit Policies Toward South Africa

It is unclear which companies in which countries are providing most of the medium- to long-term credits to South Africa. The stated policies of government export agencies and private banks in selected OECD countries on the issue of trade finance for South African clients can, however, provide some insight into likely sources of credits.

U.S. Policies and Practices

The U.S. Export-Import Bank is prohibited from supporting exports to the South African government or its agencies.[2] The bank's export credits for other purchasers in South Africa are restricted to South African companies that are majority-owned by blacks and nonwhites and to any South African companies that adhere to certain principles of equal opportunity.[3] Also, the U.S. Export-Import Bank, except for the cases noted above, has placed South Africa "off cover," meaning that no official government guarantees for trade credits are given to South Africa. Exporters from the United States either have to assume the risk themselves or arrange for trade credit insurance in the private sector.

Short-term private sector trade credits to South Africa are specifically exempted from the Comprehensive Anti-Apartheid Act. The private sector can also provide trade financing guarantees. However, according to international bankers, including many in the United States, U.S. banks are reluctant to provide credits associated with trade to South Africa. A U.S. Export-Import Bank official stated that there has been a decrease in the number of U.S. banks that are confirming letters of credit (one form of credit associated with trade) for South Africa. This official knew of one specific bank that was still providing credit as of September 1989, but believes there are not many others. This view was corroborated by the Office of Foreign Assets Control in the Treasury Department, which conducted a survey in 1987 and found very low levels of bank credits for exports to South Africa.

[2]The prohibition does not apply if the President determines that significant progress toward the elimination of apartheid has been made and transmits to the Congress a statement describing and explaining that determination. To date, no such determination has been made.

[3]These principles are nonsegregation of races in all work facilities; equal and fair employment for all employees; equal pay for equal work for all employees; initiation and development of training programs to prepare nonwhite South Africans for supervisory, administrative, clerical, and technical jobs; an increase in the number of nonwhites in management and supervisory positions, a willingness to engage in collective bargaining with labor unions; and improvement in the quality of life for employees in such areas as housing, transportation, schooling, recreation, and health facilities

According to private and governmental financial experts we interviewed, factors deterring U.S. banks from providing short-term trade credits include

- the absence of Export-Import Bank guarantees,
- the combined economic and political risks in South Africa,
- the increase in laws at the state and local level in the United States directing government business and pension plan investments away from companies and banks dealing with South Africa, and
- the growth in public sensitivity on the apartheid issue.

The decrease in export credit financing is also partially a result of the adverse effect of the world debt crisis on banks. Banks are now more cautious about becoming exposed to highly indebted countries, partly because of the costs of setting aside loan loss reserves for loans with a reduced likelihood of repayment. South Africa's foreign debt as a proportion of gross domestic product and in comparison with the debt of other countries is low, but South Africa has frozen payments on the short-term bank lending portion of its external debt. This action has made South Africa an unattractive borrower for international banks.

According to officials from the Export-Import Bank, companies trading with South Africa must be extending trade credits on their own because these credits are not provided or guaranteed by the U.S. government or by the U.S. commercial banking sector. Most of the U.S. companies we spoke to either traded on open accounts or had turned to credits from their European subsidiaries.

Policies and Practices of Other Countries

The government export finance agencies of Canada, Australia, and New Zealand have kept South Africa off cover for short-term trade insurance. The following members of the Berne Union continue to guarantee export credits to South Africa: Austria, Belgium, France, Germany, Italy, Japan, Spain, Switzerland, the United Kingdom, and Zimbabwe. Some of these countries have short-term financing available without restriction, but most financing is available on a case-by-case basis with some limits on total commitments and on individual transactions. Medium- and long-term financing, while still officially on cover, is subject to greater restrictions.

The Berne Union reported the following as of September 1989:

- The German export-import bank Hermes has the largest total commitments outstanding to South Africa. Hermes has $281.3 million in short-term commitments and $2.73 billion in medium- and long-term commitments. Hermes offers maximum terms of 5 years for credit, with limits of $28.8 million per transaction; anything over $11.3 million is approved only in exceptional cases.
- The United Kingdom's Export Credit Guarantee Department has outstanding short-term credit commitments for exports to South Africa of $197.7 million and medium- and long-term commitments of $2 billion. Short-term trade credits are open without restrictions. Medium- to long-term trade credits are also open, but subject to a total commitment ceiling and limited to $16.8 million per transaction.
- France's export credit agency, COFACE, has $178.8 million in short-term commitments and $1.2 billion in medium- and long-term commitments. All credits are open on a case-by-case basis, with no total or individual limits.
- Japan's Ministry of International Trade and Industry has $69.1 million in short-term credit commitments for exports to South Africa and $251.9 million in medium- and long-term credit commitments. Higher levels of Japanese government guarantees would be expected because of its large amount of trade with South Africa. The Japanese government seems to limit credits to South Africa because of its sensitivity to U.S. legislative restrictions toward South Africa. As a result, it is possible that the bulk of credit to support Japan's trade with South Africa is provided from internal sources by the Japanese trading companies themselves.

According to a report by the Commonwealth Committee of Foreign Ministers on Southern Africa, Hong Kong provides trade financing for exports to South Africa from Hong Kong, Japan, and Taiwan, mainly through endorsing letters of credit or taking over notes with terms of up to 18 months. Hong Kong may also be documenting and financing exports from other countries; these exports do not pass through the colony.

Taiwan is South Africa's second most important Asian trading partner after Japan, and South Africa is actively trying to expand its relationship with that country. According to an economic officer from the Coordinating Council of North American Affairs, Taiwan's representative in Washington, D.C., Taiwan practices normal banking relations with South Africa. The Export-Import Bank of China (Taiwan) has financial programs for suppliers and buyers of exports to South Africa just as it does for those of other countries. South Africa is one of the few countries that has a diplomatic mission in Taiwan, a reflection of the open trading relationship that exists between the two countries.

Both economic and political considerations influence the provision of trade credit to foreign customers. Most exporters who have dealt with South Africa say the country is a reasonably good credit risk. In some countries, however, political pressure and/or perceived political risks have resulted in prohibitions on medium- and long-term trade credits, even though South Africa may still officially be on cover. Thus, European Community member countries voluntarily agreed in 1986 not to provide new investment funds to South Africa, including credits associated with trade of longer than 5 years' duration. Britain recently lifted this voluntary moratorium on new investment, but it remains in force throughout the rest of the European Community. The previously mentioned outstanding medium- and long-term credits associated with trade from European countries were either of less than 5 years' duration or came before the 1986 ban.

In October 1989, the Commonwealth of Nations adopted a proposal that limited credits associated with trade to South Africa to 90 days and took them off cover from official government export credit agencies. This action has the effect of transferring the risks of providing trade credits from the taxpayers to the market. The United Kingdom, however, has rejected this proposal. The United States has already taken South Africa off cover.

Impact of Ban on Credits Associated With Trade

A ban on U.S. credits associated with trade would primarily affect short-term credits provided by U.S. suppliers still trading legally with South Africa because most U.S. banks are already voluntarily withholding such credit from South African clients. As a result, the effect on South Africa of a unilateral U.S. ban would be limited, though it might reduce the volume and value of U.S. exports to South Africa. Such a unilateral ban might marginally decrease imports into South Africa for a period, while alternative sources of supply are sought. U.S. exporters may be able to offset some of the effects of a U.S. ban. For example, the exporters could get credits through foreign banks and overseas subsidiaries, enter into joint ventures with other foreign manufacturers, or use open account trading, as they have in the past. However, they may lose some business to exporters from countries that are still allowed to arrange credits.

According to Treasury's Office of Foreign Assets Control, the historic levels of compliance with current U.S. restrictions on financial transactions with South Africa show that the compliance with any new ban on trade financing to South Africa would probably be substantial.Extensive monitoring of bank and company compliance with current restrictions has led agency officials to conclude that there have been no violations. These officials believe U.S. companies know it is in their best interest to comply.

Only a multilateral agreement to ban export credit finance for South Africa could be effective. Without such an agreement, South Africa might shift its trade to the significant number of countries still willing to provide credit. With restricted access to such credit worldwide, the South African economy could be severely injured by the necessity to pay cash or to barter for its imports. To generate the cash, South Africa would be required to reduce imports and increase exports. Reducing imports could reduce economic growth.

Excluding South Africa From the American Depositary Receipt System

Exclusion of South African shares from the ADR mechanism would have minimal direct impact on South African companies because they do not use the United States as a source of new capital. Divestiture of ADRS would result in a change of ownership of existing shares on the secondary market; U.S. investors might have to sell their interests at lower prices while permitting other investors, many of whom might be South African, to purchase South African shares at a reduced price. A ban on South African ADRs, moreover, might be circumvented. Larger investors could still buy the underlying shares, and a system similar to the ADR could be created offshore. Consequently, effectively prohibiting U.S. ownership in South African businesses would require banning the purchase and holding of the underlying shares as well as the ADRs.

Although a forced divestiture would have few direct economic effects on the South African economy, it might have a psychological impact, contributing to a slight lowering of South African business confidence, thus having some negative effect on South Africa's ability to raise new capital.

Background

American Depositary Receipts simplify the purchase of foreign shares by American investors. An ADR is the negotiable certificate for a share in a foreign company that gives the owner the right to dividends and to changes in the capital value of the company's stock. The underlying South African stock for an ADR is held by a U.S. American depositary bank through an account in a South African bank. The U.S. bank issuing the ADR for the shares collects all dividends from them and makes payments to the ADR holders for a fee.

ADRs are bought and sold in the market and offer a number of conveniences to the investor. The ADR system simplifies the process of owning a foreign share, thereby allowing more investors to own foreign shares. An ADR translates various foreign methods of issuing shares and registering their ownership into a standardized, American format. Unlike dividends on the foreign shares, dividends on ADRs are paid in U.S. dollars. In addition, ADRs can also be separated by the depositary bank into parcels at more convenient prices if the original share price is either very high or very low; one ADR may represent as little as one-tenth of an actual share or as much as 5 or 10 shares. It may be less convenient to hold the actual share than an ADR because of the efficiency of the U.S. clearing and settlement system and the ease of trading ADRs. Although ADRs may be a more convenient method of investing in foreign shares, particularly for the smaller investor, these shares are less liquid than ordinary shares, however. They may also cost more because the depositary bank charges a fee for handling ADR transactions.

Euromoney magazine lists 66 South African ADRs that were active as of mid-May 1989. Anyone may own ADRs, but most financial analysts we interviewed believe that American investors are the main holders. According to a major South African brokerage house, the majority of U.S. investments in South Africa is in American Depositary Receipt form. Foreign equity in South Africa is heavily concentrated in mining shares, and South African ADRs reflect this concentration, because the receipts have been issued mainly in the gold mining sector.

According to table 4.1, ADRs are the dominant form of nonresident stock holdings in the South African mining industry, accounting for 48 percent of all foreign ownership in 1987 and 1988.

Table 4.1: Percent of Foreign Holdings in South African Mining Shares

Percent of Shares on Issue

	As of December 31, 1987		As of December 31, 1988	
	Percent of holdings	Number of shares	Percent of holdings	Number of shares
American Depositary Receipt holdings	48.4	313,546,666	47 9	292 601,598
ASA, Ltd. holdings[a] (American owned)	1.4	9,120,000	1 5	9 120,000
London registered holdings[b]	33.4	216,254,434	33 3	203 531,139
Other European registered holdings	8.8	56,869,279	10 5	64 118,390
Other foreign registered holdings[c] (Cape registered holdings)	8.0	52,052,617	6 8	41 237 019
Total foreign holdings	**100.0**	**647,842,996**	**100.0**	**610,608,146**

[a]ASA, Ltd., is a South African, closed-end, nondiversified investment company investing in South African companies, 50 percent of which are gold mines, and is listed on the New York Stock Exchange.

[b]Shares registered on the London International Stock Exchange.

[c]Shares registered on the Johannesburg Stock Exchange and the portion of ASA, Ltd that is foreign owned.

Source: GAO analysis of various financial sources.

Impact of Excluding South Africa From the ADR System

Excluding South Africa from the ADR system would require the liquidation of all South African ADRs held by American investors.

Current Restrictions on ADRs

The Comprehensive Anti-Apartheid Act of 1986 prohibits new investment in South Africa. In practice, it prevents U.S. investors from buying shares in South African companies issued after passage of the act, but allows them to retain and trade shares issued prior to enactment. South Africa issued distinct pre- and post-enactment shares so that ADR depositary banks could differentiate between the two issues and aid compliance with the act.

As a result of the Comprehensive Anti-Apartheid Act, the ADR mechanism cannot be used by South African companies to raise capital in the United States through issuing new shares. ADRs are used only in the secondary market for the resale of pre-enactment stock.

Direct Effects of ADR Divestiture on the South African Economy

Because ADRs cannot be issued for new South African shares, no new capital is available from the U.S. market for business expansion and mining exploration in South Africa. Using ADRs to trade old shares on secondary markets merely alters the composition of the ownership of South African mining companies. Because South African companies raise no new capital through the ADR system, forced divestiture of ADRs can only result in the transfer of stock ownership. Most financial analysts we interviewed stated that South African companies were more or less indifferent to participation in the ADR system and would feel minimal effect if excluded.

Widespread forced selling of South African ADRs, however, could depress the price of the underlying South African mining shares in the short term. The U.S. investor might get lower prices for the shares when selling them.[1] Both South African and other foreign investors could then be well positioned to purchase South African ADRs at a reduced price during forced sales. In addition, the U.S. investor holding the ADR would have to pay all fees associated with divesting, or selling, the ADR.

Potential for Circumvention

A ban on South African ADRs would not prevent American citizens from buying and holding South African pre-enactment shares. Thus it would still be possible, although somewhat less convenient, to own the actual underlying share, known as the Cape share. While the ADR is the more popular form of investment in South African mining stocks, some larger investors do hold Cape shares. We found that larger investors, such as

[1] We did not examine whether this would trigger the requirement in the Constitution that the U.S. government compensate individuals for the taking of private property.

pension funds, are willing to hold the underlying Cape share to avoid paying the dividend fee to the intermediary depositary bank and to have voting rights. Because investors in South African mines tend to be sophisticated, they may be better equipped and more willing to purchase the actual share itself. The U.S. gold fund with the largest holdings of South African gold mining shares has 61.4 percent of these shares in ADRs and 38.6 percent of its shares in the underlying Cape share. Fund managers told us they base their decision to purchase either the ADR or the Cape share on price alone.

According to security fund representatives, institutional investors are beginning to favor holding the actual Cape share and, as restrictions on pension funds are loosened, this trend is expected to accelerate. In addition, some larger investors are taking stock out of the ADR form because, while it initially costs money to convert from ADR to share form, holding the actual share brings bigger returns over time.

If additional restrictions are placed only on owning South African ADRs and not on the share itself, U.S. investors could continue to hold South African ordinary shares. Therefore, if South Africa were excluded from the ADR system and investors were forced to divest, the sophisticated investor would be able to convert the ADR to the underlying share and continue to have access to South African stocks. Larger investors could buy the underlying shares through a custodian bank in South Africa or the London stock market. Thus, forced divestiture would primarily affect small investors, who might be forced to sell their ADRs at lower prices and be excluded from the market for South African shares.

Representatives of a gold mutual fund with the largest South African gold share holdings mentioned another form of circumvention. According to these representatives, if South African ADRs were banned, they could continue to purchase the pre-enactment Cape share and offer it to their clients through their mutual fund. To avoid this method of circumvention, any restrictions would have to ban the holding of South African Cape shares as well as South African ADRs.

If ownership of South African ADRs were banned, this action might not prevent similar transactions from being conducted offshore. If divestiture of ADRs were required, a substitute market could easily be opened outside the United States for U.S. investors to buy and hold the South African shares in a form similar to that of the ADR. Alternatively, the market for South African stocks registered and purchased in London might expand. Such a shift of transactions overseas would take business away from U.S. banks without necessarily hurting South Africa.

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