Peacekeeping slashed in R44,8 bn arms deal

Failure to take sufficient account of the 1996 Defence White Paper when the procurement of modern weapons was considered has resulted in increased military expenditure. By **Raenette Taljaard**

Taljaard has been appointed director of The Helen Suzman Foundation. She also lectures at the Wits School of Public and Development Management

"Capital investment — The department will make sure that the weapon systems acquired through the strategic armaments procurement programme are delivered on time and efficiently integrated into existing structures. The transfer of sufficient skills and technology to the SANDF to ensure future readiness supports this. The SANDF's core capabilities will be improved by these new combat systems". Vote 21 — Defence, Budget 2006.

With the debate on the defence budget vote in parliament on 31 March 2006 controversially raising the spectre of a fifth Corvette being acquired for the South African navy[1], and the arrival of the SAS Manthatisi Type 209 submarine in Simon's Town exactly a week later on 7 April, questions of defence budgeting and where South Africa's spending trajectory for defence is heading arise quite starkly yet again.

With South Africa's current account deficit, though adequately financed by investment inflows at present, at a 22-year high of over 4,2 per cent of GDP, these questions gain increased significance as all arms deals are heavily import-content biased and impact directly on the balance of payments. As the South African Reserve Bank points out, the arrival of another Corvette as well as three aeroplanes in the fourth quarter of 2005 had, along with other factors, an impact: *"The acquisition of a naval vessel during this quarter, together with the importation of three aeroplanes in the first quarter of the year, lifted the import value of the category for vehicles and transport equipment by about 20 per cent in 2005 as a whole"*.[2]

As always, the raising of such questions occurs against the ever-present backdrop of South Africa's socio-economic priorities of poverty alleviation and the pressing need to materially alter the economic legacy of apartheid. The questions also arise against the broader institutional backdrop of the defence review "update" — with its renewed focus on the demands on South Africa for peace support involvement and disaster relief across the continent — currently being processed by the department of defence and parliament respectively.

The more conventional strategic posture contained in the Defence White Paper and the defence review, and the arms deal that followed it, is clearly confronting new challenges — both in policy development terms and in terms of acquisition and operational challenges. The airlift procurement decision ("partnership agreement" according to government) — the Airbus A400M — is the clearest manifestation to date of this shift in strategic thinking in procurement terms.

With the special defence account consuming on average 35,6 per cent of the defence budget vote — primarily for the arms deal — the South African government will have to confront key questions concerning the overall defence strategy and posture of the South African National Defence Force (SANDF). They will need to be matched with strategic answers that include the requisite resource-split between capital and current expenditure within the overall stretched defence budget in order to achieve all the goals set nationally, regionally, continent-wide, and

Projected cost in relation to the acquisition of strategic armaments *(Table one)*

Vote 21 Defence - Budget 2006

Financial year												
2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	Total
R million												
2901	4223	6342	5864	4502	6331	4536	3633	3158	1160	1098	1045	44793

indeed, globally, under the rubric of regional peacekeeping.

Despite a current price tag of R44,8 billion over 12 years, the Strategic Defence Procurement Programme (aka the arms deal) has already started to reveal some of its hidden costs of integration of equipment, operation and maintenance and training. In the case of the South African Airforce (SAAF) the costs of training personnel for the reception and integration of fighter aircraft into the airforce will place pressure on this programme in the overall budget. Similarly, the full integration of the four Corvettes as well as the reception of the first two submarines will place pressure on the maritime combat capability budget sub-programme.

As table one makes clear, the final payments on the sizeable arms deal fall due in 2011/12.[3]

When government concluded the defence white paper process, and embarked on force design procurement decisions in accordance with the defence review, cabinet was confronted with a clear-cut affordability study.

It sought to ascertain the degree of risk of varied levels of defence spending on the overall macro-economic balances in the South African economy: the balance between defence expenditure, as part of overall government expenditure, and debt and deficit management; the balance between the need for expensive, foreign currency financed debt denominated hardware and the balance of payments/current account and the balance between local and foreign denominated debt in government's overall debt profile.

These challenges were clearly specified by the affordability study: "*... the briefing warns of the significant impact the arms acquisition deal could have on the budget deficit and on South Africa's ability to borrow money*".[4]

The affordability study pointed very explicitly to the vulnerability of the cost of the package to currency fluctuation and emphasised the costs of financing in the deal. These costs, unhedged as they are, fluctuate when the rand fluctuates: when the rand strengthens the financing costs (in foreign denominated debt) go down and when it depreciates they predictably escalate: "*The briefing says the calculations by Warburg Dillon Read show that "for every R1 depreciation in the dollar exchange rate, the cost of servicing foreign debt will increase by R2,5 billion and principal repayments will increase by R4,8 billion", adding "it is clear that the scale of this currency risk is sizeable over the 20-year period [of payment].*"[5]

The recent budget shed more light on the detail of the financing costs of the deal and the overall cost of the deal itself. The agreements with the European export credit agencies are worth more than South Africa's current debt obligations to the World Bank — as can be seen from tables two and three, drawn from the 2006 budget.[6]

Questions of defence budgeting occur against the backdrop of socio-economic priorities of poverty alleviation and demands on South Africa for peace support involvement and disaster relief

As treasury states in the budget review, total loan redemptions have been R415 million more than anticipated due to repayments for arms deal financing: "*Total loan redemptions amounted to R28,8 billion in 2005/06, R415 million more than anticipated. This is mainly due to the net impact of the prepayment of a US$89 million arms procurement loan (R653 million) and a lower rand value of foreign loan redemptions due to the stronger currency (R240 million)*".[7]

As treasury points out, US$1bn equivalent will be borrowed to cover maturing foreign debt: "*In 2006/07, the equivalent of US$1bn will be borrowed in the international market to cover maturing foreign debt. Including the disbursements on arms procurement loan agreements and the World Bank loan, government will raise the equivalent of US$1,6bn, US$1,4bn and US$1,3bn over the MTEF period*".[8]

It is not explicitly clear from the budget which financing vehicle was utilised for the purchase of the four Super Lynx 300 maritime helicopters (an estimated contract cost of approximately R787 million). The four Lynxes were formally purchased towards the end of 2003 — after the arms deal Joint Investigating Team's (JIT) report's dust had settled. According to the GCIS' *South Africa Yearbook*[9], the delivery of the maritime helicopters is scheduled for 2007 and handover to the SAAF in 2008.

In addition, and more controversially, government concluded a further partnership agreement ("declaration of intent" ratified by Cabinet in April 2005) with Airbus Industrie to purchase eight A400M airlift carriers — in pursuance of an increasing African

Cabinet has concluded a further partnership agreement with Airbus Industrie to provide eight A400M military cargo haulers at a cost of about R1 billion each

Union-wide peace mandate — with the delivery of the first aircraft expected to occur in 2010. This is at an additional cost of R8 billion over and above the R44,8 billion of the arms deal: "the decision to purchase eight cargo haulers at a cost of about R1 billion each is likely to raise questions about the choice of the high-tech Airbus A400M and the industrial participation benefits that the government believes will flow from the deal. With delivery tentatively scheduled for 2010, the cost burden of the Airbus programme will begin to fall due in 2008, growing rapidly in 2009 just as the financial commitments of the current defence procurement programme... begin to wind down".[10]

Despite this government's overall foreign denominated debt remains manageable at 13,4 per cent of GDP, and the overall debt position of government appears to be declining with total net loan debt expected to continue to decrease averaging 28,7 per cent over the next three years. Although such decreasing overall debt levels are favourable, the principled question about favouring foreign denominated debt of this magnitude for defence acquisition remains contentious.

In addition, it has been government's stated debt policy position to emphasise further reductions in the cost of servicing debt in order to increase additional resources for economic development and poverty relief — again raising legitimate questions about the decision to opt for the mix of priorities and goals that produced the arms deal itself and the scale of the procurement concluded.

The cost of the deal is far more substantial (R44,8 billion over 12 years), after the overall consistent currency depreciation of the past few years, than the initial contract price concluded by cabinet (R29,9 billion over 12 years — all options exercised) at the time of contract signature[11] towards the end of 1999. Government's fortunes in respect of the cost of the deal have, however, certainly benefited from the recent tax bonanza produced by the South African Revenue Service (SARS) (resulting in an overall lower budget deficit and more funds available to government), as well as the relative strengthening of the rand in more recent months (resulting in clear savings in respect of the unhedged financing structures of the procurement of close to R1 billion).

The affordability study pointed very explicitly to the vulnerability of the arms deal package to currency fluctuation: the costs, unhedged as they are, fluctuate when the rand fluctuates

It is in this context, and against the backdrop of a near-record current account deficit, that questions must be asked about the macro-economic impact of the arms deal on the balance of payments. There can be no doubt that the arms deal is not the sole factor for the present current account position. The insatiable appetite of South African consumers for imported products and skyrocketing crude oil prices are certainly additional contributing factors. But along with other acquisitions, such as the ongoing SAA Airbus fleet upgrade, and future acquisitions, such as the Airbus A400M, the overall and longer-term impact on the South African current

Finanancing of net borrowing requirement 2004/5 - 2008/9 *(Table two)*

Extract: table 5.4, Budget Review 2006, p91, Medium Term Expenditure Framework (MTEF)

R million 2004/5 Outcome	2005/6 Budget	2005/6 Revised	MTEF 2006/7	MTEF 2007/8	MTEF 2008/9
Foreign loans (net): Arms procurement loan agreements					
3407	4708	3164	3569	2940	2139

Foreign loan issues 2005/6 *(Table three)*

Extract: table 5.7, Budget Review 2006, p94

As at 31 January 2006		R million
Market loans		0
Concessionary: World Bank		43
Arms procurement loan agreements		2821
	AKA-Commerzbank (Submarines)	*820*
	AKA-Commerzbank (Corvettes)	*5*
	Societe Generale (Corvettes)	*211*
	Mediocredito Centrale (Light utility helicopters)	*99*
	Barclays (Hawk/ Grippen)	*1686*
TOTAL		2864

account must be considered given the length of the respective procurement contracts and their life-span to final equipment delivery (2012).

Given the overall importance the cabinet affordability study placed on the prospect for Industrial Participation (IP) agreements to cushion the impact of these purchases on the South African current account, claims of IP delivery must always be measured against the broader backdrop of 'inflows' (counter-trade-related direct investment and/or counter-trade project-related exports) versus 'outflows' (payment schedules for equipment and/or foreign debt maturation).

Towards the end of 2005, the department of trade and industry (DTI) briefed parliament's portfolio committee on trade and industry on National Industrial Participation (NIP) programme performance. According to the department the overall NIP programme, of which the arms deal forms part, has generated R23 billion (US$3,5 billion) worth of investments and sales credits with programmes ranging from the local manufacture of galleys for the Airbus A319 and A320 to the production of cockpit modules for the BMW 3-series for export purposes. The minister of trade and industry has stated that NIP has generated 8000 new work opportunities and 134 new projects[12] — well short of the much more ambitious arms deal targets! The DTI is currently having to monitor US$15 billion worth of NIP obligations (defence and non-defence) that are all due by 2013.

This is a near-impossible task given manpower pressures at the DTI and a raft of policy challenges. Already three of the five main suppliers in the SDP have missed their NIP scheduled obligations for offsets. In the words of the Director General Lionel October: "Two of the five main contractors in the SDP have achieved the targets in their contracts, with one exceeding the set targets. At this stage of the reporting cycle, we are confident that the others have identified projects that will help them reach the two-thirds milestone target set out without the need to invoke the penalty clauses in their contracts".[13] Given the difficulties around the contractual validity of IP agreements highlighted in the findings and recommendations of the JIT report, and in subsequent audits of the DTI's IP programme by the Auditor-General' office, it is hardly surprising that ensuring NIP compliance by prime contractors is proving to be such a headache despite the citation of high milestone achievements by the major arms deal suppliers.

There can be no doubt that with increased peacekeeping obligations a different perspective follows and, perhaps a resultant desire to shift attention away from the arms deal to new strategic challenges and their funding requirements. Whilst these new goals are fully understandable and defensible, the financial consequences of the arms deal hamstrings any flexibility of focus in responding to new challenges.

There can also be no doubt that the aid-agency-driven mantra of defence expenditure cuts and ratios of defence spending at 2 per cent of GDP can be articulately challenged within the evolving context of redoubled AU-wide efforts at enhancing and building peace and security — with the associated pressures for defence expenditure for peace-keeping and peace support operations that this brings. But that is not to suggest that a clear strategic analysis must not inform force design decisions or that the defence ministry is

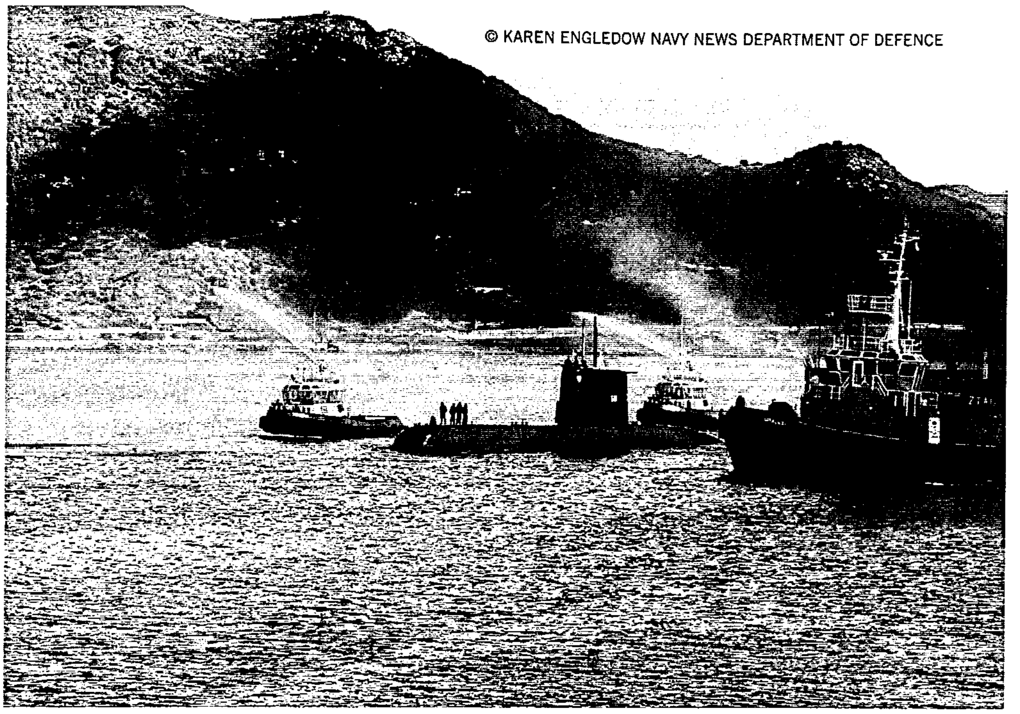
The arms deal is not the sole factor responsible for the present near-record current account deficit. The insatiable appetite of consumers for imported products is a contributing factor getting a new excuse to squander resources and plan inadequately.

Herein lies the rub — particularly in the case of South Africa in the context of the ongoing SDP delivery.

The 1996 Defence White Paper included clear precepts of the renewed importance of peacekeeping and peace-enforcement as critical pillars of South Africa's defence challenges across the region and continent. The Strategic Defence Procurement Programme certainly did not attach adequate weight to peace mandates. The pressures for peacekeeping and peace enforcement should realistically have been foreseen in a global context where there have been numerous frustrations at UN inaction and/or inadequate actions. South Africa's analysis of its strategic environment was therefore accurate whilst the procurement decision was flawed.

As the department of defence conducts the update of the defence review, largely in order to reflect the strategic challenges globally and locally and the institutional changes embodied in the Defence Act and the Public Finance Management Act, two key challenges emerge[14]. The first is the clear need to learn from the arms deal process and its aftermath. Not to learn negative lessons that cause institutional harm in the longer-term by having an arguably "watered down" process of an "update" instead of a full new consultative process. But to learn positive lessons about building societal consensus around potential shared goals — such as AU-wide peacekeeping. The update or alternatively a fully-fledged new White Paper process offers a unique opportunity to accomplish exactly that. Societal consensus about the arms deal will not be realised, but societal agreement about the desirability of peacekeeping could be reached via a proper process. Secondly, ensuring that goals/aims and means meet. The salient lesson from the 1996 White Paper process and the 1998 defence review was the mismatch between the goals and the equipment purchased to realise the aims.

There can be little doubt that the update must result in a closer match given the clear budget constraints the department of defence faces. ❑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The SAS Manthatisi (S101), the first of the Type 209 submarines built in Germany, arrived in her homeport, Simon's Town, on 7th April 2006

The pressures for peace-keeping and peace enforcement should have been foreseen in a global context where there have been numerous frustrations at UN inaction and/or inadequate actions

Endnotes

1 Minister Mosiuoa Lekota, Defence Budget Vote Speech, National Assembly, Cape Town, 31 March 2006.
2 SARB, Quarterly Bulletin, March 2006.
3 Vote 21 — defence — budget 2006, programme 9: special defence account, p.486, *Estimates of National Expenditure.*
4 *How Cabinet chose guns over butter, Mail & Guardian,* 26 April 2001.
5 *Rand on a slippery slope, Mail & Guardian,* 26 April 2001.
6 National Treasury (2006), chapter 5, *Asset and Liability Management,* in Budget Review, p. 91 & p.94.
7 n.3 Budget Review p. 91.
8 Chapter 5, *Asset and Liability Management,* Budget Review 2006, Budget 2006.
9 GCIS, *South African Yearbook 2004/05,* p. 502.
10 Dawes, N. *No plane, no gain, Mail & Guardian,* 9 December 2004; *Govt signs Airbus Military deal amid criticism, Mail & Guardian,* 28 April 2005.
11 *Cabinet decision on strategic defence procurement,* GCIS, 15 September 1999.
12 Pressly, D. *NIP programme has generated R23bn for SA, Mail & Guardian,* 14 October 2005.
13 *Arms Deal Offsets deliver US$3,5bn in eight years,* SAPA, 14 October 2005. (Companies such as Ferrostaal, Agusta and ThyssenKrupp were not performing to government's satisfaction at this stage. Ferrostaal subsequently made new IP announcements).
14 Department of defence, Annual Report 2004/ 2005 p. X and p. XIV.