

The role of Public Sector Enterprises in the South African Economy

David Fourie

School of Public Management and Administration,
University of Pretoria, Pretoria, South Africa

ABSTRACT

This article focuses on economic growth and development in the South African economy to provide background on the involvement of state owned enterprises (SOEs) in the economy. SOEs make an essential contribution to economic development, not only locally, but also regionally and internationally, by sourcing capital equipment, finance and, most importantly, partnerships for development. This article analyses the role of four SOEs in the Republic of South Africa, namely Eskom, Transnet, South African Airways (SAA) and Denel, and discusses their financial contribution and performance.

INTRODUCTION

Worldwide, the public service needs to respond to a changing environment to meet the demands resulting from globalisation, growing consumer expectations and increased physical demands. Despite a strong economic policy framework, in many countries, including South Africa, job creation and productivity growth remain too low to underpin the rapid and sustained GDP per capita growth that is required. Better performance on these fronts is needed to reduce poverty. Public and private enterprises of all types and sizes have to become adaptive, innovative and internationally competitive. The challenge for every government is to build a platform for growth consisting of suitable infrastructure and logistics, competitive input prices, skills, technology and innovation and partnerships, efficient regulation and effective government offerings. In this endeavour, state owned enterprises (SOEs) are critical mechanisms to assist governments to achieve economic growth and service delivery, but also to reduce a country's tax burden. For South Africa, SOEs are vital to the growth of the economy and in the development of the country's strategic sectors, especially energy, transport, telecommunications and manufacturing.



ECONOMIC GROWTH AND DEVELOPMENT AS A BACKGROUND TO SOE INVOLVEMENT

The sovereignty of a state's economy and economic development is governed by various international laws, agreements and practices. In this context, the United Nations (UN) affirms the rights, duties and responsibilities of states regarding development and advancement in its *Charter of Economic Rights and Duties of States* (UN 1974). Article 1 specifically sets out the state's choices with reference to a particular economic dispensation, asserting that "every state has the sovereign and inalienable right to choose its economic system as well as its political, social and cultural systems in accordance with the will of the people, without outside interference, coercion or threat in any form whatsoever" (UN 1974). However, given the interrelatedness of states in the global environment, according to Article 14, "every state has the duty to cooperate in promoting a steady and increasing expansion and liberalisation of world trade and an improvement in the welfare and living standards of all peoples" (UN 1974).

According to the UN's World Economic Situation and Prospects 2013 mid-year update report released in May 2013 (UNDESA & UNCTAD 2013), global economic growth is likely to remain below potential for some time, and the situation continues to be exacerbated by weak employment opportunities. The projected global economic growth was also revised downward from a 2,4% projection in December 2012 to 2,3% in 2013, anticipating the same growth pace as in 2012, before gradually increasing to an estimated 3,1% in 2014 (UNDESA & UNCTAD 2013). Although new policy initiatives in several major economies have reduced systemic risks and have assisted in stabilising consumer, business and investor confidence since late 2012, these initiatives have contributed only marginally to economic growth, and even in these economies the promotion of job creation initiatives still lacks dedicated support. In developing economies, unresolved weaknesses continue to pose some risks and lead to uncertainties. In the BRICS countries (Brazil, Russia, India, China and South Africa) in particular, there has been a significant deceleration in GDP growth since 2011. This may be ascribed to a combination of weak external conditions and domestic impairments: the current environment of low global interest rates and moderate volatility also poses some risks for these economies, since it might lead to a depreciation of domestic currencies, excessive credit growth, an accumulation of substantial leverage and asset price bubbles (UNDESA & UNCTAD 2013).

Although the 2008/2009 economic downturn exposed the limitations of domestic demand-led growth path characteristics and job creation initiatives, South Africa's strong macroeconomic policy framework has contributed positively towards growth and development since the early 1990s, and the country's good track record of fiscal prudence underscores a framework considered fairly stable (OECD 2010). However, South Africa's economy has been under significant pressure because of external demand conditions and domestic challenges, primarily due to industrial action and factionalism in the mining sector. The country's nominal GDP is estimated at R814 billion according to figures released for the first quarter of 2013. This is approximately R1 billion less than the fourth quarter of 2012. The largest industries, as measured by their nominal value contribution during the first quarter of 2013, were (1) finance, real estate and business services at 22,4%, (2) general government services at 16,8%, (3) the wholesale, retail and motor trade and catering and accommodation

industry at 16% and (4) the manufacturing industry at 12,6% (StatsSA 2013). The country's short-term economic prospects remain unsatisfactory against this background. Consumer spending is anticipated to be modest, and fixed investment spending by the private sector is likely to be constrained by surplus production capacity. Notwithstanding these indicators, which seem to indicate a slowdown in development, the public sector aims to advance its capital expenditure programme (IDC 2013).

SOES AS VEHICLE FOR DEVELOPMENT IN SOUTH AFRICA

SOEs make essential contributions towards economic development, not only locally, but also regionally and internationally, in that they attract and source capital equipment, finance and partnerships. However, the macroeconomic environment affects their role and contribution: consecutive years of global economic growth were recorded in the early 2000s, but inflationary pressures and the turmoil in the developed financial markets, mainly in the United States (US) and the European Union (EU), resulted in a downsizing of global growth by 2008/2009. This inevitably had a negative compounding effect on the South African economy, which is not surprising considering South Africa's trade agreements with the EU, which receives almost a third of the country's manufactured exports. Moreover, existing infrastructure constraints and poor investor sentiment posed a number of domestic challenges (*Financial Times* 2013).

The fact that SOEs contribute to the South African economy and development is not a new phenomenon. The postal service was probably the first indispensable asset of the governorate of the Dutch East India Company when, by the late 1700s, the acting governor of the Cape, Johan Isaac Rhenius, opened a post office at the Castle in Cape Town on 2 March 1792. Regular inland mail services commenced and, notwithstanding intermittent conflict between the Dutch and the British, the South African Post Office gradually increased its inland distribution range via horseback, mail carts, trains, and eventually aircraft. According to Jerome and Rangata (2003:6-7), by the early 1920s, SOEs had become instrumental in shaping the South African economy. These enterprises were initially given a mandate to strengthen import-substitution industries and operated as exclusive franchises. Some of the larger companies included the Electricity Supply Commission, which later changed its name to Eskom. Its task was to develop, produce and maintain electrical power distribution. There was also the Iron and Steel Corporation (later Iscor) which was to secure iron and steel production; and the Industrial Development Corporation (later IDC) which was to assist in the establishment of new industries such as the Phosphate Development Corporation to mine and process phosphate minerals to advance agricultural and peripheral practices; the South African Coal, Oil and Gas Corporation to produce synthetic fuels and derivatives from coal; and the Southern Oil Exploration Corporation to locate crude oil against the background of the oil and petroleum embargo imposed on South Africa. Other more recent examples are the South African Broadcasting Corporation (SABC), a news and actuality broadcast service in Afrikaans, English and some other indigenous languages; the Armaments Development and Production Corporation and later Armaments Corporation of South Africa (Armscor), responsible for all research and development pertaining to munitions and military paraphernalia; and South African Airways (SAA), which functions as the national airline.



All were established to ensure the country's sustainability and self-sufficiency. Many state corporations also established subsidiary companies in partnership with private firms, and several held controlling shares of stock in private firms (Jerome & Rangata 2003:6-7).

The initial goal for the establishment of some SOEs was import-substitution, but by the 1980s, the then National Party-led government opted to focus on economic development through stringent export policies). Armscor was one of the more successful companies, so armaments and military equipment formed the mainstay of exports. During this period, South African SOEs contributed the highest proportion of the GDP of any country outside the former Marxist Socialist Bloc. By the late 1980s, however, a number of SOEs faced privatisation because they were financially unsustainable, were funded from limited state resources, were not an attractive proposition enabling them to acquire immediate capital for additional projects, and were so inefficient that they elicited unwanted criticism against the government (Klopper 2010:4).

Hence, private individuals were allowed to purchase shares in many SOEs. In essence, the government appointed a majority of corporate directors, permitting senior managers to employ personnel outside the ambit of government control. The primary controlling mechanism of the government regarding these semi-privatised companies was granting or withholding state finances. Eskom was granted an opportunity to acquire private capital, but most other entities relied solely on government funds for their capital financing. Privatisation created several complications – the most problematic of which was the strategic anomaly of allowing foreign buyers to own and control critical South African industries. This was perceived as a conceivable obstacle by the mid-1990s, when the newly elected African National Congress government argued that this move was a strategy to deny the new government control over the economic resources of the country. Nevertheless, by 1995, the Government of National Unity acknowledged the potential benefits of privatisation, particularly against the background of the obstacles the government faced in relation to the implementation of the newly adopted RDP and GEAR strategy, which required immediate funding (Jerome & Rangata 2003:9).

THE CONTEXT OF SOES IN THE SOUTH AFRICAN ENVIRONMENT

There is no standard definition for an SOE. Some key characteristics include their status as established legal entities operating within a commercial environment, and the fact that a government is a shareholder. In the South African context, the starting point for defining a national or provincial SOE is the *Public Finance Management Act, 1999* (Act 1 of 1999), commonly referred to as the *PFMA* (RSA 1999), which lists public entities, and their subsidiaries (although these are not explicitly listed), in Schedules 2 and 3 – the major entities are listed in Schedule 2 (National Treasury 2013).

The *PFMA* lists approximately 300 public organisations consisting of nine constitutional institutions, 21 major public entities, 153 national public entities, 26 national government business enterprises, 72 provincial public entities, and 18 provincial government business enterprises. Constitutional institutions are listed as Schedule 1 organisations, major public entities as Schedule 2 organisations, and the remainder as Schedule 3 organisations.

Some of the large SOEs involved in infrastructure development programmes have been separated from their policy-making ministries and now resort under the Department of Public Enterprises (DPE) as the SOE shareholding ministry where the Minister of Public Enterprises represents the interests of government as the shareholder, while the relevant policy ministry focuses on policy-related issues.

The current dispensation presents governance challenges, the interrelatedness of government's strategic objectives has already ensured the development of mutually inclusive policies pertaining to the governance of the SOEs. The departments concerned include the Department of Energy, the Department of Transport, the Department of Communications and the Department of Minerals and Energy (DPE 2012(b):2). The DPE provides shareholder oversight to the nine SOEs that are governed within departmental programmes.

The DPE is currently concerned with structuring a developmental portfolio focusing on efficiency and financial stability within the SOE environment to promote South Africa's national capacity regarding identified areas of manufacture and infrastructure development. Performance measurement in this regard remains imperative, and identified key performance indicators relating to an increase in the economic value of a particular portfolio, as well as its outputs aimed towards developmental initiatives, are vital tools towards obtaining the desirable outcomes (DPE 2008:8).

Government is investing in large-scale projects relating to water, transport, electricity, telecommunications and infrastructure at an estimated cost of approximately R3,2 trillion by 2020 (DPE 2012:iii). SOEs are central to building industrial capacity to strengthen South Africa's economy to meet the demand for global goods and services. They are, by their very nature, ideally positioned to fulfil the country's developmental objectives through public-private facilitation roles, coordination and social interaction. The building of collaborative relationships with important customer communities can also ensure higher levels of investment and operational efficiency, especially with regard to incorporating communities in development plans and projects (DPE 2012(a):ii).

Financial soundness, stability and an increase in revenue resources are important imperatives within the corporate environment, but they may prove difficult to achieve if an enterprise is defined by a specific long-range strategic intent which requires it to maximise economic outcomes, as opposed to focusing on profit margins only. The Minister of Public Enterprises, Malusi Gigaba, is adamant that SOEs "are now viewed explicitly as vehicles for socio-economic development ... [and that] a decision has been taken to strengthen and align them to government's delivery mandate" (Gigaba cited in SabinetLaw 2010).

The reasoning behind this emphasis on the role and function of SOEs in South Africa may be contextualised in the deliberate direction taken in the government's policy relating to the state's pursuit of market goals to structure the developmental state as the edifice of national well-being. Government investment in infrastructure can contribute effectively to increased investment by users of that infrastructure, to opportunities for infrastructure equipment suppliers and to benefits supporting peripheral economic initiatives and developmental opportunities, such as the increased use of railway infrastructure, as opposed to road transport networks. A core principle of the envisaged contribution of SOEs towards developmental objectives is also framed in procurement initiatives aimed at promoting industrial investment and governance practices relating to targeted investments in industry to minimize South Africa's dependence on the export of raw resources (SabinetLaw 2010).



SELECTED SOES AND THEIR CURRENT STATUS WITHIN THE PERFORMANCE PARADIGM

SOEs are catalysts for growth and development due to their dual role in the economy, namely that of creating a demand for goods and services with a multiplier effect on the one hand, and creating peripheral supporting industries on the other (DPE 2012(a):ii). As infrastructure development and strategic positioning are critical objectives of the South African government, the four largest SOEs within the DPE portfolio, namely Eskom, Transnet, SAA and Denel, are analysed in this article.

Eskom

Eskom is the largest producer of electricity in South Africa (approximately 95%) and Africa (approximately 45%) (Eskom 2011(a):13). The utility ranks among the top 20 utilities in the world in terms of its electricity generation capacity. Electricity generation forms the core function of Eskom, but the company is also active in all elements of the electricity supply chain, which includes the transmission and distribution thereof to industrial, mining, commercial and residential consumers (Eskom 2011(a):13).

Issues that currently impede optimal performance include the high electricity prices charged by municipalities, slow progress in the rural electrification programme, the need to extend the building programme beyond the Kusile and Medupi power stations, continued labour unrest at the Medupi power station, irregular and wasteful expenditure and the outsourcing of services for which internal capacity can be developed (RSA 2013).

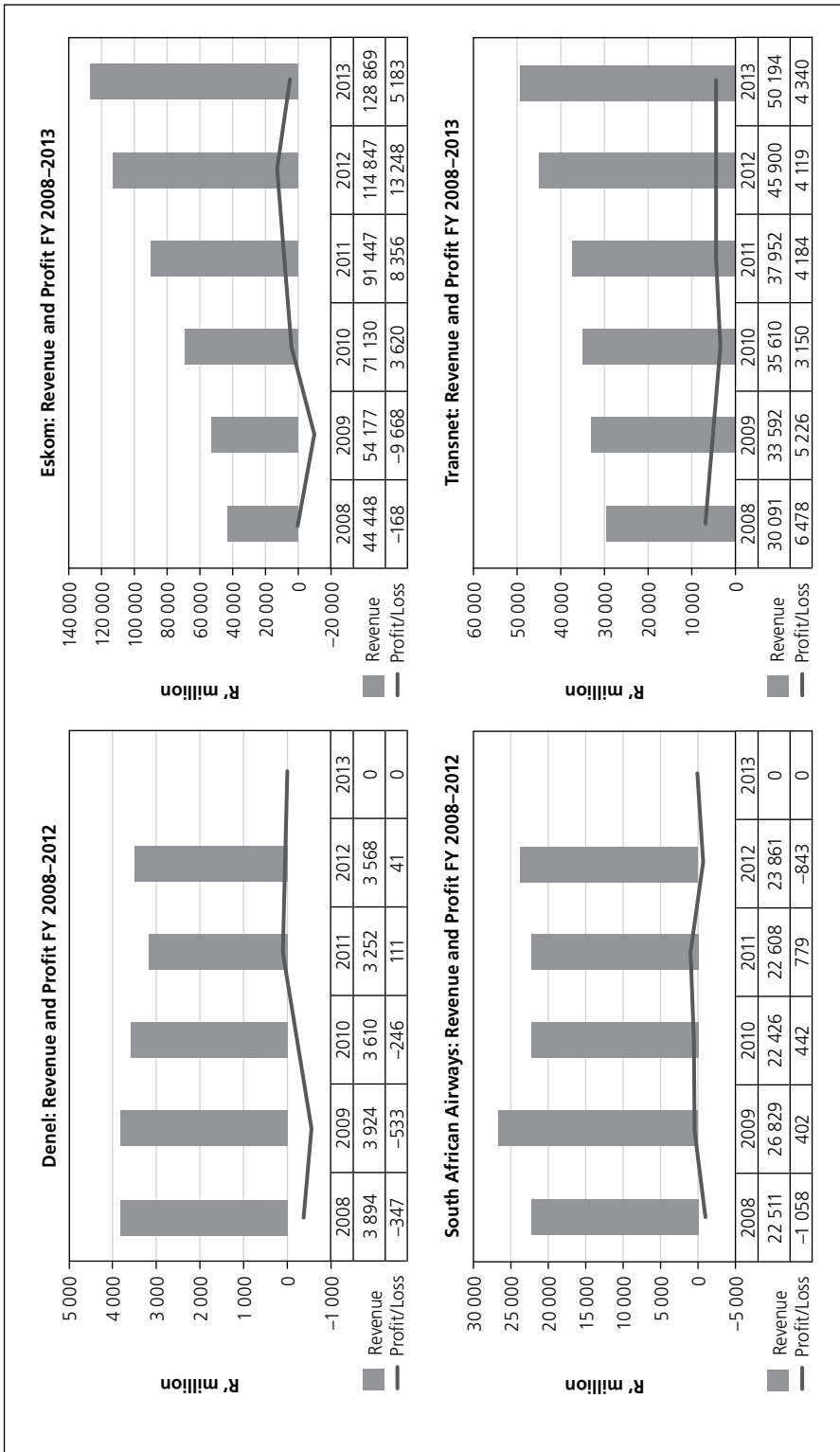
Transnet

Transnet operates as an integrated freight transport company formed around a core of five complementary divisions, comprised of freight rail, rail engineering, the national ports authority, port terminals and pipelines supported by various interrelated projects that reinforce the group as a whole (Transnet 2012).

During the 2011/2012 financial year, Transnet (2012) reported fruitless and wasteful expenditure totalling R89,6 million. Although irregular expenditure in that period amounted to R195,5 million, there was an improvement compared to the R8,3 billion during the 2010/2011 financial year. There was also some development in the Competitive Supplier Development Programme, a programme focusing on skills development, job creation and the preservation and localisation of suppliers and Original Equipment Manufacturers. During the 2011/2012 financial year, R14,1 billion obligations were concluded with suppliers of R5,4 billion, representing 39% of the total contract value (Transnet 2012). The total recognised B-BBEE expenditure accounted for 80% of the total procurement expenditure (Transnet 2012). Transnet has also invested more than R160 million in its social expenditure programmes, which include health care, teacher education and sports development.

Issues that impede optimal performance currently include delays and cost escalations in construction ventures, the performance of board members, the performance of Transnet Freight Rail and the need to revive unused railway lines for passenger trains (RSA 2013).

Figure 1: Financial performance of selected SOEs (2008/2009–2012/2013)



Sources: Denel (2009, 2010, 2011, 2012); Eskom (2009, 2010, 2011, 2012, 2013); SAA (2009, 2010, 2011, 2012); Transnet (2009, 2010, 2011, 2012, 2013).

South African Airways (SAA)

During the 2011/2012 financial year, SAA (2012) did not present optimal figures. The entity incurred fruitless and wasteful expenditure of R4 million, R3 million of which was due to baggage claims, penalties and fines. Irregular expenditure to an amount of R128 million was also incurred for the purposes of business continuity, due to non-adherence to supply-chain management processes. However, the SAA board has established a committee to develop a 20-year long-term turnaround strategy.

Numerous issues currently impede optimal performance, especially high airport taxes, landing, parking and handling costs, the lack of a coordinated government strategy, fuel costs, monetary fluctuations, competition law, outdated and aging aircraft, the lack of strategic planning and innovative thinking, financial inefficiency and skills shortages (RSA 2013).

Denel

The Denel group was formed in 1992, when the manufacturing subsidiaries of Armscor were divided to structure Armscor as the procurement agency for the former South African Defence Force (now the South African National Defence Force), while the manufacturing divisions were combined under Denel as divisions which included properties and engineering services, informatics, aerospace and systems manufacturing. Denel is a major participant in South Africa's defence-related industries and a strategic supplier of unique products and full lifecycle support within the military environment. The group's footprint also extends to the broader South African manufacturing industry, through its outsourcing of significant elements of production and the acquisition of raw materials. However, as a state-owned aerospace and defence technology concern, Denel has not performed optimally for many years, primarily due to a decrease in local defence spending, the restructuring of the international arms industry and the current state of the world economy, which influences armaments procurement and development (Denel 2009:8).

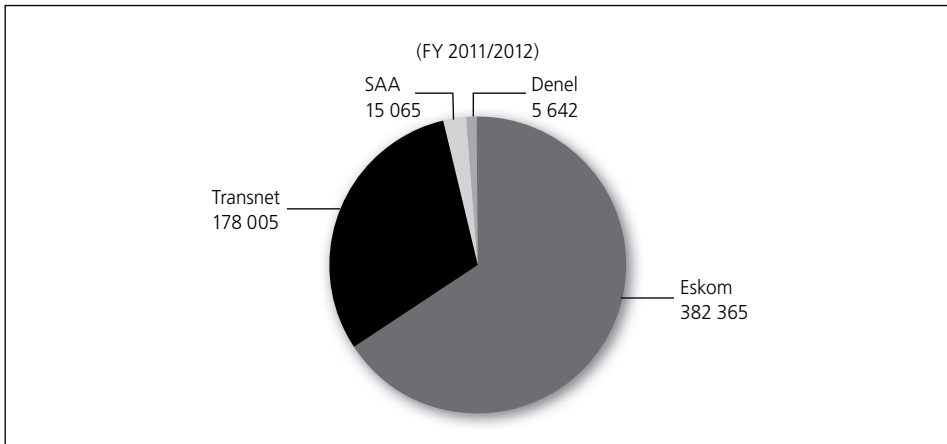
Issues that currently impede performance include competition from developed economies, alignment between military acquisitions and industrial strategy, international clients' opting for indigenous solutions, an escalation in geo-political influences, and an overall lack of growth in the global defence industry (RSA 2013).

FINANCIAL PERFORMANCE OF SELECTED SOES

The performance of the selected SOEs between 2008/2009 and 2012/2013 is indicated in Figure 1.

The restated financial results for Eskom between the 2008/2009 and 2011/2012 financial years indicate that the group's revenue increased with an average of 158,38%. Taking into account the 2012/2013 financial results, the group posted a 189,93% increase in revenue since 2008 (Eskom 2009, 2010, 2011, 2012, 2013). Transnet followed a similar trend. The restated financial results for Transnet between 2008/2009 and 2011/2012 indicate that the group's revenue increased with an average of 52,53%. Considering the 2012/2013 financial results, the group posted an overall revenue growth of 66,80% since 2008 (Transnet 2009,

Figure 2: Relative size of selected SOEs by Asset Base (R' million)



Source: (Eskom, 2012; Transnet, 2012; SAA, 2012; Denel, 2012).

2010, 2011, 2012, 2013). At the time when this study was done, Denel and SAA had not yet published their reports for the 2012/2013 financial year. However, between 2008/2009 and 2011/2012, these enterprises, although they are smaller than Eskom and Transnet, did not present comparable gains. The financial results for SAA between 2008/2009 and 2011/2012 indicate that the group only reported a 5,99% growth in revenue (SAA 2009, 2010, 2011, 2012). Denel in fact experienced a negative average growth of -8,37% for the same period (Denel 2009, 2010, 2011, 2012).

The 2011/2012 asset base of selected SOEs, as indicated in Figure 2, amounted to R581,077 million. Eskom and Transnet's 2012/2013 financial statements reflect an increase in their respective assets. Eskom's asset base increased from R382,365 million to R432,024 million (a 12,98% increase), while Transnet's asset base increased from R178,005 million to R203,896 million (a 14,54% increase) (Eskom 2012, 2013; Transnet 2012, 2013).

Trade and investment inconsistencies have an impact on the performance of South African SOEs, and legacy issues, enterprise-level strategies and industry drivers also play a role. Since South African SOEs vary in maturity and size, each with unique requirements, the strategic developmental goals and objectives cannot be negated. SOEs such as Denel and SAA, although they are in the early stages of improving their operating performance through turnaround strategies, remain unprofitable and continue to be undercapitalised, with weak financial positions (DPE 2008:12).

CONCLUSION

The role of SOEs in the South African economy is crucial to achieve government's developmental objectives, especially in view of a shortage of key infrastructure relating to electricity, ports and rail technologies. To achieve these objectives, SOEs need to change their financing structures to include governance principles contained in frameworks such as those presented in the King III Report. New sources of funding should also be acquired and this could be achieved through expanded investment plans provided by development

finance institutions. However, specific governance issues still present some challenges. Notwithstanding operational challenges affecting the generation of sustainable revenue, sudden and frequent changes in board composition seem to be commonplace. It is important to understand the political-administrative interface and to clearly identify governance rules in this regard. From an administrative perspective, the lack of a single department responsible for all SOE line and functional matters also tend to present some difficulties. The development and/or institution of an unambiguous model or arrangement incorporating the developmental objectives of the shareholder and policy departments should receive priority. In essence, corporate governance in SOEs needs to be improved through clear and unambiguous policy directions that are isolated from undue political interference, while simultaneously promoting transparency, efficiency and effectiveness.

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