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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/87

10:00 a.m., June 20, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
	C. J. Batliwalla, Temporary
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	
N. Wicks	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

D. Brand, Principal Resident Representative for South Africa. African Department: J. B. Zulu, Director; A. B. Diao. European Department: L. A. Whittome, Counsellor and Director; U. Dell'Anno, L. J. Lipschitz, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Director; R. C. Williams. External Relations Department: D. Cheney. IMF Institute: A. Peacey, Participant. Legal Department: G. P. Nicoletopoulos, Director. Treasurer's Department: D. S. Cutler, D. Gupta. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, J. R. N. Almeida, S. El-Khouri, S. M. Hassan, P. Kohnert, I. R. Panday, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, R. Bernardo, J. Bulloch, M. B. Chatah, L. E. J. Coene, T. A. Connors, C. Flamant, I. Fridriksson, J. M. Jones, M. J. Kooymans, P. Leeahtam, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, G. W. K. Pickering, E. Portas, J. Reddy, J. Schuijer, Shao Z., D. I. S. Shaw, P. S. Tjokronegoro, A. Yasseri.

1. MANAGING DIRECTOR - REAPPOINTMENT

Mr. de Groote, speaking on behalf of the Executive Directors, congratulated Mr. de Larosière on his reappointment as Managing Director.

2. SOUTH AFRICA - 1983 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation and review under the stand-by arrangement with South Africa (EBS/83/100, 5/20/83; Sup. 1, 6/17/83; and Sup. 2, 6/17/83). They also had before them a report on recent economic developments in South Africa (SM/83/111, 6/3/83).

Mr. Brand made the following statement:

> My authorities fully agree with the staff's assessment of the performance of the South African economy in 1982 and the prospects for 1983.
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> Expectations that real economic activity in South Africa would continue to decline during 1983 have now been strengthened by the preliminary figures which became available in respect of the first quarter of 1983 showing a decline of 4 percent in real gross domestic product and a decline of 11 percent in real gross domestic expenditure in this quarter compared with the first quarter of 1982. These developments have been accompanied by welcome signs of reduced inflationary pressures. Compared with an increase of 16.4 percent in the consumer price index and 14.4 percent in the producer price index over the twelve months ended April 1982, these prices increased by 12.6 percent and 12 percent, respectively, over the twelve months ended April 1983.
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> On the external side of the economy, preliminary figures for the first quarter of 1983 also confirm the sharp turnaround in South Africa's financial and economic position from the third quarter of 1982. Expressed in seasonally adjusted annual terms, a surplus of approximately R 2 billion or 2.4 percent of GDP was attained in this quarter, compared with a deficit of R 3 billion or 3.8 percent of GDP for 1982 as a whole.
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> The outcome of the overall balance for the first quarter was, however, strongly influenced by a strong net capital outflow of R 645 million. The increase in net foreign reserves during the first quarter of 1983 amounted to R 164 million, which was followed by increases of R 289 million and R 420 million respectively in net and gross foreign reserves during April and a decline of R 323 million in gross foreign reserves of the Reserve Bank during May. My authorities are delighted by the results of

the comprehensive package of policy measures that were specifically introduced over the past two years or so to achieve adjustments to the unfavorable developments in the South African economy. These measures worked rapidly and effectively to bring about a rapid improvement on the external side of the economy.

The recessionary conditions experienced in the domestic economy and the expectations that, despite a possible resumption of growth toward the end of 1983, the final outturn for the year as a whole would still be negative, have given rise during the past couple of months to pressure being exerted on the relevant South African authorities for the adoption of measures that would stimulate the economy. The proponants of this approach have also quoted the favorable developments in the current account of the balance of payments to support their case.

Developments that would advance the resumption of positive growth in the South African economy would be most welcome from the point of view of employment creation, a matter of paramount importance. However, the performance of the South African economy during the past few years with regard to inflation and the impact that the high and sustained rate of inflation has had, inter alia, on the ability of South African exporters to compete abroad, have renewed and strengthened the conviction of my authorities that every effort should now be made to attain a marked and sustained reduction in the inflation rate as soon as possible. This policy objective has now been adopted as a policy priority of the highest order, and my authorities are therefore in full agreement with the view of the staff that the policies in the period ahead should focus strongly on this problem. Resumption of economic growth in future would have to be dependent on a recovery in exports and thus to a large extent on a healthy economic recovery in the industrial countries of the world. A policy of artificial stimulation of the South African economy at this stage has been firmly rejected by the South African Minister of Finance. It would only exacerbate inflationary pressures further.

In their renewed efforts to reduce the rate of inflation as soon and as much as possible on a permanent basis, my authorities will not only rely on traditional monetary demand management policies. They are also looking at the problem from the supply side, including ongoing and more effective measures to increase the supply and quality of skilled manpower as well as possible adjustments to promote better use of the country's manpower resources. The problem of administered prices is another area that is and will be receiving further specific attention in conjunction with the private sector in the coming months.

My authorities subscribe to the view that a conservative approach to fiscal and monetary policy will continue to be appropriate in the coming months, with a policy mix that provides for continued restraint on government spending, the financing of the deficit before borrowing from nonbanking sources, and a reduction in the rate of increase in the money supply.

In order to further control liquidity in the domestic economy, it was recently decided to raise the amount of treasury bills offered at the weekly tender and to resume sales of government stock to the public. New stock to the value of R 700 million has already been sold to the market since April, and a further R 150 million of stock is being expected to be sold within the next few days. These initiatives helped to arrest the declining trend in domestic interest rates. Indeed, recent issues of government paper were allocated at higher yields than previously. The rates on three-month bankers' acceptances and treasury bills also increased to 13 percent and 12.48 percent, respectively, on June 10, 1983. A general tendency toward higher rates is therefore clearly discernable in both the money and capital markets. This has been further confirmed on June 13, when two of the leading South African commercial banks increased their prime lending rate by 1 percent to 15 percent. It is expected that this action will soon be followed by other financial institutions.

As for exchange rate policy, my authorities are maintaining the policy objective of allowing the exchange rate of the rand to be determined flexibly in response to market conditions. The effective exchange rate of the rand at the end of May 1983 was 2.1 percent higher than at the end of 1982.

My authorities have been able to keep the deficit before borrowing in respect of the 1982/83 fiscal year to 2.8 percent of GDP despite an unavoidable increase in expenditure that exceeded original appropriations. This deficit, which was kept to the absolute minimum, was made possible by a large increase in revenue. As described in the staff report, the budget deficit was more than fully funded outside the banking system. This policy, in fact, caused a sharp reduction in bank credit to the Government and made it possible to transfer a substantial amount to the stabilization account.

My authorities also remain firmly committed to a policy of restraining government expenditure in respect of the 1983/84 fiscal year and to finance the budget deficit from nonbank sources. Adjustments to the salaries of government and most other public sector employees have been restricted to normal annual salary scale increments and to adjustments relating to the policy of occupational differentiation. As indicated by the Minister of Finance in a recent letter to the Managing Director, that part of the import surchange which is still effective will be removed at the latest by the end of November despite the tight budgetary position. This is at least one month earlier than previously agreed. Moreover, the matter will be kept under constant review, and, should any improvement in the situation take place, the intention of my authorities would be to accelerate the removal of the surcharge.

As is evident from the figures quoted above, the capital account of the South African balance of payments has recently been characterized by a considerable volatility of capital flows. The reasons for this phenomenon have been fully explained in the staff report. These developments have exerted a strong influence on the country's foreign exchange reserves position. Despite the uncertainties created by this somewhat volatile situation--which is, of course, also influenced by developments in the gold price--and the associated need for the maintenance in future of a higher average level of reserve holdings, and despite its technical compliance with the benchmark data of the Fund, my authorities have so far refrained from making further purchases under the stand-by arrangement. My authorities trust that, with the measures in place now, it would not be necessary to purchase any further amounts under the current stand-by arrangement, even though South Africa may be fully qualified to do so.

In this connection, it is acknowledged by the staff that a continued improvement in the South African economy's external payments position may give rise to the development of a conflict between the objectives of monetary control and the maintenance of the external competitiveness of the manufacturing sector. My authorities are glad to note in this regard that the staff agrees that, in line with the very important objective to contain the inflationary situation in the South African economy, monetary control should be pursued even at the risk of some further appreciation of the rand. My authorities believe that maintenance of monetary control now would be more in the interest of a sound external competitive position of the economy over the medium term and would facilitate the medium-term objective of diversifying the production and export base of the economy, which would be beneficial to employment creation in the longer run. The South African Minister of Finance has recently declared in this regard that although the monetary authorities are satisfied with the way in which the spot foreign exchange market has developed, the time has arrived to give further attention to the development of the forward exchange market, i.e., measures to make this market more independent and market oriented. The Reserve Bank is already giving consideration to possible adjustments that will promote this aim and will therefore lessen the impact on the Treasury of the arrangements with regard to the forward exchange market that are in force at present. In conclusion, I wish to express, on behalf of my authorities, their appreciation to the management and staff for the most efficient and constructive way in which the consultations with them have been conducted.

Extending his remarks, Mr. Brand said that South Africa had decided to make a voluntary repurchase in respect of part of the amount purchased under the financial program approved by the Executive Board on November 3, 1982 (EBM/82/140 and EBM/82/141). The transaction would be completed before the end of August 1983. The possibility of a voluntary repurchase had been discussed with the South African Minister of Finance by the Fund staff during its mission in March 1983. At that stage, the Minister of Finance had indicated South Africa's willingness to consider a possible voluntary repurchase toward the middle of the year depending on further developments in the country's foreign exchange reserves position and in the gold price.

South Africa's foreign exchange reserve position had shown large fluctuations on a monthly basis since the beginning of 1983, Mr. Brand added. The volatile situation made it difficult for his authorities to make a final decision at the present stage about the precise amount that would be repurchased voluntarily. Conditions had changed substantially since the Fund's mission visit. For example, the gold price had dropped from about $500 per ounce to about $400 per ounce. South Africa's net reserve position was also showing signs of weakening. Therefore, the authorities intended to make a final decision on the amount of the repurchase as soon as a clearer trend in the net foreign reserve position and in the gold price developed in the course of the coming few weeks. It would also be necessary to take into account likely developments in South Africa's reserve position in the coming months.

Mr. Erb stated that he agreed generally with the staff appraisal and supported the proposed decision. Adjustment in South Africa's external accounts had responded rapidly to the Government's stabilization measures as well as to gold prices that had been higher than originally projected. As the authorities rightly emphasized, further progress needed to be made in reducing inflation since it remained high relative to the major industrial countries. Premature relaxation of financial policies might be tempting from a short-term employment perspective, but it would be costly in terms of reducing inflation.

Commenting on fiscal policies, Mr. Erb noted that South Africa had attained the program targets. He welcomed the authorities' intention to phase out the import surcharge by the end of November 1983, and he urged them to eliminate it as soon as possible. An import surcharge was not a preferred revenue source, even when there was a need for tax revenues. Elimination of the surcharge would also have a one-time deflationary impact on the price level.

The analysis that the staff had made of labor market rigidities in the South African economy was of special interest, Mr. Erb observed. In addition to other undesirable consequences, those rigidities clearly kept South Africa's long-run growth rate below its potential and were, therefore, very costly. Good economic management, along with important noneconomic reasons, would necessitate the removal of those rigidities; he therefore urged the authorities to work to relax them without delay.

He agreed with the staff that the effect of the labor market rigidities on the balance of payments was uncertain. For example, in the short run, their removal might have an unfavorable impact on the balance of payments, but that possibility did not lessen the importance of eliminating them. By strengthening South Africa's long-run growth potential and by enhancing the flexibility of the domestic economy, the authorities would be strengthening the country's balance of payments position over the longer term.

South Africa's external position had improved markedly over the previous several months, Mr. Erb remarked, although there remained considerable volatility in the capital account and in the price of gold. He welcomed the authorities' intention to use the Fund's resources only on a truly stand-by basis. He also welcomed the information that the authorities expected to make a voluntary repurchase under the stand-by arrangement and the compensatory financing facility if their balance of payments position continued to strengthen in the coming months.

Mr. Lovato said that he also agreed with the staff appraisal and recommendations. The economic situation in South Africa had improved more quickly than expected; in particular, the developments in the current account of the balance of payments were impressive, the deficit of 7.5 percent of GDP in the first half of the year having moved into surplus on a seasonally adjusted basis. As the main purpose of a stand-by arrangement was to restore balance of payments equilibrium and the adjustment program appeared to have been successful, he welcomed the authorities' intention to refrain from further purchases under the stand-by arrangement at present and to consider an early repurchase if the balance of payments position continued to improve. For the same reason, he urged the authorities to remove the remaining 5 percent surcharge on imports as soon as possible, if only because of the beneficial effects with regard to inflation.

Real government spending had been increased in FY 1982/83 by an amount described by the staff as "disquieting," Mr. Lovato continued. The budget deficit as a percentage of GDP had been contained within a level that was not high by international standards, but that outcome had occurred "largely owing to the unexpected buoyancy in gold mining." Given the fluctuations in the price of gold and the difficulty in forecasting its trend, it would be wise to keep the growth of public spending well below the rate of inflation, as planned for in the FY 1983/84 budget. At the same time, the resources for capital expenditures and manpower training should be increased beyond the budgeted levels.

Although Directors were reviewing a stand-by arrangement designed to last only 14 months, Mr. Lovato commented, he urged the authorities to pay more attention to factors that went beyond short-term adjustment, i.e., to the structural roots of South Africa's problems. To tackle those problems, industrial policy ought to aim at diversifying export production so as to reduce cyclical fluctuations. Exchange rate policy could assist that approach by following a path that favored the competitiveness of the manufacturing sector while avoiding additional inflationary pressures. Furthermore, productivity had to be improved; but a solution to that devoted to education and training in some parts of the country and among some social classes if all sections of the population were to be able to participate in the mobility process. Furthermore, serious limitations on geographical mobility remained in place, a factor that could inhibit the attainment of the authorities' employment objectives. The subject was of such important concern that it would have to be reviewed again at the next Article IV consultation. He hoped that at that time the South African authorities would be able to inform Executive Directors not only of their continued success in dealing with short-term economic problems but also of significant progress in removing the inhibitions to greater mobility in the South African economy.

Mr. Laske observed that the determined implementation of the Fund-supported program under the stand-by arrangement had, in conjunction with an increase in the price of gold, brought about a rapid improvement in the external position of South Africa. External developments would probably continue to be favorable, although the price of gold had recently shown signs of weakness. He welcomed, therefore, the authorities' decision to make no further purchases after the first disbursement under the stand-by arrangement and to consider a voluntary early repurchase.

He agreed in general with the staff appraisal, Mr. Laske continued. With regard to monetary policy, the improvement in the external situation, on both current and capital account, had triggered upward pressure on the rand, to which the authorities had reacted with a flexible exchange rate policy and with actions to mop up the excess liquidity created by the inflow of short-term money. The authorities quite obviously were confronted with a policy dilemma, a dilemma experienced by other countries in the past. They were rightly concerned about the competitive position of the nongold industrial sector, which suggested that the exchange rate appreciation should not be too pronounced. On the other hand, the continuously high rate of inflation made tight control of monetary growth necessary along with sterilization of the rand counterpart of the monetary inflow. Striking the appropriate balance between those two objectives had required skillful handling. When the overfunding of the budget--the technique employed to mop up excess liquidity--had threatened to undermine the achievement of their fiscal objectives, the authorities had abandoned that course of action.

Purely from the point of view of fiscal policy, the authorities' approach had made sense, Mr. Laske considered, but, from a broader economic perspective, it might have been more appropriate to continue the mop-up operation in the interest of maintaining monetary control. Such continuation would possibly have forestalled the steep fall in domestic interest rates, the extent and speed of which did not appear to have been consistent with price developments. It might also have prevented M-3 from rising considerably more than had been projected under the financial program. He agreed with the staff's view that the interest cost to the budget arising from such overfunding operations ought not to be looked at in isolation, but in connection with the earnings from foreign reserves acquired in the process. When the gold price had stopped rising and had begun to decline earlier in 1983, the dilemma had faded away. However, if the problem re-emerged, a careful weighing of the fiscal merits and monetary advantages of sterilizing excessive money inflows would be highly advisable.

The external improvements had permitted the authorities to ease foreign exchange controls, Mr. Laske remarked. He welcomed the lifting of controls for nonresidents and the relaxation of controls on residents, as well as the authorities' decision to eliminate the import surcharge ahead of schedule. The staff provided interesting information and reflection on the connection between labor market policies and constraints in economic growth. The authorities should pay more adequate attention to those relationships in order to enable the country to gain the full benefit of the economy's growth potential in the longer run.

Mr. Mtei stated that, although much could be said about the social, human, and political aspects of the policies currently being pursued by the Government of South Africa, he would confine his remarks to the purely economic aspects of the papers before the Board. In that way, he would abide by the requirements of the Articles of Agreement, which, as Sir Joseph Gold had explained in his recently published article (IMF Survey, 5/23/83), enjoined the Fund from interfering in the internal political affairs of member countries.

Recalling his chair's position when the issue of South Africa's requests for a stand-by arrangement and a drawing under the compensatory financing facility had been brought to the Board in November 1982, Mr. Mtei noted that his chair had requested a postponement of the discussion in order to allow time for consultations with all his authorities and for more detailed consideration of the complex issues involved. At that time, some Directors had just assumed their substantive positions in the Board and, therefore, had not had time to consider the matter fully. His chair had hoped that, given more time, it would have been able to be in a position to take a firm stand on the matters on the basis of their economic merit. The staff report for the Article IV consultation and mid-term review of the stand-by arrangement clearly demonstrated that, if the decision had been postponed for a few weeks, the evolution of South Africa's financial position would have indicated that the requests for the stand-by arrangement and for the purchase under the compensatory financing facility had been quite unnecessary. For that reason, he maintained that the request for postponement had been correct; regrettably, it had not been accepted by a majority of the Board.

The staff's statement that the external payments objectives of the program had been realized more quickly than expected at the time of the negotiations for the stand-by arrangement was less a reflection of the economic policies of the South African Government and more an indication that the assumptions on which the program had been built had been unduly pessimistic, creating the semblance of a balance of payments need when the underlying conditions had pointed in a different direction, Mr. Mtei continued. It was worth noting that South Africa's overall balance of payments had changed from a deficit of SDR 2 billion in the first half devoted to education and training in some parts of the country and among some social classes if all sections of the population were to be able to participate in the mobility process. Furthermore, serious limitations on geographical mobility remained in place, a factor that could inhibit the attainment of the authorities' employment objectives. The subject was of such important concern that it would have to be reviewed again at the next Article IV consultation. He hoped that at that time the South African authorities would be able to inform Executive Directors not only of their continued success in dealing with short-term economic problems but also of significant progress in removing the inhibitions to greater mobility in the South African economy.

Mr. Laske observed that the determined implementation of the Fund-supported program under the stand-by arrangement had, in conjunction with an increase in the price of gold, brought about a rapid improvement in the external position of South Africa. External developments would probably continue to be favorable, although the price of gold had recently shown signs of weakness. He welcomed, therefore, the authorities' decision to make no further purchases after the first disbursement under the stand-by arrangement and to consider a voluntary early repurchase.

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One of the basic indicators of adjustment apparent in most other programs, Mr. Mtei observed, was the extent to which government expenditure was restrained. Such restraint had been one of the objectives of fiscal policy in the program with South Africa, with aggregate expenditure budgeted to rise by 11 percent. However, fiscal policy had been clearly expansionary. The expenditure overrun in FY 1982/83 had been about R 1.25 billion, or almost 7 percent of the original expenditure estimate. A significant portion of the overspending had been accounted for by increased defense spending, which was clearly economically unproductive, and which had facilitated South Africa's belligerent incursions into neighboring states in his constituency.

The budget had also been affected by increased subsidies, "representing transfers to subsidized transport services for blacks, the black homelands, and housing for civil servants," Mr. Mtei added. With regard to the first two categories of transfers, the problem had its roots in the apartheid policy of the Government of South Africa, a policy that was economically irrational, as the staff report recognized. If blacks and nonwhite minorities were given the opportunity to develop their skills and to earn at rates commensurate with their productivity, irrespective of race, the question of special subsidies would not arise. The decision to develop separate homelands, requiring huge expenditures, was not the most efficient way of using the country's resources, especially when most of those homelands were located in areas in which natural resource endowment was minimal.

The public sector wage bill was another area of fiscal policy that demonstrated lack of adjustment, Mr. Mtei considered. The staff stated that there was "an underestimation of the public sector wage bill" by R 84 million. The usual terminology in Fund programs for that phenomenon was an expenditure overrun. Compared to the requirements made of many other countries in their efforts to adjust, several of which had income levels far below that of South Africa, fiscal policy had certainly remained lax. In fact, the budget would have been in a worse position had gold revenue not increased by about R 650 million.

Commenting on the presentation of the fiscal situation for FY 1983/84, Mr. Mtei noted that not only was expenditure budgeted to increase by about 8.75 percent above the revised estimates for FY 1982/83, but, in addition, the staff believed that it was highly probable that additional appropriations would be made. In that regard, he invited the staff to comment on the likely outcome for the budget. Could the outcome be considered consistent with the normal progress of a Fund-supported program?

The Appendix to SM/83/111 recognized that the labor market in South Africa was characterized by formal and informal impediments stemming from laws and government policies and practices, Mr. Mtei remarked. He invited the staff to comment on the statement on page 14 of EBS/83/100 that "the mission found broadly based acknowledgement that the legal impediments to vertical labor mobility had been virtually eliminated." The various impediments to both geographical and vertical mobility of labor resulting from government employment policies and inadequate training for certain groups had caused chronic shortages of skilled labor and had served as a constraint on potential growth, as several Directors had pointed out. A rate of growth of 5 percent was required to keep unemployment from rising. However, a rate of growth of only 4 percent was attainable with the projected availability of skilled labor, implying that under current policies there was no way to reduce unemployment or to attain full utilization of the labor force. The impact of the skewed labor market structure had directly affected the cost performance of South Africa's manufacturing sector, in which unit labor costs had jumped by 5.5 percentage points between 1981 and 1982. The staff had suggested that that development had partly been the result of a slower rate of increase in productivity. However, such an explanation left many unanswered questions; he invited the staff to comment further on the issue.

The so-called job reservation regulations, which excluded certain race groups from some categories of employment, had impeded vertical mobility of labor, discouraged the acquisition of skills by certain race groups, distorted the occupational allocation of labor, and hindered optimal use of the labor force and proper functioning of the labor market, Mr. Mtei went on. Impediments to horizontal or geographical mobility of labor also affected morale and hindered efficiency. All those factors led to high interregional and interrace group pay differentials and added to inflationary pressures. With excess supply of labor in some areas and shortages in others, the natural consequences were economic inefficiency and higher costs of production. In that regard, it was regrettable that there was no indication of any clear prospects of improvement in the educational system or of the abolition of those irrational regulations in the present employment policies and practices of South Africa. He hoped that the matter would be the subject of serious discussion between the staff and the authorities at the time of the next Article IV consultation. His chair would be interested in knowing of the specific actions that the authorities had taken or intended to take to improve the situation.

On the external payments side, Mr. Mtei observed, the short-term liabilities of more than SDR 1.5 billion in mid-1982 had almost been eliminated. It appeared that the purchases under the stand-by program and the drawing under the compensatory financing facility might have been used to replace commercial borrowing. It was clear from the staff report that South Africa's external payments position had improved to the extent that it no longer needed further use of Fund resources. Therefore, having regard to the position that his chair would have taken if consideration of the request had been delayed for a few weeks, his chair's dissatisfaction with the economic policies being pursued by South Africa currently, and the developments in the country's external account, the second sentence of the proposed decision, giving South Africa the right of further purchases without new understandings with the Fund, should be deleted. The proper use of Fund resources required that balance of payments need and other criteria relating to the adjustment process had to be demonstrated to the Board before further purchases could be made. He accepted Mr. Brand's announcement that there would be an early repurchase; the staff should follow closely the developments in South Africa's external payments position with a view to initiating consultations with the authorities for further early repurchases in keeping with the provisions of Article V, Section 7(b) of the Articles of Agreement. Furthermore, the authorities should pursue an aggressive debt management policy as recommended by the staff, involving increased expenditure on debt service, including the debts owed to the Fund.

Mr. Wicks said that he agreed in general with the remarks made by Mr. Lovato, Mr. Erb, Mr. Joyce, and Mr. Laske. He welcomed the fact that the South African authorities had been able to refrain from further purchases under the stand-by arrangement, as well as the information provided by Mr. Brand about a voluntary repurchase. He hoped that the latter would take place.

With regard to the Article IV consultation, Mr. Wicks continued, he agreed broadly with the staff comments. The Appendix to SM/83/111 on the economic costs of the various labor laws deserved emphasis. He agreed in full with the staff's conclusion that "the full economic potential of the country will not be realized in terms of overall growth or diversification of the production base." The prospects for reducing unemployment among the greater part of the population would remain poor while those labor market rigidities persisted. He agreed with Mr. Mtei's comments on the unfortunate consequences for unemployment of a growth rate below 5 percent. He supported the proposed decision.

Miss Le Lorier observed that the demand restraint policies of the authorities had helped to bring about a substantial turnaround in the external position. In judging the performance achieved, she found it difficult to assess the respective weights to be attached to the increase in gold prices and to the impact of the stabilization policies. However, there was little doubt that a number of positive changes had occurred in the conduct of financial policies, particularly monetary and exchange rate policy. Further progress remained necessary in the financial field along the lines suggested by the staff. She agreed with the staff's recommendations.

The fight against inflation, which could not be dissociated from the removal of labor market distortions, remained a more fundamental priority, Miss Le Lorier stated. A substantial reduction in inflation was the only promising means by which the competitiveness of the nongold sector could be at least partially protected from the adverse effects of exchange rate volatility. While monetary control was indispensable, it could not do the job alone. There was strong evidence that labor market restrictions were reinforced in periods of acute rises in labor costs rather than being weakened at such times.

The reduction in inflation was an intermediate objective in the pursuit of the maximum potential medium-term growth, Miss Le Lorier continued. The latter objective was beyond reach in the present circumstances. According to the South African authorities' own estimates, the rate of growth required to keep unemployment from rising was unattainable, given the insufficient availability of skilled labor. While informal impediments to labor mobility might be strong, it was clearly urgent to remove legal and regularity impediments, especially since changes in labor market policies would be felt only after a considerable time lag. The public sector had a leading role to play not only because of its regulatory powers but also because it had made less progress than the private sector in moving to a more rationally diverse skilled labor force.

She found it deeply regrettable that, despite sizable overruns in fiscal expenditure in FY 1982/83, insufficient restructuring had occurred in favor of expenditures on education and training, Miss Le Lorier commented. It was urgent that such expenditures be stepped up sharply. She was not convinced by the argument that, leaving aside the question of the possibility of restructuring fiscal expenditure, such an effort would result in a higher fiscal deficit. The fiscal deficit appeared moderate, the room for its nonbank financing sizable, and the impact of current public expenditures on imports manageable. A number of countries with good records on inflation had successfully pursued a restrictive monetary policy while permitting some support to domestic demand through the fiscal deficit. South Africa could follow the same approach, particularly with regard to an increase in public expenditure that would help to reduce inflationary pressures over the medium term. The increase in public expenditure on education and training should clearly be accompanied by the removal of such practices as short-term labor contracts, which were inconsistent with constructive training efforts. In general, the removal of structural rigidities in the labor market should be given a much higher priority. She was confident that the next Article IV consultation report would include information updating the useful Appendix to SM/83/111 and the staff recommendations in that regard.

Commenting on the design of the arrangement, Miss Le Lorier reiterated her chair's view that the performance criteria were of little significance once the price of gold rose significantly higher than assumed at the beginning of the program. A review clause, or several review clauses, upon which further purchases would have remained contingent, would have been more appropriate. In several recent cases, notably in programs with centrally planned economies, the staff had recommended review clauses in order to buttress traditional performance criteria not considered to be satisfactory. Although the reasons would have been different, namely, the volatility of gold prices and the high sensitivity of the external and domestic situation to that volatility, a similar approach would have been warranted in South Africa's case. She welcomed the intention of the authorities to refrain from further purchases and their active consideration of an early repurchase.

Mr. Zhang recalled that his chair had opposed approval by the Executive Board of the South African authorities' request for a stand-by arrangement and for a purchase under the compensatory financing facility in November 1982. His chair's position remained unchanged; therefore, he opposed the proposed decision.

Mr. Tvedt stated that his authorities agreed with the staff that, in view of the positive developments in South Africa's external situation, it was reasonable that the country should refrain from making further drawings under the stand-by arrangement. He welcomed Mr. Brand's statement to that effect, and his announcement that a voluntary repurchase would be made later in 1983. He welcomed the staff's provision of more detailed comments on labor market policy than it had provided in November 1982. He fully shared the staff's critical views of labor market policies in South Africa which, inter alia, represented an obstacle to mobility and training and, therefore, suppressed economic growth and development. His authorities believed that in its future relations with South Africa the Fund should emphasize a change in labor market policies.

Mr. Tshishimbi remarked that, toward the end of the 1970s, factors of external and domestic origin had combined to generate the strong and unsustainable demand that had characterized the South African economy. In particular, the trebling of the gold price had resulted in a tremendous increase in South Africa's export earnings, more than offsetting the adverse shifts in the nongold terms of trade, and, for many years, helping to mask the effects of the high demand on the external current account and on the budget. Above all, it had helped to mask more fundamental structural difficulties facing the South African economy. When the price of gold had fallen in 1981 and 1982, the budget and external imbalances had appeared more clearly.

Against that background, the South African authorities had embarked on the stabilization program, Mr. Tshishimbi continued, in support of which they had requested and obtained the current stand-by arrangement with the Fund. The program had been designed primarily to achieve a viable external position through a reduction in domestic credit expansion, including a special target on domestic credit to the Government, restraint in public spending, and a flexible exchange rate policy. The program had also provided for phasing out the import surcharge.

The staff reports that the external targets for 1982 had been met or exceeded, Mr. Tshishimbi noted. The current account deficit, originally expected to reach about 6 percent of GDP in 1982, was estimated to have been about 3.75 percent. For 1983, a surplus of 2 percent of GDP was expected, instead of a deficit of 2 percent. With the depreciation of the rand and the rise in interest rates, large capital inflows had contributed to the turnaround in the overall balance of payments position and had allowed substantial accumulation of foreign reserves. The South African Government had indicated that it would remove the import surcharge by the end of November 1983.

How had all those developments taken place so quickly after the introduction of the stand-by program in November 1982, Mr. Tshishimbi inquired? He fully agreed with the staff's explanation that the rise in the gold price above the assumed level of $315 had made it possible for the Government to meet the external targets and the budget targets. The budget deficit had been held at 2.8 percent of GDP. While the financial program had intended to limit budget expenditure growth to 14 percent in 1982, the outturn had shown a growth rate of about 17 percent. Total outlays had exceeded the stand-by estimate by about R 740 million, about 30 percent of which had been represented by military expenditures. If the gold price projections had turned out as expected, the budget deficit would have widened. South Africa had been able to maintain the budget deficit at the targeted percentage of GDP only because the price of gold had risen substantially above the program's projection and, as a result, revenue from the gold mining sector had increased sharply. However, by adjusting expenditure to the higher revenue, the South African Government appeared to be placing itself in the same position as it had been in earlier, before the decline in gold prices; therefore, it was again masking the real problems facing the economy.

For FY 1983/84, Mr. Tshishimbi added, total expenditure was expected to increase by 8 percent over the revised estimates for FY 1982/83. The staff expected that additional appropriations would lead to a further expansion in total expenditure, both in real terms and as a proportion of GDP. The staff seemed to welcome the commitment to freeze salary scales for government employees in the hope that that action would contribute to restraining public expenditure and would provide a signal for wage moderation in the private sector. While he shared the first part of the staff's hope, he was concerned about the effects that the action could entail for the private sector labor market, already characterized by many rigidities.

The South African economy needed a sound basis for medium-term growth, Mr. Tshishimbi considered. In that regard, labor market regulations in South Africa were not consistent with the realization of the country's full growth potential. Shortages of skilled labor clearly constituted a medium-term constraint on potential growth. The long-standing labor market policies of the South African Government were the roots of the distortions and the less than optimal use of labor resources. The efforts that the staff had reported toward the elimination of legal impediments to vertical labor mobility were welcome, but the Executive Board should urge the staff to continue to press for the elimination of the remaining job reservations, especially in the mining industry.

The Board should also give the staff clear guidelines to press for the elimination of all the impediments to geographical mobility of black workers from rural to urban areas and between urban areas, Mr. Tshishimbi went on. He agreed with the staff that those restrictions were responsible for pay differentials between areas, and added to inflationary pressures in labor shortage areas and to unemployment in labor surplus areas. The restriction on black workers' mobility, in particular the system of short-term migrant labor contracts, was particularly detrimental to on-the-job training because it forced black workers to return to the recruitment point on the expiration of their contracts. It would be appropriate to urge the authorities to address that question and the general question of education to improve the skills of black workers; in that regard, he strongly supported the section of the staff appraisal that dealt with the issue.

The South African economy had not performed as well as might appear from a first reading of the staff report, Mr. Tshishimbi stated. The attainment of the program targets had hinged crucially on a major external development in the price of gold. Given that the reported increase had taken place so soon after the approval of the program by the Executive Board in November 1983, it was puzzling that the price of gold had been estimated at such a pessimistically low level in the original stand-by paper. If the price of gold had been set at a higher, more realistic, level, it would have been difficult to establish a balance of payments need at the time of the request, and the current stand-by arrangement would not have been granted. Recognizing those facts, the South African authorities had made a decision to refrain from further purchases under the arrangement. Mr. Brand had stated that the authorities were considering an early repurchase under the arrangement and the compensatory financing facility. He urged them to implement that course of action.

Mr. de Vries observed that there had been a sharp turnaround in South Africa's economy, as a result of the restriction of domestic demand, the increase in the price of gold, and the improvement in the balance of payments in conjunction with higher interest rates and higher capital inflows. However, the situation remained volatile. While government expenditure had risen, the budget deficit had been kept in check partly because revenues had risen as a result of the increase in the gold price. There were a number of conflicts among various policy objectives, so that it could not be said with certainty that the sharp turnaround would continue.

There were also a number of structural weaknesses in the South African economy, Mr. de Vries continued. For example, there was the high volatility in the price of gold, the main export product, which was compounded by South Africa's keeping its reserves mainly in gold. Thus, if the balance of payments weakened, the value of reserves also fell. While South Africa's adherence to that policy might be understandable, it increased volatility nevertheless. The volatility of inward and outward capital flows hampered monetary policy. Another weakness was the lack of skilled labor, and the resulting pressure on the wages front for higher wages.

The South African economy was also characterized by a number of rigidities, Mr. de Vries commented, some of which were evident in manpower policy. He agreed with those Directors who had commented on the lack of skilled labor and the necessity for expanded education and training. Similar rigidities characterized other areas. For example, controls on the export of capital by residents remained in place, and the import surcharge remained. A relaxation of controls in all such areas would be appropriate. The South African authorities should eliminate the remaining restrictions on capital outflows, since such a policy would help to remove some of the pressures on the appreciating rand. Removal of the import surcharge would also, indirectly, assist exchange rate policy. The revenues could be collected through other taxes. Perhaps the authorities should consider various techniques to stimulate capital outflows, such as early prepayment of debt.

He could support the proposed decision relating to stand-by arrangement, Mr. de Vries added. Mr. Brand had said:

> ... with the measures in place now, it would not be necessary to purchase any further amount in terms of the current stand-by arrangement, even though South Africa may be fully qualified to do so.

It appeared that Mr. Brand was saying that, although South Africa met the specific terms of the stand-by arrangement, it did not intend to purchase because it no longer had a balance of payments need, a fundamental requirement. If that interpretation of the sentence was correct, he fully supported it. He also welcomed Mr. Brand's statement to the effect that South Africa intended to make a voluntary early repurchase if the situation continued to improve. The South African authorities had repaid a number of their creditors; it was, therefore, appropriate that the Fund should be among them.

Some comments by Executive Directors were worrisome, Mr. de Vries considered. They seemed to be saying that because the program had been effective and because South Africa had needed to use Fund resources for only a short period, it should not have drawn at all. However, some years previously, the United Kingdom had used Fund resources and, when its situation had improved, had repurchased early. The fact that the South African authorities had come to the Fund when their situation had appeared difficult, that they had turned the situation around, and that they were, therefore, planning to repurchase early and voluntarily showed that the stand-by arrangement was an entirely suitable use of Fund resources.

Mr. Jaafar remarked that South Africa had made a dramatic turnaround in its external payments position; barely six months previously the request for a stand-by arrangement had been considered by the Board. The quick turnaround underscored the point that the earlier appraisal had grossly overestimated the degree of need. It confirmed the doubts held by some Directors at that time about the gold price assumption chosen by the staff. Those Directors had believed that, if the assumption with regard to the gold price had been realistic, there might not have been a case for a stand-by arrangement at all. The misgivings and opposition of those Directors who had spoken against the program in November had been justified, and, in that regard, he supported Mr. Mtei's comments on the development of gold prices.

Chart 2 on page 4(a) of EBS/83/100 showed gross reserves expressed in weeks of imports, Mr. Jaafar noted. In the first quarter of 1983, gross reserves had amounted to about three weeks of imports, if gold was valued at SDR 35 per ounce. If South Africa's valuation of gold was used, reserves would have been in excess of 6.5 months of imports. For example, in Table 1 on page 22 of the same paper, gross reserves at the end of 1982 were estimated to have been 3.1 months of imports. Since South Africa was a major gold producer, such an amount could be considered adequate. In that regard, he invited the staff to say whether there was a standard technique used by the Fund for calculating reserves in terms of imports.

Commenting on labor policies, Mr. Jaafar observed that the situation had not improved. Significant changes could not be expected unless the authorities' long-standing labor market policies and practices were radically changed in favor of equal opportunity. As a start, changes should be made in education and training in order to improve shortages of skilled manpower in the medium term. Disproportionate spending between white and black schools would have to be altered. The ratio of 13 to 1 in favor of white schools referred to by the Institute of Race Relations was deplorable, since the black population provided the largest source of labor in South Africa. The employment restrictions and the limitations on geographical mobility had led to distortions and inequality in wages and income. South Africa could realize its potential for higher growth if the various restrictions were removed. He agreed with the staff that the removal of those restrictions would necessarily require reordering of spending priorities. However, he did not believe that such a reordering would lead to a substantial increase in total budgetary expenditures if expenditures in other areas, such as defense, were reduced.

Strict control of labor constituted a burden to the country similar to the costs incurred through protection and subsidies in other situations, Mr. Jaafar stressed. At present, the effective cost could only be roughly estimated. Such excessively strict labor policies were inappropriate and were not conducive to the structural adjustment that the Fund sought to promote. No Fund adjustment program could be meaningfully applied to South Africa unless the unfair labor practices were removed. Therefore, he opposed the proposed decision and proposed that the current stand-by arrangement with South Africa should be terminated.

Mr. Finaish recalled that he had stressed in November 1982 that no convincing case had been made for South Africa's need to draw on the Fund. He had also been among the many Directors who had underlined the serious constraints that South Africa's labor policies placed on the attainment of sustainable economic growth. The turn of events since November provided further evidence for questioning the need for the stand-by arrangement and for the substantial drawing on the Fund. The staff papers before the Board highlighted the sharp improvement in the external position and the staff indicated the intention of the authorities not to draw further under the stand-by arrangement at present. The shift in circumstances had introduced fundamental changes in the underlying assumptions of the arrangement, thereby raising serious questions about the relevance of the present program in the period ahead, as well as about the need to adjust repurchase obligations in light of the substantially improved position of the country.

The objective of the stabilization program had been to attain a sustainable external position in 1983, Mr. Finaish continued, mainly through demand management measures. That objective had been realized "much more quickly than was expected" in the staff's words. The current account had turned from a deficit equivalent to 7.5 percent of GDP in the first half of 1982 to near-balance in the second half and was projected to improve further to a surplus of 2 percent of GDP in 1983, compared with a deficit of 2 percent originally projected at the time of the stand-by arrangement. The balance on capital account and the overall balance, as well as reserves, were also expected to improve. The terms of trade were expected to improve by 9 percent in 1983, instead of deteriorating by 2.5 percent as assumed earlier. Those developments had made it easier for the authorities to unify the dual exchange market and to reduce the import surcharge earlier than envisaged under the program.

Those substantial changes in the economic background seemed to have created what the staff called "new dilemmas" for the conduct of economic policies in 1983, Mr. Finaish commented. Those dilemmas included the implications of the appreciation of the rand, the difficulties of maintaining control over monetary aggregates due to the large external surplus, the pressures to shift to a more reflationary fiscal policy, and the need for increased attention to domestic supply constraints, which the authorities had hitherto been reluctant to deal with. Thus, economic policy had to deal with a considerably different set of circumstances, with the main focus shifting from the external sector to the problem of domestic inflation.

In such circumstances, it was highly questionable whether the stand-by program remained relevant to the new situation, Mr. Finaish considered. Different assumptions, different priorities, and different policies were needed. The appropriate course was to terminate the present arrangement and to develop policies more in line with the evolving new realities and new prospects. Some elements of the previous policies might remain useful, but the policy mix could not remain unchanged. Termination of the stand-by arrangement could have no adverse financial implications for the country, as South Africa had not used the full amount of the arrangement, and the authorities had already indicated that further purchases were not currently intended.

In November 1982, some Directors had suggested a further step to address the possibility of more rapid improvement in the external position than had been envisaged, Mr. Finaish recalled. They had suggested that an early repurchase should be made by the authorities. The South African representative had indicated that that option could be "discussed further during the mid-term review of the stand-by arrangement." The staff clearly stated in EBS/83/100 that the program's objectives had been "realized much more quickly than...expected," and that "South Africa's financial and economic position had turned around much more sharply than anticipated at the time of the stand-by negotiations." In light of those clear conclusions, an early repurchase was justified; there was no reason to delay the final decision on the subject.

Commenting on the longer-term outlook, Mr. Finaish noted that the staff had correctly pointed out that, as prospects improved, increased attention had to be paid to the longer-term problems of alleviating the principal domestic supply constraint. He had been among the many Directors who had urged that more attention should be paid to such matters by the staff. It was, therefore, encouraging that more information had been included in the present papers on South Africa's labor policies and their economic impact, but further analysis was needed of the magnitude of the distortions that such policies inflicted on the economy. The Fund was familiar with the impact of such measures as subsidies, price controls, and differential interest rates and exchange rates, which were considered sufficiently grave to justify termination of programs. In the South African context, it was relevant to assess the distortions that a complex system of restrictions imposed on nearly four-fifths of the population. That system interjected the Government into the labor market to distort employment, education, training, and the occupational and geographic mobility of labor. It also resulted in major distortions in investment and finance within the country, and in the use of foreign exchange. It turned the government budget away from economic infrastructure to military and domestic security purposes. As sources of inefficiency, those distortions should concern the Fund. A deeper awareness of those unfamiliar distortions could significantly affect the Fund's judgment of the South African economy; he looked forward to a more elaborate discussion of such factors in future staff papers. He opposed the proposed decision.

Miss Batliwalla stated that her chair had opposed South Africa's request in November 1982 because it had not been convinced about the country's balance of payments need and the strength of its adjustment efforts. Subsequent developments, as outlined in EBS/83/100, had vindicated the stand taken by her chair and others. She welcomed the assurance given by Mr. Brand that the South African authorities trusted that, with the measures now in place, it would not be necessary to purchase further amounts under the current stand-by arrangement, even though the country might be fully qualified to do so. However, since the proposed decision was open ended and since South Africa could, if it chose, automatically draw on the remaining stand-by resources, she opposed the proposed decision, not only in keeping with her chair's earlier stand, but also for the reasons well elaborated by Mr. Suraisry and Mr. Finaish.

Mr. Salehkhou observed that the staff had reported that South Africa had been successful in overcoming many of its economic and financial shortcomings. The staff had demonstrated that in all areas of external, monetary, and fiscal policies, South Africa's performance had been satisfactory, but not with regard to labor market policies and manpower training and utilization, which remained areas of economic constraint. The staff had implicitly said that such areas were the result of certain social policies and, inter alia, lack of equal job and training opportunities for all South Africans. Those policies were pursued to the extent that the Government accepted the existence of certain economic problems and hardships, but it did not commit itself to the elimination of social discrimination. The absence of equitable economic and social policies continued to create unbalanced economic conditions in South Africa.

The staff indicated in its appraisal that the country's manpower resources were not used efficiently or with care, Mr. Salehkhou continued, that regulatory impediments to vertical labor mobility had not been eliminated; that there was scarcely an adequate effort to upgrade the skills of large part of the population; that the inflationary pressures on labor shortage and unemployment were caused by restrictions on the geographic mobility of labor; that the high labor turnover was a result of the short-term migrant labor contracts encouraged by the aforementioned restrictions, and that such restrictions created "serious imbalances in the economy of South Africa."

He was not surprised that the staff implicitly, but definitely, had confirmed his observations at the time of the previous Board discussion of South Africa, Mr. Salehkhou remarked, when it indicated that "in order to avoid serious imbalances in the economy, it is essential that the impediments and restrictions governing the labor market be removed." Those restrictions were merely political impediments that directly affected the economic policies and structure of South Africa. The case of South Africa was a clear example of the fact that Directors could not and should not disregard the tremendous influence of sociopolitical policies on the economic conditions and structure of a member country.

At the time of the Executive Board's discussion of South Africa in November 1982, Mr. Salehkhou went on, the Fund's resources had not been as limited as at present, and the availability of resources in private financial markets had not been as scarce. Currently, it was almost impossible for low-income developing countries to reach a financial agreement in the private market. However, because of creditworthiness and a generally secure resource base, private financial institutions were available for a country such as South Africa when required. He invited the staff to comment on whether South Africa's external borrowing needs would have disappeared had the request by some Executive Directors concerning postponement of the Board's discussion on November 3, 1982 been adhered to.

If the Fund was to use its limited resources in the most obviously needed cases, Mr. Salehkhou commented, Executive Directors should apply the rule of uniformity to the economic evaluation of member countries. As predicted, the approval of a loan to South Africa had not proved to be in the best interest of the Fund. In terms of the Fund's public image, it had, unfortunately, generated a great deal of undesirable controversy around the world; in terms of the availability of Fund resources, the Fund currently found itself in a more difficult situation than six months previously. Another fundamental question was whether a static approach to the rule of uniformity was consistent with the objectives of the Fund. Should Executive Directors consider each member country individually according to its own conditions, or should they compare the economic variables of fairly similar cases to judge which country was in greater need of the Fund's resources? He strongly believed that, if Directors wished to observe the rules of the Fund in a dynamic and productive manner, they should compare the degree of objective needs among member countries.

The South African authorities should promptly and completely make the early repurchase indicated by Mr. Brand, Mr. Salehkhou urged. He strongly opposed the proposed decision, particularly as it left no opportunity to examine the balance of payments need of South Africa in the Executive Board before a future transaction was made. He reiterated his earlier suggestion for the issuance of a paper for discussion by the Executive Board on the legal aspects of the relationship between the United Nations and the Fund, with emphasis on both the letter and the spirit of the laws governing the UN family.

The Director of the European Department commented that, although the improvement in the external position of South Africa had been due in substantial part to a rise in the price of gold, there had also been a sharp compression of domestic demand below the level originally projected. Domestic demand had fallen by 4 percent in 1982, instead of declining by 2 percent as originally expected, and a further decline of 4 percent was likely in 1983.

Commenting on the question of need, the Director noted that the Executive Board had steadfastly insisted on a broad approach. It had never agreed to define need in terms of a particular measurement or forecast. The Board's discussions on the subject stressed that in assessing balance of payments need a number of factors had to be taken into account, including the size of reserves, whether reserves had been falling, whether the country in question had had to borrow heavily abroad, and developments in the exchange rate the current account position. On the basis of a consideration of all those factors, the Executive Board had agreed to a stand-by arrangement with South Africa in November 1982. In accordance with standard practice in the Fund, the stand-by arrangement had been put forward to support a package of policy measures being implemented by the authorities. The staff had deliberately chosen to project a low price for gold, not in the context of defining need, but in order to ensure that financial policies would be tight enough to achieve a sustainable balance of payments position by 1983.

The performance criteria for fiscal policy had been set in terms of the expansion of credit to the government sector, the Director continued, and the criteria had been observed. On the revenue side, the budget had benefited a good deal from the improvement in the gold price, but other measures had also played a part. Even if the price of gold had remained unchanged, the credit ceilings would not have been breached. Nevertheless, the staff continued to believe that the control of public expenditure in

South Africa was insufficiently rigorous. There would probably be an overrun in expenditures in FY 1983/84, but, as revenues would probably also be higher than estimated, the deficit as a percentage of GDP would probably be in line with expectations, and perhaps lower. Nevertheless, it could be argued, as one Director had suggested, that, at a time when the authorities' external objectives were being achieved, and when domestic demand was falling more sharply than had been envisaged, some relative looseness in fiscal policy was appropriate.

The dilemma for the authorities with regard to monetary policy was similar to that faced by other countries when, as a result of various measures and improving external conditions, exchange rate expectations were sanguine, and the authorities in question were faced with a large inflow of funds from abroad, making control of the monetary aggregates difficult, the Director commented. The staff's firm recommendation was that priority should be given to the control of the monetary aggregates, and the authorities, after some hesitation, agreed with that recommendation. The result of such an approach was to place pressure on the exchange rate. The extent to which a rise in the exchange rate could be accepted was being closely studied by the authorities. If the dilemma became acute, they would have to consider further action, perhaps along the lines suggested by one Executive Director with regard to the freeing of controls on capital exports. The authorities had already used the technique of early repayment of loans.

The staff had sought to fulfill the requests made by Executive Directors in November 1982 for a review of labor market practices in South Africa, the Director stated. It would continue to keep the subject under review. The staff agreed with those Directors who had pointed out that the problem of the shortages of skilled labor could not be overcome without substantially higher expenditures on training and education. With regard to wages, the public sector wage bill had been higher than expected as a result of a more rapid than expected filling of vacant positions, almost certainly associated with the restraint being imposed on domestic demand.

One Director had suggested that, given the inherent volatility of the price of gold, more frequent reviews of the program would have been appropriate, the Director noted. The staff had believed that the conservative estimate of the price of gold had provided a built-in safeguard, in that, if the price of gold rose higher than expected, the external position would almost automatically have improved; in addition, the fiscal position would have become easier. If the price had fallen, the stand-by arrangement provided for automatic adjustments to credit policy. In such circumstances, a review clause might not have added much.

The South African authorities needed to keep adequate holdings of foreign exchange in their reserves, the Director of the European Department observed. Their reserve management policy was made more difficult by the volatility of the price of gold, and they had sought to diversify out of gold as opportunities arose, particularly through the use of swap arrangements. Nevertheless, the proportion of foreign exchange in the reserves had not risen as much as the staff would have preferred, or indeed, as much as the authorities themselves would have preferred. The staff believed that, if the authorities continued to use the available opportunities to diversify as conditions in the gold market permitted, their objective of seeking a minimum of about SDR 1 billion in foreign exchange could be achieved, and that it was broadly appropriate. Finally, the staff did not use a standard rule of thumb with respect to the import cover of reserves when judging the question of a member's need in connection with a proposed stand-by arrangement.

Mr. Brand noted that the Appendix to SM/83/111 focused on the labor market in South Africa with regard to the so-called rigidities that might continue to exist and their effect on the economy. The broad conclusion reached was that not only was further progress toward easing the impediments and restrictions governing the labor market required to avoid serious imbalances in the economy over the medium term, but also that increased expenditure on certain areas of education and manpower training was necessary.

His authorities fully agreed with that conclusion, Mr. Brand stated. He assured the Executive Board that they were working to find additional methods and, where appropriate, to adjust their policies as far as possible to prevent such imbalances from developing over the medium term. In that regard, numerous factors were present that not only made it difficult to formulate and to reach agreement on the precise adjustments that might be required, but that also affected the ability to adjust, and the efficiency with which any adjustments might be implemented.

First, there was the question of the availability of finance, Mr. Brand commented. In that regard, the South African authorities, like the authorities in any other country, had to face up to the unavoidable economic realities that, in any particular year, the demands for funds were invariably far larger than what could be financed from available financial resources. Difficult allocative choices had to be made, therefore, but, compared to most other developing countries, the share of its annual budget that South Africa set aside for education and training could not be regarded as insignificant or small, especially not during the previous five years or so.

In South Africa, Mr. Brand continued, attention next had to be directed to the division of educational expenditure between the different population groups. In that connection, the staff compared the per capita expenditure on white and black education in 1970 and 1980. It could not be denied that those figures showed scope for increased expenditure on black education. There were, however, certain factors that had to be taken into consideration when those per capita figures were interpreted. First, it was a common and accepted fact that expenditure on primary education was much less expensive than expenditure on secondary education. In the case of blacks, for example, the per capita expenditure on secondary school education in 1982 had amounted to about R 480, compared with about R 160 on primary education. Against that background, if it was taken into account that in 1982 the ratio of primary to secondary pupils in black schools amounted to 84:16 compared with 50.50 in white schools, it had to be acknowledged that that was an important factor explaining the disparity in the per capita figures quoted by the staff.

It was also generally accepted that the bulk of expenditure on education was made up of the salaries of teachers, Mr. Brand remarked. In the South African context, that factor again had a strong influence on the substantial difference in per capita expenditure figures between population groups. At present, the majority of white teachers continued to be better qualified than their black counterparts and on average, therefore, earned higher salaries. It was estimated that about 80 percent of black teachers still had lower qualifications than their white colleagues. The influence of that factor on the per capita figures was, however, enhanced to a certain extent by the fact that, in most categories of black schoolteachers, contrary to the position of black university lecturers, the wage gap vis-à-vis the salaries for whites had not yet been eliminated completely. It was hoped that the elimination process could be completed in the near future. The result of the latter process, together with the effects of the ongoing and intensified efforts to improve the qualifications of black teachers, would lead to a sharp increase in the per capita expenditure on black schoolchildren in future.

It was important not to leave out of consideration the influence on the per capita expenditure figures of the differences in the growth rates of the numbers of white and black pupils, Mr. Brand argued. In that regard, in the period from 1970 to 1980, the number of black school pupils had increased by about 29 percent compared with an increase of about 10 percent for white pupils. The rapid rate of increase had a significant effect on the per capita expenditure on blacks. In that connection, it was worth pointing out that, despite the high rate of increase in black pupils, an average rate of increase in real expenditure of about 8 percent a year had, nevertheless, been achieved over the period in question. Therefore, despite the ground that had to be made up compared with expenditure on education for whites, which had increased in real terms at a lower average annual rate of about 5 percent, significant progress had been made.

A further important consideration in understanding the problem faced by South Africa in the provision of basic educational opportunities and facilities had to be taken into account, Mr. Brand went on. Even if unlimited financial resources were available to fund education programs, the ability to use such funds was sharply curtailed by the insufficient availability of exactly that "commodity" that such educational programs were supposed to supply. In other words, it would be possible to erect new schools in virtually unlimited numbers in a short period, but it would be impossible to staff those schools properly because it was impossible to train and provide a sufficient number of suitably qualified teachers in the short term. The provision of teachers of a high caliber had to be seen as a long-term project, but it was receiving the highest priority attention of the authorities.

In light of those realities, Mr. Brand stated, the South African Prime Minister had declared on May 5, 1980:

> The Government pledges itself to the goal of equal education for all population groups but emphasizes that the historical backlog cannot be overcome overnight. My Government and I are prepared to accept a program whereby the goal of equality in education for all population groups can be attained as soon as possible within South Africa's economic means.

A number of additional facts relating to the subject of the supply of skilled labor deserved attention, Mr. Brand considered:

1. The expansion of education facilities for blacks during the past couple of decades had developed in a system that at present included not only pre-primary, primary, and secondary education, but also trade and vocational training, higher technical and commercial education, adult education, advanced technical, and university education.

2. The same standards applied in black schools as in the schools of other education departments in South Africa with regard to syllabuses and examinations. The same core syllabuses were used and the Joint Matriculation Board required the same standards from black pupils for university entrance as from any other pupil in South Africa.

3. At present there were 31 teacher training colleges for blacks in South Africa with a total enrollment of almost 13,000 students. From 1972 to 1981 almost 56,000 black teachers had been trained. There had been almost 84,000 black teachers in South Africa in 1982. The qualifications of teachers were being improved through the following measures:

- Existing training courses were continually being revised and adapted. At the beginning of 1982 new three-year secondary teachers' diploma courses, with standard 10 (Grade 12) as admission requirement, had been instituted. As from 1984, two-year teacher courses and poststandard 8 courses would no longer be offered.

- Courses had been introduced for teachers wishing to improve their professional qualifications. In addition, an adult education program had been instituted. At present, more than 4,000 teachers were enrolled under the latter program.

- Regular in-service training courses were offered to ensure that teachers kept abreast of the latest developments and innovations.

4. There had been a total of 3,641,726 black pupils in primary and secondary schools in South Africa in 1982 (excluding the independent national states).

5. The percentage of black children of school-going age (7-16 years) at school had increased from 75.2 percent in 1975 to 79.2 percent in 1980.

6. The number of black pupils who had passed the matriculation examination had increased from 4,327 in 1972 to 30,272 in 1981, and, according to official projections, those totals would increase to 68,000 by 1990 and to 180,000 in the year 2000.

7. There had been 11,010 full-time university students at the four black universities in 1982. In addition, there had been 13,135 blacks enrolled in other universities in South Africa in the same year.

8. There had been 37 technical colleges--trade and vocational training--and two technikons for blacks in South Africa in 1982.

9. Since 1979 all textbooks had been supplied free to pupils in schools under control of the Department of Education and Training. The expenditure in that regard amounted to R 9.36 million in 1982/83 compared with R 3.5 million five years earlier.

10. Since 1981 compulsory education had been introduced in those black schools where it had been requested by the school committees concerned. Compulsory education amounted to an undertaking by the parents to send their children to school until they reached the age of 16. At the same time, the Education Department undertook to provide such children with books, stationery, and the usual other facilities needed for tuition. In 1982 there had been 75,030 children in primary schools involved in compulsory education.

Commenting on the question of the geographical restriction on the mobility of labor, Mr. Brand regretted that he was not in a position to add much to what had been reported by the staff on that subject. The vexed problem of orderly urbanization was a problem experienced in many countries of the world, including many countries in Africa. Draft legislation on the subject was at present under consideration in South Africa by a select committee on constitutional affairs, and it was expected that the committee would, inter alia, define new criteria for the obtaining of rights to live and to work in urban areas. How those criteria would be formulated was not known at present.

The effots to provide better incentives to industrialists to establish themselves in decentralized areas would soon be augmented by the establishment of the Development Bank for Southern Africa on September 1, 1983, Mr. Brand added. The primary objective of the Bank would be to mobilize and to apply resources for economic development. The Bank would, in that regard, allocate its resources with a view to optimizing regional development for the subcontinent as a whole, rather than from the viewpoint of the narrow interests of the individual member states. The new regional development policy, together with the activities of the Development Bank, could, therefore, be expected to create important employment opportunities in rural areas in the medium term.

His authorities were determined to succeed in creating as soon as possible sufficient facilities and conditions to enable each individual in the country to develop his abilities to the fullest extent possible, Mr. Brand emphasized. Owing to the financial impediments involved, and to the fact that the objective also involved a human development process, it had to be expected that the results contemplated would be generated to the desired extent only over the medium term. That expectation was in line with the views expressed by the staff. In that regard, the challenge involved was severely complicated by the fact that the rate of population growth of most of the population groups in South Africa remained high. In the case of blacks, for example, the rate had remained close to 3 percent in 1980. Finally, in 1983, expenditure on education and training would be the largest single expenditure item in the South African budget for the third consecutive year.

One Director had commented on the interpretation to be attached to his earlier statement concerning further possible drawings by South Africa under the stand-by arrangement, Mr. Brand noted. His authorities' position was that, while South Africa qualified legally to make further drawings, they did not expect that it would be necessary to do so in light of the policy measures already in place and on the assumption that no unexpected events occurred, for example, with regard to the price of gold.

Mr. Erb commented that the question of balance of payments need had been an important consideration at the time of South Africa's request in November 1982, given the country's reserve situation and its borrowing prospects. He had been satisfied at that time that the requirement of need had been met, since the arrangement did not involve enlarged access, the amount involved under the arrangement was only 57 percent of quota, and the staff had judged that South Africa had reached its commercial borrowing capacity over the short run. In addition, there had been the potential for early repurchase. He invited the staff to clarify the early repurchase provisions and to indicate under what circumstances they would apply.

The staff representative from the Treasurer's Department said that the first step in the application of the early repurchase provisions took place in the context of the operational budget and the designation plan, when the staff examined the position of each member, whether debtor or creditor, in order to come to a conclusion regarding the strength of the country's balance of payments and gross reserve position. A special provision in the relevant decision--Decision No. 6273-(79/158) G/S--referred to the position of countries indebted to the Fund:

> If the member has outstanding purchases in the General Resources Account, the assessment of its balance of payments and gross reserve position will include judgments on whether the member's

position shows an improvement in comparison with the position at the time it made its last purchase from the Fund, on the extent of the improvement, and on whether it is likely to be sustained in the foreseeable future. Special attention will be given to the recent and prospective evolution in the various components of the member's balance of payments, including developments in the member's net reserves to the extent that data are available.

In the context of that decision the staff had looked closely at the position of South Africa on the occasion of the most recent operational budget, the staff representative continued. It had concluded that it was too early to judge that South Africa's position was sufficiently strong for inclusion in the designation plan. If the staff had proposed the inclusion of South Africa, and if the Executive Board had decided that the proposal had been justified, the consequences would have been: first, South Africa would have been included in the designation plan for whatever amount the calculations showed; and, second, South Africa would have been subject to the guidelines for early repurchase, whereby a calculation would have been made if the amount of an early repurchase expected to be made during the relevant budget period. Mr. Brand's statement that South Africa intended to make a voluntary early repurchase was outside the framework of that decision. On the occasion of the next operational budget and designation plan, if the staff judged that the position of South Africa at that time was sufficiently strong, it would propose to include the country in the designation plan and it would thus become subject to the early repurchase decision.

Mr. Erb commented that some Directors had appeared to be suggesting a change in the conditionality criteria. Along with other Directors, he had judged South Africa's case in the context of a stand-by arrangement, in which it was appropriate to seek economic policy changes that would redress the temporary balance of payments problem faced by the country. The request had not related to the extended Fund facility, which normally involved closer scrutiny of structural problems within a country. In the latter case, it would have been appropriate to focus greater attention on the labor market rigidities. However, the suggestions by several Directors on the degree to which Executive Directors should take into account social and political factors when examining the economic circumstances of a member had been inappropriate. The different social, political, and, it could be added, religious practices in a member country all had indirect effects on the economic situation of the country, and the Board should be careful not to go too far in the direction of in-depth examinations of the economic consequences of such practices. To do so would be contrary to Article IV, Section 3(b) of the Articles of Agreement, which stated that, in fulfilling the surveillance function, "the principles adopted by the Fund...shall respect the domestic, social, and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members."

Mr. Mtei remarked that it was not unusual for a stand-by arrangement to be followed by further stand-by arrangements, and, in such circumstances, the Fund had frequently made judgments with regard to economic policies that extended beyond the short term. In any case, the agenda before the Board included an Article IV consultation, and it was proper to discuss medium-term policies in that context. With regard to the proposed decision, he invited the staff to clarify the final sentence, which read: "No additional understandings are necessary regarding the circumstances in which further purchases may be made by South Africa under the stand-by arrangement."

The Director of the Legal Department replied that the sentence reflected the provision in the stand-by arrangement calling for the establishment of understandings prior to July 31, 1983 with regard to exchange rate policy and the removal of the import surcharge. It was necessary for the Executive Board to review developments in those two areas and to decide whether further understandings were needed. The sentence in question stated that the Board had conducted that review and that it judged that no further understanding regarding further purchases under the arrangement were necessary. The effect of the sentence was that South Africa would be able to make further purchases under the arrangement if it qualified under all other provisions. With regard to the requirement of need, each user of the Fund's resources, whether a stand-by arrangement was involved or not, had to represent to the Fund that it had a balance of payments need when it made a request for a purchase. That requirement was not affected by the inclusion of the sentence in the proposed decision.

Miss Le Lorier observed that the most immediate objective of the stand-by arrangement, i.e., the attainment of an improved external position, had been fully achieved. It might, therefore, be argued that performance criteria alone had been sufficient. However, in a number of cases, difficult problems had arisen with regard to the appropriateness of performance criteria relating to external developments. For example, Directors had considered cases in which credit ceilings had been contingent upon the availability of external financing, and, in some of those cases, the Executive Board had decided that the domestic credit ceiling should be revised downward if the availability of external financing turned out to be better than expected. In other cases, it had judged that, even if the availability of external financing turned out to be better than expected, the country should be permitted to go toward the full amount of the initial credit ceiling.

In South Africa's case, Miss Le Lorier continued, the question of adjustment was not confined to the immediate short-term period of the stand-by arrangement. Could Directors be certain that the required adjustment was adequately covered by the quantitative performance criteria? For example, the volatility of gold prices remained a relevant issue even if the external account improved in line with the projections in the program. A review clause on monetary policy would have been justified in helping the authorities not only to limit the growth of the monetary aggregates, but also to consider adjustments in the external area with respect to the behavior of the exchange rate. The arrangement had included a provision that automatically adjusted the domestic credit ceiling downward if the price of gold happened to be lower than expected, but it had made no provision for a situation in which the gold price was higher than expected.

The Director of the European Department said that the program had been designed in the way referred to by Miss Le Lorier with several considerations in mind. First, if the price of gold rose higher than expected, the impact on government revenues would be felt quite quickly. In that sense, there would be an automatic adjustment of fiscal policy appropriate to the circumstances. Second, the arrangement had included provisions for a six-month review, the subject of the present meeting, and if circumstances had been markedly different, the staff would not have hesitated to suggest to the Executive Board and to the South African authorities that a change in the performance criteria for the second half of the year would have been justified. Furthermore, given the work load on Executive Directors and the staff, it was desirable to avoid too many review clauses. In economies in which the transmission effects of economic policies were less well known, relatively frequent reviews could be appropriate, but that factor had not been relevant in South Africa.

The Chairman then made the following summing up:

> Many Executive Directors noted that the external payments objectives of the stabilization program had been achieved more rapidly than had initially been envisaged. While the improvement in the external account position had been due principally to the recovery in the price of gold, a number of Directors acknowledged that the adjustment measures adopted by the authorities had contributed to reducing domestic demand pressures in 1982, as reflected in the pronounced fall in the volume of imports, especially in the latter half of the year. Nevertheless, Directors expressed serious concern about the persistence of strong inflationary pressures, the rapid pace of monetary expansion, and the failure to contain government expenditure in 1982/83 to the targeted level.
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> Directors regretted that the rate of inflation had remained high, a development that was attributed principally to the relatively high rate of growth of money, over which the authorities still did not have full control. However, a number of Directors stressed that the chronic shortage of skilled labor had certainly also contributed to excessive wage increases.
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> Directors noted that all performance criteria under the stand-by arrangement had been adhered to through March 1983. Nevertheless, the considerable unanticipated improvement in the external accounts had led to a faster than expected expansion of broad money. Several Directors took the view that further action to slow the rate of monetary expansion could and should be taken.

The South African authorities' recent decision to ease exchange control on capital outflows and to unify the exchange system for the rand was welcomed. Notwithstanding that decision, Directors shared the view that a flexible exchange rate policy would continue to be necessary for the restoration of effective control of the money supply. Although such a policy could have an adverse effect on the external competitive position of the nongold export sector in the short run, it was stressed that, in present circumstances, priority had to be given to the objective of lowering inflation.

It was noted that the authorities had contained the budget deficit in 1982/83 to the equivalent of 2.8 percent of GDP and that they had financed the deficit in a noninflationary fashion. Nevertheless, many Directors regarded fiscal policy as having been insufficiently tight, or even lax. In particular, a number of Directors voiced concern at the failure of the authorities to reduce government expenditure in real terms and regretted that a large part of the expenditure overrun had involved outlays of a nonproductive nature. Directors stressed that the South African authorities should endeavor to contain total expenditure in 1983/84 to the budget estimates and that in any case they should seek a reduction in the volume of current government outlays. At the same time, however, a number of Directors emphasized the need to increase expenditure for education and training. Directors noted that the South African authorities had already reduced the import surcharge from 10 percent to 5 percent and had decided that the remaining import surcharge would be removed by the end of November 1983 at the latest. They urged the authorities to eliminate the remaining surcharge as soon as possible.

Directors were very critical of the labor market policies of the South African authorities. Those policies were held responsible for the chronic shortages of skilled labor, which tended to impart a significant inflationary bias to the economy and to retard economic growth and structural change; in addition, they might well compound the recurrent imbalances on the external front. It was noted, in particular, that a growth rate of the economy of 5 percent, needed to keep unemployment from rising, could not be achieved or sustained under current labor policies. While the progress made in eliminating regulatory impediments to vertical mobility was noted, Directors urged the South African authorities to increase markedly government spending on education and manpower training, especially for the lower-income population groups, and to ease restrictions on the geographical mobility of labor. Directors asked the staff to continue actively to follow those issues in the framework of the Fund's Article IV consultations with South Africa.

Several Directors who had initially doubted that South Africa had a need justifying the use of Fund resources maintained that recent balance of payments developments reinforced their position. But the majority of the Board felt that the requirement of need had been met.

The decision of the authorities not to make further purchases under the stand-by arrangement in the present circumstances as well as the decision to make a voluntary early repurchase by the end of August 1983 was welcomed.

It is expected that the next Article IV consultation with South Africa will be held on the standard 12-month cycle.

The Executive Directors then took the following decision:

South Africa has consulted with the Fund in accordance with paragraph 3(b) of the stand-by arrangement for South Africa (EBS/82/173, Sup. 1, 11/8/82) and paragraph 3 of the letter dated October 4, 1982, attached thereto. No new understandings with the Fund are necessary regarding the circumstances in which further purchases may be made by South Africa under the stand-by arrangement.

Decision No. 7435-(83/87), adopted
June 20, 1983

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/86 (6/17/83) and EBM/83/87 (6/20/83).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/159 (6/16/83) is approved.

APPROVED: November 2, 1983

LEO VAN HOUTVEN
Secretary