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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/92

3:00 p.m., June 7, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
C. H. Dallara	
J. de Groote	
	X. Blandin
	G. Nguyen, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	
R. K. Joyce	
	J. R. N. Almeida, Temporary
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
N. Wicks	T. A. Clark
	I. Angeloni, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant
K. O. Baer, Assistant

Also Present

Principal Resident Representative for South Africa: A. H. Peacey; E. Matthee. IBRD: P. Bottelier, Latin America and the Caribbean Regional Office. Asian Department: J. R. Marquez-Ruarte. Central Banking Department: S. P. Leite. European Department: L. A. Whittome, Counsellor and Director; B. E. Rose, Deputy Director; U. Dell'Anno, Y. Horiguchi, H. O. Schmitt, R. G. Thumann, H. Vittas. Exchange and Trade Relations Department: M. Guitián, Deputy Director; J. T. Boorman, L. H. Duran-Downing, G. R. Kincaid, P. Neuhaus. Fiscal Affairs Department: M. Katz, F. Sanchez Ugarte. Legal Department: J. G. Evans, Jr., Deputy General Counsel; J. M. Ogoola, S. A. Silard. Treasurer's Department: K. Boese. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, J. Gil-Diaz, J. P. Pujol, L. M. Valdivieso. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. M. Ainley, G. R. Castellanos, D. Hammann, K. A. Hansen, S. M. Hassan, A. Steinberg, E. M. Taha, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: G. Biron, M. B. Chatah, Chen J., J. J. Dreizzen, R. Fox, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, S. Kolb, M. Lundsager, R. Msadek, J. A. K. Munthali, K. Murakami, E. Olsen, W. K. Parmena, D. J. Robinson, J. E. Rodríguez, M. Sarenac, A. A. Scholten, A. J. Tregilgas, B. D. White.

1. MEXICO - 1985 ARTICLE IV CONSULTATION; REVIEW UNDER EXTENDED ARRANGEMENT AND PROGRAM FOR THIRD YEAR

The Executive Directors resumed from the previous meeting (EBM/85/91, 6/7/85) their consideration of the staff report for the 1985 Article IV consultation and the review and program for the third year under the extended arrangement (EBS/85/123, 5/13/85; and Cor. 1, 6/5/85). They also had before them a report on recent economic developments in Mexico (SM/85/148, 5/23/85; and Cor. 1, 6/5/85), together with an information notice on the real effective exchange rate of the Mexican peso (EBS/85/99, 4/23/85).

Mr. Jensen remarked that the success of Mexico's adjustment program was an example of what could be achieved when national authorities showed will and determination in pursuing strong adjustment policies. The Mexican example would serve as a lesson for other countries with similar imbalances inherited either from ill-conceived economic policies or from the financial crisis of the early 1980s.

The Mexican effort had shed some light on the practical difficulties of implementing exchange rate and commercial policies, Mr. Jensen observed. In the Mexican context, those policies were particularly sensitive because of their interrelation with external developments, especially with capital flows and trade relations between industrial and developing countries.

Three crucial ingredients would be necessary for Mexico to achieve its medium-term objective of sustained economic growth with financial stability and viable external balance, Mr. Jensen continued. The first ingredient, based on well-consolidated external accounts, would be attention focused on the domestic economy to make further progress on inflation and structural reforms. Particularly important would be the phasing out of price rigidities, a firmer control over the parastatals, the replacement of import restrictions by a tariff system, and a general enhancement of the private sector--policies to which the authorities had clearly committed themselves.

The second ingredient would be the softening of the protectionist stance of industrial countries and Mexico's main trading partners, Mr. Jensen said. Although the issue of protectionism had continued to receive attention under the Fund's surveillance mechanism and in other forums, unfortunately little or nothing had been done to improve the immediate outlook. While developing countries had been continually pressed to pursue more competitive exchange rate policies and introduce more liberal trade systems, the industrial countries were claiming that existing import restrictions were necessary to placate demands for greater protection and ease social concern over the unemployment issue.

The third ingredient necessary for the attainment of sustained economic growth would be Mexico's return to more normal and voluntary access to international capital markets, Mr. Jensen remarked. Such a return would be contingent both on the maintenance of a correct exchange rate and on the liberalization of exchange restrictions in order to avoid a further misallocation of resources. Despite the high social and political costs of an exchange rate devaluation, the benefits from such a move might include improved resource allocation and export competitiveness. In addition, a devaluation would have to be complemented by the reduction of trade barriers abroad, so as not to erode the potential benefits of positive export elasticities, thereby jeopardizing the authorities' initiatives and efforts. Although import restrictions and a multiple exchange rate system had minimized the cost of adjustment and enabled the authorities to consolidate the external accounts, avoid excessive reliance on new financing, and improve Mexico's relations with the international financial community, a liberalization of exchange restrictions was necessary to avoid a further misallocation of resources.

Voluntary capital flows would be crucial to the success of the country's adjustment efforts, Mr. Jensen concluded. With the recent transition to multiyear debt rescheduling and the Fund's proven adaptability to circumstances, as in the enhanced surveillance exercise, there was hope that Mexico might step from a world of financial crisis to one of continued progress and development.

Mr. Joyce remarked that the Mexican experience had been particularly important for all member countries, not only for those countries that had found themselves in financial crisis. The Mexican experience not only pointed the way to new methods for dealing with the problems of developing countries but also demonstrated what a country could do if it had the determination.

Mexico had made remarkable progress since 1982, particularly in the external sector, Mr. Joyce said. Because the current account had moved into surplus, debt had been rescheduled, and new money packages negotiated, there had been an elimination of arrears and a considerable rebuilding of reserves. The Mexican economy had started to grow again in 1984 with strong export growth, some increase in investment, and stronger than projected domestic savings. Inflation had also decelerated from its very high levels in 1982, although progress had been less than expected. Indeed, there had been some slippage toward the end of 1984 from the program's targets both for inflation and for the public sector deficit.

In large part, the generally favorable developments reflected the strong adjustment measures that had been taken over the past couple of years in the fiscal, monetary, wage, and exchange rate areas, Mr. Joyce observed. The broad range of policies that had been included in the proposed program for 1985 were encouraging. Given the still unacceptably high rate of inflation, the effects of the recent weakening of the international oil market, and slippages on fiscal account in late 1984, the authorities had properly decided on stricter discipline in the adjustment process and a tightening of both monetary and fiscal policies. They had also recognized the need to focus on the longer-term issues in the 1985 program, in particular on economic efficiency, policy reform, and the adoption of new measures to improve economic management.

Regarding fiscal policy, the decision to reduce the 1985 budget deficit by more than had been planned initially was welcome, Mr. Joyce continued. Also appropriate was the decision to concentrate on cutting current expenditure, where much of the slippage had occurred in 1984, and to increase investment expenditure in real terms. The wide range of fiscal measures of a structural nature which the authorities had taken was impressive, including the review of the tax system, a new system of controls on borrowing and spending by state enterprises, and the rehabilitation or divestment of selected public enterprises.

In the context of monetary policy, the three goals for 1985 of further reducing inflation, attracting increased domestic savings, and encouraging a net capital inflow were all commendable, Mr. Joyce emphasized. In the circumstances, the authorities should continue their overall strategy of cautious monetary management and maintain positive real interest rates. Also appropriate were the measures giving the Bank of Mexico more flexibility in conducting monetary policies; those measures included legislation permitting the central bank to conduct open market operations by intervening in treasury bill markets or by issuing monetary regulation bonds, and limited government control of bank credit. The authorities' decision to align the rate on preferential credits with the cost of funds was also appropriate, as was the adoption of ceilings on financial operations of development banks and official trust funds.

Although the authorities had tightened fiscal expenditure in February and March, thus reducing the rate of inflation in recent months, increases in controlled prices had clearly had the effect of adding to inflationary pressures, Mr. Joyce observed. Indeed, the authorities had adopted more stringent demand management policies and had liberalized some import controls, hoping to control the rate of price increases. However, there was concern that the increase in the minimum wage granted for 1985 had sent misleading signals to the private sector regarding potential inflationary developments. While the authorities were eager to see real wages rise in step with growth in productivity and output, and were under pressure to accede to demands for wage increases, increases in the minimum wage would undoubtedly make the achievement of inflation targets in 1985 more difficult.

As to the external sector, import liberalization measures needed to be implemented more quickly, Mr. Joyce stated. By the end of 1985, only 35-45 percent of merchandise imports were to be covered by tariffs; the remainder would still be subject to import licenses. Moreover, press reports indicated that domestic political pressures might delay the implementation of some measures, putting even modest targets at risk. Also, there was growing evidence that the exchange rate policy, despite decisions in December 1984 and March 1985 to increase the daily rate of devaluation, might not be adequate if non-oil exports were to grow at the rate projected for 1985. Assuming weak world petroleum markets, non-oil exports would have to grow very rapidly for Mexico to restore acceptable rates of output growth while maintaining a viable balance of payments position. The weak non-oil export performance in the second half of 1984 and the weakening in the first quarter of 1985 were matters of concern; indeed, non-oil exports had been 16 percent lower than in the first quarter of 1984. In part, the weakening export performance was attributable to the significant erosion of the very favorable competitive position that Mexican exports had attained through the large devaluations in 1982.

Although the authorities had remained committed to managing the exchange rate flexibly, the margin between the free market and the parallel market exchange rates had been increasing and had reached 20 percent, Mr. Joyce remarked. Thus, the authorities should re-examine the exchange rate as well as the rate of daily devaluation, possibly revising their timetable for liberalizing imports.

The authorities' plan to shift emphasis from import licensing to tariffs was fitting, Mr. Joyce said. Such a shift, together with the appropriate exchange rate and domestic pricing policies, should improve overall economic efficiency and help guide investment to areas in which Mexico had a comparative advantage--provided, of course, inflows did not continue to be discouraged by controls and establishment requirements. By vigorously pursuing more liberal trade and investment policies, the authorities could help restrain inflationary pressures and provide increased competition for domestic companies, some of which seemed to operate in a monopolistic or oligopolistic environment.

In conclusion, the Mexican authorities had taken great strides toward establishing domestic and international confidence in their economy, Mr. Joyce observed. They had implemented sound economic policies and managed the external debt responsibly, thus ensuring that economic growth would be firmly based and leading Mexico to re-establish its normal access to international capital markets.

Mr. Nimatallah commented that the improvement in Mexico's economy since late 1982 had been remarkable. In sharp contrast to the crisis atmosphere that had prevailed at that time, Mexico was beginning to benefit from its continued adjustment efforts. The streamlining of the debt service profile, which was one of the cornerstones of the adjustment strategy, had allowed Mexico not only to service its debts normally but also to arrange new voluntary loans. Those loans, in turn, had given the authorities room to concentrate on the resumption of growth in output and employment.

In the second year of the program, Mexico had made considerable progress in stabilizing and restructuring the economy, Mr. Nimatallah continued. The balance of payments and reserve positions had been strengthened and the growth in output had exceeded program targets. The settlement of arrears in the early part of 1984 had been a further important step in the restoration of Mexico's creditworthiness, an achievement that was due in part to close cooperation with the Fund.

Despite that progress, demand management policy had been relaxed and inflation had remained substantially above the program target, Mr. Nimatallah said. In the period ended December 1984, the public sector deficit and financial intermediation by development banks and trust funds had exceeded the program limits. Furthermore, Mexico's competitive position had been weakened following the appreciation of the effective exchange rate. Thus, the measures that the Mexican authorities had taken to redress the weaknesses were welcome. Budgetary outlays had been cut back and the official exchange rate had been depreciated at a faster pace. Still, a number of concerns remained with respect to wage settlements, fiscal performance, and commercial and exchange rate policies.

With respect to wages, the 1985 settlement had been slightly less than in 1984, but still higher than assumed in the 1985 budget, Mr. Nimatallah observed. Wage policy had also seemed more liberal than appeared consistent with the objective of reducing inflationary expectations. Experience in 1984 had shown that a higher than projected increase in wages was likely to add to cost pressures and make it difficult to achieve the inflation target.

There was concern that the budget deficit might be larger than expected owing to the 1985 wage settlements and the weakening of the oil market unless appropriate corrective measures were taken, Mr. Nimatallah remarked. He wondered whether it was still reasonable to expect that outlays on public wages and salaries would remain at the previously budgeted levels. As the steady reduction in the budget deficit had been at the heart of the adjustment process in recent years, it was critical that the authorities continue their efforts to reduce the fiscal deficit further. Accordingly, the Mexican authorities' decision to cut an additional Mex$200 billion from the public sector outlays for the remainder of 1985 was commendable.

The slow pace of import liberalization was disappointing, Mr. Nimatallah observed. While the authorities should pursue the liberalization process vigorously, that process should not only improve resource allocation but also help to reduce inflation by lowering the cost of both imports and domestic production.

The recent net loss in international reserves and the persistent discrepancy between the official and parallel market exchange rates required keeping the exchange rate under close review, Mr. Nimatallah stressed. Careful review was needed not only to maintain the competitiveness of non-oil exporting industries but also to strengthen Mexico's ability to service its debts and fully restore its creditworthiness. Thus, he hoped that the Mexican authorities would unify the exchange markets, as the existence of multiple markets had given rise to some distortions, and might have had an unfavorable effect on confidence when there were no balance of payments reasons to continue such practices.

In sum, clearly the Mexican authorities were committed to adjustment and had been moving toward the realization of sustained growth, Mr. Nimatallah said. Having kept the program on target and having met all performance criteria for the first quarter of 1985, the authorities merely needed to intensify their efforts to further reduce the budgetary deficits, to limit the rate of monetary growth, and to achieve realistic exchange rate and commercial policies.

Mr. Grosche commended the authorities on their remarkable ability to implement the necessary policy measures during the first two years of the extended program. Within a relatively short period of time internal and external disequilibria had been substantially reduced, and prospects for improvement had emerged in an economy that had been a major trouble spot. From an international point of view, the most remarkable achievement had been the long-range rescheduling arrangement with private banks. Chart 6 in the staff report (EBS/85/123) demonstrated how the "hump" in 1987 and 1988 had been transformed into a slowly rising debt burden which was commensurate with the growing debt-servicing capacity of the Mexican economy.

In the past year, program targets had been missed and policy slippages had occurred which, if uncorrected, could impair the future well-being of the Mexican economy, Mr. Grosche remarked. Adjustment in the fiscal area had been relaxed, as evidenced by the indicative criteria at the end of 1984. Insufficient adjustment of the exchange rate had resulted in a real appreciation of the peso and the erosion of Mexico's international competitiveness. Credit policy had been less restrictive than provided for under the program and import liberalization had been slower than expected. In fact, the increase of non-oil exports in 1984 had played only a small role in the dramatic improvement of the current account in that year.

After rather lengthy discussions, a program had been worked out providing for corrections in nearly all the key areas of the economy, Mr. Grosche continued. The program rightly focused on the public sector budget and on structural issues, while providing for increased revenues and reduced expenditures. The cautious monetary stance was welcome, but in order to reduce inflationary pressures, wage policy would have to play a crucial role as well. After the substantial increases in minimum wages at the beginning of 1985, further wage increases would have to be contained. The recent 18 percent increase, which put overall increases in 1985 up to the 1984 levels, seemed too expansionary, particularly in view of the declining inflation rate.

In the context of structural reforms, the authorities were to be commended for the comprehensive review of trade policy, Mr. Grosche remarked. The shift from a licensing system to import tariffs should help the Mexican economy overcome the distortions created by the current system. In addition, the authorities could emphasize their commitment to a more liberal commercial policy by resuming negotiations to join the General Agreement on Tariffs and Trade.

The relaxation of import controls should be accompanied by a more realistic and flexible exchange rate policy, Mr. Grosche stressed. The slow growth in non-oil exports and the slowdown in overall exports at the beginning of 1985 had shown that actions so far had been inadequate, especially to offset the damaging effect of the high inflation rate on the real exchange rate. In addition, unification of the exchange rates would facilitate structural reforms in the public sector and in external trade. Also, more effective trade and exchange rate policies might have a positive impact on foreign direct investment. Foreign direct investment had substantially declined from 1983 to 1984, and Mexico might have problems attracting more non-debt-creating capital inflows than it had obtained previously.

The May 1985 issue of World Financial Markets, published by Morgan Guaranty, had made an overwhelmingly clear case for flexible exchange rates and liberal trade policies in Mexico, Mr. Grosche maintained. The article pointed out that without liberal trade policies, flexible and realistic exchange rates, and prudent domestic demand management, it would be much more difficult to overcome the problem of international indebtedness than previously anticipated. Thus, opening up the economy and relying more on an outward-oriented strategy was crucial for the Mexican economy.

Finally, it was unclear to him why Mexico's access to Fund resources had not been reduced for the remainder of the program, Mr. Grosche said. In the case of Malawi, where discussions between the authorities and the staff for the third program year had been interrupted for seven months, the Board had approved reduced access to Fund resources for the remainder of the extended arrangement. The reasoning behind the decision was that it would have been difficult to approve of continued access at an annual rate that was inconsistent with the current policy on access limits. He also asked why Mexico's last purchase would take place following the completion of the arrangement in 1986, especially in light of the Executive Board's recent discussion of the timing of performance criteria and the phasing of purchases.

Mr. Fugmann remarked that Mexico had made significant and remarkable progress in improving its economic performance since the 1981-82 financial crisis. Recent developments had contributed to a further improvement of both domestic and international confidence in the Mexican economy, as evidenced, inter alia, by the recent negotiations for a multiyear rescheduling arrangement. Still, additional adjustment measures would be required to consolidate earlier gains.

According to Mr. Ortiz's statement, imports had surged by nearly 40 percent in the first four months of the year, while both oil and non-oil exports had dropped significantly, Mr. Fugmann noted. The result had been a trade surplus of about 40 percent below that of the same period in 1984. If the trend continued, it was likely that the trade surplus for the whole year could be US$3-4 billion below that projected by the staff for 1985.

The authorities had also encountered resistance in their efforts to liberalize trade, Mr. Fugmann observed. The authorities were planning to introduce trade liberalization measures based on the DIMEX arrangement, a major step toward creating a more internationally competitive and restriction-free environment. However, it appeared that the authorities' initiative had been strongly resisted by Mexican industry and that the DIMEX scheme would be implemented in a modified and more gradual form than envisaged originally. In general, Mexico would have to proceed much more rapidly to liberalize trade; that action would help restrain inflationary pressures and promote competition in the domestic markets.

Finally, the agreement in principle that Mexico and its foreign creditors had reached on September 8, 1984, which had established the guidelines for the multiyear debt restructuring agreement and the Fund's enhanced surveillance role, had been finalized in March 1985, Mr. Fugmann commented. It would be of interest to learn more about the Fund's role in that agreement.

Mr. Fujino observed that despite the slippage from the program targets, the Mexican authorities had pursued a steadfast adjustment process in 1984. The balance of payments continued to be favorable, with a current account surplus of more than US$4 billion; the surplus had been achieved in large part through the rise in nonpetroleum exports rather than through the curtailment of imports in 1983. As a result of the growth of non-oil exports and the recovery of private investment, which had increased by a healthy 5.4 percent, real economic growth had been 3.5 percent.

By contrast, inflationary trends had been less than encouraging, Mr. Fujino continued. The program target for the inflation rate had been substantially exceeded in 1984, with the end-of-period consumer price index having ceased to decelerate during the fourth quarter of 1984. A combination of factors had most likely contributed to inflationary pressures. First, larger nominal wage increases than had been implicit in the program had contributed to the downward rigidity in inflationary expectations. Also, due to some apparent relaxation of expenditure controls, the public sector deficit had deviated from the program targets in the latter part of 1984, contributing to inflationary pressures. Although monetary policy had continued to be relatively restrained during most of the year, the combination of private and public demand for credit had created pressures on domestic savings in the last quarter of 1984; the resulting credit expansion in December 1984 and January 1985 had worked against a further decline in inflation. Finally, import liberalization had been slower than expected with domestic producers able to maintain a monopolistic-like position despite a general relaxation and liberalization of domestic prices.

The authorities' effort to reduce inflation and maintain a strong balance of payments position was crucial to the attainment of stable economic growth over the medium term, Mr. Fujino commented. Major corrective measures had recently been introduced. In February 1985, the authorities had decided not to activate the contingency deficit reserve included in the 1985 budget. The original 1985 budget estimates had also been adjusted to reinforce public finances. Credit expansion had been tightened in February and March 1985 by placing monetary regulation bonds with commercial banks and by increasing interest rates.

A continued reduction in the public sector deficit should remain the key element of the adjustment effort in the 1985 program, Mr. Fujino remarked. A reduction of the deficit to 4.1 percent of GDP for 1985 would seem consistent with a further slowing of inflation, the reduction in reliance on foreign borrowing, and a strengthening of domestic investment; the attainment of that target was particularly important. Thus, both the revisions of the original 1985 budget and the improvement in the management of certain public enterprises that had been operating inefficiently were welcome. As there was little room for slippages, the impact of deferred interest payments on the 1985 fiscal deficit might be greater than expected--a development that called for close monitoring.

The authorities' plan which would result in an overall credit expansion in 1985 of 16 percent of the currency outstanding at the end of 1984, seemed consistent with the objective of reducing inflation, Mr. Fujino said. The maintenance of positive real interest rates would be indispensable to strengthening domestic savings. In addition, the continued reduction of financial subsidies should contribute to a more effective use of available credit.

The relaxation of price controls had been a positive move, Mr. Fujino remarked. However, the authorities would be well advised to liberalize import controls as well as price controls to promote greater efficiency and reduce inflation. Although the decline of real wages by 31.4 percent in two years indicated the serious nature of the adjustment process, the relatively generous wage award in 1984 and the adjustment in minimum wages in January 1985 could be cause for future concern.

In their conduct of external policy, the authorities' key tool in reversing trends in the balance of payments in 1983 had been a sharp devaluation of the Mexican peso in late 1982, Mr. Fujino observed. During 1983 and 1984, however, the currency had appreciated in real effective terms. There had been a notable difference between the movement of the real effective exchange rate adjusted for relative prices and its movement adjusted for unit labor costs. Indeed, although the authorities had argued that the Mexican peso was competitive on the basis of relative unit labor costs, the deceleration in the growth of nonpetroleum exports in the second half of 1984, in spite of favorable market conditions, gave rise to concern that the margin for maneuver in exchange rate policy was limited. To maintain a strong balance of payments position, the authorities would have to monitor developments in the exchange rate closely and be prepared to take timely action as needed.

The authorities had not been prepared to eliminate the dual exchange market, Mr. Fujino noted, although the recent widening between the free market rate and the informal parallel market rate called for an effort to unify the exchange market.

Finally, the implementation of adjustment policy by the authorities demonstrated their capacity to correct any deviations, Mr. Fujino concluded. The performance criteria for the third year seemed to be appropriate, and he could support the proposed decision.

Mr. Polak pointed out that although the Mexican economy had shown commendable progress during most of 1984, toward the end of the year the program had gone rather seriously off track. True, performance criteria that had been related to purchases under the extended arrangement had been observed, but some of the targets for December 1984 had been substantially exceeded, particularly the targets for the overall public sector deficit, for domestic credit expansion, and for inflation. Although the staff report had not dwelled on the weaknesses in Mexico's performance during the latter part of 1984, the footnote on page 1 had hinted at the difficulties encountered; from October 1984 to March 1985 it had taken nine sets of talks to conclude the consultations between the Mexican authorities and the mission representatives. Clearly, if the Fund was to continue pointing to Mexico as an example that others should follow, a return to a firm policy stance would be essential.

The Mexican authorities had taken strong measures to get the program back on track, but there was doubt as to whether internal and external targets could be met, Mr. Polak remarked. The trend in non-oil exports was worrisome, with non-oil exports in the first quarter of 1985 at 15 percent below their level in the first quarter of 1984; to meet the projection for 1985 as a whole, non-oil exports during the remainder of 1985 would have to exceed the 1984 level by 28 percent. As a result, the balance of payments might suffer, affecting Mexico's net international reserves as well as its ability to meet the June performance criterion.

Inflation was clearly a major concern for the domestic performance of the economy, Mr. Polak continued. To consolidate the achievements to date, both a further decline in inflation and control over monetary developments would be needed. Until November 1984, the impact of a larger than expected increase in net international reserves had been broadly offset by the Bank of Mexico, which had reduced its net domestic assets much more than required under the program. As a result, currency in circulation had increased; but the money supply had increased much faster to accommodate higher than planned inflation. Having observed a similar divergence between the Bank of Mexico's offsetting actions and a surge in the money supply in 1983, he wondered whether the staff and authorities were making correct estimates of the public's real demand for currency and the Bank's liquidity position.

Another matter of concern to him was that the staff considered the increase in financial assets resulting from the Bank of Mexico's actions to be a positive sign, Mr. Polak remarked. According to the staff, the Bank's policies had "resulted in an acceleration in the growth of financial savings.... The flow of deposits into the banking system...registered strong growth in 1984." An analysis linking an expansion in the money supply to the growth of financial savings could only lead to the wrong policy conclusions. In reality, excessive credit creation had produced an excessive incease in M-3 in late 1984, an increase that was in part absorbed by higher than planned inflation but produced reserve losses in 1985. Thus, it was clear that the authorities would have to use monetary policy to reduce inflation. Along with reduced fiscal expenditures, the strengthened monetary policy would put the inflation target for 1985 within reach.

The sharp real appreciation of the peso since early 1983 had limited the flexibility of exchange rate policy, Mr. Polak observed. The real exchange rate had returned to its level of early 1980, which had by no means been appropriate. With present policies, maintenance of that 1980 rate was the best that could be expected. An early review of the exchange rate, based on a careful examination of trends in non-oil exports and capital flows, seemed warranted in light of the importance of liberalizing the import regime.

The favorable developments over the past two years had allowed the ratio of external public debt to GDP to fall, and a further decline was expected in 1985 and in the years thereafter, Mr. Polak noted. After having doubled between 1980 and 1984, public external debt was envisaged to increase by 6 percent in the period to 1990, a very satisfactory development and an example of how countries should deal with their debt burdens. Although it would remain high, the debt service ratio had become manageable in the medium term as a result of the multiyear rescheduling arrangement. With a good economic performance and the help of enhanced surveillance, Mexico was well placed to recover from its severe financial difficulties.

On an analytical point, Mr. Polak suggested that the staff should pay attention in future reports on Mexico to the shifts in real assets and liabilities to which Mr. Ortiz had referred. Although he accepted the underlying reasoning for back dating the last purchase--namely, the need to link it to the year-end performance criteria--he would prefer the more open technique of extending the arrangement by two or three months. He saw no reason for not granting an explicit waiver of the three-year limit in paragraph 3 of Section II of the decision establishing the extended Fund facility. Backdating the February 1986 drawing might create statistical discrepancies in the end-of-year figures for Mexico's Fund position as published in International Financial Statistics.

Also, a case for more restricted access by Mexico could be made, Mr. Polak considered. The Venezuelan and Mexican experiences had been somewhat similar--multiyear rescheduling arrangements, enhanced surveillance, similar levels of foreign exchange reserves--yet Venezuela had been included on the transfer side of the operational budget whereas Mexico expected to draw another 103 percent of its quota in less than a year. Granted the desirability of maintaining until the end of the year the present phasing of purchases in relation to the performance criteria, Mexico might be well advised to draw smaller amounts--perhaps one half of those specified--provided its balance of payments and reserve positions were developing satisfactorily.

Mr. Clark remarked that the adjustment program that Mexico had been pursuing with determination and skill in conjunction with an extended arrangement had led to remarkable progress during the past two and one-half years.

The two main components of a program supported by an extended arrangement, Mr. Clark considered, were first, a set of macroeconomic measures adequate to reduce or eliminate the main imbalances in the economy; and second, a parallel set of structural measures, which were essential if adjustment was to be successful in the long run, but which might not have an effect for some time.

If his chair had reservations about the Mexican adjustment program, it would be because there were some recent signs that momentum in both those areas had been lost, Mr. Clark noted. Deviations from the program with respect to fiscal performance and inflation had been greater at the end of 1984 than originally expected; remaining price restrictions were extensive; and there had been only modest progress in eliminating import controls. The elimination of such restrictions by the end of the program would be crucial for an effective implementation of the program. Although such slippages were not surprising in the context of a country pursuing a severe adjustment program over a long period, they indicated that Mexico still had some way to go before the economy was set on a path of sustainable growth and able to resume normal financial market access.

He too had been concerned about the slippages in current expenditure during the second half of 1984, Mr. Clark said. Fortunately, they had been corrected; and the authorities had also decided to forgo activating the contingency reserve. In addition, with the combined operating deficit of state enterprises, excluding PEMEX, running at half their current revenue, the financial position of many parastatals had been difficult. The authorities' intention of singling out the public sector for attention in 1985 and their plans for some privatization were thus welcome.

There had again been a substantial overrun on credit extended by the development banks, which was disappointing, especially since such credit was in part subsidized, Mr. Clark continued; he hoped that it would not recur. He was curious about the recent proposal to substitute a portfolio requirement to hold government debt for a reserve requirement with the Bank of Mexico. He would be interested if the staff could assess the likely impact on the conduct of monetary policy, which would presumably depend partly on the liquidity characteristics of the debt that the banks would be required to hold.

Although the authorities had made considerable cuts in real wages, continued wage restraint would be necessary to reduce inflation substantially, Mr. Clark stressed. He wondered whether the 18 percent increase in the minimum wage effective in June, in addition to the 30 percent increase in January, was consistent with an inflation target of 35-45 percent.

The improvement in Mexico's export performance over the past three years had been heavily dependent on the U.S. market, Mr. Clark noted. Since 1982, the increase in exports to the United States had been almost double that to the world as a whole. In part, that trend reflected oil trade, but it also underlined the potential effect of a slowdown in the U.S. economy on the Mexican recovery.

Owing in part to the marked decline in exports to the rest of the world, Mexico's trade performance in the first quarter of 1985 had been rather disappointing, with a 15 percent fall in non-oil exports against the same period in 1984, Mr. Clark observed. The slowdown in exports might also have been due to the continued appreciation of the peso. Although the authorities had increased the daily rate of depreciation so that the cumulative depreciation would amount to about 40 percent over the remainder of 1985, there was a danger of a further real appreciation if the authorities did not meet their inflation targets. In addition, there had continued to be a disparity between the free and parallel market rates and between cost and price competitiveness. Consequently, the authorities should be encouraged to monitor the rate closely and to accelerate the rate of depreciation if necessary.

Finally, even though he saw no particular problem with the timing of Mexico's drawings under the third year of the extended arrangement, he would be interested in a comparison of the procedures followed in the cases of Mexico and Malawi, Mr. Clark remarked. In addition, it seemed that some of the overshooting of the fiscal variables at the end of 1984 had effectively been ratified by setting performance tests for 1985 in terms of flows rather than levels. He would welcome the staff's comments on that point.

Mr. de Groote said that he approved the proposed program for the third year of the extended arrangement for Mexico, but he was concerned that slippages in Mexico's performance in 1984 had not been sufficiently emphasized in the staff's analysis. Although the staff stated that there had been a major turnaround in economic conditions in 1984, the indications were that the recovery had been modest. Domestic inflation had declined and total employment had increased slightly. The shift to surplus in the current account had been remarkable, external arrears had been almost eliminated, and foreign exchange reserves had been replenished. Those improvements were attributed to strong demand management based on a sharp decline in the fiscal deficit, the deceleration in the growth of monetary and credit aggregates, a restrictive wage policy, and firm adjustments in exchange and interest rates. The upturn in Mexico's economic performance had enabled the country to conclude successful negotiations with foreign creditors on debt relief agreements. In a world ridden by the debt crisis, Mexico was an example of what countries burdened with foreign debt could do, with enough sacrifice and determination, to unburden themselves. Not only could debtors see that their efforts had not been hopeless but creditors had become more convinced that investment in the Third World was not necessarily a lost cause.

Again, he could not agree with the staff's characterization of Mexico's performance during 1984 as continuing to be positive, despite some slippages, Mr. de Groote remarked. In his view, such an assessment did not distinguish between real progress and the implementation of a Fund-supported program. The positive performance in 1984 had been accompanied by growing signs of policy changes that Mexico could not afford either in the short or the long run. Inflation had been 50 percent higher than expected, the rate of growth of nonpetroleum exports had declined, the pace of import liberalization had been slower, and a high minimum wage award had been granted.

It was especially regrettable that the Mexican authorities had relaxed their demand management policy precisely at the time when the country's external balance had become stabilized and most of the debt relief agreements had been concluded, Mr. de Groote noted. If the financial markets were left with the impression that the Mexican authorities lacked continuity of purpose, there was a danger that they would limit their contribution to Mexico's recovery. In the second part of 1984, the relaxation of demand management had involved practically every aspect of the economy. The public sector deficit had been 6.2 percent or 7 percent--including interest payments due but not paid--of GDP instead of the 5.5 percent envisaged, reflecting the relaxation of expenditure controls. In late 1984 and in the first two months of 1985 there had been a sharp increase in credit demand: credit to the private sector by development banks and official trust funds had exceeded the program limits established for 1985 as a whole. The depreciation of the Mexican peso in the free market had fallen short of the adjustment required to avoid a loss in competitiveness. Clearly, a major debtor country like Mexico could not relax its adjustment effort. The continuation of that effort should be considered a precondition for continuing Fund support of debtor countries and also an assurance of further credit flows to the Third World. Only in that way could a new debt crisis be avoided.

There should be no further relaxation of the demand management effort under the 1985 program, Mr. de Groote observed. Special emphasis should be given to increasing the export competitiveness of the Mexican economy; that development would depend on the elimination of trade barriers, which as the staff stated, gave many domestic producers a monopolistic or an oligopolistic position. A liberalization of trade policy and an appropriate exchange rate policy would contribute to an increase in overall economic efficiency and thus improve price performance and curtail inflation. Given the balance of payments constraints, the competitiveness of the Mexican economy could only be restored under a consistent demand management program such as the one outlined in the letter of intent. It was imperative that the Mexican authorities not condone the view that the Mexican economy had arrived at a safe haven and that the adjustment efforts could be relaxed.

Mr. Zhang noted that the program for 1985 was intended to reinforce and carry forth the economic adjustment that had begun at the end of 1982. Many internal and external imbalances had been reduced between 1982 and 1984, and some of the general conditions for the resumption of stable economic growth had been established. Although considerable progress had been made under the program, in the future, developments on three fronts might cause concern.

First, inflation would have to be reduced further within the framework of the 1985 program, Mr. Zhang observed. True, there had been a slight reduction in the rate of inflation during recent months: the consumer price index had risen by only 19.8 percent during the first four months of 1985 compared with 21.8 percent during the same period in 1984. But, given the expected rate of devaluation for 1985, it was doubtful that prices could be kept from rising at a higher rate for the remainder of 1985. Furthermore, unless the rate of wage increase could be restrained in 1985, an upward wage and price spiral would most likely emerge.

A second cause for concern was whether the process of cutting real wages could be continued indefinitely, Mr. Zhang said. Real wages had registered a sharp drop in 1983 and had continued to fall by an additional 7.4 percent in 1984, with the cumulative average reduction in real wages since the beginning of the adjustment program amounting to 31.4 percent. The Mexican authorities' view was that wage reductions would prevent further wage and price spirals and contribute to the success of the adjustment program. The responsible attitude of the trade unions and the acceptance of a drastic lowering of living standards by wage earners had contributed greatly to the reduction of real wages, but it was doubtful that the process could be continued indefinitely. In fact, statistics showed that total real private consumption between 1982 and 1984 had fallen by 8.5 percent, well below the fall in real wages. It was not clear whether private consumption by nonwage earners had actually been rising, or whether there had been a redistribution of income in favor of nonwage incomes.

Third, there was some question as to whether the recovery in private fixed investment in 1984 would continue into 1985 and beyond, Mr. Zhang remarked. The recovery of private fixed investment would be crucial for the resumption of medium-term economic growth in Mexico following the present sharp deflationary experience.

Mr. Angeloni noted that while the Mexican economy had registered significant improvements in 1984, trends in public finances and inflation had been less satisfactory than hoped. Despite the generally favorable outlook, recent difficulties in the fiscal and inflationary fronts were potentially worrisome, indicating that the road ahead was not devoid of considerable problems.

An analysis of the fiscal accounts revealed that the public sector deficit in 1984 had exceeded the target by about Mex$200 billion, or about 1 percent of GDP, an amount that would have been even greater if account had been taken of arrears in interest payments to the central bank, Mr. Angeloni observed. Apparently, most of the deficit had originated in increased public expenditure, particularly interest payments and wages.

The authorities understandably attached importance to maintaining the necessary social and political support for their economic policies, but it was nevertheless worrisome to think that recent developments could jeopardize the future of the economic program, Mr. Angeloni remarked. The targeted public sector deficit of Mex$1,785 billion for 1985 might be ambitious in light of the planned reduction of about Mex$250 billion of interest arrears to the central bank, especially in comparison with the 1984 deficit of Mex$1,826 billion plus Mex$200 billion for the accumulation of arrears. It would be interesting to have some reassurance about the feasibility of the fiscal program for 1985 and a calculation of the impact of the projected increases in minimum wages on the fiscal deficit.

The effect of price liberalization without trade liberalization might well be increased inflation, Mr. Angeloni continued. Developments in the real exchange rate, which was different when measured on the basis of relative prices as opposed to labor costs, indicated that Mexico seemed to have lost competitiveness between 1982 and 1984 because of rising prices rather than costs. Such evidence was consistent with the view that producers had taken advantage of price liberalization to increase their prices without having to face foreign competition. In the short run, price competitiveness was more important than labor cost-based competitiveness. Thus, the authorities should proceed with determination to open up the domestic goods market to foreign competition. The authorities had expressed their intention to do so by substituting import controls with tariff barriers; such an approach, although acceptable on a transitional basis in view of the benefit for public finances, was not optimal, since in the long run significant tariff barriers would tend to dampen the effect of trade liberalization by increasing domestic prices.

The recent increase in the daily adjustment of the exchange rate in relation to the U.S. dollar from Mex$0.13 to Mex$0.17 and to Mex$0.21 was appropriate in view of the differential between the domestic and global rates of inflation, Mr. Angeloni considered. Flexible management of the exchange rate was crucial if Mexico was to maintain external competitiveness in nonpetroleum products, especially given the uncertainty surrounding the demand for and price of oil products.

Mr. Nguyen said that he agreed with the thrust of the staff appraisal and supported the proposed decision. Mexico's adjustment strategy, supported for two years under an extended arrangement, had been essentially successful. The trade and current account balances had shown a dramatic improvement, with official reserves having been replenished at a faster pace than projected to cover almost eight months of imports. Development in the domestic economy, although less impressive, had also been encouraging, given the previous imbalances, with the public sector deficit having been sharply reduced and inflation brought down from nearly 100 percent to 60 percent from 1982 to 1984. After a decline of 5.3 percent in 1983, real GDP had grown by 3.5 percent in 1984, a development that was more in conformity with Mexico's long tradition of steady growth. It was therefore not surprising that based on renewed confidence, the debt rescheduling negotiations had been conducted successfully.

However, the implementation of a less stringent policy beginning with the last quarter of 1984 had resulted in less encouraging indicators in the first four months of 1985, Mr. Nguyen continued. Inflation had remained steady at 20 percent and the trade surplus had dropped sharply by 40 percent. Moreover, the decline in world oil prices had put additional pressure on the balance of payments and thus had narrowed the Government's room for maneuver.

The authorities' determination to return to the adjustment path followed since 1982 was commendable, Mr. Nguyen said. The letter of intent gave the highest priority to the fight against inflation and emphasized the strengthening of public finances as a cornerstone of the adjustment strategy. Although those were appropriate objectives, no quantitative objective for inflation had been set. The authorities had not made any reference to the 35 percent projected increase in the price level mentioned in the Budget Bill. In fact, Mr. Ortiz had projected an inflation rate of 45 percent for 1985. Furthermore, the distinction made between the economic deficit and the financial deficit would result in lowering the projected deficits for 1984 and for 1985. Despite the fact that the inflation target for 1984 had been too ambitious, it was of the utmost importance that slippages be avoided in the targets for inflation and the fiscal deficit in order to maintain the program's credibility.

The authorities were considering appropriate additional measures in the 1985 program, Mr. Nguyen noted. Monetary and credit policies appeared to be consistent with the objective of fighting inflation, as did the pursuit of an active interest rate policy. The most innovative and positive aspect of the program was the authorities' decision to open up the economy. Two prerequisites seemed to be particularly important: first, the liberalization of prices accompanied by strong measures against monopolistic practices, and second, the maintenance of a strict wage policy.

The decision to gradually remove impediments to trade was welcome, Mr. Nguyen continued. The authorities would need also to implement a flexible and realistic exchange rate policy. There were two risks attached to the overvaluation of a currency. The first was the risk of capital flight. Although he realized that capital flight was projected to decline--from minus US$3.3 billion to minus US$1.7 billion during 1985--he was concerned about the loss of foreign reserves in the first few months of 1985; the authorities should thus monitor capital movements closely.

Second, an overvalued currency entailed the risk of a loss of market shares, Mr. Nguyen pointed out. In a less favorable world economic environment, Mexico should avoid an overvalued peso so as to increase its share of non-oil exports progressively while satisfying domestic demand. Mexico was accustomed to trading within the dollar area and usually did not take into consideration the appreciation of the U.S. dollar vis-à-vis European currencies in evaluating the general level of domestic prices. However, it would seem more realistic for the Mexican currency to reflect developments in currencies other than the U.S. dollar. For example, the peso had been at the same rate against the French franc in December 1984 as in January 1983; the real effective exchange rate in February 1985 had been the same as at the end of 1979. Such worrying developments surely explained the less than satisfactory export performance, especially in non-oil exports, in the first quarter of 1985.

Structural reforms in three sectors would be needed in the longer run, Mr. Nguyen observed. Agricultural policy had oscillated between two objectives: self-sufficiency and stronger integration into the world market. That issue would have to be tackled, and the Mexican authorities would find the expertise of the World Bank helpful. In industrial policy, the encouragement of small and medium-sized enterprises seemed appropriate given the scarcity of financing and the unemployment problem. Finally, the authorities should work to streamline and consolidate the banking and financial systems.

Mr. Rye noted that the Mexican Government had persevered with its economic adjustment policies and that the results had in some respects been most impressive. Mexico had been rewarded with a significant return of international financial confidence and with the willingness of international banks to negotiate with the Government a more manageable debt profile for the decade ahead.

However, the task confronting the Mexican authorities remained a formidable one, especially as the prospects were not as favorable as might have been hoped, Mr. Rye observed. The Mexican authorities must continue to emphasize measures designed to avoid the risk of any recurrence of balance of payments difficulties. In that regard, two developments were of concern. First, at the end of December 1984 the 12-month rate of inflation had reached 59 percent, substantially above the 40 percent sought under the program. Second, there had been substantial appreciation in 1984 of the real trade-weighted effective exchange rate.

Despite some improvements in inflation, as illustrated in the May 1985 figures, the underlying pace of inflation had remained too high to achieve sustained growth and to avoid the recurrence of balance of payments difficulties, Mr. Rye stressed. He welcomed the authorities' commitment to a reduction in the rate of inflation, particularly as illustrated by their statement that inflation "is at this time the most serious and pressing problem facing us because it erodes the standard of living of large segments of our society. It is, therefore, our intention to continue seeking a rapid and sustained reduction of inflation." To turn their good intentions into practice, the authorities would need to resist inflation more vigorously by further reducing the size of the public sector deficit, strengthening financial policies, reducing effective protection, and moderating wage increases.

It was essential that the authorities cut back the fiscal deficit to slow inflation, reduce reliance on foreign financing, and strengthen domestic investment, Mr. Rye continued. Although the public sector deficit had been lower than in 1983, the figure for 1984 had been 6.2 percent of GDP, in excess of the 5.5 percent target. Thus, it was critical that slippages in fiscal policy be avoided. The authorities would need to monitor developments closely and be prepared to adopt further corrective policy measures as required. The undertaking to reduce the public sector deficit to 4.1 percent of GDP by the end of 1985 was not overambitious. However, the authorities' decision in February to forgo activation of the contingency deficit reserve and thus reinforce the public finances had been heartening; they should continue to avoid the temptation to make use of the contingency reserve.

Monetary and wage policies had clearly contributed to inflationary pressures during 1984, Mr. Rye added. Excessive credit expansion in December 1984 and January 1985 had been undoubtedly responsible for the disappointing inflation record in the first few months of 1985. It was vital for the authorities to firmly adhere to the 16 percent programmed increase in overall credit expansion in 1985. Inflationary expectations had also been adversely affected by the increases granted in minimum wages during 1984. Minimum wages had been further adjusted by 30 percent at the beginning of 1985, a decision that was understandable in the circumstances; but the authorities would need to exercise great care with respect to the 1985 midyear adjustment in minimum wages.

The process of freeing imports from prior licensing and other administrative barriers had not proceeded at the speed originally expected during 1984, Mr. Rye remarked. He urged the authorities to accelerate their comprehensive revision of foreign trade policy. Trade liberalization was the most effective method to counter any monopolistic pricing that might arise when controls over domestic prices were being relaxed. The authorities were right not to reimpose price controls.

Finally, the evident disagreement between the staff and the authorities over whether Mexico's competitiveness had been significantly eroded by the real appreciation of the peso during 1984 was of concern, Mr. Rye said. Some erosion of competitiveness had taken place as evidenced by the deceleration of the rate of growth of nonpetroleum exports and of nonfactor services in the second half of 1984. Moreover, while movements in the real effective exchange rate as measured in terms of unit labor costs had not been as obvious as those measured in terms of relative prices, there had been some appreciation in the exchange rate. The maintenance of real effective exchange rates during 1985 would depend upon the fulfillment of the authorities' domestic and external inflation assumptions. And, if the authorities persisted with their intention to open the economy on the import side, the exchange rate would have to be further depreciated. For the time being, it was vital that the Mexican authorities persevere with their adjustment program on the basis of what Mr. de Groote had aptly called "continuity of purpose." Such continuity would be in the interests not only of the Mexican people themselves but also of the world financial system as a whole.

Mr. Alhaimus noted that the performance of the Mexican economy during 1984 had shown some important achievements. Of major significance had been the strengthening of economic activity, with a GDP growth rate of 3.5 percent--a rate well over the program projection and in sharp contrast to the large fall in the rate of growth in 1983. The improvement had come mainly in response to the growth of non-oil exports and to the recovery of private investment. The strong performance in the external sector had also been maintained despite the large rise in imports. The capital account had shown a large improvement and net international reserves had increased despite lower than programmed levels of official external borrowing. Monetary and credit policies had remained on the whole somewhat restrained, and the growth of financial savings had accelerated.

Performance had been well below program targets with respect to the fiscal deficit and inflation, Mr. Alhaimus observed. The relaxation of demand policies in the second half of 1984 had contributed to the slower pace of fiscal adjustment and to a higher than programmed rate of inflation. Thus, it was commendable that the program for 1985 sought to intensify efforts to reduce inflation while maintaining moderate growth and a satisfactory balance of payments.

The broad approach of the 1985 program appropriately emphasized fiscal restraint and inflation control, Mr. Alhaimus continued. Fiscal restraint was essential given the uncertain prospects of the oil market, on which Mexico still depended heavily. Additional cuts had been made in public sector outlays. The monetary and credit policies contemplated by the authorities also seemed to be consistent with the objective of controlling inflation and strengthening financial savings. Even though the performance of the external sector was bound to be less favorable than in 1984 because of the large rise in imports and fall in oil proceeds, the further depreciation of the peso was expected to enhance competitiveness.

Looking at the medium-term prospects, it was encouraging that the staff projected a 5-6 percent real growth rate from 1986 to 1990, along with the maintenance of a strong balance of payments and the gradual convergence of domestic inflation with that of Mexico's main trading partners, Mr. Alhaimus concluded. Naturally, such prospects would depend not only on the course of events in the world economy but also on the continuation of the Mexican authorities' adjustment efforts.

Mr. Salehkhou remarked that Mexico had continued to make progress under the extended arrangement that it had agreed with the Fund in 1982. Economic performance in 1984 had been satisfactory despite some setbacks toward the end of the year, including the relaxation of demand and credit policies, slippages in the fiscal deficit target, and the subsequent higher than expected inflationary pressures. The rise in the GDP growth rate had been higher than programmed, and the external balance had improved because of the steep rise in export values, not because of import contraction, as had been the case in 1983. Foreign exchange reserves had grown faster than expected, but the wide inflation differential with Mexico's trading partners had defeated the purpose of the series of minidevaluations during 1984 and early 1985, which had not halted the real appreciation of the exchange rate. The Government, however, had reiterated its commitment to accelerate the pace of currency devaluation when needed.

The 1985 program was consistent with the objective of achieving medium-term economic stability, Mr. Salehkhou continued. The overall public sector cash deficit would be limited to 4.1 percent of the projected GDP, and public sector savings would rise from 0.1 percent of GDP in 1984 to 2.8 percent in 1985, indicating that the authorities had made tremendous efforts to control costs and rationalize the budgets of public enterprises.

Monetary and credit policies had been conducted prudently and flexibly since the start of the program, with the Government fine-tuning the money supply as occasion demanded, Mr. Salehkhou observed. Credit had been further tightened when it became apparent that monetary expansion was faster than expected and was contributing to some loss in international reserves. In the 1985 program, targets for the central bank's net domestic credit growth had been based on a moderate increase in international reserves and an increase in total credit equal to 16 percent of the currency outstanding at the end of 1984. Such targets should help to decelerate inflationary pressures, which had remained a major cause of concern despite the significant progress that had been achieved.

Closely related to the inflation problem was the wage and income policy which had complemented the authorities' adjustment strategy in 1983, causing real wages to fall significantly, raising profitability and production incentives, and helping to reduce manufacturing costs and inflation, Mr. Salehkhou commented. By contrast, in 1984 wage policy had been directed toward maintaining real wages in order to reflect cost of living increases. In the 1985 program, the authorities had prudently related the projected increase in minimum wages to productivity gains, thus formulating a wage policy that discouraged inflation.

In the external sector, important gains had been made, notably the settling of arrears and the strengthening of international reserves, Mr. Salehkhou said. In addition, exchange rate policy would continue to be managed flexibly in 1985 in order to maintain the competitiveness of non-oil exports. With regard to restrictive exchange practices, the authorities had reiterated their commitment to further liberalization and eventual unification of the currency rates. In the meantime, it seemed appropriate to maintain temporary exchange control measures while generalized exchange controls were being phased out. He supported the proposed decision.

Mr. Mtei remarked that when Mexico's extended arrangement had been agreed in 1982, the Mexican economy had been experiencing negative output growth, rapid rates of price inflation, widening public sector deficits, and a deteriorating balance of payments position. External reserves had been virtually depleted and the country had accumulated arrears on its external payments. In the media and in professional journals, the situation had been commonly referred to as "the international debt crisis," as Mexico and other major borrowers were thought to be on the brink of default on their external debt service payments. However, after two years of a comprehensive adjustment program, the outlook was much brighter.

The progress achieved thus far had been broad-based, Mr. Mtei noted. After contracting in 1983, real output had grown by more than envisaged under the program, affecting employment favorably. Although inflationary expectations had not been dampened enough to achieve the inflation targets under the program, some remarkable progress had been made. In addition, the public sector deficit had been significantly reduced, and the improvement in the balance of payments had been reinforced by a reduction in import demand and by the restoration of competitiveness through a devaluation of the Mexican peso. As a result, non-oil exports had performed well in 1984.

The program for 1985 represented a further strengthening of the adjustment effort, Mr. Mtei maintained, in the shape of a set of well-founded and comprehensive measures. The program deserved the support of the Fund.

Although all quantitative performance criteria had been met in the 1984 program, indicative ceilings on financial intermediation by development banks and official trust funds had been exceeded, Mr. Mtei observed. Such excesses had led the staff to place ceilings on those operations; he asked why the Mexican authorities had not been expected to meet such ceilings in the first place.

A positive aspect of the Mexican program had been the multiyear rescheduling of external debt, Mr. Mtei emphasized. Rescheduling was important to Mexico, considering that the debt service problem would persist for a long time. It was even more important that the terms and conditions of such relief be softened considerably; otherwise, rescheduling would only shift the burden into future years. As the multiyear debt relief would go beyond the life of the current extended arrangement, the authorities had requested the arrangements for enhanced surveillance under Article IV.

As in other countries that had dual exchange rate systems, Mr. Mtei noted, the exchange rate for the peso on the parallel market had been moving further away from the free market rate, despite an initial sharp devaluation that had restored competitiveness. However, the tendency to view the parallel market rate as reflecting actual market forces should be resisted, as a host of factors affected the parallel rate. The most that could be expected was a reduction in transactions in the parallel market.

Finally, he would be interested in the staff's view on the legal question of whether Mexico's extended arrangement could be prolonged by three months, Mr. Mtei said. In particular, he asked why Mexico's access had not been reduced, whereas in a similar case of an interrupted program--that of Malawi--the amount remaining to be drawn under the arrangement had been reduced.

The staff representative from the Western Hemisphere Department noted that the balance of payments performance had weakened in the first quarter of 1985 and there had been some reserve loss. Export performance had also weakened, with both non-oil exports and oil exports reflecting a decline in the price of the latter in the early part of 1985. The staff had taken those developments into consideration in making the balance of payments projections for 1985. By their own nature, those projections were subject to change, although revisions that might have been made to the estimates would probably have canceled each other out. For example, while performance in non-oil exports in the first few months of 1985 had been weak, interest rates in the international financial markets had been falling. Thus, although individual items in the balance of payments were subject to constant change, there was no major reason to adjust the overall balance of payments projections for 1985 at present.

Data through the end of May 1985 had shown that there had been a loss of international reserves of about US$150 million in the period from March to May, the staff representative added. For the end-June target for international reserves to be met, there would have to be some reserve gain in the course of June of some US$115-120 million. Such a gain was not improbable in a country like Mexico, where reserves could increase by fair amounts in the course of a few weeks.

There had been some appreciation in the effective exchange rate over the period of the program since 1983, based on exchange rate estimates adjusted both for unit labor costs and for the inflation differential with other countries, the staff representative continued. In the case of the exchange rate adjusted for unit labor costs, the margins created at the end of 1983 had been intended to provide Mexican producers with an edge of competitiveness over producers abroad. The margin had been quite wide in 1983, but it had narrowed since then, and the expectation was that the authorities would not allow any further erosion, particularly in light of the sluggish performance of non-oil exports.

In addition to measures taken in December 1984 and again in March 1985 in response to exchange rate developments, the staff representative remarked, further measures had recently been adopted authorizing the banks to operate foreign exchange houses and thus participate in the parallel market. Assuming that they did so, the number of transactions on the market would increase and there would be a more flexible exchange rate. For the parallel market to work smoothly, the authorities would have to look closely at the differential between the rates prevailing in the parallel market and the controlled market; that differential could serve as one of the bases for making future changes in the controlled market rate.

Wage policy during 1983 had made a significant contribution to the fight against inflation, but recent wage adjustments had not contributed to a further lowering of inflation, the staff representative said. Nominal wage adjustments, not real wages, were important in determining inflationary expectations. In setting their prices, producers would have to take into account the 18 percent increase in minimum wages at the beginning of June, together with the 35 percent increase at the beginning of 1985.

As for the impact of the minimum wage adjustments on the budget, not all government employees would benefit immediately from the wage increase, the staff representative noted, because they generally were paid at a rate above the minimum wage. Of course, the announcement of the minimum wage increase had a certain influence on collective bargaining contracts reached in the public sector, particularly with public sector corporations, which held wage negotiations at different times of the year. The minimum wage increase would also affect the salaries of those government employees who earned less than the minimum wage and of those whose salaries were adjusted in September. The practice of making only two minimum wage adjustments a year--one in January and one at midyear--was not likely to change.

As to whether the targets set for inflation in 1985 were realistic, the staff representative recalled that when the budget for 1985 had been originally prepared in late 1984, the Government had announced a target for inflation of 35 percent but had had to revise its inflation projection in the light of developments in late 1984 and early 1985. Thus, in preparing the program for 1985, an inflation rate more on the order of 40-45 percent had been used. Fortunately, during May 1985 prices had increased by much less than either the authorities or the staff had expected, and if that trend continued throughout 1985, the target could certainly be achieved.

The measures adopted in February and March 1985 would go a long way to assist the authorities in the achievement of the fiscal targets, the staff representative commented. Additional fiscal cuts on the order of Mex$200 billion had been made to try to ensure that the targets were achieved. As he understood it, those cuts would not imply a reduction in cash expenditure for the year but were rather a way of ensuring that the fiscal targets were achieved, particularly in light of the possible weakening of the receipts of the state petroleum company.

The changes in reserve requirements for commercial banks contained in the new banking legislation did not imply a major change in present practices, the staff representative added. Previously, commercial banks had been required to place a large proportion of their deposits--48 percent--with the central bank in the form of reserve requirements, whereas under the new law, the requirement was only 10 percent. Under the previous system, proceeds from the reserve requirements had been used for the most part by the central bank to lend to the Government; under the new procedures, commercial banks would have to lend the equivalent of up to 35 percent of their deposit liabilities to the Government. In a sense, the change merely made the transferral of resources to the Government a more transparent transaction; the fact that the Government would have to pay an interest rate tied directly to the rate that the banks had to pay on their deposits would ensure that the Government was paying the cost of the resources that it used. With the change, it would be very clear that the government deficit involved a cost, which the public as well as government officials could see reflected in the budgetary expenditures.

As the staff understood the DIMEX scheme, which had been finally approved, it was only slightly different from the one described in the authorities' letter of intent, the staff representative commented. Under the original proposal, exporters were able to use up to 40 percent of the value of their exports to obtain automatic import permits. Under the scheme that had finally emerged, the figure had been lowered to 30 percent. In addition, exporters taking advantage of the scheme would have to pay a minimum tariff of 25 percent of the value of their exports. To the extent that those imports were needed for export production, the usual rebate from the import tariff would be granted. Other technical changes included the requirement that the export value added should be at least 30 percent for an exporter to be eligible under the DIMEX scheme, thereby preventing its abuse.

The only ceiling that had been added to the program in 1984 had been the one limiting the accumulation of unpaid accrued interest at the central bank, the staff representative remarked. Owing to the impact of the accrual of such interest on the economy, the same ceiling had been included in the 1985 program. The payment of unpaid accrued interest at the central bank in 1984 would have implied an increase in the public sector deficit; as it was, the central bank had had to finance the costs of the accrued interest anyhow. The ceiling for 1985 was meant to prevent any more accumulation of accrued interest and to reduce some of the existing stock.

The program for 1985 had set ceilings on financial intermediation, the fiscal deficit, and certain monetary variables, the staff representative explained. Although neither the ceiling on financial intermediation nor the limit on the overall deficit had been observed at the end of 1984, the program for 1985 included no changes in the ceiling on financial intermediation. In 1985, the last drawing was contingent on the observance of the ceilings that had been set through the end of December, whereas in 1984 the last drawing had been contingent on the end-September ceilings. The fiscal ceilings were of course set in the form of flows; ceilings on monetary variables had also been established in terms of flows, but taking into account levels of the stocks of various economic variables through the end of 1984. In addition, the program for 1985 had taken account of the deviations that had occurred with respect to the program, and the measures undertaken to control those deviations.

The projections for growth in the medium-term scenarios were in real terms, the staff representative noted. The figures in the staff report for growth in non-oil exports and imports--8 percent and 5 percent, respectively--would be much larger in nominal terms.

The impact of Fund-supported programs on income distribution was difficult to measure because it would most likely be felt in the medium term rather than in the short term, the staff representative commented. Any program involving the kind of adjustment inherent in the Mexican program would imply a certain redistribution of income in favor of sectors like the export sector, a development that might improve the balance of payments performance but not necessarily benefit other sectors.

There had been a trade-off between maintaining the level of employment and increasing real wages in the Mexican program, the staff representative observed. Despite a very sharp drop in economic activity in 1982 and 1983, the decrease in the level of employment had been relatively moderate, the result of a conscious effort by the labor unions and the Government to maintain employment. The quantitative impact of the wage policy on income distribution among workers would have to be calculated for the various sectors of the economy.

In observing the monetary variables, the question that always arose was whether their behavior was the result of a supply phenomenon or a demand phenomenon, the staff representative remarked. In Mexico, the behavior of M-1 had been fairly different from the behavior of M-3. The money supply had decreased quite sharply in real terms from 1983 to 1984. In fact, the money supply had declined steadily from early in 1982 until the end of 1983, after which it had started to recover. A decreasing money supply reflected the impact of the interest rate policy, and in particular of positive interest rates, on the growth of financial savings in the banking system and the reversal of the capital flight that had been occurring previously.

The policies followed to control the growth of the money supply had resulted in a lowering of the consumer price index, which had declined throughout most of 1983 and the first half of 1984, the staff representative from the Western Hemisphere Department contended. The fact that private credit had remained below the levels assumed under the program for that period had been a less favorable development. The lack of demand for credit had been reflected in a larger accumulation of reserves than programmed for 1983 and 1984. The sharp increase in the money supply in the last quarter of 1984, on the other hand, had been accompanied by a similarly sharp rise in the demand for credit, by both the private and public sectors. The latter development was the reason why the staff viewed monetary policy as having been lax during the last quarter of 1984, although the staff had judged overall monetary performance during 1984 favorably.

The Deputy Director from the Exchange and Trade Relations Department noted that no deviations had occurred in the programs for the first two years of Mexico's extended arrangement, and purchases had been made according to schedule. In that context, a comparison had been made with the case of Malawi, where the deviations from the program had taken place from the middle of the second year of the arrangement, with the result that the resources that had remained unused would have been carried over into the third year, a carry-over that was not present in the case of Mexico. There had, however, been a delay in bringing Mexico's program for the third year to the Executive Board, which had required the resources to be distributed so that drawings were linked closely to the authorities' policy measures for the entire annual program period, especially as access under the arrangement was for the maximum amount.

In negotiating the 1985 program, the staff had sought in effect to reverse the overshooting of the indicative targets that had occurred at the end of 1984, the Deputy Director explained. In that context, it had been considered important to subject the first drawing of the third-year program to performance criteria for March 1985; in fact, the data showed that for the first quarter of 1985 there had been compliance with the performance criteria. Had there been no delays with the program for the third year, it would have been possible to submit it to the Board before the end of the first quarter; a drawing would have taken place upon approval of the program, and further drawings would have taken place on the basis of performance in March, June, and September of 1985. Instead, a delay had occurred but the performance criteria for March had been observed, and the proposed program envisaged that there would be a drawing following approval of the program with three subsequent purchases subject to performance tests in June, September, and December 1985.

With regard to the final purchase in early 1986, which was subject to observance of the performance criteria for end-December 1985, two alternative courses of action could be considered, the Deputy Director remarked. One option, as Mr. Polak had suggested, would be to waive the provision of the decision on the extended Fund facility that limited an extended arrangement to three years. The second option would be to use the technique that had been discussed in the staff paper on the relationship between performance criteria and the phasing of purchases (SM/84/259), which allowed for the establishment of testing dates near or at the end of the arrangement; in that case, the actual purchase would take place after the arrangement had expired, provided that the criteria had been observed and that the request had been made before the expiration of the period of the arrangement. In the case of Mexico the second option had been chosen because it allowed the drawings to be phased closely in line with policy actions envisaged under the program for the third year, and because it was in accordance with the Fund's general practices. At the same time, that option enabled the total amount in the last year of the arrangement to be disbursed over a period broadly in line with that envisaged at the outset of the arrangement.

The assessment of whether or not a member needed an arrangement with the Fund involved a measure of judgment, the Deputy Director from the Exchange and Trade Relations Department commented. A country might have an actual or a potential balance of payments need when it requested access to Fund resources. Given the slippages that had unfortunately occurred at the end of the second year of the arrangement, which would have to be reversed in the third year, Mexico would seem to qualify in both senses.

The staff representative from the Legal Department remarked that the legality of the phasing under Mexico's arrangement was best understood in the context of the staff paper on the relationship between performance criteria and the phasing of purchases. It would be recalled that Executive Directors had expressed concern about the present requirement that a request be received by the Fund before an arrangement expired because the performance criteria for the period ending with the arrangement would be unverified. Therefore, under the technique proposed, the staff would set performance criteria at the end of the arrangement and ascertain that they had been observed some time after the expiration of the arrangement. The purpose was to reduce the risk of slippages in the program. When the proposal had been brought to the Board, Directors had not focused on the particular issue of performance criteria and phasing, but no objection had been raised to the technique in question. The technique seemed appropriate in the case of Mexico; the authorities would have to request the last drawing before the expiration of the arrangement but report the relevant data on the end-of-year performance criteria before February 20, 1986.

Mr. Ortiz noted that one of the more fundamental questions that had been raised by a number of Directors concerned the feasibility of carrying through with the program for 1985, given the deviations at the end of 1984 and developments in the first months of 1985. There was evidence that the fiscal targets were realistic. During 1983 and 1984, the fiscal deficit had actually been a fiscal surplus, taking into account the effects of inflation on debt; in 1983, the surplus had been about 9.3 percent of GDP and in 1984, somewhat less than 7 percent of GDP. In sum, the public sector had been paying interest over and above the actual deficit, and more real debt amortization would take place during 1985. Even the more traditional yardstick--fiscal deficits as a percentage of GDP--indicated that the fiscal targets could be met. Government expenditures had been reduced from 48 percent of GDP in 1982 to 38 percent in 1984 and were scheduled to be reduced further to 35.7 percent in 1985. Total expenditures had been reduced by more than 10 percentage points in a period of three years. In short, his authorities had persistently pursued ambitious targets and had acted swiftly to correct perceived deviations in the fiscal area.

The monetary measures that his authorities had taken had proved to be effective, Mr. Ortiz observed. Interest rates on money market instruments such as treasury bills and commercial paper had increased sharply during May, reflecting monetary contraction. Likewise, interbank rates had increased, reaching levels of over 100 percent as banks scrambled for funds to meet their monetary regulation deposit requirements, a very high rate compared with any other interest rate during previous months.

In addition to monetary and fiscal measures, which were designed to correct short-run deviations, there had been fundamental changes in commercial policy, Mr. Ortiz continued. While his authorities recognized that trade liberalization was long overdue and should have taken place at an earlier stage of the program, it had been strongly opposed by various influential sectors of society. In addition, the Government had often found itself in a weak position in its attempts to encourage more liberal commercial policies in a world in which protectionism was on the rise. The weaker than expected export performance of some products during the first few months of 1985 could be directly attributed to trade barriers raised against Mexican exports. On many occasions, the growing protectionist sentiment of some of Mexico's major trading partners had had a damaging psychological effect on potential exporters, who were discouraged from making plans to increase sales abroad in view of the uncertainties involved in exporting. Therefore, the efforts of the governments of several major industrial countries to fight protectionist tendencies were welcome.

The DIMEX scheme was significant in that it eliminated a great deal of red tape that exporters encountered in the process of obtaining and retaining import permits, Mr. Ortiz explained. His authorities were confident that the new instrument would make inroads into the system of protection, since domestic producers would be in a much weaker position to overcharge for imports used by current or potential exporters. He emphasized that the DIMEX scheme was not a substitute for the more thorough and comprehensive liberalization effort that was being undertaken. The final objective of Mexico's commercial policy was to eliminate or reduce to the minimum the number of imports subject to licensing. In addition to the introduction of the DIMEX scheme, the goal for 1985 was to increase the number of freely imported products to between 35 percent and 45 percent of total imports.

Some Directors had questioned the reason for the fluctuations in the domestic interest rate at different stages in the program, Mr. Ortiz noted. The interest rate variations stemmed from movements in the inflation rate itself, which had resulted from the increase in prices of public sector goods and services concentrated in the first months of the year, as well as the minimum wage increases granted at the beginning of each year. Thus, inflation rates peaked at the beginning of the year, and when they began to abate, interest rates became negative for a few months. With that sort of monthly fluctuation in inflation rates and interest rates, his authorities had been reluctant to guarantee continuous positive yields for fear of upsetting the market and disrupting the operations of commercial banks and other financial intermediaries. Rather, they had tried to follow an interest rate policy that would aim at positive interest rates on average. Unfortunately, the recent sizable increases in interest rates had posed severe strains on the operation of commercial banks.

Nearly all Directors had expressed some concern regarding the increases in minimum wages, stating that those increases might have prevented a further decline in the inflation rate and fueled inflationary expectations, Mr. Ortiz observed. In fact, the minimum wage increases throughout the program period illustrated that wage negotiations had always been forward-looking, so that nominal wage increases had consistently been lower than past inflation rates. Otherwise, real wages would not have fallen. To that extent, the wage policy had not been responsible for the increase in inflationary pressures; there had been absolutely no indexation of wages or other key prices in the economy, one of the reasons why the program had been successful thus far.

Although concern had been expressed over the reserve losses experienced within the first months of 1985, there had been considerable reserve gains during the course of the program, Mr. Ortiz continued. In 1983, reserves had increased by US$5.5 billion, compared with the program target of US$2 billion in reserve gains. In fact, when the program had been originally presented to the Board, the reserve target for the whole program had been US$6 billion; thus, in one year reserve gains had equaled the targets for the whole program. During 1984, reserve gains had again exceeded the program target by US$1 billion.

Fluctuations in reserves were typical, Mr. Ortiz commented. Reserves could not be expected to increase continually. The most important reason for the decrease in reserves during the first months of 1985 had been the large amortization payments of public sector debt, including PEMEX payments associated with the debt restructuring agreement. Another possible explanation for reserve losses was the loss of foreign exchange under the dual exchange rate system. As with any such system, an incentive existed for the evasion of exchange controls through import overinvoicing or the resistance of exporters to surrender foreign exchange earnings. In spite of the loss in reserves, the use of foreign credit had been limited to trade credit and some small arrangements with multilateral and bilateral agencies during the first month of 1985.

A number of Directors had expressed concern about the real appreciation of the exchange rate and its effects on the competitiveness of Mexican exports, Mr. Ortiz recalled. Despite the appreciation in the exchange rate in 1983 and 1984, the balance of payments performance had nevertheless been one of the strong points in the program in both years. Given the size of the real overshooting of the exchange rate devaluation in 1982, a real appreciation was to be expected. At the same time, the authorities had shown flexibility in implementing all the required policy measures, including exchange rate measures. The rate of depreciation had been stepped up twice, and action had been taken recently to improve the functioning of the free market, an indication of the authorities' willingness to do everything necessary to prevent the deterioration of the balance of payments. It was important to remember that measured in terms of unit labor costs, the exchange rate still allowed Mexican exports to enjoy a substantial competitive margin despite the recent large appreciations. Thus, an exchange rate depreciation would produce windfall gains for exporters and other domestic firms. In fact, during the previous two years, profit shares had risen at the expense of wages. By the same token, firms had been able to contribute to the solution of domestic and external debt problems.

In the course of the previous two and one-half years, his authorities had shown the capacity and the political determination to pursue the enormous challenges facing them, Mr. Ortiz remarked. Without dwelling on the costs of adjustment and the burden that it had imposed on the population of Mexico, he pointed out that the evidence of his authorities' commitment to adjustment was to be found in the figures on real wage behavior and per capita consumption included in the staff report and in his statement. Many of the decisions taken during the previous two and one half-years had been extremely painful and difficult, but the important point was that the decisions had been taken and the necessary adjustment measures had been firmly implemented. The attitude and approach followed by his authorities since the beginning of the program had been characterized by responsibility and realism; responsibility in the acknowledgment and acceptance of the consequences of having followed inconsistent policies or delayed the application of corrective measures; realism in acknowledging that Mexico would have to correct its internal and external disequilibria in order to resume a path of stable growth and to improve the outlook for employment and the general welfare of its population; realism also in recognizing that the social costs incurred had not been a product of adjustment, but of the disequilibria that had made adjustment necessary in the first place. Thus, his authorities were convinced that the continuation of the adjustment effort was absolutely necessary, and they were prepared to take the necessary actions to ensure the success of the economic stabilization strategy.

The Chairman made the following summing up:

Executive Directors expressed in general their broad agreement with the thrust of the appraisal in the staff report for the Article IV consultation with Mexico.

Directors warmly commended the authorities on the remarkable gains that Mexico had made in recovering from the 1981-82 crisis. This had involved determination and political courage. While slippages had occurred in the program during 1984, Directors noted that the authorities had shown readiness to swiftly correct policies to deal with deviations from the programmed path and to adopt further measures in support of the adjustment effort. On the whole, economic performance had improved in 1984 and financial imbalances had been reduced further, but Directors expressed concern about certain developments since late in the year.

Directors welcomed the indications that economic recovery had started. They observed, however, that the adjustment effort was not yet completed, that it was proving very difficult to slow inflation, that the Mexican peso had appreciated significantly in real effective terms, and that Mexico's net international reserve position had deteriorated in recent months. Directors expressed some concern that the adjustment effort had been relaxed in the second half of 1984, and emphasized that the momentum of adjustment had to be regained in order to consolidate earlier gains in restoring confidence and to set the stage for sustained growth. In this context, Directors noted the more favorable development of consumer prices in May 1985, but added that the minimum wage settlements which had taken place in 1985 were likely to add to the difficulty of reducing inflation. Directors also regretted that progress in the implementation of structural adjustments in the exchange and trade areas had been slower than anticipated.

Directors noted that the 1985 program called for a further strengthening of the public finances, mainly through reductions in current expenditure. They welcomed the additional cuts decided in February-March 1985 and the decision not to activate the contingency reserve authorized in the budget, and regarded the 1985 fiscal target as appropriate. The cutback in the size of the public sector deficit was seen as essential in the effort to slow inflation, while the steps taken to prepare tax reforms, to strengthen the finances of public enterprises, and to scale down the public sector's involvement in various economic activities could be expected to contribute to a better use of the economy's resources in the medium term.

In the course of 1984, monetary policy had become too accommodative, many Directors observed. They therefore welcomed the recent marked tightening of monetary and credit policies. The introduction of monetary regulation bonds and the increase in domestic interest rates were expected to improve the control over demand growth and to encourage domestic savings. However, Directors were uncertain whether enough had been done in this area. Concern was expressed about the overruns in the operations of financial intermediation by development banks and official trust funds. Given the momentum of demand expansion, Directors emphasized that the authorities would be well advised to take additional measures in this area should demand continue to grow rapidly and domestic financial savings prove weaker than expected. In view of the continued outflow of private capital, some doubt was expressed regarding the adequacy of interest rate policies.

Directors noted that since the arrangement is already in its third year, it was important that the authorities move forcefully to implement the needed structural changes; therefore, they welcomed the adoption of a series of supply-side measures to complement demand management policies. Directors expressed disappointment about the slow pace of import liberalization, but noted the recent decision to accelerate trade liberalization and to deal with problems in the structure of protection. In this context, they took note of the approval of the DIMEX scheme, which had positive aspects as a transitional feature but of course should not be considered a substitute for trade liberalization. Directors generally urged the authorities to move more aggressively in this area with a view to raising economic efficiency in general and to improving the conditions for the growth of non-oil exports, which was seen by Directors to be crucial for the maintenance of a sustainable external position in the medium term.

Directors recognized that steps had been taken in December 1984 and March 1985 to improve the international competitiveness of the Mexican economy, but they were concerned that policy in this area was not sufficiently flexible, particularly in view of the insufficient exposure of public and private enterprises to the stimulus of foreign competition, the recent weak performance of non-oil exports, and the continuation of high rates of inflation. Directors noted with concern recent developments in private capital outflows, the drop in official international reserves, and the widening of the differential between rates in the controlled and the parallel exchange markets. Directors urged the authorities to monitor developments in the exchange rate area very closely to facilitate timely action to ensure the maintenance of external competitiveness and the protection of the overall balance of payments. Directors stressed the distortions and confidence-reducing effects arising from the continued existence of multiple exchange markets, and urged the authorities to unify the exchange system as quickly as possible.

Directors welcomed the signing of the multiyear restructuring of the public sector external debt with commercial banks. This, together with the reduced reliance on net external borrowing by the public sector and the progress made toward adjustment, had significantly improved Mexico's capacity to manage its external debt. Directors stressed the importance of both pursuing appropriate demand management and exchange rate policies and implementing structural reforms to facilitate Mexico's return to international capital markets and sustained economic growth. In this context the enhanced Article IV consultations in 1986 should contribute to the process of normalization of Mexican access to financial markets.

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

Mr. Polak remarked that he had no qualms about the legality of scheduling Mexico's last drawing after the expiration of the arrangement. His question was why the last drawing, scheduled for February 1986, had

had been backdated to December 1985 in the proposed decision. He suggested that the relevant words "to be effective on that date" be deleted from paragraph 3 of the proposed decision. The arrangement between the Fund and Mexico would continue to exist until February 20, 1986, and he saw no reason why the last drawing should not take place on March 1, 1986.

The staff representative from the Legal Department explained that the wording of the proposed decision was not meant to extend the period of the arrangement, but merely to facilitate the receipt of the verified data from the Mexican authorities. If the staff received data for the end of 1985 that showed that the performance criteria had not been met, the Mexican authorities would not be able to make the last purchase. The statement that the request would be "effective on that date" was intended only to bring the request within the terms of the arrangement.

The Chairman commented that the proposed decision was worded to indicate the need to receive Mexico's request for the last drawing before December 31, 1985. However, the words "to be effective on that date" could be understood to have a different, operational meaning, and he would propose their deletion from the proposed decision.

The Deputy General Counsel commented that the words "to be effective" could give the impression that the value date was to be backdated, but that was not the intention. The references to "purchases" in the arrangements were to requests to purchase and not to value dates, to which specific reference was made in other paragraphs. The value date for the subject request would be after February 20, 1986, when the information regarding performance criteria had been received and it was determined that a purchase could be made in accordance with the terms of the decision. The words "to be effective" had been included merely to state that the request for the purchase would be valid if it had been made earlier within the period of the arrangement, although contingent on compliance with the performance criteria for the end of the year. The words "if the request for the purchase is submitted on or before December 31, 1985" were sufficient.

The Executive Board then took the following decision:

1. The Fund and Mexico have held consultations pursuant to paragraph 4(d) of the extended arrangement for Mexico (EBS/82/203, Sup. 4) and as contemplated in paragraph 29 of the letter dated November 10, 1982 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico attached thereto, in order to review the implementation of the measures described in that letter, to reach understandings on the policies and measures that Mexico will pursue over the remainder of the program period, and to establish suitable performance clauses for the year 1985.

2. The letter dated March 24, 1985 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico, together with the Technical Memorandum of Understanding

attached thereto (EBS/85/70, 3/25/85), shall be attached to the extended arrangement for Mexico. The letter dated November 10, 1982, together with the Technical Memorandum attached thereto, and the letter dated January 3, 1984, together with the Technical Memorandum attached thereto (EBS/84/1, 1/3/84), shall be read as modified and supplemented by the letter dated March 24, 1985 and the attached Technical Memorandum.

3. Beginning on the effective date of this decision, Mexico will have the right to make purchases under the extended arrangement up to a total amount equivalent to SDR 1,203.745 million, provided that the amount of such purchases shall not, without the consent of the Fund, exceed (i) the equivalent SDR 295.8 million before August 20, 1985, (ii) the equivalent of SDR 598.4 million before November 20, 1985, or (iii) the equivalent of SDR 901.0 million before December 31, 1985. After December 30, 1985, a purchase may be made if the request for the purchase is submitted on or before December 31, 1985, the data for that date are received on or before February 20, 1986, and those data show that the performance criteria were observed as of December 31, 1985.

4. Purchases under the arrangement in accordance with paragraph 3 of this decision may not be made:

(a) during any period in which:

(i) the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 1 of the attached Technical Memorandum, has not been observed; or

(ii) the data at the end of the preceding period indicate that the limit on the overall public sector deficit, as specified in paragraph 3 of the attached Technical Memorandum, has not been observed; or

(iii) the data at the end of the preceding period indicate that the limit on the unpaid interest accrued to the Bank of Mexico on claims on the nonfinancial public sector, as specified in paragraph 4 of the attached Technical Memorandum, has not been observed; or

(iv) the data at the end of the preceding period indicate that the target for the net international reserves of the Bank of Mexico, as specified in paragraph 7 of the attached Technical Memorandum, has not been observed; or

(v) the limit on the net credit to the public sector by the Bank of Mexico, as specified in paragraph 2 of the attached Technical Memorandum, is not observed; or

(vi) the limit on the net domestic assets of the Bank of Mexico, as specified in paragraph 5 of the attached Technical Memorandum, is not observed; or

(vii) the limit on financial intermediation conducted by the national development banks and official trust funds, as specified in paragraph 6 of the attached Technical Memorandum, is not observed; or

(b) after September 30, 1985, until the review contemplated in paragraph 8 of the attached Technical Memorandum is completed.

5. In accordance with Executive Board Decision No. 7908-(85/26) of February 20, 1985 on overdue payments to the Fund, the extended arrangement for Mexico is amended to read as set out in the Attachment to EBS/85/123.

Decision No. 8001-(85/92), adopted
June 7, 1985

2. SOUTH AFRICA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with South Africa (SM/85/120, 5/1/85). They also had before them a report on recent economic developments in South Africa (SM/85/140, 5/16/85), together with an information notice on the real effective exchange rate of the South African rand (EBS/85/78, 3/28/85).

Mr. Arnold Peacey, Principal Resident Representative for South Africa, and his assistant, Mr. Emile Matthee, were also present.

Mr. Peacey made the following statement:

The staff documents under consideration by the Board for the most part provide a reasonable analysis of economic conditions in the country, and the South African authorities agree with the broad thrust of the staff appraisal.

Background developments

Any discussion of the performance of the open, developing South African economy should perforce take into account the overwhelming impact that extraneous economic trends--such as in the world price of South Africa's primary export commodity, gold--and other noneconomic international factors have on the economy.

The most striking feature of the performance of the economy in 1984 was the marked change in cyclical conditions as the unsustainable demand-led "miniboom," which commenced in the second quarter of 1983, was brought under control and the ensuing downswing gathered momentum in the second half of 1984.

Despite the restrictive financial policies formulated early in 1984 for the ensuing fiscal period, developments soon indicated the need to reinforce them. Consequently, the general sales tax was raised by 3 percent to 10 percent effective July 1, 1984 and monetary policies tightened in August 1984 to curb the still evident excessive demand. With the interest rate structure raised sharply, the prime rate reached 25 percent.

In September 1984, despite large demands resulting from extraneous factors such as the prolonged drought, a further review of government expenditure resulted in a significant cutback in the additional requirements of departments. In this way, the Government has reinforced, and has since maintained, fiscal discipline, as is evident from the fact that the revised government expenditure figure of R 27.2 billion set in September 1984 was achieved and the deficit before borrowing was limited to 3.2 percent of gross domestic product, only marginally above the 3 percent level originally budgeted. Additional steps taken at the end of January 1985 to reverse the decline in the external value of the rand, concomitant with a fortuitous, albeit modest, increase in the gold price, proved to be successful.

The 1985/86 budget, despite a measure of rebudgetization, was specifically designed to further reinforce this ongoing process of fiscal adjustment. Increases in expenditure were further limited, taxation raised substantially, and the deficit before borrowing--before provision for transfer to the tax reserve account--reduced significantly to 2.2 percent of gross domestic product.

Recent trends

Recent trends confirm that the present economic strategy is proving effective. Preliminary estimates--quoted at seasonally adjusted annual rates--indicate that the real gross domestic product declined for the fourth consecutive quarter by a further 1.5 percent in the first quarter of 1985.

Real gross domestic expenditure has likewise continued to fall significantly, the decline in the first quarter of 1985 amounting to 14 percent. While government consumption expenditure has remained more or less unchanged, all other main components of expenditure declined: real private consumption by 3.5 percent, real gross fixed investment by 5.5 percent, and real inventories by R 600 million. Employment among all sectors of the population in the nonagricultural sectors decreased by 0.5 percent in the fourth quarter of 1984, a trend continuing in 1985.

The current account of the balance of payments continued its strong, improving trend in the first quarter of 1985. Despite the still relatively modest level of economic activity abroad, an exceptional rise in merchandise exports, in both volume and value terms, to R 17,850 million--annualized--was recorded. The depreciation of the rand caused import prices to rise moderately. Import volumes, however, declined by 7.5 percent, illustrating the insignificance of the very few import restrictions still in operation. As a consequence, a small increase in the volume of merchandise imports, to the value of R 22,630 million--annualized--was recorded. In the light of the most recent trends, exports are now expected to increase in value by some 30 percent and imports by approximately 6.5 percent in 1985.

The capital account recorded an outflow of some R 2,700 million in short-term funds in the first quarter, mainly as a result of increased short-term foreign debt repayment. This has, to an extent, redressed the temporary, unfavorable maturity structure of South Africa's external debt. Long-term capital inflows amounted to R 366 million in this period.

Gross reserves of the South African Reserve Bank amounted to R 4,363 million on April 30, 1985. The increase in net and gross gold and other foreign reserves during April amounted to R 742 million and R 400 million, respectively.

The large capital outflow during the first quarter of 1985 neutralized the positive effect that the surplus on current account would normally have had on the exchange rate of the rand. The depreciation in the effective exchange rate of the rand from December 31, 1984 to May 30, 1985 amounted to a mere 0.8 percent.

The rate of inflation, as measured by the consumer price index (CPI), accelerated further during 1985. Calculated over a 12-month period, the rate of increase in consumer prices rose from 13.3 percent in December 1984 to 16 percent in February 1985, declined to 15.1 percent in March, and rose to 15.8 percent in April. As is, for example, evident from the sharply increased gasoline price, this rise was to a large extent due to higher import prices resulting from the depreciated rand. The inclusion of indirect taxation in the computation of CPI statistics also results in an upward bias in this measure of inflation; despite their disinflationary impact, therefore, the general sales tax increases of July 1, 1984 and March 25, 1985 are still exerting an upward influence on the CPI.

Although money supply growth remained high during the first quarter of 1985, the quarterly rate of increase declined substantially. The quarterly increase in M-3, at a seasonally adjusted annual rate, amounted to only 13.2 percent in the fourth quarter of 1984. The velocity of circulation of money (M-1) declined from 9.7 a year in the first quarter of 1980 to 4.7 a year in the fourth quarter of 1984.

Bank credit, mainly in the form of bank overdrafts, remained the principal counterpart of the increase in money supply during the first quarter of 1985. However, the quarterly increase in bank credit to the private sector, at a seasonally adjusted annual rate, declined from 37.2 percent in the fourth quarter of 1984 to 9.5 percent in the first quarter of 1985. Short-term and long-term interest rates began to decline after the introduction of the 1985/86 budget and are now lower by 3 percent and 1.5 percent, respectively.

Issues from the Exchequer during April 1985 were lower than envisaged during the preparation of the 1985/86 Part Appropriation Bill and precisely in line with the cash-flow projection prepared at the time of the main budget, a further manifestation of the efficacy of the Government's present fiscal policy.

Monetary policy and developments

The steps taken since 1980 to create more market-oriented instruments of monetary policy have resulted in substantial reintermediation and hence in a significant decline in velocity of money circulation. Although money supply continued to rise at an excessive rate until November 1984, monetary control was, in fact, much tighter than superficially apparent. This is evident from the statistics contained in the staff report and the most recent trends quoted earlier.

As mentioned, market forces have, in response to the effectiveness of fiscal and monetary policies, already caused a substantial decline in interest rates. The Reserve Bank has consequently adjusted its discount rates downward by 1 percent on two occasions, despite substantial further sales of treasury bills and government stock on the open market. These sales were aimed at arresting any premature decline in the interest rate pattern and to fund the Government's seasonal financing requirements in a noninflationary manner. Stock to a net value of no less than R 1,360 million has in fact been sold to the nonbank private sector since April 1, 1985. Nevertheless, the present prime interest rate, after peaking at a real rate of some 13 percent, still represents a real rate of interest of no less than 7 percent.

With respect to the completion of the longer-term phase of transition from direct to market-oriented instruments of monetary policy, my authorities are looking forward to the final report of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa, dealing, inter alia, with the desirability and feasibility of setting and announcing target ranges of growth for monetary aggregates, within a matter of months.

Pursuant to the Second Interim Report of the Commission on "Building Societies, the Financial Markets and Monetary Policy," draft legislation affecting the operations of building societies has been considered by the authorities and will be presented to Parliament shortly. The authorities have already announced that the Reserve Bank's commitment to provide forward exchange cover through the banks to the private sector will gradually be phased out and that this commitment will finally be terminated in September 1986. It is estimated that cover outstanding for the last 12 months before this date will be minimal.

Fiscal strategies in 1985/86

As re-emphasized by the Minister of Finance to the mission and as is indeed evident from the budget strategy for the 1985/86 fiscal year, the determination of expenditure priorities and the containment and constant control of government spending are top priorities of the Government.

The limited increase of 11.4 percent in nominal terms in budgeted government expenditure, the large imposition of R 1,737 million in additional taxation, the very modest amount of new stock borrowings amounting to only R 716 million, and the reduction of the deficit before borrowing to only 2.2 percent of GDP are elements of the renewed resolve to balance the mix of fiscal and monetary policy measures to prepare the way for sound and sustainable longer-term growth.

Although the Government would have wished to pare expenditure still further in the 1985/86 budget, overhasty, excessive austerity measures at this stage could do lasting damage to the longer-term development process, particularly in view of the absence of concessional sources of development finance from abroad. Various initiatives related, for instance, to the programs of the Development Bank of Southern Africa and the Small Business Development Corporation, bilateral regional developments, basic and advanced education, employment-related training, and the Population Development Program have reached critical stages of implementation. All these programs place a heavy burden on government expenditure but, on the other hand, will in time have a very beneficial effect by enhancing the productivity of labor as a source of production. A delicate balance therefore exists between the short-term need to prune expenditure and the need to upgrade the quality of factors of production, especially labor, to ensure future economic development. Moreover, there is also a pressing need to maintain and expand the physical infrastructure.

The State President's Committee on National Priorities is currently engaged in reviewing public sector priorities in line with the Minister of Finance's commitment in his budget speech, first, to reduce the level of government involvement in the economy, and second, to restructure expenditure priorities in order to attain the longer-term economic development objectives. This, of course, includes the whole question of privatization and deregulation.

Structural considerations

a. Tax reform

The authorities have, in line with experience elsewhere, come to the conclusion that, in view of changed economic circumstances, the present tax structure no longer suits the needs of the 1980s. In November 1984 they therefore appointed a tax commission with particularly wide terms of reference to review urgently the country's entire tax system with a view to attaining the maximum creation of wealth and employment opportunities throughout the country.

b. The Population Development Program

The Population Development Program, devised in 1984 to meet the challenges presented by increasing population pressures, focuses on the need to improve the quality of life of particularly the country's developing societies. The Program calls for simultaneous coordinated initiatives over a broad front of disciplines involving youth education, adult literacy, health and medical services, family planning techniques, employment creation programs, and orderly urbanization.

It is estimated that the total urban population of South Africa will double to more than 30 million by the year 2000 and that the number of blacks in this population will increase even more rapidly, from about 9 million in 1980 to some 21 million, i.e., a very rapid annual urbanization growth rate of about 4.4 percent.

Economically speaking, this implies a possible increase in total disposable income of households from $17.5 billion in 1980 to about $40 billion, calculated at 1980 prices, by the year 2000--an annual growth rate of about 4.2 percent. The share of blacks under these assumptions will grow from about $5 billion to nearly $15 billion, an annual growth rate of 5.2 percent, to be spent mostly on consumer goods, for the greatest part domestically produced.

An interesting feature of this approach of "inward industrialization" via urbanization is the new emphasis on the productive use of savings and of capital from abroad. The principle of positive real rates of return on capital invested has been reinstated as a basic element of the economic policies of the authorities and of business practices in the private sector.

This scenario depends very largely on a rapid rise in the level of industrial skills among the urbanizing black population. In this respect, circumstances in the country are improving substantially.

c. Education and training

Since 1978/79 the annual percentage increase in the budget for the education of blacks has been consistently higher than those of other state departments. The number of blacks successfully completing their secondary school education trebled between 1975 and 1980. By 1990 the number of black matriculants will exceed that of whites by a considerable margin and by the year 2000 their number will be dominating the secondary education scene. In fact, with just more than 6 million children at school today, this total is expected to double over the next 25 years. This will necessitate further significant increases in government expenditure in this field over the next decades.

The industrial training profile shows a similar explosion. For example, since 1979 there has been an increase of about 32 percent a year in the number of people receiving in-service training. Present projections of manpower demand and supply indicate that the number of trained people could begin to exceed the demand for the first time in this country's history by the turn of this decade--that is, if the increase in the capital/labor ratio can be arrested.

It should be noted, furthermore, that in terms of the National Policy for General Education Affairs Act, 1984, there is only one coordinating ministry and department to determine general education policy on a national level, and that, while adjustments in curricula to respond to particular environmental and cultural requirements are possible, the education departments serving the different population groups are in effect executive departments within a single uniform system of education, using the same core syllabi.

d. Employment creation

Due to the very rapid population growth in South Africa, and the recent slackness in growth rates, the creation of adequate job opportunities has continued to be a top priority in the Government's economic strategy. Efforts to curtail unemployment have, therefore, on occasion perhaps resulted in the Government following a less than optimal mix of fiscal and monetary policies.

One of the cornerstones of the employment strategy has been the creation of employment opportunities commensurate with the geographical supply of labor. A regional development strategy, involving various tax and other incentives to foster job creation activities and to provide the necessary physical and social infrastructure, has therefore been pursued with an increasing degree of both intensity and success.

In addition to this strategy, the Government is also devoting serious attention to the question of urbanization. The State President stated during his address at the opening of the 1985 session of Parliament that "steps to promote orderly urbanization and to eliminate negative and discriminatory aspects of influx control are receiving urgent consideration."

Various significant changes, as part of this ongoing process of orderly urbanization, have been effected lately, including, for instance, relaxation of influx-control measures, promotion of home and land ownership, and the upgrading of residential infrastructures.

Experience has shown conclusively, however, that where uncontrolled influx is allowed--be it in South Africa or elsewhere in Africa--the oversupply of labor has caused a material lowering of earnings--by as much as 10-15 percent a year. This, in turn, has been followed by a substantial lowering of living standards of, and an increase in unemployment among, those persons who are already legitimately resident in the relevant areas. In addition, uncontrolled influx has been known to overextend existing infrastructure with concomitant socioeconomic problems.

The last vestige of statutory job reservation referred to by the staff is due to be scrapped by the Government should employers and employees not reach agreement on the question before December 31, 1985.

e. Other aspects

All of these trends have profound socioeconomic and political implications that must be taken into account in the redevelopment of the administrative infrastructure of the country. Thus, for instance, in formulating demographic policies, the authorities must take account of the mutual interaction of the growing degree of urbanization and of population mobility and the impact of the dynamics of economic development. Moreover, the existence of a well-established private enterprise economy in South Africa implies that the communal attitudes of the majority of the rural population will have to adjust to the concept of private land tenure and capital formation.

Consequently, my authorities have embarked upon a comprehensive restructuring of all levels of the public sector dispensation. This process will see, inter alia, the disappearance of the four, second-tier, provincial administrations, currently responsible for a large proportion of expenditure on education, health, and road services, by the end of 1986 and their replacement by smaller regional structures, including regional services councils. All population groups will be represented in these councils. Urgent discussions are being held at the moment to try not only to find a viable financial base for these regional bodies but also to devise methods by which all population groups can participate meaningfully in other decision-making processes of the country.

It is obvious that these far-reaching demographic, social, and economic processes can only be ensured under conditions of harmonious interregional cooperation. It is intended that the Development Bank of Southern Africa should play a pivotal economic role in this respect. I understand that the Development Bank, which was created with such a dispensation in mind, would gladly assist in promoting the coordination, integration, and progression of these processes across regional, national, and international borders in southern Africa.

Mr. Joyce observed that developments in the South African economy over the past few years had been disappointing. Admittedly, some of South Africa's difficulties could be attributed to adverse external factors, particularly the weakness in the price of gold, but the authorities' economic policies had also been an important factor. Too often those policies had been inconsistent, taken too late, and quickly abandoned once the end of an immediate crisis appeared to be in sight. In addition, structural rigidities, especially in the labor market, were a growing charge on the economy and a growing constraint on the potential rate of economic growth. South Africa was interested in developing the industrial sector, but unless its policies were implemented with much more force and unless fundamental structural adjustments were made at an early date, it might eventually have to settle for needlessly low rates of growth and serious financial problems. That would be a most unfortunate outcome in South Africa's present stage of economic development, given its abundant natural resources and above all the aspirations of all its people.

South Africa had experienced pronounced economic fluctuations since the expiration of its last stand-by arrangement with the Fund, Mr. Joyce continued. During the discussion of the staff report for the 1984 Article IV consultation, many Executive Directors had expressed concern about the impact on inflation and the external balance of the domestic financial policies being pursued at that time. Regrettably, the situation had not changed. Inflation had declined only modestly in 1984 and it remained high. The deterioration in the external balance and the rapid fall in the value of the rand were also of concern. Although external factors were partly to blame, expansionary financial policies had aggravated their impact. Recent efforts to tighten fiscal policies, however, were welcome. The rate of growth of credit had also eased as a result of higher interest rates.

The Government was committed to tightening the stance of demand management in 1985, Mr. Joyce noted, but the authorities must avoid the slippages that had all too often occurred in the past. They seemed to have recognized the associated dangers, having pointed out that one of the main aims of demand restraint in the period ahead was to restore the credibility of government policies and to generate confidence in a more market-oriented approach to economic management. He agreed with the South African authorities that unless tangible results could be produced fairly quickly, protectionist measures would inevitably increase, as would calls for an even greater degree of direct government regulation of financial and economic activities. If those pressures could be resisted, the Government would be in a better position to take the steps required to correct the imbalances in the economy.

Despite the intention of the authorities to reduce the fiscal deficit, greater emphasis could have been placed on expenditure restraint, Mr. Joyce considered. The sharp rise in government expenditures relative to GDP had been a major factor in triggering recent economic difficulties, and stronger control over public spending could make an important contribution to the promotion of greater economic stability. The major challenge of monetary policy was to maintain a nonaccommodating stance not only for the immediate future but through the medium term. The decision to set monetary targets was helpful, but the authorities should err on the side of caution because of high inflationary expectations. The losses incurred by the Reserve Bank as a result of its intervention in the foreign exchange market had also had an impact on the rate of monetary expansion. He recognized that the authorities found such intervention necessary because of the lack of a developed forward exchange market, but the high costs involved suggested that they should consider reducing its extent.

The overall judgment of the staff was that the economy was delicately poised, Mr. Joyce noted. While there were some promising signs--notably the fiscal measures in the 1985/86 budget and the move to tighten monetary policy--the overall balance of payments position remained vulnerable, given the low level of reserves on hand. The longer-term prospects for achieving durable growth were tenuous at best. Indeed, the medium-term prospects were of most concern. The staff was adamant about the need to bring inflation under better control and to undertake far-reaching structural reforms. Certainly, the various structural rigidities and artificial barriers to the movement of labor would have increasingly adverse effects on the economy and on its prospects unless they were dealt with.

The economic consequences of South Africa's manpower and population policies were of particular concern, Mr. Joyce went on. It was not the first time that his chair had had occasion to call attention to the negative economic impact of those policies, nor would it be the last. Quite apart from their social consequences, which many Directors regarded with growing concern, the measures adopted under those policies were impeding the geographical and occupational mobility of the majority of the work force. They resulted in shortages of skilled labor and were accompanied by high and growing unemployment. The staff report had drawn attention to a recent study published in the Quarterly Bulletin of the South African Reserve Bank on the potential gross domestic product of South Africa; the authors had concluded that the potential growth rate of the economy had declined from an average rate of 5.5 percent in 1967-74 to about 3 percent in 1983-84, partly as a result of the shortage of skilled labor. Moreover, if the potential rate of growth was to move back up toward the 3.5-4 percent range, the authors considered that substantial increases in the rate of savings would be required. What was perhaps even more worrying was the time required for any steps that the Government might take to correct those problems to work their way through the economy. Current policies were not only an immediate cost but were also to some extent foreclosing the future. Indeed, the South African Central Economic Advisory Service estimated that output growth to 1990 would average at best 3.5 percent. The inevitable consequences of their policies should seize the authorities with the will to change them fundamentally so that the economy could grow to the benefit of all.

Mr. Mtei stated that he was in broad agreement with the staff appraisal although he wished to underline its general observation about the South African authorities' constant refusal to implement inevitable adjustments in their economic and social system. The same point had been made by many Executive Directors, including his chair, during the discussion of the staff report for the 1984 Article IV consultation, and he was sure that the urgent need for adjustment measures would emerge again as one of the main recommendations of the Executive Board to the authorities in Pretoria. Most of South Africa's problems, which could only become worse in the absence of reform, were self-imposed and deeply rooted in the rigid apartheid system. Economic developments in 1984 were in large part a reflection of the authorities' failure to introduce adjustment measures; for most of the year, GDP had declined and it had continued to fall in the first quarter of 1985. The rate of inflation had accelerated from 11.7 percent in 1984 to about 16 percent, while unemployment had increased and substantial capital outflows had persisted.

The continued lack of focus of fiscal and monetary policies had contributed to the double digit rate of inflation and the substantial capital flight, Mr. Mtei noted. It would have been of great analytical interest to have consolidated data for a wider public sector, including all levels of government and public enterprises, because the Central Government represented only about half of that sector in terms of revenues and expenditures. Furthermore, the deficit of public enterprises could account for as much as 6 percent of GDP and their borrowing operations must have a major impact on interest rates. In 1984/85, as in previous years, the Central Government had incurred substantial expenditure overruns, indicating a continuing weakness in budgetary control as well as costs related to the establishment of the so-called homelands. Although the budgetary deficit of about 3 percent of GDP had been financed without resort to bank financing, it had led nevertheless to some crowding out of the private sector in capital markets, thereby contributing to rising interest rates. The budget for 1985/86 projected a deficit of 2.5 percent of GDP, to be financed from nonbank sources, but he would be most surprised if there were no expenditure overruns, given the lack of a clear order of priorities.

Similarly, accelerating private sector credit expansion had led to a sharp increase of the money supply, fueling high inflation, Mr. Mtei added. The authorities should have found effective ways of checking those expansionary tendencies. Interest rates had been rising constantly, with the prime overdraft rate reaching 25 percent in January 1985 but without either restraining credit expansion sufficiently or arresting capital outflows. A significant proportion of those outflows might thus have been induced by political considerations arising out of international pressures against the country's racist policies. As he had explained in his statement on South Africa in 1984 (EBM/84/87, 6/6/84), the perpetuation of high interest rates was having a negative impact on investment not only in South Africa but in the member countries of the Rand Monetary Area that were in his constituency and that had to maintain high rates of interest to avoid massive capital flight to South Africa.

A current account deficit equivalent to 1 percent of GDP might not be alarming in comparison with that of other countries, but South Africa's overall balance of payments deficit of R 1,429 million in 1984 was the highest in recent years, Mr. Mtei said. The short-term capital outflow of R 3,059 million had been largely responsible for that outcome and might well signify a turnaround in the balance of payments, being perhaps just the beginning of a growing trend of disinvestment in South Africa in the absence of reforms. The staff had attributed the export of capital to exchange rate and political developments but it was far more likely, based on many serious analyses of the prospects of the South African economy, to have arisen from decisions to invest in a country that had greater long-term stability and better growth potential than South Africa.

For example, unit labor costs had risen by nearly 20 percent in 1982 and had continued to rise by more than 11 percent in 1984, significantly more than the rate of increase in costs of OECD countries where the major part of South Africa's exports were sold. Exports to African countries, where South Africa would sell most of its manufactured goods if it were not for its repugnant apartheid policies, had declined even further, to 6.5 percent in 1984. In the years ahead, therefore, not only continuing short-term capital outflows but even long-term capital outflows could be expected.

South Africa had considerable resources for growth, Mr. Mtei stated. All that was lacking was a rational, working economic system. The land was strategically located and was larger than the combined area of Belgium, France, the Federal Republic of Germany, Italy, and the Netherlands. South Africa was endowed with numerous mineral resources and was the largest producer in the world of about six key minerals, including manganese, gold, and chromium. The country had a population of 31 million and a labor force estimated at 9.5 million. However, only the interests of the 2 million in the white labor force were considered. Restrictions on the mobility of people in order to contain the majority of the native population in relatively small and infertile "homeland" areas led to great underutilization of land and labor. The exclusion of more than 80 percent of the population from the ownership of capital had resulted in a situation in which the Central Government had to own numerous enterprises. As in most countries, those enterprises registered large deficits that contributed to inflationary pressures and high interest rates.

The authorities' labor policies were at the core of their economic problems, as he had explained at great lengths in June 1984, Mr. Mtei recalled. The staff report showed clearly that the main bottleneck was the increasing scarcity of skilled labor that was inherent in the apartheid system, alongside the growing unemployment of semiskilled and skilled labor, and that resulted directly from the fragmentation of the labor market under the economic and social system. Appendix II to the report on recent economic developments revealed how those impediments limited geographical and occupational mobility and contributed to a continued shortage of skilled manpower; it also showed how the system contributed to increasing unemployment and to cost-push inflation. No progress whatsoever had been made toward implementing the various recommendations proposed for improving the labor market. Meanwhile, unemployment among blacks and the so-called coloreds was at least 30 percent and was moreover concentrated among younger people, whereas unemployment among whites was virtually nonexistent.

The high differentiation of wages--the ratio of black workers' to white workers' wages was 1 to 5--was underpinned by the education differential, Mr. Mtei observed. Therefore government policy might be expected to aim at speeding up the education and training of the black population; on the contrary, central government budgetary estimates for 1985/86 showed a faster increase in expenditure on education for whites, at R 2,660 million, nearly twice the figure of R 1,385 million earmarked for black education even though the black population was more than four times the size of the white population. Furthermore, per capita government expenditure on a white student was R 1,184 compared with R 235 on a black student in 1984. Clearly, no serious effort was being made to tackle the labor force problem. Mr. Peacey's remark that the share of blacks' income might rise to $15 billion out of a possible total disposable household income of $40 billion by the year 2000 illustrated the situation that the regime would like to perpetuate.

The growth momentum was coming to a halt on many fronts in the absence of fundamental changes that would bring about an optimum allocation of resources together with competition and dynamism in the economic system of the Republic of South Africa, Mr. Mtei noted. There had been a secular decline in the GDP growth rate, high rates of inflation, labor instability, rising unemployment, and a deteriorating balance of payments. Even the South African authorities themselves were aware of the dim prospects ahead, as indicated in the article published in the Quarterly Bulletin of the South African Reserve Bank, which had been cited in the staff report, and in the estimates of the Central Economic Advisory Service. It was emphasized in those publications that the slowdown in the rate of GDP growth from over 5 percent a year in the period 1967-74 to about 3 percent in 1974-83 had been due mainly to the limited availability of skilled manpower. His own assessment was that the situation would worsen in the years ahead both because of the scarcity of skilled manpower and because of the increasing number of man-days lost in strike activity. More cost-push inflation and a greater loss of markets would in turn speed up capital flight, and interest rates would remain too high to allow meaningful investment. It was in the long-run, enlightened interest of South Africa that the authorities pay heed to international advice that pointed to the urgency of reform.

Finally, Mr. Mtei said, he had been pleased to note from the staff report that an attempt had been made to obtain data on Namibia disaggregated from those on South Africa. The attempt had of course been unsuccessful but he hoped that when Namibia attained independence in the following year, it would be able to obtain its own national statistics.

Mr. Dallara recalled that at the time of the 1984 Article IV consultation with South Africa, his chair had concentrated its attention on two principal issues. First, the need to tackle some of the then existing imbalances in the South African economy; and second, the need for basic structural changes to improve the potential for growth by fully utilizing the country's human, natural, and capital resources in a more efficient and open economic setting. Progress had been made during the past year in adjusting the immediate imbalances in the economy, but in a number of areas it had been neither substantial nor, most probably, lasting. At the same time, some progress had been made in dealing with structural problems although the basic need for fundamental structural change remained.

The generally unsatisfactory performance of the South African economy in recent years had been due in part to unfavorable exogenous developments, but it had clearly also been due to inappropriate domestic policies, Mr. Dallara went on. Slow real economic growth, negative fixed investment for three years, stagnation in per capita income, rising unemployment, high inflation, and a rather fragile balance of payments position had been characteristic. Among the improvements in the economy was the significant rise in real GDP. However, fixed investment had declined, albeit at a slower rate. At the same time, the rate of inflation had fallen slightly, the ratio of the central government deficit to GDP had been somewhat lower, and there had been a major improvement in international competitiveness as a result of the sharp depreciation of the rand.

Those generally positive developments had to be qualified in some important respects, however, Mr. Dallara continued. A main source of growth during the past year had been the increase of nearly 9.5 percent in public consumption due to budget expenditure overruns. Inflation had to some degree been suppressed by delays in adjusting administered prices. The reduction in the budget deficit had relied on an emergency tax increase, and the exchange rate depreciation had not been particularly orderly.

The rather mixed performance had been accompanied by some recent favorable policy developments, Mr. Dallara commented. Renewed fiscal restraint, including public wage restraint, should encourage wage restraint in the private sector; there was also evidence of a strengthening of the current account and the balance of payments. Yet long-term growth prospects remained clouded, largely attributable to South Africa's manpower policies. The policy impediments were spelled out in some detail in both the text of the staff report and the two interesting appendices. Specifically, the continued restrictions on geographical and, to a lesser extent, occupational mobility of the labor force were inhibiting long-term economic growth potential by limiting the supply of labor, fostering capital-intensive investment at the expense of job creation, contributing to recurring shortages of skilled labor at a time of rising unemployment, feeding cost-push pressures on inflation, and fostering large wage differentials. While there had been some favorable developments in the area of training and education and in occupational mobility, they did not constitute the kind of fundamental change that was needed. He joined others in encouraging the authorities to move ahead promptly and decisively to make basic changes in their manpower policies that were essential if the South African economy was to achieve the growth potential of which it was otherwise capable.

The nonwhite labor force had made relative progress recently in real wages, Mr. Dallara remarked. However, chronic inflation problems indicated that wage restraint would continue to be necessary to contain the rapid growth of unit labor costs and at the same time help to maintain recently improved international competitiveness. In that connection, the authorities' decision not to grant any general increase in government pay rates and to reduce bonus payments should be helpful in promoting wage restraint in the private sector. Increases in prices due to exchange rate depreciation, adjustments in administered prices, and indirect tax increases were to a certain extent inevitable and even desirable. Second-round inflation based on those initial impulses must be avoided, which obviously called for monetary restraint.

Fiscal trends and policies were unfortunately not only an important underlying cause of the unsatisfactory economic performance of the past few years but were central to the stabilization of the economy and the strengthening of economic prospects for the period ahead, Mr. Dallara observed. There had been a steady upward rise in the ratio of central government expenditures to GDP, a rise that had amounted to 5 percentage points since 1980. Expenditure overruns had been an obvious problem. In 1984, the estimated growth in nominal expenditures of 12 percent had turned out to be 22 percent, and real expenditure growth, instead of being neutral, had been nearly 7.5 percent. Among other adverse effects, such a rapid growth of public spending pre-empted real resources that might otherwise be put to use in the private sector. Furthermore, the steady growth of spending and the danger of growing budget deficits had forced the authorities periodically to resort to emergency tax increases. Those had taken the form of increases in the sales tax, both in 1984 and in 1985, adding to the steady upward trend in the ratio of revenues to GDP. Apart from the fact that the ratio of direct taxes to current personal income was showing a steady rise, a growing share of general government current income was also accounted for by the individual income tax. Those trends would continue to have adverse effects on incentives to work and save and posed a serious structural problem for the longer term. Therefore, he welcomed the establishment of a Commission of Inquiry to study the tax system and make recommendations on possible changes by the middle of 1986. The authorities also needed to develop more precise spending priorities for the long term. Certainly, improved data on operations of the general government and of the public sector were required. Rough staff estimates indicated that the overall fiscal deficit might be 5 percent of GDP for the Central Government, and not 3 percent of GDP as recorded for 1984, and as much as 8.5 percent for the entire public sector.

While the setting of some monetary targets might help to achieve and maintain better control over the monetary aggregates by attempting to control nominal spending and the rate of inflation, the first priority must be to establish a credible policy of tighter monetary control, Mr. Dallara stated. The authorities would therefore have to avoid the temptation to repress a rise in interest rates; the mobility of capital necessary to allocate resources most efficiently could not be achieved in the absence of realistic interest rates. For the past few years, the overall flexibility and depth of the capital markets had been improved, and he encouraged the authorities to take additional steps in that direction to permit capital to make a positive contribution to the overall growth of the economy.

Rather dramatic movements in the exchange rate of the rand had taken place over the past year, Mr. Dallara recalled. The rapid depreciation through January 1985 had been partially reversed but the real effective rate was still well below its peak in 1983. International competitiveness seemed on the whole to have been strengthened, with favorable consequences for the profitability of the gold mining sector and of non-gold exports as well. However, the depreciation will be working its way into domestic prices in 1985, a development that would need to be taken into account in the formulation and execution of monetary policy. In the absence of sufficiently restrained financial policies, the improvement in South Africa's external position could again be rather quickly eroded. Given the low level of reserves, the volatility of capital flows, and the build-up of forward cover commitments, the authorities' adherence to a flexible exchange rate policy would continue to be important.

Mr. Nimatallah noted that economic growth had been weak, inflation had remained very high, and unemployment had risen markedly in South Africa over the past several years. Serious financial imbalances had developed, the external position was volatile, and deep-rooted structural problems persisted, particularly in the labor market. It was a poor record by any standard and was particularly disturbing from the Fund's point of view. South Africa had entered into a large stand-by arrangement in late 1982, which had supposedly been designed to help it to implement adjustment policies to deal with those problems. It would be recalled that he had expressed serious doubts at that time about the nature and scope of the proposed measures and about the heavy front-loading of drawings, which risked reducing the incentive to adjust.

Unfortunately, events had confirmed his judgment, Mr. Nimatallah continued. Indeed, the authorities seemed never to have intended to adjust seriously. The policies followed had not been consistent with the objectives of the 1982 program. There had been virtually no fiscal adjustment; government borrowing had soared; and the money supply had eluded control. That lack of resolve had exacerbated existing problems: inflation was higher than in 1982 and foreign exchange reserves had declined sharply. More fundamentally, and despite assurances to the contrary, extensive government regulation of markets had continued, with further distorting effects on resource allocation and growth potential. In effect, the Fund's limited resources had been wasted at a time when they were badly needed by other members that were prepared to adjust; that should not be allowed to happen again.

Looking ahead, it was time to reverse what the staff had called the drift of economic policies, Mr. Nimatallah said. Firm and consistent financial policies were needed to control inflation and improve growth prospects. Such policies should be accompanied by far-reaching structural reforms to improve efficiency, resource mobility, and resource allocation.

Without comprehensive budgetary accounts, it was difficult to assess fully the extent and impact of government spending on the economy, Mr. Nimatallah commented. It was also difficult to design and implement effective corrective measures. The authorities should therefore speed up the process of bringing all extrabudgetary funds into the budget. In the meantime, they should set expenditure targets that were conducive to the reduction of inflation. Every effort should be made to avoid slippages. On the revenue side, the authorities should correct deficiencies in the tax system and broaden the tax base.

It was disappointing that the authorities had failed to control the pace of credit and monetary expansion, Mr. Nimatallah said. Besides the inflationary implications, the availability of credit had facilitated the financing of capital outflows, weakening the balance of payments. A more restrictive monetary and credit policy needed to be pursued to bring inflation down and to strengthen the foreign reserve position. The introduction of monetary targets might therefore prove helpful. The exchange rate strategy had improved the competitiveness of exports, but a further reduction in domestic costs would be needed to maintain it, which, in turn, would require measures to reduce rigidities in the goods and labor market, apart from financial restraint. The authorities should also reduce their reliance on import controls and liberalize the trade system.

Finally, Mr. Nimatallah noted, as he had stated on previous occasions, the economy of South Africa would remain distorted, and its performance would be below potential, unless far-reaching social and economic changes were made to remove impediments to labor mobility and efficient resource allocation. The authorities' efforts in those areas left a lot to be desired. For example, the authorities continued to retain statutory restrictions on the geographic mobility of labor. The coexistence of unemployment with a shortage of skilled manpower reflected fundamental deficiencies in the educational system and training programs. It was a deplorable situation, particularly as it affected the majority of the population. Educational and skill differences had tended to reinforce the pattern of unequal income distribution in South Africa. Unless the South African authorities could be urged to tackle those fundamental problems in a more serious and credible manner, he could foresee more disruptions and distortions in the economy, caused exogenously by sanctions like the one imposed by the U.S. Congress, or caused endogenously by a worsening of those fundamental problems.

Mr. Goos considered that the unsatisfactory price and balance of payments performance of South Africa in 1984 could largely be attributed to lax financial policies. The aim under the 1985/86 budget to reduce the fiscal deficit was therefore most appropriate and indeed critical to the restoration of financial stability in the domestic and external economy. Renewed failure in containing the fiscal deficit would be bound to have negative effects on South Africa's economic standing. In that sense, the credibility of the country's financial policies would be put to the test in the year ahead. Further cuts in expenditure instead of another sizable increase in taxation would have been more in conformity with the Government's repeatedly declared objective of strengthening the role of private sector activity. The pronounced and lasting increase of the tax burden would certainly be counterproductive in that respect. Not much information was available about the program of privatization, which had led in late 1983 to an official announcement about the Government's intention to reduce progressively its own role in the productive sector. He had therefore been pleased to learn from Mr. Peacey's statement that privatization as a general policy was still in existence, and he asked for additional information about present plans in that respect. In any event, the introduction of the early warning system for expenditure overruns, as well as the effort to consolidate all public expenditure within the central budget, were encouraging signs of a new commitment to contain fiscal expansion.

The stop-go pattern of monetary policy in the recent past seemed to have contributed to deeply embedded inflationary expectations, as the lack of improvement in price performance indicated, Mr. Goos continued. Against that background, the reduction by the central bank of interest rates on its refinancing instruments was a cause for concern, although he had noted from Mr. Peacey's statement that the reduction, like the previous one, had been in response to declining market rates. The May adjustment had again been officially justified by the increased room for maneuver provided by external economic improvements, which must not be allowed to perpetuate past policies that had tended to place more emphasis on low interest rates than on securing an appropriate money supply. The introduction of monetary growth targets could make a useful contribution to a more stable monetary policy, provided the targets were set at a sufficiently ambitious level and supported by consistent fiscal policies.

The stabilization effort had to be complemented by measures aimed at correcting severe rigidities in goods and labor markets, Mr. Goos stated. The high degree of monopolization in the economy, stimulated by widespread protective import duties and import licensing requirements, had hampered the conduct of an efficient monetary policy; such protectionist measures also inflicted high costs on the overall economy. The rather slow progress toward dismantling quantitative import controls--as well as the intention to raise protectionist barriers in other respects--was therefore quite worrisome. In general, the authorities seemed to lack a consistent strategy for fostering competition in the goods market. A much greater role for antitrust action within such a strategy would be of critical importance to reverse the increasing trend toward monopolization.

Despite some welcome changes in South Africa's labor market policies in recent years, apartheid continued to impose a heavy burden on the overall economy, Mr. Goos said. The rigid segmentation of the labor market remained a severe impediment to the mobility of black workers, whose lower levels of education and vocational training had significantly adverse effects on productivity and on South Africa's economic growth potential. For those and for other obvious reasons, the timely elimination of all labor market restrictions would certainly be in the best interest of the country.

It was the firm belief of his authorities that international confidence would depend critically on the efficiency and stability of South Africa's economy as well as on the Government's willingness and ability to undertake further political reforms, Mr. Goos concluded.

Mr. Rye said that he found it extremely difficult to quarrel with either the staff's analysis or its conclusions.

In Mr. Peacey's statement, he had noted a reference to a decline in import volume by 7.5 percent in the first quarter of 1985, which was said to illustrate the insignificance of the very few import restrictions still in operation, Mr. Rye observed. The logic of that statement was hard to follow, and it also seemed to be at some variance with the indication by the staff that about 20 percent of total imports were still subject to licensing requirements.

A longer-term issue was raised by the "inward industrialization" approach through urbanization that had been described by Mr. Peacey and that involved a doubling of the urban population of South Africa to 30 million by the year 2000, Mr. Rye noted. Such a policy was open to serious question both on social grounds and on account of the massive economic costs entailed in the major restructuring of the economy. In view of South Africa's economic difficulties in recent years, a more gradualist approach might be more appropriate for a number of reasons, including the lessening of economic strains.

Mr. Salehkhou stated that it was evident from the staff report that South Africa had not followed the recommendations of the 1984 Article IV consultation. Lax financial policies had led to a revival of domestic demand with a consequent upswing in inflationary pressures and a worsening of the unemployment situation. Those developments had resulted from the deep structural imbalances of the economy and the disparities that existed between population groups, sanctioned by legal impediments and statutory regulations. The South African Resident Representative had clearly recognized that state of affairs by admitting that "social and economic processes can only be ensured under conditions of harmonious interregional cooperation," conditions that were clearly lacking and for well-publicized reasons.

The performance of the South African economy had been unsatisfactory over the past several years, Mr. Salehkhou commented; per capita income was stagnating, unemployment was increasing, and double-digit inflation was still on the rise. Adjustment policies repeatedly recommended by the staff had been introduced reluctantly on a perennially periodic basis only when crises had emerged. Soon thereafter, the measures had been lifted or offset by countermeasures, leading to sizable overruns in expenditures and extrabudgetary outlays.

A consistent policy to combat inflation would not only rely on traditional monetary demand management but would also tackle the problem from the supply side by making better use of the country's manpower resources, Mr. Salehkhou stated. The present Article IV consultation had revealed, just as all previous ones had, that the Government's lax financial policies had played an important role in soaring government outlays and the high pace of credit and monetary expansion, and that their consequence had been to undermine the Government's credibility in conducting economic affairs on both the national and international levels. Furthermore, the authorities' inability to establish and maintain adequate control over inflationary pressures had resulted in erratic patterns of growth and the misallocation of resources. The persistent legal interference with the functioning of the labor market had become so onerous that it had contributed to large-scale underutilization of the country's manpower. It was therefore not surprising that the budget deficit had become larger in 1984 owing to constant expenditure overruns. Even the basic principle of using the budget as a fiscal indicator was no longer valid in South Africa because of the practice of uncontrolled borrowing through extra-budgetary funds.

The economic policy of South Africa could hardly be regarded as adequate in terms of improving the standard of living of the people, since continued labor market regulations kept the growth rate below its real potential, Mr. Salehkhou observed. The progress in upgrading the skills of the population, to which the South African representative had referred, remained an elusive dream for the majority of the people. The rate of unemployment among unskilled workers was already over 20 percent and the increase in 1984 of nonagricultural employment had fallen short of the growth in the labor force, which was estimated at 2.5 percent a year. In addition, there had been an increasing number of industrial disputes and a large number of man-days lost in pay and discrimination-related strikes.

It was imperative, as he had stated on previous occasions, Mr. Salehkhou recalled, that government spending have as a clear and unequivocal objective the upgrading of the educational qualifications and skills of low-income population groups, and the removal of inhumane legal impediments to the occupational and geographical mobility of labor. The job reservation regulation, which excluded certain race groups from some categories of employment, had a negative effect on the growth of the economy, contributed to a rise in unemployment, and accentuated income differentials between groups. Those internationally illegal regulations explained clearly why there was a shortage of skilled labor on the one hand and rising unemployment of semiskilled and manual labor on the other hand, accompanied by vast geographical and racial wage differentials. The Government's expenditures on the education of various racial groups perpetuated that dichotomy as nonwhites received on a per capita basis one fifth of the allocation reserved for whites.

The Government's labor policy was not without consequence for the country's external position, Mr. Salehkhou remarked. One obvious example was the inability to capitalize on the depreciation of the rand to promote non-gold exports because the unit cost of manufactured goods kept rising due to the perpetration of capital-intensive projects when labor-intensive schemes should be developed. Furthermore, the widening scope of industrial unrest was leading to short-term capital outflows of alarming proportions that had reached their peak in early 1985. The measures introduced to curb demand in 1984 had not supported the exchange rate, which had continued to fall against all major currencies.

Prevailing talk abroad of trade sanctions and the possibility of some foreign companies withdrawing from South Africa were fostering a climate of uneasiness and lack of confidence in the future of the South African economy, Mr. Salehkhou said. The often-mentioned ban on the sale of Krugerrands would have a sizable negative impact on the current account if it were implemented. Yet against that background, the Government was continuing to allow easy access to the Reserve Bank discount window, thereby facilitating the financing of capital outflows. The results of such a policy were evident in the drain on reserves, which had reached a low of two months of imports in 1984, while total external debt had risen to 48 percent of GDP in that year from 32 percent in 1983, with moreover an unfavorable maturity structure.

Although the balance of payments remained vulnerable, the current account had staged a small comeback by the end of 1984, largely due to a reduction in imports, Mr. Salehkhou noted. Had the authorities carried out the recommendations of the staff and the Board, the external position would have improved much more, allowing the repurchase of Fund resources, of which several countries already applying Fund-supported adjustment programs were more seriously in need for the economic betterment of their own harmonious societies.

He was pessimistic about the outlook for the years ahead, Mr. Salehkhou commented, despite the recommendations implicit in the 1985/86 budget on the reinforcement of stabilization measures that had often been contemplated but never seriously considered. The fiscal deficit was supposed to be reduced, but the latest information suggested that it might be increased because government overruns were apparently difficult to control, despite extensive revenue measures. Overall growth prospects continued to be poor on account of the slowdown in economic activity and the fact that losses in some industries had offset the advantage of the depreciation of the rand. The rate of inflation was expected to increase from 11.6 percent in 1984 to 16 percent in 1985 as a result of the depreciation. While the current account was expected to show a surplus as a consequence of demand restraint, the country continued to fail to capitalize on its opportunity for increasing non-gold exports because of its biased employment practices and the consequent misallocation of available resources.

In sum, Mr. Salehkhou concluded, it was hard to accept the fact that a country with so much potential wealth had been reduced through mismanagement to seeking the limited resources of the Fund and asking for technical assistance when the majority of sub-Saharan African countries were in much greater need of the Fund's attention.

Mr. Blandin said that, like other Directors, he considered the results of South African economic management unsatisfactory. He supported the thrust of the staff's appraisal and endorsed its recommendations on the short-term adjustment measures needed in the fiscal, monetary, exchange rate, and balance of payments areas.

The long-term prospects for sustained and balanced growth in South Africa were being inhibited by structural rigidities, Mr. Blandin continued. The use of human resources in particular, despite constant advice and recommendations, had had, as the staff had stressed, "deleterious effects on the growth performance of the economy, while also contributing to the secular rise in unemployment." It should suffice to mention only some of the more obvious problems that had to be tackled: the lack of skilled workers due to insufficient educational efforts; administrative restrictions on the geographical and sectoral mobility of labor; and considerable disparities in wages and income. All those problems were linked to the maintenance of the apartheid system. Despite some recent and very timid legal progress mentioned by Mr. Peacey, numerous rigidities not only continued to exist but were evidently being institutionalized under the educational system.

In conclusion, Mr. Blandin stated, no significant improvement of the economic situation in South Africa could be expected in the absence of radical structural measures to improve the social consensus in the country.

Mr. Jayawardena said that he was in full agreement with the staff appraisal. He recalled the unanimous view of the Executive Board at the time of the 1984 Article IV consultation with South Africa that deeply buried structural problems were afflicting the economy, especially in the labor market, leading to a serious misallocation of resources and making macroeconomic management extremely difficult. At the same time, his chair had expressed the view that if the South African authorities genuinely believed that those rigidities were not holding back the progress of the economy and the people, the Fund should prepare medium-term scenarios simulating the outcome of alternative policies to demonstrate to the authorities the usefulness and practicality of reducing or eliminating those rigidities. The in-depth study that he had expected was in no way evident in the staff report, apart from the detailed account in Appendix II to the report on recent economic developments of the labor market and the reference in the staff report to recent studies showing that the growth potential of South Africa had been significantly set back by labor market rigidities. Furthermore, no medium-term balance of payments scenario was given, except for an estimate of the current account deficit in a table on medium-term debt projections; such a scenario would have been helpful because some progress might have been expected since the 1984 Article IV consultation.

The usefulness of the Article IV consultation with South Africa would have been enhanced greatly, Mr. Jayawardena considered, had the staff analyzed the country's economic problems and prospects in a more meaningful way. South Africa would also have been assisted in leaving behind it the stop-go cycle of the past enabling it to concentrate on real economic issues.

Recently, the Executive Board had been talking about improving the Fund's surveillance function, Mr. Jayawardena noted. Consultations were to be held on a more continuous basis, and staff reports on many member countries were already taking account of the outcome of the consultation for the preceding year. Unfortunately, that approach had not been adopted in the staff report for the 1985 Article IV consultation with South Africa. Annual consultations with South Africa could not serve a very useful purpose if they revealed little or no visible improvement from year to year. Thus, he joined other Directors in urging that the staff reports for all Article IV consultations be framed against the background of the discussion in the Executive Board. More specifically, he would like to know in 1986 what action the South African authorities had taken to deal with their manpower problems and structural rigidities; if no action had been taken, he would want a good economic explanation.

That line of action was necessary because all the evidence indicated that structural problems were at the root of South Africa's difficulties, Mr. Jayawardena concluded. Also, the Fund had to be concerned to protect the revolving character of its resources. Finally, to be effective, surveillance must be improved.

Mr. Clark commented that recent economic developments and economic management in South Africa were indeed disturbing, in particular because the authorities seemed to have responded to problems with ad hoc measures, which had sometimes been reversed when signs of improvement were seen, rather than with a consistent long-term strategy. Furthermore, some recent objectives had been incompatible; for instance, attempts to keep interest rates low and then to prevent exchange rate depreciation had been equally ineffective. He did not deny that South Africa's problems had to some extent been caused by exogenous factors, including the effects of drought and most notably the continued weakness of the gold price. As Mr. Peacey had stated, such problems were common to many developing countries, but South Africa's policies had not increased the resilience of the economy to withstand such shocks. Instead, a large number of regulations and controls had been introduced that damaged growth prospects in the longer run. The importance of growth was well brought out by the staff's statement that sustained increases of 4.5 percent a year in output would be needed to absorb the growth of the labor force.

The economy of South Africa was at present delicately poised, Mr. Clark remarked, to use the staff's words. The current account had begun to improve quite sharply in response to the tightening of fiscal policy earlier in 1985 and to the fall in the exchange rate. Developments in the first quarter of the year suggested that the projected surplus of SDR 1 billion in 1985 might be exceeded. But against the background he had outlined, such an outcome should not be the basis for a relaxation of policy: the authorities should be urged to take the opportunity to introduce measures designed in a medium-term framework to bring about lasting improvements in the public finances. He emphasized in particular the need for expenditure restraint, which would in turn help to control monetary growth, to contain inflationary pressures, and to relieve the current burden of high real interest rates. The consistent pursuit of those objectives would also enhance the credibility of government policy, with beneficial effects on confidence.

Another essential component of such a strategy must be structural change in the labor market, as all other Directors had emphasized, Mr. Clark continued. The authorities seemed to have recognized that rigidities in that area had inhibited and would continue to inhibit economic development, but there was a large step to be taken between diagnosis of the problem and the adoption of policies that would bring about significant progress in remedying that important economic weakness.

The increase in central government expenditure since 1980 had been accompanied by a sharp rise in the tax burden, Mr. Clark noted. Although the budgeted reduction in the deficit as a percentage of GDP would be welcome, if achieved, it was disappointing that more of the adjustment was not planned to come from the expenditure side. The budget did, however, assume the success of public sector pay restraint and a considerable slowing of the growth of interest payments on public debt, but he would be interested to know what further scope there was for economy in other areas of expenditures.

Fiscal imbalances and the associated high real interest rates were having an adverse effect on other members of the Rand Monetary Area, as he had pointed out at the time of the 1984 Article IV consultation with South Africa, Mr. Clark went on.

In light of the importance he attached to establishing a medium-term framework for policy, the authorities should be encouraged to adopt a system of publicly announced monetary targets, Mr. Clark stated. However, recent shifts in the velocity of circulation of money had probably been associated with reintermediation and the process of financial innovation, suggesting that the target range should probably be largely indicative at first. The broader monetary aggregates seemed to have been distorted less and might provide more suitable targets. Consequently, he accepted the authorities' view that even if monetary targets were adopted, attention would still have to be given to a range of monetary indicators.

The medium-term projections and sensitivity analysis of the balance of payments brought out the potential debt-servicing difficulties faced by South Africa, Mr. Clark remarked. However, it would have been useful if those projections had been developed rather more fully.

Mr. Fugmann said that his authorities were in agreement with the staff's explicit and detailed critical assessment of economic policies in South Africa. Excessive government spending, a far too accommodating monetary policy, and the lack of persistent stabilization efforts had contributed to the unsatisfactory economic performance. Thus, even though there were several reasons for that outcome, factors relating to the apartheid system had such clearly negative effects that sound economic development was seriously obstructed. He referred to the effects produced by, for instance, the lack of mobility in the labor market and the unsatisfactory educational opportunities for a large part of the population. Measures adopted to liberalize labor market policies in recent years were clearly insufficient because they had not brought about any change in the system's foundation. The continued fight against inflation would need to be combined with far-reaching structural changes designed to remove artificial obstacles to the allocation of resources.

He had noted the staff's criticism of South Africa's statistical reporting, Mr. Fugmann concluded. He also agreed that it was incorrect for South Africa to report statistics on Namibia to the Fund as if Namibia were part of South Africa.

Mr. Polak stated that Mr. Blandin's comments reflected his own views. On a technical point, he noted that the staff and Mr. Clark had cautiously commended the authorities for giving consideration to targeting the money supply. It seemed to him that decades of experience in the Fund suggested that a country like South Africa, faced with an overwhelming risk of capital outflow, would do much better to target domestic credit expansion rather than the money supply. The reason was simple and had been stated often: if capital flight drained money out of the country, a money supply target would attempt to dam up the flow, which would however continue, whereas adherence to a domestic credit target would push up interest rates and stem the outflow.

The staff representative from the European Department noted that the policy of announcing monetary targets that the authorities intended to introduce could, in principle, play a useful role in dampening inflationary expectations and promoting a stable financial framework. At present, however, some caution was called for in pursuing such targets as the velocity of circulation of money was still rather volatile, suggesting that the authorities might run the risk of failing to meet the targets--thereby undermining credibility--even though monetary conditions might in a broader sense be appropriate. Given the authorities' adherence to a flexible exchange rate policy, it would probably not make much difference if the authorities targeted domestic credit expansion rather than the money supply. At any rate, if the authorities were to pursue monetary targets, it would obviously be necessary for them to try to reach them by restraining domestic credit expansion rather than by allowing any sizable outflows of foreign exchange through the balance of payments.

The staff shared Mr. Goos's feeling of unease about the authorities' recent decision to lower official rediscount rates, the staff representative continued. It was not, of course, surprising that market interest rates had tended to come down in recent months. The growth of nominal spending had been slowing down since the latter part of 1984, and there were indications that the demand for credit had been subsiding; the balance of payments on current account had been improving and was back in surplus; and the budget had been relatively well received by the markets, thereby helping to restore business confidence. Nevertheless, it was still very important for the Reserve Bank not to be seen as taking the initiative in pushing interest rates down. The rate of inflation was still very high, the capital account of the balance of payments remained weak, and the credibility of policy in general had not yet been fully restored. In the circumstances, the staff believed that it would have been preferable for the Reserve Bank to have waited until the banks themselves had lowered their lending rates before taking any action to reduce its rediscount rates. Moreover, it remained advisable for the authorities to "lean against the wind" by resisting to some extent the downward pressure on interest rates until inflation was firmly under control.

The lack of consolidated data for the public sector as a whole was a serious constraint on the assessment of the stance and effects of fiscal policy, the staff representative noted. Statistics on the finances of the larger public enterprises were available, and they indicated that in some cases their financial position was rather weak. Nevertheless, most of the difference between the deficit of the Central Government and that of the broader public sector was accounted for by the investment expenditure of the public corporations rather than by operational deficits of public enterprises.

No specific steps toward privatization of public enterprises had been taken since 1983, when there had been a sale of the South African Coal, Oil, and Gas Corporation (SASOL) shares, the staff representative reported, but the authorities had indicated at various times their continuing interest in the policy, and in the budget for 1984/85 they had announced that certain hospital services would probably be privatized.

The steady rise in the ratio of government expenditure to GDP in the past few years had reflected to some extent unforeseen developments, the staff representative remarked, but in a few instances it had resulted from inadequate allowance for expenditures that were fully foreseen. The authorities had taken measures in the 1985/86 budget that would allow them to improve public expenditure control and avoid the overruns of the past few years. It remained to be seen whether those measures would prove adequate. The obvious candidates for expenditure restraint were pay rates and employment in the public sector, but it was also clear that the easing of restrictions in the labor market would in due course create scope for reducing some items of public expenditure, for instance, subsidies paid to commuters.

The potential impact of rigidities in the labor market on the growth performance of the economy over the medium term had been discussed with the authorities for a number of years, the staff representative explained, and the adverse implications of maintaining those restrictions had been re-emphasized in the staff reports. Alternative scenarios of the economy's growth performance in the absence of those restrictions would be very difficult to construct and would have to be based on a large number of speculative assumptions. The staff had taken note of the suggestion that more detailed projections of the balance of payments over the medium term should be made.

Although South Africa had made some progress in the past few years in moving from a protective trade system that relied heavily on direct controls to tariff protection, the staff representative observed, the percentage of imports remaining subject to direct controls was still relatively high.

Mr. Peacey remarked that a rapid turnaround was under way at present in the monetary and balance of payments positions, particularly over the past two months, and he pointed out that South Africa had both a volatile and resilient economy.

As for short-term movements in the monetary area, Mr. Peacey noted, at the time of the budget in mid-March, short-term treasury bills tendered had yielded a return of 21.8 percent, whereas the rate during the previous week had been 18.78 percent. Moreover, despite tender applications of some R 300 million, the Government had been able to allot only R 100 million at 17.5 percent. Thus, since the budget date, the rate on treasury bills had declined by some 4.5 percent. Furthermore, whereas the prime rate had been 25 percent at the time of the budget, it had declined with the discount rate of the Reserve Bank, which had been reduced twice by 1 percent. In addition, the differential between the prime rate and bankers' acceptance rate had increased from 3.5 percent to 5 percent, despite the reduction of the prime rate by 2 percent. On the previous day, 3-year government stock of 1988 had yielded about 15.69 percent, and stock of 2005 and 2006--21-year stock--had yielded about 15.41 percent and 15.72 percent, respectively. Thus, the 3-year and 21-year rates were very much in line, indicating that the process of rectification of the inverse interest rate structure was under way. Interest rates were declining at a time of substantial outflow of short-term funds, while the rand exchange rate had remained firm. There had been a virtual cessation of demand for credit because of the lack of consumption spending. The South African authorities had repeatedly confirmed their commitment to austere monetary and fiscal policies for as long as was necessary.

Privatization assumed an important position in the philosophy of the South African authorities and was of equal interest to an important regional institution in the sphere of development, namely, the Development Bank of Southern Africa, Mr. Peacey said. The South African Government had promoted the sale of shares in the South African Coal, Oil, and Gas Corporation (SASOL), and the Iron and Steel Corporation (ISCOR) had sold some of its subsidiaries. Certain governmental services, such as hospital services, had also proved to be more efficiently run when operated by the private sector than by the government sector. The South African authorities had desisted from becoming involved in housing schemes other than those aspects involving low-cost housing and urban infrastructure. But apart from withdrawing from activities that might be better undertaken by the private sector, the Government was also actively engaged in an effort to improve productivity in the public sector itself. A major overhaul of the government structure was under way and the State President had asked the State President's Council to investigate ways of eliminating red tape and of promoting deregulation in general. Nevertheless, it would obviously be necessary to take care not to increase costs by replacing one monopoly by another, especially given the large developing component of the South African economy.

He held no brief for the Development Bank of Southern Africa, which had been established by treaty, Mr. Peacey remarked. He would merely point to an interesting passage in its recently released annual report, in which the Chairman stated that "it is gratifying that in addition to the large number of standard infrastructure projects handled by the Bank that were processed, the Bank also received a number of applications that provided it with the opportunity to experiment with the application of guidelines for interstate cooperation and private sector involvement. As far as private sector involvement is concerned, it became apparent that in addition to advising participating governments on steps to encourage and facilitate private sector involvement, there is also a clearly apparent need to change a persistent perception on the part of the private sector that development is essentially a public sector responsibility."

He would respond bilaterally to the question that had been raised about South Africa's import restrictions, Mr. Peacey added. In addition, he would defer a response on the outcome of the De Kock Commission as its report was expected to be issued in the weeks ahead.

The increasingly important role of the Fund in appraising macroeconomic policies of member countries, and the interesting mix of developed and developing components in the South African economy, suggested that it would be useful to respond in a more fundamental way, both directly and indirectly, to the points made by Executive Directors by addressing the broader economic circumstances from which financial policymaking in South Africa was derived, Mr. Peacey considered.

First, the exceedingly difficult environment with which the South African authorities had had to cope during the past four to five years, to cite the President of the World Bank's remarks on sub-Saharan African countries, made the recent "preoccupation of policymakers with crisis management... understandable," Mr. Peacey continued. Unless exogenous factors should strike again, however, South Africa was emerging from that extraordinarily difficult condition with its economic structure and development momentum intact and without an undue long-term foreign debt burden. Despite shortterm budgetary pressures, the South African Government had recognized--to quote again from remarks by the President of the World Bank--that the Bank "has a responsibility to look beyond current crises and address investment issues and policy and institutional reforms that are crucial to the securing of sustained growth and social progress." Indeed, the President of the World Bank had warned that the preoccupation of policymakers with immediate pressures tended to remove the focus from a number of longer-term development issues on which action was no less urgently required. In that context, as must be evident, his authorities had been paying unremitting attention to the implications of the rapid growth of the country's population and particularly to those aspects of economic dispensation that might have been hampering rapid adjustment and, hence, the return to a sustainable growth path commensurate with those population pressures.

The South African authorities recognized that there might be certain bottlenecks or disfunctions to growth, or in the words of the President of the World Bank, obstacles or weaknesses, Mr. Peacey remarked, but they did not consider those hindrances to be permanent rigidities. The role of his authorities in support of investment and the promotion of socio-economic welfare, as of the World Bank, was an evolutionary one. However, he wished to associate his authorities with the view expressed by the Fund staff with respect to the global effects of Fund-supported adjustment programs (SM/85/97, 4/4/85). Such Fund programs "should be assessed in the medium to long term (certainly more than a year) rather than in the short run; adoption of an excessively short-run framework will almost inevitably ignore any positive growth effects of supply-side and structural measures in programs, and will make it very difficult to distinguish between the adjustment to a sustainable internal and external position and that sustainable position itself." The President of the World Bank had addressed the question of the pace at which the development adjustment process took place very well when he had stated that "the problems which we typically have to address require a series of operations that act in a cumulative manner and proceed at a politically realistic pace. One cannot 'jump start' a developing economy."

A new phase of growth in South Africa was taking place in a longer-term context, Mr. Peacey emphasized. Whereas economic growth in South Africa between 1930 and 1960 had been largely related to the urbanization of the domestic white population, and the rapid expansion of the 1960s had been largely a function of immigration from abroad over more than a decade, the third wave of industrialization in the decade and a half until the end of the century would be urban based, supported by the substantial movement of the rapidly growing black population into existing and emerging cities. It was important to note, however, that the first two periods had created, with the support of the public sector, breathing space for the private sector to expand and for the open market and free enterprise philosophy irrevocably to take root in South Africa. Indeed, his authorities were bound by the country's 1983 constitution "to further private initiative and effective competition." That point underlined the extent to which his Government was committed to applying market-oriented instruments on the one hand, and the extent to which developing societies would be exposed and have to adjust to such philosophies in the process of economic development on the other hand. More important, however, economic development in South Africa was also set to be geared to a growing, increasingly dynamic and self-reliant domestic market. That stabilizing progress might be worth closer analysis in the southern African context.

Another feature of the developing South African economy was the marked extent to which, as in the developing world at large, national and regional differences and complexities belied superficial, sometimes perilously stereotyped, observations of existing conditions, Mr. Peacey observed. Regional economic development in South Africa was therefore promoted with due regard to the distinctive features of each region within the country. Moreover, his Government had stated in a recently published white paper on industrial development strategy that it accepted that the Republic of South Africa would have to adapt to changes occurring in the international economic environment if it wished to compete successfully in the world's market places. It had added that the Government also "accepts that, because of the divergent nature of different industries, it is not possible to develop uniform and identical strategies with a view to achieving the objectives laid down. It is necessary to develop distinctive strategies for different industrial sectors on the basis of their potential and the importance of the contribution which they make to economic growth and in terms of factors such as the provision of employment, technology and technical innovation. In that connection, the Government intends to make studies on a sectoral basis and to develop, in consultation with the various sectors, strategies which will address the distinctive needs of those sectors." The white paper pointed out that "differentiated strategies will always have to be in keeping with the international trade commitments of the Republic of South Africa." As was evident, the authorities encouraged the private sector to seek out profitable development ventures. Consequently, the market--including the financial service sector--would play an important role in the identification, location, and cumulative support of the development process.

At the time of the 1984 Article IV consultation with South Africa, he had drawn attention to the substantial financial implications of the urbanization process, Mr. Peacey recalled. In that connection, he wished to refer to the interesting conclusions of an article in the most recent issue of Finance & Development on the financial pull of urban areas in developing countries. 1/ One salient observation of the author was that the basic policy issue in that respect was not so much the financial urban bias of savings as such but rather the extent to which urban-biased savings further accentuated regional economic disparities. As the author had observed, "the criteria for redressing financial urban bias derive from considerations of dynamic economic growth and allocative efficiency, as well as regional equity and welfare."

It was for just such reasons that his authorities had attached so much importance to the invaluable ongoing research being done by numerous commissions and institutions in South Africa, such as the De Kock and Margo Commissions and the Development Bank of Southern Africa, Mr. Peacey

1/ Amand G. Chandavarkar, "The Financial Pull of Urban Areas in LDCs," Finance & Development, International Monetary Fund and International Bank for Reconstruction and Development (Washington), Vol. 22 (June 1985), pp. 24-27.

said. They recognized the close interrelationships, through the market, between domestic development and foreign economic processes that had such an important bearing on the country's balance of payments and reserve positions. In a nutshell, his authorities recognized the encouraging possibility of alleviating, with the passage of time, the severe impact of volatile external conditions on domestic conditions--to which he had referred in his opening statement--and thus of promoting exchange stability through the maintenance and promotion of orderly, balanced development of all the country's productive resources through open markets.

In South Africa, as had been observed by the President of the World Bank with respect to the economic needs of developing countries in general, Mr. Peacey went on, "the agenda ahead of us is a full one, and our future role in helping the adjustment and long-term development process will make heavy demands on our energy and ingenuity. And it will demand sustained support from the international community."

Finally, Mr. Peacey assured the Chairman that his authorities would be giving the comments of the Board the serious attention they deserved.

The Chairman made the following summing up:

> In concluding the Article IV consultation with South Africa for 1985, Directors expressed their broad agreement with the thrust of the staff appraisal. They noted with concern the deterioration in the performance of the economy over the past several years as reflected in slow growth of output, high unemployment, the persistence of double-digit inflation, and the recurrent weakness of the balance of payments. While the volatility of the external environment had contributed to those developments, Directors emphasized that economic policies had failed to deal adequately with the task of promoting financial stability and reducing structural problems.
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> Directors noted that the massive depreciation of the rand between June 1984 and January 1985 was symptomatic not only of exogenous factors but also of the failure to implement timely and comprehensive adjustment policies. The rapid growth in government spending and the inadequate control of the money supply had been particularly damaging in this respect. While the current account had strengthened in recent months, the outflow of short-term capital was continuing, despite the tightening of monetary policy, and the overall external position remained precarious. This underscored the need for continued efforts to promote adjustment and restore credibility in economic policies. Speakers generally emphasized the importance of pursuing firm financial policies over the medium term and of resolutely tackling the structural problems so as to bring inflation under control and to promote balanced growth.

In view of the sharp rise in the ratio of central government expenditure to GDP in recent years, which had been compounded by extrabudgetary spending, Directors regretted the inadequate restraint on the spending side in the 1985/86 budget. Directors noted, however, the tightening of fiscal policy envisaged in the 1985/86 budget and urged the authorities to ensure the implementation of the intended policy. Directors said that the South African authorities should set clear objectives regarding the path and composition of government spending as well as a clear timetable for the implementation of privatization, while bearing in mind the need to avoid a further substantial rise in the overall tax burden. Directors also encouraged the authorities to proceed expeditiously with the compilation and publication of reliable data for the entire public sector; such data were viewed as indispensable for the assessment of the stance and effect of overall fiscal policy.

With regard to monetary policy, Directors noted that the authorities had failed to keep the pace of credit and monetary expansion under control. They judged that the authorities' reluctance to allow interest rates to rise was perhaps the most important factor behind the rapid growth of money and credit during 1984. While the growth of nominal spending now appeared to have begun to slow, following a tightening of monetary policy in the second half of last year, Directors judged it imperative for the authorities to avoid a relaxation of policy until there was clear evidence that the rate of inflation was subsiding. Directors stressed that the key issue facing the monetary authorities was how to maintain over the long term a course of policy conducive to a progressive reduction in the rate of growth of nominal spending and inflation. They observed that, although the introduction of publicly announced monetary targets could serve a useful purpose in pursuit of such a policy, the successful application of monetary or domestic credit targeting would hinge on the authorities' willingness to allow interest rates to be determined flexibly.

Directors strongly advised the authorities to undertake major structural reforms so as to reduce distortions in resource allocation. In that context, they expressed very serious concern about the rigidities that continued to prevail in the labor market. Directors emphasized the harmful effects that labor rigidities have had on the functioning and the growth performance of the economy and the efficiency of resource allocation by encouraging a rise in the capital intensity of production and compounding the effects of bottlenecks in the labor markets. They again urged the authorities to take major steps to reduce labor constraints, including steps to enhance the geographical and occupational mobility of labor and narrow the existing large gap in educational opportunities between various population groups, which would lead in time to a clear improvement in the performance and the growth potential of the economy.

Directors agreed that the continuation of a flexible exchange rate policy was in general appropriate. Directors observed that, while the large depreciation of the rand in the past year or so had imparted a further inflationary impulse to the South African economy, it also had resulted in a marked improvement in the competitive position of the non-gold traded goods sector. Directors cautioned, however, that the competitive gains would disappear quickly unless the existing large gap between cost increases in South Africa and those in the main trading partners were narrowed substantially. They emphasized that financial restraint was indispensable in this respect but that it needed to be supplemented by more fundamental action to increase competition in the markets, including action to roll back direct import controls.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/91 (6/7/85) and EBM/85/92 (6/7/85).

3. NIGER - TECHNICAL ASSISTANCE

In response to a request from the Nigerien authorities for technical assistance in the areas of Treasury operations and budget procedures, the Executive Board approves the proposal set forth in EBD/85/139 (6/3/85).

Adopted June 7, 1985

APPROVED: March 27, 1986

LEO VAN HOUTVEN
Secretary