April 18, 1997
Approval: 4/25/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/51

10:00 a.m., May 29, 1996

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
A.A. Al-Tuwaijri	S.M. Al-Turki
	A. Fayolle
	H. Paris, Temporary
	M.B. Alemán, Temporary
	A. Ruocco, Temporary
I. Clark	C.X. O'Loghlin
B.S. Dlamini	J.A.K. Munthali, Temporary
H. Evans	J. Shields
	C. Austin, Temporary
K.P. Geethakrishnan	H.B. Disanayaka
	R. Kannan, Temporary
	J.C. Martinez Oliva, Temporary
J.E. Ismael	L.M. Cheong
	D. Gotz-Kozierkiewicz
	H. Kaufmann, Temporary
	W.C. Keller, Temporary
A. Kafka	J. John, Temporary
	J. Prader
	A. Cserés
	H.A. Barro Chambrier
K. Lissakers	B.S. Newman
	M. Brettschneider, Temporary
	T. Oya, Temporary
A. Mirakhor	M.-H. Mahdavian, Temporary
	J. Leiva, Temporary
	R. von Kleist, Temporary
	Y.Y. Mohammed
	T.K. Gaspard, Temporary
	B. Andersen
D.V. Tulin	A.V. Mozhin
	V.Y. Verjbitski, Temporary
E.L. Waterman	J.-H. Kang
	I. Moon, Temporary
J. de Beaufort Wijnholds	O. Havrylyshyn
	Han M.
	He J., Temporary

L. Van Houtven, Secretary and Counsellor
A. Rotenberg, Assistant

Also Present

IBRD: L.E. Derbez, South Asia Regional Office; G. Tidrick, Africa Regional Office; and S. Hume, Latin America and the Caribbean Regional Office. African Department: A. Basu, Deputy Director; C. Brachet, Deputy Director; G.E. Gondwe, Deputy Director; P.A. Acquah, B.F.W. Bingham, P. Doyle, J. Fajgenbaum, C.A. François, H. Hino, R.D. Kibuka, J.T. Reitmaier, S. Shirai. Central Asia Department: H. Neiss, Director; B.B. Aghevli, Deputy Director; W. Chu, C.V.A. Collyns, D. Goldsbrough, M. Muhleisen. European II Department: J. Odling-Smee, Director. External Relations Department: S.J. Anjaria, Director. Fiscal Affairs Department: A.M. Wolfe. Legal Department: J.M. Ogoola. Policy Development and Review Department: D.N. Lachman, Deputy Director; J. Gold, S.M. Schadler, C. Puckahtikom. Research Department: J. Santaella. Secretary's Department: R.H. Munzberg, Associate Secretary; K.S. Friedman. Southeast Asia and Pacific Department: K. Saito, Director; A. Singh, Deputy Director; G. Bascand, J. Hicklin, M.R. Kelly. Western Hemisphere Department: C.M. Loser, Director; J.-P. Amselle, S. Backes, G. Bindley-Taylor, E.S. Kreis, S.P.O. Itam, S.P. Tokarick, G. Yadav. Advisors to Executive Directors: P.A. Akatu, L. J. F. Erasmus, S. S. Farid, K. M. Heinonen, A. R. Ismael, J. Jonáš, B. Konan, Y. Margoninsky, M.F. Melhem, G. Mucibabici, R. Rainford. Assistants to Executive Directors: R.D. Bessone Basto, P.I. Botoucharov, A.G. Cathcart, C.K. Duenwald, S. Fukushima, M. Giulimondi, D.S. Hakura, J. Hamilius, R.J. Heinbuecher, O.A. Himani, T. Issataev, E. Kouprianova, K. Kpetigo, T.-M. Kudiwu, G.A. Kyriacou, J. Mafararikwa, Ng C.S., A.R. Palmason, N. Prasad, G.P. Ramdas, M.W. Ryan, D. Saha, S. Simonsen, Song J., V. Trivedi, L.B.J. van Geest.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director stated that his visit to Indonesia in the preceding week had occurred at the end of the Article IV mission. The visit had been designed in part to reinforce the work of the mission and in part to enable him to meet the policymakers and get a better sense of the situation in Indonesia.

The President had welcomed an exchange of views on the state of the economy, and in particular on the issues of how to deal with the risk of overheating and with potential banking system problems, the First Deputy Managing Director said. The current account deficit was heading toward 4 percent of GDP, and the inflation rate toward 10 percent. Action was required, but the problems were not of serious concern, in the sense of a looming crisis. The President had clearly thought about those issues in advance, and it was clear that the government was thinking them through.

Meetings held with the Minister of Finance, the Minister of Economic Coordination, and the Minister of Planning had been equally constructive, covering the same two topics—the overall macro situation and the banking situation—the First Deputy Managing Director continued. The discussion with the Governor of the central bank, who had graciously hosted the visit, also extended to other aspects of the economy and to issues in central banking. Indonesia's credit was very good. During the period of his visit, Bank Indonesia had arranged an impressive $500 million stand-by line of credit for 10 years with a very large group of banks at 61.25 basis points above LIBOR.

An interesting lunch had also been held with six of the seven "samurai"—the seven renowned economists who had designed and had been running Indonesia's economic program for many years, the First Deputy Managing Director added. The discussion had focused on how the program had evolved, and the current economic prospects, as well as Indonesia's interest in the international multilateral debt initiative. He also had given a public lecture in Jakarta to the Indonesian Economic Scholars Association on "Sustaining Success in the ASEAN Countries," and another at the Gudgemuda University in Yogyakarta, where the facilities—and the questions posed by the students who had attended the lecture—were outstanding.

On the whole, the government appeared to be well aware of the problems it faced, the First Deputy Managing Director said. The authorities recognized that the creation of a fiscal surplus would help ease the current account pressures and avoid an appreciation of the currency. At the same time, that fiscal prescription was difficult to accommodate for a country with a balanced budget requirement. Nevertheless, the authorities were certainly thinking about how to deal with creating a fiscal surplus in the current situation, and would likely move in that direction in some manner, although perhaps not with a great deal of public announcement.

2. NEPAL—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Nepal (SM/96/116, 5/15/96). They also had before them a background paper on selected issues (SM/96/117, 5/16/96).

Mr. Ismael made the following statement:

Nepal's economic performance improved in 1995/96, thanks to a weather-induced bumper harvest and stronger growth in the manufacturing and services sectors. An encouraging development was that the rise in nonagriculture (particularly manufacturing) activity was fairly broad based, reflecting to some extent, the success of earlier reform efforts. At the same time, inflation remained stable and the external position has recovered ground lost earlier in the fiscal year, with official reserves rising to 4.6 months of imports by mid-March.

While political events over the past two years have, regrettably, slowed the implementation of some structural reforms, the authorities remain committed to the reform process and the pursuit of sound macroeconomic policies. The new coalition government that was installed in September 1995 recognizes that concerted efforts are needed to make up for lost ground and revitalize the reform process. In this regard, my authorities are grateful for the frank exchange of views with the staff during the consultation discussions with Nepal. They endorse the general thrust of the staff report and welcome the policy advice to address emerging macroeconomic imbalances and pave the way for sustainable long-term growth.

As noted in the staff report, my authorities have never shirked from taking corrective measures to address macroeconomic imbalances and would like to reaffirm their commitment to the pursuit of sound stabilization and structural reforms. They look forward to continued Fund support in their endeavors and intend to pursue a policy package that can be supported by the Enhanced Structural Adjustment Facility (ESAF). In addition to its important catalytic role in facilitating financial flows from multilateral and bilateral donors, the Nepalese authorities also regard the ESAF as providing a valuable framework for achieving continued financial discipline and for persevering with the reform process.

Toward this end, my authorities are committed to a new medium-term program to revive the momentum of structural reform, as well as building upon earlier progress in macroeconomic stabilization. The program involves a three-pronged strategy of (a) economic liberalization to create an environment conducive to dynamic private sector development; (b) continued financial discipline to ensure macroeconomic stability; and (c) a reorientation of the role of government, focusing on improving Nepal's infrastructural and human capital stock. It is envisaged that these policies will help sustain high and broad-based growth which, in turn, would pave the way for improved living standards and a reduction in poverty.

My authorities have already implemented several key policy measures to maintain macroeconomic stability, including increases in interest rates and substantial adjustments of public sector prices for fertilizer and petroleum products. It is recognized that macroeconomic stability in Nepal hinges on fiscal discipline. In this regard, budgetary management and expenditure controls are being rationalized to ensure a stronger grip on public finances. Actions taken include tightened procedures for expenditure releases and intensified project monitoring to reduce the time lag between domestic expenditure commitments and reimbursements by external donors. A pilot project is under way to develop a new financial management information system for financial offices at the district level. Measures have also been introduced to cut back on spending on low-priority projects, as well as to postpone the implementation of projects that have not yet been launched. The implementation of these budget management reforms will help ensure that fiscal policy is firmly back on track in 1996/97.

At the same time, my authorities recognize the need to pursue further measures to broaden the tax base and improve tax administration. In October 1995, the revised 1995/96 Budget included a program to expand the tax net to 50,000 new tax payers. Following legislative approval of the value added tax (value-added tax) in December 1995, preparations are under way with the aim of introducing the value-added tax in 1996/97. In this regard, my authorities welcome the technical assistance being provided by USAID and other bilateral agencies. The authorities recognize the need to limit the use of new tax holidays as an investment incentive and intend to review the Industrial Enterprise Act accordingly.

My authorities share the staff's views about the advantages of maintaining the close economic and financial linkages with India and intend to continue with the present exchange rate peg in the near term. The peg has helped to anchor financial policies. In this exchange rate setting, the authorities' twin objectives for monetary policy are to maintain a comfortable foreign reserve position while ensuring sufficient liquidity to meet the needs of a growing economy.

In terms of progress in privatization, 10 out of a total of 62 public enterprises were either sold or liquidated between 1991 and 1994. My authorities are committed to accelerating the privatization process by privatizing/liquidating another five enterprises by the end of 1995/96 and a total of 14 enterprises by the end of 1996/97.In addition to outright privatization of public enterprises, my authorities are also encouraging private sector participation in the telecommunications and power sectors. At the same time, appropriate steps will be taken to improve management of enterprises remaining in the public sector.

My authorities are aware of the importance of financial sector reform in ensuring a dynamic private sector role in developing a modern, market-oriented economy. In this regard, my authorities share the staff's view that a major priority is the restructuring and eventual privatization of the two large publicly owned banks. The government is in the process of selling another 5 percent of shares in Nepal Bank Limited to employees. Effectively, this would raise private ownership of the Bank to 54 percent. A further divestment of 20 percent of the Bank's shares will be made in 1996/97. A comprehensive restructuring and rehabilitation program is being considered for the Rastriya Banijya Bank as a prelude to eventual privatization. My authorities welcome the Fund's plans to provide technical assistance to help improve the efficiency of the financial system and strengthen central banking operations.

My authorities acknowledge the staff's views on the importance of trade reform. Their commitment to liberalize trade restrictions over the longer term remains unchanged. Import tariffs will be streamlined in coordination with the broader tax reform package. Nepal has obtained observer status in the World Trade Organization (WTO) and will consider applying for full membership, based on the experience gained. To facilitate an early decision on membership in the WTO, my authorities have also requested the WTO to assess the implications of full membership for Nepal.

In closing, I would like to reiterate that my Nepalese authorities are determined to continue the pursuit of a strong macroeconomic and structural reform program. As in any country, whenever there is a change in government, the result is often political uncertainty and the inevitable delays in policy implementation. This has been the case for Nepal. However, the policy stance remains unchanged and the new government is committed to continuing with the reform process to ensure the successful integration of Nepal into the global market economy. My authorities are determined to make up for lost time and move forward at a faster pace. They recognize the urgency for remedial measures to address the narrow production base and the vulnerability of the export sector. In this regard, my authorities would like to express their appreciation to the Fund and other multilateral and bilateral donors for all their support and assistance in facilitating Nepal's economic transformation. My authorities look forward to the continued support of the international community for their endeavors. Such support is essential to enable Nepal's reform process to proceed more quickly and set Nepal firmly on the path of sustainable growth and macroeconomic stability over the longer term.

Mr. Moon made the following statement:

First, let me join other members of the Board in commending the staff for its high-quality work in preparing the staff report and the background paper.

I think it is fair to say that the recent economic performance in Nepal has been mixed. On the positive side, progress has been made in moving ahead with a number of structural reforms, including the planned introduction of a value-added tax as well as instituting a process through which government expenditures could be reviewed and prioritized. Notwithstanding such progress, macro-economic management this year has not been satisfactory. I believe that the heart of the problem lies in the following two elements:

First, on the fiscal front, government has failed to contain the level of budget deficit.

Second, the monetary authorities have accommodated the fiscal slippage by extending credit to the government while not sufficiently raising the interest rate in the treasury bills auctions.

This in turn implies that the authorities must tackle the problem on both of these fronts in order to put macroeconomic management back on track for the rest of the year and beyond:

More specifically, the authorities should stick to their plan of curtailing nonessential expenditure during the rest of the fiscal year in line with the downward revision of the revenue projections. To support such efforts, timely monitoring of the fiscal outcomes would be needed and the formulation of a contingent expenditure plan, depending on the revenue outcome, would also be helpful. For the fiscal year 1996/97, an expenditure plan should be made based on a more realistic projection of revenue, and government domestic borrowing should be contained to half a percentage point of GDP as proposed in the staff report.

On the monetary side, the exchange rate peg with India naturally implies that the monetary stance of Nepal must closely follow that of India in order to sustain the fixed exchange rate regime and reap the benefits of the fixed exchange rate regime. Loosening of the monetary stance through monetization of the budget deficit threatens the very base of macro-stability. In this respect; the proposed plan to put a ceiling on the central bank credit to the government is an appropriate step to take and should be strictly adhered to. At the same time, measures to deepen the government securities market should be implemented, such that noncentral bank financing of the budget deficit could be achieved without too much pressure on the market.

Lastly, since policy slippage in recent years would have undermined the general credibility of the government's policies, authorities should take additional care to build up credibility. This would require, among other things, formulation of realistic goals and achieving them.

We wish the authorities the very best in the challenging period ahead.

Mr. Disanayaka made the following statement:

The excellently compiled staff reports testify that this has been a year marked by good macroeconomic performance, but Nepal is still challenged by many of the problems that we had visited last year. Admittedly, there are no short term solutions to problems of low income and poverty alleviation, and an economy such as Nepal's cannot diversify overnight, but the need for the authorities to persist with strong structural measures will prevail for several years to come. The journey has just begun.

As far as the last year is concerned, on the positive side, GDP growth has bounced back to near 6 percent reflecting recovery of agricultural output, and inflation has remained at around 7.5 percent. On the negative side, however, the combined impact of deteriorating trade performance, weakened monetary stance, and the spending pressures on the fiscal position could well undermine these gains. We note that the new government has taken measures to address these imbalances, including raising of interest rates and tightening of fiscal controls, as well as other measures to re-start the reform process. It is too early to comment on either the sustainability or effectiveness of these initiatives, but we welcome the prospects of the Fund resuming discussions with Nepal on an ESAF supported program next month, when the package of measures can be consolidated with staff support. We agree with the staff that the way forward for Nepal is through a combination of agricultural development, exploitation of hydroelectric and tourism potential, and closer integration with India. I would like to comment on a few points for emphasis.

The immediate challenge is going to be on the fiscal front. The attainment of fiscal objectives depends essentially on containing spending at 2 percentage points below target. The selected issues paper accompanying the staff report carries a detailed section on social and other indicators: a 74 percent adult illiteracy rate, very high unemployment rates, including 38 percent educated unemployment, 40 percent of the population below the poverty line, and a GNP per capita that places Nepal among the World's ten poorest countries. Given this background, and given the recent degree of political instability, I would hesitate to support the approach to cut spending further, because the last two years' performance provides ample evidence of where the spending cuts are most deeply effected. In 1994–95, development expenditure was 1.7 percentage points of GDP below budget levels, and in 1995–96 it is estimated to be 3.3 percentage points below the budgeted level. But is there an alternative?

In the prevailing social conditions, it will be difficult to disassociate Fund advice from policies that lead to continuing poverty unless some "crash" programs that can jump-start output growth and job creation can be taken up. I would like to emphasize some sectoral issues. Clearly the need to exploit tourism potential demands priority. Last year we had pointed to the need to go after the big spenders in tourism, and are happy to note that the subject forms part of staff advice on growth strategy. We would welcome information on the potential that the sector might hold for Nepal, both in terms of hard currency earnings and employment generation potential. Notwithstanding limitations in systemic infrastructure, there were recently reports of people being prepared to pay up to $50,000 to challenge Mt. Everest; is Nepal fully capitalizing on this?

Regarding power, last year the focus was on the large Arun project, with alternative fiscal and output scenarios of life with or without the project. This year, though not as large, we have the Kali Gandaki Project. Are there any risks to the project apart from financing requirements, similar to the pressures that led to the Anti-Arun campaign? Is there scope to look at some diversification of investments within the power sector itself to hedge such risks?

On external policy, I would like to congratulate the staff for an excellent assessment of trade liberalization in their background paper. Nepal is facing some of the problems associated with the reduction of special terms after the Uruguay round, and whether or not we agree with the description of these effects as "new opportunities and challenges," it is clear that the initial impact on Nepal will be negative. If the studies quoted by the staff hold good, Nepal could lose 90 percent of its production to stiffer competition. In addition, Nepal may lose benefits under the General System of Preferences (GSP) that will erode its share of the carpet export market. Finally, as a net food importer Nepal may stand to lose as agricultural prices are liberalized. All these are challenges facing Nepal in the next few years. The country has to find adequate ways of meeting these challenges with a view to minimize their adverse consequences. This being said, we can support the staff position that it would be in the long-term interest of Nepal to join the World Trade Organization.

Nepal has many challenges ahead, and a populace exhausted by lack of growth and employment is not charitably inclined toward reformers, but, as Mr. Ismael also assures us, we could be confident that there is enough courage and determination to stay the course. We also support Mr. Ismael's invitation to the international community to continue with multilateral and bilateral support for the effort. In this respect, we would encourage the authorities to take all the steps that are necessary toward entering into an ESAF arrangement with the Fund in the near future. We wish them success in these efforts.

Mr. Han made the following statement:

It is encouraging to note that the Nepalese economic situation has improved in 1995/96 with strong growth and stable inflation, in particular, as indicated in Mr. Ismael's very helpful statement, the stronger growth witnessed in nonagriculture activity. Nonetheless, as a predominantly rural country characterized by heavy reliance on agriculture and a few other sectors, Nepal's economy has been vulnerable to weather changes and external developments. In this regard, in order to foster a broadly based long-term growth, greater efforts are needed to improve the conditions for the agricultural sector and to strengthen the nonagricultural sectors by making effective use of its natural resource advantages. Success in these areas will be facilitated by the acceleration of structural reforms and the pursuit of sound macroeconomic policies.

With these remarks, as I can generally agree with the thrust of the staff assessments and recommendations, I would like to make the following specific comments.

The maintenance of macroeconomic stability, which is critical to pushing forward structural reforms, will be secured by preserving tight financial policies. In the fiscal area, as the growth of government spending has not yet been fully brought back under control, it is necessary to cut spending on low-priority items. To ensure the efficient allocation of government resources, firm action should be taken to improve budgetary management and expenditure controls, with the support of bold steps to undertake civil service reform. However, given the persistently low revenue/GDP ratio, fiscal discipline could only be sustained by boosting revenue performance. Therefore, increased emphasis should be placed on the enhancement of revenues by further efforts to reform tax system and improve tax administration as well as steps to broaden the tax base.

On the monetary front, as the staff pointed out, under the fixed exchange rate regime, credit growth should be brought under control in line with the balance of payments objective and projected trends in money demand. One of key measures for the attainment of this monetary policy task is to prevent excessive government borrowing from the banking system. To this end, improved monetary management should be facilitated by increasing the central bank's autonomy in the conduct of monetary policy and developing indirect instruments. Comprehensive restructuring of the banking system and further strengthening of the central bank's supervisory capacity would be more conducive to the operation of monetary policy.

Finally, on sectoral reforms, we concur with the staff that further development of the agriculture and power sectors is crucial to enhancing Nepal's long-term growth prospects, and therefore should receive priority. In particular, given the weak infrastructure and limited human resources, increased investment in infrastructure for agriculture and social spending on education and health care should be prioritized.

With these remarks, I wish the authorities every success in their future endeavors.

Mr. Kaufmann made the following statement:

Let me only make some brief comments on the staff 's report on Nepal, which gives in general a balanced overview of the economic situation and the major problems to be addressed.

First, I am probably more skeptical than the staff about the country's ability to implement further reform steps; it is usually very difficult to stick to far-reaching reforms in a highly fragile political environment.

Second, I wonder whether the staff is too optimistic regarding the external debt service. While the staff is stating that these debt service obligations will remain low in the medium-term, a report entitled "Nepal's Economy and External Assistance Requirements," presented by the government of Nepal at the recent Paris Aid-Group Meeting states that "the debt service ratio, which was 0.7 percent in 1984/85 expanded to 16.7 percent in FY 1994/95. This is expected to increase even further in the future." Could the staff comment on the discrepancy between its figures and the ones provided by the government?

Third, I feel that the report has not given much importance to the analysis of the developments in the tourism sector, which in the meantime has overtaken garment and carpet exports as the principal earner of foreign currency. I would be interested in knowing how the staff assesses the growth potential of this sector, and which major policy measures should be undertaken to stimulate such a growth ?

Fourth, I would appreciate some staff comments on Nepal's decentralization policy, which emphasizes fiscal decentralization and village empowerment. While decentralization has of course its cost, I think that it could in the long run lead to a more accountable, efficient, and effective use of scarce public resources.

My final point concerns the timing of the Article IV consultation with Nepal. I wonder why the staff report is again presented to the Board shortly before the budget-presentation in Nepal. Would it not be easier for the Board to evaluate the situation after the budget discussion has taken place? Certainly, we could better distinguish between intentions and real actions.

With these remarks and questions, I thank the staff for its well written report, and wish the authorities all the best in their future endeavor.

Mr. Gaspard made the following statement:

On the fiscal front, I would emphasize that cuts in nonpriority expenditures should be followed by an overhaul of the country's system of financial management, which appears to be the root cause of Nepal's fiscal problem. Major improvements in budget procedure, starting with the 1996/97 budget, should definitely be undertaken, including the preparation of a three-year public expenditure review program with World Bank assistance, and the formulation of an annual core program of development expenditure, as well as other institutional changes to improve fiscal management. Also, while I can agree with the importance of strengthening tax revenues, I have some concern with regard to the implementation of a value-added tax in early 1997. It will be important first to adequately prepare for its implementation, considering the poor administrative capabilities in the past. Staff comments in this regard would be appreciated.

On structural reform I welcome the authorities' intention to proceed more aggressively with the privatization of public enterprises. At the same time, it is important to improve the management of the remaining public enterprises by requiring them to operate with hard budget constraints while allowing them to adjust prices in line with actual costs. I would also encourage the authorities to make faster progress in financial sector reform, particularly with regard to the restructuring and eventual privatization of the two large publicly owned banks, which account for over 70 percent of total deposits.

Finally, I wish the authorities success in their efforts and in their forthcoming negotiations for a new ESAF.

Mrs. Paris made the following statement:

The staff is to be commended for having provided a comprehensive set of papers which clearly highlight the remaining structural impediments that should be addressed in order to raise long-term growth in Nepal. I find myself in broad agreement with the staff's appraisal and echo the previous speakers who welcome the present commitment of the authorities to make progress under structural reforms. At this stage of the discussions, I will limit my intervention to a few comments.

I concur with the staff that the fixed peg against the Indian rupee has served Nepal well in providing a framework of macroeconomic discipline and in fostering close economic links with India. Such system imposes however strict conditions and I salute the actions taken to close the gap between Treasury bill rates in Nepal and those in India. I also consider that it will be very important to contain government domestic borrowing and rigorously restrict the growth of net domestic assets. I welcome in this respect the corrective measures taken by the government against recent fiscal slippages and encourage it to rationalize further non essential spending and put in place a strong budget for fiscal year 1997.

I understand that the next possible ESAF arrangement is to focus on a fiscal framework in a medium term perspective and the implementation of some key structural reforms such as the restructuring of the financial sector, privatization and tax reform: these are right priorities and I am pleased to see broad understanding between staff and the authorities of Nepal.

This said, I would like to make a last comment on the medium term outlook for the balance of payments. Present difficulties of the export sector in Nepal, dominated by garment and carpets, are well explained in staff's background paper and, considering the structural factors at play, there is an obvious case for a greater product and market diversification. The medium term balance of payments scenario assumes a prompt recovery of export performance, based on increased trade with India and broader diversification. Although such favorable scenario could actually materialize, one should nevertheless also consider less optimistic assumptions. In this respect, I believe that the alternative scenario should more differentiated from the baseline, so as to better underline the vulnerability of Nepal to exogenous shocks. I wonder whether the staff could comment on this.

Ms. Brettschneider made the following statement:

As I share the thrust of the staff's appraisal and endorse their recommendations, and as other speakers have already covered the key issues, I will limit myself to just a couple of points for emphasis.

First, I found the background paper on the Growth Response to Reform in Nepal very interesting. In the area of privatization in particular, I noted that a USAID study found that despite the retrenchment of roughly 1,100 employees in the context of the original privatization program, the overall employment effect of the privatization effort was positive. This should be a motivating factor as the new government attempts to rejuvenate the privatization program. We hope this message has gotten out to the Nepalese public as well, and, indeed, to our other members who are grappling with their own privatization programs.

Second, as other speakers have already noted, we cannot stress enough the importance of strengthening Nepal's human resource base in the interest of its long term growth prospects. With the adult literacy rate hovering at a mere

25 percent, the authorities cannot afford to deny education and other social sector priorities the attention they deserve.

Finally, the report outlines the deficiencies in Nepal's economic and financial data. We join the staff in encouraging the authorities to address these weaknesses in order to improve their capacity to make sound policy decisions. The nature of the problem seems to be more an issue of the quality of the data, rather than quantity.

In closing, I would like to note that we were glad today's Article IV consultation went forward on schedule, as opposed to delaying the discussion until an ESAF program was agreed upon. Like Mr. Shields, we found it useful to get a sense of the issues needing attention in advance of the passing of the Nepalese budget and subsequent program negotiations with the staff.

Mr. Munthali made the following statement:

In his helpful statement, Mr. Ismael has acknowledged that the political transition in Nepal has had its own costs. The macroeconomic stabilization and structural reform process, which was gathering momentum, started to falter in mid-1994. However, he reassures us that the new coalition government, which assumed office in September 1995, has been taking corrective action in order to address the emerging imbalances and to resuscitate the reform process. In this regard, we endorse the authorities intention to anchor their policy initiatives through a program that could be supported by the Enhanced Structural Adjustment Facility.

Since we are in broad agreement with staff appraisal, especially on the elements that should form the core of such a program, I will only limit my brief comments on the prospective fiscal measures that would form the centerpiece of the adjustment process. Let me say at the outset that we are encouraged by the apparent meeting of the minds between the staff and the authorities on those specific elements, including in particular the urgent need to foster fiscal discipline which the authorities also consider to be the key to macroeconomic stabilization. The attainment of the fiscal objective would have to be made by the combination of strict expenditure restraint and revenue enhancing measures. We can fully subscribe to the recommended revenue measures, including the anticipated introduction of the value-added tax. These and other measures would not only widen the revenue base but also improve buoyancy. It is needless to say that these measures should be supported by the appropriate strengthening of tax administration in order to maximize revenue receipts.

On the expenditure side, the cutting back of spending on low-priority, less productive projects, the tightening of procedures for monitoring and control, and the overall rationalization of government spending are steps in the right direction. Although the comprehensive review of the 1995/96 budget was not followed by concrete action because of the continuing political difficulties, the authorities should be encouraged to incorporate such measures in the 1996/97 budget as intended. In addition, the staff has advised the authorities to support these cutbacks with pertinent reforms in order to curb the growth of government expenditure in the medium term. These would necessarily include the early introduction of a three-year rolling investment expenditure plan and other management reforms to bolster monitoring and control procedures. The combined effect of all these measures should provide adequate room for flexibility so as to accommodate specific programs aimed at minimizing the cost of adjustment on the poor sections of society and to initiate other productive investments to alleviate the widespread poverty in the country. Perhaps this would provide the authorities with a basis for mobilizing the necessary political consensus for continued adjustment.

Mr. Alemán made the following statement:

First, I would like to join other Directors in commending the staff for the papers prepared on Nepal for the 1996 Article IV consultation. The new coalition government that took office in September 1995 has started again the structural reform process. The Nepalese authorities have demonstrated that their work is making encouraging progress toward the establishment of macroeconomic stability and market reforms. While the unfortunate events that in the past regrettably promoted macroeconomic imbalances have been overcome, the authorities through their strong commitment to restart the implementation of sound macroeconomic policies should continue pursuing a very strong structural adjustment process.

These commitments, as stated in Mr. Ismael's statement, undoubtedly will bear fruit in the near future. Results on the economic performance are still mixed, while GDP growth will recover from 2.25 percent in 1994/95 to almost 6 percent in 1995/96, inflation will remain around the 7.5 percent. However, the external position is weakening with the consequent threatening of the stabilization efforts.

Since we are in broad agreement with the staff appraisal, let me make only two remarks for emphasis purposes.

First, regarding the fiscal issue, we concur with the staff that the Nepalese program based on tight financial policies consistent with an exchange rate peg to the Indian rupee, should have as a key element of the macroeconomic framework, a very tight fiscal policy. In this context, although this policy should insure a strict limit to the public sector's domestic borrowing, we urge the authorities to take the adequate steps to bolster revenues. The value-added tax and other tax reforms, as well as the improvement in tax administration, will contribute to the raising of public savings during the next years.

The positive actions already taken by the authorities to strengthen the fiscal position are commendable. However, we urge the authorities to improve the budget management process, including a strict control of current expenditures. The efforts on these aspects, complemented by an adequate monetary policy, should guarantee that the government's borrowing would be kept within prudent limits allowing a major availability of resources for the private sector.

The second key element is structural reforms. We think that the authorities must proceed further in their privatization efforts and move ahead rapidly in the financial sector reform. The restructuring and eventual privatization of the two large public owned banks, should be made as soon as possible. This will ensure a more dynamic private sector role, toward the building of a market-oriented economy, and will contribute in the moving of financial resources required in the production process. Also, in this context, the actions already taken in the agricultural and power sector are steps in the right direction. However, much remains to be done and we urge the authorities to go ahead in their privatization program.

With this comments, I wish the authorities well in their future endeavors and expect to discuss in the Board a Nepalese request for an ESAF arrangement in the near future.

Mr. Shields made the following statement:

I join other chairs in welcoming the efforts of the Nepalese authorities to improve the overall macroeconomic management and to move the economy back to a state where an ESAF program can be put in place. Indeed, I hope that the July budget will include the final necessary measures, and that we can see the ESAF sometime afterwards.

The only additional point I wish to make concerns the underutilization of donors' funds. The authorities have not been utilizing all the financing available, and the problem appears to be due partly to the release system for the funds, and partly to the lack of any systematic project accounting system which would enable reimbursements to be monitored effectively. Also, in some large projects, financial management responsibilities have been ill-defined, a situation that has been exacerbated by high staff turnover. Obviously, the task is not made any easier by the fact that there are different approaches taken by different donors. Nevertheless, I think a more systematic approach on the Nepalese part would produce considerable improvements.

Mr. Oya made the following statement:

As I agree with the thrust of the analyses and advice in the staff report, I would just like to make some brief remarks on Japanese assistance for the Kali Gandaki project. At the Aid Group Meeting in April, my authorities pledged a co-financing loan from the OECF with the Asian Development Bank amounting to ¥16.9 billion (about $160 million) for the Kali Gandaki project.

I am pleased to inform the Board that preparations for finalizing the loan are progressing smoothly and effectively on both sides. I hope the authorities will continue to cooperate fully with the OECF during the preparations.

I also hope the authorities will continue to implement corrective measures in consultation with the Fund and move to another ESAF as soon as possible.

With these remarks I wish the authorities well and every success in the future.

The staff representative from the Central Asia Department said that the tourism sector of Nepal—which had contributed only about $160 million in earnings in the preceding year—was not expected to grow by much more than 10 percent a year in dollar terms in the foreseeable future owing to a number of structural impediments. The Kathmandu Valley—the main tourist arrival site—was heavily polluted by industrial development and by the growth of Kathmandu itself, and progress to clean it up was slow. Transportation links and facilities needed to be upgraded, and there were an insufficient number of flights into Kathmandu. Current discussions with India to increase the number of daily flights between India and Kathmandu represented an important step, as India was possibly the largest potential source of tourists for Nepal. Also, while foreign capital had been permitted to contribute to the development of large hotels currently in excess supply in Kathmandu, barriers to foreign participation in the small tour company business had led to an undersupply in that area. The new government had taken measures to liberalize the policy, and some progress was being made.

Agreement with donors on the financing of the large Kali Gandaki power project had been reached, and implementation was scheduled to commence the following year, the staff representative continued. However, the environmental impact of the project was still under review by nongovernmental organizations, and a number of public hearings on environmental impact were expected in the following months. Also, the court challenge to the 20 percent increase in electricity tariffs, which the government had recently introduced to help finance the domestic costs of the project, would be heard by the Supreme Court within a few weeks. Hence, there was still some risk the project could be delayed.

Power sector development in Nepal would continue to be dominated by large public sector projects reliant on concessional financing, the staff representative emphasized. Greater private sector involvement in the power sector was being promoted. For example, the medium-size 60 MW Khimti Kola hydropower project was moving forward quickly, and a number of other projects were being discussed. Adequate returns on those projects should be generated under recent pricing policy. Nevertheless, the power purchase agreement with the local electricity authority in the Khimti Kola project, for example, included a government guarantee. That type of contingent liability could give rise to budgetary problems in the future, an issue that would be considered before a request for an ESAF arrangement were presented to the Board.

Under its decentralization strategy, the government continued to provide financial support to local government bodies that had been granted by the previous short-lived UML government, pending development of a more coherent policy framework, the staff representative added.

The prospects for implementing the value-added tax within the current fiscal year had been set back by problems in arranging adequate external financing, the staff representative explained. USAID, which had been funding most of the technical assistance for the value-added tax project, had run into financing constraints of its own, and, while alternative financing had been obtained from the Danish aid agency, it would take some time to put all the pieces in place. Budget constraints had also set back the hiring of needed personnel. Hence, the implementation of the value-added tax would likely be delayed at least until the start of the next fiscal year..

The discrepancy between the debt-service ratio reported by the Nepalese government and that shown in the staff report was probably due to a difference in the definition of debt service, the staff representative said. The government figure most likely included domestic debt service as well as external debt service. In any event, even the higher 16 percent government figure did not suggest the country was in imminent danger of not meeting its external obligations. Of course, the medium-term prospects were subject to some uncertainty. The alternative scenarios presented in the staff report—which assumed 10 percent faster import growth and declining aid receipts—indicated that the impact of those developments on the debt-service ratio was basically minor. Of course, if imports were to grow much more rapidly, corrective action would be required to prevent a fall in reserves.

The timing of the current Board discussion had been set in accordance with the standard 12-month cycle for Article IV consultations, and in response to previous requests by Board members not to delay consultation discussions on account of continuing discussions with members on their adjustment programs, the staff representative explained. Eighteen months would have elapsed since the previous Article IV consultation, had the staff waited until after the budget had been presented to hold the Article IV consultation.

Ms. Brettschneider stated that she was glad that the consultation discussion had not been delayed until after the budget had been presented.

Mr. Ismael made the following closing statement:

> I note the Board's concern about recent policy slippages and the need for Nepal to accelerate the reform process. As I had explained in my opening statement, the delays were due to the change in government and do not represent a change in policy stance. The political will to persevere with economic reform remains strong, and my authorities are committed to further reforms to promote a more open and private sector driven economy. They recognize that structural reform holds the key to expanding Nepal's production base and growth prospects over the long term.
>
> Fiscal consolidation efforts are to be continued, with special emphasis on revenue mobilization and current expenditure restraint. Revenue mobilization efforts will be based on broadening the tax base as well as strengthening administrative capabilities. Development expenditure management will be improved through better prioritization and proper classification of projects into core and noncore categories, a more efficient allocation mechanism, and adequate monitoring. This standard would apply to both domestic and foreign resources. On the data issue, I will convey the Board's concern about the need to improve the quality of the economic and financial statistics provided to the Fund.

Finally, on behalf of my Nepalese authorities, I wish to thank the staff for its excellent work in Nepal. The authorities look forward to working with the Fund on a reform package that can be supported by an ESAF program.

The Acting Chairman made the following summing up:

Executive Directors welcomed Nepal's improved economic performance in 1995/96, during which inflation had remained stable and the external position had recovered ground lost earlier in the financial year. Directors supported the government's economic strategy based on, first, economic liberalization to strengthen private sector activity; second, continued financial discipline; and, third, reorientation of the role of government, with a focus on provision of infrastructure and development of human resources. They also supported the continued pegging of the exchange rate to the Indian rupee, and endorsed the authorities' intentions regarding key structural reforms, including the introduction of the value-added tax, improvements in public expenditure management, privatization, and restructuring of the large publicly-owned banks.

Directors emphasized that ensuring a sound fiscal position was the centerpiece of the stabilization strategy. Further corrective measures would be needed during the remainder of the present fiscal year to rein in the growth of government spending, while the 1996/97 budget would need to prune nonessential spending further and to contain measures to boost revenue. The introduction of a three-year expenditure plan and other public expenditure management reforms would help to ensure that government spending was deployed more effectively in line with development priorities. Directors also underlined the importance of staying the course on the introduction of the value-added tax, which was critical for sustained progress in raising public saving and reducing reliance on aid inflows. The provision of adequate institutional arrangements was essential to ensure the effective implementation of the value added tax.

Directors noted that keeping a tight rein on the government's domestic borrowing requirements would serve to support the tight monetary stance. They urged the authorities to gear open market operations to the needs of monetary policy and to ensure the alignment of interest rates in Nepal with those in India.

Directors observed that, in Nepal's circumstances, a commitment to a fixed exchange rate peg with the Indian rupee provided a key element of policy discipline, while helping to promote close economic and financial integration with India. Directors believed that, if effectively implemented, the authorities' stabilization program would be successful in reversing the weakening in the external position that had occurred in the preceding year, and would provide the basis for a viable medium-term balance of payments outlook. They urged continued efforts to diversify production and markets. In that respect, Directors suggested that Nepal should seek membership in the World Trade Organization, which would help to promote the country's market access.

Directors stressed the need for an ambitious structural reform program to improve Nepal's growth performance and the prospects for poverty alleviation. A revitalized privatization program should aim at increasing the private sector's role in some of the large public sector enterprises, as well as making further headway in privatizing a substantial number of smaller enterprises. A broad set of financial reforms was needed to rehabilitate and privatize the publicly-owned commercial banks, foster more efficient financial intermediation, and facilitate monetary management through indirect instruments. Directors also emphasized the need for a series of structural reforms, with priority being given to the agriculture and power sectors. Directors welcomed indications that progress was being made in putting in place a substantial power investment program, with an important role for the private sector. They also welcomed the government's intention to place greater emphasis on investment in human capital. Directors hoped that, with strong macroeconomic and structural reform policies firmly in place, Nepal would build the base to request an arrangement under the Enhanced Structural Adjustment Facility at an early date.

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

3. SOUTH AFRICA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with South Africa (SM/96/97, 4/26/96). They also had before them a background paper on selected economic issues (SM/96/109, 5/10/96).

The staff representative from the African Department made the following statement:

The rand closed at R 4.36 per $1 on May 24, compared with R 3.66 per $1 on February 15, 1996, a depreciation of 16 percent, caused primarily by anticipation of an imminent wholesale abolition of exchange controls on residents and political uncertainties. However, it has strengthened from its lowest point of R 4.50 per $1 on May 9, which followed the withdrawal of the National Party from the government of National Unity. Since February 15, long bond yields have increased by over 280 basis points to over 16 percent, money market rates have risen by over 260 basis points, and the markets' expectations of the bank rate during 1996 have been revised upwards. The industrial index on the Johannesburg Stock Exchange has fallen by almost 9 percent over this period.

Gross reserves of the South African Reserve Bank declined from R 15.5 billion ($4.2 billion) at end-January, to R 11.7 billion ($2.7 billion) at end-April. The bulk of this decline occurred in April. The net open forward position of the reserve bank rose from $6.8 billion on February 15, 1996 to $12 billion at end-April, with the greater part of this increase taking place in February–March. Both gross reserves and the net open forward position of the reserve bank have remained unchanged thus far in May. Nevertheless, the rise in the net open forward position entails the risk of exchange losses, in addition to those already incurred as a result of the depreciation of the rand.

The reserve bank raised the bank (discount) rate by one percentage point to 16 percent with effect from April 29, and the commercial banks responded by raising the prime lending rates from 18.5 percent to 19.5 percent. Subsequently, the commercial banks raised their prime lending rates again to 20.5 percent on May 17, even in the absence of a further increase in the bank rate.

The authorities attempted to restore orderly conditions in the market by reaffirming their commitment to cautious macroeconomic policies, structural reforms, and continued step-by-step liberalization of exchange controls on residents.

The reserve bank has revised downward its projection of real GDP growth to 3½ percent in 1996, and that of the current account deficit to 2–2¼ percent of GDP. However, it has expressed concern about the inflationary impact of the depreciation, suggesting that the depreciation will add some 2½ percentage points to the increase in consumer prices in 1996.

The rand had been unexpectedly strong during 1995, and although the recent depreciation has been too rapid, it is otherwise welcome. It is desirable to regain stability, but this should not be achieved by the reserve bank's intervention in the spot or forward exchange markets. To restore confidence and contain the inflationary consequences of the depreciation that has already occurred, including their likely effect on wage negotiations, the expeditious implementation of the following steps would seem appropriate: a further increase in the bank rate to sustain the most recent increase in the banks' prime rate; the announcement of a strengthening of the fiscal position for 1996/97 by cutting spending; efforts to limit wage increases; and an early statement to address the uncertainties concerning the authorities' stance on policies on structural reform to raise growth and employment, followed by the implementation of the structural measures needed to achieve those objectives. These actions, along with steps to reassure markets that exchange controls on residents will be eased gradually when conditions permit, should also help strengthen confidence.

The staff has been and remains in close contact with the authorities.

Mr. Dlamini made the following statement:

The South African authorities would like to express their appreciation to the staff for its comprehensive and objective analysis of the South African economy. They found the recent Article IV consultations most helpful in enhancing their own policy discussions and improving economic management. The authorities are also grateful to the Managing Director for his encouragement and advice during his recent visit to South Africa.

South Africa has continued to consolidate the political system inaugurated some two years ago. Under the new constitutional dispensation, the country is poised to move forward under the rubric of democratic institutions in its quest for stability, economic growth and social development. The challenges are many, a number of which have been mentioned in the staff report; but the authorities are determined to build and nurture the social consensus that will enable the government to take the bold actions necessary to keep South Africa firmly on the new course it has set for itself. In the sphere of economic management, this means the achievement of high sustainable growth, an increased effort to address the unemployment problem, and a firm commitment to the full integration of South Africa into the world economy, supported by prudent financial policies and structural reform. In this connection, the authorities have already taken steps in the area of trade and exchange control liberalization and labor market reform, while setting a course for the strengthening of public sector finances, based on the announcement and systematic pursuit of medium-term fiscal targets.

As noted in the staff report, the policies pursued by South Africa in 1995 achieved substantial success in raising business confidence, reducing inflation and sustaining the recovery in output. Real GDP grew by 3.3 percent compared to 2.7 percent in 1994, despite a sharp decline in agricultural production due to drought and the poor performance of the mining sector. The improved growth performance was driven by strong domestic demand, reflecting in large part, the rapid growth in fixed investment, with manufacturing sector investment leading the way. Overall, real net investment rose by 1½ per percentage points to 3.8 percent of GDP.

On the inflation front, tight monetary policies and the accompanying appreciation of the rand in second half of 1995 played a major part in reversing the upward inflationary trend in the first half of the year. The 12-month rate of increase in consumer prices fell from 11 percent in April 1995 to 7 percent in December while the underlying inflation rate was reduced to just over 7 percent in December 1995 from its recent peak of 9.2 percent in May 1995 and around 17 percent in 1991. Against the background of the downward trend in the underlying rate of inflation, wage settlements have moderated in nominal terms, with the 12-month rate of increase in remuneration per worker in private sector declining from 17 percent in 1990 to about 12 percent in 1994. However, real wages in the private sector increased by 4.6 percent during the same period and the authorities recognize that increased labor productivity has thus far only partially offset the relatively high unit labor costs, with adverse consequences for the country's competitiveness.

The overall balance of payments position strengthened in 1995, despite the deterioration in the current account, which widened to a deficit of 2.6 percent of GDP from 0.5 percent of GDP in 1994. The increased deficit was the result of the sharp increase in imports, mainly capital goods, related to the rapid rise in investment. The capital account continued to improve, with inflows being sufficient to cover the current account deficit and permitting a buildup in net foreign reserves. The improved reserve position enabled the South African reserve bank to intervene in the market to maintain orderly conditions when the rand came under pressure in the first quarter of 1996 due to unfounded rumors and uncertainty about the direction of economic policy, in particular with respect to the elimination of capital controls on residents. At the same time, the authorities acted swiftly to assure the market that they remained committed to fiscal consolidation and monetary restraint. They have allowed the exchange rate to continue to be determined by market forces. In the last two weeks, the rand has regained some of the earlier losses following another increase in the reserve bank rate and renewed efforts by the authorities to reassure the foreign exchange markets.

As part of the process of integrating South Africa more closely into the global financial system, the authorities have taken significant steps to liberalize exchange controls. Early in 1995, exchange control on nonresidents was abolished. The credibility of the South African government regarding its commitment to maintaining financial stability ensured that this process occurred without disrupting financial or foreign exchange markets. The authorities also announced their intention to gradually remove exchange control on residents. Steps that have already been taken in this regard include, the approval of asset swaps by pension funds, unit trusts and insurance companies, and the relaxation of conditions for investment in the Southern African region. In addition, the reserve bank has begun to withdraw from the forward market in foreign exchange by relinquishing the requirement on exporters to obtain forward cover, terminating official forward cover for nonfinancial transactions and reducing the implicit subsidy on short-term borrowing. In the area of international trade policy, the authorities achieved considerable progress in fulfilling the obligations agreed to at the Uruguay Round. Prominent among this was the abolition of the surcharge on imported goods in October 1995.

However, the high level of unemployment remains a vexing problem for the South African authorities, and improving the situation is a matter of the highest priority to ensure that the benefits of economic growth are more evenly spread throughout the population. This has brought to the fore a number of issues that must be addressed, ranging from the deepening of structural reforms in the labor market to finding ways of increasing the use of more labor-intensive technologies. In this regard, the authorities have established a Labor Market Commission to make recommendations for modalities for improving employment opportunities, and are expecting its report soon. The authorities have also introduced a new Labor Relations Act which will facilitate a smoother functioning of the labor market. In the meantime, they have welcomed the discussion with the staff on the unemployment question, which has focused attention on, among others, the potential gains from greater flexibility in private sector remuneration; the benefits to be accrued from policies that would enhance competitiveness in skill-intensive sectors, especially those geared toward exports; measures aimed at improving labor productivity, including the provision of better training and education; and land reform and extension services that would facilitate more gainful employment in agriculture in the rural areas. It is obvious to the authorities that a multi-faceted approach is needed and that policies that can be taken in the short run would have to be complemented by long range measures, especially those related to human resource development and the use of more labor-intensive technologies.

The 1996/97 budget continues along the deficit reduction path: it envisages a reduction in the actual deficit from an estimated 5.5 percent of GDP in 1995/96 to 5.1 percent in 1996/97. Also, it aims at restructuring expenditure, focusing on education, health and other social services. The deficit target is to be achieved through both higher revenue and expenditure restraints. Revenue measures include a 17 percent tax on interest and net rental income of retirement funds, increases in certain excise taxes and the fuel levy, and improved tax administration through the merger of Inland Revenue and Customs and Excise into the South African Revenue Service. Meanwhile, steps have been taken to rationalize the tax system to correct for past bracket creep, raise the minimum taxable income threshold, and reduce the number of tax brackets. The major adjustments in the budget come in the area of expenditure. Real expenditure cuts are planned for defense and subsidies. Also, the authorities have started the reform of the civil service aimed at substantially reducing the number of employees over three years, while changing the salary structure. In the 1996 fiscal year a reduction of some 100,000 positions is envisaged. The authorities are also considering a thorough restructuring of the social security system, in which the social partners in the National Economic Development and Labor Council (NEDLAC) will participate. To minimize the inflationary potential of the government's fiscal operations, the authorities plan to finance the deficit almost wholly through the issue of government securities in the domestic markets. A slight decline is projected in the government debt/GDP ratio, from 56.0 percent in 1995/96 to 55.6 percent in 1996/97.

On monetary policy, the primary objective of the authorities over the medium term is to reduce the rate of inflation to a level that is comparable to that of the country's most important trading partner countries. To this end, the monetary authorities are committed to maintaining a tight monetary stance in 1996. In order to signal this intention to the market, the reserve bank is maintaining its guideline growth rate for the broad money aggregates in the range of 6–10 percent which was set in 1995. The tight monetary stance was further strengthened in April when the bank rate was raised by 1 percentage point to 16 percent.

In sum, since the national elections in 1994, substantial progress has been made toward establishing credible domestic policies that would improve both the immediate and long-run prospects of the economy. In the years ahead, building on this progress, the authorities intend to keep the South African economy well-positioned in the global economic community. This approach leads them to continue to accord increasing importance to revitalizing the economy while reducing the existing inequalities of income and economic opportunity. In this regard, the authorities welcome the emphasis placed in the staff report on the package of reforms that are deemed necessary to stimulate employment and growth in the country's economy. Initiatives are presently under way for an interdepartmental discussion on the proposals in the report in an attempt to arrive at a common position. Moreover, a draft policy framework for growth, employment creation and redistribution is being finalized within the national government. It is envisaged that the Fund, among others, will be approached to act as a sounding board for the draft framework.

Mr. Cserés made the following statement:

The staff is to be congratulated on the excellent report and background paper which distinguish between the immediate policy issues and the medium-term structural problems that will require continuous effort to resolve. South Africa's sound economic management has been rewarded by recovery, but the relative slowness of growth and widespread poverty testify to the urgency of overcoming deep-seated structural weaknesses. Stabilization should therefore be supplemented by rapid structural adjustment to enable the economy to meet the aspirations of all South Africans.

South Africa's most pressing problem is high unemployment and the inefficiency of the labor market. The measures the staff has suggested to stimulate higher growth and employment seem suitable for addressing this issue, and I hope their advice can soon be translated into a concrete, feasible action plan. I believe that the authorities are serious about promoting job growth and will pay close heed to these recommendations.

In the area of the budget, the authorities must continue to struggle to meet two goals. One is to generate resources for financing social outlays in addition to increased capital spending within the constraint of deficit reduction. Given the sharp decline in savings and investment in recent years, which not even 1995 was able to reverse, the importance of reducing government dissavings must be emphasized. In 1995, in pursuit of the primary objective of fiscal policy, the government exercised considerable fiscal restraint to contain the growth in government spending, despite large special transfers and additional expenses incurred with South Africa's constitutional transformation.

It is important for the authorities to continue their course of fiscal consolidation in order to boost domestic savings and reassure the financial markets. Given the limited room for raising taxes, the staff is correct that fiscal policy must remain focused on containing and redirecting expenditures. Accelerating privatization and stepping up sales of some of the state's assets should contribute to attaining the fiscal consolidation targets in the medium term. The authorities should also strengthen revenue performance by improving the efficiency of tax administration and broadening the tax base, especially by integrating the large informal sector into the formal economy. Unlike many developing countries, in South Africa the bulk of government revenues comes from taxation: transfers and ordinary income from the sale of goods and services are comparatively insignificant. Given the fixed tax base and tax rates, changes in government revenues fairly closely follow changes in economic activity. The authorities should therefore also be prepared to adjust the budget in case economic growth and revenues fall below expectations. This is especially true because the 4 percent growth projected for 1996 would be the highest in many years. This projection differs from that of the Governor of the Reserve Bank of South Africa, who recently predicted 1996 growth at about 3.5 percent "despite recent increases in interest rates." I would therefore like to ask the staff to comment on the realism of South

Africa's fiscal target, and what kinds of contingency measures are at hand if slippages should occur.

Before borrowing and debt repayment, the government deficit as a percentage of GDP decreased only moderately in the last two fiscal years. This probably indicates the existence of structural deficiencies in government finance. This is apparently confirmed by the further sharp increase in government debt and the already high tax burden on those households enrolled in the formal sector of the economy. I wonder whether there are any estimates of the structural and cyclical components of South Africa's budget deficit?

The authorities are committed to an outward looking trade policy with access to foreign capital markets. Trade and investment policies are closely linked in the sense that foreign investment will be attracted only if conditions are favorable for foreign trade. The dramatic changes in South Africa's transactions with the rest of the world clearly reflect its desire to normalize its international financial and trade relations. Inflows of international capital have gradually translated into growing surpluses that have removed financial constraints on economic growth and removed the need to maintain surpluses in the current account to offset capital outflows.

The resulting healthier balance of payments position has enabled the authorities to prolong the upturn in economic activity, but the normalization of international financial relations and the liberalization of capital transactions have significantly increased the volatility of financial transactions. Rejoining the international financial community has exposed South Africa to large capital flows between developed and emerging markets which are capable of suddenly reversing direction. This volatility has serious implications for macroeconomic policies and the management of foreign reserves and overall liquidity in the economy. It should be stressed that this volatility, combined with the low level of international reserves, does not give South Africa much room for policy mistakes.

I fully share the staff's view that the main causes of the recent deterioration in market sentiment toward the rand have been domestic. There is an urgent need to resolve these uncertainties before the positive growth effects of greater access to external financing are wiped out by an increase in the country risk premium causing higher domestic interest rates. As in the past, the monetary policy stance can help bolster investor confidence in the rand. The recent attacks on the rand, the high money supply and bank credit expansion, and the evident growth of inflationary pressures all call for the authorities to adopt a more cautious and conservative monetary policy.

One of the government's fundamental strategies is to embark on a path of export-led growth. But for external trade to become the engine of growth, South Africa's must improve or at least maintain its competitiveness. As the staff notes, the problem of competitiveness is closely connected with labor issues. The possibility of solving the problem with incomes policy is slim, given the size of the wage adjustment that would be required and the chance of reaching agreement with the social partners. And even the recent emergence of a balance of payments deficit was principally attributed to a strong rise in fixed investment and inventory accumulation and the sharp drop in the value of net gold exports, there is a risk that declining productivity growth together with the rise in real remuneration per worker could bring a reversal in the decline of unit labor costs and the risk that the balance of payments will once more become a constraint on growth in the medium term.

Mr. Clark made the following statement:

It is gratifying to note that 1995 provided a third successive year of all-round macroeconomic improvement, continuing the process of steadily increasing rates of real growth in South Africa, and of equally steadily declining average annual inflation. Though the external current account deficit widened sharply, the external position was buoyed by strong capital inflows which helped to treble official reserves to one month's import cover. This broad outcome has been underpinned by the authorities' determined adherence to their medium-term deficit reduction program, and by their cautious stance of monetary policy, as well as by the structural reforms already undertaken, particularly in the trade and exchange system.

Yet, with the authorities constrained for the time being to walk the tightrope between implementing strong policies and dealing with the country's enormous social needs, the overall outlook is not without risk, including a possible undermining of confidence by the recent withdrawal of the National Party from the Unity government. In particular, staff and the authorities show understandable apprehension over the possibility of the economy drifting to equilibrium at a substantially sub-optimal level of, employment. The emphasis in the policy discussions with the authorities on exploring medium-term strategies for lifting the growth rate and reducing unemployment is therefore very appropriate.

It is sobering, as shown in the authorities' medium-term scenario, that even with the recovery being maintained with growth of 3½ percent to the end of the century, the open unemployment rate, instead of declining, will rise slightly over the medium-term to 33½ percent. This is a forbidding prospect. The alternative medium-term scenario presented by staff, in which growth would move up to 6½ percent by the turn of the century, is therefore not merely a more desirable framework, but virtually an imperative for the authorities. The critical question concerns the choice of strategic policy interventions that would move the South African economy in the direction of this alternative scenario.

The staff has usefully outlined a range of measures, which they rightly emphasize are mutually reinforcing, toward this objective. Prominent among these is their proposed initiative to make South Africa's rigidly dualistic labor market more flexible, through reform of the country's minimum wage system. The particular approach favored by the staff, of applying differential minimum wage levels for older and younger members of the unskilled labor force, in order to encourage quicker absorption of unemployed youth, does have a certain appeal, for all the reasons stated. However, notwithstanding the staff's views to the contrary, one can sympathize with the reported reservation of the authorities about possible negative implications for older workers. It is especially troubling that if these negative implications materialize, dependents of older workers would be adversely affected, compounding the already enormous social problems of the country. It is conceivable however that the staff's approach could work without the feared negative spillover, where lower minimum wage levels for young unskilled workers could be combined in an assured manner with arrangements for their employers to finance their training, as proposed by the staff.

Regarding the important element of land reform in the package, the staff's preference for a market-based approach is understandable, but the high political salience of the issue will make it difficult for the authorities fully to adopt a market approach. The staff notes that a critical defect of the restitution concept is that the government budget would have to bear the cost of implementation of the scheme. On balance, the tax-based self-financing approach suggested by the staff provides real possibilities for advancing the land reform component of the adjustment programme. Critical details will need to be addressed such as how to select the beneficiaries, and how to ensure that the tax yield is sufficient to finance both the administrative costs and the cost of the flat rate grant. Also, I would welcome information on the authorities' response to the staff's proposal.

Although there has already been substantial progress in trade liberalization, the staff believes that further opening of the economy must be a part of the reform package, in the expectation that this will get to the heart of the cost competitiveness problem of skill intensive industries. Of course, there is always the possibility that further liberalization will, in the short run, lead to an erosion of output in the affected industries. Whether this risk materializes or not will depend on the strength of complementary and supporting measures. Certainly, there is a positive prospect that with such measures in place, the possibility of an asymmetric free trade arrangement with the European Union could provide South African skill-intensive industries with a basis both for maintaining production and securing gains in cost-competitiveness.

The staff sees an exchange rate depreciation, as being an essential element in the suggested strategy for achieving higher growth and reducing unemployment. This raises a number of questions. Would this require a shift from the authorities' present move toward a market-determined exchange rate system to a managed float, with the authorities entering the market to pursue more rapid accumulation of reserves? Also, how does the staff's suggested exchange rate strategy square with the reported satisfaction of the authorities in mid-March with then prevailing exchange rate, and with their more recent view (following the further weakening of the currency in April) that the rand was undervalued? Broadly, was the extent of the depreciation of the rand earlier this year between late February and late April sufficient for the staff's suggested strategy or is the staff contemplating a further depreciation of the rand beyond the level registered more recently? In the meantime, I commend the authorities for radically reforming the exchange system a year ago by abolishing the financial rand.

In the broader area of the overall macroeconomic framework for stability and growth, the fiscal position warrants special comment. While the authorities are to be commended for their steady adherence to their deficit reduction strategy, the path of fiscal consolidation is too gradual in light of the need to strengthen government saving in support of increased domestic investment, while at the same time protecting outlays in the social area. One wonders whether there is not scope for both the revenue and expenditure sides to contribute to stronger fiscal consolidation, instead of the expenditure side mainly, as reflected in the alternative medium-term scenario presented by the staff. Preliminary estimates put tax revenue in 1995/96 at 24 percent of GDP, down from 24.7 percent of GDP in 1994/95, and is budgeted to reach 25 percent in 1996/97. This chair suggested last year that efforts should be made to restore the revenue/GDP ratio to the somewhat higher levels achieved in former years. Even with the revenue-compressing effects of the rationalization of corporate and individual income tax, there is scope for reasonably strong revenue enhancement from improvements in tax administration and other measures as implied from the work of the Katz Commission.

On the expenditure side, there is a continuing challenge to strengthen expenditure control, reduce the wage costs of government, and cut subsidies and transfers that are not part of a well-targeted social safety net. The strong compression of defense outlays in recent years relative to GDP, and the on-going program of civil service rationalization are welcome developments that will progressively strengthen public finances, while aiding the restructuring of public expenditures to support the social sector. The authorities are strongly encouraged to maintain these efforts within the framework of the alternative medium-term scenario presented by the staff, and thereby reinforce the adjustment process appreciably.

I wish the authorities well as they face the great challenges that still lie ahead.

Mr. Gaspard, speaking on behalf of Mr. Shaalan, made the following statement:

It is heartening to see that the South African authorities have maintained sound financial policies over the past two years. The resultant general improvement in investor confidence accompanied by a large increase in longer term capital inflows is clearly evident. The improved environment has contributed to a significant increase in private fixed investment, an acceleration in real GDP growth and in an impressive inflation performance in 1995. Moreover, the authorities' policies were instrumental in ensuring that the abolition of the financial rand, which was undertaken in the unsettling aftermath of the Mexican crisis, proceeded smoothly.

Clearly, increasing employment has been, and must still be, the central focus of economic policy in South Africa. Labor intensive activities should continue to be accorded priority in the efforts to promote faster growth. Despite South Africa's very high unemployment level, a number of distortions remaining from the country's historical legacy have resulted in a high capital intensity of both industrial and agricultural production which explains the limited employment gains associated with the recent output gains. In view of the scale of unemployment and the complexity of the distortions there can be no quick fixes to this problem. A comprehensive package of reforms, to be implemented in a medium to long-term context, is urgently needed.

The staff has presented the core elements of a structural reform package to stimulate growth and employment that merits serious consideration by the authorities. The package is comprehensive and its elements are broadly consistent and mutually reinforcing. It appropriately includes a reform of the minimum wage structures in a way that would promote the employment and training of younger unskilled workers and which would differentiate between provinces according to levels of unemployment. The staff's market-based land reform proposals would also accelerate labor absorption in agriculture while avoiding the potentially large government liability of the land reform program that is currently under way. At the same time, the employment of skilled labor would be enhanced as reduced trade protection pushes real skilled wages down and improved training and education expands the pool of skilled labor. In this connection it is important to note that continued uncertainty with regard to the authorities' trade liberalization program increases the short-term adjustment and employment costs associated with it. The wide scope available for discretionary adjustments to tariff rates on a case by case basis seems to be contributing to a "wait and see" attitude by potential new investors. To enhance the credibility of the authorities' trade reform, this room for discretion should be minimized.

External and financial policies should, of course, be supportive of the proposed structural reforms. I would stress, however, that while I agree that an accelerated depreciation of the rand would be expected to stimulate exports and the production of tradables in the longer term, and would therefore be expected to mitigate the pressures on the external balance resulting from tariff reductions, it is important not to downplay the risk it poses to inflation in the short term. I believe proper sequencing is important here. Inflation risks will be minimized if the proposed structural measures are allowed to take effect before such a depreciation takes place, and if financial policies are sufficiently tightened to support it. Another concern is the possibility that inducing a depreciation prematurely before confidence in the effectiveness and sustainability of the authorities reform program is sufficiently strong, particularly if exchange controls for residents are relaxed significantly, may lead to an overshooting of the exchange rate and to an excessive rise in interest rates. I would be interested in the staff's elaboration on these risks in the particular circumstances of South Africa. On the fiscal front and the clear need to increase public savings, I have some concern with regard to the authorities' decision to cap the revenue to GDP ratio. This means that the burden of adjustment is to fall solely on expenditure reduction at a time when strong pressures to increase spending on unmet social needs will remain very strong. Success in the effort at restructuring and prioritizing expenditures while increasing their effectiveness, particularly in education, will therefore be crucial.

To conclude, it is important that the authorities build on the sound policies they have pursued since 1994. They should be prepared to take action soon on a bold, comprehensive package of reforms that would begin to tackle the deep-seated structural weaknesses of the South African economy. I would encourage the authorities to proceed with a sense of urgency in the task of achieving consensus on the design of a detailed, step by step reform program that would enhance growth and employment while minimizing the risks. I, therefore, welcome their initiative, as expressed in Mr. Dlamini's helpful statement, to explore staff proposals further within the various government departments and then to finalize a draft policy framework that would be discussed with the main social players within the country.

Mr. Wijnholds made the following statement:

This is a most interesting and ambitious report. It describes a comprehensive strategy aimed at simultaneously addressing all of South Africa's major problems in the economic sphere. As such its implementation would bring about far-reaching changes and could provoke both a quantum jump in South Africa's economic growth as well as a major dent in its extremely high unemployment rate. Before attempting to give an assessment of the strategy, I wish to make a few remarks on recent economic developments.

The authorities deserve praise for implementing basically sound economic policies in very challenging times. In maneuvering between, on the one hand, the high expectations of the new electorate, and the demands from the labor unions and, on the other hand, the requirements of sound market based macroeconomics, the government has not let itself get pressured into short term-ism.

However, market confidence in the continuation of this positive trend is still shaky, as illustrated by the recent sharp depreciation of the rand. Moreover, present policy is not leading to substantial inroads into solving South Africa's structural problems in the near to medium future. A continuation of very high unemployment and low per capita income growth entails the risk of a growing—potentially destabilizing—dissatisfaction among the population and a possible tendency to revert to old economic philosophies. Clearly the desirable rapid transition to a more dynamic market setting will require measures that are likely to be politically sensitive. Therefore, much effort will have to be put into educating the population about the rationale for the required changes, including appealing to the solidarity of the labor unions with the unemployed. This effort would hopefully provide a better environment for the continuation, at an accelerated speed, of the required structural changes.

The staff's advice for the authorities to adopt a structural reform package consisting of six pillars to be cemented in a formal social pact is certainly timely. I noted with satisfaction from Mr. Dlamini's statement that the authorities are determined to build and nurture the social consensus enabling them to take the necessary bold actions.. I will first make a few remarks on the various elements of the package and then go on to the question of implementation.

First, a reform of the minimum wage structure is crucial for addressing the competitiveness problem. The suggestion to apply a sliding scale for the minimum wage levels of youthful workers, for which the example of the Netherlands is cited by the staff, and to differentiate minimum wage structures by province, has much to commend it. A logical extension of this approach is stepping up the training of unskilled workers, both on the job as well as by improving the general educational system. The fact that productivity of expenditure for education is low points to a need for assistance in this area, particularly for a World Bank project.

On trade liberalization, more clearly needs to be done. After decades of a high level of protection, stronger exposure to world competition and increased access for South African exporters to world markets, particularly in the European Union, is highly desirable. Resistance in the private sector should be mitigated by other elements of the package.

The land reform proposals take us rather far from the Fund's traditional areas of advice, and I would envisage a stronger role for the World Bank here when it comes to implementation. The proposal to levy a tax on large land holdings, while likely to speed up land reform, could be expected to meet with stiff resistance in certain quarters and will have to be carefully crafted.

As to fiscal policy, I fully agree that there is a need for higher domestic savings and therefore for faster fiscal adjustment than envisaged so far by the authorities. The staff believes that this will also foster a real depreciation of the rand. I would appreciate an explanation of this latter point of which I am not fully convinced. Indeed, I would think that confidence factors could work in the opposite direction.

This brings me to the element of the exchange rate as part of the package. The staff feels that downward pressure on prices on account of other measures would take away the danger of inflationary pressures arising from depreciation. There is, however, a risk here that should not be downplayed too much. Moreover, I am somewhat concerned by the explicit mention of depreciation as part of the package. I note that the staff makes the important qualification of an 'appropriate' depreciation. Still the temptation to solve the competitiveness problem largely through exchange rate adjustment could be considerable and should not be encouraged in any way. In this regard, I would also express some concern at the suggestion on page 23 that since the necessary adjustment of real wages would be (much) easier without having to cut nominal wages, further reduction in inflation might have to be postponed until after the package was in place.

The monetary authorities were of the view that the prospects for having the package in place soon were limited. If that is indeed the case, the question arises whether some parts of the package could not be implemented earlier. Indeed, an all-or-nothing approach with respect to adoption of the package might lead to overall inaction. In addition, account should be taken of the likelihood that the measures have different time frames of implementation. Hence, while progress should be pursued on the whole package, backtracking in certain areas should not delay other measures from advancing.

It seems to me that a certain natural sequence for the proposed measures can be identified. In the first place, stronger fiscal adjustment is a necessity that is not directly influenced by the other measures, but does in turn enhance the effect of a number of the other suggested adjustments and should therefore be put on track before these other adjustments.

The fiscal deficit has been coming down steadily according to plan. Nevertheless, the deficit level remains rather high, also compared to past figures for South Africa. In the meantime, monetary policy is appropriately directed to bringing down inflation. This effort requires high real interest rates, which undoubtedly affects private investment. In that light it is important to bring down the fiscal deficit at a faster pace than is presently the case. This would more evenly share the burden of achieving price stability between monetary and budgetary policy, and thus bring down real interest rates. From a purely macroeconomic point of view, it would be preferable to reduce the deficit by constraining expenditure while leaving revenues untouched. But it is probably more feasible to increase revenues as well, through, among others, broadening the tax base. This should also lead to a reduction of real interest rates since monetary policy would be unburdened, but would be accompanied by a smaller crowding-in effect of private investment. Other early elements of the package should be labor market reform and trade liberalization.

In conclusion, given the urgency of South Africa's economic problems, I would encourage the speedy adoption and implementation of a structural reform package as proposed by the staff, albeit with less explicit emphasis on depreciation. If, however, the comprehensiveness of the package delays its implementation, progress should in my view be made on the individual components, with a particular emphasis, in first instance, on stronger fiscal consolidation than foreseen by the authorities and a wage-flexibility-inducing reform of the labor market.

The Acting Chairman wondered why exchange rate policy should not be used, in an adjustment program with contractionary monetary and fiscal policies, to mitigate the risk of deflation.

Mr. Wijnholds remarked that the danger with a depreciation strategy was that it downplayed the inflationary risk. The rand had already depreciated considerably, and that had to be taken into account in assessing whether or not it would be wise for the staff to be promoting a further depreciation. Moreover, like Mr. Clark, he was concerned that that policy advice would appear to contradict the view held by the authorities that the rand had become undervalued after the recent depreciations.

Mr. Andersen said that he shared Mr. Wijnholds's views. He noted that the other key elements in the policy package to stimulate employment and growth would serve to improve confidence in the markets, and would thereby reinforce the authorities' efforts to move toward a market-determined exchange rate system.

Mr. Waterman said that he too had some sympathy with Mr. Wijnholds's view. With the substantial depreciation of the rand in recent months, it was unclear how much more real depreciation the country could absorb, and it was now important to move forward with the other measures in the proposed reform package.

The Acting Chairman said that what he had questioned in his intervention was the general proposition that it would be less painful for a country to achieve needed price adjustment through domestic prices rather than the exchange rate. The staff's advice would certainly account for developments since the release of the staff paper.

Mr. Evans made the following statement:

I think we should begin by recognizing the successes of the past year. Growth has increased, inflation has come down, and the fiscal deficit has been reduced. There was a moderate relaxation of exchange controls, and the resulting inflow of long-term capital has boosted investment. Of course, the need for higher growth and the extraordinarily high level of unemployment remain major problems.

The causes of unemployment lie in South Africa's long history of having a closed and distorted economy; in a serious lack of investment and a resulting shortfall in the capital stock, both physical and human capital; in the distortions in the labor market, caused by minimum wages, wages boards, trade union powers, compelling industry-wide wage setting; and in some serious deficiencies in terms of competition in the product markets. Perhaps we should add to the list the uncertain climate created by high levels of crime and the consequent insecurity. The needed response to the unemployment problem is to create both the macro and micro conditions under which employment growth can take off, as in Scenario B. I agree with most of what the staff says on both accounts.

Strengthening macroeconomic policies, preferably by cutting expenditure more in 1996/97 and beyond, is clearly necessary. A stronger and credible medium-term framework for fiscal and monetary policy is required to help reassure markets that the budget deficit is under control and that the medium-term path of interest rates will be downward.

As far as the exchange rate is concerned, I think the staff is right that the recent depreciation has been welcome. Like Mr. Waterman, I interpret the authorities' statements as implying that they are now reasonably content with the level of the rand. I take it that the recommendation in the paper for a further depreciation was considered before the most recent depreciation; or perhaps the advice is conditional on various other structural adjustments occurring as well. I would welcome staff comment on this point. Where the exchange rate will end up in South Africa is still highly uncertain, and will depend on the accompanying policies. There is a good case for moving toward a floating rate, and avoiding particular targets or committing too much of the reserves to intervention, as has been done recently.

With respect to structural reforms, I would have preferred more emphasis in the staff report on privatization, partly as a way of raising the low levels of productivity, reducing the budget deficit, and attracting foreign investment. More generally, the staff has put forward an interesting package, which takes into account, perhaps more than usual, the political constraints. The staff has tried to suggest practical second-best ways of moving forward despite these constraints. A key structural issue is, of course, labor market liberalization and efforts to reduce unemployment. No doubt the first-best solution is the abolition of the minimum wage. The staff has suggested that significant progress can be made instead by targeting reductions in minimum wages on young people and in particular areas. In the same way, it might be possible to lift restrictions on the small- and medium-size enterprise sector, which is such an important source for new employment.

I agree with the staff that further trade liberalization should produce big benefits from increased competition within South Africa and that there are real advantages in going for more specific commitments on trade to reduce the scope for lobbying by special interests.

Improving the efficiency of the current education and training system clearly has a high priority. I hope that the World Bank will be able to play a significant role in this area. Like Mr. Wijnholds, I was interested in the suggestion of how to reduce the potential burden on the budget and increase employment from land reform. Like him, I think there are some major political difficulties here.

I think the authorities would do well to draw on the staff's expertise to develop a package that would maximize the economic benefits as well as be politically acceptable. I hope that the proposal for an informal workshop will soon be realized. However, like Mr. Wijnholds, I wonder whether it is advisable to suggest that the various elements of the package all have to be implemented together—that is, all or nothing. We usually recommend that a government push ahead with reform wherever, and in whichever sectors, it is politically possible to do so, without waiting for a comprehensive plan to be agreed. I think this approach should be applied to South Africa. A strategy of all or nothing could put the authorities in a bind, and could risk eroding the pact amongst the social partners. So much of the needed reform will have to come from reducing the powers of vested interests—the unions and those firms and industries, which have benefited from the closed and distorted economy in the past. In certain circumstances it may be difficult to avoid the pressures. Therefore, it will be important to seize the opportunity for reform as it arises.

Mr. Barro Chambrier made the following statement:

Let me commend the staff for its comprehensive report and well-focused background papers. The background papers bring to our attention some very important policy issues and I commend the candid assessment of the staff as regards these sensitive issues.

In the short time since taking office, the new South African authorities have shown their commitment to prudent policies which have contributed to economic stability and to increased investor confidence. Inflation has fallen and real GDP growth has increased. The South African authorities deserve to be commended for their policy stance, in the face of the daunting challenges that they face in terms of meeting the unfulfilled basic needs of the majority of the population. Nevertheless, it is worrisome to note that after three years of economic recovery, the unemployment rate remains excessively high, and the outlook remains uncertain.

There is no doubt that the unemployment situation is the most pressing problem facing the authorities, because of its potential destabilizing effects. In this regard, I agree with the staff that "the immediate challenge is to raise employment growth considerably, by increasing the labor intensity of production and by raising the rate of output growth."

The package that is proposed by the staff certainly addresses the main causes of unemployment. I share the view that the wage structures need to be reviewed, that there should be improved opportunities for education and training, and that there is a need for land reform as well as trade liberalization. The exchange rate, too, can play an important role in this strategy. Of all these measures, a successful land reform has the best potential for absorbing a large number of unemployment. But, this may take a long time to take effect. Mr. Clark has drawn our attention to some of the weaknesses in the authorities' plan and to that proposed by the staff, and I share his concerns. Overall, it is doubtful that these mutually reinforcing measures and even a higher level of economic growth will be enough to have a noticeable impact on the extremely high level of unemployment. Under present conditions of high expectations, it is not certain that the authorities will be given much more time.

In the event, it will be necessary for the authorities to consider additional ways to create large number of jobs quickly. As has been shown in previous cases, the only successful measure that can have such an immediate impact is the undertaking of large public work programs which will have the advantage of not only reducing unemployment, but also address many of the other challenges that face the authorities, such as the provision of adequate housing, schools, hospitals and other much needed infrastructure in the areas inhabited by the majority of the population. Moreover, these projects will give the authorities time to put in place the economic and structural policies that will strengthen the private sector and allow it to be the primary creator of jobs. I think the Reconstruction and Development Program of the authorities is aimed at addressing some of these issues. Is there any thought to expand the scope of the RDP to include large public work programs. Staff comments will be appreciated.

On macroeconomic policies, the authorities' approach up to now have been appropriate. Gradual fiscal consolidation will have to be continued. However, I would caution against too severe cut in expenditure, but I do recognize that more efforts are needed to rationalize budgetary expenditures and social programs. While the possibility of increasing taxes may be limited, ways to broaden the tax base should be considered. In this regard, taxes on the mining industry and tariffs on external trade could be reviewed. Overall, the 1996/97 budget goes in the right direction, with declines envisaged in defense outlays and export subsidies. However, the reduction in capital expenditure remains of concerns because of its adverse impact on future growth.

On monetary policy, I note that interest rates have been pushed up quite high, probably in order to defend the rand which had come under pressure several times in the past year. While this policy has helped to keep inflation under control, I wonder if it is really appropriate at this time. Moreover, it would appear that the high interest rates are attracting short-term capital into South Africa and could be a cause of instability should there be a reversal in investors' confidence. If this policy is maintained, it is difficult to see how the higher level of economic growth will be achieved? Perhaps the staff may comment on the direction of monetary policy at this time in South Africa and what effects it may be having on commercial banks' lending?

On trade reform, I welcome the steps that have been taken toward trade liberalization and the commitment of the authorities to maintain an open trading system. In this regard, I would encourage the authorities to pursue steadfastly their plans for tariff reductions. An open trading system will give South Africa the best opportunity to improve efficiency and also to remain competitive, while remaining an engine of growth in this region of the world.

The proposal by the EU for a free trade area with South Africa is interesting. However, while noting the potential benefits of such an agreement for South Africa, I note that South Africa also has regional trade agreements. Could the staff indicate the potential effects of the agreement with the EU on the other regional agreements, especially the Southern African Development Community (SADC) and the South African Customs Union (SACU)?

Regarding the trade agreement with the EU, it appears that South Africa's agricultural products may be excluded, could the staff provide some additional information on this issue?

As regards exchange rate policy, I note the staff's recommendation for an appropriate depreciation of the exchange rate. While the structural package that is needed to stimulate growth and employment will also require an exchange rate adjustment, I would, however, caution against a policy that relies on exchange rate depreciation to maintain competitiveness. Mr. Gaspard has drawn our attention to the potential risks of such an approach and I share his concerns. Moreover, it is doubtful that the external accounts will strengthen by much as imports will cost more and such an approach does not encourage modernization or improve efficiency. A comprehensive package of macroeconomic policies that support an appropriate and stable exchange rate will produce better benefits in the longer run.

Finally, as noted by Mr. Dlamini in his very helpful statement, significant progress has been made by the authorities in laying the foundation for political stability and sound economic management. Nevertheless, the authorities will be faced with serious challenges in the years to come. Their success will depend on the consensus that can be achieved regarding, among others, the direction of economic and financial policies and also by their success to meet the basic needs of the population. The authorities have shown that they understand the problems facing them. I hope that they will receive the critical assistance needed to continue on the path of adjustment and to create a better future for the inhabitants. I encourage the authorities to persevere in their efforts and I wish them well in their endeavors.

Mrs. Cheong made the following statement:

Recent developments in South Africa once again illustrate the power of international investors and financial markets. Despite authorities' remarkable commitment to stabilization policies that have yielded satisfactory results and facilitated moderate economic growth, the markets view that the authorities still need to prove their credibility. As long as such sentiments remain, South Africa will need to reinforce its macroeconomic policy stance before the markets will concede to it any benefit of the doubt.

On page 48 of the background paper, the staff has clearly summarized the required action to establish a track record of sound economic management. In addition to the three points mentioned by the staff, I should add a fourth requirement, namely the need for the authorities to inform the public and international investors of its medium-term program on an investment and growth strategy, together with the macroeconomic policy package to ensure that this strategy will be realized. This economic package should identify the growth and employment creation targets, the corresponding investment requirement and its financing, the engine of growth, whether the public or the private sector and all the structural reform required to stimulate investments (tax and competition policies, labor market reforms, social reconstruction programs, health and education reforms, measures to increase savings and investments, among others).

A policy package of this nature will provide the needed direction being sought by investors. Mr. Dlamini in his statement mentions that such a policy framework is being finalized. In this program, the government's credibility must be established by ensuring that while growth strategies can change mid-stream to take account of changing circumstances, rules governing investment and private sector participation (including exchange controls) should continue to progressively favor private investors. In this area, the South African authorities need only look at experiences of other emerging economies where existence of four or five-year economic plans that are accompanied by an equally credible complementary fiscal, monetary and exchange rate policy, have been one of the primary factors that provided the requisite direction to facilitate private and public sector investment decisions. These plans also incorporate the program of sequencing of financial and other economic liberalization measures. Once market players are clear on the policy direction, it will create a natural path toward establishing market confidence.

Like other Directors, I am also interested in the staff's response to questions on its recommendation for exchange rate depreciation to improve competitiveness. In a situation where the authorities already view current rates to be undervalued, staff recommendations on further depreciation raises concerns on consistency in staff advice among Fund members. In discussions on other countries, the advice has always been to avoid use of exchange rates to improve competitiveness.

Turning to the fiscal policy, I agree with points raised by other Directors with regard to fiscal consolidation. I only wish to add some views on the authorities' plan to restructure expenditure to relieve poverty and inequality. In this regard, I wish to draw attention to expenditure on education as a proven measure to reduce poverty and inequality among the populace. As the staff pointed out, although expenditure on education is high by international comparisons, its productivity is low. A longer-term budget strategy is required to ensure that education expenditure is in line with skills development. A two-pronged strategy on education expenditure has worked in my country which in the 1960s and 1970s faced the same situation as in South Africa, although on a much smaller magnitude. This strategy involved budgetary allocations to make available to all, education at the primary and lower secondary level (up to age 15) and a financing and selection system to enable children from poor families to pursue upper secondary and tertiary education. All it needs is for one member in each family to escape the poverty trap, and it paves the way for the betterment of the livelihood of whole communities. This is only possible through high expenditure on education. World Bank participation in this goal is useful, but I note that current discussion with the World Bank does not include assistance on basic education.

Related to the education and employment creation strategy is the labor reform issue. I have two areas of concern. First, I would appreciate the staff's clarification on the disadvantages of an absence of a minimum wage and the staff's preference for a restructure of the minimum wage . While other Directors view a restructure of the minimum wage as appropriate, from the perspective of another developing country , I am not convinced that restructuring the minimum wage is useful. I always thought that wages should be related to productivity and demand and supply factors. The unemployment situation in South Africa is due to lack of job opportunities rather than the wage factor. It would seem more practical to concentrate policies on employment creation and let the market determine wage levels. In a developing economy, minimum wages seem a luxury, while a planned restructure of wages that differ across provinces and age groups could turn out to be more distortionary unless there is absolutely complete information on competition factors.

Another concern on the labor front is trade unionism. The recent currency pressures were also contributed by investor perception that the government is sympathetic to promoting strong trade unions that can make excessive demands for wage increases. For example, there is a view that the benefits of exchange rate depreciation on exports could be short-lived, if labor unions are successful to solicit wage increases in line with expected higher inflation. In many Pacific Basin countries, employment creation was facilitated by developing labor unions that were more cooperative in meeting long-term growth objectives, This cooperative effort was built on transparent rules governing legal procedures to settle disputes and legislation to ensure that adequate workers' rights can be maintained. The labor reform work that is being undertaken in South Africa should pay due regard to the disruptive nature of strong unions. While unions are necessary as a counterbalance to ensure adequate worker benefits, the ongoing labor reform must give comfort to the private sector that unions will not create destabilizing conditions.

Mr. Al-Tuwaijri made the following statement:

The South African authorities continue to face a most daunting challenge in transforming the economy and placing it on a sustainable growth path. Developments since the last Article IV consultation have confirmed the commitment of the authorities to proceed as rapidly as practicable. At the same time, market uncertainty and recent pressures on the rand serve to highlight the delicate phase of economic policy.

The main task at this stage is to ensure an economic environment more conducive to sustainable growth while meeting various shorter-term needs. As the staff report suggests, the complexity of the task ahead would involve all areas of financial and structural policies. Under the circumstances, policies need to be implemented strictly within a coherent and comprehensive medium-term package of mutually reinforcing financial and structural strategies.

I find myself in broad agreement with the staff appraisal and will make only four remarks.

First, structural reforms are an overriding priority. Enhancing Labor-market flexibility is key to reducing unemployment as well as enhancing competitiveness. It is clear that policies in this area will be very difficult to implement. However, delays in the formulation and execution of a credible and far-reaching strategy risks the country's impressive long-term growth potential. Trade reforms are also an important element for enhancing competitiveness. Reforms implemented to date are encouraging. Furthermore, the potential free trade agreement with the EU would offer South Africa important opportunities. However, the concerns of the authorities and staff in this area seem to be well taken, and I hope that negotiations can be concluded at an early date.

Second, I welcome the progress made in fiscal consolidation. While the need for an improved level of public services in certain areas is apparent, a higher level of expenditures is not necessarily the optimal course of action. Efforts need to focus on careful prioritization and measures to enhance the efficiency of government expenditures. The formulation of a medium-term framework, along the lines suggested by the staff, should help in reducing uncertainties regarding the future course of fiscal policy. In this connection, maintaining the revenue/GDP ratio at a reasonable level should remain an important objective.

Third, with greater liberalization the rand has become a more reliable barometer of market sentiment. Recent market pressures have served to highlight the importance of maintaining firm and clear commitments to the future course of policy. The monetary authorities have reacted promptly and appropriately to market pressures. I share the view of the staff that the depreciation of the rand, though sudden, is welcome. Gains from the depreciation, however, could quickly dissipate in the absence of a more supportive financial stance.

Fourth, the pace of further liberalization of exchange controls needs to be carefully considered. There is a risk that a rapid pace of liberalization may lead to excessive depreciation. However, a slow pace of liberalization will maintain distortions and may invite markets to test the authorities' resolve.

Finally, South Africa's efforts to date have been well rewarded through an improved performance of the economy and increasing investor enthusiasm. It is now time to consolidate these gains through the formulation of a comprehensive financial and structural reform agenda that would help reduce market uncertainties and enable the economy to realize its impressive long-term potential. I wish the authorities every success in the difficult challenge ahead.

Mr. Andersen made the following statement:

It is encouraging to note the remarkable achievements by the South African authorities in managing their economy during the difficult period of political transition. In particular, I would like to commend the authorities for their continued adherence to outward-oriented market-based economic polices underpinned by fiscal and monetary prudence. Nonetheless, as mentioned by the staff, the recent weakness of the exchange rate underscores the fragility of the progress made thus far, and the need for vigilance.

The staff has produced an interesting set of papers which gives a rather detailed analysis of the complex set of issues that will need attention in the period ahead. The main challenge is, of course, to maintain a strong, growing economy than can provide the resources for a more just society, without undermining its dynamic nature and future growth prospects. Against the background of the unusually gloomy labor market statistics, it is evident that much greater effort is needed to support both higher sustainable growth rates and increase the labor intensity of production.

Accordingly, I share the view that a comprehensive package of mutually reinforcing measures are urgently needed and that the prospects for success of such a package would be greatly improved if it were to form the core of a social pact.

I am also in broad agreement with the staff's recommendations, but would like to comment briefly on some of the main elements of the proposed policy package. Before doing that, I would like to welcome the envisaged close contact between the authorities and the staff in connection with the interdepartmental discussions on the proposals in the staff report, as mentioned by Mr. Dlamini in his statement.

First, strong emphasis is appropriately placed on the need for a more flexible and better functioning labor market. The challenges ahead have already been commented upon in details by previous speakers, and I have little to add. The labor market problems was in the forefront also in last year's discussion, and I find it somewhat disappointing to see that the authorities have hesitated to attack this problem with the urgency needed.

Second, while I acknowledge that the trade reforms already adopted and implemented represents significant steps toward addressing the need for trade liberalization, and that I too would like to welcome the authorities' unambiguous reaffirmation of their determination to resist any reversal of the trade liberalization process, I share the view that a further opening of the economy must be part of the reform package, and the reported resistance in the private sector to trade liberalization is indeed regrettable.

Third, the staff, in the main report, saw an exchange rate depreciation as being an essential element in the suggested package. Now I note from yesterday's statement from the staff, that after the significant depreciation more recently, the staff's emphasis is on the need to regain stability on the foreign exchange markets through a tightening of the macroeconomic policies together with appropriate steps regarding structural reforms. I welcome that the main focus is now put on the underlying policies. As already alluded to, I share many of the views expressed by Mr. Wijnholds and I would like to caution against using any "forced depreciation" to gain competitive advantages, and I would also be concerned that a depreciation would add to the inflationary risk which is already quite high, a risk that is confirmed by yesterday's statement by the staff. More generally, I agree with Mr. Clark that the previous staff recommendation raised a number of questions. It may not be that straightforward to achieve a depreciation within a market-determined exchange rate system, in particular if a number of other measures, including a tightening of fiscal policy, is being embarked upon simultaneously, i.e., measures that increases confidence. Rather, I would argue that the authorities should err on the side of great caution in their policies and take the steps needed to ensure that the exchange rate is not seriously out of line with fundamentals. To the extent this will be done through a significant acceleration and deepening of structural reforms, as well as supportive fiscal, monetary and income policies, this should certainly be welcomed. On the other hand, statements alone about policy commitments are seldom, if ever, enough to calm down markets on a sustainable basis. Regarding the remaining exchange restrictions, I welcome the recent agreement between the reserve bank Governor and the Finance Minister to take small steps more regularly and continue with the program if phasing out the restrictions.

Finally, let me just give some brief comments on the fiscal policy. To my mind there is no doubt that a stronger and more front-loaded fiscal consolidation is urgently needed. Also some market reports seems to put fiscal policy concerns at the heart of the recent turmoil on the foreign exchange market. These speculations are based on a fear that official figures do not tell the true story about South Africa's debt accumulation. The factors mentioned includes the statistical adjustment made with effect from the 1994/95 budget to reflect the output contribution of the informal sector, the comprehensive use of issuing discounted bonds and the corresponding underestimation of interest payments, the large "rollovers" of unspent funds from one fiscal year to the next, something that is clearly not sustainable, and the risk that the business cycle may enter a downward phase. Staff comments on the validity of those concerns would be appreciated. In any case a significant strengthening of fiscal policy is strongly warranted as also noted by the staff. Like Mr. Clark, I wonder whether there is not scope for both the revenue and expenditure sides to contribute to stronger fiscal consolidation, instead of the expenditure mainly. I would also like to emphasize the potential significant contribution from accelerated privatizations. A strengthening of the fiscal policy would also alleviate the burden put on monetary policy which presently is quite high, not least when measured by the level of real interest rates, and I share the view that a further tightening may well be needed in view of the inflation prospect should the necessary support from fiscal policies fail to appear.

Ms. Lissakers made the following statement:

Many of my colleagues have made points that I would make myself, and I agree with Mr. Wijnholds's comments, for example, on the minimum wage, although I wait for the staff's elaboration on some of his questions and also on the emphasis on education and training.

I think we all recognize and certainly should commend the South African authorities for the great skill with which they have steered the South African economy through a very tumultuous, politically and economically difficult period. And I think the staff report quite rightly now focuses on the primary challenges facing South Africa, which are accelerating growth and job creation. I think it is hard to argue with the basic components of the reform package the staff lays out, and I think that the scenario A and scenario B exercise is particularly useful in highlighting some of the trade-offs in the different growth paths that can be taken, depending on the pace with which certain reform measures are taken. I think it is also clear that there is a linkage among the measures. So it is useful up to a point to think about this as a package, but I think there is also risk, as some of my colleagues have said, in overemphasizing the package in an "all-or-nothing" manner. On page 15, the middle paragraph, the staff report notes the mission emphasized that all the elements of the package should be implemented together as they are mutually reinforcing, and then lays out the risks of moving on one without moving on the other components. I recall hearing, along with a number of you, Czech Republic President Vaclav Havel talk about his ten laws of economic transformation, and one that comes to mind here is his warning that there is no perfect sequencing in economic transformation. "When an opening presents itself, seize it, and move through it as quickly as possible." I think that the recent devaluation of the rand, depreciation of the rand, may in fact be such an opening.

Leaving aside the pluses and minuses of why the rand depreciated, the fact is that the depreciation does take away some of the downside risk of more rapid trade liberalization, and, indeed, presents an improvement in international competitiveness that should make some other elements of the reform effort easier to digest. I think the staff report and background paper make a very strong case for much more rapid trade liberalization, concluding that many of the structural difficulties that South Africa faces, including the uneven distribution of wages, and so on, are a direct legacy of the highly protectionist trade structure that South Africa has had for many years.

On page 51 of the supplement, the paper lists the effect of this protectionist trade regime: it resulted in distorted rates of remuneration of factors employed intensively in the protected sectors, notably those of skilled labor; it raised the capital intensity of the domestic economy by encouraging the production of capital-intensive final goods; and it impeded the growth of nontraditional exports by weakening the international cost competitiveness of these products. That seems to me a pretty strong case for moving faster than is currently contemplated on the trade front. I would note that the table on page 55 shows that at the moment, at least, the tariff rates are still quite high. On a weighted average on capital goods, it is 21 percent, import-weighted average on intermediate goods is 15 percent—that is perhaps not so bad—and on final goods is 20 percent. Significant gains could flow from accelerated action on the trade front, and I would welcome the staff's response to this point. A more aggressive approach on the trade liberalization could capitalize on the opportunity that has presented itself.

On the question of the exchange rate regime, what makes some of us nervous is the argument that there should be a proactive depreciation stance by the monetary authorities in pursuing the reform package rather than a stance of letting the market find its own level. Obviously, actions, for example, on unwinding the central bank's net open position and/or liberalizing capital controls could have a significant impact on the exchange rate and keep it from appreciating excessively, even if there is substantial gain in confidence and capital inflows, and obviously the trade opening could have a similar countervailing effect, as well. So I do not know that there is so much dilemma.

On the exchange regime in this forward-market operation, I certainly see the risk and the cost to the Central Bank of having a large position in this exchange rate environment. On the other hand, it is an interesting tool. It is a rather unique tool of market intervention, and I wonder whether the staff's view is that this should be eliminated completely from the reserve bank's intervention arsenal, or whether it should be preserved as at least a potential instrument so long as South Africa has low reserves, as it does, which makes direct intervention a somewhat limited option.

On the fiscal side, I welcome Mr. Clark's question about the balance between expenditure cuts and increased revenue in achieving deficit reduction. Obviously, it is partly a function of the growth path, but there is also the question of whether it would not be desirable to maintain a slightly higher percent of GDP of tax revenue, given the enormous social needs of the economy. Is an approach that focusses on expenditure cuts consistent with meeting social needs? I hope the staff will respond to Mr. Barro Chambrier's question about public works.

Given the enormous social strains, I would think that the focus of World Bank support aught to be on addressing the immediate needs in the primary and secondary education levels, as well as on employment generating projects (for example, putting shovels in people's hands and having them build roads). We are proposing to do that in the West Bank and in Haiti. I do not see why the same principles would not apply in South Africa under current circumstances. Some of the Bank's activities appear a bit grandiose and detached from the situation on the ground.

I have to say, I was not dazzled by the description of what the World Bank is doing in South Africa right now. "The capacity building, development institute is assisting South African universities in courses in economic development." I suppose that this is the top-down approach to education. Whatever happened to "each-one-teach-one," and focusing on primary education, which would deliver the quickest payoff?

Finally, I commend the staff for being quite creative in trying to design, for example, the approach to minimum wage reform in the context of the political and social reality in South Africa, and I think the same is true of the land reform proposal. I wonder whether the proposed tax-based land reform scheme has been tried elsewhere, whether it is something that the staff has invented, or whether this is a World Bank design?

Mr. Kannan made the following statement:

We are fully aware of the difficulties which South Africa faces today and against this background, we commend the authorities for their commitments in placing South Africa on a sound macro footing. In particular, it is worth mentioning that the output growth has recovered to 3.3 percent in 1995 from 2.7 percent in 1994 and the inflation has decelerated to 8.6 percent in 1995 from 9.0 percent earlier. A small decline in fiscal deficit was also witnessed.

However, the challenges are many and stabilization should therefore be supplemented by rapid structural adjustment measures. As rightly observed by the staff, the most pressing problem is high unemployment and the inefficiency of the labor market. In resolving the unemployment issues, the authorities must try to reconcile the conflicting views of business community and labor market so that the proposed change in competitiveness does not jeopardize labor market reform. Like Mr. Gaspard, I believe that a comprehensive package of reforms to be implemented in a medium to long-term context, is urgently needed. Labor intensive activities should continue to be accorded high priority in the efforts to promote faster growth. In this context the importance of better training and education needs to be duly recognized. I fully agree with Mr. Dlamini in his remark "It is obvious to the authorities that a multifaceted approach is needed and that policies that can be taken in the short run would have to be complimented by long rage measures, especially those related to human resource development and the use of more labor intensive technologies."

On the fiscal policy front, the deficit reduction exercise is to be pursued with vigor in order to give a boost to domestic savings and to reassure the financial markets through both revenue augmenting and expenditure restraint measures, the latter being aimed at restructuring toward education, health and other social services. The planned civil service reform which also has a major role in this task, must be pursued as scheduled.

On the monetary policy, we share the staff's view that the primary objective should be to reduce inflation to a level that is comparable to that of South Africa's most important trading partners. Hence a tight monetary policy stance in 1996 is appropriate. However, we could not understand fully the relevance of the broad money, growth target of 6–10 percent in 1996, the same as in 1995. The actual outcome was 15 percent in 1995 and the staff has projected a 12 percent growth in 1996. The staff may like to elaborate on this.

Given the need to give a boost to investment and growth, the increase in capital good imports is quite understandable and hence a tolerable increase in current account deficit is acceptable. But in financing this deficit, the authorities must avoid resorting to heavy short-term capital inflows in view of the volatility of such flows. For example, in 1995, short-term capital accounts for about 50 percent of the current account deficit. (page 30, Table 2). Moreover, the authorities are yet to strengthen the necessary policy instruments to handle the situation, in case they witness a reverse flow in such short-term capital. In narrowing the gap between savings and investments, the importance of augmenting domestic savings is also to be duly recognized.

With reference to the external sector issues, we are happy to note that the financial rand was abolished in March 1995 thereby, removing foreign exchange controls on nonresidents. We also welcome the authorities intention to gradually remove exchange control on residents.

We generally endorse the staff proposal of six core components in the structural reform package. However, we are not clear about the following and staff comments on these three issues would be welcome:

(1) The sequencing or prioritization of these components is to be well debated. As these six measures are to be supplemented by other policy

measures like privatization and restructuring of civil service, we doubt whether the authorities have the necessary administrative capacity to implement these measures, if they have to carry out in a simultaneous manner.

(2) Of these six measures, the appropriate depreciation of the rand seems to be the linchpin. But it seems that the authorities have different views on this (page 24, paragraph 3). If so, the success of the whole package is not clear at this stage.

(3). Even if the whole package is carried out as explained under "'Scenario B'" of the medium-term projection, we feel that the inflationary impact of the proposed depreciation of the rand is underestimated, if we consider the last four to five years' experience.

With these comments, I wish the authorities every success in their endeavors.

The staff representative from the African Department said that, in proposing an exchange rate depreciation, the staff had taken into account the need to avoid further unemployment that could result from the proposed package of policy reforms, as the Acting Chairman had mentioned. The prospect of deflation once the reforms were in place could not be viewed as positive, given the already very high unemployment rate in South Africa. Concern that accelerated trade liberalization—also a part of the package—would lead to pressure on the current account had also led the staff to recommend an exchange rate depreciation. However, the staff was against the use of the exchange rate as a tool to improve competitiveness in the absence of structural reforms, as the report had clearly stated.

The recent market-driven depreciation of the rand had put the cart before the horse, the staff representative noted. The depreciation was supposed to have supported the reforms, not to have preceded them. Now the main concern was ensuring that the gains from the depreciation were maintained. For that reason, the staff was recommending a further tightening of financial policies so that the gains would not be eroded by inflation.

Several speakers had wondered how the authorities could ensure a real depreciation in the context of a floating rate system, the staff representative continued. Removal of exchange restrictions on residents was one way. The central bank could also further reduce its forward book. Forward market intervention was a very useful tool that the monetary authorities should probably hold on to but use only very sparingly.

Some speakers had suggested increasing revenues to further reduce the deficit, the staff representative recalled. The authorities felt quite strongly that revenues should not exceed 25 percent of GDP, as that might encourage greater use of the tax system as a tool for redistribution, which they wished to avoid. Moreover, the provincial governments were considering raising taxes, which limited the room for the central government to raise additional revenues. To further reduce the deficit, the authorities were urged to cut back on export subsidies—particularly in light of the recent depreciation—and subsidies to businesses and consumers.

Attempting to address the unemployment problem in the interim through more public works programs would be prohibitively costly, the staff representative said, given the sheer size of the unemployment problem. The authorities had a public works program in place through the reconstruction and development program. However, to put an additional half-million people to work through that program—about 10 percent of the unemployed—would add some 2 percent of GDP to the deficit.

Mr. Barro Chambrier said that he had not intended to imply that the entire burden should be placed on the budget, as the public works programs could be financed through a combination of donor assistance and some additional domestic tax increases. However, at 32 percent of the labor force, the level of unemployment was extraordinarily high, and he strongly encouraged the Fund and the World Bank to assist the authorities in finding feasible ways to reduce it.

The staff representative from the African Department said that contingency measures had not been discussed with the authorities since achievement of the fiscal target was not at risk. Expenditures were authorized on a nominal basis, but the government had an exceptionally good system of expenditure control. Hence, if no increases in appropriations were made later in the year, the fiscal target could be achieved with no difficulty. Also, South Africa's structural and cyclical deficits were not much different, owing mainly to the lack of an unemployment insurance system in South Africa.

Further increases in the bank rate to help stabilize the exchange market and restore confidence had been recommended to the authorities, the staff representative continued. Interest rates were expected to remain high for quite some time, until confidence had been restored. Until recently, borrowing by the private sector had been very strong, growing well beyond the reserve bank's guidelines for credit expansion. Looking ahead, in real terms the lending rate was not expected to rise much higher than in the recent past.

Monetary and credit aggregates had grown in the recent past at a faster pace than their guideline ranges as a result of higher capital flows intermediated through the banking system, the staff representative noted. M3 had exceeded the guidelines two years in a row. However, the monetary authorities did not consider the guidelines to be targets, but rather a tool to signal to the markets what the likely monetary policy stance would be. The mission had suggested to the monetary authorities that the growth of M3 might not have predicted well inflationary pressures, and that narrow monetary aggregates might be better indicators of expected inflation.

The authorities had taken a keen interest in the staff's market-based land reform proposals, the staff representative remarked. The proposals might be reflected in the Minister of Finance's forthcoming statement on the medium-term policy framework. The staff was unaware of any precedents to the market-based proposal, which had been developed in cooperation with the World Bank as a cost effective alternative to the present land reforms in South Africa.

Eliminating minimum wage protection altogether was not feasible in South Africa, the staff representative pointed out. South Africa did not have a minimum wage under the central government's control; rather there were many different wage floors set by collective bargaining agreements and administered at many different institutional levels. The staff's proposal to lower the wage floors for the youth would not only help more young people gain employment, but it would also indirectly serve to lower the entire wage structure, through competition.

Agricultural goods would not be excluded from the European Union trade agreement, although the EU was proposing to limit the share of agricultural products that could be imported or exported duty free to 62 percent of agricultural exports, the staff representative stated. The staff had strongly encouraged the authorities not to accept that limit outright, but rather to negotiate for a larger market access. A trade agreement with the European Union would impact importantly both on the Southern African Development Community and the South African Customs Union, as elaborated in the selected economic issues paper. Briefly, members of SACU would lose the comparative advantage they had enjoyed over South Africa as an investment location, because they had benefited from preferential access to EU markets under the Lomé Convention. They would also lose customs revenue, on which they relied heavily. For those reasons, the staff had proposed that South Africa enter discussions with those countries on how best to minimize the impact of the trade reform, and to make arrangements to compensate for the lost revenue from import duties. The staff had also proposed that South Africa offer SADC a parallel arrangement to that offered by the EU, including more timely access to South African markets duty free.

The trade reforms could move faster and further than the authorities' current plans, as some speakers had suggested, the staff representative indicated. Trade liberalization would not only enhance economic efficiency, but propel the much-needed growth. At the same time, since an adequate supply response depended on removing the rigidities in the labor market and other reform measures, trade reform could not fruitfully be moved too far ahead of the other policies.

A number of speakers had expressed concern that the staff's presentation of the structural reform measures as an "all-or-nothing" package could unduly delay the reform process if consensus among the social partners could not be reached, the staff representative recounted. The various reform measures being proposed were mutually reinforcing, and there were no indications thus far that the authorities were unwilling or unable to move forward on all the policy fronts owing to political constraints.

Ms. Lissakers queried whether the staff envisioned political constraints down the road.

The staff representative from the African Department said that no one element of the reform package faced such opposition that it would be necessary for the authorities to proceed without it. The possibility of implementing the package as a whole existed. One of the main purposes of the social pact was precisely to bring the interested parties together, discuss the package openly, air differences, and come to an agreement that would enable the reforms to be implemented as a package. That process had already succeed in South Africa in other important areas. The Labor Relations Act, which had been approved in 1995, was one example. Following close consultations between the government employees, labor unions, and businesses, the labor legislation had been enacted without any difficulty.

Ms. Lissakers said that she had understood that the land reform and minimum wage reform proposals had encountered some opposition, and she continued to strongly urge that, if at some stage support for the whole package could not be secured, the whole process not be held back. Regarding deficit reduction, the mining industry accounted for 9 to 10 percent of GDP, yet contributed less than 2 percent of total tax revenues. Hence, the authorities might consider increasing the contribution of that sector to revenues, particularly as it was no longer considered a potential source of major employment growth.

Mr. Evans stated that he shared Ms. Lissakers's concern that an all-or-nothing approach might stall the process, and he asked the staff to elaborate on the reasons for its approach. Also, noting that the social pact was a dialogue among government, trade unions and industry, he wondered who represented the interests of the unemployed.

The staff representative from the African Department said that, while it was true that the land reform and minimum wage reduction could encounter some resistance, the elements of the package were mutually reinforcing in a number of important ways. If the real wage structure was not lowered, trade liberalization would lead to more unemployment, and not to the needed labor-intensive growth that was hoped for. With the structural reforms in place, the reduction of the fiscal deficit would be essential to avoid serious strain on the balance of payments. Proceeding without the proposed land reform would expose the urban centers to continued overwhelming migration from the rural areas, which currently suffered from very high unemployment. Clearly, that would not be sustainable; hence the need for the land reforms. The rationale behind the exchange rate policy recommendation had already been explained. Hence, all elements of the reform package were essential for a feasible long-term solution to very high unemployment. In response to Mr. Evans, he noted that the government was responsible for representing the interests of the unemployed, although other groups also supported their cause.

The staff representative from the World Bank, responding to concerns that not enough was being done in the area of education, explained that South Africa's demand for assistance in that area had declined in recent years. Although the authorities remained interested in the issue, financing was not the main concern or constraint. Jurisdiction over education was split between the central government and the provinces, and was presently a subject of much national debate. In that context, the World Bank was not viewed as a natural partner. Nevertheless, basic education remained a high priority, and the Bank had cooperated with the previous government before the transition, and in the early days of the new government, to help formulate policies. Many of those ideas—which were contained in the Bank's recently published education sector strategy paper—had been incorporated into the government's policy statements. Also the Bank remained productively involved in many other aspects of South Africa's development, including recent work on land reform.

Mr. Martinez Oliva made the following statement:

> First, let me welcome the second Article IV consultation with South Africa after the political transition. Today, South Africa is in the middle of a difficult process of economic transformation and faces serious challenges. Yet, its potential as a leading economy in Africa is enormous. South Africa may become a pole of growth and a model for many African countries. South African political and economic stabilization, the achievement of sustainable high growth, and trade liberalization can, therefore, be considered priorities involving a much larger area.
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> Like many other speakers, I believe that the weakness of the rand, the uncertain growth outlook, and the observed resistance by the private sector to the implementation of trade liberalization are all reasons for concern. Against, this background, sharp social inequalities and a staggering unemployment rate demand urgent actions. These involve delicate policy dilemmas about meeting social needs without disrupting the macroeconomic equilibrium, as any welfare

gain attained at the expenses of higher budget deficits and inflation rates would be illusory and hit the poor most. The staff recommendation and the authorities' determination to keep the budget deficit and the debt/GDP ratio on an unequivocally declining path are therefore appropriate.

The approach suggested by the staff to cope with the poor growth outlook and the delicate situation of the labor market seems also the right one. Higher, labor-intensive, and export-led growth can only be pursued through a coordinated package of structural measures to improve competitiveness. The extreme urgency of a comprehensive package focused on wage flexibility, trade liberalization, land redistribution, and training can be hardly overstated. In its absence, even the lower-growth outlook envisaged by the staff in its medium-term scenario "A" might turn out to be overly optimistic. Indeed, some private forecasters do not exclude a possible decline in the growth rate next year, should market pressures on the rand arise requiring a tighter monetary policy.

Indeed, the risk is in place that the lack of strong and determined efforts to address the underlying structural problems of low growth and high unemployment could exacerbate the worries of foreign investors and involve potential pressures on the rand, pressures that should be resisted by the authorities. Currency fluctuations since February are probably explained by a renewed perception of political instability and of the deepness of its economic roots. Capital flows have proven to be volatile and largely dominated by short-term speculative movements. It is not in South Africa's interest just to simply attract capital. It must, rather, secure it in the form of foreign direct investment. This will only be achieved through structural policies conducive to higher growth, lower unemployment rates, and declining social strains.

In this vein, the extraordinary inequalities in land distribution are a very serious issue, both socially and economically. There are unavoidable conflicting political pressures, some inertia of a situation developed and strengthened over an extended period of time, and even fears that hasty restitutions may involve transitional problems and reactions from the financial markets. In this situation, market-based solutions in line with the staff's suggestions (page 14) may make a significant contribution to solving the problem. Nonetheless, I share Mr. Clark's opinion that adopting a market approach could involve some problems of implementation.

Finally, I understand that the administration's room for maneuver is not limitless and agree with the staff that the highest priority and sense of urgency must be attached to the core elements of the proposed structural package. However, also the launching of a privatization program, long delayed thus far, could contribute significantly to the medium-term, fundamental policy goals of fiscal consolidation and higher growth and employment. The authorities could consider defining an operational privatization plan as soon as they are able, in collaboration with the Bretton Woods institutions.

Mr. von Kleist made the following statement:

As I agree with most of the main points made by the previous speakers, particularly on the need for fiscal restraint and structural measures to resolve the problem of unemployment, I will limit my comments to a few points.

On exchange rate policy, I share the preference expressed by Mr. Evans and others for a flexible market-determined exchange rate. I do, however, also share Mr. Wijnholds's concern about the downward spiral of depreciation and inflation. Both views are compatible only if the South African authorities leave no doubts about their commitment to macroeconomic stability and the creation of a supply sided and supply-side-driven market-based self-sustained growth process.

Owing to South Africa's recent history, the trade unions have an above-average political influence. In the fight against unemployment, this could be a considerable asset. However, if the trade unions do not recognize their shared responsibility for the unemployed, this political weight could also pose a substantial risk for overall developments in South Africa. Labor's response to the recent increase of interest rates by commercial banks, as reported in today's "Financial Times," are certainly not in the best interests of the country as a whole. The growing number, especially of young, unemployed is probably one of the reasons for the skyrocketing rate of violent crime. Anecdotal evidence of companies operating in South Africa suggests that security-related costs are beginning to approach those related to production. I wonder whether the staff could offer some additional insights into this problem.

South Africa could be an engine of growth for much of sub-Saharan Africa, as Mr. Martinez Oliva has also just noted. Conversely, if South Africa remained mired in economic difficulties and political uncertainty, this would weigh heavily on many of its neighbors. The economic success of South Africa thereby exerts a much bigger influence than mere GDP numbers may suggest.

Miss John made the following statement:

First, I would like to commend the South African authorities on recent achievements. Among these have been real GDP growth of 3.3 percent in 1995, a reduction in inflation to the 12-month rate of 6.5 percent in February this year, and a strengthening of the balance of payments in 1995 which occurred despite the deterioration in the current account. Moreover, it is noteworthy that this improving trend is likely to be sustained in 1996.

At the same time however, the authorities continue to face major challenges, perhaps the most significant among which is the high level of unemployment. We note that even under the more optimistic medium-term scenario, unemployment is likely to remain a major problem beyond the year 2000. It is quite appropriate, therefore, that the policy discussions gave primary focus to measures to stimulate growth and employment.

We are, therefore, quite encouraged to note in Mr. Dlamini's statement that the report of the Labor Commission, established to make recommendations for improving the employment situation, is expected shortly, and that a draft policy framework for growth, employment creation and redistribution is being finalized. The various initiatives now need to be marshaled into a comprehensive, clear and workable program of immediate and medium-term actions. In this connection, I share the staff's views that the program of reform should address the root causes of the problem (the interaction between poor education and high wage floors among the unskilled, trade barriers in the skill-intensive sectors, and legal and other impediments to the development of efficient smallholder agriculture), and that the reform package would need to contain several elements. Accordingly, reforms should incorporate measures to (1) reform minimum wage structures (to allow lower wage floors for younger workers and to allow differences by provinces depending on the level of unemployment); (2) deepen trade reforms to improve cost competitiveness (thereby increasing access to world markets); (3) enhance the education and training of the work force (to relieve the shortage of skilled labor); and (4) bring about a market-based land reform system (possibly incorporating a flat rate grant to purchasers of small plots of agricultural land).

It is of some concern, however, that even with the proposed reform package, the decline in open unemployment is expected to be relatively slow over the medium term. In view of this, I would have expected to see in the staff's proposals a more precise timetable for the various elements of the reform package than the reference that "efforts to develop the package should not be delayed."

The program of structural reforms would need to be supported by appropriate financial and external policies. In this connection, the abolition of the financial rand in March 1995 and the relaxation of exchange controls on residents are positive steps. The authorities must also be commended for adhering to their policy objectives to steadily reduce the fiscal deficit. For fiscal 1995/1996, this deficit would be reduced to 5.1 percent of GDP (from 5.5 percent of GDP in fiscal 1994/1995) through a combination of higher revenues and lower expenditures. On the revenues side, measures would include adjustment to excise taxes, removal of a number of value-added tax exemptions and improved tax administration, while on the expenditures side, a fundamental reform of the civil service, involving a reduction in the number of employees and a streamlining of salaries, is envisaged. Nevertheless, a further tightening of fiscal policy would be required to allow a substantial reduction in the government's dissavings, and the authorities would need to maintain tight control of monetary policy in light of the recent pressures on the rand and expansion in the monetary aggregates.

Clearly the authorities have before them a monumental, yet, I am sure, an attainable task and I would like warmly to wish them continued success.

Mr. He made the following statement:

I join the previous speakers in commending the South African authorities for the progress toward stability, economic growth and social development. I broadly agree with the well-focused analysis by the staff and would like to make one comment on the measures to address unemployment.

Among the key elements of the package, elaborated on by the staff, including wage structure reform, trade reform, tax-based land reform, and improving education and training, the authorities seem to lack confidence in implementing the last element. It should be noted that the capacity of the young to get employed may dwindle if they remain idle for long. Thus, persistence of unemployment of a large proportion of the young population would not only threaten social stability, but also cause a deterioration in the quality of the labor force and erode the competitiveness of the economy in the long term. While measures to improve education and training may be costly, lack of adequate action in this regard would prove more so.

With this remark, I wish the authorities success.

Mr. Verjbitski made the following statement:

I shall devote my comments to the issues related to policy advice for the South African authorities in the period ahead, particularly, bearing in mind the recent nervousness in the markets regarding the government's future economic strategy.

The staff has to be commended for doing its best to provide to the South African authorities timely and sound policy recommendations, which are both realistic and ambitious. The role of the Fund's technical assistance to the authorities can be expected to become more prominent in the near term, as the costs of policy slippages may be particularly high for South Africa in terms of its continued access to external financing under the circumstances of rapidly changing market sentiment. I welcome, in this regard, the authorities' intention, expressed in Mr. Dlamini's helpful statement, to use the Fund as a sounding board and seek some kind of seal of approval from the Fund for their draft policy framework. Perhaps, the Fund should consider the feasibility of providing resident advisers to the government at this crucial time when the country is at a crossroads of future development. I would welcome the staff's views on this matter.

Undoubtedly, the biggest challenge for South Africa's majority government would be in ensuring early progress in employment of a large number of young and unskilled long-time unemployed residents. This must be achieved, primarily, through reallocation of the available financial resources, by avoiding inflationary pressures and a public debt trap. The staff papers make a convincing case in favor of implementing a comprehensive package of strong fiscal and structural reform measures for South Africa, as piecemeal adjustment efforts could yield, at best, a small reduction in the government debt/GDP ratio and no serious improvement in the employment situation in the medium term.

It is clear from the staff's analysis that, to achieve a decline in unemployment, South Africa will need to reach a sustainable 6 percent real annual growth rate by the turn of the century. For that purpose the country will require a sizable increase in fixed investment of some 8 percentage points of GDP, of which approximately 80 percent will need to be financed from additional domestic public and private savings. This implies that a fiscal tightening of some 7–8 percentage points of GDP will be needed through the end of the 1990s. Moreover, according to the results of empirical research conducted by the staff, this increase in government saving will have to be disproportionately based on real expenditure cuts rather than on additional revenue measures to minimize the amount of the offset by lower private saving (owing to some unavoidable effects of the conditions for Ricardian equivalence).

I share the thrust of this analysis and encourage the South African authorities to make progress in as many directions of structural reform, suggested by the staff, as possible. Although a comprehensive approach to reform would be desirable, like Mr. Wijnholds and other previous speakers, I do not advocate an "all-or-nothing" attitude to the package proposed by the staff. Some sequencing of policy measures is, indeed, desirable. Labor market reforms and restructuring of the education system should not be delayed until the authorities are ready to proceed with measures in other areas.

On the exchange rate policy, I have some sympathy for the view that the recent depreciation of the rand was welcome, albeit too rapid. In general, the reserve bank would be well-advised to limit its intervention in the spot and forward exchange markets, particularly, at a time when the country's reserves are at a rather low level equivalent to just one month of imports. Competitiveness is another relevant consideration in this regard.

On minimum wage restructuring, like Mrs. Cheong, I am not convinced that the Dutch system will be better for South Africa than, for example, the U.K.'s productivity-based approach, given the very high level of structural unemployment in South Africa and the need to promote development of small enterprises.

Finally, I have two questions for the staff. The first one is related to the staff's assumption of a constant level of real interest rate of 5.6 percent for South Africa until the end of this decade. As this level is assumed to remain the same in Tables 15 and 16 (page 87 of the selected issues paper) under the different scenarios for the near term, I would seek some clarification from the staff regarding this "magic" figure and the related sensitivity of the staff's projections.

My second question relates to the issue of worker immigration. The background paper indicates that about 300,000 immigrant workers and some 1,000,000 temporary workers arrive annually in South Africa. Have these worker immigration patterns changed recently with improvement in the security situation in some countries in the SADC region?

I shall conclude at this stage by wishing the South African authorities every success in overcoming the daunting challenges facing them in the period ahead.

Mr. Keller made the following statement:

The debate on the economic and social strategies to be pursued is ongoing in South Africa. The staff has contributed to it with a valuable set of reports. Indeed, consistent—and mutually reinforcing—strategies of structural reform and economic stabilization and growth are crucial to consolidate the encouraging results of economic performance achieved so far: in 1995, real growth was positive for the third consecutive year, inflation was further reduced, despite strong domestic demand, and private investment continued to expand. The bold and successful abolition of the financial rand deserves here particular mention. These results confirm that the South African authorities are conscious of the fact that the decisive action of structural reforms is necessary to reduce the deep-rooted distortions inherited from the past and to maintain their track record on a sustainable high level. We are confident that they are undertaking as much reform as they possibly can on the basis of what they deem politically feasible.

The substantial increase in the current account deficit, which accompanied the expansion, could be financed without problems in 1995 by robust capital inflows, partly in the form of foreign direct investment. The lengthening of the maturity structure of these flows represented a further positive signal of investor confidence. However, the basic fragility of the situation was recalled by the shock of the repeated attacks on the rand since February 1996 and the resulting reduction in international reserves detailed in the staff's statement. Overall, 1996 should see a stabilization of the balance of payments position.

Although the authorities appropriately intend to proceed cautiously with the liberalization of exchange controls for residents, the full elimination of such controls within a reasonable time frame remains an important goal. The fact that rumors on an imminent rapid and complete liberalization move reportedly originated mainly from within the country, and that the beneficiaries of such measures may thus have been themselves responsible for triggering the speculation, sheds an ambiguous light on the South African markets' expectations on their own behavior in the case of full capital transfer liberalization.

On the positive side, the markets' test has given the authorities a possibility to confirm their determination to stay their policy course and strengthen their credibility. The correction of the rand's real exchange rate after the appreciation in the second half of 1995 may also have improved the competitiveness of the South African economy. Thus, a window of opportunity may have been created for measures to speed up reform to reduce the existing bias in favor of capital- and skill-intensive production through labor and trade policy reforms. The agenda set out in the reports is nothing short of a blueprint of fundamental change in the inherited growth model, which has failed to deliver. We find the analysis very well-founded and would wish that the South African authorities give it the deserved attention in their efforts to address the blatant unemployment and education issues as well as land reform.

With regard to labor policy, the Labor Reforms Act, generally well received by the different social partners, might be well complemented now by decisions on increased employment flexibility and reforms of the minimum wage system, bedded—if possible— into an encompassing social pact. This package should send out the right signals for the skill mix needed and create strong incentives for the educational sector to provide it, starting with training from basic levels. The proposals to strengthen land reform with the integration of market-based elements do satisfy reasonable economic logic.

The approach of trade liberalization based on a free trade arrangement with the European Union and the use of the most favored nation clause is interesting and promising in a view to open the production structure of the South African economy and induce an export-oriented growth strategy with higher factor productivity and a more rational allocation of scarce financial and human capital resources. In this context, increased openness toward the SADC trading partners may be of particular importance, considering the complementarily of the economies, and may usefully contribute to the stabilization and the development of the region.

With regard to fiscal policy, we acknowledge the prudent and gradual nature of the 1996/97 budget measures in the present economic and political context. However, we agree that somewhat bolder steps toward fiscal consolidation would be helpful. Whereas reduced public dissaving remains an aim in its own merit in order to allow for higher domestic saving and investment, it has again received additional urgency by the recent events as they have further increased the burden on monetary and credit policy for economic stabilization.

Although the fiscal deficit as a percentage of GDP should decrease, public works and education expenditure will increase substantially. While there is no doubt on the needs in these areas, both the authorities and the staff note that productivity in these areas is particularly low. It appears important to improve the effectiveness of these expenditures in parallel to their expansion. Finally, regarding public assets reorganization and privatization, we would encourage the staff to follow closely the formulation of the future action program mentioned in the background paper and to provide timely advice to the government.

In conclusion, let me mention—for the sake of completeness—two, still largely unresolved, issues, which should receive attention in the future:

First, the distribution of executive competence between the central government and the Provinces, and its fiscal impacts, are a difficult political issue, which may hold considerable potential, as well as dangers, for fiscal consolidation.

Second, regarding public assets reorganization and privatization, we would encourage the staff to follow closely the formulation of the future action program mentioned in the background paper and to provide timely advice to the government.

We would appreciate receiving the staff's preliminary comments on these two issues.

Mr. Ruocco made the following statement:

We welcome the renewed impetus of the South Africa economy since the new government took office approximately two years ago. Economic indicators show that the government of National Unity in 1995 has substantially achieved its goals, particularly in terms of GDP growth, decline in inflation, increase in private investment and strengthening balance of payments despite deterioration of the current account. However, much more remain to be done along the line already traced by the authorities in their medium-term economic program.

To be brief, if continued improvements are envisaged, there is no much room for policy mistakes and slippages without potentially damaging the course of economic action now under way. Important measures have been already adopted, but the current situation is demanding the acceleration of some measures to avoid backward movements.

The momentum to deep policies is awaiting, which requires among others, to continue tightening financial policies, and to introduce policies to deal with structural rigidities. At this stage of the discussion, I will only refer to these two policies in my intervention.

With regard to tightening financial policies, the authorities should pursue fiscal consolidation, implying a more aggressive reduction in public deficit, which remains high, and should also maintain tight monetary policy. Both are required to abate resurging inflationary pressures and give the necessary support to exchange market stability.

It is true that the 1996/97 government budget reaffirms the authorities' commitment to reduce the overall deficit over the medium term, but public sector savings improve only modestly. While the approach attempting to restructure expenditure rather than resort to a substantially higher tax burden to finance additional expenditure looks appropriate, given the limited room for raising taxes, the authorities through their fiscal policy must remain focused on containing and redirecting expenditure, while strengthening revenue performance by improving the efficiency of tax administration and broadening the tax base.

If fiscal projections materialize at levels estimated in the staff report, we do not see how the fiscal policy goes some way toward reducing the burden on monetary policy in the pursuit of financial stability. In this scenario, monetary policy seems to be called for a more active role, and therefore, it will continue supporting an important part of the burden of the adjustment in the short run, when a more restrictive fiscal policy is highly needed. This focus on fiscal policy is perhaps the healthiest way to reach financial stability and avoid inflationary pressures, rather than forcing additional depreciation of the rand.

In the meantime, structural reforms have to be accelerated rapidly to establish the basis for a sustained economic growth with price stability in the medium term. In this connection, the centerpiece of the structural reform is the labor market, particularly because of the problems surrounded wage settlement and the high unemployment rate. In dealing with distortions to the wage structure and the unemployment situation, the authorities are also dealing with the main constraints on growth; therefore, the structural reform package proposed by the staff mission looks appropriate to this end, which also helps to maintain or increase competitiveness as the key to reach balance of payments viability, in particular current account, and reach higher savings and investment ratios.

With these remarks, we wish the South African authorities well in their efforts toward economic adjustment and growth, suggesting them to make every effort to deepen in structural reforms, including not only the labor market and land reforms, but also educational reform, while reaching the necessary political and social support.

Mr. Fayolle made the following statement:

I will also limit myself to the following two brief comments :

First, a higher level of growth in the medium term, which is essential in order to reduce the level of unemployment, will not be achieved without dealing with the structural rigidities and imbalances inherited from apartheid. Therefore, I welcome the remarkable consistency of staff advice in the structural area since 1994, but I would be more hesitant about analyzing precisely each measure, as I am not competent enough to give a personal assessment, especially on the land reform one. I must confess that I have some doubts that this institution has to be very specific in this particular area.

Second, there is an urgent need to deal with the consequences of the depreciation of the rand. The depreciation of the South African currency was needed as a component of a comprehensive package in order to improve the competitiveness of the economy. It had been forced by market pressures, but the authorities have to implement all the measures needed in order to preserve the gains of this depreciation in terms of competitiveness and to avoid the inflation/depreciation spiral. I think this Board should therefore send a very clear recommendation to the authorities to implement firmly the measures contained in the penultimate paragraph of the staff representative statement published yesterday. This is to say, tightening the monetary policy, strengthening the fiscal position, and limiting wage increases.

Mr. Mahdavian made the following statement:

South Africa's economic performance and social-political achievements can only be assessed in the context of deep-rooted legacy of a system that for decades had disregarded the basic needs and rights of the majority of the population. The exceptionally high and legitimate expectations of a large portion of the population place a daunting challenge before the authorities at this very difficult juncture. So far the authorities have been successful in striking an appropriate balance between meeting social needs to the extent possible and maintaining an adequate momentum of growth. It is important that they continue their basic strategy of reform and adjustment to address both issues.

The current set of papers on South Africa has correctly focused on core components of a structural reform program to address the urgent problems of the economy. The staff also has rightly emphasized that the prospects for success of such a package would be greatly improved if a social pact is formed in support of the reform package. This is all the more important since the pressing social and economic problems of South Africa could only be addressed in the presence of a strong and lasting economic growth that requires the consensus of all parties. I am glad to note that South Africa has done fairly well in the last couple of years. The overall balance of payments position has strengthened despite the deterioration of the current account stemming from strong domestic demand and the liberalization of the external sector. The recovery which started with a modest growth in 1993 accelerated in 1994 and 1995 and gross fixed investment has increased substantially. More important, the authorities' commitment to policy reform has been enhanced and foreign investors' sentiments toward South Africa improved substantially during 1995 as evidenced by financial market developments. Despite all these favorable developments economic growth and investment performance are below the levels needed to address the daunting social and economic problems of South Africa, particularly the high unemployment. Moreover, there were speculative attacks on rand that at times had destabilizing effects on the economy. I welcome the recent announcement by the authorities regarding their cautious approach with respect to further liberalization of exchange transactions for residents.

Improved medium-term growth potential and job creation should form the core elements of the medium-term framework. Significant increase in South Africa's growth can only come from an export-led growth strategy. In the excellent exposition on "mining taxation" in the selected economic issues paper, the staff maintains that the gold mining industry had moved into a mature phase during the last decade and is facing the prospects of entering into a declining phase. The contribution of nongold mining to production and employment seems to be modest also. For many decades, South African economy has been a relatively natural-resource based economy. In the medium-term, the need for growth and employment creation could be addressed by strong policy aimed at greater diversification of the economy. The staff is correct in asserting that the present fiscal regime of the mining sector may be detrimental to a dynamic outward-oriented diversified economy and efficient resource allocation.

On financial policy, it is encouraging to note the authorities' commitment to reduce the overall deficit over the medium-term. This policy may not be ambitious enough toward reducing the undue burden on monetary policy in the pursuit of financial stability. Although the tight monetary policy in 1995 has achieved substantial success, inflationary pressures may still emerge. Furthermore, the possibility of more speculative attacks on rand and the need for containing additional inflationary pressures resulting from depreciation of the currency require continued tight monetary policy. If such a tight monetary policy fails to dispel attacks on rand and to restore stability, a further tightening of fiscal policy may be required. In such an event a contingency plan is needed to avoid the possibility of reversing the course of policies and undoing the progress won over time.

The uncertainty prevailing with regard to economic policy is not good for markets and for South Africa's participation and integration in the world economy. The economy is at a crossroads and more than ever needs a coherent, long-term growth strategy that can be supported by the population at large and by business and labor in particular. Such a strategy can help attract further foreign investment and other sources of financing in support of domestic savings. I hope the staff report and Board discussion on South Africa contribute to enhance the likelihood for such a breakthrough.

With these remarks I wish the authorities the very best in the challenging period ahead.

Mr. Waterman made the following statement:

One advantage of speaking last, or near last, is that you have the capacity to learn more and the need to say less. In many respects, South Africa has made good progress in recent times, but the challenges are clearly great. The statement by the staff representative underlines how crucial the present period is.

After the immediate challenge of restoring a degree of stability in foreign exchange and bond markets is addressed, a package of reform measures, as suggested by the staff, has obvious attractions. Given the limited implementation capacity and the political challenges involved, focusing the technical and political effort on the core elements of the proposed measures makes good sense to my mind. At the same time, I agree with others that it is better not to have an overly firm view on sequencing, and the authorities should be prepared to do things when the opportunity arises.

The particular staff focus on measures to reduce the extraordinarily high level of unemployment, particularly amongst the young, is appropriate, and education and training are obviously helpful in the longer term, but clearly the rigidities in the South African labor market need to be addressed. If anything, given the concentration of economic power and the bias to protect those in employment, there is probably a risk of doing too little rather than too much. So, like some others, I worry that the proposed evolutionary approach may bring limited benefits.

Clearly, reforms in other areas will also be important. Experience elsewhere has underlined the usefulness of trade reform, both for structural gains for an economy and also for reforms in the labor market. So ongoing reductions in protection will obviously be very important to South Africa's performance. On the face of it, the prospect of a free trade area with the European Union, with comparable arrangements with regional partners, seems an attractive way forward to me, particularly if it is a way of keeping the process of trade liberalization going.

Mr. Leiva made the following statement:

An economic performance characterized by an improving rate of growth, falling inflation, increasing fixed investment, adherence to a medium term fiscal deficit reduction program, trade and exchange liberalization accompanied with accumulation of international reserves would be a satisfactory performance for any country. Considering the political change of historical proportions South Africa has undergone during the last two years, this performance is remarkable and far exceeds anyone's expectations.

Yet, the main message I perceive, from the excellent set of papers on the South African economy the staff has provided us, is that this performance is not enough. Bold actions are called for, the annual rate of growth needs to be increased persistently to reach 6.5 percent by the year 2001 and fixed investment should be expanded to sustain higher medium-term growth by 7–9 points, over the 17 percent of GDP achieved last year.

Medium-term Scenario A describes the results of maintaining basically the successful policies of the last two years without additional measures to correct underlying factor price distortions. The prognosis for many aspect of economic performance is acceptable: inflation is projected to fall steadily, government dissaving is reduced, external debt service is manageable. Moreover, growing at 3.5 percent a year is sufficient to maintain a small but steady increase in real GDP per capita.

However, the rate of unemployment remains unchanged. In the foreseeable future, one-third of the labor force would be unemployed. This is unacceptable for many reasons, not the least of which is that it makes Scenario A improbable. Social and political tensions are likely to disrupt growth and stability. To ensure that any medium-term scenario is viable the problem of unemployment must be addressed.

I commend the staff for focusing its analysis and recommendations on this medium-term challenge and for developing a consistent structural reform package to tackle its main aspects. Since earlier comments have considered many of these aspects, I will make a few remarks on the immediate effects of the package and its educational component.

On the short-term versus medium-term effects, two components of the package may have a short-term effect of reducing employment rather than expanding it. While recognizing that the rand depreciation would help, other experiences of eliminating barriers to trade have shown that at first, liberalizing imports eliminates jobs at a faster pace than the export expansion creates new jobs. A similar negative short-term effect on employment should be expected of the fiscal policy component of the package. This includes the civil service reform which will reduce 300.000 government jobs over the next three-year period, including 110.000 during the current fiscal year.

Are these workers sufficiently skilled so that they will easily find jobs in other sectors of an expanding economy? I would welcome the staff's views on this issue.

Moreover, the positive effects on employment of other components of the package may take longer than envisaged. Land reforms often need prolonged periods to bring about significant changes on rural productivity and employment. For different reasons, similar lags may be expected of the educational and training improvements' impact on the labor markets. If the reform to minimum wage structures were promptly implemented, results could be seen sooner. Prompt implementation, however, is uncertain. Finally, depreciation of the rand should have a more rapid impact in export expansion and investment in outward oriented activities, but the effect in employment will be limited until this investment concentrates in labor intensive production.

Regarding the educational and training component of the package, I would like to stress the key role of the supply of skilled labor in the prospects for export expansion, growth and employment in South Africa..

The fact that the skilled labor markets seem to clear and that constraints to their supply seems to be currently affecting competitiveness highlights the urgency to improve and expand the educational effort.

In the context of the reform package, the staff rightly maintains that once an outward-oriented price structure has been established as a result of the trade reform, the supply of skilled labor would emerge as the binding constraint to sustained higher growth in South Africa.

I would appreciate the staff to elaborate further on the relationship between the current educational and training efforts and the need for relaxing the skilled labor supply constraints.

The peaceful transition to majority rule has exceeded, to this moment, the world community's expectations. I wish the South African authorities similar success in managing the difficult challenges still ahead.

Mr. Oya made the following statement:

At the outset, I commend the staff for its comprehensive and clear economic analysis reflected in the paper. This is very useful.

In 1995, the authorities' efforts toward macroeconomic stabilization began to bear fruit. The growth rate increased, private investment rose strongly, and the inflation rate fell. Although the current account has been weakened owing mainly to the sharp increase in imports caused by strong domestic demand, private capital inflows were strengthened and investors' confidence was significantly improved; this is reflected in the decline in the long-term bond yield differential with U.S. treasury bonds. Moreover, the removal of exchange controls on nonresidents in the beginning of 1995 has greatly increased the availability of foreign savings, which finance private investment growth. I welcome these positive developments and commend the authorities' efforts.

Against this generally favorable macroeconomic background, resolving structural problems underlying the low-growth and high-unemployment situation and dealing with volatile capital inflows are two main policy challenges for the authorities.

Regarding the first, the staff suggests a comprehensive policy package comprised of the following: reform of the minimum wage structure; strengthening of trade reform; improvement of education and training; tax-based land reform; strengthening of fiscal reform; and an appropriate depreciation of the rand. Although I broadly endorse this policy advice, I have a different view on exchange rate policy. Traditionally, this chair has cautioned against relying too heavily on exchange rate policy, and I welcome the authorities' current policy stance of allowing the exchange rate to continue to be determined by market forces.

I would have no difficulty with the depreciation of the rand if it is orderly and reflects changes in the economic fundamentals, but I would have difficulty if the authorities were to continue to include the depreciation of the rand as one of the policy objectives.

It is a reasonable assessment that the main factor in the recent decline of the rand is uncertainty about the course of future policy rather than the deterioration of macroeconomic fundamentals. In this respect, the early adoption of a policy package to deal with structural problems in the real sector, as well as an explicit indication of the authorities' stance on exchange controls on residents, would contribute to easing the pressure on the rand.

On the fiscal front, I expect the authorities will meet their current medium-term fiscal target. I also endorse the idea of development of a rolling five-year fiscal target. This might help strengthen confidence in the subsequent fiscal stance.

South Africa will, I hope, play a leading role in regional economic development through further integration into the world economy and by overcoming domestic economic problems. With these remarks, I wish the authorities every success in their future endeavors.

The staff representative from the African Department said that the staff did not have data on private expenditures on security. With respect to sending a resident advisor to South Africa, in the current circumstances, the authorities preferred to implement the policies on their own.

The expected timing of the adjustment program would ultimately depend on how quickly consensus could be reached on the key elements of reform, the staff representative continued. The authorities were working hard to put together the policy framework, as Mr. Dlamini had noted in his statement, and hoped to announce the framework within the next three or four weeks.

An analysis of the authorities' fiscal program suggested that, without the structural reform measures, a real interest rate of 5.6 percent would be required to induce the needed level of private savings, the staff representative explained. With implementation of the structural reform package, lower real interest rates could be realized, as a much stronger response from private sector savings would be expected, along with higher external capital inflows.

Privatization was not included in the core package of reforms, as it was one policy area with which the labor unions had difficulties, the staff representative continued. Another reason was that the parastatals in South Africa were quite efficient and financially independent and did not contribute to the deficit. The authorities realized that the proceeds from privatization could be used to pay down the public debt, and thereby make room in the budget for additional social spending or deficit reduction. They had identified certain enterprises, such as Telekom and South African Airways, with which to start the privatization program.

In response to a question from Mr. Mohammed, the staff representative noted that the civil service reforms were not expected to leave public employees out of work for very long. Most of the downsizing was being accomplished through a voluntary program, including early retirement. Moreover, finding alternative employment would not be arduous for government employees, as their skills were in demand. Those that faced the real problems were the unskilled and unemployed. Trade liberalization and fiscal consolidation would initially increase unemployment. That was why the staff had emphasized the importance of also moving forward with the labor reforms, since lowering the wage structure would encourage the export-oriented growth sectors to expand quickly and absorb labor .

The Ministry of Finance was very much aware that the provinces risked creating a financial burden that they might later not be in a position to bear, the staff representative indicated. The experience in Latin America was quite telling in that regard. For that reason, the Ministry was very firm on moving forward with the draft of legislation that would impose controls on how much provinces could borrow.

Mr. Dlamini made the following closing statement:

> The South African authorities would like to express their appreciation to the staff for their comprehensive and objective analysis of the South African economy. They found the recent Article IV consultations most helpful in enhancing their own policy discussions and improving economic management. The authorities are also grateful to the Managing Director for his encouragement and advice during his recent visit to South Africa.

South Africa has continued to consolidate the political system inaugurated some two years ago. Under the new constitutional dispensation, the country is poised to move forward under the rubric of democratic institutions in its quest for stability, economic growth and social development. The challenges are many, a number of which have been mentioned in the staff report; but the authorities are determined to build and nurture the social consensus that will enable the government to take the bold actions necessary to keep South Africa firmly on the new course it has set for itself. In the sphere of economic management, this means the achievement of high sustainable growth, an increased effort to address the unemployment problem, and a firm commitment to the full integration of South Africa into the world economy, supported by prudent financial policies and structural reform. In this connection, the authorities have already taken steps in the area of trade and exchange control liberalization and labor market reform, while setting a course for the strengthening of public sector finances, based on the announcement and systematic pursuit of medium-term fiscal targets.

As noted in the staff report, the policies pursued by South Africa in 1995 achieved substantial success in raising business confidence, reducing inflation and sustaining the recovery in output. Real GDP grew by 3.3 percent compared to 2.7 percent in 1994, despite a sharp decline in agricultural production due to drought and the poor performance of the mining sector. The improved growth performance was driven by strong domestic demand, reflecting in large part, the rapid growth in fixed investment, with manufacturing sector investment leading the way. Overall, real net investment rose by 1½ per percentage points to 3.8 percent of GDP.

On the inflation front, tight monetary policies and the accompanying appreciation of the rand in second half of 1995 played a major part in reversing the upward inflationary trend in the first half of the year. The 12-month rate of increase in consumer prices fell from 11 percent in April 1995 to 7 percent in December while the underlying inflation rate was reduced to just over 7 percent in December 1995 from its recent peak of 9.2 percent in May 1995 and around 17 percent in 1991. Against the background of the downward trend in the underlying rate of inflation, wage settlements have moderated in nominal terms, with the 12-month rate of increase in remuneration per worker in private sector declining from 17 percent in 1990 to about 12 percent in 1994. However, real wages in the private sector increased by 4.6 percent during the same period and the authorities recognize that increased labor productivity has thus far only partially offset the relatively high unit labor costs, with adverse consequences for the country's competitiveness.

The overall balance of payments position strengthened in 1995, despite the deterioration in the current account, which widened to a deficit of 2.6 percent of GDP from 0.5 percent of GDP in 1994. The increased deficit was the result of the sharp increase in imports, mainly capital goods, related to the rapid rise in investment. The capital account continued to improve, with inflows being sufficient to cover the current account deficit and permitting a build-up in net foreign reserves. The improved reserve position enabled the South African Reserve Bank to intervene in the market to maintain orderly conditions when the rand came under pressure in the first quarter of 1996 due to unfounded rumors and uncertainty about the direction of economic policy, in particular with respect to the elimination of capital controls on residents. At the same time, the authorities acted swiftly to assure the market that they remained committed to fiscal consolidation and monetary restraint. They have allowed the exchange rate to continue to be determined by market forces. In the last two weeks, the rand has regained some of the earlier losses following another increase in the reserve bank rate and renewed efforts by the authorities to reassure the foreign exchange markets.

As part of the process of integrating South Africa more closely into the global financial system, the authorities have taken significant steps to liberalize exchange controls. Early in 1995, exchange control on nonresidents was abolished. The credibility of the South African government regarding its commitment to maintaining financial stability ensured that this process occurred without disrupting financial or foreign exchange markets. The authorities also announced their intention to gradually remove exchange control on residents. Steps that have already been taken in this regard include, the approval of asset swaps by pension funds, unit trusts and insurance companies, and the relaxation of conditions for investment in the Southern African region. In addition, the reserve bank has begun to withdraw from the forward market in foreign exchange by relinquishing the requirement on exporters to obtain forward cover, terminating official forward cover for nonfinancial transactions and reducing the implicit subsidy on short-term borrowing. In the area of international trade policy, the authorities achieved considerable progress in fulfilling the obligations agreed to at the Uruguay Round. Prominent among this was the abolition of the surcharge on imported goods in October 1995.

However, the high level of unemployment remains a vexing problem for the South African authorities, and improving the situation is a matter of the highest priority to ensure that the benefits of economic growth are more evenly spread throughout the population. This has brought to the fore a number of issues that must be addressed, ranging from the deepening of structural reforms in the labor market to finding ways of increasing the use of more labor-intensive technologies. In this regard, the authorities have established a Labor Market Commission to make recommendations for modalities for improving employment opportunities, and are expecting its report soon. The authorities have also introduced a new Labor Relations Act which will facilitate a smoother functioning of the labor market. In the meantime, they have welcomed the discussion with the staff on the unemployment question, which has focused attention on, among others, the potential gains from greater flexibility in private sector remuneration; the benefits to be accrued from policies that would enhance competitiveness in skill-intensive sectors, especially those geared toward exports; measures aimed at improving labor productivity, including the provision of better training and education; and land reform and extension services that would facilitate more gainful employment in agriculture in the rural areas. It is obvious to the authorities that a multi-faceted approach is needed and that policies that can be taken in the short run would have to be complemented by long range measures, especially those related to human resource development and the use of more labor-intensive technologies.

The 1996/97 budget continues along the deficit reduction path: it envisages a reduction in the actual deficit from an estimated 5.5 percent of GDP in 1995/96 to 5.1 percent in 1996/97. Also, it aims at restructuring expenditure, focusing on education, health and other social services. The deficit target is to be achieved through both higher revenue and expenditure restraints. Revenue measures include a 17 percent tax on interest and net rental income of retirement funds, increases in certain excise taxes and the fuel levy, and improved tax administration through the merger of Inland Revenue and Customs and Excise into the South African Revenue Service. Meanwhile, steps have been taken to rationalize the tax system to correct for past bracket creep, raise the minimum taxable income threshold, and reduce the number of tax brackets. The major adjustments in the budget come in the area of expenditure. Real expenditure cuts are planned for defense and subsidies. Also, the authorities have started the reform of the civil service aimed at substantially reducing the number of employees over three years, while changing the salary structure. In the 1996 fiscal year a reduction of some 100,000 positions is envisaged. The authorities are also considering a thorough restructuring of the social security system, in which the social partners in the National Economic Development and Labor Council (NEDLAC) will participate. To minimize the inflationary potential of the government's fiscal operations, the authorities plan to finance the deficit almost wholly through the issue of government securities in the domestic markets. A slight decline is projected in the government debt/GDP ratio, from 56.0 percent in 1995/96 to 55.6 percent in 1996/97.

On monetary policy, the primary objective of the authorities over the medium term is to reduce the rate of inflation to a level that is comparable to that of the country's most important trading partner countries. To this end, the monetary authorities are committed to maintaining a tight monetary stance in 1996. In order to signal this intention to the market, the reserve bank is maintaining its guideline growth rate for the broad money aggregates in the range of 6–10 percent which was set in 1995. The tight monetary stance was further strengthened in April when the bank rate was raised by 1 percentage point to 16 percent.

In sum, since the national elections in 1994, substantial progress has been made toward establishing credible domestic policies that would improve both the immediate and long-run prospects of the economy. In the years ahead, building on this progress, the authorities intend to keep the South African economy well-positioned in the global economic community. This approach leads them to continue to accord increasing importance to revitalizing the economy while reducing the existing inequalities of income and economic opportunity. In this regard, the authorities welcome the emphasis placed in the staff report on the package of reforms that are deemed necessary to stimulate employment and growth in the country's economy. Initiatives are presently under way for an interdepartmental discussion on the proposals in the report in an attempt to arrive at a common position. Moreover, a draft policy framework for growth, employment creation and redistribution is being finalized within the national government. It is envisaged that the Fund, among others, will be approached to act as a sounding board for the draft framework.

The Acting Chairman made the following summing up:

Executive Directors were gratified that the year 1995 marked the third successive year of steady progress by South Africa, noting that the reduction in inflation, the rise in private fixed investment, and the increase in economic growth were important successes of the political transition and the financial policies of the government of National Unity. Directors recognized that the authorities faced competing demands for strong policy actions to foster investor confidence and actions to meet the urgent social needs of the population. Accordingly, in associating themselves with the thrust of the staff appraisal, they emphasized that the recent rapid depreciation of the rand underscored the need for a prompt further tightening of financial policies supported by measures aimed to address the underlying structural causes of extremely high unemployment and relatively low growth. Directors stressed the importance of a comprehensive and bold strategy and the need to foster social consensus.

Directors commended the authorities for the pursuit of prudent policies, including the reduction in the fiscal deficit in 1995/96, the tightening of monetary policy in response to the incipient inflationary pressures that emerged in late 1994, the continued progress on the liberalization of trade and capital controls, and new legislation on labor relations to begin to address the roots of industrial tension. They noted that these actions represented a first stage in establishing a track record of cautious policies, and thus were crucial in improving market confidence, which had been instrumental in the reduction of the net open forward position of the South African Reserve Bank.

Directors commented that the recent depreciation of the rand was appropriate in the circumstances of South Africa, but that supporting financial policies should be put in place to maintain the gains from devaluation. The abolition of foreign exchange controls on nonresidents in March 1995, with the elimination of the financial rand system, was commendable, but had exposed the economy more directly to shifts in investor sentiment. Financial policies, therefore, needed to respond accordingly. In that light, Directors endorsed the increase in the bank rate at the end of April and the authorities' commitment to step-by-step liberalization of the exchange controls on residents. They cautioned against large-scale intervention in the spot or forward exchange markets in support of the currency.

Directors took the view that further expeditious policy action was needed to contain the inflationary impulse from the depreciation of the rand that had already occurred, and to restore confidence in the foreign exchange markets. In particular, they recommended a further increase in the bank rate to sustain the most recent increase in the banks' prime rate, a reduction in public expenditure during the current fiscal year, and efforts to minimize the impact of the depreciation of the rand on the current round of wage negotiations. In the absence of progress in these areas, they cautioned that the contribution of the exchange rate depreciation to competitiveness might be eroded by increased inflation.

Directors also emphasized that confidence would be bolstered by the announcement of determined implementation of a comprehensive medium-term strategy based on a structural reform package aimed at addressing the problems of high unemployment and low growth. In this regard, they welcomed the priority that the authorities attached to raising growth and employment, and agreed on the need to act without delay.

Directors took the view that the scale and nature of the unemployment problem necessitated focused and coordinated policy initiatives in a number of areas, aimed to increase the demand for unskilled labor and to improve the overall competitiveness of South African industry. An appropriate package would target reform of the wage structure, including adjustments to both skilled and unskilled labor employed in the formal sector. This reform might best be brought about by a combination of reforms to minimum wage structures, and early efforts to stimulate the supply of skilled labor, which would require a strong emphasis on education and training in particular. They also noted that adjustments in rural labor markets might best be achieved through a comprehensive market-based land reform program. They suggested that policy options in many areas, including the offer of a free trade area from the European Union, should be viewed in light of their contribution to adjustments in the wage structure, and hence to the stimulation of employment-intensive growth. Directors stressed the important role of further trade liberalization in improving economic efficiency and growth.

These elements of the package would require the support of financial policies, with monetary policy focused on maintaining the control of inflation, exchange rate policy in support of trade liberalization, and fiscal policy designed to strengthen domestic savings. Directors urged the authorities to concentrate their technical and political efforts in the areas central to the success of the program. They also stressed the mutually reinforcing nature of the package as a whole. While it would be preferable and desirable to implement the package as a whole, Directors noted that that might not in practice be possible, and that the authorities should stand ready to implement parts of the program in a well-sequenced manner, or even as the opportunities present themselves. Some speakers took the view that exchange rate policy, supported by appropriately tight financial policies, could help in the resolution of South Africa's structural problems and avoid excessive reliance on deflationary wages policy. Other Directors, however, emphasized the dangers of inflation inherent in reliance on the exchange rate instrument and stressed the overriding priority of maintaining internal balance through strong monetary restraint.

Directors expressed concern that the guideline range for M3 had been exceeded by a considerable margin for two consecutive years, and noted that if that were to be repeated again in 1996, the credibility of the guideline range apparatus might be compromised. They underscored that a further tightening of monetary policy was key to restoring financial stability and to containing inflation.

Directors commended the authorities for the maintenance of effective fiscal control during 1995/96, including control over the borrowing of lower tiers of government, as well as for their plans to reduce the deficit and government dissavings supported by structural fiscal reforms in tax administration and debt management. Hence, they urged the authorities to monitor closely the use of unspent allocations for investment that had been rolled forward into 1996/97, including funds earmarked for the Reconstruction and Development Program to ensure that the fiscal objective is achieved. They also noted that increases in public sector wages would need to be counter-balanced by substantial reduction in the size of the civil service if the medium-term fiscal framework was to be achieved. Several speakers believed that the authorities should aim to increase the revenue-to-GDP ratio, and that they should be ready to take additional fiscal measures in the event revenue fell below projections. The enormous needs of social outlays and for infrastructure argued for an appropriate balance between revenue increases and restraint on expenditures in general.

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

4. GRENADA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Grenada (SM/96/108, 5/9/96). They also had before them a statistical appendix (SM/96/113, 5/14/96).

Mr. O'Loghlin made the following statement:

My Grenadian authorities broadly agree with the analysis of recent developments and with the thrust of policy recommendations contained in the staff report. As a relatively new administration—which took office less than a year ago—they view the report, and even more so the frank exchanges with the staff in the course of the consultations in St. George's, as a very valuable aid to policy formation.

The past year has been broadly positive for Grenada. Despite a slower growth in tourism and a significant decline in public investment, the economy expanded by 2 percent. Private investment remained above 25 percent of GDP. Reflecting lower public investment, the deficit on the current account of the balance of payments improved by 6 percentage points of GDP. International reserves rose to almost four months' imports. Inflation remained low. The public sector—taking account of external assistance—moved from deficit into surplus. Relative to GDP, external debt declined marginally—and, but for valuation changes, would have fallen in absolute (U.S. dollar) terms.

On the fiscal front the share of day-to-day spending in national income declined while the revenue ratio rose—partly because improved tax administration led to collection of tax arrears. In consequence, public sector savings rose by 1¼ percent of GDP to 5½ percent approximately. Public investment—adjusted for the divestment of GRENELEC (the former public sector electricity producer)—fell from 11 percent of GDP to 7 percent. This decline reflects both the completion of some projects financed with external assistance and the more restrained approach to spending generally which was adopted last year. However, in constraining public investment my Grenadian authorities sought to prioritize developments which might best support future economic growth—including educational and sectoral economic investment. Despite lower external assistance and lower receipts from privatization than in 1994, the public sector had an overall financial surplus last year.

The public finances will remain in this more satisfactory shape in 1996. The revenue ratio will decline a little, reflecting last year's catching-up of tax arrears. But day-to-day spending is also budgeted to fall as a share of national income, so that public sector savings will remain at the 1995 level. Public investment will increase substantially, again with priority afforded to educational and sectoral economic developments aimed at strengthening future growth prospects. The higher investment will be largely financed by stronger levels of external assistance, which also will facilitate a substantial reduction in public sector domestic debt.

Needless to say, my authorities are deeply grateful to donors for their continued help in developing the Grenadian economy. In this context, they wish to assure the Board that they are extremely conscious of the importance of fully discharging all external obligations. They have budgeted to further reduce, this year, the (small) arrears of such payments referred to in the staff report.

On monetary policy, Grenada continues to participate in the Eastern Caribbean Central Bank (ECCB), and thus to have an exchange rate fixed in terms of the U.S. dollar. This arrangement has benefited price stability, with consumer prices increasing at about 2 percent last year and, despite some increases in indirect taxes, unlikely to exceed 3 percent this year.

Economic policy more broadly continues to aim at enhancing the competitiveness and growth potential of the economy. Under regional (CARICOM) arrangements Grenada is lowering customs tariffs over time—spurring domestic competitiveness generally. Taxes on profits and earnings have been reduced, to heighten incentive to effort and entrepreneurial activity— with admitted adverse effects in terms of the progressivity of taxation, but in the interests of longer-term development. A strong program of privatization is under way, which should help—over time—to reduce the costs of services which are critical to business success. Certain other public services are to be reconstituted into stand-alone statutory bodies, with the aim of improving operating efficiency and—together with continued restraint in public spending generally—of minimizing the burden of taxation on the economy. My authorities believe that these policies will enable the maximum benefit to be gained—in particular in terms of expansion of tourism, Grenada's major "product"—from the infrastructural improvements which donor aid and domestic public savings are financing.

Miss John made the following statement:

The economic strategy adopted by the Grenadian authorities from 1994 has resulted in a turnaround in economic performance. From negative growth in 1993, real GDP became positive in 1994 (2.5 percent), and strengthened further to 2.7 percent in 1995. Furthermore, this reversal was accompanied by low inflation. (The 12-month rate of increase in consumer prices fell from an average of 4 percent over 1992/93 to 2 percent during 1994/95.) On the external account, performance also improved in 1995 with the deficit on current account falling to 5 percent of GDP and imputed reserves at the ECCB reaching 3.7 months of imports. In addition, progress was made with regard to the implementation of structural reforms, including a reduction in the size of the civil service.

These gains have been achieved in the context of tighter fiscal policies which have resulted in a strengthening of the current fiscal surplus to 2.2 percent of GDP compared with an almost balanced position in 1994.

The new authorities which took office in Grenada in June 1995 have indicated their commitment to build on these achievements by pursuing policies to enhance economic growth while keeping inflation low. To this end, they propose to maintain the level of public savings, enhance further the efficiency of the civil service, and continue the program of divestment. In addition, they propose to accelerate the public sector investment program and focus its activities on enhancing infrastructure.

In order to achieve these outcomes, the authorities are encouraged to continue to strengthen the fiscal position. To this end they would need to ensure adequate implementation of the new tax system, including avoidance of ad hoc exemptions, while continuing to maintain a more restrained approach to spending.

As noted by the staff, the Grenadian economy is highly susceptible to external shocks affecting tourism, which accounts for 34½ percent of its GDP. Priority should, therefore, be given to strengthening its production base, in particular, through the development of agriculture. In addition to providing some diversification of its output, this would help to relieve the unemployment situation, which appears to be high, even if the estimated figure of 28 percent includes some seasonally and voluntarily unemployed.

Finally, the experience with medium-term macroeconomic planning has yielded positive results and, like the staff, we would encourage the authorities to formulate a comprehensive medium-term economic program for the period ahead.

Mr. Ruocco made the following statement:

The efforts made by the Grenadian authorities since early 1990s have resulted in important improvements as the Board has noted during recent years, and 1995 was another year of positive economic results.

Because we are in general agreement with the staff appraisal, I will refer only to some issues which we believe deserve particular attention.

First, looking at GDP growth by sectors, we observe that nontradable sectors are expected to led global growth during 1996, suggesting possible lost of competitiveness of the tradable sector. In this regard, while important targets have been achieved in the tourism industry, it is also very important to strengthen nontourism activities, particularly agricultural and manufacturing sectors. Their production and export levels have been significantly reduced during recent years. In this respect, it is important for the authorities to capitalize the technical assistance provided by the World Bank in the agricultural area and to improve competitiveness in the industrial sector, as a way to diversify the economy, reduce the high unemployment rate (which remains at 28 percent), and generate favorable conditions for exports.

In this context, it should be noted that some indicators are likely to suggest that the past trends in these sectors, particularly the agricultural sector, have been affected, not only by plant diseases, but also by the real appreciation of the regional currency (10 percent higher than at the beginning of the 1980s). More recently, from early 1994 to end-1995, the staff report shows that the exchange rate depreciated by about 5 percent, bringing it close to the level prevailing at the beginning of 1990. This seems to reflect that the exchange rate remains overvalued, suggesting a way of explanation why agriculture and manufacturing have not recuperated their former output levels, while productivity gains seem not to be present in these sectors during the referred period of time.

In addition, the cost of wages in agricultural and manufacturing sectors is probably being influenced by the performance and higher wage level of the tourism industry, limiting, therefore, their competitiveness.

Second, Grenada's economy remains vulnerable to external shocks as the tourism industry is its main source of foreign exchange. This situation reinforces the need for diversification, which will help to maintain a more solid balance of payment and growth.

With these remarks, we wish the Grenadian authorities well in their efforts toward economic adjustment and growth.

Mr. Austin made the following statement:

I agree with the earlier speakers and endorse the staff report which depicts a positive performance over the past year. The issues are well covered in the staff papers, which, along with the consultations, have provided valuable guidance to the new government, as Mr. O'Loghlin informs us. I would like to make three observations to underscore the recommendations in the staff appraisal.

As the previous speakers have mentioned, Grenada's balance of payments position is sensitive to tourism receipts. That is well illustrated by the contrasting figures for 1994 and 1995. I hope the projected better outcome for 1996 is therefore the beginning of a steady trend. I wish to reinforce a comment made by my predecessor at this time last year about the importance of the 1992–94 structural adjustment program not becoming a one-off exercise. I strongly support the proposition in the staff appraisal, and endorsed by previous speakers, about the need to formulate a comprehensive medium-term economic program, including a rolling public sector investment program. I also encourage the authorities to take a medium-term strategic look at the overall economy, not just the investment component. I recognize this is no small task for the authorities in a country the size of Grenada, but it should pay off over time.

The fiscal position seems rather fragile. I would echo the cautionary messages in the staff appraisal about the new tax system. Substantial reduction in income tax thresholds carries the risk of increased reliance on indirect taxation, which in turn could lead to greater tax evasion, and ultimately affect the tax revenue stream. I think it is important that the authorities keep an eye on this new program, and be prepared to revisit it if necessary.

Finally, I would like to congratulate the authorities on their continued efforts to clear their rather small levels of external arrears, and I would encourage them to complete this as soon as possible.

Mr. Fayolle, observing that the staff appraisal of Granada's progress was very similar to the summing up at the conclusion of the 1995 Article IV consultation, wondered whether the current report might not have been considered on a lapse of time basis, along the lines suggested by his chair at the time of the work program discussion.

The Acting Chairman, taking note of Mr. Fayolle's suggestion, remarked that a Director could, with advance notice, request that an Article IV consultation be handled on a lapse of time basis.

Mr. O'Loghlin said that the authorities were off to a good start. Thus far the budget appeared to be on target, although the authorities recognized that revenues had to be monitored, and corrective action taken if necessary. While the economy would continue to depend on tourism, and contributions to that sector were required to maintain Grenada's market share, emphasis also needed to be placed on economic diversification to limit the extent of the country's exposure and dependence on that single important sector. Finally, the authorities were very conscious of the need to eliminate the small overhang of external arrears.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal and observed that Grenada's recent efforts at fiscal consolidation and economic reform had begun to yield higher rates of economic growth combined with low inflation and a rising cushion of international reserves at the Eastern Caribbean Central Bank.

Directors welcomed the authorities' intention to continue policies that would foster the strengthening of Grenada's production base and price stability over the medium term. In that context, they urged the authorities to develop soon a comprehensive policy framework, including a three-year public sector investment program. Directors emphasized macroeconomic stability and improvements in infrastructure as prerequisites for sustained growth through private sector activity. They stressed that investment efforts must be complemented by higher domestic saving, particularly higher public sector saving over the medium term.

Directors cautioned against any fiscal slippage in 1996. In particular, they observed that the tax measures in the 1996 budget would represent a significant shift in the tax burden from direct to indirect taxes, and that it raised questions about equity of the tax system, possibilities of evasion, and sustainability of revenue growth over the medium term. They urged the authorities to strengthen tax administration, eliminate ad hoc tax exemptions, and prepare a contingency plan, preferably of expenditure cuts, to deal swiftly with any unanticipated revenue shortfalls.

Directors stated that in order to help increase public sector saving it was important to maintain expenditure control, particularly through wage restraint and civil service reform. They urged that the operations of the statutory bodies be monitored closely, with a view to privatizing them as soon as possible. Directors were encouraged by the authorities' intention to intensify efforts to divest public assets in 1996.

Directors noted that the monetary and exchange rate arrangements of the Eastern Caribbean Currency Union remained satisfactory, and that Grenada had maintained relatively low rates of inflation. In that context, they welcomed the tariff reductions in the common external tariff of the Caribbean Community, and emphasized the need to maintain firm control over domestic costs—particularly wages and costs in the tourism sector—to improve the competitiveness and the growth prospects of the economy over the medium term, and to help increase employment. Directors also urged the authorities to continue their efforts to eliminate Grenada's remaining external arrears.

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

5. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Havrylyshyn on the completion of his service as Alternate Executive Director for the Republic of Armenia, Bulgaria, the Republic of Croatia, Cyprus, Georgia, Israel, the former Yugoslav Republic of Macedonia, the Republic of Moldova, the Netherlands, Romania, and Ukraine.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/50 (5/24/96) and EBM/96/51 (5/29/96).

6. REPUBLIC OF KAZAKSTAN—STAND-BY ARRANGEMENT—WAIVER OF PERFORMANCE CRITERION

1. The Republic of Kazakstan has consulted with the Fund in accordance with paragraph 3 of the Stand-By Arrangement for the Republic of Kazakstan (EBS/95/78, Sup. 3), as amended, in order to reach understandings regarding further measures to achieve the objectives of its program and the circumstances in which purchases may take place under the Stand-By Arrangement..

2. The Fund determines that no additional understandings are necessary, and that, notwithstanding the nonobservance of the performance criterion specified in paragraph 3(b) of the Stand-By Arrangement, as amended, the Republic of Kazakstan may proceed to make purchases under the Stand-By Arrangement, as amended.

Decision No. 11264-(96/51), adopted
May 24, 1996

7. FORMER YUGOSLAV REPUBLIC OF MACEDONIA—STAND-BY ARRANGEMENT—WAIVER OF PERFORMANCE CRITERIA AND REVIEW OF EXTERNAL FINANCING

1. The former Yugoslav Republic of Macedonia has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement (EBS/95/67, Sup. 2) and the final paragraph of the letter of April 5, 1995 from the Minister of Finance and the Governor of the National Bank of the former Yugoslav Republic of Macedonia.

2. The letter of the Minister of Finance and the Governor of the National Bank of the Republic of Macedonia dated May 16, 1996 shall be attached to the Stand-By Arrangement, and the letter of April 5, 1995, with attached memorandum, as modified, shall be read as supplemented and modified by the letter dated May 16, 1996.

3. The Fund decides that the review contemplated under paragraph 3(d) of the Stand-By Arrangement has been completed and that the former Yugoslav Republic of Macedonia may continue to make purchases in accordance with the terms of the arrangement notwithstanding the

nonobservance of the performance criteria for March 31, 1996 specified in paragraphs 3(a) (iii) and 3(a)(iv) of the Stand-By Arrangement.

Decision No. 11265-(96/51), adopted
May 24, 1996

8. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 95/17 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAM/96/84 (5/23/96) is approved.

APPROVAL: April 25, 1997

REINHARD H. MUNZBERG
Secretary